

Corporate Fraud Issues II

In This Issue

November 2003

Volume 51
Number 6

United States
Department of Justice
Executive Office for
United States Attorneys
Office of Legal Education
Washington, DC
20535

Guy A. Lewis
Director

Contributors' opinions and
statements should not be
considered an endorsement by
EOUSA for any policy, program,
or service.

The United States Attorneys'
Bulletin is published pursuant to
28 CFR § 0.22(b).

The United States Attorneys'
Bulletin is published bi-monthly
by the Executive Office for United
States Attorneys, Office of Legal
Education, 1620 Pendleton Street,
Columbia, South Carolina 29201.

Periodical postage paid at
Washington, D.C. Postmaster:
Send address changes to Editor,
United States Attorneys' Bulletin,
Office of Legal Education, 1620
Pendleton Street, Columbia, South
Carolina 29201.

Managing Editor
Jim Donovan

Technical Editor
Nancy Bowman

Law Clerk
Marian Lucius

Internet Address
[www.usdoj.gov/usao/
reading_room/foiamanual.
html](http://www.usdoj.gov/usao/reading_room/foiamanual.html)

Send article submissions to
Managing Editor, United States
Attorneys' Bulletin,
National Advocacy Center,
Office of Legal Education,
1620 Pendleton Street,
Columbia, SC 29201.

- Interview with United States Attorney James B. Comey Regarding the Department of Justice's Policy on Requesting Corporations under Criminal Investigation to Waive the Attorney Client Privilege and Work Product Protection** 1
- Revised Principles of Federal Prosecutions of Business Organizations: An Overview** 5
By Sean R. Berry
- The Commodity Futures Trading Commission's (CFTC) Assault on Fraud** 9
By Daniel A. Nathan
- Expert Testimony in Criminal Securities Cases** 16
By Bruce M. Bettigole
- Corporate Crime Prevention Programs** 23
By David M. Nissman
- Professional Responsibility Issues in Corporate Fraud Matters** 29
By Claudia J. Flynn and Rima Sirota
- The FBI Response to Corporate Fraud** 32
By Michael Degnan
- Introductory Letters and First Year Highlights of the Corporate Fraud Task Force** 35
- 'Zero Tolerance' for Corporate Fraud** 47
By Deputy Attorney General Larry D. Thompson
Reprinted with permission from Wall Street Journal
- New York No Longer Has Dibs on Securities Fraud** 49
By Greg Ferrell
Reprinted with permission from USA Today

Interview with United States Attorney James B. Comey Regarding Department of Justice's Policy on Requesting Corporations under Criminal Investigation to Waive the Attorney Client Privilege and Work Product Protection

Q: Mr. Comey, the white collar defense bar is agitated about requests to corporations under criminal investigation to waive the attorney client privilege and work product protection. Can you explain DOJ's policy?

A: As you know, the *Principles of Federal Prosecution of Business Organizations* govern this issue by providing guidance to prosecutors making the very important decision of whether to criminally charge a corporation. The *Principles* set forth many factors to consider, one of which is whether and to what extent the corporation cooperated with the Government's investigation. In evaluating cooperation, the *Principles* tell prosecutors that they can consider whether the corporation turned over any internal investigation it may have conducted, and waived privileges.

In my view, for a corporation to get credit for cooperation, it must help the Government catch the crooks. Sometimes a corporation can provide cooperation without waiving any privileges. Sometimes, in order to fully cooperate and disclose all the facts, a corporation will have to make some waiver because it has gathered the facts through privileged interviews and the protected work product of counsel.

Q: What exactly are prosecutors looking for when they ask a corporation to waive privileges?

A: Prosecutors are generally seeking the facts: what happened, who did, how they did it. Although the facts gathered by an attorney

providing advice to a corporation may be covered by both the attorney client privilege and work product doctrine (*Upjohn v. United States*, 449 U.S. 383 (1981)), prosecutors are not generally seeking legal advice or opinion work product; they are just seeking the facts, including factual attorney work product. Of course, disclosure of interview notes or the facts contained in the notes reflects the questions asked by the attorney, which may result from prior research, as well as the attorney's focus during the interview. The disclosure, however, involves a minimal intrusion on the privilege, and may be necessary if the corporation chooses to earn leniency through cooperation.

Q: Don't you sometimes ask the corporation to provide information that is classic attorney client privilege, i.e. counsel's advice to the corporation?

A: Yes, but rarely. For example, where the corporation is claiming it engaged in the conduct in good-faith reliance on advice of counsel, such disclosure may be requested. Or, where employees may have disregarded advice of counsel that a particular course of conduct would violate the law, or be of questionable legality, successful prosecution of those employees may require Government access to that advice of counsel, and the information would also be highly relevant to making the charging decision on the corporation.

Q: What about the defense bar complaint that DOJ requires waivers?

A: The *Principles* do not *require* waiver, and do not even require cooperation. Rather, all relevant factors need to be assessed in making a charging decision. Moreover, if a corporation that chooses to cooperate can do so fully without waiving any privileges, that is fine. Waiver is not required as a measure of cooperation.

For example, assume a corporation comes to us to report that they have discovered a billion dollar accounting error. Their lawyers have conducted an internal investigation and the corporation has learned exactly what happened. Further assume that when they meet with us, they explain that they do not wish to waive privileges, but will immediately provide a briefing on what they have learned and will bring in all the witnesses the government will need to figure out exactly what happened. If the corporation does that, we would likely consider that to be cooperation worthy of earning credit in the charging decision (as well as under the Sentencing Guidelines), even though there was no waiver, because the corporation timely told us what it knows about what happened, who did it, and how it was done. (Of course, in our experience, many corporations choose to go farther in order to demonstrate their commitment to cooperation by voluntarily waiving privileges and forging a much closer relationship with Government investigators in order to uncover wrongdoing.)

On the other hand, if critical witnesses won't consent to interviews and, therefore, the government cannot fully reconstruct the crime, or gather sufficient evidence to prosecute those who are culpable, the Government may turn to the corporation and seek the information imparted when those particular employees were interviewed. The corporation will then have to decide whether to waive its privileges. If it does not, and the investigation is stymied, or certain high level officials have to be immunized and go free, the Government will probably not view this as cooperation in evaluating charging decision factors.

Q: Does that mean that if a corporation does not waive or fully cooperate it will be indicted?

A: Absolutely not. A prosecutor must consider a wide range of factors in making a charging decision. There is no litmus test. For example, in situations where all the other factors militate against charging, failure to cooperate and/or waive should certainly not lead to

filing charges. Looking at the other extreme, all the cooperation and waivers in the world may not obviate the need to charge a corporation that has engaged in very serious misconduct, involving high level management, over a long period of time. So, cooperation will not guarantee non-prosecution; and cooperation and waiver are not pre-conditions for a decision not to prosecute.

Q: But what about the repeated complaints by the defense bar that prosecutors routinely ask for waiver?

A: I have heard the complaints, but I don't see evidence of such a widespread practice. If defense counsel mean that prosecutors routinely ask corporations to cooperate and to furnish the Government with all the information known to them about the criminal activity, I certainly hope that is going on. Corporations are unique entities that enjoy many privileges. The Department expects them to conduct their affairs in a scrupulously honest fashion and maintain effective compliance programs that deter and detect any misconduct. When misconduct is discovered, the Department expects corporations to self-report to law enforcement, including any regulators, to investigate the misconduct, to discipline any wrongdoers, and to cooperate fully with government investigations. Cooperation doesn't just mean complying with subpoenas. It means—and I hate to sound like a broken record—telling the Government what the corporation knows about what happened, who did it, and how they did it. In short, we expect cooperating corporations to help us catch the bad guys.

If a corporation can do that without waiver, prosecutors should give them the opportunity to do that. If the questions are fully answered without a waiver, prosecutors should consider that to be meaningful cooperation in evaluating all factors in making the charging decision. If a corporation wishes to go farther and share work product and privileged materials in order to enhance the Government's investigation, so much the better. Whether a corporation's failure to cooperate at all, or failure to waive if necessary to answer those questions, will result in a charge, is a separate issue that can only be answered by evaluating all the factors.

Q: What do you think about the defense bar's contention that waivers will interfere with their ability to investigate the wrongdoing

because employees won't agree to be interviewed if they know the information they provide or their "statement" is likely to be turned over to the Government.

A: I don't agree, and we have not seen that happen. Experienced attorneys routinely advise an employee that the interview is covered *only* by the corporation's attorney client privilege and that the corporation could decide to waive it. Indeed, many corporations have regulatory obligations to make disclosure of information learned in such interviews. A corporation also has the ability to require an employee to cooperate with its counsel on pain of dismissal. On many occasions, employees who have stolen from corporations willingly confess when confronted by counsel, even though they realize that the consequences will likely be loss of employment, and possible referral to the authorities. To be sure, employees who have engaged in criminal activity may decline to be interviewed. But the fear that the interview might be disclosed to the Government (as opposed to getting the employee in trouble with the corporation) has little impact. In any event, that possibility does not change the fact that, in order to fully cooperate, a corporation has to help the Government solve the crime.

Corporations self-report and waive the privilege all the time without being requested to do so by the Government. When corporations are victimized by employees, they conduct an internal investigation and frequently decide to voluntarily furnish the evidence to the authorities and seek prosecution. There is no parade of horrors conjured up by the defense bar when, on their own initiative, they waive the attorney client privilege or work product protection.

Q: What do you think about the defense contention that requests for waiver will discourage corporations from conducting internal investigations?

A: We have been actively investigating and prosecuting corporations for decades, and seeking corporate cooperation throughout that time period. We have seen no evidence at all that corporations refrain from conducting internal investigations because, in order to obtain leniency for cooperating, they might be asked to waive a privilege. Many corporations have regulatory obligations to investigate and find out the facts. In some instances there may also be a fiduciary obligation to investigate. If

the corporation is under criminal investigation, its attorneys need to uncover and learn the facts in order to adequately represent the corporation, as they will also have to do, given the likelihood of related civil litigation. In addition, one must remember that waiver of the privilege is voluntary and may only be necessary if the corporation chooses to cooperate in order to obtain leniency from the Government and/or the Court. In short, I have a hard time imagining that a corporation would refrain from conducting an internal investigation because of some fear that they might wish to share the results of it with the government.

There are also those who contend that the "requirement"—and there is none—that corporations waive the privilege, will discourage implementation of compliance programs, and aggressive efforts to deter and detect fraud. I cannot believe that a corporation will not seek to prevent criminal activity—for which it will be liable—because, if it does occur, and it is discovered by the Government, the corporation might seek to waive the privilege to obtain leniency from the Government or the Court.

Q: Doesn't the corporation's relationship of trust with its employees sour if the employees understand that the corporation will report misconduct to the Government, and won't that also undermine the self-reporting the Government is trying to encourage?

A: A corporation must explain to its employees the premium it puts on obtaining full information about misconduct of any kind and that reporting wrongdoing to the authorities, including the regulators and where appropriate criminal investigators, is a good thing to do, and is part and parcel of good corporate citizenship. The message has to be sent that disclosure of misconduct will be rewarded, and failure to disclose will be punished. Employees who have only made mistakes will understand; employees who have information about others will also understand, especially when the corporation protects them from retaliation; employees who have committed crimes, have no trust to undermine.

Q: Doesn't waiver of the privilege allow the Government to piggy-back on the investigation conducted by the corporation?

A: Yes, and there is nothing wrong with that. This is about the public's interest in

uncovering corporate crime in a timely fashion, not only to prosecute the wrongdoers, but also to minimize additional losses and maximize restitution. Some internal investigations cost millions of dollars and analyze hundreds of thousands of documents. Federal prosecutors don't have funds for that, and would be unable to replicate that work. They can, however, work with a report of such an internal effort in order to conduct a thorough and complete Government investigation. Ultimately, however, we go back again to the core issue, which is whether a corporation wants to earn leniency in the charging decision and under the Guidelines. If it does, then it will have to figure out a way to tell the Government what it knows about the misconduct and to help us catch the wrongdoers.

No corporation can be forced to cooperate. But isn't cooperation what good corporate citizenship is all about? If a corporation prefers that the Government *not* find out the true facts, or take a longer time to gather the same facts the corporation has gathered, then it won't provide full and timely disclosure. How that will affect the charging decision, which is based on numerous factors, will vary in every case. If the corporation is charged, it will obviously have a negative effect on the Guidelines calculation.

- Q:** Doesn't waiver of the privilege cause collateral problems with civil litigants who will argue that the waiver entitles them to the same information as the Government?
- A:** While there is varying case law in this area, it is true that courts have held that waiver to the Government during a criminal investigation can result in a waiver with respect to civil litigants. There is pending litigation about the enforceability of Government agreements to keep privileged information confidential and there have also been legislative proposals to protect information disclosed via waivers to the SEC. So the landscape in this area may be changing.
- B:** What if a corporation enters into a joint defense agreement claiming it is the only way employees will speak to it, and so the corporation can't waive the privilege even if it would otherwise want to?
- A:** It is hard for me to understand why a corporation would ever enter into a joint defense agreement because doing so may prevent it from making disclosures it either

must make if it is in a regulated industry, or may wish to make to a prosecutor.

In any event, how a joint defense agreement will affect a corporation's ability to cooperate will vary in every case. If the joint defense agreement puts the corporation in a position where it is unable to make full disclosure about the criminal activity, then no credit for cooperation will be factored into the Government's charging decision, and it will get no credit for that cooperation under the guidelines. On the other hand, a corporation may learn only some things pursuant to a joint defense agreement and still be able to make a full disclosure to the Government of all relevant information in a sufficient manner to qualify for cooperation credit.

- Q:** Isn't the Government's desire to obtain interview notes of employees just an end run around the Fifth Amendment? You know the employee has to talk to the corporation on pain of dismissal, and you expect the corporation to fire employees who won't speak, so you indirectly force employees to relinquish their Fifth Amendment rights by putting them between a rock and a hard place. Is that fair?
- A:** If you are suggesting that a corporation should not have a policy of firing an employee who won't consent to be interviewed by the corporation about possible misconduct, I'm not sure that's a corporation acting in its shareholders' interests. Should the Government request the results of interviews conducted under pain of dismissal? Yes, of course. The Government needs to find out what happened. And interviews with employees are usually the source of the corporation's knowledge. It is obviously up to the corporation to decide whether it wants to cooperate or supply the details of the interviews.
- Q:** Don't you ask corporations to fire employees who refuse to be interviewed by the Government, or who formally invoke the Fifth Amendment?
- A:** Certainly with respect to the Fifth Amendment, the Government is not permitted to disclose the invocation of the Fifth in the Grand Jury and should not be discussing that topic at all with anyone other than the witness's counsel.
- Moreover, the Government does not ask corporations to fire employees who refuse to be interviewed by the Government. What the

Government focuses on in evaluating corporate compliance programs is whether a corporation properly disciplines employees who have engaged in or facilitated serious misconduct, or who have committed crimes. If a company continues to employ an individual when it has evidence in its possession that establishes criminal activity, the Government will likely view that as a serious flaw in the corporation's compliance program, and reflective of a problematic corporate culture.

Of course, if a corporation determines in good faith that an employee did *not* commit a crime or engage in serious misconduct, in evaluating the corporation's conduct and culture we would not "penalize" the corporation for not firing such an employee even where the employee declined to submit to a Government interview.

Q: Mr. Comey, overall, how do you think the *Principles* are working?

A: I think they work very well. They have served the function of educating all DOJ attorneys about the need to give careful consideration to charging corporations, whose conduct can cause immense harm, and whose prosecution can result in enormous benefits, not only in restitution to victims, but in being a catalyst for tremendous changes for the good in many industries. They also instruct prosecutors to carefully consider a variety of critical mitigating factors, such as cooperation, collateral damage, and alternative remedies. In short, they provide a balanced framework for DOJ attorneys to make difficult decisions. In the process, they also greatly assist private counsel and corporations by spelling out the kinds of things that matter to prosecutors. ♦

Mr. Comey wishes to acknowledge the invaluable assistance of his Chief Counsel, Shirah Neiman, in the preparation of this Q & A. ❧

Revised Principles of Federal Prosecutions of Business Organizations: An Overview

Sean R. Berry
Assistant United States Attorney
Northern District of Iowa

I. Introduction

The decision whether to charge a business organization with a criminal offense can be one of the most complex charging decisions that federal prosecutors face. Recognizing this, on June 16, 1999, then-Deputy Attorney General Eric Holder issued a memorandum entitled *Federal Prosecution of Corporations* (the Holder memo), Memorandum from Deputy Attorney General Eric Holder to the United States Attorneys' Offices (June 16, 1999) (on file with the Department of Justice). This nonbinding memorandum was based on the Principles of Federal Prosecution in the United States Attorney's Manual, § 9-27.000, and contained a number of general principles, with accompanying commentary, designed to assist federal prosecutors in evaluating corporate charging decisions.

Now more than ever, federal prosecutors are faced with difficult charging decisions involving corporate subjects and targets. As a result of the Department of Justice's (the Department) ever increasing number of corporate criminal investigations, on January 20, 2003, Deputy Attorney General Larry D. Thompson issued a new memorandum concerning corporate charging decisions. *Federal Prosecutions of Business Organizations* (the Thompson memo), Memorandum from Deputy Attorney General, Larry D. Thompson to the United States Attorneys' Offices (January 20, 2003) (on file with the Department), *available at* www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00162.htm. This new memo drew on the combined efforts of the Department's Corporate Fraud Task Force and the Attorney General's Advisory Committee, and replaced the Holder memo of June 1999. While retaining the general principles and commentary enunciated in the Holder memo, the Thompson memo increases federal prosecutors' emphasis on, and scrutiny of, the authenticity of a corporation's professed cooperation. It addresses more specifically the

efficacy of the corporate governance mechanisms in place in order to ensure that these measures are truly effective, rather than mere paper compliance programs.

This article will provide an overview of the Thompson memo and will highlight the memo's significant additions to the Holder memo.

II. The principles of corporate charging decisions

The Thompson memo begins with this general principle of corporate criminal responsibility:

Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment. Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate, results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government to address and be a force for positive change of corporate culture, alter corporate behavior, and prevent, discover, and punish white collar crime.

Memorandum from Deputy Attorney General, Larry D. Thompson to the United States Attorneys' Offices, *supra*.

The Thompson memo explains that, in deciding whether to seek charges against a corporation, prosecutors generally should first apply the same factors used in determining whether to seek charges against natural persons. *Id.* at § II.A. Thus, the prosecutor should weigh all of the factors normally considered in the sound exercise of prosecutorial judgment: the sufficiency of the evidence; the likelihood of success at trial; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of non-criminal approaches. *See* USAM §§ 9-27.220-9.27.320.

However, due to the nature of the corporate "person," some additional factors must be considered when conducting an investigation, determining whether to bring charges, and negotiating plea agreements. As set forth in *Federal Prosecutions of Business Organizations*, these factors are:

- **the nature and seriousness of the offense** – including the risk of harm to the public, and any applicable policies and priorities governing the prosecution of corporations for particular categories of crime;

- **the pervasiveness of wrongdoing within the corporation** – including the complicity in, or condonation of, the wrongdoing by corporate management;
- **the corporation's history of similar conduct** – including prior criminal, civil, and regulatory enforcement actions against it;
- **the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents** – including, if necessary, the waiver of the corporate attorney-client and work product protections;
- **the existence and adequacy of the corporation's compliance program**;
- **the corporation's remedial actions** – including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies;
- **collateral consequences** – including disproportionate harm to shareholders, pension holders, and employees not proven personally culpable, and the impact on the public arising from the prosecution;
- **the adequacy of the prosecution of individuals responsible for the corporation's malfeasance**; and
- **the adequacy of non-criminal remedies** such as civil or regulatory enforcement actions.

Id. at § II.A. (citations omitted).

As with the factors relevant to charging natural persons, the Thompson memo makes clear that these factors are intended to provide guidance rather than to mandate a particular result. *Id.* at § II.B. Indeed,

[t]hese factors are intended to be illustrative of those that should be considered and not a complete or exhaustive list. Some or all of these factors may or may not apply to specific cases, and in some cases one factor may override all others. For example, the nature and seriousness of the offense may be such as to warrant prosecution regardless of the other factors.

Id.

While some of the above factors would appear to be self-explanatory, *Federal Prosecutions of Business Organizations* provides additional guidance and discussion as to these factors in subsequent sections, and prosecutors involved in corporate criminal investigations should carefully review these sections prior to making their charging decisions.

III. Scrutiny of corporate cooperation efforts and voluntary disclosure of wrongdoing

Perhaps the most significant addition contained in the Thompson memo concerns the prosecutor's evaluation of corporate cooperation and voluntary disclosure of information and wrongdoing.

In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives, to make witnesses available, to disclose the complete results of its internal investigation, and to waive attorney-client and work product protection.

Id. at § VI.A.

The Thompson memo begins its analysis of corporate cooperation by discussing two factors from the Holder memo, and then it addresses a new factor to be considered by prosecutors evaluating a corporation's cooperation in a criminal investigation.

First, in assessing the adequacy of a corporation's cooperation, the prosecutor may weigh the completeness of the corporation's disclosure including, if necessary, a waiver of the attorney-client and work product protections, both with respect to its internal investigation and its communications between specific officers, directors, and employees and counsel. Such waivers permit the government to obtain statements of possible witnesses, subjects, and targets, without having to negotiate individual cooperation or immunity agreements. In addition, they are often critical in enabling the government to evaluate the completeness of a corporation's voluntary disclosure and cooperation. Prosecutors may, therefore, request a waiver in appropriate circumstances. *Id.* at § VI.B.

A second factor that may be weighed by the prosecutor in making his or her charging decision is whether the corporation appears to be protecting its culpable employees and agents. For example, a corporation's promise to support culpable employees, financially or otherwise, may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation. *Id.*

The new factor to be considered when assessing the authenticity of a corporation's cooperation during an investigation "is whether the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction)." *Id.* Examples of such obstreperous conduct include:

- overly broad assertions of corporate representation of employees or former employees;
- inappropriate directions to employees or their counsel, such as directions not to volunteer information or to decline interviews;
- making presentations or submissions that contain misleading assertions or omissions;
- incomplete or delayed production of records; and
- failure to promptly disclose illegal conduct known to the corporation.

Id.

By adding this third factor, the Thompson memo increases the emphasis on, and scrutiny of, a corporation's cooperation. "Too often business organizations, while purporting to cooperate with a Department investigation, in fact take steps to impede the quick and effective exposure of the complete scope of wrongdoing under investigation." Cover Memorandum from Deputy Attorney General Larry D. Thompson to United States Attorneys' Offices, *supra*. This new factor makes clear that such conduct should weigh in favor of a corporate prosecution. *Id.*

IV. Detailed evaluation of existing corporate compliance programs

The second significant addition in the Thompson memo concerns the prosecutor's evaluation of the adequacy of a corporation's existing compliance program. Compliance programs are established by corporate management to prevent and to detect misconduct, and to ensure that corporate activities are

conducted in accordance with all applicable criminal and civil laws, regulations, and rules. *Federal Prosecutions of Business Organizations* at § VII.A.

Like the Holder memo before it, the Thompson memo recognizes that no compliance program can ever prevent all criminal activity by corporate employees. Critical factors in evaluating any compliance program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees, and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. *Id.* at § VII.B.

Also like the Holder memo, the Thompson memo notes that the Department has no formal guidelines for corporate compliance programs. The Thompson memo, however, includes a new framework to assist prosecutors in evaluating existing compliance programs. "Prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct." *Id.* For example, prosecutors should consider whether:

- the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations;
- the directors are provided with information sufficient to enable the exercise of independent judgment;
- internal audit functions are conducted at a level sufficient to ensure their independence and accuracy;
- the directors have established an information and reporting system in the organization reasonably designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law.

Id. By considering these factors, prosecutors may better determine whether a corporation's compliance program is merely a "paper" compliance program or whether it is truly designed and implemented in an effective manner to detect and prevent misconduct. *See* Cover Memorandum from Deputy Attorney General Thompson, to United States Attorneys' offices, *supra*.

V. Attorney-client and work product protection waivers

One significant "non-revision" of the Holder memo is noteworthy. Amidst controversy, no change in the use of waivers of the attorney-client and work product protections has been included in the Thompson memo.

As in the Holder memo, prosecutors may certainly take into account a corporation's willingness to waive its attorney-client and work product privileges in evaluating the corporation's cooperation. *See Federal Prosecutions of Business Organizations* at §§ II.A(4) & VI(A & B). A prosecutor may also request a waiver when necessary to enable him or her: (1) to determine the completeness of the corporation's disclosure; (2) to evaluate the accuracy of that disclosure; (3) to identify potential targets and witnesses; and (4) to obtain evidence to use in its investigation and any resulting prosecution. *Id.* at § VI.B. Any requested waiver, however, "should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue. Except in unusual circumstances, prosecutors should not seek a waiver with respect to communications and work product related to advice concerning the government's criminal investigation." *Id.* at § VI.B n.3.

As in the Holder memo, the Department still does not, as a matter of course, consider waiver of a corporation's attorney-client and work product protections an absolute requirement in cooperating with the government's investigation. Indeed the principles contained in *Federal Prosecutions of Business Organizations* do not require, or even encourage, a prosecutor to seek a waiver in all circumstances, and they make it perfectly clear that such waivers are not absolute requirements for a corporation's cooperation. *Id.* at § VI.B.

VI. Conclusion

Corporations can be, and often are, valid targets of criminal investigations.

Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate, results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government to address and be a force for positive change of corporate culture, alter corporate behavior, and prevent, discover, and punish white collar crime.

Federal Prosecutions of Business Organizations at § I.A. The general principles and commentary in *Federal Prosecutions of Business Organizations* provide a framework within which to make the difficult charging decisions that arise during the investigations of corporate subjects and targets. ❖

ABOUT THE AUTHOR

❑ **Sean R. Berry** is an Assistant United States Attorney in the Northern District of Iowa where he is responsible for the investigation and prosecution of white collar and computer crimes. Mr. Berry was Chief of the Major Frauds Section in the Central District of California prior to joining the Northern District of Iowa's United States Attorney's Office.✉

The Commodity Futures Trading Commission's (CFTC) Assault on Fraud

*Daniel A. Nathan
Chief, Office of Cooperative Enforcement
Division of Enforcement
Commodity Futures Trading Commission*

The bad news is that commodities fraud is taking its place on the corporate and consumer fraud landscape alongside financial fraud, prime bank schemes, front-running, and other unfortunate by-products of the modern financial era. The good news is that the Commodity Futures Trading Commission (CFTC) is up to the job of pursuing this fraud, and has been pursuing it in close cooperation with the Department of Justice and U.S. Attorneys, among others.

As a result of increasing recognition by regulators of the prevalence of commodities fraud, and the CFTC's aggressive enforcement program attacking that fraud, the CFTC's Division of Enforcement has gained recognition and respect for its important role in financial regulation. The significance of the CFTC's regulatory regime in the broader worlds of corporate fraud and sophisticated white collar schemes is evidenced by the CFTC's membership in the President's Working Group on Financial Markets and the President's Corporate Fraud Task Force. Always active in pursuing matters within its jurisdiction, in recent years the Division of Enforcement (Division) has participated in joint fraud investigations and enforcement actions with other federal and state civil and criminal agencies, and presented training in commodity violations,

including energy-related and foreign currency trading violations, to other regulators.

From a public protection standpoint, this is all to the good. Greater awareness by the law enforcement community of the CFTC's jurisdiction, and the Division's ability to aggressively prosecute commodities fraud, means that more of this fraud will be addressed by the CFTC, on its own or together with criminal authorities. Moreover, as more regulators nationwide pursue criminal and civil commodities fraud cases on the federal and state level, members of the public will learn to recognize the many common forms this fraud takes and be better able to protect themselves against it.

I. The CFTC's jurisdiction

A. What commodities fraud looks like

Consider these increasingly common scenarios:

- An individual invests funds in a pool, or self described "hedge fund," only to find that the money and the promoter have disappeared.
- An individual receives an unsolicited "cold call" or spam e-mail, or sees an ad on television, promoting investments in heating oil options based on the brokerage firm's purported track record. The ad encourages the public to take advantage of the approaching winter and the inevitable rise in heating oil prices.
- An investor receives an aggressive solicitation for the purchase of a specified foreign

currency, such as the yen or euro, in order to take advantage of volatile exchange rates caused by an uncertain global economy.

- An energy company reports false information about the price and/or the volume of its transactions in natural gas or crude oil.

These are all common forms of commodity futures and options fraud—which are not limited to fraudulent trading practices occurring in the hectic trading pits as depicted by Eddie Murphy and Dan Ackroyd in *TRADING PLACES* (Paramount Pictures 1983). These varieties of fraud are all within the CFTC's enforcement jurisdiction, and have been the subject of numerous CFTC investigations and enforcement actions over the years. This article will attempt to explain how these violations fit into the CFTC's statutory scheme.

As with virtually all financial investment vehicles, investing in commodity futures and options is subject to fraud. It is difficult to quantify how prevalent such fraud is, or to compare the numbers to those of securities or corporate fraud. As with much securities fraud, the superficial indicia of commodity fraud, including false representations and omissions, artificial prices, and illegal instruments, do not spring into existence until proven through typically sophisticated investigations and analyses.

The public's frequent lack of familiarity with the commodity futures and option markets often serves to obscure the very existence of these schemes. Often, when a member of the public is defrauded in a commodity scheme, he does not know what hit him. A commodities scheme may appear as an investment in a pool of funds that more resembles a securities investment. The investment might be disguised as an interest in an actual physical commodity such as precious metal or foreign currency, whereas the economic reality is that the transaction is in a future based on those commodities. The "come on," that is, the solicitation inducing the investment, might look like mere puffery best addressed by a state consumer agency or the Federal Trade Commission. Consequently, customer complaints about such transactions might not reach the agency that most effectively and directly regulates such conduct—the CFTC.

B. Some CFTC history

The CFTC originally was part of the Department of Agriculture. In 1974, Congress established the CFTC as an independent agency with the mandate to regulate commodity futures and option markets in the United States. In the

early days of the agency, "futures" typically referred to futures on agricultural and other physical commodities such as corn, wheat and soy, as well as metal and energy products. Such traditional futures contracts have been traded in the United States for more than 150 years, and have been under federal regulation since the 1920s. These days, the majority of futures and options are based upon a wide variety of financial instruments, including foreign currencies, U.S. and foreign government securities, stock indexes, and, most recently, futures on individual stocks.

The futures markets play an important role in the nation's economy by providing a means for price discovery and for offsetting price risk. The CFTC is responsible for securing the economic utility of futures markets by, among other things, ensuring their integrity and protecting market participants against manipulation, abusive trade practices, and fraud. By investigating possible violations, bringing enforcement actions when it finds violations, and working closely with criminal authorities on the more egregious violations, the Division of Enforcement plays a vital role in meeting these responsibilities.

As in the securities industry, fraud takes on many forms in the futures and options industry. It can occur at any stage of a transaction in commodity futures and options, from the initial trade recommendation given by a broker or advisor to the ultimate execution of the trade on the floor of a futures exchange. The CFTC and the industry's self-regulatory organizations, including the futures and options exchanges and the National Futures Association, oversee all stages of transactions, and have jurisdiction and authority to police these transactions and the registered firms and people who commit them.

II. The Division of Enforcement investigates and brings actions alleging violations of the commodities laws and regulations

The CFTC's Division of Enforcement has the powers of an independent federal agency to investigate possible violations of the federal commodity laws that it enforces and, where violations are found, bring enforcement actions to obtain, among other things, proscriptive and monetary relief. These laws encompass the Commodity Exchange Act (CEA) and the Rules and Regulations promulgated by the CFTC. For those prosecutors who have worked on securities cases, it is helpful to think of the Division's investigative powers and procedures as being quite similar to those of the Securities and Exchange Commission. For those new to the

agency, a general outline of the Division's investigative powers follows.

The Division commences its investigations based upon information received from a variety of sources. These include: members of the public, including commodity broker customers; the financial community, including the futures and options industry and self-regulatory organizations; other Commission divisions; state, federal, and international regulators; and the media. The Division, itself, identifies possible violations through proactive means, by focusing on areas of possible fraud and applying its techniques of market analysis and surveillance.

Information is obtained in investigations in one of two ways. It may be obtained on a voluntary basis through the power to examine registrants granted by CEA § 4g(a); 7 U.S.C. § 6g(a) (with respect to futures commission merchants, introducing brokers, floor brokers, and floor traders), and § 4n(3); 7 U.S.C. § 6n(3) (with respect to commodity trading advisors and commodity pool operators). It may also be obtained through use of investigative subpoenas. The power to issue subpoenas is granted by the Commission to the Division through entry of an order of investigation. 17 C.F.R. § 11.4(b).

At the conclusion of an investigation, the staff may recommend that the Commission authorize the Division to initiate an administrative proceeding, which would be assigned to one of the Commission's administrative law judges, or a civil injunctive action in federal district court. Sanctions available in an administrative proceeding include a cease and desist order, an order denying, suspending, revoking or restricting a registration, a trading prohibition, restitution, and civil monetary penalties. CEA § 6(c); 7 U.S.C. § 9. In a federal court action, the Commission may obtain an injunction, as well as restitution, civil monetary penalties, and a full range of equitable remedies. CEA § 6c; 7 U.S.C. § 13a-1. The Division frequently files actions in federal court to obtain emergency relief, such as a restraining order which, as specifically authorized by the CEA, can include an order preserving books and records, granting immediate access to books and records, freezing assets, and appointing a receiver. Section 6c(a); 15 U.S.C. § 13a-1(a).

Recidivists are a problem in an industry that relies heavily on the integrity of its professionals to attract customers. The Division pursues these violators of the orders obtained in enforcement actions. Violation of a cease and desist order can be enforced administratively or in federal court, and violation of a civil injunction can be enforced

through a contempt proceeding in federal court. Unlike many executive branch agencies, the CFTC possesses "independent litigating authority," meaning that the CFTC litigates its own enforcement actions instead of referring them to the Department of Justice (Department). The CFTC handles federal appeals through its own Office of General Counsel.

Commodity-related violations can be referred to the Department as well as state prosecutors. The CEA has specific criminal sanctions making it a felony to, among other things, steal or convert funds received for futures transactions, manipulate the price of commodities or commodity futures in interstate commerce, make a false report to a futures exchange, or willfully violate any provision of the CEA. CEA § 9; 7 U.S.C. § 13. Criminal activity involving commodity futures and options and other commodity-related instruments can also constitute mail fraud, wire fraud, or conspiracy.

III. Commodities fraud pursued by the Division of Enforcement

The Division pursues fraud both in the regulated futures and options environment and in the unregulated environment. The regulated environment consists generally of those individuals and firms, including exchanges, registered under the CEA and Regulations to participate in some way in futures or options transactions. The unregulated environment potentially includes a much broader group of unregistered individuals and firms who offer or trade in financial instruments that, as a legal matter, are futures or options, but operate with little regulation in a manner that is quite susceptible to fraud. Many of the typical factual and legal claims made in cases charging fraud in the two environments are quite similar. For example, lying to a potential customer about the profitability of a futures investment is solicitation fraud whether done in a regulated or unregulated environment. This is not surprising, since many of the individuals who perpetrate scams in the unregulated environment started out as futures industry registrants, and brought with them the schemes they first developed in the regulated environment. In the Division's experience there has been a "revolving door" between the regulated and unregulated environments for perpetrators of commodities fraud.

This article will focus on five areas of commodities fraud in which the Division has been active. The investigations conducted and cases filed in these areas revealed schemes that also would be appropriate criminal cases in that the

fraud was egregious, often involving outright theft, with many victims who were elderly, ethnic, or otherwise particularly vulnerable to fraud. Fraudsters reach their targets through aggressive telemarketing practices, dubious television infomercials and radio spots, and deceptive advertising over the internet. In addition, the Division has been particularly active in the last year investigating energy-related conduct, both on its own and in conjunction with other civil and criminal authorities.

The CEA's general anti-fraud provision, Section 4b, makes it unlawful, among other things, for any person, in connection with any order to make, or the making of, any futures contract for or on behalf of any other person, to cheat or defraud the other person, willfully to make any false statement, or willfully to deceive or attempt to deceive such other person. CEA § 6(c); 7 U.S.C. § 9. Section 4c of the CEA, 7 U.S.C. § 6c, and Regulation 33.10, 17 C.F.R. § 33.10, apply the same fraud prohibition to commodity options.

A. Sales solicitation fraud by introducing brokers

To understand how an introducing broker can defraud its customers, it is necessary to understand its role in the transaction process. In the futures and options industry, the customer-broker relationship is often established with an introducing broker who solicits and accepts orders for the purchase or sale of commodity futures or options. Introducing brokers do not, however, accept money in payment for these orders. Rather, introducing brokers forward orders to a futures commission merchant, who also can solicit or accept orders, and who sends the orders to the floor of an exchange for execution.

Introducing brokers are barred by the CEA's general anti-fraud prohibitions from cheating or defrauding a customer on whose behalf it solicits an order. CEA § 4b; 7 U.S.C. § 6b. The prohibition includes misrepresentations made to potential or existing customers when soliciting a new account or an order. An introducing broker, or an associated person of an introducing broker, cannot misrepresent, among other things: future profitability, *Commodities Futures Trading Comm'n v. Sidoti*, 178 F.3d 1132, 36 (11th Cir. 1999); the risk of futures or options trading, *Clayton Brokerage Co. of St. Louis v. Commodities Futures Trading Comm'n*, 794 F.2d 573, 580 (11th Cir. 1986); the broker's performance history, *In re JCC, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,080, 1994 WL 183817, *8 (CFTC May 12,

1994), *aff'd*, *JCC, Inc. v. Commodities Futures Trading Comm'n*, 63 F.3d 1557 (11th Cir. 1995); or the broker's background—in short, any fact that a reasonable investor might consider material in making an investment. *Commodities Futures Trading Comm'n v. R.J. Fitzgerald & Co.*, 310 F.3d 1321, 1332 (11th Cir. 2002). The Commission has taken numerous administrative and civil injunctive actions against registered introducing brokers engaged in solicitation fraud.

A common variety of fraud by introducing brokers involves so-called "seasonality" misrepresentations, or misrepresentations based on well-known and expected weather patterns or events. For example, it is illegal to tout heating oil futures or options in the fall based on the claim that one can profit from the increase in heating oil prices that accompany the advent of cold weather. These statements are false and misleading because the prices charged by the futures and options markets already factor in the trends in the weather and, therefore, profit is only available from the occurrence of unpredictable events or price movements. *R.J. Fitzgerald & Co.*, 310 F.3d at 1332 ("[A]s with the Commercial, the Seminar, in its heating oil mathematical illustration, misleads potential customers by suggesting that historical movements and known and expected seasonal patterns can be used reliably to predict profits on options.").

Seasonality fraud also can occur with reference to other well-known non-seasonal events. An example is a claim that one can profit in energy futures or options based on the war against terrorism in the wake of September 11, 2001, or on the war in Iraq. This suggests that the seller has superior knowledge to that of the typical investor or professional trader. The markets already factor in the anticipated effect of a possible disruption in the Middle East on energy supplies.

In the last several years, the Commission has released three Consumer Advisories on this issue:

- warning the public about investing based on seasonal demand and other public information, <http://www.cftc.gov/opa/enf98/opacaw.htm>;
- warning about promises of profits from futures and options trading based on the tragic events of September 11, 2001 and other public information relating to the war on terrorism, <http://www.cftc.gov/opa/enf01/opa4584-01.htm>;

-
- and one in November 2002, warning about claims that futures or options trading will be profitable because of a possible war with Iraq, <http://www.cftc.gov/opa/enf02/opa4724-02.htm>.

B. Commodity pool fraud

In the commodity futures and options industry, investment vehicles known as commodity pools aggregate investor funds for the purpose of trading commodity futures or options contracts. Commodity pools often are an investor's first avenue into the futures and options markets. They represent a very loose analogue to investment companies or mutual funds in the securities industry, which pool investor funds for investment in securities. Like those entities, commodity pools are subject to regulations regarding registration, reporting, and record-keeping. They are managed by commodity pool operators (CPOs), which are individuals or firms that solicit or accept funds, securities, or property, for the purpose of trading commodity futures contracts or commodity options. CEA § 1a(5) ("commodity pool operator" defined); 7 U.S.C. § 1a(5).

Similar to the introducing brokers discussed above, commodity pool operators cannot misrepresent the profitability or risk of futures and options, or the pool's performance history. CEA §§ 4b, 4o; 7 U.S.C. §§ 6b, 6o; *Commodities Futures Trading Comm'n ex rel. Kelley v. Skorupskas*, 605 F. Supp. 923, 932 (E.D. Mich. 1985) (CPO committed fraud by misappropriating customer funds, issuing false monthly statements to customers, and soliciting with deceitful performance tables). CPOs also must accurately describe the anticipated use of the funds and the fees charged. On the most serious level, commodity pool operators often are guilty of outright theft of the funds. Many of the cases brought by the Commission, often in coordination with criminal authorities, have involved "affinity fraud"—that is, commodity pool operators who raise money from victims who have preexisting ethnic, religious, or social ties to the operators. Frequently these cases are termed "Ponzi schemes" because the pool operator uses the funds he solicits from new investors to pay purported profits to existing investors, rather than from trading profits, as the investors anticipate. The Commission has issued a Consumer Advisories warning about pool investment opportunities, even when offered by someone known to you. <http://www.cftc.gov/opa/enf02/opa4610-02.htm>.

C. Commodity trading advisor fraud

Individual retail investors also frequently enter the futures markets through the services of Commodity Trading Advisors, (CTAs), which in general are individuals or firms that, for pay, issue analyses or reports concerning commodities, including the advisability of trading in commodity futures or options. CEA § 1a(6); 7 U.S.C. § 1a(6). CTAs provide advice with varying degrees of involvement in their customers' trading decisions, from giving general instructional manuals about trading, to managing customer accounts with authority to place trades at their own discretion. In between those extremes are services that provide real-time trading signals by fax, e-mail, or telephone, computer programs that generate signals based upon technical factors by tapping into market pricing services, and instructional seminars. As with other commodity professionals, CTAs are prohibited from fraudulent conduct, which includes misrepresentations about profitability, risk, and performance history. CEA §§ 4b, 4o; 7 U.S.C. §§ 6b, 6o. The CFTC has also found that other types of falsehoods constitute material misrepresentations, such as statements about the background and experience of the CTA, or illusory money-back guarantees. *See, e.g., R&W Technical Services v. Commodities Futures Trading Comm'n*, 205 F.3d 165 (5th Cir. 2000).

CTAs commonly promote trading systems by use of the internet. The low cost of operating a web site to advertise on the Internet makes it easy to reach a worldwide audience. Many such CTAs do not register, and often are not required to register, with the CFTC.

The Commission's regulations single out one type of claim about performance for special attention, and the Commission has been aggressive in warning the public about, and pursuing, this conduct. In soliciting customers, many CTAs will provide so-called hypothetical trading performance records. These are track records that reflect how the advisor's trading formula or program would have performed had trades actually been placed in the market, based upon application of the formula to actual market prices. Such performance records might have value to demonstrate, on a theoretical basis, that the CTA's formula responds to the market in a way that generates profits. In extreme cases, the hypothetical performance record reflects a formula that was generated by nothing more than performing a regression analysis on actual historical data and, in effect, connecting the dots. Therefore, the resulting formula reflects nothing more than hindsight, without the benefit of

economic analysis, a circumstance which certainly should not be misstated by the CTA. However, the Commission has long recognized that such hypothetical results have very limited predictive value, and has enacted a Regulation that prescribes a disclaimer that must accompany the presentation of any hypothetical results. That required disclaimer well expresses those limitations:

Hypothetical or simulated performance results have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not been executed, the results may have under-or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representations being made that any account will, or is likely to, achieve profits or losses similar to those shown.

Commission Regulation §4.41. The Commission also issued an Advisory in 2000 that warns about trading systems that guarantee high profits with minimal risks.

<http://www.cftc.gov/opa/enf00/opa4397-00.htm>. Misrepresentation of hypothetical trading results as real constitutes fraud under the CEA and Commission Regulations. *R&W Technical Services*, 205 F.3d at 169-70.

D. Off-exchange fraud—foreign currency (forex) and precious metals

Recent years have seen a sharp rise in the incidence of foreign currency trading scams. Much foreign currency trading is legitimate and futures and options on foreign currencies, whose value typically is based on the exchange rate between the relevant foreign currency and the dollar, trade on the Chicago Mercantile Exchange. However, various forms of foreign currency trading have been promoted in recent years to defraud members of the public. Promoters often attract customers through ads in newspapers, radio or cable television promotions, attractive Internet sites, and cold calling. As with the other forms of commodities fraud, these ads might claim high returns and limited risks from these investments, boast a profitable trading history, and purport to have extensive experience and expertise in this sophisticated area. Some solicitations might falsely claim to give retail investors access to the so-called "interbank market." However, the interbank market, which is the informal network of banks and other large financial institutions that trade an estimated \$1.5 trillion in currency on a

daily basis, is effectively closed off to the retail public. Finally, many forex shops offer employment to members of the retail public as traders in foreign currency. Those who take up the offer often end up being fleeced while becoming unwitting participants in the fleecing of others. *Commodities Futures Trading Comm'n v. Noble Wealth Data Information Services*, 90 F. Supp. 2d 676, 681 (D. Md. 2000) ("Friends and family of the traders were thus subjected to the same claims that Noble Wealth used to lure traders into its scheme.") *aff'd*, *Commodities Futures Trading Comm'n v. Baragosh*, 278 F.3d 319, (4th Cir. 2002).

The CEA makes it illegal to offer foreign currency futures or option contracts that are not traded on a designated exchange to retail customers, unless the offeror is a regulated financial entity, including a futures commission merchant or broker-dealer, or an affiliate of such an entity. Further, for those contracts not offered by a regulated financial entity (or by a futures commission merchant), the CFTC has anti-fraud jurisdiction. As an initial legal hurdle, the Commission must establish that the foreign currency investments offered by the defendants are futures or options within its jurisdiction. Promoters typically identify options as such, however, futures typically are presented as physical or "spot" commodity interests. To prove that these interests actually conform to the legal definition of "future," the Commission has to demonstrate that they exhibit the "facilitating characteristics" of a future, that is, for example, that they are capable of being settled through a cash payment.

The Division of Enforcement has brought many actions in recent years to shut down illegal forex operations. The majority of these actions have been emergency civil injunctive actions in federal court, in which the court granted the Commission's request to freeze assets and give the Division immediate access to books and records. Roughly half of those actions were brought cooperatively with a federal or state criminal authority or another regulator. Cumulatively, the number of investors and the amount of money lost in the schemes that were the subjects of these actions is enormous. The Commission has also issued Consumer Advisories warning about unregistered foreign currency schemes. <http://www.cftc.gov/opa/enf98/opaforex15.htm>.

E. Energy-related violations

In the wake of the collapse of Enron, the CFTC has joined its fellow agency-members of the Corporate Fraud Task Force and the Enron

Task Force in investigating improper conduct within its jurisdiction that affected the energy markets. The possible violations being looked at are natural applications of the CFTC's enforcement jurisdiction to trading in energy products in the energy markets. The actions filed to date, and investigations being pursued, involve:

- manipulation, or attempted manipulation, of the price of natural gas, crude oil, or electricity futures, or of the physical commodity in a manner likely to effect the price of the future;
- round-trip trading, also known as wash sales, in order to, among other things, report artificial volume or fraudulent revenues;
- false reporting of trading volumes or prices; and
- failure to maintain required records.

To the extent that this conduct, if proven, affects the legitimate forces of supply and demand in the energy marketplace, it harms consumers by increasing the prices paid for energy.

IV. Conclusion

The CFTC's Division of Enforcement investigates and prosecutes financial fraud violations that hurt a broad range of retail customers. The CFTC's ability to meet its responsibilities is enhanced when the law enforcement community and the public recognizes that this fraud comes within the CFTC's jurisdiction, and refers that fraud to the CFTC's Division of Enforcement. The Division's increasing cooperation with other law enforcement entities and participation in interagency enforcement activities is designed to raise the consciousness of federal and state regulators, and thus increase the likelihood that malfeasors will be caught and prosecuted before they can do much harm.❖

ABOUT THE AUTHOR

❑ **Daniel A. Nathan** has been the Chief of the Office of Cooperative Enforcement since that Office was created within the Division of Enforcement of the Commodity Futures Trading Commission in September 2002. In that position, he is responsible for outreach to other federal and state civil and criminal authorities, and for coordinating the CFTC's investigations and litigations of commodity-related violations with other authorities. Mr. Nathan was Deputy Director of the Division from July 1997 until September 2002. From 1985 until 1997, Mr. Nathan was in the Securities and Exchange Commission's Division of Enforcement, the last seven of those years as an Assistant Director, where he supervised investigations of financial fraud, insider trading, and market manipulation, among other things.❖

Expert Testimony in Criminal Securities Cases

Bruce M. Bettigole
Chief Counsel, Criminal Prosecution
Assistance Group
NASD (formerly known as National
Association of Securities Dealers)

I. Introduction

Expert testimony is an essential part of the government's case in virtually any criminal securities trial. Securities cases generally involve unfamiliar concepts, impenetrable industry jargon, and activities whose criminal nature is not always obvious to the average juror. A good expert can go a long way toward overcoming these obstacles. At NASD's Criminal Prosecution Assistance Group (CPAG), our assistance to prosecutors routinely includes recommending government expert witnesses, providing supporting data analyses, assisting with expert witness preparation, and providing outlines of cross-examination of defense experts. But what are the contours of admissible expert testimony in securities cases? This article examines the available case law, predominantly from the Second Circuit, and offers guidance concerning potential issues of admissibility.

II. The District Court's "gatekeeper" obligations

In *Daubert v. Merrill Dow Pharmaceuticals*, 509 U.S. 579 (1993), the Supreme Court rejected the requirement that expert testimony have received general acceptance in the relevant scientific field, a standard that originated with *Frye v. United States*, 293 F. 1013, 1014 (D.C. Cir. 1923). *Daubert* found the *Frye* test too restrictive, and held instead that the Federal Rules of Evidence require trial courts to exclude scientific expert testimony that is not sufficiently relevant or reliable. *Daubert*, 509 U.S. at 589, 597. The Court specified that the trial courts must be flexible in performing this essential gatekeeper function, and identified level of acceptance, testing, peer review, and error rates, as specific factors that might prove helpful in making the reliability determination. *Id.* at 593-94. Subsequently, the Court held that this gatekeeper function of the district courts extends to nonscientific experts as well. *Kumho Tire Co. v.*

Carmichael, 526 U.S. 137, 147 (1999) (testimony of engineer in automobile accident trial).

Kumho specified that trial courts

may consider one or more of the more specific factors that *Daubert* mentioned when doing so will help determine that testimony's reliability. But, as the Court stated in *Daubert*, the test of reliability is 'flexible,' and *Daubert*'s list of specific factors neither necessarily nor exclusively applies to all experts or in every case.

Id. at 141 (emphasis in original); FED. R. EVID. 702 advisory committee's notes (2000 amends.) (explaining why *Daubert* factors were not codified into the Rule).

This clarified the trial court's gatekeeper role regarding expert testimony in securities cases, because other than economists (*Blech Securities Litigation*, 2003 U.S. Dist. LEXIS 4650, at *69 (S.D.N.Y. 2003)), most experts in securities cases do not offer scientific testimony based on peer-reviewed methodology. Securities experts instead routinely testify on the basis of their own experience, whether as regulators, industry participants, or outside counsel or consultants. *See SEC v. U.S. Envtl.*, 2002 U.S. Dist. LEXIS 19701, at *12-13 & n.7 (S.D.N.Y. 2002) (holding application of specific *Daubert* factors unnecessary, where expert relied on trading records and other documents and compared that information with his knowledge of the industry; court noted finding no cases in which *Daubert* factors were applied in evaluating testimony of securities expert).

It is worth noting that *Blech* permitted an expert to testify "as to what ordinary broker activity entails and as to the customs and practices of the industry," *Blech*, 2003 U.S. Dist. LEXIS 4650, at *57, but excluded testimony that certain trades were proper, because this was based almost entirely on trading records, utilized no "express methodology," and involved no discussions with the firm's trader. *Id.* Other rulings regarding expert testimony in that case, however, seem inconsistent with any notion that work experience and trading analyses are insufficient indicia of reliability. *Id.* at *61-62.

Under Rule 702 of the FED. R. EVID., experts must possess sufficient "knowledge, skill,

experience, training, or education." The disjunctive phrasing of this list of qualifications is particularly important for securities experts. Although some of the most respected government experts are drawn from academia, many prosecutors have turned to current and former attorneys of NASD and consultants who formerly served as attorneys or investigators with the Securities and Exchange Commission (SEC). On rare occasions, current attorneys or other employees of broker-dealers have been available as government expert witnesses as well. Generally, courts do not have much difficulty accepting such witnesses, even though most of their expertise is drawn from their work experience rather than formal education. *See United States v. Russo*, 74 F.3d 1383, 1394-95 (2d Cir. 1995) (expert had sufficient experience as a consultant, general securities principal, and controller of a large options trading firm to testify regarding impact on stock price of unauthorized trading and parking of securities); *U.S. Envtl.*, 2002 U.S. Dist. LEXIS 19701, at *13 (qualifications of government expert consisted primarily of his experience as a regulator, compliance director, and securities consultant, who had testified as an expert in approximately thirty securities cases, and his "knowledge of typical trading activity and the types of trading patterns that an experienced trader would recognize as irregular"); *Blech*, 2003 U.S. Dist. LEXIS 4650, at *50-70. As the advisory committee's notes to FED. R. EVID. 702 expressly state, "In certain fields, experience is the predominant, if not sole, basis for a great deal of reliable expert testimony."

This is consistent with the generally liberal acceptance of expert testimony. *Daubert*, 509 U.S. at 587; *United States v. Dennis*, 625 F.2d 782, 797 (8th Cir. 1980); *Blech*, 2003 U.S. Dist. LEXIS 4650, at *68; FED. R. EVID. 702 advisory committee's note (2000 amends). As stated in *Daubert*, "Vigorous cross-examination, presentation of contrary evidence, and careful instruction on the burden of proof are the traditional and appropriate means of attacking shaky but admissible evidence." *Daubert*, 509 U.S. at 595. Of course, the substance of the testimony must still be within the area of the witness' expertise. *See United States v. Chang*, 207 F.3d 1169, 1172 (9th Cir. 2000) (excluding testimony of defense expert on history and purpose of Japanese notes, who admittedly had no training or experience in identifying counterfeit notes, in case where issue was whether the notes in question were known to be counterfeit).

The trial judge has broad discretion as to the necessity of a "reliability" hearing. *Kumho*, 526 U.S. at 152-53; FED. R. EVID. 702 advisory committee's note (2000 amends). Although defense counsel may seek a reliability hearing, in part to obtain material for cross-examination, courts generally appear to recognize and reject such ploys in criminal securities cases.

III. Subjects of expert testimony

Expert testimony in securities cases, at a minimum, involves background information about the securities industry and an explanation of the relevant normal industry practice. The government may also want to have the expert perform analyses of trading activity, review documents or transcripts of testimony, consider hypothetical questions, and opine on whether the trading activity and other evidence is consistent with normal industry practice. The government might want the expert to explain the history, purpose, and meaning, of various statutes and regulations, as well as the rules of self-regulatory organizations (SROs), or even offer an opinion on whether the defendant's conduct was consistent with these statutes, regulations, and rules. Not all of these forms of expert testimony are permissible, but the contours of forbidden areas are not always clear, and the fact specific nature of the analysis makes it difficult to predict how a particular case will be resolved. This is especially true outside the Second Circuit, where the relevant case law is limited.

A. Securities 101

The least controversial use of government experts in securities cases is to provide background information concerning the securities industry, sometimes referred to as "Securities 101." The securities expert is generally called upon to ensure that the jury has a basic understanding of what a public company is, the nature of common stock, warrants, or other relevant types of securities, the roles played by corporate officers and directors, auditors, market makers, clearing and introducing firms, stockbrokers, and other relevant actors, the nature of stock quotations and transactions, the existence and contents of relevant documentation, and similar matters. *See United States v. Bilzerian*, 926 F.2d 1285, 1294-95 (2d Cir. 1991) (expert's testimony regarding general background on federal securities regulation deemed permissible); *Marx & Co. v. Diners Club*, 550 F.2d 505, 512 (2d Cir. 1977) (stating in *dicta* that securities experts can testify on valuation issues, "how the bid and asked price of an over-the-counter security gets into the 'pink sheets,' how price

stabilization works, or how a stock exchange specialist operates the nature of an option contract, or of a convertible preferred stock....") Expert testimony about ordinary practices in the securities industry is properly offered "to enable the jury to evaluate a defendant's conduct against the standards of accepted practice." *Bilzerian*, 926 F.2d at 1295, citing with approval *Marx*, 550 F.2d at 509. Testimony regarding SRO rules is generally permitted as evidence of industry practice. *United States v. Jensen*, 608 F.2d 1349, 1356 (10th Cir. 1979) (expert permitted to interpret NASD rules as rules of a "private association" which were outside the court's expertise); *Blech*, 2003 U.S. Dist. LEXIS 4650, at *10-11. (SRO rules "are evidence of industry practice but do not constitute an exemption from liability"). Since juries do not possess any meaningful background in these areas, there should be no question that it would assist the jury to have a government expert provide essential background information and definitions, and explain the normal functioning of the industry, without offering to address the conduct of the defendants.

The advisory committee's notes to FED. R. EVID. 702 state that expert testimony may properly "educate the fact finder about general principles, without ever attempting to apply these principles to the specific facts of the case," and offer the specific example of testimony "on how financial markets respond to corporate reports." This type of testimony may be useful not only in accounting frauds and other cases involving misrepresentations in annual and quarterly reports of public companies, but also by inference in securities prosecutions involving fraudulent research reports or misleading Internet postings.

B. Usurping the role of the judge or jury

The admissibility of expert testimony becomes more problematic when prosecutors seek to have the expert state opinions concerning the facts of the case and/or interpret statutes and regulations. FED. R. EVID. 704 expressly provides that "testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact." However, as the advisory committee's notes point out, Rule 702's requirement that the testimony be "helpful" to the jury and Rule 403's proscription against evidence that "wastes time" preclude expert testimony that "would merely tell the jury what result to reach, somewhat in the manner of the oath-helpers of an earlier day." See also *United States v. Duncan*, 42 F.3d 97, 101 (2d Cir.

1994) (noting in tax evasion case that "[w]hen an expert undertakes to tell the jury what result to reach, this does not aid the jury in making a decision, but rather attempts to substitute the expert's judgment for that of the jury's"); *Hygh v. Jacobs*, 961 F.2d 359, 364 (2d Cir. 1992) (excluding testimony that use of force by police was "not justified" and "totally improper"); *United States v. Wood*, 207 F.3d 1222, 1236 (10th Cir. 2000) (medical expert testimony that treatment was "reckless" improperly described requisite mental state for manslaughter).

These Rules also exclude legal conclusions, or, as the Advisory Committee put it, "opinions phrased in terms of inadequately explored legal criteria." See *Russo*, 74 F.3d at 1395; *Bilzerian*, 926 F.2d at 1294; *Molecular Tech. Corp. v. Behbehani*, 925 F.2d 910, 919 (6th Cir. 1991) (expert testimony concerning "the requirements of federal securities disclosure laws" held improper and not harmless error; no discussion of specific testimony). The example provided by the Advisory Committee is that the question, "Did T have capacity to make a will?" would be excluded, while the question, "Did T have sufficient mental capacity to know the nature and extent of his property and the natural objects of his bounty and to formulate a rational scheme of distribution?" would be allowed. FED. R. EVID. 704 advisory committee notes (1972 proposed rules).

The line between helpful testimony regarding ultimate factual issues and inadmissible testimony that tells the jury what result to reach, or what the law provides, is not always clear. The poster child for improper testimony of a government expert in a criminal securities case is *United States v. Scop*, 846 F.2d 135 (2d Cir.), *rev'd in part on other grounds*, 856 F.2d 5 (2d Cir. 1988), in which the witness repeatedly testified that the defendants were "active participants and material participants . . . in a manipulative and fraudulent scheme," and admitted on cross-examination that his opinions were, in part, based on his personal views of the credibility of fact witnesses. *Id.* at 138. However, the Second Circuit pointed out that had the expert "merely testified that controlled buying and selling of the kind alleged here can create artificial price levels to lure outside investors, no sustainable objection could have been made." *Id.* at 140. This was consistent with *Marx* where the Second Circuit emphasized that an expert may testify "whether he thinks the method of trading was normal, but not, in our view, whether it amounted to illegal manipulation under Section 9 of the Securities Exchange Act of 1934." *Marx*, 550 F.2d at 512; see also *SEC v. Lorin*, 877 F.

Supp. 192, 196 (S.D.N.Y. 1995), *aff'd in part and remanded in part on other grounds*, 76 F.3d 458 (2d Cir. 1996) (expert testimony that the bid and asked quotations and general practices in executing transactions "were inconsistent with those of a lawful market maker").

Testimony that utilizes statutory terminology thus may be viewed as usurping the role of the court, and testimony regarding the credibility of witnesses tends to be considered usurping the province of the jury. The courts have been much more receptive to the testimony of securities experts if they avoid using key statutory terms or voicing their opinions on the credibility of witnesses. *See Russo*, 74 F.3d at 1395; *Bilzerian*, 926 F.2d at 1294.

In *Bilzerian*, the court excluded, as an impermissible legal conclusion, testimony by a defense expert that certain loans obtained by the defendant to purchase securities were "personal funds" within the meaning of Section 13 D of the Securities Exchange Act. This was viewed as tantamount to saying that the defendant's disclosures on his 13 D form were not misleading. 926 F.2d at 1295. By contrast, the court permitted the government expert to explain ambiguities in a blank Schedule 13 D. The Second Circuit, in part, seems to have distinguished the government expert's testimony based on a limiting instruction given by the district court that the expert was furnishing "background concerning the meaning of terms, the procedures which are followed and his opinion as to the reason for these procedures. He is not here to give his opinion as to what the law requires. That is a matter which must be presented to you by the court." *Id.* at 1295. It is not clear how the government expert's testimony on the meaning of terms in a blank Schedule D, even if not coupled with testimony applying the facts of the case to that interpretation, was not a legal opinion, albeit one that did not seek to tell the jury whether the funds in issue were "personal funds."

In *Russo*, the government expert summarized and described a small brokerage firm's trading patterns, including how the stock of two small companies was kept off the market through unauthorized trading and parking, and concluded that the price of these stocks would have declined significantly in the absence of these measures. *Russo*, 74 F.3d at 1388-89. The expert's testimony that certain securities transactions constituted "parking," without offering any opinion regarding the defendants' state of mind or whether they had violated the securities laws, was held to be proper. *Id.* at 1395. The court rejected the defense

argument that the expert's testimony implicitly involved the legal conclusion that the defendants intended to park stock. *Id.*

In *AUSA Life Insurance Co. v. Dwyer*, 899 F. Supp. 1200 (S.D.N.Y. 1995), the court rejected expert testimony that expressed conclusions that applied the facts to specific statutory provisions, stating it was:

hard to imagine expert opinions that more clearly usurp the function of the trial judge in instructing the jury . . . than [expert witness] Coffee's assertions that Gallo was not a controlling person of JWP within the meaning of Section 15 of the Securities Act of 1933 or Section 20 of the Securities Exchange Act of 1934 [record citation omitted], and that the statements made by Gallo in the certificates he signed are not actionable under Rule 10b-5. . . .

Id. at 1203; *see also Kidder, Peabody & Co. v. IAG Int'l Acceptance Group, N.V.*, 14 F. Supp. 2d 391 (S.D.N.Y. 1998) (granting motion to preclude expert testimony of law professor who sought to opine that party had acted reasonably and in good faith, holding that these were questions for the jury).

In *SEC v. U.S. Environmental*, the court distinguished the impermissible expert testimony in *Scop* that the defendants were active participants in the "manipulation," which the court viewed as implying knowledge of their mental state regarding the manipulation and "more along the lines of a legal conclusion." *SEC v. U.S. Envtl.*, 2002 U.S. Dist LEXIS 19701, at *20. The court permitted testimony that certain defendants in *U.S. Environmental* were essential participants in an attempt to increase the price of the stock, which the court viewed as a factual conclusion "arrived at by studying the trading records..." *Id.* at *19-20. The defense unsuccessfully argued that expert testimony that prearranged trading produced artificial prices and mislead investors was just an indirect way of saying that "manipulation" had occurred. The court expressly found that there was a "material difference" in the language, such that the expert had not improperly usurped the province of the jury. *Id.* at *17-19.

Blech, 2003 U.S. Dist. LEXIS 4650, noted the restrictions of *Scop* on the use of statutory and regulatory language like "manipulation" and "scheme to defraud," but appeared to allow very similar testimony:

Berg [the expert], therefore, cannot simply state that he knows the market was manipulated. He can, however, point to

factors indicating to him that market manipulation occurred, testify as to Bear Stearns' practices, and provide his reasoning as to why he believes they were manipulative. Rather than asserting, "Bear Stearns actively engaged in manipulative conduct aimed at directly affecting the market prices of the Blech Securities" [affidavit citation omitted], Berg should describe the evidence indicating that Bear Stearns' actions were manipulative. He cannot conclude, "Bear Stearns knowingly directed material components of a complex, concealed manipulative scheme to artificially inflate and maintain the market prices for Blech Securities during the time in which it acted as the clearing [firm] for DBCO." [affidavit citation omitted]. Instead, he should limit himself to explaining why he believes that Bear [Stearns] had knowledge that there did not exist a viable market for Blech Securities and that it acted upon this knowledge.

Id. at *63-64. *Blech* also permitted testimony regarding "painting the tape," "parking," and "withholding of supply," all of which are forms of manipulation. *Id.* at *66.

The extent of the list of terms that securities experts are forbidden from defining or using to describe the facts of the case is, at best, uncertain. *Scop*, found the expert's use of the terms "fraud" and "manipulation" inappropriate in part because they "are not self-defining terms but rather have been the subject of diverse judicial interpretations." 846 F.2d at 140. This concern at times has led other courts to preclude the use of specialized, but nonstatutory terms. *See United States v. Pereira*, 281 B.R. 194, 199-200, 2002 U.S. Dist. LEXIS 13008, at *13 (S.D.N.Y. 2002) (expert testimony regarding whether defendant was the "alter ego" of the corporation deemed improper). On the other hand, some courts appear willing to permit expert testimony regarding subsidiary legal issues. *See Note, Expert Legal Testimony*, 97 HARV. L. REV. 797, 802 (1984) (noting lack of clarity in case law, and opining that courts may "admit legal testimony more readily when it concerns a collateral issue (particularly a complex one) than when it relates to the main subject in dispute"). Testimony regarding forms of manipulation, such as parking and painting the tape, might well be viewed by some courts as indistinguishable from impermissible testimony regarding specialized statutory terms like "manipulation." *But see Russo*, 74 F.3d at 1393-94 ("parking" held not to be a legal term requiring jury instruction).

In *United States v. Barile*, 286 F.3d 749 (4th Cir. 2002), the court held that the defense expert should have been permitted to testify that the defendant's statements in a pre-market notification to the Food and Drug Administration concerning a product enhancement for cardiac monitors were reasonable, but not that there were no materially misleading comments. *Id.* at 761. The decision to exclude "materiality" testimony was based on this word having a "specialized legal meaning." *Id.* This would seem to be at least as appropriate in the securities context, where materiality is often an element of the offense. In *United States v. Cohen*, 518 F.2d 727 (2d Cir. 1975), however, the Second Circuit permitted expert testimony by an SEC witness regarding the "reach of the concepts of 'underwriter' and 'materiality.'" *Id.* at 737. Materiality was an element of the crimes charged, which included the mailing of a fraudulent offering circular. This decision thus seems inconsistent with *Barile* and *Scop*, as "materiality" has been the subject of extensive judicial interpretation (*See TSC Indus., v. Northway*, 426 U.S. 438, 449 (1976)) and is generally defined by the court in jury instructions. *See also United States v. Lueben*, 812 F.2d 179, 184 (5th Cir. 1987) (defense expert should have been permitted to testify that false statements regarding income, employment, or net worth would not have had "capacity to influence" loan officer, since this was distinguishable from the legal question of whether the statements were "material").

In *Police Retirement System of St. Louis v. Midwest Investment Advisory Service*, 940 F.2d 351 (8th Cir. 1991), the testimony of the SEC's former Director of Market Regulation regarding the history and purpose of Section 28(e) of the Securities and Exchange Act as to "soft dollar" arrangements and the securities industry's practices and procedures would apparently have been deemed proper. However, his additional testimony regarding the meaning of the provision and his conclusion that the conduct of the defendants was completely sheltered by the provision was held to have been improper. *Id.* at 357. The Eighth Circuit in that case expressly rejected the erosion, evident in some courts, of the prohibition against experts testifying on the meaning of the law.

The case law thus indicates that attempts to explain statutory language or to give opinions as to whether the conduct in question was illegal, fraudulent, or manipulative, seem unlikely to be permitted. Other terms that may be deemed sufficiently specialized, such as materiality, parking, or painting the tape, may also be off limits in some courts. Background information,

descriptions of standard industry practice, and analyses of the facts concerning the conduct in question, are likely to be permitted, although opinions on whether the conduct was consistent with normal practice may be excluded as too close to simply telling the jury what result to reach.

C. Commenting on witness credibility

Experts are generally not permitted to comment on the credibility of witnesses, as this is viewed as outside their area of expertise and constitutes improper usurpation of the role of the jury. In *Scop*, the government expert had been extensively involved in the investigation, and admitted on cross-examination that his opinions were based in part on his views on witness' credibility. The Second Circuit found this to be an impermissible intrusion on the jury's fact finding. *Scop*, 846 F.2d at 142; see *United States v. Benson*, 941 F.2d 598, 604 (7th Cir. 1991). In *SEC v. U.S. Environmental*, the defense unsuccessfully sought to exclude testimony by the government witness as having "weigh[ed] in" on witness credibility because he relied, in part, on certain depositions. The court found, however, that to the extent the witness relied on depositions, this reliance was limited to undisputed admissions. 2002 U.S. Dist. LEXIS 19701, at *20-21.

Similarly, in *United States v. Duncan*, the Second Circuit held that an IRS agent who had interviewed other government witnesses properly limited his expert testimony to factual conclusions that were not based on the credibility of other witnesses, because his testimony concerned tax returns whose falsity was apparent from land and tax records. 42 F.3d at 102. In *Blech*, however, the court ruled that an expert's opinions concerning the "tenor" and "tone" of certain deposition testimony was improper testimony about witness credibility, as such issues were within the jury's competence. 2003 U.S. Dist. LEXIS 4650, at *58-59. The safest procedure is to have the expert state that he is assuming the truth of specific testimony, without making any judgment about whether the testimony is, in fact, true. See *Scop*, 846 F.2d at 143.

D. Commenting on the state of mind of the defendant

The general rule is that a securities expert cannot testify concerning the defendant's state of mind. *Scop*, 846 F.2d at 148; *Russo*, 74 F.3d at 1395. This is due to a lack of relevant expertise, as well as the express prohibition against such testimony in FED. R. EVID. 704(b), which states:

No expert witness testifying with respect to the mental state or condition of a defendant in a criminal case may state an opinion or inference as to whether the defendant did or did not have the mental state or condition constituting an element of the crime charged or of a defense thereto. Such ultimate issues are matters for the trier of fact alone.

Less direct forms of expert testimony relevant to the defendant's mental state, however, may be permissible. In *U.S. Environmental*, the government's expert was permitted to testify that certain irregular trading patterns were "red flags" that any experienced trader would have recognized. 2002 U.S. Dist. LEXIS 19701, at *10. *Blech*, surprisingly accepted testimony that a brokerage firm "was aware of" sham transactions to inflate the price of the stock, *i.e.* "painting the tape." 2003 U.S. Dist. LEXIS 4650, *66. *Blech* similarly approved of expert testimony that the firm in question knew there was no viable market for particular securities and that the firm "acted upon this knowledge," both areas that arguably involve testimony about the mental state of the defendant. *Id.* at *64. Such testimony might well be deemed inadmissible in other courts, where inferences as to the knowledge of a criminal defendant might be reserved for the jury.

Defense experts, at times, seek to testify about the lack of clarity in the law as a means of proving the absence of criminal intent. *United States v. Garber*, 607 F.2d 92, 95 (5th Cir. 1979), held that such testimony should have been permitted, regardless of whether the defendant was aware of the lack of clarity or relied on the advice of counsel. *Garber* has been heavily criticized, and this type of testimony is generally excluded. The dissent in *Garber* was followed by the Second Circuit in *United States v. Ingredient Tech. Corp.*, 698 F.2d 88, 96-97 (2d Cir. 1983), which held that when the evidence shows the defendants thought they were acting unlawfully, expert testimony on the vagueness or uncertainty of the law is irrelevant. Indeed, as *Ingredient Tech.* pointed out, the Fifth Circuit severely limited *Garber* in *United States v. Herzog*, 632 F.2d 469, 473 (5th Cir. 1980), without expressly overruling it. *Ingredient Tech.*, 698 F.2d at 97; *Kidder, Peabody & Co. v. IAG Int'l Acceptance Group N.V.*, 14 F. Supp. 2d 391, 402 (S.D.N.Y. 1998). Similarly, expert testimony regarding the reasonableness of reliance on advice of counsel, as a means of showing a lack of criminal intent, should be excluded. *United States v. Klaphake*, 64 F.3d 435, 439 (8th Cir. 1995); *United States v. West*, 22 F.3d 586, 598 (5th Cir. 1994); *Kidder*, 14 F. Supp. 2d at 402-04.

E. Hallmarks of fraud

Expert witnesses in various nonsecurities cases have been permitted to testify regarding the typical structure and operation of criminal organizations and transactions. *See United States v. Locascio*, 6 F.3d 924, 937 (2d Cir. 1993) (structure and terminology of organized crime families); *United States v. Tapia-Ortiz*, 23 F.3d 738, 741 (2d Cir. 1994) (use of accounting books and beepers by drug dealers). There have even been cases in which opinion testimony was permitted as to whether the defendant's conduct was consistent with such a typical scheme. *See Scop*, 846 F.2d at 141-42 (reviewing case law and noting concern expressed in one case that there was "something offensive" about allowing the testimony to go this far). In *United States v. Robinson*, 2000 U.S. Dist. LEXIS 694 (S.D.N.Y. 2000), *aff'd*, 28 Fed. Appx. 50, 2002 U.S. App. LEXIS 402 (2d Cir. 2002), the court held pretrial that testimony regarding the "hallmarks" of Prime Bank schemes would be admissible. However, the court noted that a more detailed proffer from the government would be necessary to ensure that the testimony not improperly invade the province of the jury by conveying the conclusion that the defendants' scheme "featured these hallmarks." 2000 U.S. Dist. LEXIS 694, at *5.

In *Robinson*, the defense raised no objection to expert testimony that Prime Bank instruments do not exist, that the Federal Reserve does not authorize or issue clearance for any such instruments, and did not do so in the case at issue. The expert was permitted to go further, however, over the objection of the defense, and offer testimony that "claims regarding Prime Bank instruments, secret restricted markets, and special trading clearances are 'hallmarks' of financial fraud schemes." *Id.* The expert was further allowed to testify about the role of the "recruiter" to counter the defendant's claim that his moving near the victim's residence was inconsistent with criminal intent. In its pretrial rulings, however, the court did exclude testimony that the defendants' scheme contained the hallmarks of prime bank fraud or that one defendant's conduct fit the role of the typical prime bank recruiter, due to the risk of improper usurpation of the role of the jury. *Id.* Despite this ruling, at trial the court apparently allowed the government expert to testify about what the prime bank notes "really meant," that certain terms were "bogus" and had "no legitimate meaning," and that various aspects of the defendants' scheme were "often used by wrongdoers who are trying to scam money." The Second Circuit, in an unpublished opinion, noted that such testimony "was close to, if not beyond,

the bounds of propriety," but held that any error was harmless. *United States v. Robinson*, 28 Fed. Appx. 50, 2002 U.S. App. LEXIS 402 at * 3.

It may be that similar testimony would be permissible in "boiler room" sales practice cases, pyramid schemes, and other forms of securities fraud, that arguably follow a well-established formula. Boiler rooms, for example, typically involve unlicensed cold callers who pretend to be licensed brokers, lie about having made successful recommendations to the victim in the past, and utilize fraudulent sales scripts to sell essentially worthless stock and receive vast, inadequately disclosed commissions. Such firms typically hire only new, inexperienced employees who can more easily be trained in these methods, or licensed brokers who have successfully utilized these techniques at other notorious firms. Boiler rooms also typically enforce undisclosed restrictions on the ability of customers to resell their securities, an illegal practice that is generally enforced by the firm's traders and owners. Although no reported cases appear to address the use of expert testimony in this context, it logically should be permitted. Whether it is necessary to have such expert testimony is another matter. The prosecutor may not want to risk creating an appellate issue, especially where cooperators are available to testify from their own experiences that these illicit practices were utilized throughout the firm, including by the defendants.

IV. Conclusion

Expert testimony regarding the basic concepts and normal practices of the securities industry should virtually always be a part of the government's case. With careful avoidance of statutory or other specialized terms that have been the subject of judicial interpretation, or comments regarding the defendant's mental state or the credibility of other witnesses, an expert should be permitted to explain why the normal practice of the industry is vastly different from the conduct described by cooperating witnesses, without attempting to state that final inference for the jury. Prosecutors who push the envelope beyond these areas, however, may find that they have created an appellate issue in return for, at most, a marginal advantage at trial. ❖

ABOUT THE AUTHOR

Bruce Bettigole has been the Chief Counsel of NASD's Criminal Prosecution Assistance Group since its inception in April, 1998. CPAG assists federal, state, and local prosecutors throughout the country in criminal securities-related

investigations and prosecutions. He was an Assistant Chief Litigation Counsel with the SEC from 1991-1998, and served as a Special AUSA from 1994-2001 in several jurisdictions. From 1981-91, Mr. Bettigole was in private practice in the District of Columbia. ☒

Corporate Crime Prevention Programs

*David M. Nissman
United States Attorney
District of the Virgin Islands*

I. Introduction

When Assistant United States Attorneys Tom Watts-FitzGerald and Environmental Crimes Section (ECS), Department of Justice (Department) attorney Richard Udell were confronted with an early settlement offer from Norwegian Cruise Lines (NCL) in an environmental criminal case, their initial reaction was typical of most of us. They would not agree to a settlement until a complete and thorough investigation was done. NCL then turned over the results of its own internal investigation which grew out of a corporate compliance program. The company waived applicable privileges, turned over witness statements that included a confession, and repeated its offer to settle early. The cooperation it offered, however, was not conditioned on a quid pro quo as to the eventual outcome.

The government was already investigating NCL for discharging oily bilge water and for misreporting the condition of oily water separators on NCL's cruise ships. An ex-employee, who had served on the SS Norway, made allegations to the United States prior to the time that NCL came forward. NCL was purchased in a hostile takeover and the new owner learned that the ex-employee had spoken to the government. The new owner hired an outside auditor to look at the ships and the auditor actually witnessed one of the ships tampering with required pollution prevention equipment (the oil water separator). Prompt disclosure was then made by the new owner, with a pledge of total cooperation.

After analyzing the company's internal investigation, the prosecutors conducted an investigation and NCL maintained a rolling production of investigative reports as they were being written. The corporation wanted closure, and due to NCL's extraordinary cooperation, the government's investigation proceeded and concluded quickly. While NCL's conduct had been ongoing, (repeated discharges of bilge oil into the ocean without processing it through an oily water separator, and false statements into their Oil Record Book during subsequent U.S. Coast Guard inspections) they approached the government with an offer to cooperate prior to the time that there were any overt steps taken in the government's investigation.

At the conclusion of the negotiations NCL pleaded guilty to a single felony count in one jurisdiction and received a fine of \$1 million dollars. In contrast, for similar conduct, but with a corporate stance that was more than mildly obstructionist, Royal Caribbean Cruise, Limited pleaded guilty to felonies in six different jurisdictions and paid over \$25 million dollars in criminal fines.

The NCL offer came on the heels of an internal audit conducted by new owners of the company. Internal audits are often components of corporate criminal compliance programs.

II. What is the purpose of a corporate compliance program?

Whether it is the money laundering abuses of BCCI or the accounting horrors of Worldcom or Enron, corporations have begun to recognize that self-policing can help them avoid serious problems. As stated in the Criminal Resource Manual of the United States Attorneys' Manual:

Compliance programs are established by corporate management to prevent and to

detect misconduct and to ensure that corporate activities are conducted in accordance with all applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own.

Federal Prosecutions of Business Organizations, Criminal Resource Manual 162, § VII. A.

Various legal sources suggest that corporations may be able to enhance their legal status as putative defendants when they have an effective corporate compliance program. In the Eighth Circuit there is a Model Jury Instruction (5.03) that allows a corporation to use its compliance program as a way of challenging the culpable mental state of a charge against it. The U.S. Sentencing Guidelines provides that the corporate sentencing penalty may be lower (by three points) if the company has an effective corporate compliance program. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f). The Sentencing Guidelines also reward voluntary disclosure and cooperation with a reduction (by as much as five points) in the corporation's offense level. *See* U.S. SENTENCING GUIDELINES MANUAL §§ 8C2.5(g). U.S. SENTENCING GUIDELINES MANUAL § 8A1.2 (k) provides that an "effective program to prevent and detect violations of law" means a program that has been reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct. Failure to prevent or detect the instant offense, by itself, does not mean that the program was not effective. The hallmark of an effective program to prevent and detect violations of law is that the organization exercised due diligence in seeking to prevent and detect criminal conduct by its employees and other agents.

Due diligence requires, at a minimum, that the organization must take the following types of steps:

- The organization must have established compliance standards and procedures to be followed by its employees and other agents that are reasonably capable of reducing the prospect of criminal conduct;
- Specific individual(s) within high-level personnel of the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures;
- The organization must have used due care not to delegate substantial discretionary authority

to individuals whom the organization knew, or should have known through the exercise of due diligence, had a propensity to engage in illegal activities;

- The organization must have taken steps to communicate effectively its standards and procedures to all employees and other agents, for example, by requiring participation in training programs or by disseminating publications that explain, in a practical manner, what is required;
- The organization must have taken reasonable steps to achieve compliance with its standards, for example, by using monitoring and auditing systems reasonably designed to detect criminal conduct by its employees and other agents, and by having in place and publicizing a reporting system whereby employees and other agents can report criminal conduct by others within the organization without fear of retribution;
- The standards must have been consistently enforced through suitable disciplinary mechanisms, including, as appropriate, discipline of individuals responsible for the failure to detect an offense. A adequate discipline of individuals responsible for an offense is a necessary component of enforcement. The form of discipline that will be appropriate will be case specific;
- After an offense has been detected, the organization must have taken all reasonable steps to respond appropriately to the offense and to prevent further similar offenses, including any necessary modifications to its program to prevent and detect violations of law.

As prosecutors, we wrestle with the equities in making a decision to charge a corporation. A corporation is often a powerful entity that develops a culture of its own. If it engages in repeated or pervasive acts of criminal behavior, it should be treated as a criminal. On the other hand, by charging a corporation we place scores of innocent people in jeopardy. Innocent people may be put out of work. Innocent pension holders, whose trustees have invested in the subject company, may have their financial futures jeopardized when a successful criminal case is launched against the corporation. For these and other reasons we proceed temperately. Analyzing the corporation's culture may help determine what measure of enforcement is necessary in a given situation. One of the best ways to analyze a

company's overall behavior is to examine its compliance program.

As stated in the USAM:

the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program. In addition, the nature of some crimes, *e.g.*, antitrust violations, may be such that national law enforcement policies mandate prosecutions of corporations notwithstanding the existence of a compliance program.

Federal Prosecutions of Business Organizations. Criminal Resource Manual 162, § VII. A.

The absence of a compliance program in a large company may be a good place to begin an inquiry into corporate culture. Why was a program not started? Did the company recognize through various operations that it was at risk of violating the law? Were there discussions among corporate officers about starting such a program? Why was the concept shelved?

In companies where programs do exist, does the program function or is it merely a paper program?

[C]ritical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. The Department has no formal guidelines for corporate compliance programs. The fundamental questions any prosecutor should ask are: "Is the corporation's compliance program well designed?" and "Does the corporation's compliance program work?" In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal conduct; the number and level of the corporate employees involved; the seriousness, duration, and frequency of the misconduct; and any remedial actions taken by the corporation, including restitution, disciplinary action, and revisions to corporate compliance programs.

Federal Prosecutions of Business Organizations, Criminal Resource Manual 162, § VII. B.

III. The audit issue

In the environmental context, corporations, as part of a compliance program, conduct audits. These audits oftentimes point out potential criminal activity. A decade ago, the regulated community asserted that it was unfair for the government to subpoena these audits and use a corporation's best efforts at self-policing against it. Attorneys working on behalf of regulated corporations even tried to develop an audit privilege. We were successful in resisting the development of such a privilege, but at the same time, we recognized that it was in the best interest of the environment and law enforcement to encourage corporations to conduct these audits. Consequently, we did not want to engage in activities that would make companies hesitate to undertake them. The Environmental Protection Agency (EPA) codified a limited use policy to address the equities. In a document entitled "Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations," EPA sets out several important limiting doctrines.⁶⁵ Fed. Reg. 19,618 (April 11, 2000).

The summary states:

The purpose of this Policy is to enhance protection of human health and the environment by encouraging regulated entities to voluntarily discover, promptly disclose and expeditiously correct violations of Federal environmental requirements. Incentives that EPA makes available for those who meet the terms of the Audit Policy include the elimination or substantial reduction of the gravity component of civil penalties and a determination not to recommend criminal prosecution of the disclosing entity. The Policy also restates EPA's long-standing practice of not requesting copies of regulated entities' voluntary audit reports to trigger Federal enforcement investigations.

Id.

In this way, regulated companies are not exposed to risk for doing the right thing. The government is not collecting audits merely to determine if it should undertake an investigation. However, once a criminal violation is discovered, the government will not hesitate to request copies of the audits. These audits are also helpful in making a determination about the efficacy of a compliance program which may be one factor in

determining whether or not to charge the corporation.

It goes without saying that any consideration that might enure to the benefit of the corporation for having undertaken a crime prevention program (or governmental self-imposed restraint on the use of compliance documents), is irrelevant in the context of what to do with an individual wrongdoer who works for the business entity.

IV. Features of a good compliance program

In the USAM's Federal Prosecutions of Business Organizations, Criminal Resource Manual 162, as well as U.S. SENTENCING GUIDELINES MANUAL § 8, business organizations are encouraged to have real, versus paper, compliance programs. In deciding whether to charge, what to charge, and what sentencing considerations are appropriate, prosecutors need to evaluate the merits of a business organization's compliance program. While much has been written about certain aspects of corporate compliance programs, it is instructive to analyze the formation of the program in order to determine if it was doomed to failure at the outset.

To begin with, compliance programs should be designed to detect the types of misconduct most likely to occur in that corporation's particular line of business. Criminal Resource Manual 162. Did the company thoroughly analyze its own business in its compliance program? For example, if a company is a manufacturing concern, did it complete a cradle to grave analysis, from acquisition to storage, use and disposal of raw and used materials, for purposes of determining compliance with environmental and other regulatory laws? If a business' compliance program made no effort to analyze its own operations, the program could not possibly be effective. Step one should be to review the compliance program's efforts to analyze its own business operations.

The next question a prosecutor may want to ask is, did the compliance program do a thorough review of all of the relevant federal, state, and local laws and regulations relevant to the company's business? If the company is a covered financial institution that accepts foreign bank accounts (correspondent accounts), did the bank assign people to review the USA PATRIOT Act and applicable United States Treasury regulations? Has the compliance section generated research to instruct employees on the new obligations to investigate the opening of foreign accounts? Are there documents in the financial institution's files that, for example, discuss

Sections 352 and 319 of the PATRIOT Act and the impact these laws currently have on bank operations and procedures? *See* 18 U.S.C. 1960. Section 352 requires financial institutions to develop internal controls and compliance programs. Section 319 requires banks to know their customers, and in the case of correspondent accounts, to know their customers when they accept foreign banks as account holders.

If the business maintains offices in foreign countries and engages in, for example, public contracting, has it familiarized itself with the Foreign Corrupt Practices Act, PUB. L. NO. 95-213, 91 Stat. 1494 (1977)? Has it researched the legal requirement to do due diligence background investigations on prospective foreign representatives, agents, and consultants?

If the business is a publicly traded company, has it familiarized itself with the specific provisions of the Sarbanes-Oxley Act? Do the files of the corporate compliance program indicate that the company is required by Section 406 of Sarbanes-Oxley to develop a code of ethics for senior financial officers? PUB. L. NO. 107-204, 116 Stat. 745 (2002). Has such a code been developed? What instructions did the compliance section distribute to senior management concerning this obligation?

If the business operates in foreign countries, was a similar effort undertaken to acquaint itself with relevant foreign laws and regulations affecting the industry? One can learn much about the nature of corporate citizenry from the research it undertakes prior to the implementation of a compliance program. For example, if a multi-national industrial concern has a wonderfully thorough compliance initiative in the United States, but has taken no similar pains to acquaint itself with relevant foreign law, do we conclude that its corporate culture is to be a good citizen or merely a compliant one due to fear of prosecution in the United States?

Having conducted an inquiry of the facts leading up to the establishment of the compliance program, the next question is does the company have a written compliance program? Is it regularly followed? For example, having determined that a financial institution is aware of USA PATRIOT Act requirements, what steps did the bank regularly follow to determine the true identity of a foreign holding company that has an account in the domestic financial institution? Did the domestic bank review the holding company's corporate certificate of good standing? Did it send someone to verify the address and residence of the

holding company or of the people using the account?

In a publicly traded company, review the required code of ethics for senior financial officers. What does the code require? Is it enforced? What are the penalties for violation of the company's code of ethics? Have violations been discovered? Were penalties meted out? How does that company's code of ethics compare with similarly situated companies? Is there an industry standard?

In examining the written compliance program, does the program or industry lend itself to measurable performance standards? If so, are there any? Are there orientation and training programs to prevent corporate crime? Are standards effectively communicated to employees? Does the company reward or discourage whistle blowers?

Are there spot and full audits to determine if there are criminal violations occurring inside the company? For example, a company engaging in international public contracting is not going to have a category in company financial records for bribes. Those companies should, however, watch for bribes that appear in other cost recovery attempts. Has the company considered this? Does it have an audit and monitoring program? If the bribes go undetected, it may subject the company to problems beyond the Foreign Corrupt Trade Practices Act, because the Internal Revenue Service (IRS) code says that bribes are nondeductible. The discovery of a bribe may occur during an IRS audit and the company's compliance program should attempt to ferret out these kinds of problems internally in order to prevent future occurrences.

What did the company do when it discovered a criminal violation? Were employees reprimanded? What efforts were made to rectify the behavior? Was the violation disclosed to authorities? Were attempts made to provide restitution to injured parties?

The USAM instructs us to:

consider the promptness of any disclosure of wrongdoing to the government and the corporation's cooperation in the government's investigation. In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying

officers' recommendations; are the directors provided with information sufficient to enable the exercise of independent judgment; are internal audit functions conducted at a level sufficient to ensure their independence and accuracy and have the directors established an information and reporting system in the organization reasonably designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law. *In re: Caremark*, 698 A.2d 959 (Del. Ct. Chan. 1996).

Federal Prosecutions of Business Organizations, Criminal Resource Manual at 162, VII. B.

In evaluating how serious a company is in preventing corporate crime, it is instructive to see where the compliance program is in the corporate hierarchy. Does the person in charge of corporate compliance have a senior management position within the company? Is it the officer's primary responsibility or is it simply added to a host of other duties? How does the corporate structure rate the importance of its criminal compliance program? Does the person running the compliance program have the authority to implement programs or simply the responsibility of recommending them to a group whose interests may be antithetical to the development of an effective program?

V. Disclosure policy

The paramount question for prosecutors in evaluating a compliance program is: does the company have a policy of disclosure to the government? If so, what are the parameters of such a program? Does the company promptly and regularly report violations of law in which it has engaged? Does it take all reasonable methods to stop the negative effects of the criminal conduct? Does it turn over its investigative reports? Does it waive applicable privileges (usually attorney client and work product privileges are the relevant concerns) in an effort to make a full disclosure? Does the company encourage or discourage its employees to respond to law enforcement inquiries?

A full and complete disclosure policy is one of the best ways of demonstrating to the government that the corporation has a non-criminal culture where the criminal behavior is not pervasive. Section VI, A of the Federal Prosecutions of Business Organizations, Criminal Resource Manual at 162 states that:

In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection.

While the Department, EPA, the Securities and Exchange Commission (SEC), and many other governmental bodies have reward policies for voluntary disclosure, self reporting does expose the company to some initial risk. However, the company runs a much greater risk by nondisclosure.

If a company discovers a problem and chooses not to report it, there is great temptation to engage in behavior designed to hide the conduct. The company can rest assured that a disgruntled employee will, at some point, notify the authorities, and then efforts to hide the crime are magnified and the penalties escalate. Moreover, as demonstrated by the NCL case, an investigation by law enforcement may already be underway, the details of which are unknown to the target.

The decision not to make disclosure to the government for fear of regulatory action can lead to far more disastrous results than the remedial measures the government might require. USA Today recently reported that, as early as 1997, manufacturer Airbus had knowledge of a defect in tail fin design. Alan Levin, *Near Crash Uncovers Crack in Air Safety System*, USA TODAY, May 27, 2003. American Airlines Flight #587 crashed on November 12, 2001 due to a tail fin break in mid flight. Two hundred and sixty-five people perished in that accident. USA Today reported that Airbus did not report to federal regulators that there was a near accident on a 1997 flight wherein a tail fin on one of its jets nearly snapped off in flight. *Id.* "Had federal regulators known earlier how easily tail fins could break in flight, the crash of Flight 587-and the deaths of 265 people-might have been prevented, according to some accident investigators and aviation safety experts." *Id.*

If a company does not self-report the crime, the company may not have the ability to end the crime and make injured parties whole. For example, assume a United States company does

public works projects in foreign countries. The company discovers that it procured a lucrative contract by fraud. Assume further that the company does not want to complete the contract once it discovers its own criminal behavior. If it does not report the crime, how does it rectify the error of its ways? Does it have a mechanism to void the contract? Does it have the ability to determine who the victims (the unsuccessful bidders) are? Can the company alone cause the public contracting entity to rebid the contract? It is obvious that in this scenario, in order to do the right thing, the company needs the government's help and it starts with self-disclosure.

VI. Conclusion

The Norwegian and Royal Caribbean cases are instructive when comparing the relationship of their approaches to the government with case disposition. NCL voluntarily disclosed its problems to the government and opened its investigative files without an agreement on case disposition. It disclosed all incidents of its criminal conduct to multiple jurisdictions. Ultimately, NCL pleaded guilty to one felony count and paid a one million dollar fine. RCCL, on the other hand, was originally caught in a Coast Guard video off the coast of Puerto Rico surrounded by an oil slick of its own making. After pleading guilty to that incident, it sought to frustrate the government's efforts to investigate its world-wide practices. One by one, separate investigations were opened in six other districts.

RCCL finally read the handwriting on the wall, changed counsel, and approached the government with a global settlement offer. RCCL pleaded guilty to multiple felonies in six different judicial districts and was fined over \$25 million dollars.

In taking decidedly different positions to law enforcement inquiry, self-policing, and disclosure, it was appropriate for the government not to view these entities as similarly situated defendants. Making the decision to charge a corporation requires a more far-reaching and complex analysis than the decision to charge individuals. Examining a corporation's compliance program may offer great insight into corporate culture and whether crime is pervasive or rare. In analyzing a corporate compliance program, there are many different components to consider, but perhaps the most telling is a business entity's disclosure policy to the government. ❖

ABOUT THE AUTHOR

□ **David M. Nissman** is the United States Attorney for the District of the Virgin Islands. He is also the author of *PROVING FEDERAL CRIMES* (2001) and the former Editor-in-Chief of the *UNITED STATES ATTORNEYS' BULLETIN*. ✉

Professional Responsibility Issues In Corporate Fraud Matters

Claudia J. Flynn
Director, Professional Responsibility
Advisory Office

Rima Sirota
Legal Advisor, Professional Responsibility
Advisory Office

I. Introduction

Corporate fraud investigations and prosecutions raise a host of professional responsibility issues. This article will address such issues, which may include choice of law, receipt of potentially privileged information, communications with represented persons, conflicts of interest, and confidential information. Because advice from the Professional Responsibility Advisory Office (PRAO) is provided only to Department of Justice (Department) attorneys and is otherwise confidential, this discussion identifies issues that may arise in corporate fraud matters but does *not* purport to answer the questions raised or to offer any advice as to the appropriate course of action. In analyzing the particular issues in an actual matter, Department attorneys may consult with their office's Professional Responsibility Officers and with PRAO as appropriate. PRAO may be contacted by telephone at 202-514-0458 or through the Department's e-mail system at PRAO, DOJ.

Please note that this article discusses corporate fraud issues in the context of the ABA Model Rules of Professional Conduct. Although this discussion provides a general framework for analysis, attorneys must analyze issues under the relevant bar rules applicable in their particular jurisdiction.

II. An analytical framework

To put the professional responsibility issues into context, we will consider the hypothetical, but not atypical, circumstances surrounding the government's investigation of corporate fraud involving Company Z and its top officers.

You are assigned to the Company Z investigation. You are admitted to the bar in Washington, D.C.; your colleague on the matter is admitted in Connecticut; Company Z is headquartered in Delaware; interviews may occur in several states; the grand jury is in Texas. Which rules of professional responsibility should you be concerned with?

A. Choice of law

In any matter, the first step is to determine which rules of professional responsibility govern your conduct. Each state has adopted its own rules of professional responsibility. Each federal district court has adopted, by local rule, the rules applicable to practice in that jurisdiction. Many federal district courts simply incorporate the rules adopted by the state in which the court sits. Some federal district courts adopt the state rules with certain modifications, while others adopt the ABA Model Rules or Code, and still others have drafted their own rules. Where the substance of the various rules potentially applicable in a matter conflict, a choice of law analysis is required. Some local rules are silent on this subject, leading the inquirer to consult traditional choice of law principles for guidance. Other rules, including Model Rule 8.5(b), specifically set forth choice of law principles for professional responsibility questions. In addition, the Department has promulgated guidance for its attorneys on this subject. *See* 28 C.F.R. Part 77.4.

B. Working with agents

You are working with Agent Undercover to investigate the Company Z fraud allegations. What are your responsibilities regarding Agent Undercover's actions? How does your involvement affect the agent's investigation?

Non-lawyers, of course, are not bound by the rules of professional conduct. Nonetheless, lawyers may be held accountable, under the rules, for the actions of non-lawyers, including agents with whom they work. In particular, the rules require that lawyers ensure that agents and other non-lawyers, with whom they are working also abide by the rules. Failure to do so may result in negative consequences for the lawyer, including disciplinary action by the local bar association. Moreover, the failure of agents to abide by the rules governing the lawyers with whom they work may have negative consequences for the case, possibly including the exclusion of evidence. It is therefore appropriate in this context for lawyers to consider the potential application of Rules 5.3 (Responsibilities Regarding Non-lawyer Assistants) and 8.4 (providing that it is misconduct for an attorney to violate the rules through the acts of another).

C. Receipt of privileged information

On her own initiative, Ms. Executive, a high-level Company Z employee, mails the FBI a stack of documents that includes copies of letters between Ms. Lawreview, Company Z's General Counsel, and Firm X, Company Z's outside counsel. May your team review these documents?

It is not unusual for an employee or other insider in the company under investigation to provide the government with information that is potentially damaging to the company. Such information arrives at the government's doorstep "tied up with a ribbon" as it were, with no government involvement in obtaining the information. Rule 4.4 (Respect For Rights of Third Persons) may be applicable, depending upon the circumstances and the local version and interpretation of the rule. Model Rule 4.4(a) prohibits a lawyer from using "methods that violate the legal rights" of a third party, including a corporation. While the government in this situation did nothing at all to obtain the potentially privileged information, you will need to determine the propriety of reviewing and using such information once it has been received. In some circumstances, it may be that the documents do not contain privileged information or the privilege may have been waived.

D. Communications with employees of a represented company

Ms. Executive then calls the FBI. She says that she wants to talk to the government about Company Z's misdeeds. A Firm X partner has informed the government that she represents both Company Z and all Company Z employees in this matter. May the agent talk to Ms. Executive?

Model Rule 4.2 prohibits communications "about the subject matter of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order." Here, you clearly wish to discuss with Ms. Executive the matter on which Company Z is represented. Accordingly, you will need to determine whether Ms. Executive, herself, is "off-limits" for purposes of the Rule. Generally, declarations by corporate counsel that they represent *all* employees of the organization have been rejected by courts and bar associations. Rather, state rules and local case law define certain categories of employees as "standing in the shoes of" the represented organization with many states adopting the following test: where an organization is represented, a lawyer may not contact employees with managerial responsibilities, employees whose acts or omissions in connection with the matter may be imputed to the organization for liability purposes, or employees whose statements may constitute an admission on part of the organization. The language and interpretation of the rule in this regard vary significantly from one jurisdiction to the next and you will need to determine whether Ms. Executive is "off limits" under the relevant local version of Rule 4.2. If Ms. Executive is individually represented by counsel and that counsel consents, most jurisdictions would permit you to communicate with Ms. Executive notwithstanding the objections of corporate counsel. Finally, note that most jurisdictions give lawyers significantly greater latitude in contacting *former* employees of a represented organization.

Once you determine that the rule does not prohibit communications with a particular employee, other rules of professional responsibility may come into play, including the Rule 4.3 prohibitions against implying that the lawyer is disinterested in the matter and giving legal advice to the unrepresented person (except the advice to obtain counsel). Moreover, Rule 4.4 cautions against seeking to obtain the organization's privileged information from its employees.

E. Preindictment communications

Having obtained the consent of Ms. Executive's individual counsel, you ask Ms. Executive to engage the Chief Executive Officer of Company Z, Mr. Bossman, who is represented by counsel, in a discussion of issues pertinent to the investigation. May you arrange this undercover operation?

As noted above, Model Rule 4.2 contains an exception for communications that are "authorized by law." Most local versions of Rule 4.2 contain this exception as well. In many jurisdictions, preindictment noncustodial covert communications by law enforcement agents are considered to fall within the "authorized by law" exception. Certain other jurisdictions have determined that the Rule simply does not apply to such circumstances in the first place. Some jurisdictions have extended this exception to overt preindictment communications in criminal matters and precomplaint communications in civil enforcement matters as well.

F. Subject matter of the communication

An indictment is returned against Company Z's Chief Executive Officer, Mr. Bossman, and the case is set in District Court. You learn that Mr. Bossman has offered to pay Ms. Informant to kill a government witness. May you wire up Ms. Informant and send her to have a conversation with Mr. Bossman about the alleged murder-for-hire?

Model Rule 4.2 applies only to communications regarding the subject matter of the representation. Consequently, you will need to determine whether Mr. Bossman is (indeed, whether he can be) represented on this new alleged crime. If you determine that the rule does not prohibit communications regarding this new crime, you will need to determine what steps, if any, are required or prudent to avoid communications with Mr. Bossman on the subject matter of the indictment on which he clearly is represented. Depending on the circumstances, one possibility might be to set up a separate "taint team" to investigate the new crime.

G. Conflicts and confidential information

You learn that one of the attorneys representing Mr. Bossman also represents Ms. Executive, an important government trial witness, in her ongoing divorce matter. What do you do?

Model Rule 1.7, and most local conflicts rules, define a conflict as the representation of one client who is directly adverse to another client, or where there is a significant risk that representation

of one client will be materially limited by the lawyer's responsibilities to another client, a former client, a third person, or the lawyer's own personal interests. Moreover, Rule 1.6 provides that a lawyer may not reveal confidential client information or use such information to the detriment of a client. Here you will need to consider whether opposing counsel's obligations to his divorce client will likely impair his representation of Mr. Bossman. For example, will the lawyer be able to honor his obligation to protect Ms. Executive's confidences when he cross-examines her? Many courts have noted that a government prosecutor should bring such potential conflicts to the court's attention as soon as possible. This obligation is seen to arise from the prosecutor's obligation to seek justice, to protect the record and verdict, and to avoid wasting judicial resources.

H. Proposed amendments to Rule 1.6

Congratulations! The jury returns a guilty verdict against Mr. Bossman on all counts. The General Counsel, Ms. Lawreview, returns to her office at Company Z where there is a stack of financial documents awaiting her approval. Noticing that the numbers do not quite add up, Ms. Lawreview goes back over previous financial documents that she filed with the SEC on Company Z's behalf and realizes then that the fraud at Company Z is much bigger than Mr. Bossman's personal transgressions. What may Ms. Lawreview do with this information?

Model Rule 1.6 permits disclosure of confidential information in certain limited circumstances, such as to prevent reasonably certain substantial bodily injury, or where the public interest in disclosure is deemed to outweigh the policy protecting client confidences. In light of recent changes in applicable law, including the Sarbanes-Oxley Act of 2002 and related rules regulating lawyer professional conduct by the Securities and Exchange Commission, various ABA committees have proposed amending Model Rule 1.6. This proposed amendment would permit a lawyer to reveal confidential client information to the extent reasonably necessary to prevent the client from committing a crime or fraud in which the client has used a lawyer's services, and which is reasonably certain to result in substantial financial injury or to mitigate or rectify such injury that has already occurred. Such provisions already exist in the local version of Rule 1.6 in a number of jurisdictions.

III. Conclusion

The rules of professional conduct must be taken into account at every stage of a corporate fraud matter, from investigation through sentencing. Familiarity with these issues at the outset will help guide your decisions throughout. As always with these sometimes difficult issues, when in doubt seek guidance at the earliest opportunity from the professional responsibility resources available to you. ♦

ABOUT THE AUTHORS

□ **Claudia J. Flynn** is the Director of the Professional Responsibility Advisory Office. Prior to being appointed to that position in January 2000, she held a number of positions in the Department of Justice: Senior Counsel to the Director, Executive Office for United States Attorneys (September 1997 to January 2000); Chief of Staff to the Assistant Attorney General, Criminal Division (February 1996 to September 1997); Chief of the Criminal Division (1994-1996); Deputy Chief of the Criminal Division (1989-1992); Assistant U.S. Attorney for the District of New Jersey (1984-1989); and Associate Independent Counsel at the Office of Independent Counsel (Adams) (1992-1994).

□ **Rima Sirota** is a Legal Advisor in the Professional Responsibility Advisory Office. Ms. Sirota has been with the Department since January 2000, when she became Counsel for Legal Ethics in the Environment and Natural Resources Division. Prior to joining the Department, Ms. Sirota was a partner in private practice at a Washington, D.C. litigation firm. Ms. Sirota currently serves as an appointed Hearing Committee member for the District of Columbia Board on Professional Responsibility. ❧

The FBI Response to Corporate Fraud

*Michael Degnan
Supervisory Special Agent
Economic Crimes Unit
Federal Bureau of Investigation*

When the Enron scandal surfaced in late 2001, stockholders and business analysts struggled to comprehend how a seemingly indestructible energy giant could lie in ruins amidst one of the largest business frauds in United States history. At that time, Enron appeared to be an anomaly in terms of fraudulent financial reporting to the public. Less than two years later, the FBI is investigating 118 cases of corporate fraud and the list continues to expand. Approximately three to six new investigations are initiated each month. The majority of these cases involve losses to investors in excess of \$100 million dollars. The shareholder loss surpasses \$1 billion dollars in at least ten cases.

Although investigations regarding Enron, Worldcom, and HealthSouth, attract significant media attention, the impact of corporate fraud on

individual shareholders is similar whether they invested with a Fortune 500 Company or a lesser known corporation. After the fraud is exposed, the value of their shares decrease significantly or become worthless.

In July 2002, President Bush formed a task force comprised of Senior Executives from numerous federal agencies to address the barrage of corporate fraud cases which surfaced after Enron.

As the lead agency dedicated to investigating corporate fraud, the FBI has focused its efforts on cases which involve accounting schemes, self-dealing by corporate executives, and obstruction of justice designed to conceal illegal activities from criminal and regulatory authorities. By utilizing this approach, the FBI is pursuing allegations which parallel the Department of Justice's (the Department) definition of corporate fraud.

Based on the number of cases which emerged in early 2002, the FBI developed an investigative

strategy designed to tackle this crime problem and prosecute the executives engaged in corporate fraud. The actions implemented within the FBI include:

- An Emphasis on Quick Turnaround - Although these cases can be long and document intensive, the FBI assigns seasoned investigators with excellent interpersonal skills to cultivate informants within each company for a roadmap of the fraud.
- Formation of Reserve Teams - Special Agents who are Certified Public Accountants or possess strong business backgrounds are members of a reserve team which supports FBI Field Offices with large corporate fraud investigations. The reserve team members receive temporary duty assignments to assist with witness interviews, search warrants, and review of financial records.
- Telephone Hotline - The FBI opened an 800 line to receive assistance from the public on corporate fraud. Since February 2003, over 1300 calls have been logged. Numerous cases have been initiated from tips provided by private citizens who contacted the hotline. The telephone number for the Corporate Fraud Hotline is 888-622-0117.
- Investigative Partnerships - The FBI formed effective partnerships with the Securities & Exchange Commission (SEC), Department of Labor (DOL), Commodity Futures Trading Commission (CFTC), Federal Energy Regulatory Commission (FERC), Internal Revenue Service (IRS), and U.S. Postal Inspection Service, to pool the investigative resources of agencies with proficiencies in specific arenas (tax, pension, energy, securities).

To date, 142 individuals have been charged with violations related to the Department's definition of corporate fraud. There have been sixty-two convictions, and numerous cases are pending trials.

One of the most disturbing aspects of corporate fraud is illustrated by the cross section of companies which allegedly have been involved in this type of scandal. Over the past year, the FBI has investigated corporate fraud schemes which led to the prosecution of executives at Homestores.com, Imclone, K-Mart, Rite Aid, Qwest, Worldcom, and other well known corporations. Corporate fraud is not unique to any business segment or geographic area. Its effect has touched a variety of industries and millions of shareholders across the United States.

In most of the accounting fraud cases, the purpose of the scheme is to deceive investors and Wall Street analysts about the true financial condition of the company. In carrying out this fraud, the share price of the subject company remains artificially inflated based on fictitious financial performance indicators. Many corporate executives become embroiled in illegal insider trading when their personal stock holdings are liquidated simultaneously with their participation in reporting false information to the public.

In far too many companies, "cooking the books" has become part of the corporate culture. In the case of HealthSouth, employee meetings were held to devise methods in which corporate earnings could be inflated despite the true operating results of the company. These discussions became known as "family" meetings and participants were "family" members. During the meetings, "family" members described their plans to fill the "hole" in order to achieve the desired earnings of corporate executives. The phony accounting entries utilized to fulfill this goal were referred to as "dirt". To date, eleven former HealthSouth employees have been charged criminally for their roles in this scheme.

The accounting fraud investigations, over the past year, have uncovered a variety of recipes utilized by corporate executives to "cook the books" of their companies. Each method is designed to make the company appear more profitable to the outside world. This illicit goal is primarily accomplished by increasing revenues or decreasing expenses. The FBI investigation of Rite Aid revealed that bogus accounting entries were booked continuously between 1997 and 1999 in order to inflate revenues. In the case of Worldcom, corporate expenses were improperly reclassified as assets to make the company appear more lucrative. Overall, FBI investigations have uncovered schemes involving phantom sales, backdated sales contracts, undisclosed side deals, illegal swap transactions, and hidden expenses, designed to deceive regulators and shareholders about the true financial condition of publically-traded companies.

Unfortunately, the number of open corporate fraud investigations has yet to reach a plateau. With several new cases initiated each month, the FBI continues to dedicate its personnel to this crisis in order to prosecute corrupt executives and stabilize the public markets which have been negatively impacted by these scandals. ❖

ABOUT THE AUTHOR

□ **Michael Degnan** has been a Special Agent with the FBI for eleven years and is a Certified Public Accountant licensed in the State of New York. From 1992-1994, he served in the FBI's Washington Field Office and investigated espionage cases involving employees of several U.S. Government agencies. From 1994-2002, he was assigned to the White Collar crime branch of the New York Office where he investigated cases involving securities and commodities fraud. Mr. Degnan is currently a Supervisory Special Agent in the Economic Crimes Unit at FBI Headquarters and oversees the FBI's Corporate Fraud program.✕

'Zero Tolerance' for Corporate Fraud

Copyright 2003, Wall Street Journal. *Reprinted with permission.*

By Larry D. Thompson

Monday, July 21, 2003

A year ago, President Bush created the Corporate Fraud Task Force to oversee a comprehensive law enforcement response to the spate of frauds at major corporations that rocked our markets and damaged investor confidence. Some have argued that certain businesses are simply too big or economically important to be subjected to criminal prosecution, even for pervasive or serious criminal conduct by senior management. I strongly disagree.

It is a bedrock principle of American law that business organizations, including corporations, may be held to account by the criminal law for the wrongdoing of employees or agents. In 1909, the Supreme Court, in the New York Central & Hudson Railroad case, held that "[w]e see no valid objection in law, and every reason in public policy" to extend criminal liability to corporations for the conduct of their employees. Even at the turn of the century the court recognized the economic power of corporations (it noted that the "great majority of business transactions" are conducted through corporations) and that corporations develop cultures that may either instill respect for the law or breed contempt and malfeasance. In the latter instance, the organization itself must be held accountable for the culture and conduct it promotes. Regulatory sanctions are often not sufficient. They can become simply a "cost of doing business" -- a cost that can be passed onto customers and shareholders.

In New York Central, the court also recognized that without corporate criminal liability, there would be no deterrent to a corporate culture that -- expressly or tacitly -- condones criminal conduct. Instead, corporations could merely appoint a "vice president in charge of going to jail" who would serve as a scapegoat for wrongful acts that actually benefitted the corporation.

Corporations should not be treated leniently because of their artificial nature, nor should they be subject to harsher treatment. The Justice Department always takes into account the real

world results of prosecutorial decisions. The department has issued guidance to prosecutors directing them to consider a number of factors before deciding whether to seek an indictment against a corporation. These include the pervasiveness of the wrongdoing in the corporation, the nature and seriousness of the offense, the corporation's history of similar conduct and the collateral consequences of prosecution, including disproportional harm to shareholders and innocent employees. Where companies have fostered a culture of fraud and deceit, however, it is the company and managers who bear the blame for harm to employees and shareholders, not the prosecutors who are merely doing their jobs.

Some have also argued that offering a corporation leniency in return for full and open cooperation with a government investigation is somehow "coercive." I strongly disagree with this notion. While it may not redound to the benefit of corrupt corporate officers, it is always in the corporation's interest to cooperate fully with the government so that matters under investigation can be resolved as quickly and fairly as possible.

The Justice Department has directed its prosecutors to evaluate the authenticity and completeness of cooperation from corporations under investigation. This is important because it allows the government to conserve its limited resources in investigations where cooperation is meaningful and reflects management's commitment to an acceptance of responsibility for the wrongful conduct at issue. The direction was necessary because some attorneys who appear before the department purporting to represent a corporation are in fact representing the interests of management. They have forgotten who their client is. As one learns in a first year corporate law class, when you represent a corporation your client is the entity -- not its management. Disturbingly, a recent survey by the American Corporate Counsel Association revealed that 20% of in-house counsel felt that their corporate culture emphasized "senior management" as the client, rather than the corporation as a whole.

The criminal law sets a standard whose transgression is, and ought to be, swift and decisive. Vigorous criminal enforcement aimed at both bad corporate executives and corporations is not only harmonious with, but also mandatory for, the country's economic vitality. A strong regime

of criminal enforcement leaves honest business people free to compete, while preventing a few bad apples from spoiling the barrel.

Mr. Thompson, Deputy Attorney General, chairs the Corporate Fraud Task Force.

Larry D. Thompson, *'Zero Tolerance' for Corporate Fraud*, WALL ST. J., Jul 21, 2003 at A-10.

New York no longer has dibs on securities fraud

Investigators across the country target white-collar crime

Copyright 2003, USA TODAY. *Reprinted with permission.*

By Greg Farrell

BIRMINGHAM, Ala. -- In a modest office in this laid-back southern city, Alice Martin is changing the way the U.S. government fights corporate crime.

When Martin, the local U.S. Attorney, extracted guilty pleas in March from two former chief financial officers at HealthSouth, she became the first federal prosecutor to enforce a provision of the Sarbanes-Oxley law holding top executives responsible for the earnings statements they issue.

With those guilty pleas, she also joined the wave of federal prosecutors across the USA who, following meltdowns at Enron and WorldCom, have suddenly made white-collar crime of utmost concern. Until recently, most prosecutors left securities fraud cases to experts in New York.

"We have an important role in helping to enforce securities laws and restoring investor confidence in the market," says Martin. "Investors have to know that illegal activity is being caught and stopped."

Corporate fraud has emerged as "one of our top priorities, second only to fighting terrorism," says Jeffrey Collins, the U.S. Attorney in Detroit who's investigating alleged fraud at Kmart.

In 2002, investigations by the Securities and Exchange Commission resulted in 259 criminal filings brought by 30 U.S. Attorneys' offices. "That is an astounding statistic in terms of the number of cases and the breadth of interest among criminal prosecutors," says Stephen Crimmins, a former SEC attorney. "Never before in the history of the SEC has there been such interest by criminal prosecutors."

The shift is partly due to the popular disgust at corporate greed that swelled into public view at Enron. "In the old days, a complex accounting prosecution would make a jury's eyes glaze over, and jurors had no particular hostility toward the defendant," says Jack Coffee of Columbia

University Law School. "Today, they come in suspicious of any corporate officer."

The Bush administration's desire to show it's tough on corporate crime also is driving the transformation of securities fraud from an arcane specialty of New York litigators. Last year, in response to the rash of high-profile scandals, President Bush formed the corporate fraud task force at the Department of Justice. Dismissed at first by critics who thought it would be little more than window dressing, the task force has dramatically altered the way securities fraud cases are handled.

At an unusual conference of U.S. Attorneys last September, Deputy Attorney General Larry Thompson urged all the attendees to ramp up their interest in securities fraud cases, and promised assistance to any U.S. Attorney who needed it. "The reason you are here today is that the entire federal law enforcement community needs to be involved in the task force's efforts against corporate fraud," he told the assembled prosecutors. "Significant corporate fraud matters arise not only in New York and Los Angeles, but in small cities and towns throughout the country."

Those efforts seem to have borne fruit. Notable cases now being handled outside New York:

* HealthSouth in Birmingham. Martin, the U.S. Attorney for the Northern District of Alabama, has gotten 11 guilty pleas so far in the investigation of the \$2.5 billion fraud at HealthSouth. Former CEO Richard Scrushy could be indicted in the next few weeks. In another local case, against defunct shoe company Just for Feet, Martin has secured one guilty plea.

* Kmart in Detroit. Collins is leading the inquiry into alleged financial mismanagement at Kmart. Two former Kmart executives have been indicted.

* Qwest in Denver. U.S. Attorney John Suthers has charged four former managers from Qwest Communications in relation to a criminal probe of accounting problems at the beleaguered telecom.

* Freddie Mac in Alexandria, Va.. U.S. Attorney Paul McNulty has opened an investigation into allegations that the former

president of Freddie Mac destroyed documents that were part of an internal accounting probe. The office is already investigating questionable accounting at AOL Time Warner.

A few years ago, those cases would probably have been handled in New York. Over several decades, federal prosecutors in Manhattan fostered a close working relationship with the SEC to handle nearly all major securities fraud cases. But in recent years, the landscape has changed.

"Orange juice isn't just for breakfast anymore, and securities fraud isn't just for the Southern District of New York anymore, either," says Charles Niemeier of the Public Company Accounting Oversight Board, created by the Sarbanes-Oxley Act to monitor auditing firms. "There's a sea change in the way cases are being investigated and prosecuted."

At the September conference, Thompson arranged for James Comey, the U.S. Attorney for the Southern District of New York, to speak. Comey's message to his fellow U.S. Attorneys was simple: If corporate fraud pops up in your backyard, you'd better move quickly; otherwise, his prosecutors in Manhattan will swoop in. Comey also offered to provide assistance to any colleague who requested it.

In the current wave of scandals, Comey's office had already snagged one of the biggest: WorldCom. It is also investigating allegations of fraud at Adelpia, Vivendi and Royal Ahold. But those cases have garnered a fraction of the attention that has been focused on Comey's obstruction charges against Martha Stewart.

Other New York-area prosecutors are also active in securities fraud cases: Roslynn Maukopf, the U.S. Attorney in Brooklyn, is investigating American Tissue; the U.S. Attorney's office in Newark, N.J., is handling the criminal investigation of financial fraud at Cendant; and Manhattan District Attorney Robert Morgenthau is spearheading the investigation of former Tyco CEO Dennis Kozlowski.

New York street brawls

But it wasn't just Comey's current caseload that served as a warning to the other U.S. Attorneys; it was the long history of the Southern District of New York, particularly under Comey's predecessor, Mary Jo White, for snagging the biggest corporate fraud cases, sometimes after fierce wrangling.

In New York legal circles, stories of White's sharp elbows in pursuit of securities fraud cases

are legend. Occasionally, the brawls between White's prosecutors and their counterparts in Brooklyn or rivals at Morgenthau's D.A. office spilled into public view.

But current and former prosecutors from each of those offices say that there's much more cooperation in New York now. Part of the credit, they say, goes to Comey, who has shown little interest in internecine combat. Part of it also goes to Deputy Attorney General Thompson, who snuffs battles before they begin.

"When there are turf disputes," Comey says, "Larry Thompson settles them." Nevertheless, he adds, "Competition among U.S. Attorneys is healthy. Taxpayers will get better law enforcement if people are working harder to make cases."

Even White -- who joined Debevoise & Plimpton after leaving the U.S. Attorney's office -- applauds the shift. "From an enforcement perspective, you need other offices involved," she says. "Sometimes, it makes more sense to do a case in San Francisco or Pennsylvania, where the headquarters are. I considered that a healthy move, despite my reputation. Given the number of scandals, the proliferation of securities fraud, you've got a lot of volume, and a lot of volume needs experts everywhere."

By the late 1990s, at the height of the Internet boom, San Francisco emerged as an important center of securities fraud prosecutions. The U.S. Attorney's office in Miami formed a securities fraud task force in 2001, almost a year before Enron melted down. Last year, an undercover operation called "Bermuda Short" resulted in the indictment of 58 individuals alleged to be part of a massive Florida stock scam.

Tom Newkirk, an associate director of the SEC's division of enforcement, says the shift away from doing cases in a limited number of jurisdictions kicked into high gear with the establishment of Bush's corporate fraud task force. "It's completely different now," he says. "Things are moving much faster."

If prosecutors in the field need assistance from Washington, they get it. Says Collins, the U.S. Attorney in Detroit: "No one's operating in the dark. If the need arose, we would not hesitate to call on them."

Justice delayed, deferred

Speed is the motivating force behind Thompson's push to get securities fraud cases launched by prosecutors across the nation. The old system of giving the Southern District of New

York major cases threatened to create a backup of prosecutions at a time when corporate fraud was emerging as a hot political topic with Democrats and Republicans alike.

Thompson would not comment for this story, but at last September's conference, he told the prosecutors: "Our goal is simple. We need to hit the bad guys hard and take away their money. When we work together, we can harness the power of the SEC to bring civil actions to freeze assets."

But the push to quickly freeze a target's assets might have contributed to the task force's one major blunder. In March, when Martin secured the first of her guilty pleas in the HealthSouth case, the SEC's Atlanta office filed inside trading charges against Scrusby. A judge granted the SEC's request to freeze Scrusby's assets.

In May, after a hearing to determine if the SEC could maintain a freeze on his assets, U.S. District Judge Inge Johnson ruled in favor of Scrusby. In a blistering opinion, she criticized the SEC's handling of the case, noting that the Justice Department itself was trying to stop the SEC from impinging on its investigation.

If Martin's prosecution of criminal wrongdoing at HealthSouth succeeds, then the asset-freeze setback will be forgotten.

Meanwhile, the national crackdown on corporate fraud raises the question of whether some prosecutors are slacking off on other crimes, such as drug-trafficking and money laundering. That's not happening, says Martin: "Other areas are not suffering. Our attorneys are simply handling bigger caseloads."

To make sure there's enough manpower to prosecute corporate crime, the Justice Department is staffing up. Thompson plans to send 35 new prosecutors and 102 support staff into the field. A source at the Justice Department says the new positions should be filled by the end of the summer.

2002 cases

U.S. Attorneys' district offices that prosecuted securities cases

in 2002 (1):

Arkansas -	Western
California -	Southern Northern Central
Colorado	
Washington, D.C.	
Florida -	Middle Southern
Georgia -	Northern
Illinois -	Northern
Indiana -	Southern
Iowa -	Southern
Louisiana -	Middle
Maryland	
Massachusetts	
Michigan -	Eastern
Minnesota	
North Carolina -	Middle
New York -	Eastern Southern
Ohio -	Northern Southern
Oregon	
Pennsylvania -	Eastern Middle
Texas -	Eastern Northern Western
Utah	
Washington -	Western

1 -- Year runs from Oct. 1, 2001, to Sept. 30, 2002.

Source: Securities and Exchange Commission

Subject : CRIME: FRAUD:
INVESTIGATION: SECURITIES

Artwork : PHOTO, Color, Gary E. Tramontina
for USA TODAY; PHOTO, Color, Paul Sancya,
AP; PHOTO, B/W, David Karp, AP

Slug : USATTORNEYS02

Cutline : In Birmingham, Ala.: Alice Martin,
U.S. Attorney in Birmingham, is leading the
prosecution of HealthSouth, a hospital chain
involved in an accounting scandal. Martin has
obtained 11 guilty pleas so far in the case, which
was opened this year.

In Detroit: U.S. Attorney Jeffrey Collins is
pursuing an investigation of Kmart's financial
situation.

Edition : FINAL

Dateline : BIRMINGHAM, Ala.

Story ID : 5288734

Greg Ferrell, *New York no longer has dibs on
securities fraud*, USA TODAY, Jul 2, 2003 at B.01.

Request for Subscription Update

In an effort to provide the UNITED STATES ATTORNEYS' BULLETIN to all who wish to receive it, we are requesting that you e-mail Nancy Bowman (nancy.bowman@usdoj.gov) with the following information: Name, title, complete address, telephone number, number of copies desired, and e-mail address. If there is more than one person in your office receiving the BULLETIN, we ask that you have one receiving contact and make distribution within your organization. If you do not have access to e-mail, please call 803-576-7659. Your cooperation is appreciated.