Combating Fraud in the Caribbean Region: Lessons from Recent Events

John H. Walsh[*]

On November 26, 2010, I had the opportunity to meet with the Caribbean Group of Securities Regulators ("CGSR") during its 7th Annual Conference[1] and speak about combating fraud and lessons learned from recent events. Following the meeting, representatives of the host, Financial Services Commission of Jamaica, requested a written version of my remarks in a format suitable for wider distribution. I would like to express my sincere appreciation to the CGSR and the Financial Services Commission of Jamaica for the opportunity to meet and speak with them about important matters of mutual interest.

Introduction

Nothing is more damaging to a healthy financial sector or more opposed to economic growth and prosperity than fraud. All securities regulators must focus on fraud. Fraud is the enemy of every investor, market, and securities regulator.

Fraud is not new. It is a long-standing problem that requires constant vigilance. While fraud is not new, recent frauds have dramatically

---

[*] John H. Walsh was Associate Director and Chief Counsel in the Office of Compliance Inspections and Examinations of the United States Securities and Exchange Commission ("SEC") but recently left the agency to join Sutherland Asbill & Brennan LLP. The SEC, as a matter of policy, disclaims responsibility for any private publication or statement by any of its former employees. The views expressed herein are those of the author and do not necessarily reflect the views of the SEC or of the author's former colleagues upon the staff of the SEC.

This article is for informational purposes and is not intended to constitute legal advice. The views expressed by the author are the author's alone, and do not necessarily represent the views of Sutherland Asbill & Brennan LLP or our clients.

1 The CGSR is composed of: Barbados Securities Commission; The Bermuda Monetary Authority; Central Bank of Belize; British Virgin Islands Financial Services Commission; Cayman Islands Monetary Authority; Eastern Caribbean Securities Regulatory Commission; Financial Services Commission of Jamaica; Guyana Securities Council; The Securities Commission of the Bahamas; Trinidad and Tobago Securities and Exchange Commission; and Turks and Caicos Islands Financial Services Commission. *See What is the CGSR*, CARIBBEAN GROUP OF SEC. REGULATORS, www.caribsec.org (last visited Sept. 11, 2011).

raised the stakes for securities regulators. Over the last few years financial frauds of extraordinary scale have been alleged, including several that involve the Caribbean Region. This article will focus on the lessons taught by recent events. Part I of this article will outline historical background and types of fraud to provide context to contemporary fraud activities. Part II will address ongoing fraud cases and their impact on securities regulators. Part III posits that securities regulators must be ready to change significantly to enhance their anti-fraud programs and identifies ten lessons that have been taught by recent events.

I. Regulators Must Never Relax Their Vigilance Against Fraud

Fraud is a centuries old issue. In fact, the first Encyclopedia Britannica, published in 1771, provides an excellent working definition of fraud. "Fraud, in law, signifies deceit in grants, or conveyances of lands, [etc.] or in bargains and sales of goods, [etc.] to the damage of another person."[2]

Moreover, efforts to combat fraud have a long history. Organized government has battled against fraud for thousands of years. For example, 3,700 years ago, at the dawn of human civilization King Hammurabi of Babylon set forth a code of laws[3] that included a law about fraud. Law 265 stated that if someone to whom property has been entrusted engages in fraud and makes false returns, then he shall be convicted and pay the victim ten-times the loss.[4]

Despite being an age-old problem, fraud is highly adaptable to new conditions. For example, the Internet recently revolutionized

---

2 ENCYCLOPÆDIA BRITANNICA 631 (William Smellie ed., 1st ed. 1771), *available at* http://books.google.com/ebooks?id=xnW408_9_SMC&num=10.

3 Hammurabi's Code is dated to approximately 1,755 BCE. *See generally* DOMINIQUE CHARPIN, WRITING, LAW, AND KINGSHIP IN OLD BABYLONIAN MESOPOTAMIA, 71-82 (2010) (noting that while Hammurabi drew on earlier collections, his code seems to have enjoyed a special status in Babylonian culture, both because of its diffusion through monumental stelas (slabs), and also because it seems to have acquired the status of a cultural classic even though we do not possess any quotations from the Code in ancient legal documents).

4 Law 265 reads, "If a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss." *EAWC Anthology: Hammurabi's Code of Laws*, U. EVANSVILLE, http://eawc.evansville.edu/anthology/hammurabi.htm (last visited Sept. 25, 2011).

communications, but as people began to use the Internet, so did fraudsters.[5] Remarkably, although the technology was novel, the frauds were not, leading commentators to note that Internet fraud was an "old trick" in a "new medium."[6]

Today, society is going through yet another transformation in its communication technologies. Social media like Facebook and Twitter have taken a prominent place in the social dialogue. Just as with the Internet, the fraudsters have taken advantage of new opportunities. The U.S. Securities and Exchange Commission ("SEC") is starting to bring fraud cases involving social media, such as the Carol McKeon case below.

While frauds perpetrated on new social media can be the same old tricks, these cases can also present novel elements. For instance, in June 2010 the SEC brought an emergency enforcement action against Carol McKeon and various related entities and individuals.[7] The SEC alleged that the defendants had touted various stocks through Facebook, Twitter, email, text messages, and on a web site. The defendants did not disclose that at the same time they were actively selling these stocks.[8] This is the old-fashioned fraud known as "scalping," where fraudsters profit from the upward movement in price created by their own promotions.[9] However, two elements in this case were novel. First, the fraudsters used state-of-the-art social media to communicate with their victims. Second, the SEC and securities regulators in Quebec worked together across international

5 For example, the Better Business Bureau has reported that there are approximately 23,000 videos on YouTube, a popular Internet site, that appear to be fraudulent schemes. *BBB Warns Cash Gifting Pyramid Schemes Flourishing Online*, BETTER BUS. BUREAU (May 17, 2010), www.bbb.org/us/article/bbb-warns-cash-gifting-pyramid-schemes-flourishing-online-9865.

6 Brendon Fowler, Cara Franklin & Robert Hyde, *Cybercrime: Internet Securities Fraud: Old Trick, New Medium*, 2001 DUKE L. & TECH. REV. 0006, *available at* http://www.law.duke.edu/journals/dltr/articles/2001dltr0006.html.

7 SEC v. McKeown, Litigation Release No. 21580, 2010 WL 2589811 (June 23, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21580.htm.

8 *Id.*

9 For a discussion of scalping, see SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

boundaries to investigate and prosecute the case.[10]

The facts and circumstances differ from fraud to fraud across time, but certain underlying themes appear again and again. As a result, it is useful to review some of the types of frauds that regularly appear and require regulators' constant vigilance.

First, fraudsters often try to act as if they are legitimate, regulated businesses.[11] For example, in the Caribbean Region, at least one questionable operation has used a formal business location, as well as facilities and structures similar to those in the formal financial sector.[12] Alternatively, in the U.S. securities market, there has been a problem with fraudsters selling "Prime Bank Notes." [13] Investors are told these notes are available only to major financial institutions and they pay tremendous rates of return with no risk.[14] In the recent SEC case against Elite Resources LLC, victims were told that if they paid a fee of more than $200,000, they would be allowed to participate in a "Top 25 Bank" guarantee program that would give them access to $100 million in credit that they would not have to repay. [15] Unfortunately, as the SEC noted, such investments do not exist.[16]

10 Litigation Release No. 21580, *supra* note 7. Hopefully, this type of international cooperation will be as widespread in the future as new communication technologies. *See infra* pp. 22-23.

11 For examples of the steps fraudsters may take to try to give authenticity to their lies, see *Fake Seals and Phony Numbers: How Fraudsters Try to Look Legit*, U.S. SEC. & EXCH. COMM'N (Dec. 2, 2009), www.sec.gov/investor/pubs/fakeseals.htm (last visited Oct. 16, 2011).

12 This problem is discussed in Claremont Kirton, *Informal Financial Activity in Jamaica: A Preliminary Analysis of the Recent Experiences with Pyramid Schemes*, *in* THE CARIBBEAN ECONOMY: A READER 464, 470 (Dennis Pantin, ed., 2005).

13 *See How Prime Bank Frauds Work*, U.S. SEC. & EXCH. COMM'N (Jun. 12, 2009), www.sec.gov/divisions/enforce/primebank/howtheywork.shtml (last visited Oct. 16, 2011).

14 *Id.*

15 Complaint For Injunctive Relief at 2, 6, SEC v. Elite Resources, LLC, No. 1:10-cv-3522-CAP (N.D. Ga. Oct. 29, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21713.pdf.

16 *Id.* at 2.

Second, pyramid scheme fraud is a constant menace. The hallmark of a pyramid scheme is "the promise of sky-high returns in a short period of time for doing nothing other than handing over your money and getting others to do the same."[17] In the Caribbean Region, several recent pyramid schemes have exploited a traditional form of mutual self-help known as "partnering."[18] U.S. securities markets confront similar problems. In a recent SEC case, respondent James H. Park claimed to be operating a multi-level marketing company selling English and Spanish language tutorial DVDs through a network of associates around the world,[19] that particularly preyed on communities in Puerto Rico and Florida.[20] New sales associates would make an investment in the DVDs and then recruit other sales associates to do the same thing, thereby profiting from recruiting new associates. Indeed, Park claimed that once they made an investment, associates would receive a lifetime of passive income with no further effort on their part. Unfortunately, as noted in the SEC's complaint, pyramid schemes are destined to collapse.[21]

Third, regulators must be vigilant for Ponzi schemes. These schemes are named after Charles Ponzi, a fraudster of the early Twentieth Century.[22] In a Ponzi scheme, new investor's money is used to make payments to earlier investors.[23] The Association of Certified Fraud Examiners has effectively described this fraud: "A simple investment scam rakes in as much money as possible and then disappears. A Ponzi stays in

---

17 *Pyramid Schemes*, U.S. SEC. & EXCH. COMM'N (Feb. 25, 2009), www.sec.gov/answers/pyramid.htm (last visited Oct. 16, 2011).

18 *See* Kirton, *supra* note 12, at 467-68.

19 Park, Securities Exchange Act Release No. 61816, 98 SEC Docket 397 (Mar. 31, 2010).

20 *See also* SEC v. Lane, Litigation Release No. 20393, 2007 WL 4320753 (Dec. 11, 2007), *available at http://www.sec.gov/litigation/litreleases/2007/lr20393.htm* (further describing the scheme).

21 Complaint for Injunctive and Other Relief at 1-4, SEC v. Park, No. 6:09-cv-01137-PCF-GJ (M.D. Fla. July 1, 2009), *available at* http://sec.gov/litigation/complaints/2009/comp21115.pdf.

22 *See "Ponzi Shemes": How Did Ponzi Schemes Get Their Name?*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/ponzi.htm#PonziName (last visited Sept. 25, 2011).

23 *See "Ponzi Shemes": What is a Ponzi Scheme?*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/ponzi.htm#PonziWhatIs (last visited Sept. 25, 2011).

business by turning some of the money back into the game."[24] Through this practice, some Ponzi schemes have been able to stay in business for years.[25]

The variety of possible Ponzi schemes is limited only by the human imagination. The Caribbean Region, as discussed in the next section of this article, has witnessed several alleged Ponzi Schemes. Similarly, in recent months the SEC has brought cases against Ponzi schemes in which investors allegedly thought they were participating in a program for trading diamonds,[26] investing in real estate construction[27] and oil ventures,[28] loans to doctors,[29] or a day trading system,[30] to name a few.

Finally, offering frauds are another continuing threat. Offering frauds depend on spreading false information about the financial product being sold.[31] For example, the Pension Fund of America, an enterprise including both U.S. and Cayman Islands entities, used a network of agents to sell millions of dollars worth of "retirement trust plans" to thousands of investors in Central and South America.[32] The Pension Fund assured prospective clients that their investment would be safe because large and well-established U.S. banks would serve as "trustees." Unfortunately, in reality up to 90% of the invested funds were used to pay exorbitant

---

24 ASS'N OF CERTIFIED FRAUD EXAMINERS, FRAUD EXAMINERS MANUAL 1.1730 (2010).

25 *Id.*

26 SEC v. Dalton, Litigation Release No. 21747, 2010 WL 4648478 (Nov. 17, 2010), *available at* http://sec.gov/litigation/litreleases/2010/lr21747.htm.

27 SEC v. Anderson, Litigation Release No. 21688, 2010 WL 3939799 (Oct. 7, 2010), *available at* http://sec.gov/litigation/litreleases/2010/lr21688.htm.

28 SEC v. Zada, Litigation Release No. 21737, 2010 WL 4493476 (Nov.10, 2010), *available at* http://sec.gov/litigation/litreleases/2010/lr21737.htm.

29 Systematic Fin. Assocs., Inc., Investment Advisers Act Release No. 3093, 2010 WL 3791953 (Sept. 29, 2010), *available at* http://sec.gov/litigation/admin/2010/ia-3093.pdf.

30 SEC v. CJ's Fin., Litigation Release No. 21619, 2010 WL 3071384 (Aug. 6, 2010), *available at* http://sec.gov/litigation/litreleases/2010/lr21619.htm.

31 For a discussion of some of the techniques used to spread false information about an offering, see *Microcap Stock: A Guide for Investors, What's So Important About Public Information*, U.S. SEC. & EXCH. COMM'N (Jun. 27, 2011), www.sec.gov/investor/pubs/microcapstock.htm (last visited Oct. 16, 2011).

32 SEC v. Pension Fund of Am., Litigation Release No. 19161, 2005 WL 724635 (Mar. 30, 2005), *available at* http://sec.gov/litigation/litreleases/lr19161.htm.

commissions, an "administrative fee," and other costs. In addition, insiders at the firm misappropriated millions of dollars for themselves.[33]

Importantly, the *Pension Fund* case also illustrates another important point about fraud: the risk of collateral damage to otherwise legitimate financial institutions. In this case, the Pension Fund's offering fraud ended up ensnaring a global financial services firm. The SEC sanctioned HSBC USA because it had served as trustee.[34] The SEC stated that HSBC had allowed the Pension Fund to: (1) use HSBC's name and logo in the offering materials; (2) use marketing materials that falsely suggested that the trust plans had been co-developed by HSBC; and (3) claim that investors' money would be "totally safe" because it would be deposited into a trust account at HSBC, when the funds were actually deposited into an ordinary checking account for the Pension Fund.[35] The SEC also noted that HSBC had received warning of problems with the Pension Fund.[36]

In the face of these ongoing frauds, a regulator could wonder what the purpose of combating fraud and remaining vigilant might be. If fraud will always be present, with a constant stream of fake products, pyramid schemes, Ponzi schemes, and offering frauds, what is the value of regulators' vigilance? The answer is not simply moral, although the moral harm done to markets by fraud is receiving new attention.[37] Rather, the answer also implicates pragmatic economic policy. Having a vigorous enforcement program is a critical element in lowering the cost of capital. Academic research has demonstrated that there is a correlation between markets with active enforcement programs and markets with lower costs of capital.[38]

---

33 *Id*.

34 HSBC Bank USA, N.A., Securities Act Release No. 8844, 91 SEC Docket 1522 (Sept. 19, 2007), *available at* http://sec.gov/litigation/admin/2007/33-8844.pdf.

35 *Id.*

36 *Id.* at ¶ 20.

37 For an excellent synopsis of the new focus on "moral markets," see e.g., Ronald J. Colombo, *Exposing the Myth of Homo Economicus*, 32 HARV. J.L. & PUB. POL'Y 737 (2009).

38 Perhaps the best-known expression of this work is found in John Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007). *See also* Ziven Scott Birdwell, *The Key Elements for Developing a Securities Market to Drive Economic*

No one can promise a fraud-free market. However, by being vigilant for fraud and punishing it severely when it is found, regulators help keep fraud in check, giving investors more confidence. The more regulators enforce, the more confidence investors have and the lower the price they will demand to invest. Working to lower the cost of capital and to support our respective economies' growth and prosperity is an important mission for all securities regulators, especially in light of recent events.

II. Recent Events Have Raised the Stakes

Fraud will always be present; thus, regulators must always be vigilant. However, in recent years the growth in fraud's scale is a new development of great consequence. In particular, three frauds of extraordinary scale have been alleged that warrant note.

The first of these frauds is the Bernard Madoff scandal. In December 2008, the SEC sued Madoff for securities fraud, alleging he had conducted a Ponzi scheme into which billions of dollars had been deposited over many years.[39] The SEC's complaint against one of Madoff's associates described the scheme:

> For decades, Madoff and others orchestrated a massive Ponzi scheme . . . [in which] Madoff solicited funds from direct investors and feeder funds by promising to invest those funds in equity securities and hedge the related downside risk, and thereby make certain rates of return. . . . In fact, however . . . Madoff [did not invest] . . . these funds in the manner described. Instead, Madoff directed that investor funds be kept in highly liquid form, including cash, certificates of deposit, and treasury bills. A large portion of these funds were used to pay investor redemption requests and to line Madoff's pockets and the pockets of those around him.[40]

Madoff was also charged with federal criminal violations arising from his scheme. In March 2009, he pled guilty and was sentenced to 150

Growth: A Roadmap for Emerging Markets, 39 GA. J. INT'L & COMP. L. (2011) (providing an excellent discussion of this work in the context of market development).

39 Complaint at 4-5, SEC v. Bonventre, No. 10-cv-1576 (S.D.N.Y. Feb. 25, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21424.pdf.

40 *Id.* at 6.

years in prison. Related proceedings continue.[41] As recently as November 18, 2010, the SEC sued more of his associates.[42]

The second recent mass-scale alleged fraud is the Robert Allen Stanford scandal. The SEC filed a complaint against Stanford and Stanford International Bank ("SIB") alleging a large-scale Ponzi scheme from the sale of SIB Certificates of Deposit ("CDs") totaling over $7.2 billion by the end of 2008.[43] SIB promoted its safety, security, and high rates of return on investments and CDs that surpassed U.S. commercial bank rates. Stanford allegedly misappropriated billions of investor dollars and invested in speculative businesses controlled by Stanford. Stanford allegedly lied to investors and invented the investment portfolio's performance to hide its fraudulent activities. The SEC alleged that Stanford made principal redemption and interest payments from these CD sales instead of earnings.[44]

In June 2009, federal criminal authorities indicted Stanford and certain SIB employees, and he was ordered detained in jail pending his criminal trial.[45] The proceedings against Stanford continue.

In addition to the allegations against Stanford and SIB, the SEC has alleged that Stanford bribed regulatory officials to sustain the Ponzi scheme. The SEC alleges that Stanford:

> bought Leroy King, the CEO of Antigua's Financial Services Regulatory Commission ["FSRC"], who accepted thousands of dollars of Stanford bribes per month to ignore

41 *Id.* at 4-5.

42 Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Two Longtime Madoff Employees with Fraud (Nov. 18, 2010), http://www.sec.gov/news/press/2010/2010-225.htm (last visited Oct. 16, 2011).

43 *Oversight of the SEC Inspector General's Report on the "Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme" and Improving SEC Performance Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. (2010) (statement of Robert Khuzami, Director, SEC Division of Enforcement, & Carlo di Florio, Director, U.S. Sec. and Exch. Comm'n Office of Compliance Inspections and Examinations), *available at* http://www.sec.gov/news/testimony/2010/ts092210rk-cd.htm.

44 *Id.*

45 *Id.*

> Stanford's Ponzi scheme. Accordingly to [the SEC's] complaint, King showed Stanford the SEC letters to the FSRC seeking information about Stanford's operations. He even permitted Stanford and his lawyers to draft the FSRC's responses back to the SEC containing false assurances that Stanford's Antiguan operations were in compliance with the law. [46]

The Director of the SEC's Division of Enforcement, an experienced prosecutor, said that this was "one of the more disturbing aspects of any case" he has ever seen.[47]

The third example of recent high-stakes fraud is David Smith's currency trading scandal. On August 18, 2010, federal criminal authorities charged Smith for fraudulent activity related to the Overseas Lockett International Corporation.[48] Smith promised to use investors' funds to engage in foreign currency trading and claimed investors could expect a high rate of return with only 20% of their investment at risk.[49] However, instead of engaging in the trading, he reportedly misappropriated clients' funds, transferring the funds to his private bank accounts and using them to furnish a lavish and expensive life style.[50] Moreover, the criminal charges allege that Smith employed numerous employees and created client account statements showing large and false monthly returns.[51] Smith raised over $220 million from thousands of investors in Florida, Jamaica, and the Turks and Caicos Islands. [52] Smith has pled guilty and been sentenced to prison in

46 Robert Khuzami, Director, Div. of Enforcement, U.S. Sec. and Exch. Comm'n, Remarks before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), http://www.sec.gov/news/speech/2009/spch080509rk.htm (last visited Oct. 16, 2011).

47 *Id.*

48 Information at 1-7, United States v. Smith, No. 6:10-cr-00232-MSS-DAB (M.D. Fla. Aug. 18, 2010).

49 *Id.* at 4.

50 *Id.* at 6.

51 *Id.* at 7.

52 *Update: International Forex Ponzi Swindler David A. Smith Sentenced To 30 Years In U.S. Jail*, PATRICKPRETTY.COM (Aug. 15, 2011, 7:27 PM), http://www.patrickpretty.com/2011/08/15/update-international-forex-ponzi-swindler-david-a-smith-senetenced.

the U.S. and Turks and Caicos Islands.[53]

Several important points arise from the expansive nature and consequences of these on-going proceedings. First, the scale of these allegations is quite extraordinary considering the amounts raised, the number of investors, and the operations' duration. These allegations are measured in millions or even billions of U.S. dollars, thousands of investors, and time spans possibly of decades.[54]

Second, these cases have received intense scrutiny. In particular, questions arose about how the frauds continued for as long as they did and grew to the size they did. In the United States, there have been a number of forensic reviews of regulators' performance, including by Congressional committees and by internal investigations of the SEC's Inspector General.[55]

Third, long-term ramifications from these immense frauds should be anticipated. To gauge an event's long-term impact, it is often useful to see how the matter has been discussed in the academic community, which is usually more detached from the heat of the moment. Nonetheless, recent academic literature suggests there will be significant consequences. One recent article, for example, describes how Madoff has spawned a new social narrative, shaped by his victims, in which financial fraud is viewed as singularly evil.[56] As a result, white-collar crime is now viewed as more dangerous to society than violent crime and deserving of harsher sanctions

53 *Id.*

54 Information at 3, United States v. Smith, No. 6:10-cr-00232-MSS-DAB (M.D. Fla. Aug. 18, 2010); *Oversight of the SEC Inspector General's Report, supra* note 43; Khuzami, *supra* note 46.

55 *See, e.g.*, U.S. SEC. & EXCH. COMM'N, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, REP NO. OIG-509 (2009), *available at* www.sec.gov/news/studies/2009/oig-509.pdf; U.S. SEC. & EXCH. COMM'N, REVIEW OF THE COMMISSION'S PROCESSES FOR SELECTING INVESTMENT ADVISERS AND INVESTMENT COMPANIES FOR EXAMINATION, REP. NO. 470 (2009), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2009/470.pdf; *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance, Before S. Comm. on Banking, Housing, & Urban Affairs* 111th Cong. (2009), *available at* http://www.sec.gov/news/testimony/2009/ts091009rk-jw.htm (statements of Robert Khuzami, Director, SEC Div. of Enforcement, & John Walsh, Acting Director, Office of Compliance Inspections and Examinations).

56 Christine Hurt, *Evil Has a New Name (And a New Narrative): Bernard Madoff,* 2009 MICH. ST. L. REV. 947, 951 (2009).

when detected.[57]

Finally, the Caribbean Region has figured prominently in several of these allegations. At least one academic has argued that in light of the role offshore financial centers played in these allegations, a serious reconsideration of the onshore-offshore relationship is in order.[58] Moreover, the problems were not isolated to the offshore sector. Many residents of the Caribbean Region were victims.[59] As societies respond to the scale, the scrutiny, and the long-term impact of these events, the Caribbean Region is likely to play a prominent role in the dialogue.

In sum, recent events have dramatically raised the stakes of the fight against fraud and several significant lessons must be considered.

III. Regulators Must Be Ready to Change Significantly to Enhance Their Anti-Fraud Programs

In the summer of 2009, in the midst of the crisis following revelation of the Madoff fraud, I served as Acting Director of the SEC's examination program. Through that experience I had the opportunity to learn first hand how regulators could respond to recent events, and formulated those experiences into ten lessons.

Lesson Number 1: Regulators Must Recognize that There Are Important Lessons to Learn, and that Addressing Them Will Involve Significant Change.

Often the most difficult lesson of all is recognizing that change is needed. The SEC had the benefit of multiple forensic reviews and the recommendations that emerged from that process. For example, the SEC's Inspector General made a significant number of specific recommendations for the examination program to address the problems and challenges he identified in his investigation of the agency's handling of the allegations against Madoff. The recommendations covered a wide range of topics, including the conduct of risk assessments, the preparation of scope memoranda, tracking examinations, and training. The SEC made it a

57 *Id.* at 984-86.

58 *See* Nick S. Dhesi, *The Conman and the Sheriff: SEC Jurisdiction and the Role of Offshore Financial Centers in Modern Securities Fraud*, 88 TEX. L. REV. 1345 (2010).

59 *See id.* at 1350-51.

priority to ensure that the agency took all necessary actions in response to the lessons learned from its handling of the Madoff fraud.[60] All of the Inspector General's recommendations for the examination program have been successfully implemented.[61]

The challenge for regulators is to recognize the need for change, engage in thoughtful analysis to address the issue, and implement the needed changes. It is essential for regulators to make sure they are learning the lessons from these frauds.

Lesson Number 2: Regulators Must Understand Fraud

A serious weakness of many investors and regulators is their unfounded belief that they will recognize fraud when they see it. Unfortunately, this may not be the case. For many people, it is difficult to believe just how convincing and appealing a fraudster can be.

To address this concern, the SEC's examination program decided to give its staff more professional training in fraud detection through massive participation in a program offered by the Association of Certified Fraud Examiners. Over one third of the more than 900 SEC examiners became Certified Fraud Examiners.[62] The staff also held training sessions establishing third-party verification of customer assets.[63] Finally, examiners worked with other interested regulators at the federal, state, and self-regulatory levels to share anti-fraud techniques and experiences.[64]

---

60 *Testimony Concerning Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges, Before H. Comm. on Financial Servs. Subcomm. on Capital Markets., Insurance, & Government-Sponsored Enterprises*, 111th Cong. (2010) (statement of Mary L. Schapiro, Chairman, U.S. Sec. and Exch. Comm'n).

61 *See* U.S. SEC. & EXCH. COMM'N, SEMIANNUAL REPORT TO CONGRESS: APRIL 1, 2010 – SEPTEMBER 30, 2010 91 (2010), *available at* http://www.sec-oig.gov/Reports/Semiannual/2010/semifall10.pdf (listing no remaining open recommendations from the Madoff reports in Table 3).

62 *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme*, *supra* note 55. As a member of the SEC staff at the time of the speech to the CGSR, the author did not recommend or endorse any private organization, including the ACFE.

63 *Id.*

64 *Id.*

Regulators can no longer rely on the belief that they will know fraud when they see it. A more professional approach is essential.

Lesson Number 3: Regulators Must Apply Effective Anti-Fraud Techniques

To catch a fraudster, regulators must often ask embarrassing questions that reveal that they do not necessarily believe what they are being told. This can be awkward, particularly in a highly professional setting. Of course, the fraudsters are quite ready to use those settings to hide their operations. Therefore, there are three types of questions that are particularly useful.

First, questions addressed to third parties that verify the information the regulator possesses are essential. This is called "Third Party Verification." SEC examiners now regularly reach out to third parties to verify information provided by registered firms. The two general approaches are verifying "up" and verifying "down." When a regulator verifies "up," he approaches custodians, depositories, counter-parties, and other institutions. For example, the regulator may ask a custodian to verify that the firm under review actually has the assets it claims. When a regulator verifies "down" it approaches customers. Generally, the purpose of this review is to confirm that the assets visible at the firm and custodian level are consistent with the customers' understanding. [65] Regulators should always approach customers with care, to avoid setting off any unnecessary panic.

Questions focused on computer forensics are also critical. The SEC's examination program recently created a new position for a computer security specialist, who is supporting information security reviews and other examinations. The specialist has been asking questions about the production of information in examinations, such as whether the information is true and complete or if items were deleted prior to production. Testing the accuracy of a production through review of the computer of origin can be very revealing.

Finally, perhaps the most uncomfortable question to address is associated with testing the misuse of original documents. Many firms now scan originals into an electronic system, and fraudsters may try to use those

65 John H. Walsh, Acting Director, Office of Compliance Inspections and Examinations, U.S. Sec. and Exch. Comm'n, Remarks at the 2009 NSCP National Meeting (Oct. 5, 2009), http://www.sec.gov/news/speech/2009/spch100509jhw.htm (last visited Oct. 16, 2011).

systems to mask forgery. One of the best ways to test a system is to select documents that were recently scanned into the system and compare the electronic version to the original. Documents can look perfect on the electronic system, but when compared to the original, often taken from the shred bin, one can readily see when someone used white-out to redirect a previously authorized wire transfer or scissors and glue to attach a client's signature to a new document. Firms do not like when the contents of their shred bin are examined, but this can help catch fraud.

Lesson Number 4: Regulators Must Deploy Robust and Multi-Faceted Approaches to the Problem

Fighting fraud cannot be done by one program alone, however good that program may be. Fraud is so elusive that an effective anti-fraud program requires multiple levels of response.

Criminal and civil enforcement are necessary. There are some fraudsters who will be deterred only by the threat of criminal sanctions. But enforcement cannot be limited to jail time; greater depth is needed. Civil enforcement is also necessary. A strong cadre of civil sanctions is very useful, such as penalties, bars from working in the regulated business, and paying back the illegal profits (disgorgement).

Anti-fraud programs also need improved examination and reporting to promote enforcement. On-site examinations can be invaluable, as examiners are often the first to arrive on the scene of a fraud. Investor education is another necessity. Investors can help fight fraud by asking questions before they invest and by contacting regulators before too much damage is done. Finally, private sector compliance and self-regulation also have positive roles to play.

Moreover, in a robust anti-fraud program, all of these tools are fully deployed and coordinated. At the SEC, bringing together different programs to enhance effective coordination has been a key initiative of Chairman Schapiro. She has described this as establishing a "culture of collaboration, information exchange, and idea sharing" that includes interdisciplinary teams and other integration initiatives.[66] Over the last two years the staff of the SEC has been focused on ensuring that all these different functions are working together. Every regulator should consider

66 *Testimony Concerning Oversight of the U.S. Securities and Exchange Commission, supra* note 60.

how it can add depth and enhanced coordination to its anti-fraud defenses.

Lesson Number 5: Regulators Must Obtain the Intelligence They Need, and Make Use of It Once They Have It

One of the more challenging aspects of fighting fraud is obtaining useful information while the fraud is in progress. Few victims complain while they think they are making money. But regulators do not want to wait until a scheme crashes before they get involved. To get ahead of the curve, regulators must respond properly to early warnings of fraud referred to as Tips, Complaints, and Referrals ("TCRs").

Improving the SEC's handling of TCRs has been a major initiative for the agency.[67] As part of this initiative, the Division of Enforcement has established an Office of Market Intelligence ("OMI") and staffed it with market surveillance specialists, accountants, and attorneys. OMI's mission is to ensure that the agency collects all TCRs in one place, combines them with other public and confidential information, and then dedicates investigative resources to those TCRs presenting the greatest threat of investor harm. In April 2010, OMI implemented an interim central system for collecting TCRs. Going forward, OMI also will strategically mine the TCR databases to identify emerging techniques and trends in securities fraud.[68] This strategic function should help identify misconduct as early as possible in the life-cycle of a fraud.

Regulators understand that it is not enough to handle a single complaint appropriately. The real challenge is to identify the crucial information in the masses of data that are constantly inundating regulatory agencies. Focusing on TCRs is a critical step towards achieving that effort.

Lesson Number 6: Regulators Need the Right Expertise

To fight fraud effectively, regulators must have expertise in the business practices it seeks to exploit. To address this need at the SEC, the examination program created a new position, the Senior Specialized Examiner ("SSE"). These positions are staffed with individuals who bring

---

67 *Testimony Concerning Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act, Before S. Comm. on the Judiciary*, 111th Cong. (2010) (statement made by Robert Khuzami, Director, U.S. Sec. and Exch. Comm'n Division of Enforcement), *available at* http://www.sec.gov/news/testimony/2010/ts092210rk.htm.

68 *Id.*

new and special expertise to the program. The examination program has recruited a variety of skills to both SSE and regular staff positions, including risk management, trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, forensic accounting, information security, derivatives, structured products, and hedge fund activities.[69]

This program began in 2009, but the new expertise has already helped the SEC in a number of ways to understand the businesses it regulates.

Lesson Number 7: Regulators Need the Right Technology

Technology is both a blessing and a curse to regulators. It is a blessing because it is such a powerful tool. Today, one examiner with a laptop and standard off-the-shelf applications can screen and review a large portfolio in ways that would have been impossible before, even to large teams of examiners. Unfortunately, technology is also a curse because it is expensive and constantly evolving. Generally, government agencies do not have a lot of money to throw at new technology. Regulators constantly struggle with how to spend their limited technology budgets, but it is critical that they keep up with advances.[70]

Lesson Number 8: Regulators Must Cooperate Across International Borders

Today fighting fraud is an international imperative. Fraudsters can easily move from jurisdiction to jurisdiction. If regulators are to fight them, they cannot stop pursuing fraud at their borders. International cooperation is essential.

The SEC is committed to enhancing international cooperation through targeted coordination and ongoing dialogue to establish a "collaborative, efficient, international regulatory structure that protects

69 Walsh, *supra* note 65

70 *See* Mary Schapiro, Chairman, U.S. Sec. and Exch. Comm'n, Brodsky Family Lecture at Northwestern University School of Law (Nov. 9, 2010) ("[T]hough we are making progress on technology, we still have far to go to keep up with our markets."), http://www.sec.gov/news/speech/2010/spch110910mls.htm (last visited Oct. 16, 2011).

investors across borders and promotes stable economic growth."[71] In the examination program, for example, the staff works with foreign regulators in a variety of ways, including providing technical assistance, sharing information, and conducting coordinated examinations.[72] The possibility of conducting more coordinated examinations is particularly exciting. If a pattern of conduct arises that appears to encompass both the U.S. and other jurisdictions, such as suspicious sales in a jurisdiction other than the U.S. where the records are all located in the U.S., the SEC's Office of International Affairs should be contacted about the possibility of conducting coordinated examinations.[73]

International cooperation is a powerful regulatory tool. It also sends a sharp message to those who might try and arbitrage their frauds across international borders.

Lesson Number 9: International Cooperation Must Be Timely and Effective

Even with international cooperation, the fraudsters will succeed if they can move faster than the regulators. For example, it can take weeks or months of processing for one regulator to obtain information from the other, while the fraudster can move money from one jurisdiction to the other in a matter of minutes. The time has come for faster cooperation and information sharing. Many jurisdictions have established financial intelligence units to conduct real-time information gathering and sharing, and, in some cases, to assist in restraining the proceeds of fraud.[74] Commentators have observed that securities regulators and financial intelligence units must continue to develop their capacities to work

71 Elisse B. Walter, Comm'r, U.S. Sec. and Exch. Comm'n, Keynote Address at the Eurofi Financial Forum 2010 (Sept. 29, 2010), http://www.sec.gov/news /speech/2010/spch092910ebw.htm (last visited Oct. 16, 2011).

72 *See* PRACTICING L. INST., THE SEC SPEAKS IN 2009 1053-54 (Linda Chatman Thomsen & Andrew J. Donohue eds., 2009).

73 *See Office of International Affairs, SEC International Initiatives*, U.S. SEC. & EXCH. COMM'N (Aug. 29, 2011, 9:07 PM), http://www.sec.gov/about/offices/oia/oia_initiatives. shtml#bilateralregcoop. For contact information for the SEC's Office of International Affair, see *Contact the SEC*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov /about/offices/oia/oia_contact.shtml (last visited on Oct. 16, 2011).

74 Birdwell, *supra* note 38, at 151-55.

together.[75] Regardless of the method used, regulators must start moving as quickly as fraudsters to effectively deter fraud.

Lesson Number 10: Regulators Must Restore Confidence in the Markets and Themselves

As a final recommendation, regulators must restore confidence in the system. One area requiring immediate attention is due diligence. As Ben Bernanke, Chairman of the Board of Governors of the U.S. Federal Reserve said, "the origins of most financial crises…can be traced to failures of due diligence or market discipline."[76] In recent months, the SEC has brought several enforcement cases in this area. One case alleged that Hennessee Group LLC promised to follow certain due diligence procedures before making recommendations and then failed to do so.[77] Another case alleged that Banc of America Investment Services claimed it would treat affiliates and third-parties the same in its due diligence process, and then secretly favored affiliates.[78] In the case against Spencer International Advisors, the firm claimed it would conduct due diligence, collected a due diligence fee, and then simply relied on whether an issuer had obtained bank credit.[79] These cases highlight the importance of restoring confidence in those who promote due diligence in our markets.

Regulators must also restore confidence in themselves. They must move actively and visibly to assess themselves and correct their flaws. They must recognize why they may be viewed unfavorably and why the regulatory practices of the past may no longer suffice. In sum, they must change and learn the lessons of recent events.

75 *Id.*

76 *See* DAVID WESSEL, IN FED WE TRUST 180 (2009). Bernanke also added, "excluding, perhaps, those attributable to natural disasters, war and other nonfinancial events." *Id.*

77 Hennessee Group LLC, Investment Advisers Act Release No. 2871, 95 SEC Docket 2049 (Apr. 22, 2009), *available at* http://www.sec.gov/litigation/admin/2009/ia-2871.pdf.

78 Banc of Am. Inv. Servs., Inc., Securities Act Release No. 8913, 93 SEC Docket 230 (May 1, 2008), *available at* http://www.sec.gov/litigation/admin/2008/33-8913.pdf.

79 Spencer Int'l Advisers, Inc., Investment Advisers Act Release No. 3059, 98 SEC Docket 3500 (July 27, 2010), *available at* http://www.sec.gov/litigation/admin/2010/ia-3059.pdf.

Conclusion

Fraud will always be present, but fighting it provides real benefits to financial markets. Recently, extraordinary allegations have dramatically raised the stakes for investors, markets, and regulators to combat fraud. Regulators must be ready to change significantly and publicly based on the ten lessons above to address today's fraud challenges.