

Statement of the Institute of International Banking Law & Practice regarding Commercial Fraud in Light of the Madoff Scam

Submitted to the Committee on Financial Services of the House of Representatives in connection with the Hearing on Assessing the Madoff Ponzi Scam and the Need for Regulatory Reform on 5 January 2009

It would be unfortunate if the Madoff scam were to be viewed as an isolated instance that had been overlooked and escaped detection. While of massive proportions, it is part of a global phenomenon that is growing exponentially, is seriously underestimated, and that constitutes a serious cancer that is attacking the institutions of finance, commerce, and trade that are vital to modern life. While there are few authoritative global figures available, conservative estimates based on national surveys and studies of international industry associations place the *annual* cost of commercial fraud, of which the Madoff scam is an instance, at annual amounts in excess of the US\$ 50 billion projected losses in the Madoff scheme.

The phenomenon of commercial fraud differs from typical consumer fraud in that its targets are sophisticated investors and companies, it utilizes and distorts the devices of modern finance and communications, the losses are enormous, and the consequences may undermine trust in the major systems of payments, investments, trade and finance.

The Madoff scam was successful because it cleverly mimicked and utilized the tools and systems of trade. In an expanding market, the scam compromised legitimate institutions through organizational and personal conflicts of interest and manipulated victims using the insights of psychology. It was able to operate for such a long time because its mode of operation and returns, while not viable, were not so extreme as to warrant careful scrutiny in the face of actual returns. But it is not alone; such schemes abound. And even as the Committee meets, other fraudsters will be seeking out victims of the Madoff scam, seeking to defraud them further in schemes claiming to be able to recoup lost funds. Robbery with a pen or computer is safer and more effective than with a gun and has attracted a bright and capable class of criminals due to its profitability and relative freedom from negative consequences.

As a result of its 20 years of experience in forming alliances to combat commercial fraud with the public and private sector, it is the opinion of the Institute that

- This phenomenon of commercial fraud cannot successfully be addressed solely by measures restricted to traditional categories of regulation or law enforcement, measures focused on punishment or penalties, and measures that stop at national borders. The problem of commercial fraud is global and the solution requires not only increased awareness, resources, and cooperation by regulators and law enforcement but requires an appreciation of the need to engage the private sector as an important stakeholder in this battle. It is the private sector that has the resources and the ability to spot these schemes and educate employees and

customers against them. To do so, private institutions need to be encouraged to seek out other organizations with similar challenges and given ways to cooperate with regulators and law enforcement. The complexities in funding public-private sector partnerships and other problems present a significant barrier to such cooperation. All such barriers to cooperation need to be explored and reduced where possible.

- Combating commercial fraud needs to once again be a focus for regulators and law enforcement agencies. The net effect of the reallocation of resources to combat terror has been to create a virtual “open season” for frauds, particularly those small enough to not attract significant public attention. Commercial fraud cannot be overlooked, however. Its enormous impact on the global economy and its potential as a source of funding and money laundering for terrorism and organized crime cannot be ignored.
- Particularly with respect to Ponzi and Pyramid schemes, both of which were part of the Madoff scam, federal legislation should be enacted similar to the bankruptcy act that would consolidate claims and litigation. Such treatment should require all victims to be treated on a pro rata basis based on their loss and not based on accidents of when funds were taken or received from the fraudulent investment. This allocation should also penalize enablers who have promoted the scheme and enable pursuit of claims related to the fraud against private institutions to be pursued in the interest of all victims. Instead of fostering a multiplicity of private litigation, such an approach would permit an orderly and efficient distribution of those funds that were recaptured.
- For too long, fraudsters have used national borders as a means of escaping regulatory or criminal consequences. Governmental agencies and private claimants are often confined by rules, policies or limited resources to the traditional boundaries imposed by nation-states. But fraudsters are free to work globally, hiding out in one nation while deploying computers or working with confederates in other nations and seeking victims around the world, operating without restrictions or consequence. This aspect of the problem can only be addressed by building international consensus, creating increased awareness of the menace of this phenomenon for all nations, rich or poor, north or south, developed or developing, and forging international institutions and conventions able to address the problem globally.
- One of the most important defenses against commercial fraud lies in professionals such as accountants, lawyers, and investment advisers. Sadly, some professionals facilitate such schemes by lending their name or credibility to them. Because of the difficulties involved in proving collaboration, most such associations or licensing bodies are reluctant to pursue claims. In the UK, the Law Society of England and Wales has developed a pro-active approach to situations where there is a possibility of such facilitation which has had a remarkable record of success. It has a staff of anti-fraud investigators with extensive powers to examine financial accounts and records. Despite the Society’s willingness to cooperate, no professional organization has been interested in discussing similar measures in the US. Moreover, there is a serious deficiency in awareness training for professionals to help them identify and combat commercial fraud.

There are examples of successful cooperation in all of the above mentioned respects. The phenomenon of Prime Bank or High Yield Fraud for example, while not eradicated, in the period from 1998 to 2005 was significantly reduced through private and public cooperation in the ways indicated. This instance of commercial fraud, which in many ways resembles the Madoff scam, is explained in *The Myth of Prime Bank Investment Scams* published by the Institute, copies of which have been made available to the Committee. Such methods of cooperation and similarly successful ones need to be identified, encouraged and expanded.

In this regard, the Institute calls to the attention of the Committee important work undertaken by the Bureau of the Public Debt, the US State Department, the North American Securities Administrators Association (NASAA), and the United Nations Commission on International Trade Law (UNCITRAL). We believe that these instances represent a way forward for the US and the world.

Prime Bank Schemes regularly claimed that they were in some mysterious manner backed by or trading at a discount Treasury instruments. These claims were wholly false but credible to persons not familiar with the intricacies of public finance. In cooperation with various interested financial organizations whose products and reputations were under attack by fraudsters, the Bureau of the Public Debt consulted informally with private and public agencies to educate, deny the use of its name and reputation, and forge informal links with financial institutions and law enforcement throughout the world. As a result of its pro-active stand, fraudsters were, to a considerable extent, denied the use of the Treasury brand to add to the credibility of their schemes.

NASAA actively encouraged state and provincial securities administrators to counteract Prime Bank Frauds within their respective jurisdictions and provided them with the educational and practical tools to do so. With the support of NASAA, informal meetings were held and conferences hosted to bring together representatives from regulators, law enforcement, banks, academics, and other private sector institutions in the US. In addition, links were forged with other similarly interested groups in Europe and Asia and sessions held in the US, Europe, and Asia with a view towards training staff, agreeing on tactics, and encouraging education. These efforts led to increased prosecution of Prime Bank Frauds but, more importantly, empowered those involved to warn, teach, and generally engage in activities aimed at prevention.

In connection with the work of UNCITRAL, the US State Department's Office of the Legal Counsel for Private International Law encouraged organizations in the US that were concerned about the need for awareness of the private sector regarding commercial fraud to bring their concerns before the UNCITRAL. As a result and with the encouragement of the US, UNCITRAL convoked a group of experts to advise the UNCITRAL Secretariat and held a global colloquium on commercial fraud which attracted widespread participation and interest and increased awareness of the scope of the problem. As a part of its cross-border fraud prevention initiative, the Secretariat, with the assistance of its Group of Experts on Commercial Fraud, formulated its report on the

Indicators of Commercial Fraud (A/CN.9/624) which is available at www.uncitral.org . A copy of this report accompanies this Statement. It should be noted that many of these Indicators are relevant to the Madoff scam, particularly Indicators 13 (Questionable or Unknown Source of Repayment) and 20 (Pyramid and Multi-Level Marketing Schemes). UNCITRAL encourages the use of this report in educational and technical assistance initiatives of Governments and international organizations, and feels it will be of particular value to fraud prevention programs in developing and transitional economies.

While these instances are tentative, they do indicate that the phenomenon of commercial fraud can be addressed and resources harnessed on a global basis in a constructive manner with relatively modest efforts and cost.

It is our hope that these long term aspects of the problem will not be overlooked and that the Committee will consider measures aimed at encouraging and strengthening those institutional initiatives that exist and have proven successful in an integrated and coordinated effort to combat commercial fraud.