Congress Passes First Financial Regulation Reforms of 2009: Expands Scope and Funding of Fraud Enforcement

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Introduction

On May 20th, President Obama signed the first piece of legislation reforming the oversight of the financial industry following the recent economic upheavals. The Fraud Enforcement and Recovery Act (FERA), Public Law No. 111-21, strengthens enforcement of securities and commodities fraud, financial institution fraud involving asset-backed securities, and fraud related to federal assistance and relief programs. Specifically, the Act expands the scope of securities fraud provisions to include commodities and derivatives fraud and extends the prohibition against defrauding the federal government to the TARP program and to the stimulus bill. The legislation provides the Department of Justice with the tools it needs to fight fraud in the use of funds under TARP and the American Recovery and Reinvestment Act.

In addition, the measure authorizes additional appropriations for the SEC and other federal agencies to investigate and prosecute fraud, and creates a Select Commission to examine the causes of the current financial crisis. The legislation also makes several important improvements to existing fraud and money-laundering statutes to strengthen prosecutors' ability to combat this growing wave of fraud.

The original Senate bill, S. 386, was introduced by Senator Patrick Leahy, chair of the Judiciary Committee, and Senator Charles Grassley, Ranking Member on the Finance Committee. It reflects a sense of Congress that fraud contributed to an unprecedented collapse in the mortgage-backed securities market. The legislation attempts to ensure that this kind of collapse cannot happen again. A main component of the reform is the

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reinvigoration of federal antifraud measures. The Fraud Enforcement and Recovery Act is a major step toward holding accountable those who have caused so much damage to the U.S. economy, while at the same time protecting economic recovery efforts from the scourge of fraud.

The Senate bill was passed with amendments by the House, creating a blended compromise measure that combines the original S. 386 with HR 1748, the Fight Fraud Act, sponsored by House Judiciary Chair John Conyers. The Senate agreed to the amendments, with a minor amendment of its own involving the Commission's subpoena power; and the House agreed to the Senate amendment and cleared the legislation for the President, who is expected to sign it.

The differences between the Senate and House measures were not terribly significant, one of which is the composition of the Commission, which the House measure calls the Financial Crisis Inquiry Commission and the Senate calls the Federal Markets Commission. The final legislation creates the Financial Crisis Inquiry Commission. Also, a section in the Senate bill amending the international money-laundering provision in the federal money-laundering statute to make it a crime for individuals to transport or transfer money in and out of the United States to evade taxes was dropped by the House.

FERA makes a number of important improvements to antifraud and money-laundering statutes. Specifically, the legislation amends the federal securities fraud statute to cover fraudulent schemes involving commodities futures and options, including derivatives involving the mortgage-backed securities that caused such damage to the banking system.

The Act authorizes additional appropriations for the SEC to fight financial fraud of $20 million for fiscal years 2010 and 2011. The legislation specifically states that the additional funds are to be used for investigations and enforcement proceedings involving financial institutions. The Act also adds $1 million a year for two years for the salaries and expenses of the SEC's Inspector General.

Senators Leahy and Grassley observed that the legislation includes important improvements to federal fraud and money-laundering statutes to strengthen prosecutors' ability to confront fraud in mortgage lending practices, to protect TARP funds, and to cover fraudulent schemes involving commodities futures, options and derivatives, as well as making sure the government can recover ill-gotten proceeds from crime.

Fraudulent Derivatives Transactions

The legislation amends the federal securities antifraud statute to cover fraudulent schemes involving commodities futures and options, including derivatives involving the mortgage-backed securities that caused such damage to the financial system. The federal securities antifraud statute was added to the U.S. criminal code by Section 807 of the

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Sarbanes-Oxley Act, which created a new federal felony for securities fraud with a 25-year penalty.

Section 807, codified as 18 U.S.C. §1348, made it easier to prove securities fraud while at the same time increasing the penalty. Before Sarbanes-Oxley, federal prosecutors were forced to resort to a patchwork of technical offenses and regulations that criminalized particular violations of the securities laws, or to treat the cases as generic wire or mail fraud. Sarbanes-Oxley criminalized any scheme to defraud persons in connection with securities or public companies to obtain their money or property. Importantly, FERA extends the strong provisions of Section 807 to frauds involving commodities, including derivatives, such as options and mortgage-backed securities.

Mortgage Lenders

At the height of the subprime lending era, independent mortgage companies, *i.e.*, those that are not depository institutions or their subsidiaries or holding company affiliates, made nearly half of the higher-priced, first-lien mortgages. The loans originated by these private mortgage companies were not generally covered by current federal fraud statutes, such as the bank fraud and bank bribery statutes.

Thus, FERA amends the definition of “financial institution” to extend federal fraud laws to mortgage lending businesses that are not directly regulated or insured by the federal government. These companies were responsible for nearly half the residential mortgage market before the economic collapse, Congress found, and yet they remain largely unregulated and outside the scope of traditional federal fraud statutes. This change will apply the federal fraud laws to private mortgage businesses just as they apply to federally insured and regulated banks.

Expanding the term financial institution to include mortgage lending businesses will also strengthen penalties for mortgage frauds and the civil forfeiture in mortgage fraud cases. It will also extend the statute of limitations in investigations of mortgage fraud cases to be consistent with bank fraud investigations. The new definition would also provide for enhanced penalties for mail and wire fraud affecting a financial institution, including a mortgage lending business.

The Act defines “mortgage lending business” to mean an organization that finances or refinances any debt secured by an interest in real estate, including private mortgage companies and any subsidiaries of such organizations.

The definition of financial institution would not apply to the suspicious activity reports (SARs) that banks and other financial institutions must file, as financial institution is defined separately under the Bank Secrecy Act.

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Fraud under TARP

The legislation would also amend the major federal fraud statute to protect funds expended under the Troubled Asset Relief Program (TARP) and the economic stimulus package, including any government purchases of preferred stock in financial institutions. This change will give federal prosecutors and investigators the express authority they need to protect taxpayer funds. Note that the amendments would only apply to major frauds against the government, where the value of the contract or services exceeds $1,000,000.

Legislative history indicates that Congress wants to ensure that federal prosecutors have jurisdiction to use one of their most potent fraud statutes, 18 U.S.C. §1031(a), to protect the government assistance provided during the economic crisis, including money from the TARP and circumstances where the government purchased preferred stock in companies to provide economic relief. See Senate Committee Report No. 111-10.

Money Laundering

The legislation will also strengthen one of the core offenses in so many fraud cases, money laundering, which was significantly weakened by a recent Supreme Court case. FERA amends the federal criminal money-laundering statute, 18 U.S.C. §1856(c), to make clear that the proceeds of specified unlawful activity include the gross receipts of the illegal activity, not just the profits.

The money-laundering statutes make it an offense to conduct financial transactions involving the proceeds of a crime, called specified unlawful activity in the statutes. These statutes, however, do not define the term "proceeds" and the term has been left to be defined by the courts. Since the money-laundering statutes enactment in 1986, courts have construed "proceeds" to mean gross receipts and not net profits of illegal activity consistent with the original intent of Congress.

But in *United States v. Santos* (2008), 128 S.Ct. 2020, CCH Fed Bank L Rep ¶101-021 [ip access users], the Supreme Court suggested that the term "proceeds" was ambiguous and gave the term a narrower meaning. In this decision, according to Congress, the Court mistakenly limited the term "proceeds" to the profits of a crime, not its receipts, and as a result, the decision limited the money-laundering statute to only profitable crimes, and permitted criminal defendants to reduce their culpability for money laundering by deducting the costs of their criminal conduct.

For example, under the decision, an executive who committed securities fraud could not be charged with money laundering if the fraud were unsuccessful in making a profit, even though there was a fully completed financial transaction. This decision is contrary to the intent of Congress in passing the money-laundering statutes. It also weakens one of the primary federal tools used to recover the proceeds of illegal activity, including mortgage

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and securities frauds. Indeed, Congress feared that, under the Court's decision, proceeds of Ponzi schemes like the Bernard Madoff case, which by their very nature do not include any profit, would fall outside the reach of the money-laundering statutes. To cure the problem, the Act specifically defines the term "proceeds" to mean any property derived from or obtained or retained, directly or indirectly, through some form of unlawful activity, including the gross receipts of that activity.

False Statements in Mortgage Applications

The legislation would also amend the false statements in mortgage applications statute (18 U.S.C. §1014) to make it a crime to make a materially false statement or to willfully overvalue a property in order to influence any action by a mortgage lending business. Currently, this false statements offense only applies to federal agencies, banks, and credit associations and does not necessarily extend to private mortgage lending businesses, even if they are handling federally-regulated or federally-insured mortgages. Similar to expanding the definition of "financial institution," this provision would ensure that private mortgage brokers and companies are held fully accountable under this federal fraud provision. This is particularly important as false appraisal fraud has proliferated during the recent financial crisis.

SEC Funding

FERA authorizes an additional appropriation for the SEC of $20,000,000 for each of fiscal years 2010 and 2011 for investigations and enforcement proceedings involving financial institutions. More specifically, the Act authorizes additional funds of $1,000,000 for each of the fiscal years 2010 and 2011 for the salaries and expenses of the SEC's Office of the Inspector General. The Act also authorizes $165 million a year for hiring fraud prosecutors and investigators at the Justice Department in fiscal years 2010 and 2011.

The Act limits these funds to the costs of investigating and prosecuting possible criminal or civil violations involving financial crimes and crimes against federal assistance programs, including mortgage fraud, securities and commodities fraud, financial institution fraud, and other frauds related to federal assistance and relief programs.

Following the spending of the funds, the SEC and Justice Department must report to Congress identifying the amounts expended and certifying that they were spent for the purposes of fighting financial fraud. The report must also identify the amounts recovered as a result of criminal or civil restitution, fines, penalties, and other monetary recoveries resulting from criminal, civil, or administrative proceedings and settlements undertaken with the funds authorized by the Act.

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Financial Crisis Inquiry Commission

The Act creates a Financial Crisis Inquiry Commission to examine the causes, both domestic and global, of the current financial and economic crisis. FERA contains a laundry list of areas that the Commission must cover in its examination, such as accounting practices, including mark-to-market and fair value rules, and treatment of off-balance sheet vehicles. The Commission must also cover the tax treatment of financial products and investment, as well as capital requirements and regulations on leverage and liquidity, including the capital structures of regulated and non-regulated financial entities.

More broadly, Congress directs the Commission to study securitization, including the originate-to-distribute model for extending credit and transferring risk; as well as the concept that certain institutions are “too-big-to-fail” and the impact of that doctrine on market expectations.

The Commission must also examine the role of credit rating agencies in the financial system, including reliance on credit ratings by financial institutions and federal financial regulators, the use of credit ratings in financial regulation, and the use of credit ratings in the securitization markets.

Corporate governance is also part of the Commission’s mandate, including the impact of company conversions from partnerships to corporations and compensation structures, including changes in compensation for employees of financial companies, as compared to compensation for others with similar skills in the labor market.

In addition, Congress directs the Commission to examine the role and impact of derivatives and unregulated financial products and practices, including credit default swaps. Also, it must examine short-selling, as well as financial institution reliance on numerical models, including risk models and credit ratings.

The Commission must submit a report to the President and to the Congress by December 15, 2010, containing its findings and conclusions on the causes of the current financial and economic crisis in the United States.

The Commission will consist of ten members, of whom three members will be appointed by the Senate majority leader and three members by the House Speaker, with two members each named by the Senate and House minority leaders. The Act commands the House and Senate leaders to consult with the relevant congressional committees when making appointments to the Commission.

It is the sense of the Congress that individuals appointed to the Commission should be prominent U.S. citizens with national recognition and significant depth of experience in such fields as banking, market regulation, taxation, finance, economics, consumer

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protection, and housing. The Act provides that no person who is a member of Congress or an officer or employee of the federal government may serve as a Commission member.

The Act grants the Commission the authority to issue subpoenas, as necessary, to conduct its investigation and meet its obligation to Congress. A subpoena may be issued only by the agreement of the chairperson and vice chairperson or by approval from a majority of the Commission's members.

The Senate amendment to the House amended version of the legislation clarified that a majority vote must include the vote of at least one member appointed by either the minority leader of the House or the minority leader of the Senate. This provides additional assurance that the examination undertaken by the Commission, and in its exercise of subpoena authority, will not be politicized.

White House Statement

The White House issued a statement at the signing indicating that FERA is landmark legislation that addresses the problems that helped create the current financial crisis. The Act's provisions would, the statement noted, provide federal investigators and prosecutors with significant new criminal and civil tools and resources that would assist in holding accountable those who have committed financial fraud. Specifically, the legislative enhancements would help the Department of Justice and the SEC to combat mortgage fraud, securities and commodities fraud, money laundering and related offenses, and to protect taxpayer money that has been expended on recent economic stimulus and rescue packages.

In the signing statement, the President said that the legislation was needed because the federal government's ability to investigate and prosecute securities and other financial fraud is severely hindered by outdated laws and a lack of resources. The Act provides the resources necessary for federal agencies, from the SEC to the Department of Justice, to pursue financial fraud cases. FERA also expands the DOJ's authority to prosecute fraud that takes place in many of the private institutions not covered under current federal bank fraud statutes, noted the President, institutions where more than half of all subprime mortgages came from as recently as four years ago. ❒

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