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More Enforcement and Prosecution Are Needed

The messages coming out of the G-20 Economic Summit held in April included promising developments in regard to three ethics-related aspects of the financial services industry: bank secrecy, the current practices of credit rating agencies, and the lack of transparency in hedge fund activities. But real action is needed to bring about positive change.

Whether or not the outcomes from the April 2009 G-20 Economic Summit include any solutions to containing the downward worldwide economic spiral or to repairing the health of the financial services industry will doubtless be debated for some time. It's encouraging that all 20 countries agreed to long-term restructurings of the financial services industry with respect to three issues that have ethics aspects: the rejection of bank secrecy, the ethical challenges involving credit rating agencies, and the desire to bring more visibility to the activities of hedge funds. Time will tell whether individual countries will actually provide increased action to enact appropriate laws to enforce these concepts and, if needed, prosecute offenders so these global mandates can be fully put into place.

Most interesting is the unanimous global rejection of continued bank secrecy. Undercover transactions have resulted in global tax evasion and money laundering through the assistance of services provided by banks in tax-haven countries. In the words of the communiqué:

"*We agree to take action against non-cooperative jurisdictions, including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over. We note that the [Organization for Economic Cooperation and Development] has today published a list of countries assessed by the Global Forum against the international standard for exchange of tax information.*"

Only bilateral agreements between countries will enable the taxing authorities to make sure that well-heeled individuals and large corporations pay all of the taxes that have been legally determined to be their fair share.

Tax-haven activity is also involved in bribery cases. As reported in the March 2009 column, the Siemens case resulted in a record fine of $800 million in the United States alone. Later, KBR, a former subsidiary of Halliburton, agreed to pay $579 million for its part in a bribery scheme in Nigeria. This is the largest corruption fine for a U.S. corporation. These convictions resulted from an FBI division created in 2007 to investigate violations of the 1977 Foreign Corrupt Practices Act. But until FBI and Department of Justice budgets can be augmented to overcome past downsizing, fewer and fewer fraud cases concerning other violations may actually result in prosecution.

Further, U.S. attorneys in some jurisdictions already have their hands full developing indictments of crooked politicians. Although the recent impeachment and removal from office of Illinois governor Rod Blagojevich has dominated most of the headlines, a *Chicago Tribune* analysis shows that Illinois is far down the list of political corruption, ranking 19th in terms of corruption convictions per 100,000 population during 1998-2007. The notoriety of Louisiana as the hot bed of corruption brought it in at third, behind only the renowned futility of the District of Columbia and North Dakota (considered a fluke because of its miniscule population).

Some of the more interesting Louisiana convictions after 2007 include a former state senator who

pleaded guilty to committing money laundering and the former head of the state's film commission, who is awaiting sentencing on accepting $80,000 in bribes. The state's high ranking looks assured for some time as the current Inspector General of New Orleans, who worked in Chicago during 1996-2002, has a work-in-progress list of 140 undercover boards and agencies that receive money but aren't covered by any city audit.

An encouraging enforcement development in the U.S. affecting tax havens occurred in February 2009 when UBS, the largest bank in Switzerland, paid a fine of $780 million and pleaded guilty to helping thousands of wealthy U.S. citizens avoid or evade paying income taxes through secret offshore accounts. Potentially 27,000 "tax cheats" and $20 billion in untaxed income may be involved in such schemes at UBS alone.

The current administration has also announced plans to accelerate IRS enforcement actions and to bring criminal charges against offenders in order to collect as much as $100 billion of the $300 billion gap between estimates of unpaid income tax and amounts actually paid. Last year, the U.S. Senate Permanent Subcommittee on Investigations said that the government "loses an estimated $100 billion in tax revenues due to offshore tax abuses" each and every year.

Also in February, AIG, the struggling recipient of federal TARP funds, sued to obtain return of tax payments stemming in large part from the company's use of aggressive tax deals, some involving entities controlled by AIG's financial products unit in the Cayman Islands, Ireland, the Dutch Antilles, and other offshore tax havens. The current administration is said to be cracking down on the practice of obtaining fraudulent foreign tax credits.

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Second, the G-20 communiqué singled out the ethical challenges facing credit rating agencies as needing special attention. The message states:

"*We agree to extend regulatory oversight and registration to Credit Rating agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest.*"

In view of the importance of credit ratings in the financial services industry, the U.S. has an important challenge in making sure that the responsibilities of these agencies are performed with competence and independence. It's unclear what the phrase "international code of good practice" means. Self-regulation in the financial services industry hasn't been very effective in the past, but perhaps oversight is an alternative to closer direct regulation by the Securities & Exchange Commission (SEC), currently the regulator for these agencies. Most needed is the development of standards for the rating process itself. Currently, there are no generally accepted methods that rating agencies should use.

The conflict of interest most often mentioned in connection with the credit rating industry is the common practice that the company being rated also provides the compensation to the agency developing the rating. This is the same conflict of interest facing every public corporation and its registered public accountant. So far, external auditors haven't drawn much criticism for their part in failing to prevent the banking fiasco. This may be because of the Sarbanes-Oxley requirements for audit committee intervention in selecting, supervising, and compensating their company's audit firm. Perhaps a similar requirement for audit committee oversight of corporate dealings with credit rating agencies should be considered.

A final important commitment of the 20 nations is to bring the shadow world of hedge funds into the more normal investment environment:

"*We agree to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds.*"

In addition to systemic financial

risks posed by the secret transactions of some hedge funds, the fact that pension funds and other more widely available products now utilize these investment vehicles demands that investor protections be provided in the same fashion as other products.

It's clear that better, more consistent practice of good governance and strong ethical principles are critically important to the success of the financial services industry and should be considered before adopting many new, costly, and complex regulatory protocols.

Examples of the lack of enforcement and prosecution of existing laws and regulations have been provided by the ethical indiscretions and outright illegal actions that have been brought to light by the scrutiny afforded recent presidential appointments. Perhaps the most egregious of these is Timothy Geithner, Secretary of the Treasury and the head of the Internal Revenue Service (IRS). During 2001-2004, he was employed in the U.S. by the International Monetary Fund (IMF). This organization doesn't participate in the Social Security and Medicare systems, but it takes great pains to help its employees pay those taxes as self-employed individuals. These efforts include paying to employees, upon proper application, the "employer's share" of payroll taxes due. Each year, Geithner applied for and received from the IMF the money for half of these taxes but didn't remit them to the IRS until prodded.

In 2006, the IRS audited Geithner's tax return and assessed additional payroll taxes and interest of $21,732 for 2004 and 2003, which he paid (penalties were waived). Previously, he had late-filed payroll taxes for a household employee for three years. After Barack Obama expressed his intent to nominate Geithner to be Secretary of the Treasury, the transition team discovered Geithner hadn't paid Medicare and Social Security taxes on his 2001 and 2002 income. He promptly paid $25,970, including interest but without penalty. Shortly after this, he filed amended returns for these years to correct other errors and omissions, paying an additional $5,566 in tax and interest. Geithner prepared his own tax returns for most of the years in question using TurboTax, which has the capability of prompting proper calculation of payroll taxes in situations like this.

It appears quite clear that this person, who should have been familiar with the tax code, or else should have obtained professional tax assistance, seemed to only pay taxes when faced with an audit. Hopefully, he'll set a more ethical example in the future so others will be motivated to comply voluntarily with tax code provisions. **SF**

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