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Fraud Intelligence

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All just one big lie

It is a commonplace that there's nothing like a downturn in the economy to expose fraud. A crisis of the current magnitude was waiting for a major swindle and Bernard Madoff, ex chairman of NASDAQ, duly obliged in December when he admitted to a US$50bn Ponzi scheme after his hedge fund was unable to meet US$7bn in redemption requests. "It's all basically one big lie," he told his sons, who immediately contacted the police. The unravelling tale, which has already led to at least one suicide and the closure of several charitable foundations, contains many of the classic elements of fraud.

Bernard L. Madoff Investment Securities reported consistent, reliable performance, through a 'split-strike' conversion strategy that supposedly profited on options and stocks in both rising and falling markets, but was not willing to provide any detail on its investment process, admittedly a not uncommon stance in the black box world of hedge funds but enough to deter some Wall Street firms like Goldman Sachs and Merrill Lynch. Instead, Madoff courted his own wealthy Jewish community in the US and in an extension of this 'affinity fraud' approach, targeted European aristocrats, many of whom were flattered to be part of an exclusive investment coterie.

Analysis by Riskdata of the 'bias ratio', a variation on Benford's law (familiar to forensic accountants as a way to detect anomalies in number series) for Fairfield Sentry, one of Madoff's largest feeder funds, suggested that his returns were 'exceptional' and so should have been treated as suspicious. Perhaps the feeder funds from major institutions like Santander – which has lost €2.33bn through its Optimal division – Man Group and Union Bancaire Privée – were drawn in by the attractive low cost structure: they were not charged for investment management but instead paid commission on each transaction, which went through a broker dealer Madoff controlled; this meant that the funds were able to levy and retain high hedge fund performance fees. Only paper trading records were supplied to clients rather than direct electronic access to a trading platform, which offered scope to back-fit deal tickets to explain the claimed returns.

In defence of some of the feeder funds, the risk that the investment manager, who was also acting as custodian, might abscond with the assets, and that the accuracy of any valuations could not be assured, was set out in the prospectus; it is a point they are likely to stress in pending litigation. Investors are unlikely to target the three-man audit firm used by Madoff Securities, but the big accounting firms, PwC, KPMG and Ernst & Young, who audited the feeder funds, are in the frame. The auditors in turn may point to the clean billing from regulators: the Securities & Exchange Commission conducted two inquiries into Madoff's investment operation,

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in 2005 and 2007, but on neither occasion did it take any legal action.

More damaging to the authorities' reputation is the revelation that the SEC was warned repeatedly of the risk. In a damning indictment of agency incompetence and dysfunctional relations between regional offices, Harry Markopolos, CFA, CFE, an independent fraud investigator, told the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises that he had warned the SEC since the start of the decade that the Madoff operation was a fraud; in less than four hours crunching the numbers he said he proved it mathematically, helped by some common sense observations like "[T]here were not enough OEX index options in existence for BM [Bernard Madoff] to be managing the Split-Strike Conversion Strategy he purported to be running." The agency consistently failed to follow up on leads Markopolous provided – he even gave it contact details of experts at the Chicago Board Options Exchange who were prepared to cooperate with an investigation and who would confirm his findings but to no avail. It was "a sickening thought" that BM could have been stopped in 2006: "One hour of phone calls was the difference between almost 3 more years of fraud and untold billions of additional investor losses." The red flags were waving at numerous points, he told the subcommittee, including, notably in the 2004, 2005 and 2006 financial statements for Greenwich Sentry, BM's largest feeder fund - the money was all in US Treasury bills at year-end and there were no investments to mark to market: "How convenient for a fraudster not to have any trading positions for an auditor to inspect. Since US Treasury Bills exist only in book-entry form, how convenient not to have any physical securities on hand to inspect either."[1]

The Madoff scandal may be the largest fraud ever but the US has a history of going one better – think 1930s New York and the intense competition to build the highest skyscraper – and the Commodities and Futures Trading Commission (CFTC) expects a 25% rise in commodity pool or hedge fund fraud cases based on Ponzi scheme activity over the 15 cases filed in 2008 to emerge in the next 12 months. On the positive side, there is bipartisan agreement in the US senate that more resource is needed to tackle the problem: legislation is proposed for a US$110m investment to hire more financial crime investigators. "Our white collar crime divisions are understaffed, under-funded and overwhelmed," admitted Senator Charles Schumer, who has brought forward the bill. Mr Markopolos was less diplomatic: "I believe the one over-arching deficiency is that the SEC is a group of 3,500 chickens tasked to chase down and catch foxes which are faster, stronger and smarter than they are."

Notes

1. The full, fascinating testimony of Harry Markopolos may be read at http://financialservices.house.gov/markopolos020409.pdf

News

Fraud cases to court top UK£1.1bn

Total fraud exceeding UK£1.1bn reached court in 2008, according to the KPMG Forensic Fraud Barometer, which registers cases where the charges involve UK£100,000 or more; it is the highest level since 1995. Organised fraud by professional gangs pushed UK£806m while the aggregate value of activity by company managers, employees and customers was UK£300m, three times the level in 2007. Financial services was the hardest hit sector, it accounted for UK£388m of losses in 63 cases, against UK£37m (36 cases) the previous year. The rise was partly explained by an alleged UK£220m attempt to break into the IT system at Sumitomo Matsui Banking Corporation, which reached court in the first half of 2008. Mortgage fraud cases grew significantly as the downturn in property prices and forced sales exposed inflated valuations – 25 actions were commenced worth UK£36m compared to 10 worth UK£3.7m in 2007.

The public sector provided a rare bright spot with a notable decline in losses to missing trader intra community (MTIC) or carousel fraud, in which VAT goes unpaid: it stood at UK£700m in 2007 but dropped to UK£115m last year following a concerted effort by HMRC, including introduction of the 'reverse charge' mechanism under which the purchasers of mobile phones and computer chips account for VAT rather than the seller.

Corporates were not so fortunate, they experienced a five-fold rise in losses to fraud, totalling UK£125m in 2008. The parties responsible worked at all levels, from a finance controller who wrote cheques to

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himself to pay for three cars, including an UK£84,000 Bentley, incurred credit card bills of some UK£150,000, and channelled UK£130,000 of his firm's money into his wife's business, to the junior PA who defrauded three employers in a row, living high on company credit cards, cashing cheques and setting up personal direct debits on business accounts. She stole over UK£200,000 before she was prosecuted.

Some individuals are incorrigible and brazen, like the convicted fraudster who applied for a UK£130,000 mortgage while still in prison or the man who made a stolen company cheque payable to himself in the sum of UK£500,000 and then sought to pay it into his bank account via an ATM.

Half of all the fraud by value was perpetrated in London and the South East (UK£527m), while the Midlands accounted for UK£380m, which was three times higher than the figure for 2007.

Brussels clears obstacles to cross-border tax probes

European Union (EU) ministers have been asked to approve an EU directive preventing their national governments from citing bank secrecy obligations as an excuse for not providing information to cross-border EU tax probes.

This legislation is based on an Organisation for Economic Cooperation and Development (OECD) model, noted Brussels. Its terms: "A requested [EU] member state cannot refuse to supply information concerning a taxpayer of the requesting member state solely because this information is held by a bank or other financial institution." Another proposed directive would widen the scope where member states must mutually assist cross-border tax inquiries, insisting the payment of all taxes and duties to all public bodies are subjects of legitimate inspection. The law would also force member states to automatically exchange information on tax refunds to non residents; and allow officials of one EU country to actively participate in enquiries in another member state, including in the early stages of such investigations.

UK£1.19bn statistic only tip of iceberg, says expert

Reported fraud may have reached UK£1.19bn in 2008, up 14% on 2007, but this is only a fraction of the true figure, says Simon Bevan, author of BDO Stoy Hayward's annual FraudTrack report. In his experience less than 5% of cases reach the criminal courts.

The retail sector has seen a rapid rise of 62% over the last two years but it is outrun by offences against the financial and insurance sector, which grew 83% last year and accounted for UK£788m or 66% of the total. The research also points to a growing risk from third parties: they were responsible for reported fraud of UK£273m last year, a rise of 347% on 2007. Supplier activity includes under-delivering goods and possibly over-charging for them as well. On the other side, customers might claim, falsely, that an order was short, keep money back against 'disputed invoices' or simply disappear without paying.

Many frauds are discovered as a result of whistleblower reports but Bevan believes that these may decline with the worsening recession as people will not wish to rock the boat and just keep their jobs.

The motives for fraud remain consistent – greed and desire for a lavish lifestyle explain nearly two thirds of cases while payment of debts and gambling are other common factors. The profile of defendants is also stable: the majority are male, between 20 and 39 followed by men aged 40 to 59.

Sentences for major frauds have increased markedly: for charges involving UK£50m to UK£100m it was 9 years in 2008 (6.79 in 2007) and when the value was over UK£100m it was 10.04 years last year against 3.88 years in 2007.

EU boosts controls on fake euros

A legal obligation has been proposed by the European Commission to force European Union (EU) banks and other credit institutions to check the euro banknotes and coins they receive for counterfeits before putting them back into circulation. Also, assuming EU ministers and the European Parliament agree, a special counterfeit-check procedure would be established for any transfer of notes and coins from national governments and central banks to EU institutions and agencies.

EU upgrades e-invoicing rules and excise IT

The European Commission believes that a reduction in tax fraud will follow a new proposed reform to European Union (EU) VAT law telling member states to remove legal barriers to electronic invoicing. Brussels wants e-invoices to have the same status as paper invoices in all 27 member states. This will help simplify tax controls and hence anti-fraud inquiries, especially cross-border probes, says Brussels.

EU taxation Commissioner László Kovács said: "Current national VAT invoicing rules are excessively

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complicated and disparate. This has…facilitated VAT carousel fraud."

Meanwhile, the European Parliament called for rules telling companies to make monthly electronic statements of their cross-border intra-EU transaction data: many member states allow quarterly paper-based statements.

It is possible that customs teams and all companies handling excised goods could use a computerised administration of such duties within the European Union (EU) in future, following the EU Council of Ministers' approval of a directive regulating such a system for all 27 EU member states. A council communiqué said: "The computerised system will offer a simplified, paperless environment for business and will facilitate more integrated and faster monitoring for the authorities."

Guernsey and UK sign tax data swap deal

The Bailiwick of Guernsey and the UK government have signed a tax information sharing agreement. The agreement is wide-ranging, committing both sides to exchanging data on request "that is foreseeably relevant to the determination, assessment, enforcement or collection of tax with respect to persons subject to such taxes or to the investigation of tax matters…" It covers information on UK VAT, income, corporation, capital gains and inheritance taxes; plus autonomous Channel Island archipelago Guernsey's income and dwellings profit tax. When information is held by third parties (such as banks) and not by the governments concerned, there is no duty to share data or force its release.

Indian audit profession reels in face of Satyam scandal

The Securities and Exchange Board of India (SEBI) has been allowed to interrogate Satyam Computer Services founder B. Ramalinga Raju and his brother B. Rama Raju over an unprecedented INDRupees 70 billion (US$1.4 billion) accounting fraud.

It is alleged that Ramalinga Raju, the company's former chairman, inflated the size of the outsourcing company's workforce by 13,000 (from 40,000 in reality to 53,000 on the books) and pocketed these phantom workers' wages.

SEBI had been pushing for access to the brothers since the scandal broke on 7 January, with the resignation of Ramalinga, who admitted the company had built up fake paper reserves, saying "the gap in the balance sheet has arisen purely on account of inflated profits" over several years. Accepting possible prosecution, he would "face the consequences".

The central government body's inquiry follows action by the public prosecutor of India's southern Andhra Pradesh state, where Satyam is based. Prosecutor Gangaraj Prasad said that Ramalinga had used fictitious names to divert INDRupees 200 million (US$4.1 million) per month from the company's accounts "for his personal wealth". Where this money has been invested is still under investigation. One major issue in the scandal is the role of PricewaterhouseCoopers (PwC), the firm's auditors. Andhra Pradesh state police have arrested two PwC auditors and charged them with criminal conspiracy and accepting bribes.

With the fallout potentially damaging PwC's reputation, its international CEO Samuel DiPiazza flew to New Delhi to meet India's corporate affairs minister Prem Chand Gupta to explain the firm's position. It has a number of large public sector contracts in India. Amarjeet Chopra, chairman of the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) said: "If the government decides against giving any consultancy work to PwC, till the investigations [into the Satyam affair] are completed, then it [firm] will have problems."

PwC is also facing a 'Public Interest Litigation' (an altruistic case brought by a third party – recognised under Indian law) filed by an organisation called the Investors' Grievances Forum in the Mumbai High Court, which demands that the firm is barred from operating in India.

Raghavendra Verma, in New Delhi, and Keith Nuthall

EU pushes for better controls on fake medicines

A proposed European Union (EU) directive has been tabled to strengthen controls on the distribution of fake and counterfeit medicines, which is an increasing problem in Europe. The law would improve supervision of pharmaceutical distributors within the EU, such as ordering mandatory audits of their work, and the creation of a database on such inquiries by the European Medicines Agency. It would also impose design standards for anti-tamper and counterfeiting features such as seals and individual product codes.

SEC wins 'crane, not airship' fraud case in USA

The US Securities and Exchange Commission (SEC) has secured a California district court ruling against

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two executives accused of releasing misleading press releases claiming they had mobile-phone equipment available strapped to "either fixed-wing aircraft or a blimp [airship]". In fact, argued the SEC, Platforms Wireless International's system antenna hung indoors from a crane. One executive Francois Draper was fined US$20,000 and told to disgorge US$14,000 in income. The other was censured.

Correction

In the article 'Healthcare – lessons from the US', which featured in the Dec/Jan 09 issue, it was mistakenly stated that the primary beneficiary of the increases in public spending that Gordon Brown, then Chancellor of the Exchequer, announced in 2002, was to be education when it should have read healthcare.

Corruption – more than a passing interest

The Law Commission report "Reforming Bribery", published in November last year, proposes to replace the existing corruption statutes, which date back to the beginning of the twentieth century [1]*. But previous draft legislation* [2] *was rejected when the economy was still buoyant, is there any chance that it will be different this time?*

"I think it's inevitable this bill will see the light of day," says **Bill Waite**, CEO of The Risk Advisory Group, "The British Government has to do something, it's been severely hurt by OECD criticism of the current position." [3] The present law is "not fit for purpose" and it would, he argues, be very hard to ignore the Law Commission's recommendations, so long in gestation. **Peter Burrell**, a partner at Herbert Smith, agrees. "After two negative OECD evaluations, the law is crying out for some sort of uniformity. I can't imagine there wouldn't be new legislation, though whether this will come before a change of government is uncertain."

The UK may have weathered criticism of its inactivity over corruption in the past but persistent rumblings about the Al Yamammah arms deal and unseemly politicised legal argument over alleged corrupt payments by BAE Systems have brought the full unwelcome glare of international publicity. "History is different now," Waite contends, "and not only because the US is so aggressive in its use of the *Foreign Corrupt Practices Act* (FCPA); enforcement action is happening in Germany, Norway and France." The Government has also gone too far for any U-turns, says Burrell, both through its own pronouncements and public statements of intent by the Serious Fraud Office (SFO) about ramping up the caseload and personnel committed to corruption work.

BAE is unusual in insisting that the US authorities prove their case, Waite notes, other businesses have compromised with the Securities & Exchange Commission (SEC) and Department of Justice (DoJ). "The consequences of losing are so high. If convicted of a federal offence, a firm faces a ban on doing any work for the US government in any capacity." The sanctions available to US prosecutors have led to some bad law, he believes, and international firms may wish they could simply go round the US and operate beyond its reach but that may not be the answer with combating corruption now a global issue: "If you ask the CEO of any multinational, they will tell you that they're not happy securing business that way." In the UK, too, lawyers are busy with instructions from corporates to carry out reviews of their anti-corruption controls, "It's definitely high on board agendas to for 2009/10," says Burrell. The automatic bar on tendering for EU projects triggered by a corruption conviction is an added incentive.

The Law Commission's proposals are welcome and address many of the defects in the old statutes in Waite's view, "but there's many a slip 'twixt cup and lip so whether the draft bill will make it through to statute in tact is another matter." The recommendations go further than the FCPA in addressing both private and public sector corruption and even now, UK law is more severe in its proscription of facilitation payments to expedite legitimate behaviour (for example, a payment to a consular official to issue a visa more quickly). "Yes, it's strange how we're ahead of the US legislation but behind on enforcement," says Burrell. In the US, if the authorities wish to pursue corporates for bribes paid to agents of private companies, they will make it a "books and records" issue, "If you don't call a bribe a bribe, but term it a consulting fee, for example, they will have a case."

Another feature by omission of both UK and US legislation is the lack of obligation to blow the whistle on corruption in one's own organisation. "In the States, most corporates will go to the DoJ and SEC anyway while in

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the UK the position is the 'same but different'," Burrell notes. Absence of a specific legal duty to report corruption per se is one reason why the SFO is keen to foster voluntary disclosure but the *Proceeds of Crime Act 2002*, which imposes personal liability for knowledge or suspicion that the business is in possession or using criminal property, provides a more urgent impetus. "If a company wins a contract through bribery, all associated funds represent benefit from criminal conduct and if a whistleblower tells the audit committee, the non executive directors and finance director will be on the hook for money laundering," says Burrell. Corporates face the choice of making a disclosure to the Serious Organised Crime Agency (SOCA) that will cover them for money laundering but in the process open up scope for a corruption enquiry – the SFO has access to SOCA's suspicious activity reports (SARs) database - or alternatively, keep quiet and carry on laundering. "In our experience, most companies make the right choice to disclose to SOCA," notes Burrell. The fact that their advisers – lawyers and accountants – have their own obligations to report suspicious activity under POCA, may also influence the decision.

A qualified lawyer, Waite is especially interested in the contemplated negligence offence under which a firm faces prosecution if it has not put in place systems and procedures to forestall bribery by its employees and agents. "The question is where the threshold lies, how much compliance resource is enough? Should firms follow the Woolf recommendations for BAE, or the Siemens [fined €1 billion by German and US authorities] model – "how many lawyers does it have in compliance now, hundreds?" If firms have to put more investment into anti-corruption controls, a further issue for their legal counsel and risk managers is how to ensure it adds value and is not just a costly tick-box exercise to satisfy the regulators, like the Financial Services Authority, which has lately fined Aon, £5.25m, its first penalty for failure to counter bribery and corruption risk and highest for a financial crime breach to date. On the positive side, strict liability is not envisaged as the standard: "The Law Commission recognises that an organisation will not always be able to stop corruption by its employees, otherwise it would not have provided this statutory defence of adequate systems and controls," says Waite.

The size of the penalties is certainly raising concern, some are huge: the headline Siemens figure will hit shareholders hard and that is before the costs of remediation, which, in the US, means retention of expensive DoJ-approved lawyers to review and monitor the firm's processes. Imposition of external counsel with a wide-ranging remit, who may have little or no experience of how a specific industry operates but insist on close inspection of day-to-day dealings, could further threaten viability in the wake of a corruption scandal. How should privilege apply and are they able to wield executive authority, to hire and fire? The very thought of lawyers having a say in running the business hangs like a sword of Damocles, says Waite; it may be enough to frighten many owners into compliance.

The Serious Fraud Office (SFO) faces all these issues in the UK as Richard Alderman, the Director, explores alternatives to prosecution. The agency's first civil settlement, reached with Balfour Beatty in October 2008, requires the firm to implement and report on the systems it has put in place to prevent a repeat of "accounting irregularities" around an Egyptian construction contract. "It is a process in evolution," Waite thinks, which is another way of saying that the SFO is making it up as it goes along. The US authorities favour deferred prosecution agreements. "I'm not aware of a similar legal process in the UK. There are arguments against: how long is it possible to delay bringing an indictment before inviting a challenge for abuse of process?"

At a more philosophical level, there is the whole question of whether the SFO should be seeking civil recovery when it was set up to investigate and prosecute serious and/or complex fraud. "The SFO has to look at the public interest," says Burrell, "As a public prosecutor, it has a code to follow and if it is not able to prosecute an individual, it has to ask if it has a case against the corporate." The answer is likely to be no if the directing mind and will of the organisation is not guilty, which leaves civil recovery as the only option. It will be interesting, he adds, to see if otherwise good corporate citizens, which come forward voluntarily, are able to escape criminal prosecution when individual employees are clearly guilty.

Waite thinks that comparison with the US position, highlighted in the De Grazia review [4] is invidious as the very heavy sentences and financial penalties there represent a pressure to plea bargain that does not weigh on defendants in the English courts: "I would hate, loathe and detest for us to adopt the US system," which relies on one defendant rushing to do the best deal with prosecutors in return for giving evidence against accomplices. There is, though, much to be said for the movement between public and private practice in America: "It's not a good idea for someone to stay at the SFO 25 years, though there may be a few star

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exceptions." The agency is in the midst of a major reform and Alderman has committed to increase the number of investigators working on anti-corruption from 65 to around 100. "It's not clear where all these staff will come from" but it will certainly be money better spent than on educating the public about the risk of fraud, says Waite. Burrell concurs and thinks that the criminal bar may be a good source, especially with changes to Legal Aid; it would also support De Grazia's observation that "The SFO's biggest challenge at the moment is to recruit and develop lawyers with the full complement of case controller skills."

The drivers on firms to come forward if they discover dubious payments in the books may be increasing but, says Waite, "at the same time, I do wonder how much value there is in looking back at transactions that may be many years old, when the current executives probably weren't in post." The approach followed by the Hong Kong Anti-Corruption Commission might be better, he thinks – it drew a line under past behaviour, with a reservation if an especially egregious case was discovered – "there was only one, involving substandard cement used in a series of apartment blocks, which collapsed."

Even if new tougher legislation is introduced in the UK, substantive change in the commercial field depends on whether there is the will to enforce it: "The US law is over 30 years old but the country seems to have more corruption cases than anywhere else so it's arguable that the compliance programmes have had only limited impact," says Waite. If it is to pursue its self-appointed role as international policeman in this area, the US will have to maintain recent momentum, whatever happens elsewhere: more high-profile and punitive sanctions for FCPA violations should be expected.

In view of the SFO's proclaimed focus, as well as UK regulators' interest, it should be a boom time for legal advisers in the UK as well. "Anti-corruption is another compliance burden that often falls to the same people who have to deal with anti-money laundering, terrorist financing and sanctions," says Burrell. The "dream scenario" is to create an overarching risk management and control framework that will cater to all these obligations. Corporates need advisers who are able to properly analyse the criminal law as well as the civil implications – "corruption frequently gives rise to civil litigation" – and tax expertise to deal with the consequences of illicit payments expensed through the P&L. Experience of how investigations are likely to unfold and the risks they pose as well as knowledge of whether prevention programmes are sound or mere window-dressing is also essential, Burrell cautions. "It should, at least, be easier to control corruption than money laundering, which involves an attack from outside." Firms themselves authorise payments out but it is far from easy, he acknowledges, to exercise vigilance over distant subsidiaries and agents.

Notes

1. *Public Bodies Corrupt Practices Act 1889, Prevention of Corruption Act 1906, Prevention of Corruption Act 1916*
2. Legislating the Criminal Code: Corruption (1998) Law Com No. 248
3. OECD report: www.oecd.org/dataoecd/23/20/41515077.pdf
4. Jessica de Grazia Review of the SFO: www.sfo.gov.uk/publications/pdfs/JdeGrazia_Final_Review_of_SFO.pdf

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Diary

Eastern Fraud Forum: Getting Your Own Back Third Annual Conference
13 March 2009
Radisson SAS Hotel, London Stansted Airport
Tel: +44 (0) 1603 680966
Website: www.easternfraudforum.co.uk

Third Annual Fraud & Corruption Summit
18 March 2009
The Dominican, Brussels
Tel: +44 (0) 20 779 8944
Website: www.mistieurope.com/fraud

Tenth Annual European Plastic Card & Online Fraud
28 April 2009
Kingsway Hall Hotel, London
Tel: +44 (0) 7017 7790
Website: www.iir-conferences.com/plasticcard

Institute of Money Laundering Professionals Sixth Annual Conference
11-12 May 2009
The Imperial Hotel, Blackpool, UK
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Rapid but measured response

An interactive employee fraud case study run by the Midlands Fraud Forum proved to be a masterclass in how to manage an unfolding drama without turning it into a crisis. ***Mark Surguy*** *of Pinsent Masons LLP and* ***Charlotte Digby*** *of Eversheds LLP recorded the action.*

When a case of possible internal fraud is discovered within an institution, organisation or company, perhaps by chance interception of some suspicious document or through a whistleblower sharing his or her concerns anonymously on a confidential hotline, it is vital to have an effective response plan.

Further investigation and legal remedies are likely to be required in most cases. We here explore the general pattern a response should follow and some action points to adopt to prevent fraud in the first place. However, the best response at each stage will depend on the nature and extent of the fraud, where it was committed (there could be cross-border implications if the company has overseas subsidiaries which are implicated, for example), the number of suspects and the relationship between them. Also relevant are the reputation and size of the company, the regulatory environment and the victim organisation's objectives. Getting off on the wrong foot could prejudice the investigation and reduce the prospects of a successful outcome. All too often it is just too late to correct poor decision-making early on.

Dealing with the whistleblower, preliminary actions and issues to consider

A Fraud Response Team should be put in place immediately the potential fraud is discovered. In some cases this may be a subcommittee of the audit committee or a specifically formed group. A full team effort is crucial at such an early stage. The role of the auditor, in-house legal team, independent forensic accountants, media advisors, in-house investigators, external lawyers and internal IT experts and any other team members should be clearly defined and kept under close review. Roles will be built around the agreed commercial objectives for the investigation. Business continuity should also be secured.

HR may want to contact the suspect and the whistleblower for interview. However, it will be necessary, whilst further inquiries are carried out, to keep the investigation covert and to avoid alerting the suspect to the suspicions. A senior HR representative, who is not the suspect's line manager, should be involved at the outset. Existing company policies should be checked: the HR team should have regard to the internal investigation procedure, legal requirements (eg, data protection, privacy considerations) as well as the need for confidentiality. The company whistleblowing policy – there should be one in place – will be very important.

Reassurance should be provided to the whistleblower. He or she needs to be protected against victimisation or other recriminatory behaviour. The gifts and entertainment policy might also be reviewed to see what would be acceptable as a reward for the tip off. It is important to ensure that the whistleblower's allegations are not too general and to check if he or she has any further or other suspicions. The whistleblower should also understand the need for confidentiality.

Background checks on the whistleblower are appropriate to discover any history of similar complaints. It is necessary to understand the likely motive behind the allegations and the risk of a malicious or other improper mindset. Any interview or informal discussion with the whistleblower should be recorded so that some evidence is kept in case the allegations are later withdrawn and also to form the basis of evidence that may be needed in Court.

The HR team needs to decide whether to interview and when (not whether) to suspend the suspect. It is likely to be too early at this stage to consider interviews and suspension but any corroborative evidence collected at a later stage should be put to the suspect at the appropriate time. If the decision is taken to interview the suspect, it will be important, first, to discuss the interview strategy (including whether to carry it out under caution or not).

Regarding evidence, a range of issues need to be addressed – document review, securing electronic evidence, confidentiality, adverse publicity and the risk of sustaining further losses. Should relevant suppliers be contacted in respect of suspect correspondence? How else are the suspicions to be investigated further?

One of trickiest decisions is whether to involve the Police. Who knows whether there is criminal conduct to investigate? Not all dishonest or unethical commercial conduct amounts to a prosecutable crime. But even if no crime is yet apparent, the victim organisation should be encouraged to consult the Police at an early stage, for early discussion regarding

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the modus operandi, vulnerability of suspects and witnesses, interview strategy, the securing of evidence for use at a possible criminal trial where the evidential burden of proof is high, and the management of expectations generally. It is important to realise that the Police can agree not to trample over a corporate and civil investigation and will help to work with the organisation to project manage the case properly, with all considerations of a parallel criminal and civil law investigation taken into account. The lack of resources within the Police Service for investigation and prosecution of commercial fraud should not be underestimated. An early approach to the Serious Fraud Office (SFO) may be advisable in the right case (see www.sfo.gov.uk for criteria).

The company's insurance policy should be reviewed to understand reporting requirements, in order not to fail to notify insurers at the right time and either forfeit any indemnity at all or find that investigation costs will be not be paid because they were not approved in advance.

Collecting/preserving the evidence and the role of external specialists

The Fraud Response Committee should usually next focus on gathering more information and investigating the allegations by reviewing the suspect's email correspondence (it should also consider the legalities of monitoring emails) and documents available on the suspect's PC or saved to the servers. Do not forget to look on his or her desk whilst the suspect is out.

A clear plan is needed for theses searches. Relevant group companies and subsidiaries should not be overlooked. Cross-border implications will need early legal input. It is necessary to understand where data resides and how it can be lawfully captured.

Consideration will have to be given to email servers, shared networks, desktop PCs, diaries, invoice and payment master files, customer and supplier databases, back-up storage media, financial records and other categories. The organisation's archive and back-up policies should be checked. The relevant period to be covered should be established. Consider whether to use external or internal resources, the Police, or even a combination of all three to do the collection. All actions should be appropriately documented and privilege should be protected over the investigation.

Those designated responsible for the internal investigation and asset recovery should ensure that they can demonstrate independence. This is a key concept for the regulator and for assurance and reputation management. One approach is to appoint external professionals to assist with the investigation.

It is crucial to act carefully, reasonably and proportionally in securing all the evidence and to do so in compliance with the *Data Protection Act* provisions and in a forensically sound manner, in accordance with the guidelines of the Association of Chief Police Officers (ACPO). All interviews, communications and actions taken should be appropriately and legally recorded to maintain confidentiality and admissibility. It may be appropriate in some cases to work overnight to collect the evidence. The IT team may not be the best group to review emails and documents on the suspect's PC although they will have to be consulted in relation to their capture. There are pitfalls for the unwary in relation to handling personal and company property: criminal offences can actually be committed by those investigating the fraud, which could play into the hands of the wrongdoers and render evidence that would otherwise be admissible inadmissible. The Data Protection Principles are likely to apply and thought should be given to ownership of computers and other equipment.

Knowing when to move from covert to overt investigation is a matter for careful judgment: once overt, the risk that evidence will be destroyed arises.

The team should carefully consider the internal message to be communicated regarding suspension of the suspect. Any suspended employee is innocent until proven guilty. If later cleared, the individual will need a route back into the organisation with his or her reputation untarnished. Achieving this should not be underestimated.

When approaching the subject of suspension, look at the employee's rights to privacy and the terms of the relevant employment contracts and IT policies. Review any reporting obligations in place before deciding to interview anyone. Consider the process for interviewing and the risk of information unintentionally spreading within the organisation. It may be appropriate to interview the suspect without suspending him immediately in order to try to obtain some admissions. If the interview is not conducted under caution, it is likely to be inadmissible later at a criminal trial. But this will not be the case in relation to future civil action.

The implications for the financial statements of the company and its reputation will have to be considered,

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especially if the victim organisation is listed on a stock exchange or subject to regulatory oversight. Rumour might develop, which could adversely impact the share price. Subject to timing and the likely materiality of the irregularities, it may be advisable to delay the announcement of results or to issue a qualified audit opinion.

In appropriate cases, it may be appropriate to write off the loss suffered by the company and move on. This is a matter to take account of in drawing up the commercial objectives that should underpin all decision-making. Where not written-off, recovery of loss will be attempted.

Asset recovery and data analysis

The legal implications of any kind of fraud, whether bribery or some other form of corruption or dishonesty, dictate that evidence may disappear once a subject is tipped off. Freezing assets including bank accounts and obtaining orders permitting the search of buildings, homes, cars and offices to secure documents and data and obtaining disclosure of the subject's assets, and other manoeuvres to protect the assets are usually essential steps, whether assets are located here or overseas. Civil legal proceedings against the suspect will inevitably have to be started, and the costs of this action will require estimating before they are incurred. It is also worth considering obtaining an order to restrain the suspect's passport if it is thought that there is a risk of the suspect leaving the jurisdiction without complying with the terms of any freezing or search orders.

Reporting obligations to regulatory authorities (including to the Listing Authority, where relevant) should be examined and directors' duties should be considered (with directors advised to seek independent legal advice if appropriate) if the victim is a listed company as some justification will ultimately be required by shareholders.

Getting search and freezing orders may well depend on extracting the right information from the electronically stored data that has been ring-fenced. Intelligent data analysis is advisable to reduce the data volume to relevant data only.

Find out whether the suspect has any computer and/or other equipment at home. If this is to be searched a court order will be required. This can be obtained as part of the search order.

So the data collected (including hard copy documents and all the other electronic documents captured, including emails) will need to be reviewed quickly. Using appropriate software for this task and centralising evidence in a secure online repository is rapidly becoming best practice.

The documents should be analysed to identify relationships that the suspect has with suppliers (including overseas) and to see whether commissions, payments, backhanders or gifts have been made within the UK or to or by overseas subsidiaries. The frequency and duration of communications could also help identify suspicious behaviours as anything unusual could be an indicator. Software can quickly identify "heat maps" to show the investigators where to look first.

Question the whistleblower about further information obtained. Collate evidence to obtain legal advice. Decide for how long the information collected and the search results should be kept before they are destroyed. The investigation may well have to consider the auditors' liability if a fraud has gone undetected over a long period of time.

A media management policy should also be put in place and a single person should be designated to answer all press enquiries.

Prevention, detection and deterrence

The Fraud Response Committee should review the company's systems, procedures and controls to improve fraud prevention and detection. Whilst this is a routine function of risk management, which will draw on the work of the auditors, the following steps should be followed:

- When a fraud has been uncovered, a specific review of lessons learned and the method by which systems were overridden or circumvented should be carried out;
- Fraud awareness training should be continuous and relevant in order to develop an anti-fraud culture within the organisation;
- The outcome of investigations should be publicised and regular audits of systems, procedures, controls and training should be put in place internally in addition to the statutory audit;
- All relevant policies should be regularly reviewed and updated to reduce or eliminate system weaknesses;
- Training should include ensuring that the staff fully understand the fraud reporting policy and that all allegations are and will be treated seriously.

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Fighting corruption: the SFO perspective

Corruption is one of the key areas of the Serious Fraud Office's work, writes **Charlie Monteith**, its senior policy adviser. We are currently investigating 16 cases of corruption. The SFO also manages the UK Register of Allegations of Overseas Corruption, which earlier this year had received over 130 allegations of bribery. We intend to move more investigators into our new Anti-Corruption Domain. This reflects our strong commitment to tackle allegations of corruption.

The new bribery Bill has the potential to widen the net to capture more corporate corruption if companies negligently fail to prevent bribery. There is a due diligence defence but until this is established anyone performing services on behalf of a company registered in England or Wales who bribes in connection with that company's business may make the company liable as well when the Bill becomes law. I anticipate that establishing the requisite 'due diligence' will be a necessity for all those within the corporate world.

Prosecution, which is traditionally what the SFO does, is not always possible because obtaining sufficient evidence for a likely conviction is not always possible. And where the evidence is sufficient, it is not always desirable in the wider public interest to prosecute. But new powers have enabled us to apply for civil remedies.

New powers: civil remedies

We have new powers to obtain an order for civil recovery of property obtained through unlawful conduct in which there is no requirement to bring criminal proceedings. We are already identifying cases where there may be insufficient evidence to give rise to a realistic prospect of conviction, but clear evidence on the lower civil standard of proof to establish that property was obtained through unlawful conduct, whether by the individual or company concerned or someone else.

The UK has also introduced Serious Crime Prevention Orders, which enable prosecutors to obtain court orders regulating the future conduct of those who have been engaged in serious crime. SCPOs can be obtained in a civil action or after a conviction. The conditions that can attach to such an order are almost limitless. A company might, for example, be asked to submit its trading accounts for scrutiny every six months.

In cases of corruption it would be permissible to restrict the territories in which an offending company could operate or to limit the types of goods and services that a company could offer. These are a valuable addition to the powers of the courts in sentencing and a significant weapon for prosecutors where the evidence obtained *in relation to the recovery of assets* does not meet the criminal standard.

We are also very interested in a plea negotiation framework.

With the new powers around, and closer working with the regulators, there are some sensible alternatives to prosecution that we need to examine while ensuring that the needs of victims remain paramount.

We want to help individuals and companies come forward with a system that commands the confidence of the judiciary, the defence, the prosecution and the wider public.

Balfour Beatty

A recent example of how we are now working was provided by a company, which, of its own volition, brought a matter to our attention.

The company accepted that unlawful conduct, in the form of inaccurate accounting records arising from certain payment irregularities, occurred within a subsidiary entity during a project completed over seven years ago. The project was undertaken by the subsidiary in a joint venture with an overseas company.

The unlawful conduct related to entries in the subsidiary company's records in respect of payment irregularities concerning the execution of the contract. The documentation prepared in connection with these payments did not comply with the requirements for accurate business records to be kept but there was insufficient evidence for corruption or bribery offences.

Once the company had discovered and investigated these payments, it immediately notified us and we conducted a detailed investigation, with which the company cooperated throughout.

In a Consent Order agreed before the High Court late last year, the company agreed to a substantial settlement payment, together with a contribution towards the costs of the Civil Recovery Order proceedings.

The company also voluntarily agreed to introduce certain compliance systems, and to submit these systems to a form of external monitoring for an agreed period.

We are committed to combating improper corporate behaviour in line with similar efforts being made in other jurisdictions and this is an important example of

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how we will use the new tools at our disposal to enhance the criminal justice process.

The outcome signals our continuing determination to deal with unlawful conduct wherever it occurs and by proceeding in this way we were able to impose a significant sanction on a major UK company.

SFO's approach and corporate self-reporting

The above example shows a method for dealing with corruption after it has happened but a major part of the transformation of the SFO has been the development of a greater role in crime prevention and public education.

We are actively engaging with the business community to learn from business leaders the problems they face in doing business overseas and to remind them of their legal and ethical obligations. The SFO is currently engaging with non-executive directors, a group uniquely placed to address issues of corporate governance.

We want to encourage Boards of corporates and their professional advisers to engage with us and to report corruption that they uncover.

We want to explore how we can show the maximum degree of leniency in cases of self-reporting. One way of showing leniency might be a civil recovery order; or we may decide not to take the case up for investigation and prosecution if the company agrees a package of measures with us. In doing this we shall, as always, consult the public interest.

We will also look at the position of individuals. We shall want to know what the company has done about them and to consider whether to commence our own investigation (leading possibly to prosecution) irrespective of what we do in respect of the corporate. The sorts of measures we will look for will include the following:

- Monitoring;
- Culture change and training;
- Board level commitment. This is particularly important; and
- Restitution.

Given cooperation and willingness on both sides, this process need not take too long.

EC Procurement Directive

What naturally exercises board room minds is Directive 2004/18/EC of the European Parliament and of the Council on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts, which excludes from participation in public contracts any candidate or tenderer (including, company directors and any person having powers of representation, decision or control) who has been convicted of a corruption, fraud or money laundering offence.

This applies only upon a conviction and is therefore not applicable to civil orders or civil remedies outlined above.

It is also interesting to consider press comment on the recent Securities & Exchange (SEC) and Department of Justice (DoJ) settlements (Dec 2008) involving Siemens: "While Siemens admitted violating the United States Foreign Corrupt Practices Act, it avoided either a guilty plea or a conviction for bribery, allowing it to maintain its status as a "responsible contractor" with the federal Defence Logistics Agency. Without that certification, Siemens could have been excluded from public procurement contracts in the United States and elsewhere. German authorities are preparing a similar certification."

Proactive investigation

We are also proactively considering risk, looking at how we identify key areas where there are major risks concerning corruption. The index, compiled with the help of national and international government and non-government agencies, will give us pointers here. We intend to go out and explore these areas and find out if this leads us to cases of corruption for investigation and prosecution.

What we are doing, as a result of all of this, is freeing up resources for the toughest cases. There are cases where we need a very determined response against very considerable opposition. We need to process these cases to the highest standards and this is a key challenge for us.

But along side this is the need to explore new methods of dealing with criminal investigations justly that avoid the need for protracted inquiries lasting several years and costing millions of pounds.

In this way, and by using the new Bribery Bill (if it becomes law), the SFO will not only play a major role in proactively investigating and prosecuting corruption but we will also, by working closely with companies seeking our help and guidance, play a central role in preventing it happen in the first place.

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Going the right way: the ethics and integrity trend

Do companies really ***mean*** *what they are saying this time? ask* ***Richard Minogue*** *and* ***Nigel Iyer****.*

Business Principles and Codes of Conduct have been in fashion for many years. These high-brow documents are meant to convey either 'how our whole company is behaving today as one cohesive body', or at least 'how we aspire to act in the future'. However, few will forget the 65-page Enron Ethics Code from July 2000. This work of fiction has been compared to the mythical Titanic's "Safety at Sea Manual" and it offered enough "Principles of Human Rights" to keep Bono – lead singer of rock band U2 and social justice campaigner - quiet for a week. [1] We believe that the world has moved on a bit since Enron. Although we are not quite there yet, Business Principles and Codes of Conduct will soon become real tools, which can drive organizations forward, both in terms of integrity and effectiveness. In a well publicised article, Professor Michael Porter claimed quite emphatically that "Corporate Social Responsibility can be much more than a cost, a constraint or a charitable deed – it can be a source of opportunity, innovation, and competitive advantage." [2] We agree with this common sense statement. If you do the right things, you often do things right.

Based on our own recent experiences, when Codes of Conduct, Ethics Policies and Business Principles are carefully prepared, every word and phrase is carefully examined, often re-written many times so that it conveys the intended message and the right nuance. The Legal or Compliance Department has to go over everything with a fine toothcomb.

In some cases, fine sounding but vague statements may have been deliberately designed to leave wiggle room for the grey areas.

"We respect the integrity of public servants".

Why not just say "We don't pay bribes to public officials"? Because sometimes we might, and it's not nice to tell lies in the Code of Conduct! The finished document is the product of great effort, deserving hours of study and admiration by each employee.

Of course, the great majority of employees only read (or rather browse) the documents when required to do so, finishing in seconds. The meanings and nuances are wasted, left to gather intranet dust on forgotten web pages. Employees do not follow the Code, they follow the example of their managers and their peers. Top management are the internal celebrities, the trend-setters. If they really intend to implement a company culture based on integrity, then they should follow Gandhi's advice: "You must be the change."

That is not to say that Business Principles and Codes of Conduct are unimportant. On the contrary, they are essential. But for them to work, managers must lead by example and teach by example. Issuing the Code and then waiting for people to comply is a recipe for disaster. It's like placing a "Water Safety" manual in one's child's room, expecting them to read it of their own free will, and then come fully equipped with a life jacket on your next family boating outing even though none of the adults has bothered to wear one…

Through their own actions and through practical training managers can bring Codes of Conduct to life.

CR > PR (Corporate Responsibility is much more than just Public Relations!)

Let's not mince words, top management have a lot of operating issues on their plate without having to spend massive amounts of time on Corporate Responsibility (CR). Other senior managers, including CR professionals and Compliance experts, are likely to exercise much more influence over the structure, content and communication of ethical principles and the Code of Conduct policies. That should not mean top management are disinterested, simply that they rely on their internal experts to do the job.

Originally, CR was a vague concept and not spelled with capital letters. Many referred to it as corporate social responsibility (CSR). Today the word "social" is probably implicit in being responsible. Companies wished to be seen as "good corporate citizens", but did not have concrete objectives or a systematic approach towards responsible behavior. Good corporate citizenship meant paying local taxes and promoting a positive brand image. Since the advent of the United Nations Global Compact [3] in July 2000, however, CR has in some companies evolved from an externally focused public relations exercise to an internal change programme.

Through Code of Conduct policies, CR managers have the opportunity to ask hard questions about how operations really work and by bringing transparency to

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the grey zone, they have the opportunity to achieve real improvement.

Does every company need its own Code of Conduct?

Considering that a Code of Conduct has become almost a standard requirement, one might think that a generic version would be available. Anyway, why should each company waste time and resources reinventing the wheel? Does it not just make sense to use the 10 principles of the Global Compact in Code of Conduct form?

Unfortunately, a Code of Conduct is no use if employees do not know how to apply it in practice. Take, for example, the 10th principle, which was added in June 2004 to address corruption: "Businesses should work against corruption in all its forms, including extortion and bribery."

Put yourself in the shoes of an employee trying to apply it. Does that mean he can or cannot accept a supplier's dinner invitation?

The Code of Conduct must not be too general – companies need to tailor it to their particular business and provide sufficient guidance for employees to decide the proper course of action in specific situations. On the other hand, the Code of Conduct cannot provide specific guidance for every possible circumstance. Real life is infinitely complicated, every situation is different. The challenge is to cover all the key areas, to apply them to the business and to provide useful guidance that is short enough to read in five minutes and that will not be out of date as soon as it is issued.

Why cultural differences are so important

Another challenge that companies face is achieving consistent standards that will make sense in different countries or even different organizational divisions.

Consider a gifts policy which states: "Gifts of nominal value, such as a bottle of wine or a promotional item showing company logo may be offered or accepted. Gifts with a value greater than US$20 may never be offered or accepted."

In Saudi Arabia, a gift of wine would be illegal. In Norway, a bottle of wine costing less than US$20 would be cheap wine indeed, hardly an appropriate gift. In Nepal, a gift worth US$20 would be far more than nominal. In China, refusing a gift would be a grave social insult.

Different cultures have different understandings of conflict of interest, nepotism, discrimination, and other Code of Conduct subjects. A participant in a Code of Conduct training session in Eastern Europe once asked us, "What is the difference between a bribe and a tip? Is it against company policy to leave a tip in a New York restaurant?"

Be truthful about grey zones

It is important to ensure that the Code of Conduct is aligned with the reality on the ground. It is easy to write lofty principles, more difficult to live up to them. Facilitation payments are one area where many companies have trouble distinguishing between fact and fiction.

If management has, after a careful study of the facts on the ground, decided it will never pay bribes or make facilitation payments, it should state the rule clearly in the Code of Conduct. If management decides that in certain circumstances bribes or facilitation payments are unavoidable then they should describe those circumstances in the Code without apology.

Just tell it as it is

We never offer or pay bribes to obtain business. We only reluctantly make facilitation payments, and only to obtain a service to which we are rightfully entitled and when not doing so would cause a disproportionate and unfair loss to the company. Such payments shall be transparently accounted for as such, and treated in accordance with local law and custom.

The authors do not advocate allowing facilitation payments – the point is that companies should not undermine credibility by publishing fictitious policies they do not intend to enforce or vague policies that are unenforceable. If the company cannot live with an accurate description of its de facto procedures, it should change the procedures, however difficult that might be.

Why what you tell people and how you behave is so much more important than what you write

After conducting training sessions in more than 25 countries, we have come to a realisation: Code of Conduct training is more important than the Code of Conduct itself. Company policies and business principles are undeniably important; they establish a point of reference and framework. But they are necessarily general, and leave much room for interpretation. The common sense and good judgment of managers and line employees determine how business principles are applied in practice. Getting

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employees to understand the spirit of company policy is far more important than their memorising the specific policy texts.

A second conclusion – the comments made by line employees during Code of Conduct training are a gold mine of insight into local risks and realities. Encouraging dialogue and systematically recording and considering employees' suggestions is the true path towards continuous improvement.

"Training" does not just mean classroom lectures, memorising rules, or signing "I have read the Code of Conduct" statements. Such legally binding, "cover your ass" declarations are really pretty useless when it comes to motivating employees.

Code of Conduct training should be entertaining, inspiring, uplifting, fun and great! And why not? We are talking about values, personal behaviour, good versus evil, fighting corruption, contributing to a better world. Code of Conduct training can be and should be inspirational.

Resources are always limited but effective and entertaining training can be carried out in a cost-effective manner and the potential savings resulting from improved compliance are huge. Code of Conduct issues are not boring. Fraud & corruption, sexual misconduct, illegal acts and other Code of Conduct issues are all relevant - and interesting.

By acting as a facilitator, rather than a teacher, the person conducting training sessions in a workshop setting can get the participants to talk about the things they have seen or heard. When discussing what is or is not acceptable, the facilitator can move in and out of the grey zone using questions that start with "What if?" Training can include ethics games, case studies, innovative group work, and role playing to capture participants' interest, get them thinking about the issues and improve their ability to apply common sense to new situations.

Multimedia training that combines key messages, interactivity and entertaining techniques, such as video examples using internal company celebrities in cameo roles, can be extremely powerful. In one major company, employees found the video clips so interesting that organisers hardly needed to roll out the training. Knowledge of it spread through the grapevine, and everybody wanted to see it.

A well designed brochure with cartoons that satirise various examples of misbehaviour creates a permanently available training tool for employees, suppliers, customers and other stakeholders. Or instead of hiring a singer or magician to entertain at the employees' party, why not incorporate a theatrical sketch based on a fraud or corruption dilemma. It works!

A success story

The Board of a major international company found in a survey that less than 10% of employees had any significant awareness of the company Code of Conduct. Corporate Responsibility responded by rolling out 30-minute, multi-language, multimedia training, including short film clips featuring top managers in dilemma situations. In the subsequent survey, over 90% of employees had a high level of Code of Conduct awareness.

Many companies, faced with the impossibility of providing sufficient guidance in a brief document include a general provision, "When in doubt, ask your manager." Whilst that may be good advice, companies had better ensure that managers respond in a correct and consistent manner.

When in doubt, ask your manager

Danielle and Miranda worked side by side but reported to different line managers. A supplier invited both of them to a Christmas dinner event and they each asked their manager's permission to attend as required by company policy. As usual, only Danielle received permission from her easy going manager.

Managers need to do much more than read the Code of Conduct. Companies should ensure that managers receive adequate training to understand the issues and background, and are given their own guidance so that they apply the Code in a consistent manner. The Code of Conduct is intended to encourage a uniform and healthy internal culture – inconsistent managerial interpretations can have the opposite effect.

Leading by example

The heads of General Motors, Ford and Chrysler, in a much criticised demonstration of poor judgment, in November 2008 flew separately in private jets from Detroit to Washington to beg the US government for money. "Couldn't you at least have shared a jet?" asked a senator. In profitable times, setting the right tone is an investment. In hard times, it might be necessary for survival.

Google's co-founders take US$1 a year in salary. Probably they don't need the money, considering the fortune they have already earned. But they surely

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understand the symbolic value of the gesture, and how it increases the value of the company and their shares.

Getting the perks

A middle manager with a tendency to self-indulgence circumvented travel policy by delaying his booking to the last minute when only business class tickets remained. As he sipped his Champagne waiting for take-off, the manager was greatly embarrassed when the company president greeted him by name on the way to her own seat in the back. The use of business class was never questioned but word of the incident spread like wildfire and business class travel dropped to near zero.

The company president was allowed by company policy to travel business or first class. But she understood that travelling economy, when a higher level of service was not important, was an opportunity to advertise appropriate behaviour.

Not every company president can afford to work for free or should travel tourist class. But managers should take every opportunity to lead by example. For starters, they should:

- Pay for their own vacation
- Turn up to meetings on time
- Travel responsibly
- Respect the speed limit
- Hire the best assistant, not just the best looking one
- Avoid conflict of interest situations
- Follow rules such as procurement procedures
- Avoid preferential treatment and nepotism.

Employees who are not managers may also be internal trend-setters, due to their age, seniority, competence or other reasons. Expatriate employees, for example, may set the standard in local companies. If expatriate employees behave as and are treated like an aristocratic class in their host country, local employees are less likely to develop company loyalty or respect the code of conduct.

Summary

Code of Conduct, Business Principles or Integrity training might sound boring or, worse still, be seen as “more corporate propaganda” but, done right, it does not have to be either. Once employees get past the text to discover the real issues they confront in their own jobs, it becomes interesting. With a little imagination, organisers can build the interest using engaging and entertaining techniques. That is when it becomes ‘engaging’.

Integrity, in an organisational ethics context, is about consistency between business principles and conducting business, between policy and practice. A successful integrity programme is the way to identify and eliminate the inconsistencies. It is important. It is the key to compliance. It builds pride in the organisation, increases loyalty and employee retention. And, not to be forgotten, it is a source of competitive advantage, delivering real value in financial terms.

While innovative training is the lifeblood of any integrity programme, there are other important elements to consider as well. Training is a valuable complement to internal control but it does not replace it. It is basic management responsibility to maintain a system of internal control that protects company assets, supports achievement of company objectives *and* avoids placing employees under unnecessary temptation.

So, with a strong integrity programme and an effective system of internal control, are we safe? No, in spite of our best efforts, people will still find ways to evade the rules. But companies can take a proactive stance even here, by monitoring the risks and actively looking for anomalies or acts of non-compliance. Early detection of non-compliance and consistent disciplinary action complete the circle of protection necessary to achieve an organisation that is truly resistant to inappropriate behavior.

Notes

1. Business First, 29 March 2002
2. Harvard Business Review, The link between Competitive Advantage and Corporate Social Responsibility, Michael E Porter and Mr Mark R Kramer, December 2006
3. www.unglobalcompact.org The Global Compact invites companies to commit to aligning their businesses to ten universally accepted principles of Human Rights, Labour, Environment and Anti-Corruption. Over 6000 organisations from 120 countries have joined so far.

Richard Minogue *and* ***Nigel Iyer*** *have over 40 years’ combined experience dealing with corporate ethics, including a long stretch investigating and detecting incidents of fraud and corruption. For the past 5 years they have focused their efforts on making sure corporate Codes of Conduct really live in practice and that there is consistency between principles and actions. They welcome comments and criticisms on richard.minogue@septiagroup.com and nigel.iyer@septiagroup.com. Their second article in this mini series will deal with how to ensure proper adherence to the Business Principles/Code of Conduct.*

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The insolvent road to recovery

The Companies Act 2006 clarified and expanded on the common law and equitable duties owed by company directors. But there are always some, especially in straitened economic times, who will disregard their obligations and seek to profit personally while the business is occupied with addressing immediate financial concerns. ***Steven Richards*** *of Jones Day considers how the law may assist impecunious and insolvent companies pursue dishonest directors.*

Insolvency and compromise agreements

Companies left in financial difficulty following a director's misconduct may have to consider the company's solvency and associated issues. After advice, they may decide that it is necessary to put the company into administration or liquidation.

When pursuing claims against directors, it often makes sense to appoint an insolvency office-holder. A liquidator, for example, has a wide range of statutory powers and causes of action that are not available to solvent companies. That said, management may be more concerned to preserve the company's solvency. As an alternative to insolvency, a company may be able to ask the court to sanction a compromise arrangement with its creditors or a class of creditors pursuant to *ss895-899* of the *Companies Act 2006* (formerly *s425 Companies Act 1985*).

Such an arrangement was recently approved by the court in the matter of *Langbar International Limited* [2006] (unreported). A number of Langbar's shareholders had purchased shares based on market announcements that misrepresented the company's asset position. The shares were subsequently suspended from trading on the Alternative Investment Market (AIM) and the company was exposed to potential shareholder claims for the resulting losses. Under the terms of the compromise arrangement, the shareholders agreed not to bring proceedings against Langbar and also agreed to assign to the company any claims that they might have against the directors thought to be ultimately responsible. In return, Langbar was obliged at its own cost to pursue both the company and shareholder claims against the directors and to distribute the net proceeds in accordance with the terms of the arrangement. Langbar was therefore able to protect itself from potential insolvency and at the same time strengthen the basis and scope of the claims brought in its name against the directors.

Collating information

Insolvency office-holders will need to collate information and documents relating to the company's affairs in order both to comply with their statutory functions and with a view to the prosecution of incompetent or dishonest directors. Steps may also need to be taken to identify the nature and scope of assets belonging to a suspected director. However, the relevant information is often in the possession or knowledge of the suspect, who is unlikely to want to volunteer it to those left running the company.

The fact that a director has shown a propensity to act dishonestly may entitle the party acting on behalf of the company to seek injunctive relief in conjunction with the issue of proceedings. In addition to prohibiting the dissipation of assets pending trial, such relief (which is available to both solvent and insolvent companies) is likely to contain provisions requiring the defendant director to disclose information and documents evidencing personal assets. In appropriate circumstances, a search order may also be granted that allows the claimant access to the defendant's premises for the purpose of collating and preserving relevant documents.

The court is unlikely, however, to extend the scope of such relief to cover disclosure of company documents. For this purpose, the relevant office-holder may rely on *sections 234-6* of the *Insolvency Act 1986*. These allow the office-holder to apply for orders requiring persons to deliver up company property (*s234*) and attend court for an examination on oath as to the affairs of the company (*s236*), and also impose on former directors and employees a statutory duty to cooperate with the office-holders by providing them with such information as may reasonably be required (*s235*).

The decision in *Daltel Europe Limited v Makki* [2005] 1 BCLC 594 provides a useful illustration of the English court's ability to assist an insolvent company in collating documents and information from a former director. Daltel was owned and controlled by Mr Makki. The company was placed into compulsory liquidation on the petition of its major creditor. A liquidator was appointed who discovered that substantial payments had been made to Mr Makki from Daltel's bank account. There did not appear to be any commercial justification for these payments and proceedings were issued against Mr Makki (including a claim for wrongful trading under *s214* of the *Insolvency Act 1986* – see below). In

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conjunction with these proceedings, the liquidator obtained freezing and extensive search orders against Mr Makki.

Shortly after the issue of proceedings, the liquidator also applied, under *s236* of the *Insolvency Act 1986*, for the examination on oath of Mr Makki about the company's affairs. This application was opposed by Mr Makki on the grounds that it would be oppressive in light of the concurrent civil litigation. This argument was rejected by the court and the application succeeded. It was held by the Judge that the fact that proceedings pending against Mr Makki, including very serious allegations of fraud, could make it oppressive to order his examination in advance of the trial, might be (and was here) outweighed by the liquidator's need for information to enable him to get on with his primary function of identifying and getting in the company's assets. This was even though it was recognised by the court that the answers given by Mr Makki would almost inevitably assist the liquidator's prosecution of the civil proceedings.

Liability of directors

Solvent companies are able to bring claims against directors for breaches of fiduciary duty or on the basis of knowing receipt of trust monies if, for example, they have abused their position of trust and diverted company funds to personal accounts.

In the event that a company is wound up, a subsequently appointed liquidator would have vested in him a number of *additional* and powerful causes of action, which may be applicable to individual directors. These include claims against past and present directors for fraudulent and wrongful trading (*s213* and *214* of the *Insolvency Act 1986,* respectively) and claims relating to the reversal of transactions at an undervalue (*s238*) and preferences (*s239*). Such causes of action can establish or widen the scope of a director's liability, which in turn may assist the ability of the office-holder to obtain a successful judgment and recover assets for the ultimate benefit of the company's creditors.

Case law developments

Potential claimants often hesitate to pursue expensive and protracted litigation. The English courts have traditionally imposed high standards of pleading and proof in cases involving dishonesty, and unscrupulous directors may seek to drag out or complicate the proceedings in order to encourage a favourable settlement.

In response, a number of rules have developed, which make it more difficult for defendants to evade liability for losses flowing from their reckless or fraudulent conduct. For example, the test for causation is not as strict for fraudulent misrepresentation as it is for negligence; it is sufficient for the former if the deceit is a substantial cause of the loss (*Smith New Court v Citibank* [1997] AC 254 HL). It was also held by the House of Lords in *Smith New Court* that, unlike other torts and breach of contract, damages in cases of deceit can be recovered for loss which is unforeseeable and outside the contemplation of the parties. Similarly, it was confirmed by the House of Lords in *Standard Chartered Bank v Pakistan National Shipping Corpn (Nos 2 and 4)* [2003] 1 AC 959, HL) that, unlike the tort of negligence, contributory negligence was not a defence to an action based on fraudulent misrepresentation.

Following the collapse of the *Equitable Life* and *BCCI* cases in 2006, the Commercial Court Users Committee set up a working party in January 2007 with the objective of streamlining heavy and complex litigation in the Commercial Court. The working party delivered its report in December 2007 and its proposals and recommendations have been implemented in the Commercial Court for a trial period in 2008.

Certain recommendations in that report are illustrative of the nature of the Committee's proposals. For example, it is recommended that statements of case should not set out detailed background facts and evidence together with law and argument. They should normally be limited to no more than 25 pages in length and should identify the key aspects of the case. In addition, at the first case management conference the court should settle a list of key issues from a draft provided by the parties. This will be a court document and will regulate the scope of subsequent witness statements and disclosure. With regards to trial, it was recommended that opening speeches for two party cases should ordinarily be no more than two days in length and time limits should be set for the examination of witnesses.

If successful, these recommendations may be implemented in other divisions of the English court and may be applied to all commercial litigation (and not only heavy and complex cases). It remains to be seen though how these proposals will interact with fraud claims given the English courts' traditional requirement for allegations of dishonesty to be pleaded in full.

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Building on sand: part 2 – continuing fallout from the sub-prime crisis

Financial and corporate share prices falling drastically, severe lack of credit in the market, banking collapses, mass unemployment, worldwide recession, increased government spending to stimulate the economy – does it sound like a familiar story? In 1929 this was the economic background at the beginning of the Great Depression. It was not until the start of the Second World War 10 years later that the American economy showed signs of recovery.

As I wrote in the spring of last year, this crisis will have ramifications for the next decade. The unprecedented crisis in the credit markets, exacerbated by the collapse of Lehman Brothers, has caused massive knock-on effects on the banking sector and wider economy. These events have provoked multi billion pound bank bailouts by governments around the world.

Many more businesses will collapse due to lack of finance, and/or downturn in consumer demand caused by the worldwide recession. So far, banks and weaker consumer brands such as Woolworths (a company established in 1909) have been the victims of the downturn, but we can expect many well-run businesses to go into administration or liquidation in the next 12 months.

In an economic downturn fraud tends to become prevalent for two reasons. Firstly, a decline in value of markets will expose frauds. Secondly, the economic circumstances will create an environment where people become desperate and commit fraud, to save their businesses or protect their jobs or bonuses. Tightening economic conditions mean people become overstretched or have unrealistic targets to meet. Under these circumstances there is more of a temptation to commit fraud. Financial figures tend to be subject to greater scrutiny and therefore fraud is more likely to be detected. Businesses that can see the cost/benefit advantage are more likely to litigate to recover losses.

With credit difficult to obtain, owners/operators of businesses can become desperate – they take risks, turning to fraudulent practices to ensure their business survives. Small and medium-sized businesses may attempt to defraud banks and other lenders by borrowing money against the future value of invoices due from their customers, some invoices may be fabricated to increase the amount of money lent.

The threat of fraudulent statements made by businesses and individuals when applying for finance make financial institutions more diligent in assessing those applications. Financial institutions are more likely to refuse credit, even to those with a good credit history. The threat of fraud and lack of credit available to financial institutions themselves have contributed to the slow-down in the UK housing market.

Returning to comparisons with the Great Depression, several frauds came to light in the wake of the 1929 Stock Market Crash and further damaged the confidence of investors. Some commentators point to a fraud by an English financier, Clarence Hatry, in 1929 as a trigger factor.

Mr Hatry attempted to merge major UK steel companies and issued stocks to cover the deal. However, some of the stocks issued were fraudulent. The same certificates had been printed twice and given as security to various banks in London. On 20 September 1929, the fraud was made public and Hatry's empire collapsed. The Bank of England raised interest rates to protect the London market causing money from the US to flow into the UK to take advantage of the higher London interest rates. This had the effect of leaving less money available for brokers' loans in New York and in the week beginning 21 October 1929, the New York stock market plummeted, not to recover its 1929 peak for another 15 years. Hatry was eventually imprisoned for the fraud.

As in the late 1920s/early 1930s, the recent downturn in the markets has resulted in exposure of alleged frauds, which has added to the lack of confidence generally: unauthorised trading at Société Générale, Madoff's alleged Ponzi-style fraud and disclosure by Ramalinga Raju, chairman of Satyam Computers (an Indian outsourcing firm), who resigned admitting accounting malpractice stretching back several years. Mr Raju said that Satyam's balance sheets were riddled with "fictitious assets" and "non-existent" cash, amounting to a UK£1bn gap that could no longer be concealed. Two partners from PricewaterhouseCoopers (PwC), auditors of the firm from 2000 to 2008, were arrested on 24 January 2009 for their alleged role in the Satyam scandal. Although nothing has been proved, comparisons have already been drawn with Andersen's role in the Enron fraud.

How have the UK's regulators/prosecutors responded to the crisis?

In 1933, Roosevelt was inaugurated as President of the United States. As a result of lack of transparency and the need for regulation of financial markets he set up the Securities and Exchange Commission (SEC).

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In the UK it is unlikely that we will see the formation of a new regulator. It is evident, however, that the Financial Services Authority (FSA), whose responsibility it is to safeguard the stability of the UK financial markets, needs to take a more robust and proactive approach to the monitoring and enforcement of financial activities.

The FSA's recent workload has included investigating mortgage fraud, and effecting a ban on short selling of thirty financial stocks, which was introduced to protect financial institutions after HBOS's shares fell by 17% in one day. It is arguable that the ban on short selling had little or no effect, especially in light of massive drops in the stocks of other banks. The FSA launched an investigation into market manipulation after the fall in HBOS's shares. No evidence was found to suggest individuals had deliberately spread false and "malicious rumours" to drive down the price and, therefore, generate profits based on their short positions. As I suggested in my article of spring 2008, proving market manipulation is notoriously difficult.

Other tricky issues have come to the attention of the FSA. David Ross, a co-founder of the Carphone Warehouse, resigned from several posts. He used shares in the company as collateral for personal loans, without disclosure. Borne out of general confusion over the disclosure rules, the FSA gave an amnesty, until 23 January 2009, for companies to disclose undeclared loans. Other directors, including Martin Sorrell of advertising giant, WPP, have subsequently disclosed their use of shareholdings as collateral.

The Serious Fraud Office (SFO) has taken a proactive approach to the economic crisis. The Director, Richard Alderman, announced a probe into the UK operations of Madoff, focussing on the victims and criminal offences that may have been committed in the UK. The probe was initiated without the investigation being referred to the SFO, which is not normally the case. The SFO is reportedly liaising with its counterparts in the US and the City of London Police. Mr Alderman has heralded the Madoff case as "a good example of the SFO's new, faster, approach to tackling fraud."

The SFO recently appealed directly to financial institutions, and professional advisers including accountants and lawyers, to work with the SFO to help identify frauds in the wake of the current economic crisis. The SFO has also appealed to individuals to become involved. Mr Alderman has launched a podcast on the SFO website in which he discusses the economic crisis and what the SFO is doing about it. The SFO has also published a web based referral form "so individual workers, ex-employees, shareholders and anyone with information can tell us about suspected 'City' fraud." It is advised that information provided to the SFO will be treated as confidential.

One should not forget the personal circumstances of people caught up in this economic crisis: the many thousands of people who, through no fault of their own, have been made redundant; the victims of frauds that have now become evident from the major market downturn; and even those well publicised instances of wealthy individuals who, not able to cope with mounting losses or foreclosures on their assets, have taken their own lives.

Echoing my thoughts in the spring of last year, I expect the shake-up in the world's financial system, including consolidation of some of the most powerful banks, to continue. The regulatory regime will become more robust. Some corporates will undergo radical restructuring or fail (as we have already seen). Expect an increase in litigation of frauds generated by and those frauds which have come to light due to the economic circumstances.

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