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Expanded Criminal Enforcement in the Financial-Services Industry

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Since the economic meltdown began in 2008, the media have waged a relentless attack on the financial industry as the greedy culprit. "So where are all the prosecutions that we were promised?" the white-collar bar has wondered. One answer is that the toxic financial instruments are too complex, and the requisite *mens rea* too elusive, for prosecutors to tell a compelling David v. Goliath story.

Case in point, the Department of Justice (DOJ) and the SEC recently announced they would not prosecute the AIG executives allegedly responsible for nearly bringing down the entire banking system with hundreds of billions of dollars of contingent deferred swaps (read "insurance") written for collateralized debt obligations. Meanwhile, the DOJ took a big hit with the acquittal of two Bear Stearns executives last year in the first trial resulting from the meltdown. The case was premised on a loss of $1.6 billion when funds collapsed that were heavily invested in mortgage-backed securities.

What's to Come

So will there really be an avalanche of prosecutions stemming from the meltdown? According to Attorney General Eric Holder, the answer is a resounding, "Yes." "We will be relentless in our investigation of corporate and financial wrongdoing, and will not hesitate to bring charges, where appropriate, for criminal misconduct on the part of businesses and business executives." We need look no further than the Savings & Loan crisis 20 years ago for a model of what is to come. In 1992, bank failures resulted in criminal charges against 500 individuals involving 71 thrifts — 24% of the entire industry. And this year, the Federal Deposit Insurance Corp. (FDIC) reported that there are 775 problem banks, nearly 10% of the U.S. industry total. By April 2010, the DOJ was investigating 3,029 mortgage fraud cases, up from 881 in 2006, and that number is likely to surge as Congress piles on enforcement dollars.

We all know there's a direct correlation: The more federal agents and lawyers, the more prosecutions. Congress gave a substantial boost to enforcement last year with the Fraud Enforcement and Recovery Act, authorizing more than $500 million for additional fraud enforcement in Fiscal Year 2010 and 2011. The DOJ is riding the wave of scorn against the financial industry with a request for a $62.6-million increase in FY 2010 for 379 new positions to "aggressively pursue mortgage fraud, corporate fraud and other economic crimes." And the 2011 budget request includes an additional $96.8 million for economic fraud, a 23% increase. That allotment will permit U.S. Attorneys to hire 88 new lawyers "to combat numerous White Collar Crimes, especially mortgage fraud, corporate and securities fraud, and financial fraud and public corruption related to the Troubled Asset Relief Program (TARP) and the American Recovery and Reinvestment Act (ARRA) spending."

The SEC is also requesting a 12% increase in enforcement funding for FY 2011, with 55% of its budget earmarked for enforcement. In testimony before the Senate Committee on Appropriations, SEC Chairman Schapiro projected that the increase would enable the SEC to open 130 more formal investigations than in FY 2010, and to file charges in 70 more civil or administrative cases. And perhaps most important, the FDIC staff is up 81% from two years ago as the agency opens satellite offices, rehires retired examiners, and keeps thousands of contract employees on call. Indeed, FDIC enforcement against officers and directors of over 200 failed banks in 2009-2010 may be the leading edge of an explosion of financial-fraud prosecutions.

Coordinating the Resources

Resources are critical, but you also have to have the right tools and an effective game plan. President Obama and Congress have responded to the anti-government, populist sentiment in the electorate with several new weapons aimed at Wall Street and its supposedly greedy, unscrupulous bankers. An Executive Order last November established the Financial Fraud Enforcement Task Force, led by the DOJ and composed of senior officials from Treasury, HUD, the SEC,

the TARP Special Inspector General, FDIC, and 18 additional Cabinet departments and other agencies. The Task Force "will build upon efforts already underway to combat mortgage, securities, and corporate fraud by increasing coordination and fully utilizing the resources and expertise of the government's law enforcement and regulatory apparatus." Robert Khuzami, the Director of the SEC's Division of Enforcement and a former Southern District of New York Assistant U.S. Attorney, echoed this mission recently: "One of the vital aspects of the task force will be to better coordinate criminal and civil enforcement efforts."

We have already seen several examples of the kind of coordination that the Administration envisions for financial prosecutions. The SEC's Abacus complaint against Goldman Sachs filed in April 2010 and settled in July, alleged that the bank failed to disclose to investors that a hedge fund client had selected AAA-rated mortgage-backed securities that were, in fact, populated by toxic subprime mortgages, and that the same hedge fund had made a short investment in the Abacus CDO. Soon after the complaint was filed in April, the media reported that a federal grand jury in Manhattan had also opened an investigation of Goldman. It remains to be seen whether the carefully crafted SEC consent decree in which Goldman acknowledged it had made a "mistake," and could have revealed more information to investors, will forestall the criminal probe.

And in two other recent cases, a Task Force member, the TARP Special Inspector General, worked with federal prosecutors to bring indictments resulting from the misuse of TARP funds. In June, the U.S. Attorney in Alexandria, VA, returned an indictment against the former chairman of Taylor, Bean & Whitaker, which had been one of the largest privately held mortgage lending companies in the country, alleging a $1.9-billion fraud scheme that led to the failure of Colonial Bank.

In another TARP prosecution, in April, prosecutors in Manhattan indicted the former President of Park Avenue Bank for making false statements to regulators in the bank's application for $11 million of TARP funds. In announcing the indictments, the TARP Special Inspector General said: "The charges today send a powerful message to those who tried to steal from the TARP ... you will be tracked down, you will be caught; you will be arrested; and you will be brought to justice."

More Teeth in TARP Prosecutions

Along with its $800 billion authorized for TARP, Congress also put bigger teeth into TARP prosecutions. The Fraud Enforcement and Recovery Act in May 2009 substantially expanded the False Claims Act (FCA) to apply to many claims where federal funds are only indirectly at issue. For instance, any inaccurate certification or representation in obtaining TARP assistance is vulnerable now under the FCA.

Because of the economic meltdown, prosecutions of financial-industry executives may take on the added dimension of "cause prosecutions" brought to right perceived public wrongs. We have seen this picture before in other contexts, and it has not always been a happy ending for the government. For example, the prosecution of the chemical company W.R. Grace and several executives for the alleged contamination of Libby, MT, with asbestos from a local mine ended in across-the-board acquittals in 2009. Despite the government's overwhelming resources and statutory advantages, defense counsel can still find effective strategies to combat "cause prosecutions" in the financial industry, as defense counsel in the Bear Stearns case demonstrated:

- Make aggressive discovery requests to learn whether government regulators were aware of, and condoned, the alleged misconduct; whether the government has received assistance from private parties such as other financial institutions; whether other government agencies like the FDIC, TARP, or the SEC have been involved in the prosecution; and whether the government offered financial inducements or immunity to witnesses in exchange for their testimony against the defendants.
- File comprehensive pretrial motions to open doors to more discovery, pare down the government's case with motions to dismiss, educate the court on the defense theories, establish credibility with the court, and lay the groundwork for evidentiary rulings and instructions.
- Make the financial system understandable, show how it works, demonstrate that gains were not outsized, and offer a compelling and consistent story from opening statement to closing argument to counter the government. Jurors are often unfamiliar with financial instruments, the mechanics of the banking system, and the principles underlying the transfer of risk on which the system is built. They may be predisposed to believe the financial institutions and their executives lined their pockets while customers or investors were left to suffer. The defense must paint a different picture.
- Turn the focus of the case on the government. Demonstrate what the government knew about the challenged activities, and when. Some regulatory agencies now promoting the criminalization of financial activities were responsible for monitoring, examining and regulating the industry when the contested behavior occurred. The government's failure to meet its regulatory obligations may ultimately undermine its own claims of financial crimes.

Conclusion

No doubt, Congress has armed prosecutors with many new weapons to combat financial fraud. With substantial additional resources, the DOJ will attempt to send a strong message to the financial community, not to mention the court of public opinion. Despite the government's decided advantages, however, there remain strong defenses for both institutions and their executives.

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