

Have Increased Government Investigations Remedied the Causes of the Financial Crisis?

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The week of May 9, 2011 revealed the best and the worst of government investigation and oversight. On May 10, 2011, the acquittal of former GlaxoSmithKline in house counsel Lauren Stevens “mark[ed] a huge rebuke to federal prosecutors, who have been aggressively seeking to pin blame on individual executives”¹ One day later, federal prosecutors won a significant victory when Raj Rajaratnam was convicted on 14 counts of securities fraud and conspiracy.²

Many experts have blamed the financial crisis of the late 2000s (“Financial Crisis”) on a lack of regulation and oversight of the financial system and corporate America. Since the Financial Crisis, the effort by regulators to investigate corporations and financial institutions has increased dramatically. With the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), government oversight continues to increase. The question is, has this new emphasis on oversight and enforcement done anything to strengthen the economy, which continues to struggle to create jobs, or rebuild value in the stock market which recently experienced six straight weeks of decline for the first time in almost a decade?

In 2009, Congress authorized the Financial Crisis Inquiry Commission (“FCIC”) to issue a report about

the causes of the Financial Crisis. The FCIC summarized the heart of the problem as follows:

Financial institutions made, bought, and sold mortgage securities they never examined, did not care to examine, or knew to be defective; firms depended on tens of billions of dollars of borrowing that had to be renewed each and every night, secured by subprime mortgage securities; and major firms and investors blindly relied on credit rating agencies as their arbiters of risk. What else could one expect on a highway where there were neither speed limits nor neatly painted lines?³

According to the FCIC, the policies over the last thirty years encouraged deregulation and reliance on corporations to self-regulate. This policy “stripped away key safeguards, which could have helped avoid catastrophe.”⁴ The report indicates that the government allowed financial institutions to “pick their preferred regulators in what became a race to the weakest supervisor.”⁵ Federal Reserve Chairman Ben Bernanke also attributed the Financial Crisis to a failure of oversight. He has stated, “[r]egulatory failure, not low interest rates, was responsible for the housing bubble and subsequent financial crisis of the last decade”⁶

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How Has the Government Responded To These Claims of Inadequate Regulation And Oversight?

Government entities have dramatically increased their enforcement spending. Across the federal government, the number of investigations in the financial sector has substantially increased since the beginning of the Financial Crisis. From 2007 to 2010, the SEC opened 3,562 investigations and brought 2,672 cases.⁷ In 2010, the SEC issued 531 orders opening formal investigations, up from 496 in 2009 and 233 in 2008.⁸

The FBI's financial crimes unit reported a significant increase in investigations and pending cases in all areas related to corporate entities, including corporate fraud, securities and commodities fraud, and mortgage fraud. Pending cases alleging corporate fraud increased steadily from 423 cases in 2005 to 592 in 2009.⁹ Pending cases alleging securities and commodities fraud increased by 33 percent from 1,210 in 2008 to 1,510 in 2009.¹⁰ The FBI-led task force against mortgage fraud, which included the Office of the Inspector General at the Department of Housing and Urban Development, announced that mortgage fraud investigations increased 33 percent from 2008 to 2009 and 275 percent from 2005 to 2009.¹¹

These increased enforcement efforts have certainly led to substantial increases in disgorgements, penalties and fines. In 2009, the SEC ordered individuals and companies to disgorge, or release, \$2.09 billion in profits, an increase of 170 percent from 2008, when it recovered \$774 million.¹² Individuals and companies paid penalties totaling \$345 million, an increase of 35 percent compared to \$256 million in 2008.¹³ From 2007 to 2009, the agency nearly doubled the number of emergency temporary restraining orders and asset freezes it sought in an effort to stop ongoing misconduct and prevent further harm to investors.¹⁴

In 2009, the FBI secured \$6.1 billion in restitution orders and \$5.4 million in fines.¹⁵ Cases of securities and commodities fraud resulted in \$8.1 billion in

restitution orders, \$126 million in seizures, \$63.4 million in recoveries, and \$12.8 million in fines.¹⁶ Operation Stolen Dreams, the FBI-led crackdown against mortgage fraud, involved 1,517 criminal defendants nationwide, including 863 informations/indictments filed and 525 arrests of those who allegedly responsible for more than \$3.05 billion in losses.¹⁷ As of September 2010, the operation had resulted in 191 civil enforcement actions, and the recovery of more than \$196 million.¹⁸

New legislation has expanded the power of certain agencies to pursue investigations, but agencies have also developed tools to increase the reach of their investigative authority. For example, in August of 2010, the SEC amended its rules to permanently grant its Enforcement Division the power to issue formal orders of investigation, greatly expanding the Division's power to compel the production of documents and testimony.¹⁹ As of August of 2009, the five SEC commissioners had delegated their power to issue formal orders to the Enforcement Division in a one-year trial program.²⁰ Robert Khuzami, the Enforcement Director, made it clear at the time that the office planned to fully employ the power to compel corporate defendants to comply.²¹ "[I]f defense counsel resist the voluntary production of documents or witnesses, or fail to be complete and timely in responses or engage in dilatory tactics, there will very likely be a subpoena on your desk the next morning."²²

Further, according to SEC commissioner Troy Paredes,

[O]ne of law enforcement's many purposes is to change the behavior of individuals by changing the consequences associated with certain conduct. In other words, law enforcement is intended, in part, to make illegal conduct an unattractive option. Law enforcement discourages individuals from engaging in illicit behavior when the expected sanction for a violation is such that compliance is the wiser course.²³

The Government also has a stated interest in targeting certain kinds of offenses and presenting them for public scrutiny. As one SEC official described it, “securities regulators often have more public and aggressive enforcement programs” than bank regulators. They encourage “punishment meted out in the public square [S]ecurities regulators believe public enforcement actions are necessary to deter fraud and reassure investors in the integrity of the system.”²⁴

However, are the disgorgements and fines resulting from these public enforcement actions the proper measure of success? Perhaps not. For example, what proportion of these payments are made by companies, who do not admit any wrongdoing, in an effort to close the investigation and focus valuable resources on the company’s business? As will be discussed later, the defense costs associated with these investigations can make settling them for significant sums of money appear to be sound business decisions even where no wrongdoing occurred.

Who Pays For the Increased Costs Of Government Investigations?

Before determining whether the increased costs of government investigations are justified, it must first be understood who is paying for these costs. The answer is not as simple as the agency conducting the investigation or the company being investigated. Instead, the answer lies with the person picking up the tab for the parties involved in the investigation.

— Taxpayers Foot the Bill

In its 2010 Performance Report, the SEC states that in 2010 it dedicated approximately \$122 million to detecting violations of the federal securities laws and \$323 million to prosecuting violations of federal securities laws and holding violators accountable.²⁵ According to the FBI’s 2011 Authorization and Budget Request to Congress, its 2010 budget included \$371 million in 2010 for addressing

financial crimes.²⁶ To help meet these expenditures the SEC’s 2010 total budgetary authority increased to \$1.571 billion, a 62 percent increase over the 2009 budget of \$970 million. At a time when seemingly no politician is willing to raise taxes, how are these increased expenses to be paid for? Are investigations yet another item the federal government should borrow money for or is it an expense that should be borne only when it can be afforded?

— Shareholders Foot the Bill

Despite the substantial amount of money expended by the government in its investigations, government investigators increasingly rely on corporate internal investigations to detect fraud.²⁷ These internal investigations by private companies and their counsel can be extremely expensive. For example, in 2010 Goldman Sachs incurred more than \$700 million in legal fees to investigate and defend itself against charges brought by the SEC for securities fraud related to the sale of subprime mortgages.²⁸ Avon Products incurred \$59 million in 2009, another \$95 million in 2010, and may incur as much as \$250 million to investigate and defend a possible violation of the Foreign Corrupt Practices Act (“FCPA”).²⁹ The same year Avon Products incurred \$95 million in legal fees, it reported pre-tax profits of approximately \$1.1 billion, which means that a single investigation eliminated nearly 10 percent of Avon’s 2010 pre-tax profits.³⁰

The losses incurred by corporations in connection with investigations extend well beyond defense and investigation costs. A company’s decision to disclose that it is subject to an investigation “may have [consequences] on the market, business relationships, employees, and relationships with government regulators or prosecutors.”³¹ These costs are reflected in share price. Share prices of companies subject to government investigations fall an average of 40 percent during the period between the initial disclosure of the investigation and the time when the investigation is resolved.³²

Because the costs are reflected in share price, the costs of government investigations are ultimately borne by the shareholders, not the alleged wrongdoers. In today's economy, shareholders come from all walks of life. There are pension funds for teachers, police officers, firefighters and other state and federal employees, employees investing through their 401-Ks and retirees seeking to protect the nest eggs they worked so hard to create. Are these the people who should bear the costs of corporate investigations?

— Cost Reduction Efforts Have Not Been Successful

In January of 2010, the SEC announced that it had revised its enforcement manual to include a new section entitled "Fostering Cooperation." SEC officials are empowered to use a series of tools that the DOJ has used successfully, including: 1) cooperation agreements; 2) deferred prosecution agreements; and 3) non-prosecution agreements.³³ They may also offer expedited immunity requests to the DOJ; proffer agreements; and oral assurances against recommending an enforcement action.³⁴ Yet, to date the SEC's cooperation initiative has done little to reduce these costs. The SEC did not enter into its first non-prosecution agreement until December of 2010, when it entered into an agreement with Carter's, Inc. It took even longer for the SEC to enter into its first deferred prosecution agreement. On May 17, 2011, the agency agreed to its first deferred prosecution agreement with Tenaris S.A.³⁵ At this point, it is unlikely that these programs are going to provide a near term solution to the escalating investigation costs facing taxpayers and shareholders alike.

— High Costs Come at a Time They Can Least Be Afforded

Does it make sense to be spending significant tax payer and shareholder money to conduct these investigations when the economy is still struggling? The increased investigation costs have come at a time when the country remains in one of the most

difficult financial periods in its history. Unemployment remains at 9.1 percent.³⁶ This is down from a high in October 2009 of 10.1 percent, but still dramatically above the pre-Financial Crisis rates of 4.4 percent and it is trending up since a low of 8.8 percent in March 2011.³⁷ More than 24 million people are unemployed.³⁸ Even the stock market, which had rebounded from a 12 year low,³⁹ has recently experienced six straight weeks of declines for the first time since 2002.⁴⁰

The U.S. national debt is in excess of \$14.3 trillion, which is nearly equal to the gross domestic product.⁴¹ The average taxpayer's portion of the national debt exceeds \$129,000.⁴² The deficit for 2011 alone is estimated to be around \$1.4 trillion.⁴³ The federal government posted its largest monthly deficit in history in February, a \$223 billion shortfall.⁴⁴

What Are The Untold By-Products Of These Investigations?

While government investigations are clearly capable of uncovering wrongdoing and disgorging unwarranted gains, it is equally clear that not all of the results of these investigations are positive. Apart from the substantial financial burden, the recent increase in investigations creates several additional problems, including the prosecution of innocent people, the failure to provide deterrent effects, continued failures to uncover egregious activity and increased delay and uncertainty.

— Prosecutions of Innocent People

The government's recent prosecution of Lauren Stevens is a prime example of when government investigation and enforcement efforts go too far. In the prosecution of Ms. Stevens, a former vice president and associate general counsel at GlaxoSmithKline, the court granted an acquittal for Ms. Stevens before Ms. Stevens even presented her defense.⁴⁵ In doing so, the judge noted that it was the first time that he acquitted without sending a case to the jury in his seven and one-half years on

the bench.⁴⁶ The Court stated unequivocally “that the defendant in this case never should have been prosecuted.”⁴⁷

— Questionable Deterrent Effects

Without the successful prosecution of individuals, the deterrent effect of government investigations is unclear. Corporations can act only through individuals and these investigations have rarely lead to the prosecution of individuals.⁴⁸ For example, in 2008 Siemens reached a settlement with the SEC and DOJ for a record setting \$800 million for violating provisions of the FCPA.⁴⁹ In spite of this settlement, nobody at Siemens has been indicted by the US government.⁵⁰ Even if actions are brought against individuals, the costs associated with internal investigations, including legal expenses for its employees, are covered by the company under investigation.⁵¹ Senator Arlen Specter addressed concerns about deterrence in a Senate Committee Meeting on the FCPA when he stated, “criminal fines are added to the cost of doing business. Going to jail is what works to deter crime.”⁵² The deterrent effect is even less clear when companies agree to settlements as a “cost of doing business” without admitting any wrongdoing.

— Continued Failure to Prosecute Egregious Violations

Unfortunately, throwing resources at a problem does not guarantee that the most egregious violators will be prosecuted. One need look no further than the Madoff ponzi scheme as a prime example. Even with substantial resources and numerous tips, the federal government failed to uncover the largest ponzi scheme in history. The SEC was repeatedly tipped off about Madoff’s fraud, but failed to address it. In a recent suit against the SEC for its failure to investigate Madoff, the District Court Judge called the SEC’s performance “sloppy,” “uniformed” and “irresponsible.”⁵³

— Increased Delay and Uncertainty

Increased investigations also routinely result in increased uncertainty. The General Accountability Office (GAO) reported to Congress that the SEC’s Division of Enforcement had a “potentially large backlog of investigations that are not likely to result in enforcement actions and for which closing packages have not been completed.”⁵⁴ The GAO concluded that “the subjects of many aged and inactive investigations may continue to suffer adverse consequences until closing actions are completed.”⁵⁵ Commissioner Paredes also recognized the exacting personal effect that the SEC’s investigations can have.

Besides inefficiently expending resources by dragging on past a productive point, inactive investigations present due process concerns that should trouble all of us. It is a serious matter for the government to exert its authority against an individual. We must not forget that investigations can wreak havoc on people and their families. If we are not going to bring an enforcement action, we owe it to people to close the investigation and send them a closing letter.⁵⁶

Dodd-Frank Presents New Challenges

Dodd-Frank is likely to increase the already heightened investigation levels because it gives increased incentives and authority to whistleblowers. Under the Act, whistleblowers are entitled to between 10 and 30 percent of any government recovery in excess of \$1 million based on violations of securities laws, commodities laws, or the FCPA.⁵⁷ The SEC recently approved a new rule that permits employees with knowledge of fraud or wrongdoing to report directly to the SEC without first reporting through internal channels.⁵⁸ This structure creates a potential windfall for whistleblowers at the expense of shareholders

and/or taxpayers, especially if whistleblowers receive awards for settlements where the company does not admit wrongdoing and justifies the settlement as a “cost of doing business.”

Some have also argued that permitting whistleblowers to report directly to the SEC creates an incentive for corporations to conduct rushed internal investigations to detect wrongdoing before it can be reported to the government.⁵⁹ The dangers of a rushed internal investigation are painfully illustrated by the experience of French carmaker Renault. In August 2010, Renault received an anonymous letter accusing three executives of accepting bribes.⁶⁰ Renault responded by tasking its internal security team with conducting an internal investigation. The internal investigation revealed that the three executives had been hiding bribery proceeds in offshore bank accounts. Renault promptly fired the employees and reported the incident to French law enforcement.⁶¹ French authorities quickly determined that the alleged offshore bank accounts did not exist and no wrongdoing occurred. By the time that result had been reached, both the company, and the accused individuals had already suffered significant harm from the earlier investigation. Not only has Renault issued a personal apology to the fired employees, but the company has suffered reputational harm from the incident and is likely to face actions for significant damages from the discharged employees.

The Financial Crisis made clear that there were problems in the financial system and the corporate marketplace. Increased oversight and investigation were the prescription of the day to remedy the problems in the market. While these investigations have resulted in the discovery of numerous violations and substantial fines, they levy substantial costs on companies, and ultimately on the U.S. economy at a time when both are a long way from a complete recovery. Unfortunately, years later, problems with corporate wrongdoing persist and it is unclear whether the substantial expenditures both in the public and private sectors

have strengthened the economy or will prevent the next crisis.

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