# forensics matters

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**Welcome to the second edition of Forensics Matters. We have introduced a new publication, Expert Matters which will concentrate on trends, cases and issues with the use of expert witnesses, whilst Forensics Matters will provide insights into key trends, events and issues in the fields of forensic accounting & investigations, fraud risk management, E-Discovery and computer forensics. This edition concentrates on two issues; bribery and corruption allegations for companies and secondly, some issues relevant when considering allegations of so-called "churning" of investors' accounts. If you have any questions about these or other forensic issues, please contact us.**

Only four countries - Germany, Norway, Switzerland and the United States - have been serious in their efforts to enforce the OECD Anti-Bribery Convention, according to Transparency International's recent Progress Report on the OECD Anti-Bribery Convention.

Countries that sign up to the OECD Anti-Bribery Convention make a commitment to ban foreign bribery by companies based on their soil, however the remaining 34 signatories to the Convention were found substantially wanting in their enforcement progress. Ten countries were held to be achieving 'moderate' achievement of the Convention commitments, including France, Japan and the United Kingdom. Countries criticised for having next to no enforcement whatsoever included Australia, Brazil, Canada, Ireland and Poland.

No countries have been more active than the United States, with its enforcement under the Foreign Corrupt Practices Act ("FCPA"). The FCPA is by far the leader in enforcement activities, with a significant number of extraordinarily large and unprecedented settlements in recent times for anti-corruption.

Particularly important is that the number and scale of investigations by the US Department of Justice ("DOJ") and the Securities Exchange Commission ("SEC") has been increasing at an almost exponential rate over recent years.

Only time will tell whether other countries in the Convention will improve their enforcement of corruption. For example, the Bribery Act was released earlier this year in the UK (a country of "moderate" achievement of the Convention commitments according to Transparency International). There is some debate, however, over whether it will herald a real and lasting change in the UK's enforcement actions, which have historically been relatively poor, and reached a low point with the cessation of the investigation into British Aerospace. However for the moment we think the more pressing issue, irrespective of the country you are based in, is to consider whether you need to comply with the FCPA given its extraterritorial reach. Many people are aware that the FCPA covers companies that have SEC reporting requirements. However, companies are often unaware of the extraterritorial reach of the FCPA and how foreign or supposedly non-US companies may be caught by simply:

- Having subsidiaries in the US;
- Doing business in US dollars, through the US post, or through computer servers located in the US; or
- Having US staff.

It is clearly more important than ever that companies know whether they must comply with the FCPA and other anti- corruption acts and have a sufficiently robust anti-corruption programme in place, where executives have a full understanding of the consequences of making improper payments or promises.


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# FCPA – are financial institutions next on the chopping block?

There have been an ever increasing number of FCPA investigations with fines over a widening variety of industries. Companies operating in the manufacturing, oil and gas, and telecommunications industries may be excused for feeling particularly targeted. Until the recently reported allegations surrounding Morgan Stanley, no financial institutions ('FIs') have been reported as having violated the FCPA[1]. Even in the Morgan Stanley case, the allegations do not relate to what one would call traditional banking business, but rather, its property investment business in China.

It is reported that Morgan Stanley uncovered actions initiated by an employee based in China that appears to have led Morgan Stanley to have violated the FCPA. The employee allegedly involved was formerly Morgan Stanley's top property deal maker in China and that the activities in question are related to Morgan Stanley's investments in real estate with state-owned entities.

Late last year the U.S. Department of Justice ('DOJ') announced they would be targeting the pharmaceutical industry and have even gone so far as to hire industry experts to assist them with their investigations.

So are FIs going to be the next industry on the chopping block? After one investigation into a company, investigations into competitors in the same industry more often than not follow.

The phenomenon is often fuelled by the perpetrators themselves, explaining their behaviour with comments to investigators such as: '...everyone in our industry does it and if you don't then you can't compete.'

## Current compliance with FCPA

Given the financial services - industry's expansion into jurisdictions where corruption is prevalent, employees in the financial services industry may be tempted to pay bribes to foreign officials to gain business or an advantage. One would therefore expect that the vast majority of the world's leading FIs would publicly disclose their compliance with the FCPA, however, when we surveyed the 'top' global banks revealed only 73 per cent of the banks publicly stated or implied that they complied with the FCPA or an equivalent legislation.

In 2009, however, the Financial Industry Regulatory Authority in the US included FCPA among its examination priorities.

What proportion of those FIs actively practice, monitor and enforce their FCPA compliance is unknown. A recent public survey by Deloitte suggests only 30 per cent of companies actively monitor for FCPA compliance.

For FCPA violations in FIs, some of the high risk areas may include: initial licensing, dealing with ongoing regulatory investigations, entering joint ventures, acquiring subsidiaries and entertaining clients.

An advantage that FIs have over other industries is that they have been subject to stringent anti-money laundering compliance leaving them with systems, databases and skilled personnel adaptable to handling compliance for the FCPA. For instance, identifying politically exposed persons for anti-money laundering compliance can also be applied for identifying foreign officials under the FCPA.

## Lessons learned from prior cases

Siemens is the largest and most high-profile corruption matter since the FCPA was enacted in 1977. The fines are in excess of SG$1 billion. Best practice for FCPA compliance has been accumulatively built on lessons learnt from prior cases and some of the highlights include, amongst others:

1. The CEO must empower those responsible for FCPA compliance within the organisation as well as promote awareness of FCPA compliance;
2. There must be policies on certain types of payment including facilitation payments, gifts, travel and entertaining expenses;
3. Ensuring all staff, management, business partners and agents of the organisations have the opportunity to report violations without fear of retribution;
4. Relevant robust internal controls that are constantly monitored and are tested regularly;
5. Continual training to ensure all staff, management, business partners and agents of the organisations are aware of their responsibilities;
6. Compliance and operations key performance indicators are driven by adhering to non-violation and not solely driven to achieving sales targets;
7. Provide disciplinary guidelines for breaches;
8. A committee to review and record actions relating to the retention of foreign agents and all contracts and payments to foreign agents;

9. Conduct regular reviews of FCPA compliance using:
   - data analytics on electronic information to highlight potential violation ‘red flags’;
   - web based surveys to regularly survey staff, management, business partners and agents of their understanding of the FCPA, compliance with it and giving them an opportunity of reporting any violations; and
   - review electronic communications for key words likely to be ‘red flags’ of possible violations;
10. Exercise due care to ensure that discretionary authority is not delegated to individuals known to have a propensity for engaging in illegal or improper activities by ensuring employee background checking is undertaken; and
11. Agreements and contracts with foreign agent provisions that cite anti-corruption representations and undertakings require compliance and set up internal and independent audits.

Obviously the size of the organisation will determine to what level the lessons above are introduced. The trend is for companies to apply these recommendations in varying degrees based of the risk of violation in the different jurisdictions and business in which they operate and for the different departments within the organisation.

How effective FIs are in complying with the FCPA depends on FI regulators as well as the tone set at the top by its CEOs. CEOs need to be committed to enforcing FCPA compliance and to actively advertise through modelling behaviour rather than words alone.

### Current investigations

Something which might focus FI executives’ attention is the DOJ indictments in January this year which heralded its ‘largest single investigation and prosecution against individuals in the history of DOJ’s enforcement of the FCPA[2]’. The DOJ obtained the evidence necessary for the indictments through covert investigations rather than the usual self-reporting of regulated entities that have characterised the typical FCPA investigations to date.

Breuer[3] from the DOJ stated; ‘the message is that we are going to bring all the innovation of our organised crime and drug war cases to the fight against white-collar criminals[4].’

As a result, companies and executives should be aware that their dealings with foreign officials will be under ever increasing scrutiny from the DOJ and SEC, which may include surreptitious recording and undercover operations in an effort to detect FCPA breaches. **END**

## Detecting improper activity in investment accounts:

**Since the financial crisis, most financial products have lost value and a number of investors have seen their investment portfolio nearly wiped out. For those who had margin-trading accounts, the wake-up-call was even worse. Were such investments wiped out only as a result of the financial crisis and client’s own investment decisions or had the account been excessively traded and mismanaged by the broker or the bank?**

A growing number of customers of financial institutions have come knocking on the door of their lawyers or advisors for an answer to that question. Lawyers and financial industry experts have assisted their clients in establishing whether their investment account had been mismanaged – usually referred to as “account churning”.

### What is Churning?

Churning refers to the excessive buying and selling of financial products in the customer’s account by a broker or banker, for the purpose of generating commissions, fees and/or bonuses and without regard to the client’s investment objectives.

To prove churning occurred in an account, three elements must be shown:

- First, the broker or banker had control over the account. Under a Discretionary Mandate (whereby all investment decisions are made by the bank or broker based on the investment objectives and risk appetite of the client as defined at the outset of the relationship), the bank or broker has control over the account because the client has authorised the bank or broker to trade without first consulting him or her and the bank or broker makes the investment decisions.

  The client receives a portfolio statement on a regular basis – usually monthly. De facto control can be established in managed accounts (also referred to as execution-only accounts or advisory accounts), mainly when it can be shown that a client routinely followed the banker’s or broker’s advice on most transactions.

- Second, there is “scienter”[5] from the banker or broker due to their intentionally engaging in excessive trading in order to generate increased commissions and/or bonuses for his or her own benefit, disregarding the client’s best interest. If close to year end a client has sold financial products with high fees towards year end (such as life insurance products), this can be an indication of the banker or trying to meet revenue targets and therefore secure a higher bonus from his company.
- Third, excessive trading occurred, i.e. transactions in the account are excessive in cost, size or frequency in view of the client’s risk profile and investment objectives as defined at the inception of the banking relationship.

The first two elements in establishing churning – control and scienter – are best answered by a lawyer but the third element – determining whether excessive trading occurred – will usually require the involvement of an expert accountant or financial industry expert.

## How to identify excessive trading

Excessive trading is usually determined by looking at:

- The annualised turnover ratio which measures the number of times the account is traded in a year. The turnover rate is calculated by dividing the total cost of purchases in the account by the average monthly equity.
- In existing case law from the U.S., it has been generally recognised that for a conservative investor:
  - an annual turnover ratio of 2 times *infers* churning;
  - a turnover ratio of 4 *presumes* churning; and
  - while 6 times is *conclusive* of churning. This is also referred to as the 2-4-6 Rule.
- In determining whether the turnover ratio is excessive, it will also be relevant for the expert to compare the turnover ratio to those of mutual funds with similar investment objectives.
- The cost-to-equity ratio, which looks at the annual cost associated with operating the account, commissions, fees charged, margin interests, etc. The cost-to-equity ratio is a measure of the amount an account must appreciate on an annual basis to cover costs. For example if the cost to equity ratio is 10 per centre, then the account needs to return 10 per cent annually simply to cover the costs associated with the account.
- In general, costs in excess of 5 per cent should be seriously questioned. In looking at the reasonableness of the cost-to-equity ratio, the expert may also look at industry benchmarks such as costs charged by mutual funds with similar investment objectives.
- Lastly, the expert will look at the number of trades in the account, the level of in-and-out trading and whether the holding periods are usually short.

Churning constitutes fraud, and in the U.S. is a violation of state and federal securities laws .

One must remember that all it takes for an individual to commit fraud is:

1. an opportunity (in this case, this means having control over a client’s account);
2. pressure (lower compensation for the broker or financial adviser due to the financial crisis – or pressure to meet sales targets that are tougher to achieve in times of financial crisis); and
3. rationalisation (the broker or financial advisor may rationalise his or her act by thinking that “I am increasing the trades not to generate commissions for myself but mainly because I think my client will earn more in the long term”).

## The effect of the Financial Crisis

While the economy was thriving, a number of customers were not scrutinising the activity in their investment account as overall their portfolio was growing. When portfolios were hit by the financial crisis and clients noticed that the bottom line of their investment statement showed a decline in investment value, many more clients  started scrutinising their accounts, but filing a claim for churning is not an easy battle.

## Quantifying Damages

Once churning has been established it is then time to quantify damages. Damages are usually quantified by looking at a “benchmark portfolio”, i.e., what would the client’s equity would have been had the account been appropriately managed. Typically a benchmark portfolio would be a mutual fund in which the client could have invested in, and should be in line with the client’s investment objectives. **END**

**Note:** A version of this article was first published in the *2010 Litigation, Arbitration and Dispute Resolution Digital Guide* published by Executive view Media Limited. The digital guide is also available for download at: http://www.executiveview.com/digital_guides.php?id=52.

**Footnotes:**

1 BNP Paribas was accused of breach of duty and promoting bribery in terms of their role in the United Nation Oil for Food Programme.
2 Department of Justice Press Release dated January 19, 2010.
3 Lanny A. Breuer is head the Criminal Division of the Department of Justice.
4 New York Times dated January 20, 2010.
5 Knowledge and intent.

# Meet the Team

In each edition we will provide a short paragraph to introduce key members of our Forensics team:

**Nigel Carson**
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Nigel is responsible for the management and delivery of Forensic Technology services, including computer forensics and e-discovery, for KordaMentha in Australia and the Asia-Pacific. He has over 10 years computer forensic investigative experience forged in the Computer Based Evidence Section of the NSW Police Special Technical Investigations Branch.

Nigel has played a key role in many notable cases including: Universal Music v Sharman - Landmark music piracy case in relation to Internet peer-to-peer file sharing (Kazaa) , Woolworths v Olson - Watershed intellectual property (IP) decision in relation to an employee moving to competitive business , Universal Music v Cooper - Landmark decision against an Internet Service Provider (ISP) for copyright infringement , Foxtel v The Mod Shop – Investigation into unauthorised programming and sharing of Pay TV smartcards, Movie Industry v RipIt4Me – Prosecution in relation to ripping of copy protected DVDs, Village Roadshow v iiNet - Landmark case against an ISP for copyright infringement via BitTorrent and Akai v Ernst & Young – Investigation into falsified audit documents in relation to a billion dollar damages claim following one of Hong Kong's largest corporate collapses.

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Abigail is the Head of the KordaMentha Forensic practice in Singapore. She is a Chartered Accountant with over 19 years experience in Asia, Australia, USA, Europe and the Middle East. Previously, Abigail was the Lead Director of Forensic at Deloitte, Singapore; Head of Forensic Accounting for Asia Pacific, Ernst & Young; and Director of ComplianceAsia.

Her experience includes: Conducting FCPA reviews and investigations, conducting forensic accounting analysis, conducting fraud investigations, conducting fraud risk mitigation reviews, asset-tracing and recovery as well as integrity due diligence, conducting financial misstatement reviews, securing and analysing data in accordance with evidentiary requirements in various jurisdictions, interviewing and recording of statements from witnesses and persons of interests, providing hotline consulting and training.

Her most notable engagements include: FCPA investigation and reviews throughout Asia; Training the investigators on the Oil for Food Program; Drafting the fraud risk review for the Iraqi Debt Reconciliation; Project managing the World Bank - anti-corruption, review on infrastructure projects in Indonesia; Investigating and recovering 40 per cent of a US$265 million fraud; Investigating financial misstatement caused by a rogue oil trader for almost US$80 million.

Whatever the factual, accounting, financial or e-discovery issues that arise, KordaMentha Forensics' expertise and experience can bring clear thinking, objectivity and effective communication of ideas to help find the facts, understand the relevant issues and clarify the financial and other impacts in a cost-effective way.

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