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Increased Fraud Penalties Are on the Horizon

By David Debold and Matthew Benjamin

The guidelines governing the sentencing of fraud offenses — long criticized as irrational, unduly severe, and the product of overt political pressure — require wholesale reform. A diverse group of stakeholders, including federal judges, defense lawyers, academics, and even the Department of Justice (DOJ), have implored the U.S. Sentencing Commission (the Commission) to conduct a comprehensive review of the fraud guidelines, memorably derided by Judge Frederick Block as "a black stain on common sense."

In the wake of this uncommon consensus, as well as Congress's directive in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act that the Commission revisit the penalties for financial institution fraud and securities fraud, the Commission has signaled that a comprehensive, multi-year review may finally materialize. In the short-term, however, the Commission's approach is less ambitious. On April 13, 2012, it responded to Congress's Dodd-Frank directive by promulgating more narrow, piecemeal amendments to the guidelines for securities fraud, mortgage fraud and financial institution fraud — a modest course of action that is unlikely to satisfy the fraud guidelines' many critics.

The Amendments

The newly adopted amendments, which will take effect Nov. 1, 2012, unless Congress modifies them through legislation, are likely to stiffen sentences for many defendants convicted of fraud offenses, particularly insider trading. At the same time, the Commission continued its recent trend toward the use of rebuttable presumptions, rather than inflexible rules, in determining certain aspects of offense seriousness. That emerging approach gives criminal defense counsel greater latitude to advocate for sentence calculation methodologies more carefully tailored to each particular case. Finally, the Commission's modest changes to its commentary will give defense counsel new ammunition for seeking below-guidelines sentences, especially in high-loss cases.

Insider Trading: 'Organized Schemes' and Abuse of Trust

The Commission voted to amend the insider trading guideline in two ways. First, it adopted a new minimum offense level of 14 — which equates to a recommended prison range of 15-21 months for defendants with no criminal record and no acceptance of responsibility — for any "organized scheme to engage in insider trading." The Commission amended its commentary to list factors that courts may consider in determining whether an insider trading scheme is "organized"; in other words, whether it involved "considered, calculated, systemic, or repeated efforts to obtain and trade on inside information, as distinguished from fortuitous or opportunistic instances of insider trading." For cases where there is little or no gain from insider trading, this amendment will therefore result in an automatic increase of six offense levels for all participants in the offense. As the profitability of a scheme increases, however, the effect of this new provision diminishes, disappearing entirely when the overall gain from the scheme reaches $30,000. Because this new provision is based on how the scheme operated, rather than the role of a particular defendant in that scheme, it may have the unintended consequence of increasing punishment for the least culpable offenders, particularly in schemes that enjoyed little or no success.

The second change to the insider trading guideline broadens the applicability of the "abuse of trust" enhancement in insider trading cases. Defendants currently receive a two-level enhancement if their abuse of a position of public or private trust significantly facilitated the crime. The pre-amendment version of this provision is not triggered unless the defendant's position was characterized by professional or managerial discretion; in other words, "substantial discretionary judgment that is ordinarily given considerable deference." The amendment will slacken that requirement in the insider trading context, specifying that the enhancement applies "if the defendant's employment in a position that involved regular participation or professional assistance in creating, issuing, buying, selling, or trading securities or commodities was used to facilitate significantly the commission or concealment of the offense." That broader standard includes a hedge fund professional who "regularly participates in securities transactions." Prosecutors can therefore be expected to argue for this sentence increase even when the defendant lacked discretionary trading or investment authority.

Calculation of Loss in Securities Fraud Cases

The Commission also amended the fraud guidelines to add a special rule for determining loss in the typical securities fraud case — one in which misrepresentations or omissions resulted in fraudulent inflation or deflation in the value of publicly traded securities or commodities. The amendment directs use of what has become known as the "modified rescissory method" for determining actual loss: first, calculate the difference between: 1) the average share price during the fraud period; and 2) the average share price during the 90-day period after the fraud was disclosed to the market. Second, multiply the difference by the number of shares outstanding.

In seeking comment on this issue in January 2012, the Commission identified

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four methods used by different federal courts around the country. Some courts employ the market-adjusted method that the U.S. Supreme Court requires in civil cases, in which the plaintiff must exclude from the calculation those changes in share price caused by forces external to the fraud, such as general declines in the market. The reasoning of these courts is that, where a defendant's liberty is at stake, the calculation should be no less reliable than it is in civil cases, where the most the defendant faces is a judgment to pay damages.

Adoption of the "modified rescissory method" threatens to undermine that progress, because it imposes no duty to disaggregate the causes unrelated to a defendant's criminal conduct.

Despite the Commission's adoption of a less exacting methodology, this amendment continues the Commission's recent trend of using rebuttable presumptions rather than one-size-fits-all rules. The new provision directs the court to presume that the modified rescissory method has accurately calculated the actual loss, but a party may rebut that presumption and persuade the court that it is not a "reasonable estimate of the actual loss." The court may consider, "among other factors, the extent to which the amount so determined includes significant changes in value not resulting from the offense (*e.g.*, changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts, conditions, or events)." In last year's amendments, the Commission took a similar approach to calculating losses from health care fraud, directing that the aggregate dollar amount of fraudulent bills submitted to a government health care program "shall constitute *prima facie* evidence of the amount of the intended loss," but adding that this means it is sufficient evidence to establish that amount only "if not rebutted." In each case, a defendant may argue that the "presumptive" approach overstates the seriousness of the harm resulting from his offense.

Mortgage Fraud and Financial Institution Fraud

Another amendment tackles the thorny issue of how to determine the amount of "credit" a defendant should receive for undisposed loan collateral in a mortgage fraud case. First, the guidelines will no longer direct determination of what the collateral is worth at the time of sentencing. Instead, the court is to determine value as of the time of the defendant's plea or guilty verdict. This change eliminates the problem of a moving target, where the probation department must revisit the question of value whenever sentencing is adjourned for an appreciable amount of time. Second, the amended guideline creates another rebuttable presumption; in this instance, it is presumed that the most recent tax assessment value of the collateral is a reasonable estimate of the fair market value. In deciding the appropriateness of the presumption, the court may consider how recent the assessment was and "the extent to which the jurisdiction's tax assessment practices reflect factors not relevant to fair market value." Because the Commission heard testimony at its hearing on March 14 that many jurisdictions base tax assessment value on factors unconnected to fair market value, this presumption may carry little weight in many cases.

The Commission's other change in this area is to broaden the applicability of a four-level enhancement for offenses involving specific types of financial harms, including jeopardizing a financial institution or organization. The Commission amended the instructions to direct courts to consider whether one of the listed harms was likely to result from the offense, but did not result because of federal government intervention "such as a bailout." As Judge Patti B. Saris, Chair of the Commission, noted in announcing the amendments, this reform "ensures that no defendant will receive a reduced penalty because of a … bailout." Given how the new provision is worded, defense counsel will want to argue that "federal government intervention" should be limited to something comparable to a "bailout," as opposed to a broader reading that might encompass successful law enforcement efforts to stop a scheme before it fully plays out.

Potential Departures

Finally, the Commission expanded the provisions in the fraud guidelines that govern when a judge may depart above or below the recommended sentencing guideline range. First, the Commission noted that an upward departure may be warranted if the offense created a risk of substantial loss beyond the loss determined under the guideline, "such as a risk of a significant disruption of a national financial market." Second, the Commission provided new guidance on downward departures, adding the example of a securities fraud where fraudulent misrepresentations inflate the price of a stock in a manner that produces "an aggregate loss amount that is substantial but diffuse, with relatively small loss amounts suffered by a relatively large number of victims." The new language states that, in such cases, the guidelines tables for amount of loss and number of victims may combine to produce an offense level that substantially overstates the seriousness of the offense, thus warranting consideration of a downward departure. This is a small step in the right direction, adding a departure ground to the variance arguments already available in cases like these.

What Does the Future Hold?

Given the long-standing calls for wholesale reform of the fraud guidelines, the Commission's recent actions — some of which actually increase penalties for certain fraud offenses — will satisfy few critics. Fortunately, the Commission appears to recognize this reality. In announcing the amendments, Chair Saris explained that they are merely "the first step in a multi-year review of the fraud guideline" and specifically acknowledged criticisms regarding disproportionate or disparate sentences, "particularly in high-loss fraud cases." And the Commission's proposed priorities for the 2013 amendment cycle, noticed on May 24, 2012, include "a comprehensive, multi-year study of § 2B1.1 and related guidelines, including examination of the loss table and the definition of loss."

Chair Saris's statement and the Commission's proposed priorities give hope that the Commission will soon begin to address the fraud guidelines' more fundamental flaws, in particular their overemphasis on loss and failure to account for significant mitigating factors such as lack of personal gain, less culpable motives, and lesser degrees of intent. That Chair Saris acknowledged the desirability of further work in this area only reinforces the need for courts to continue to assess, on a case-by-case basis, whether a sentence below the recommended range is warranted.