LJN LAW JOURNAL NEWSLETTERS

Business Crimes Bulletin ®

An incisivemedia publication

Volume 16, Number 8 • April 2009

The Law Enforcement Response to the Financial Crisis

By Mark K. Schonfeld

Last month, the Senate Judiciary Committee held a hearing entitled "The Need for Increased Fraud Enforcement in the Wake of the Economic Downturn." During the hearing, Sen. Patrick J. Leahy (D-VT) said, "I want to see people prosecuted … . Frankly, I want to see them go to jail."

As the financial crisis has deepened, the pressure for prosecutions from politicians, the media and the public has grown. In turn, federal and state law enforcement and regulatory agencies have devoted vast resources to investigating the crisis. Thus far, the number of resulting cases has been limited. A question remains whether law enforcement will ultimately seek to hold individuals or entities legally accountable for such a widespread crisis. In the meantime, in this environment of heightened law enforcement scrutiny and financial volatility, executives at financial firms face particular risks when communicating with investors and making judgments about financial disclosures.

The Investigations

Investigations related to the financial crisis have been a top priority of the SEC and the Department of Justice (DOJ). The SEC has stated that it has over 50 pending investigations, and the FBI says it has 38 criminal corporate fraud investigations related to the financial crisis. It is also likely that additional resources are on the way. President Obama's budget request for fiscal year 2010 seeks a 13% increase in the SEC's budget, and a bill introduced by Sens. Charles Schumer (D-NY) and Richard Shelby (R-AL) would add $110 million annually for enforcement staff.

The investigations have evolved with the crisis and followed developments in the markets. When the financial difficulties of subprime lenders rippled through the markets for mortgage-backed securities, the government initiated investigations into the collapse of those sectors. Investigations focused on the major relevant actors in the creation and sale of mortgage-backed securities and collateralized debt obligations, including subprime lenders, investment banks, broker-dealers, credit rating agencies and insurers. The issues under investigation included whether lenders properly accounted for loans in their portfolios and established appropriate loan loss reserves; whether investment banks conducted appropriate due diligence, accurately disclosed the risks associated with structured products and properly valued instruments held in their portfolios; and whether the credit rating agencies skirted procedures or compromised their ratings.

As the crisis deepened, the financial condition of the major investment banks, saddled with large concentrations of real-estate-related assets, deteriorated substantially. Speculation spread about the ability of the nation's major investment banks to survive as independent companies, and their stock prices declined precipitously. In response, the government initiated investigations into whether the price of financial stocks was being artificially pushed down by short sellers intentionally spreading false rumors or by manipulation of the market for credit default swaps on an issuer's debt.

The government has been unusually public about these investigations, in part to demonstrate that law enforcement is on the case and in part to quell investor fears and limit false rumors. Thus, in September 2008, the SEC announced a "sweeping" investigation of market manipulation, requiring hedge funds and others to disclose, under oath, trading activity in securities of financial institutions and in credit default swaps. Similarly, in October 2008, the U.S. Attorney for the Southern District of New York and New York's Attorney General publicly confirmed a joint investigation of whether traders manipulated the market for credit default swaps to drive down the price of financial stocks.

As financial institutions actually failed or were acquired through government organized transactions, the government commenced investigations into whether disclosures by senior executives of financial institutions were misleading in light of the subsequent demise or acquisition of the company. The press has reported on investigations of senior executives of several major financial institutions relating to their public statements.

New investigations keep coming. As public attention has focused on compensation paid to senior executives of companies receiving funds under the Troubled Asset Relief Program (TARP) and other government assistance, the New York Attorney General has disclosed ongoing investigations into whether such compensation and any related disclosures have violated any laws.

Mark K. Schonfeld is a partner with Gibson, Dunn & Crutcher LLP in New York and Co-Chair of the firm's Securities Enforcement Practice Group. He previously spent 12 years at the SEC, the last four as Director of the SEC's New York Regional Office.

The Emergency Economic Stabilization Act created a Special Inspector General with a broad mandate to investigate and audit the purchase, management and sale of assets under TARP. The Special Inspector General has already sent letters seeking accountings from firms that received TARP funds and has become an active participant in investigations, including New York's investigation of executive compensation. Finally, investigative hearings are being conducted by several Congressional committees.

The Cases

Despite all of the investigative activity, the number of cases to date has been limited.

Perhaps the most prominent criminal case to arise from the financial crisis has been against two hedge fund managers at Bear Stearns. *United States. v. Cioffi and Tannin*, E.D.N.Y No. 08 Cr. 0415 (indictment 6/18/08). The defendants were portfolio managers of two Bear Stearns hedge funds that had invested in collateralized debt obligations and mortgage-backed securities backed by subprime mortgages. The hedge funds collapsed in the summer of 2007 from losses incurred on the mortgage-related investments. The government alleges that, in the months leading up to the collapse, the defendants made misrepresentations to the funds' investors to stave off withdrawals, including overstating the funds' returns, understating the funds' exposure to securities backed by subprime mortgages, and misrepresenting their personal investments in the funds. The indictment and parallel SEC complaint juxtapose the defendants' optimistic statements to investors in conference calls with more negative views they exchanged in company and personal e-mails.

In another case, *United States v. Tzolov and Butler*, E.D.N.Y. No. 08 Cr. 370 (September 2008), the government charged two brokers at Credit Suisse. The indictment and parallel SEC complaint (in the Southern District of New York) allege that the defendants' customers requested to invest in auction rate securities backed by student loans, but that the defendants instead invested the customers' funds in auction rate securities backed by subprime mortgage assets. The customers lost liquidity when the subprime market froze.

In 2007, the DOJ led "Operation Malicious Mortgage," in which more than 400 people were charged with various forms of mortgage-related fraud, including lending fraud, foreclosure rescue schemes, and mortgage-related bankruptcy schemes.

The SEC and several state regulators also reached substantial civil settlements with major broker-dealer firms that sold auction rate securities. The cases have alleged that the firms' brokers did not adequately disclose to investors the liquidity risks. Under the settlements, firms in the aggregate have agreed to redeem investors' holdings of over $60 billion.

The Implications

In recent prior financial scandals, the government was able to target conduct that contributed to the larger crisis. In the accounting fraud scandals of Enron, WorldCom and Adelphia, the government successfully prosecuted executives at the highest level. When the bubble of initial public offerings (IPOs) burst, the SEC and state regulators brought civil cases against many of the nation's largest investment banks relating to analyst research and IPO allocation practices. The investment banks paid $1.6 billion in settlements with the regulators, and most of the money was put in court-supervised funds for distribution to investors.

However, today's crisis is so broad and deep that the government may not be able to show how misconduct of particular individuals at high levels of corporate management contributed to it. Nevertheless, the heightened scrutiny by the government has significant implications for any executive of a public company, financial-services firm or hedge-fund adviser.

First, there is a greater need for caution when formulating disclosures about a company's financial condition and future prospects. It is axiomatic to say that when you speak, you must speak the truth. But deciding what to say is unusually challenging in the current environment where volatility, uncertainty, and market dislocations obscure the value of illiquid assets and make it hard to give guidance on the future.

Second, the difficulty in valuing illiquid assets enhances the importance of maintaining and documenting processes for valuations. It is unlikely that the government will try to make a case simply by second-guessing particular valuations. Rather, the government will be looking for evidence of an intent to achieve fraudulent valuations. Such evidence could include disregarding contemporaneous sales of similar assets at substantially lower values than held, or manipulation of models or valuation processes to achieve a desired result.

Third, it is more important than ever that employees use e-mail appropriately. The *Cioffi and Tannin* case demonstrates once again that e-mail remains one of the best sources of evidence for the government. It is essential that employees understand that e-mail will typically become a permanent record of their communications, and that whatever they write in e-mail will be viewed by the government with the benefit of hindsight. The need has never been greater to ensure that internal communications among executives are consistent with external communications to investors.