# WHITE-COLLAR CRIME FIGHTER

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YOUR SECRET WEAPON IN THE WAR ON FRAUD

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## IN THE NEWS

### Good News About Securities Fraud Litigation

The number of securities fraud class actions filed in 2006 was the lowest since adoption of the Public Securities Litigation Reform Act of 1995.

***Details:*** According to latest research, securities fraud class actions plunged by 38% from 2005 to 2006—from 178 filings to just 110.The decline is even more dramatic when measured by market capitalization losses.

***Example:*** In 2006 the total Disclosure Dollar Loss (market capitalization losses at the end of the class period), dropped by 44%—from $93 billion in 2005 to $52 billion in 2006.

***Also significant:*** Excluding cases involving options backdating (20 in 2006), "core" securities class actions in 2006 totaled only 90 cases—down 53% from the historic norm.

*Possible explanations:*

•Strengthened federal enforcement—reflected in increased pressure from the SEC and Justice Department on corporations to conduct internal investigations that implicate individual executives responsible for the frauds.

•A strong—and substantially less volatile—stock market. This typically reduces the number of cases filed.

***White-Collar Crime Fighter* source:** *Securities Class Action Filings 2006 Year in Review* report by Stanford Law School Securities Class Action Clearinghouse, a joint project between Stanford Law School and Cornerstone Research, http://securities.stanford.edu.

## IN THIS ISSUE



Chuck Gallagher

# Do You Have What It Takes to Be a Fraudster?

## Lessons from an Honest Person Turned Felon

I am your typical honest, hard-working middle class American. I went to college, earned a masters degree in accounting, became a CPA and landed a great first job at a local accounting firm in North Carolina.

I had a wife and two great kids and all was well with the world. Until…

About two years into my career as a CPA, which had me handling trusts and retirement accounts for corporate and individual clients, I decided I wasn't becoming "successful" fast enough. I noticed professionals of my age driving fancy cars while I commuted to work in a plain old Buick. People I hung out with had bigger houses than I did, their wives wore more expensive jewelry than mine did and they ate at restaurants that I couldn't afford.

***Result:*** My wife and I began to feel driven to "keep up with the Joneses" by spending money we didn't have.

Before I knew it, I was two months behind in my mortgage payments and the bank was starting to call with "reminders" to keep my payments current.

### THE PIVOTAL POINT

The financial pressure was beginning to keep me up at night, worrying about how I could avoid getting deeper into debt. Because I'm an honest, law-abiding citizen, my first thought was to ask for a short-term loan from my family. Other options I considered were using one of those outfits that offers unsecured consumer loans at high interest rates…or taking cash advances on my credit cards.

***Fateful opportunity:*** Because I was the trustee for several of the client accounts managed by my CPA firm, I had total freedom to manage the money in those accounts.

It didn't take long to realize that I had a basically risk-free opportunity to "borrow" from any of these accounts by simply writing myself a check.

But since I considered myself an honest person, I initially rejected that option because I could see no way around the hard fact that such fiduciary impropriety boiled down to plain old theft.

It didn't take long, though, for me to become a poster boy for the Fraud Triangle.The pressure of those mortgage payments along with my craving for "success" was intensifying. The opportunity to secretly make the "loan" to myself was at my fingertips, and I rationalized the fraud by convincing myself that "it's just a loan and I'll pay it back, so no one will ever know about it."

I "borrowed" $5,000 from a client's retirement account. And I actually drafted an IOU and stuck it in the client's file—to make the whole thing feel legitimate.

### REPAYMENT: BEGINNING OF THE END

True to my self-image as an honest person, I repaid the "loan" within a few months with money I received as a salary bonus. It felt great to be free of that burden—with my integrity intact (or so I thought).

***Problem:*** It was too easy to perpetrate this fraud. Of course, I didn't think of it as fraud at that time, and so I cer-

tainly never thought I'd ever get caught.

Still driven by my frenzied pursuit of "success," I rationalized a second "loan" from a client account.

***Long story short:*** I didn't get caught the second time…or the third time…or even the fourth time. For three and a half years I stole money, repaid portions of it, stole more, repaid portions, and on and on. This proverbial vicious cycle soon became addictive. The seemingly risk-free nature of the activity, together with the "rewards" of being able to afford the trappings of "success" created an emotional high that I never even thought of giving up.

Then, one day, a client called saying he needed to liquidate an investment I had recently helped him make because he urgently needed the cash.

***Problem:*** I hadn't invested the money. I had stolen it. And at that point, I had no immediate source of funds to replenish his account—either legally or illegally. I knew at that moment that my life as I knew it was over. I knew I was going to face some serious consequences, though at the time I didn't know how serious. By that time I had embezzled a total of $256,000.

***What happened:*** I made restitution to the clients I had stolen from, but that wasn't enough. The IRS and the Department of Labor weren't prepared to let me off the hook that easily. After making the long and painful journey through the legal system, I ended up with an 11-month sentence in federal prison, followed by five years probation.

### LESSONS LEARNED

As an anti-fraud professional, you might be saying to yourself, "Big deal. He's just another one of the thousands of fraudsters out there. He just got unlucky and got caught."

***Reality:*** True as that may be, the lessons I learned are lessons that I hope no one else, currently or soon to be working for a corporation or other organization will be forced to learn the way I was…

***Lesson #1:*** **If you've never stolen from your employer or your customers, but find yourself thinking about doing it because you can…understand this: *you can't.*** You may get away with it the first time. But if you're like most honest people who ended up on the wrong side of the law the way I did, that first "taste" won't be your last. Your first success will give you the confidence to "go again." And if you don't get caught, you'll go a third time. Before you know it, you'll be a fraud addict and getting caught will only be a matter of time. You will face consequences…and you won't like them.

***Lesson #2:*** **American culture's emphasis on material possessions as the measure of personal success is a potential death trap.** The bigger your house, the fancier your car, the more exclusive your country club, the more "successful" you are. At least that's what popular culture has drilled in to us.

***Problem:*** I fell into this trap in a dan-

## Beyond Firewalls: Ways to Defend Against Cyber-Crime

Finely tuned firewalls can help your organization keep many of the "bad guys" from stealing confidential company data, sabotaging your network or exploiting other vulnerabilities.

Unfortunately, no high-tech defense against cyber-crime is adequate in today's world of increasingly sophisticated Internet crime.

***Effective:*** In addition to technological defenses, the best strategy for protecting your organization's computer systems is to build "redundancy" and "diversity" into the systems.

***Definitions:*** "Redundancy" is the approach of having more than one server, operating system or business application running at all times. "Diversity" similarly involves having more than one of everything, but each individual system component is different.

***Example:*** Running part of your business on Windows machines and other key parts of it on Linux systems. That way, if an attacker successfully compromises one system, you can still operate with the other.

Additionally, diversity dictates that organizations physically distribute their network components among several locations—to further stymie cyber-criminals.

***Added benefit:*** Diversity also allows you to upgrade security on your systems with patching, without risking your entire system if a patch proves to be flawed.

***White-Collar Crime Fighter* source:**

Martin Lindner, senior member of the technical staff in the Networked Systems Survivability Program at the Software Engineering Institute (SEI) of Carnegie Mellon University. This article is based on a recent SEU podcast, *Proactive Remedies for Rising Threats,* http://www.cert.org/podcast/show/remedies.html

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Mission Statement

*White-Collar Crime Fighter* provides information of maximum practical value to organizations and individuals involved in all facets of investigating, detecting and preventing economic crime.

This community includes law internal auditors…fraud examiners…regulatory officials…corporate security professionals…senior executives…private investigators…and many more.

The editors of *White-Collar Crime Fighter* strive to gather and compile the most useful and timely information on economic crime issues.

Comments, suggestions and questions are welcome. Please fax us at 203-431-6054, or E-mail us at editor@wccfighter.com. Visit us on the Internet at www.wccfighter.com.

gerous way. I lost sight of the non-material things that give life real meaning. Things like watching your kids grow up, friendships, physical and emotional health—none of it meant anything to me. I became obsessed with the need to acquire and that's what got me into the financial hole that led to my first white-collar offense.

***Solution:*** We all need to take a step back and get our priorities straight. Sure, it's nice to have a big house and an $80,000 SUV. But in the end, none of that stuff can be the ultimate source of happiness…or success.

***Lesson #3:*** **Justifying criminal action by convincing yourself that "everyone is doing it" is deadly.** Unfortunately, as the rash of mega-corporate frauds and govern-

**If you've never stolen from your employer or your customers, but find yourself thinking about doing it because you can…understand this: you can't**

ment ethics scandals prove, people in positions of power seem increasingly willing to blur the line between right and wrong, even if it's "just this one time."

***Problem:*** While fraudulent and unethical conduct may be on the rise, that doesn't mean that if you join the crowd, you won't get caught. And when you do, society suddenly becomes a lot less tolerant than you thought it was before you got caught. Spending even one single day in jail is horrible beyond description. And your ordeal won't end after you serve your time. Your criminal record will follow you wherever you go…it will ruin your personal life, your career and your self-esteem.

***White-Collar Crime Fighter* source:**

Chuck Gallagher, a former CPA who spent 11 months in Federal Prison Camp at Seymor-Johnson Air Force Base. Chuck is an extremely lucky ex-con, in that he possessed the intelligence and character to face his wrongdoing, pay for it and move on to regain emotional and physical well-being. He was also lucky enough to know a senior executive of a public company who saw the decent qualities in him and took a chance by offering him a job as a sales and marketing manager. He currently is earning an honest living at that job and spends his free time speaking to corporate and academic audiences about his former life as a fraudster.

Information on Chuck's presentations to college and university students can be found at www.chuckgallagher.com.

**FRAUD RISK REDUCTION**

Christine Doxey, *APEX Analytix*

# Enterprise Risk Management (ERM) Versus the "Fraud Perfect Storm"

Between 2001 and 2002—in the wake of the mega-scandals of Enron, Tyco, WorldCom, etc.—a "perfect storm" of devastating forces hit corporate America. *Most significant…*

- Loss of integrity and trust in the "system," resulting in a massive loss of share value.
- Intense anxiety on the part of boards of directors and audit committees about civil and criminal liabilities.
- Widespread perception of the executive suite as a "crime scene."
- Health-threatening worry on the part of employees about job security, 401ks and pensions.
- A multi-pronged attack on the accounting profession with ultimate implementation of tough new oversight.
- Intense pressure on the SEC and Justice Department to restore confidence in financial markets.
- A rash of fraud and ethics investigations of securities brokers, bankers and rating agencies.

*Major targets of the resulting legislative and regulatory backlash…*

- Lack of independence on the part of boards of directors, external auditors, rating agencies, securities analysts and lenders.
- Lack of integrity in financial statements, operating performance and communications with shareholders.

## THE NEW GOVERNANCE

***Result:*** The "perfect storm" resulted in a groundswell of demand for vigilant oversight of fraud risk. *Corporate directors are now virtually required to ensure that...*

- They understand the organization's fraud risks and the risk alert process.
- Potential impacts of high-risk frauds on key stakeholders have been assessed.
- Risk mitigation plans are in place to avoid "spiral" effects or "meltdowns"—fueled by what in the case of WorldCom was referred to as "poisonous corporate culture" fostered by top management.
- Fraud risk mitigation policies are in place, such as auditor independence, code of conduct and governance guidelines.
- Fraud risk management practices are established, monitored and evaluated.
- The organization has crisis preparedness plans in place for such "worst case" scenarios as accounting conflicts of interest…improperly booking expenses…insider trading…illegal insider loans, etc.

## FRAUD RISK IN THE ERM MODEL

The enterprise risk management (ERM) model defines business risk as the possibility that an event will occur and will adversely affect the achievement of objectives. Deloitte & Touche defines risk as the potential for loss or impairment of existing assets and future growth. In the late 1990s and early 2000s, fraud risks topped the list of business risks, thanks to the events leading up to the "perfect storm." *These included…*

- Financial reporting fraud ("book cooking").
- Theft of assets (cash skimming, inventory theft, embezzlement, etc).
- Serious breaches of Code of Conduct.
- Insider trading and other securities fraud.

***Result:*** Today, management at all levels must understand and contribute to the organization's continuous con-

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