Curtis C. Verschoor, CMA, Editor

SEC Has Five Prominent Fraud Cases in One Month

July was a busy month for the SEC. Five of the enforcement cases charged or settled that month involved large, well-known companies, including KBR, Goldman Sachs, Dell, General Electric, and Citigroup.

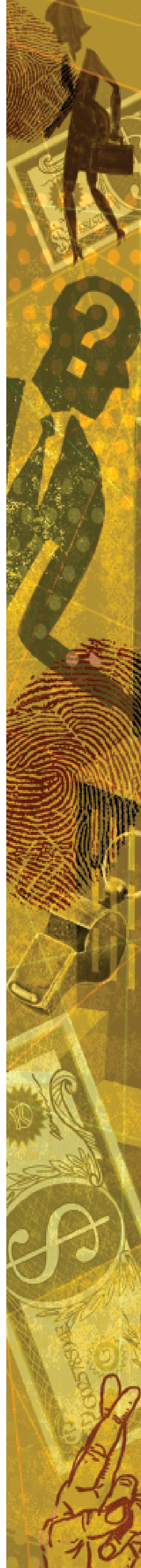
July could have been a slow summer vacation month this year. Instead, it turned out to be surprisingly productive for the Securities & Exchange Commission (SEC)—not because of the number of fraud cases it charged or settled, but because of the size of penalties and the prominence of the guilty companies. There were only seven enforcement cases considered significant enough to merit a press release that month, but five of those cases involved large and very-well-known companies.

On July 7, the SEC concluded a case about a joint venture that bribed foreign officials in Nigeria, a violation of the Foreign Corrupt Practices Act (FCPA). The venture companies consisted of Italian oil company ENI and its subsidiary Snamprogetti; Technip, a global engineering, construction, and services company based in Paris; and the U.S. defense contractor KBR, the former subsidiary of Halliburton Company. Through agents in the U.K. and Japan, the joint venture funneled more than $180 million in bribes to Nigerian government officials. In addition to the use of Swiss bank accounts, carloads of cash were hand-delivered to a hotel in Abuja, Nigeria. The total sanctions to the companies amounted to $1.28 billion, including disgorgement of profits from the illicit contracts of $400 million. According to the SEC, this is "the largest combined disgorgement amount ever in an FCPA violation." A criminal settlement with one of the companies involves a fine of $240 million and a deferred prosecution agreement, but no prison time for anyone.

A few days later, the SEC announced a record-setting settlement fine of $550 million with Goldman Sachs & Co. because of the firm's misleading actions in marketing to investors a subprime mortgage product just as the U.S. housing market was beginning to collapse. In disclosures about Goldman's synthetic collateralized debt obligation (CDO), facts were hidden that hedge fund Paulson & Co. Inc. played a role in selecting the contents of the CDO while simultaneously taking a short position against the product in the marketplace. Goldman neither admitted nor denied guilt in the transaction. Two-and-a-half months after the settlement, Fabrice Tourre, the principal Goldman officer involved, asked a judge to dismiss the SEC's fraud claim against him because the transaction didn't occur in the Unites States.

As part of the settlement, Goldman also agreed to "reform its business practices" as a part of its "present comprehensive, firm-wide review of its business standards." New procedures include submitting residential mortgage products to a firm-wide capital committee for approval and requiring marketing materials to be approved by the legal or compliance department. At least once a year, the Goldman internal audit function must provide assurance that these actions are being taken. Further, where Goldman is lead underwriter, its outside counsel must also review pertinent compliance documents. At least once a year, all individuals involved with structuring or marketing of mortgage securities offerings must complete training in federal disclosure requirements. None of the individuals involved faces prison time.

On July 22, the SEC reported settling with Dell, Inc., the computer maker, for a penalty of



$100 million. Dell also agreed to enhance its disclosure processes, including the retention of an independent consultant to recommend improvements and enhance training regarding the disclosure requirements of the federal securities laws. Dell was charged with using fraudulent accounting to make it falsely appear that the company was consistently meeting Wall Street earnings targets and reducing its operating expenses.

The SEC's complaint further alleged that Dell's most senior former accounting personnel engaged in improper accounting by maintaining a series of "cookie jar" reserves that they used to cover shortfalls in operating results. Dell failed to tell shareowners that its results were influenced by large payments for agreeing not to use CPUs from manufacturers other than Intel. When Intel payments stopped, Dell told the public that the cause of lower operating profitability was that it priced too aggressively in the face of slowing demand and that component costs had declined less than expected. Dell neither admitted nor denied guilt.

Dell's Chair and CEO Michael Dell, former CEO Kevin Rollins, former CFO James Schneider, former regional VP of Finance Nicholas Dunning, and former Assistant Controller Leslie Jackson neither admitted nor denied the SEC's charges. Michael Dell and Rollins each paid penalties of $4 million and agreed to an order that restrains them from aiding or abetting securities laws violations in the future. Schneider's penalty was $3 million plus disgorgement and interest of $126,000. Dunning paid $50,000. Schneider, Dunning, and Jackson consented to the issuance of administrative orders suspending each of them from appearing or practicing before the SEC as an accountant for varying periods. The SEC stated that it was continuing its investigation of other individuals.

Three of the seven July CFTC fraud enforcement releases mention criminal charges, whereas none of the SEC press releases does so.

Just five days after the announcement of the Dell settlement, the SEC announced a $23.4 million settlement with General Electric (GE) for FCPA violations of bribery activities in connection with the United Nations Oil for Food Program in Iraq. The SEC alleged that two GE subsidiaries, along with two other subsidiaries of public companies that have since been acquired by GE, made illegal kickback payments in the form of cash, computer equipment, medical supplies, and services to the Iraqi Health Ministry and the Iraqi Oil Ministry. Without admitting or denying the SEC's allegations, GE and its subsidiaries have consented to the entry of a court order enjoining them from any future violations of securities laws.

On July 29, the SEC settled a charge of false disclosure with Citigroup for payment of a $75 million penalty. At a time of intense focus on banks' exposure to subprime mortgages, Citigroup represented that the subprime exposure in its investment banking unit was $13 billion or less, when in fact it was more than $50 billion. Former CFO Gary Crittenden agreed to pay $100,000, and former head of investor relations Arthur Tildesley, Jr. (currently the head of cross marketing at Citigroup) agreed to pay $80,000. Everyone involved neither admitted nor denied the SEC charges, but all have consented to the entry of a court order enjoining them from any future violations of securities laws.

Two other SEC cases involving lesser-known alleged violators were reported during July and involved requests for emergency asset freezes. New York accountants Laurence M. Brown and Ronald Mangini were charged on July 22 with bilking a dozen people for $2 million in a Ponzi scheme. In the other July enforcement press release, the SEC charged brothers Samuel E. Wyly and Charles J. Wyly, Jr., of Dallas with violating federal securities laws governing ownership and trading of securities by corporate insiders. While sitting on corporate boards, the Wyly brothers reaped more than $550 million in undisclosed gains by trading stock in those public companies through entities located in foreign jurisdictions and hidden to conceal their ownership and trading of those securities.

The SEC wasn't the only busy agency. The most interesting Commodity Futures Trading

Commission (CFTC) fraud enforcement press releases in July included charges for:

- Phillip Milton, Gregory Center, and William Center, who operated a $28 million Ponzi scheme in connection with a commodity pool.
- Paul Greenwood, who operated a $1.3 billion investment scam, and Stephen Walsh, who, with Greenwood, misappropriated at least $553 million from commodity pool participants.

It's interesting to note the contrast between the CFTC cases and SEC cases. Three of the seven July CFTC fraud enforcement releases mention criminal charges, whereas none of the SEC press releases does so.

Just a few days into August, the SEC charged Thomas Flanagan, vice chairman of Clients and Markets and a high-ranking partner at Deloitte, with insider trading and the subsequent loss of independence for the firm. Flanagan made significant profits trading on inside advance information, such as earnings releases, earning guidance, and acquisitions, from nine audit clients, such as Best Buy, Sears, and Walgreens, and consulting client Motorola. Flanagan also passed along tips to his son, who also profited by trading on the nonpublic information. The Flanagans agreed to pay $1.2 million to settle the charges, but they didn't admit or deny the SEC's allegations and thus avoided criminal penalties. Deloitte wasn't sanctioned, but Robert Khuzami, director of the SEC's Division of Enforcement, said, "All audit firms should learn from this unfortunate episode and employ vigorous controls designed to ensure compliance with the SEC's auditor independence rules."

With all these high-profile, prominent fraud cases charged or settled by the SEC in just one month leading to no prison time, it seems more resources should be devoted to proving criminal charges. Monetary fines and promises never to repeat the behavior don't seem to be effective deterrents. **SF**

Curtis C. Verschoor is the Ledger & Quill Research Professor, School of Accountancy and MIS, and an honorary Senior Wicklander Research Fellow in the Institute for Business and Professional Ethics, both at DePaul University, Chicago. He is also a Research Scholar in the Center for Business Ethics at Bentley University, Waltham, Mass. His e-mail address is curtisverschoor@sbcglobal.net.