

Securities FRAUD

Detection, Prevention,
and Control

LOUIS
STRANEY



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and Control*

LOUIS L. STRANEY



WILEY

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Preface

Full and accurate disclosure is a cornerstone of financial services. For that reason, it is appropriate to begin with the acknowledgement that this is not a “how-to” book. Additionally, this is not a “tell-all” exposé of Wall Street. Furthermore, I have made no attempt to instruct the reader how to invest or bring legal action against their financial adviser or firm. For the institutional investor, securities firm, regulator, or policy maker, I make no claim that this book, in and of itself, will make your organization bulletproof. Most importantly, much to the disappointment of swindlers, this is not a cookbook for fraud.

Given these caveats, the premise for this book is rather limited: *With reasonable care, for all potential victims, in most instances, securities fraud is preventable.* And except for the extremely lucky, prevention requires insight. Unfortunately, most accounts of investment misconduct have focused on the “how to” elements, and totally neglected the “how not to” option. With this disclaimer in mind, I welcome you to the “how not to” be a victim of securities fraud experience.

There are a number of things that I dislike. Among those are certain vegetables, weak coffee, dead batteries, and conventional wisdom—the most offensive on the list. It baffles me how any writer can rely upon so-called conventional wisdom to stimulate insight or worthwhile dialogue. Conventional wisdom is free at the barber shop or locker room, so why purchase it? With this in mind, I do enjoy a lively battle. You will find a number of metaphors related to war in this book. That was intentional on my part. Securities fraud is economic terrorism and unless we accept it as a serious threat, we cannot prevail. It would be encouraging to discover that after reading this book, many of you become enraged to the point that you attempt to disprove my theories, or to overhaul the system.

You will soon discover that I have used a linear approach with general topics discussed first, which will lay the foundation for more specific concepts in later chapters. For example, every attempt will be made to first establish a solid base of working definitions in a historical context. From this platform of knowledge and conceptual insight, it is a natural transition to understanding the jargon and devices of securities fraud. It is

important to visualize “how we arrived at this point,” and this can only be accomplished with a thorough study of core elements. However, a rigidly sequential methodology is admittedly unimaginative so I will often overlay an important concept with a personal experience or all around good yarn. In my opinion, chronicles must be good stories first and only then can they evolve into worthwhile messages.

Even though the destructive nature of securities fraud is very much a media topic, Chapter 1 will quantify what I believe to be a pandemic problem. In Chapter 2, a four-century overview of the financial markets will demonstrate that the development of the financial markets was based on the notion of “shared interests.” Think of Chapter 2 as hearing about the old days from an elderly family member. In the attempt to be succinct, major securities statutes and regulatory guidelines will be limited to 11 mandates in Chapter 3. You will find that even though there is randomness in the financial markets, the number 11 has a somewhat mysterious heritage. Since many will be interested in the artist’s palette and brushes—the tools of his craft—Chapter 4 is dedicated to a description of the most common securities and devices used in fraudulent acts. At first consideration, Chapter 4 may seem redundant for the more experienced investors. Nevertheless, the markets are fast paced in design and destruction so this chapter should contain new knowledge for all readers. Chapters 5 through Chapter 8 are dedicated to identifying the four categories of victims which includes both individual investors and firm. Only after understanding these four unique perspectives can we hope to detect and protect investment misconduct and securities fraud. Chapter 9 provides an extensive list of early stage cases or developments that are worth monitoring. Additionally, the chapter has a section unique to this book which focuses on my personal contact with individuals who are accused or convicted of securities fraud. Chapter 10 includes examples of “red flags” and tough questions to ask your adviser (and yourself) before establishing an investment relationship. However, it must be stressed, this book was written to build upon cumulative knowledge. If you skip Chapters 1 through 8, Chapter 9 may be entertaining but certainly not significant in impact. Conclusions, recommendations, and forward-thinking concepts are discussed in Chapter 10. As we conclude, you will be drawn to notions well beyond so-called conventional wisdom, siloed vision, and traditional theories. At this point, you should be less likely a victim of securities fraud and more likely an agent of change.

LOUIS L. STRANEY
Santa Fe, New Mexico
October 2010

Acknowledgments

I have several acknowledgments but for the sake of brevity I must limit my comments. First, I want to say thanks to my second grade teacher for punishing me for writing the story about the unwed ducks having ducklings. Her provincial attitude gave me everlasting resolve. Well beyond my initial efforts reflecting on open marriages in ducks, I must offer my sincere thanks to retired University of Louisville professors Charles Breslin and Dr. Mary Ellen Rickey. Every ounce of their being was dedicated to discovery and wisdom.

My initial research on securities fraud was encouraged by Joseph Wells and John Gill, and meticulously edited by Laura Hymes at the Association of Certified Fraud Examiners. At John Wiley, I deeply appreciate the efforts of Tim Burgard and my editors Stacey Rivera, Helen Cho, and Laura Cherkas, who played a critical and immensely helpful role in completing this project. They shared my belief that it was the right time to take a leadership role in this topic, and I thank each of them for being part of that effort.

Of course, my longtime Wall Street colleagues and friends were essential fellow travelers in my career. Along with the rules, regulations, annual budgets, and investment strategies, I most respect the guidance from comments such as, “just do the right thing,” and “the clients pay the bills.” Possibly the most memorable advice came from the venerable Wall Street legend, Lewis Glucksman: “No deal is too large to walk away from!”

Without the understanding and support of my family, this book would not have been possible. Demonstrating extraordinary patience and confidence, throughout the years they supported my Wall Street career. With even more resilience, they were enthusiastic collaborators, editors, critics, unpaid reviewers, and co-conspirators on this project. My sincere thanks to everyone: Harper, Willa, Noel, Lee, Hillary, Adam, Mom, Dad, and the most patient and supportive partner imaginable, my wife, Mary.

Please be assured that I know who pays the bills—my readers—and I very much appreciate your interest in what I believe to be the least reported, yet preventable, disease on this planet: securities fraud.

Introduction

I can calculate the motion of heavenly bodies, but not the madness of people.

—Sir Isaac Newton

Some writers will reluctantly admit that they want their work to be commercially successful. Not me. I am up-front about that. My biggest fear is to find that investment fraud has become passé and the much-needed dialogue has become supplanted by some short-term crisis. Fully accepting that even in the age when worthwhile content is free from Internet sources, there is a role for instructive texts. After all, the *New York Times* still has a book section. Oprah has a reading list. Most towns still have their Andrew Carnegie-financed public libraries. I have no expectations that a study of despair and deception will fly off the shelves or be constantly streamed through e-book conduits. Reaching for a wide audience through a topic that I feel is of major importance, I knew that I had several issues to consider. The balance between fact and fantasy must lie somewhere between a PowerPoint presentation and a romance novel.

After no small amount of reflection, I decided that the appeal of the well-received writer often lies in tone and voice. Artfully, successful writers weave romantic and mystical events throughout the plots. By necessity, the topic of this book somewhat defines the tonal approach. Contextually, it is necessary to communicate an extensive set of facts, trends, and something journalistically akin to hard news. Even though the topic somewhat drafts the design, the author has the hammer and nails. With this in mind, even the most formal context can accommodate some edginess.

In my opinion, it was critical that I approach the events and characters from a unique perspective. If you have previous experience with texts on securities fraud, many are either tonally rigid or so relaxed that there is little substance to the content. I dislike both extremes so I was led to the conclusion that tone was a variable somewhat out of my control and I would rely heavily on voice.

In that spirit, I will take unapologetic liberty with voice. An important goal is that both the author and the reader will be woven into the fabric of the story. I trust that each of you will join me on the decks of the ships of the Dutch East India Company as well as on Wall Street trading floors. Much of the material in this book was drawn from my personal experiences of three decades as a senior manager on Wall Street and my second career as a securities litigation consultant and expert witness. Some examples will be drawn from carefully disguised cases where I have acted as a part of the drama. Therefore, the voice of this book is mine and has been shaped by hardscrabble experience and training, and further influenced by your victimization.

As with global accents and dialects, there are many voices to choose from. For example, one extreme would be the quick-witted journey of Mark Twain in his *Innocents Abroad*. Twain's voice is approachable and in movie terms G-rated. The other extreme is the enormously successful commentary on the American dilemma portrayed in Hunter S. Thompson's *Fear and Loathing in Las Vegas*. If you are willing to accept that Twain is for the General Audience, the Gonzo Journalist, Thompson, is an unchallenged Restricted rating. Recognizing the limitations and achievements of both Twain and Thompson, I determined that my voice would borrow from each—something along the lines of, *Innocent Loathing on Wall Street*. *Innocent* to the extent that it is my belief that the issues and challenges discussed in this book should be obvious to everyone; and *loathing* because I have found that unless something implodes too few are taking these issues seriously.

Throughout this book, there are graphically expressed opinions. Even though I have had the pleasure of working with many extraordinary editors and professionals at John Wiley, the opinions and theories (many of which are likely very controversial) in this book are strictly mine. As Hunter Thompson cautioned (or possibly promised), "Buy the ticket, take the ride."

Specificity, including the names of individuals and examples are essential to this book. Every attempt has been made to utilize reliable sources. However, the reader should expect that as this book ages, some court decisions can be reversed, allegations can be withdrawn. In some situations, Presidential pardons may be issued. Benchmark cases and examples were chosen with a complete absence of judgmental prejudice. Both the publisher and this writer plan to aggressively revise this book to maintain a sense of accuracy and timeliness. At the outset, I will accept the fact that punishment for securities fraud, relative to other crime, is often uneven and illogical. To pass judgment on the eventual outcome of any particular case is well beyond the scope of this work. Those issues are for the courts, the regulators, and our nation's leaders.

As a reader's guide, it should be noted that this narrative is generally chronological, but not without an occasional meandering to another period or topic. Additionally, each chapter was designed to build upon prior knowledge and to be consumable in approximately one hour of reading. All the same, as with my flexible chronology, the reader should expect that some chapters will require an adjusted time commitment.

The critical issue is avoiding victimization from investment misconduct and fraud on every level and from every perspective. With this in mind it is to be expected that the approach for each reader will be highly subjective. In getting started, there are many options. Feel free to start with the index. Read it aloud to your grandchildren. Use the book as a contribution to your religious organization. Memorize the text from back to front. Track down a family-related felon, or see if your firm or favorite stock is mentioned. Your methodology will be successful if at the conclusion of this experience, you are less likely to be a victim of securities fraud.

Contents

Preface	xiii
Acknowledgments	xv
Introduction	xvii
CHAPTER 1	
The Face of War	1
Cost of Defeat	1
Drawn and Quartered	2
Art and Fog of War	3
Origins	4
The Best of Times—The Worst of Times	4
Lords of Chaos	6
Predictably Controversial	7
Conventions for Prevention	7
The Moderately Trained Advising the Moderately Informed	7
Non Sequitur	8
Flawed Logic	9
Human Capital	10
Ordinary People Performing Extraordinary Deeds	10
Fraudster—Not the Typical Job Applicant	11
Heroes and Villains	12
New Notions for Old Issues	12
A Collarless World	13
Definitions: Securities, Investment, Fraud	14
Bad Advice, Bad Luck, Bad Service—But Not Fraud	16
Methodology	18
What You Need to Know versus What Someone Wants You to Know	19
Dismantling Silos	19
Magician's Curtain	20
Notes	20

CHAPTER 2

Shared Interests	25
Trade Secrets	25
Dutch East India Company	26
Shared Interests	27
Merchants and Pirates	28
Uniformly Non-Uniform	28
Scale Reconsidered	29
Transfer of Risk	29
Innovation Out of Necessity	30
Nation of Farmers	31
NYSE	31
Rags to Ritzes	32
Cazique of Poyais	33
Land That Never Was	33
Mosquito Coast	33
Statutory Foundations	35
Call to Arms	35
Gatekeeper—Lock—Key	36
Far Out of Line with Reason	36
Other Voices, Other Rooms	37
Grains and Gold	38
Notes	38

CHAPTER 3

The Eleven	41
Greater Than 10 yet Less Than 12	41
1. The Kansas Securities Act (Blue Sky Law)	42
2. The Securities Act of 1933	43
3. The Securities Exchange Act of 1934	44
'34 Act Provisions	45
4. The Glass-Steagall Act of 1932	47
5. The Commodity Exchange Act of 1936	48
6. The Investment Company Act of 1940	49
7. The Investment Advisers Act of 1940	50
8. The Bank Secrecy Act of 1970	50
9. The USA Patriot Act of 2001	51
10. The Sarbanes-Oxley Act of 2002	52
11. <i>Shearson/AMEX v. McMahon</i>	53
Safety Nets—A Misnomer	54
Coverage Caveats	56

Beyond the Rules	56
Notes	56

CHAPTER 4

Funding and Fraud	59
It Really Doesn't Matter	59
Securities? No. Securities Fraud? Yes!	60
Montgomery to Manhattan	62
Promises, Promises	64
A Rotten Compromise	67
Common Stock, Uncommon Results	68
Read the Label	71
Financial Purgatory	73
An Evil Equation	74
Transition to Victimization	75
Notes	75

CHAPTER 5

Command and Control	79
Absolutologist	79
By the Numbers	80
It Starts at the Top	80
Carlo "Charles" Ponzi	80
Robert Vesco	84
"King" of White-Collar Crime	84
Guns and Butter	85
White Knight from Detroit	86
Tom Adams	87
Robert E. Brennan	87
Blue-Eyed Devil	87
Michael de Guzman et al.	91
Fact: Stranger Than Fiction	91
"He Was a Slob"	92
Forced Marriage	93
Fallout	94
Bernard L. Madoff	94
I Am Not Accepting New Clients	95
Silos	95
Totality and Nothingness	96
Sell Down until You Can Sleep	97
Notes	98

CHAPTER 6**Paid to Steal****101**

At All Costs—Protect the Brand	101
Michael Holoday	102
Free Rider	102
Colossal Failure to Supervise	103
Canadian Securities Regulation	103
Talent for Trading	105
Holoday Epilogue	107
Nick Leeson	107
Torpedoed	107
Black Hole of Deception—88888	108
“I’m Sorry”	109
Michael Milken	110
Full Disclosure	110
Drexel’s Structure	110
Robert L. Citron	112
O.C. Pools	112
Prop 13	113
Devil in Disguise	113
Yanming	115
A Great Fall from the Great Wall	115
Notes	116

CHAPTER 7**Outside Inside****119**

Investor Fraud	119
Anthony “Tino” De Angelis	120
“Powerful Forces Are Working Against Me”	121
Oils and Fats	122
Oils and Water	123
Simple Math	123
Ivan Boesky	124
Six Degrees of Separation	124
G. Foster Winans	125
Fifth Estate	125
Martha Stewart—“I Was In Prison You Know”	127
Circus	127
Common Denominator	128
Magic of Algorithms	129
Notes	130

CHAPTER 8

Misunderestimated	131
Adviser Fraud	131
Patterns	131
Jordan Belfort—Robert Brennan Incarnate	132
Frank Gruttadauria	134
Martin Frankel (or One of Twelve Other Aliases)	137
Captain Money—J. David Dominelli	139
Eric Bartoli (A.K.A. Enrico Orlandini)	141
Retrospective	143
Notes	144

CHAPTER 9

Days of Future Past	147
Dystopian Future	147
Rating Agencies	148
Trevor Cook (Oxford Global Partners)	148
<i>Patricia Cornwell v. Anchin, Block & Anchin</i>	149
Derivatives	149
Huang Guangyu	149
Galleon Group Hedge Fund	150
Jerome Kerviel	150
Kenneth Lewis	151
Semion Mogilevich	151
Sean David Morton	152
Rebecca Parrett	153
Pathway to Prosperity	153
Goldman Sachs	154
Marcus Schrenker	155
R. Allen Stanford	155
Kenneth Ira Starr	156
Structured Products	156
Weizhen Tang	157
Douglas F. Vaughan	158
In Their Own Words	158
Eric Bartoli (Enrico Orlandini)	159
Lance Poulsen	160
Richard Scrushy	161
Synthesizing Raw Data	162
Notes	162

CHAPTER 10**The Warrior's Path****185**

Endless Struggle

165

Who?

166

Why?

168

How?

168

Who Says So?

168

APPENDIX**Frequently Used Abbreviations****175****About the Author****177****Index****179**

The Face of War

In such a world of conflict, a world of victims and executioners, it is the job of thinking people, not to be on the side of the executioners.

—Albert Camus

COST OF DEFEAT

We live in a postwar society. In human capital and monetary value, the decades-long conflict has taken a horrific toll. And as painful as it is to face, by a large and embarrassing margin, we lost.

By any measure, it was a very odd series of battles. Admittedly, our forces were not well trained or outfitted. We relied on outdated resources while our enemy effectively used the latest technology. When we captured a leader of our opponent, the punishment was often a token reprimand. Curiously, when our adversary was struggling for survival, we extended a life line. And most alarming, except for infrequent interludes, our national leadership seldom felt that our struggle was a priority. After choosing the weapons, establishing the rules of engagement, and designing the field of battle, repeatedly we were outflanked, and finally we were soundly defeated in the war against investment fraud. Well-executed evil strategy often triumphs over well-intentioned weak tactics.

Unfortunately, there has yet to be a “war to end all wars,” so we must choose. We can accept the defeat and withdraw or commit to a new strategy. This book has been written for those who refuse to submit and who understand that there is really only one choice—win all wars against economic terrorism.

Our losses—“Junk Bond Crisis,” “Match King Ivar Kreuger,” “Billionaires’ Boys Club,” “Martin Frankel,” “Mortgage Crisis,” “Enron,”

Canada's "Bre-X," "Bank of Credit and Commerce International," "Parmalat," "Hong Kong Accumulators," "WorldCom," "Satyam," "Tyco," and "Bernard L. Madoff Securities"—in many ways were just as destructive and embarrassing as military blunders. Financial services firms have also felt the claws of the serpent. The venerable English bank, Barings, was forced to insolvency by the fraud of a single rogue trader, Nick Leeson. It survived nearly three centuries of European wars and pestilence, but it was no match for a trader with the ability to place enormous leveraged bets on the market. Credit Suisse Bank, after unwittingly serving as the launch pad for the fraud of institutional derivative salesman Eric Butler and his co-conspirator Julian Toslov, has a badly tarnished image. There are many victims—private investors, institutions, employees of financial services firms, and even the complex Rube Goldberg contraption we refer to as the global economy. Without a change of fundamental direction, the struggle will continue to take its toll. Securities fraud is many things, but first and foremost it is democratic. Its destruction is widely distributed and shared by all.

DRAWN AND QUARTERED

There is no shortage of misinformation related to losses through investment fraud. Many unsubstantiated opinions are pronounced by Wall Street and legal commentators, but often lack quantitative insight. In general, all forms of fraud and misconduct are dependent on deception, so estimates of monetary and consequential damages from this activity are exponentially understated. Victims often nurse their wounds in private while potential victims remain largely uninformed of the all too frequent risks of investment fraud—perhaps the most underreported disease on the planet.

On a corporate level, due to the fear of loss of brand confidence and competitive concerns, fraudulent activity is often handled unofficially, off the books and out of the press, something similar to the retirement compensation of some former CEOs.¹ On an individual level, embarrassment or family considerations often cause the fraud to go unreported. Stanford University and Cornerstone Research, using data gathered from class action suits, estimate that the annual losses in the United States associated with securities fraud exceed \$400 billion—approximately twice the gross domestic product (GDP) of Chile and up nearly tenfold since 1997.² The world's largest antifraud organization, the Association of Certified Fraud Examiners (ACFE), offered the following insight.

Fraud by its very nature, does not lend itself to being scientifically observed or measured in an accurate manner. One of the primary