THE RULE OF LAW AND ECONOMIC DEVELOPMENT IN RUSSIA

Economic Regulation In the United States: Current Mechanisms for Enforcement

Dr. Nandini Ramanujam
Assisted by: Mara Verna and Julia Betts

McGill Faculty of Law
Montreal, Quebec
July 2011

McGill

Economic Regulation in the United States

Introduction

Traditionally, fighting economic wrongdoing has used a heavy-handed approach of rules backed by sanctions. This method can be devastating, costly and inefficient if it then shuts down a business that was otherwise healthy and productive. Another method is to let corporations police themselves, as they are in the best position to understand their motivations, structures and practices. This method lacks accountability to the wider public and does not necessarily stop wrongdoing. Instead more nuanced approaches are required, which combine both traditional methods while taking into account costs, time, effectiveness and overall benefit to society. Such mechanisms as compliance programs, corporate leniency programs, and deferred prosecution agreements (DPA) are creative and flexible ways to reform wrongdoing and prevent recidivism while ensuring that a business remains operational. Voluntary disclosure and amnesty programs give powerful incentives to corporations to disclose wrongdoing before it can progress, and whistleblowing is an effective way of encouraging internal corporate oversight. A correct balance of approaches can encourage real reform, deter future wrongdoing, and reduce administrative costs while nonetheless punishing those who have committed a crime.

As a leading economy, the United States is faced with ever growing types of wrongdoing that require creative solutions. This report will examine key economic activities and the innovative regimes that regulate them. These include the qui tam provisions of the False Claims Act, Deferred Prosecution Agreements under the Criminal Division of the U.S. Justice Department, the Antitrust Division's Corporate Leniency Program, similarly within the Justice Department, as well as legislative and policy reform under the Internal Revenue Service at the Department of the Treasury. Further, there will be a brief examination into the U.S. factors that led to the 2008 financial crisis, as the means to explore the overlap between regulatory concepts such as deregulation and desupervision. Lastly, the newly formed Consumer Financial Protection Bureau will be discussed. Under each regime, regulatory objectives and legislative frameworks will be presented alongside strengths and weaknesses. Each of these regimes are shaped by the social, political, legal and economic climate within the United States. As such, they might provide comparative examples, as any regime and its developments rely substantially upon such necessary and unique contextualization.

I. False Claims Act and Qui Tam Provisions

The False Claims Act (FCA) was created in 1863 to combat fraud in army contracts during the American Civil War. It allowed the government to pursue civil suits and criminal prosecution against persons who fraudulently misrepresent a claim to the federal government.[1] Today the FCA deals only with civil claims (the criminal act was separated in the 1870s). Under the FCA, a person is liable "who knowingly submits a false claim for payment to the federal government, knowingly uses a false statement to induce government to pay a false claim, conspires to defraud the government to pay a false claim, or knowingly uses a false statement to decrease an obligation to pay money to the government."[2] It need not require specific intent by the defendant but "reckless or deliberate ignorance of the truth or falsity of the claim presented to the government."[3] The scope of liability has been broadly interpreted by courts to include, among other things, negligence suits[4] and false advertising in healthcare[5].

1 *Civil False Claims Act*, 31 USCA §§ 3729-3733 (1863) [FCA].

2 William E Kovacic, "The Civil False Claims Act as a Deterrent to Participation in Government Procurement Markets" (1998) 6 Sup Ct Econ Rev 201 at 211.

3 FCA, *supra* note 1.

4 In 1996 the FCA was used by the government to reach a settlement with a Nursing Home for billing for "inadequate care" thus stretching the meaning of a false claim into the realm of negligence in Michael M Mustokoff, Jody A Werner and Michael S Yecies, "The Government's Use of the Civil False Claims Act to Enforce Standards of Quality of Care: Ingenuity or the Heavy Hand of the 800-Pound Gorilla" (1997) 6 Annals of Health L 137.

5 *United States ex rel Franklin v. Parke-Davis*, 147 F Supp 2d 39 (D Mass 2001): the court decided that Parke-Davis knowingly made false statements (off-labeling) that ultimately caused the submission of false claims.

Legislation

There are four qui tam[6] statutes on the books in the United States, but the most widely used is the False Claims Act of 1863. Qui tam provisions allow a private party to sue on behalf of the government. In 1986, an amendment to the FCA introduced robust qui tam provisions because it was believed that in cases of fraud, insiders often have better resources than prosecutors to detect fraud.[7] Under this amendment, the private citizen (relator) can file a claim to the government who has the duty to diligently investigate the claim within 60 days. Then the government can choose to reject the claim completely, intervene in the case, or decline to intervene but allow the relator to proceed with the case. In cases where the government intervenes, the relator is entitled to between 15 to 25 percent of the guilty defendant's damages, however, where the government chooses not to intervene, the relator is entitled to a higher percentage of damages, between 25 to 30 percent. As of yet, there are no guidelines indicating when a prosecutor should or should not intervene, or when to dismiss a case. Whistleblowing provisions provide relief in the event the whistleblower, or in this case, the relator, receives retaliation, discrimination or is fired as a result of an investigation of fraud under FCA.[8] When the government chooses not to intervene or dismiss a case, the FCA delegates nearly absolute prosecutorial discretion to the relator, such as powers to investigate, to file a suit, to choose what theories to litigate and to settle.

In 2009 an amendment to the FCA broadened the net so that any company, which receives money at any point down the chain from the government (such as the subcontractor of a government contract) can be the target of an FCA investigation, opening the door to new categories of potential defendants. It also expanded the scope of liability by asking whether the claim 'could have influenced' the government's decision as to payments.[9]

Strengths

Since 1986 a striking pattern has emerged. Of the nearly $22 billion dollars recovered under the FCA between 1986 and 2008, $13.6 billion was directly the result of qui tam provisions.[10] The number of cases initiated by private individuals has increased dramatically: in 1998 only 1 percent of qui tam cases successfully recovered damages, whereas ten years later, in 2008, 77 percent of the money recovered was from qui tam cases. The number of fraud cases brought under the FCA has steadily increased from 400 cases in 1987 to over 700 in 1997, and just over 500 cases in 2008.[11] In the U.S., the FCA has become the primary weapon for combating fraud. The returns in some sectors can be very high. According to a Senate hearing report, for every dollar spent investigating healthcare fraud $15 dollars were recovered to the public coffers.[12]

The nature of fraud is such that it is often heavily concealed and known only to a few insiders. In addition, fraud cases frequently involve detailed expertise of a particular industry. Whistleblowers usually have the requisite insider knowledge and expertise and are therefore often in the best position to detect fraud and uncover it. For example, Tina Gonter's expertise as a metals inspector was instrumental in helping her to detect her employer, who was defrauding the U.S. Navy by falsely reporting safety standards.[13] The qui tam provisions have allowed the government to broaden its reach and expand into new areas of investigation without extra resource expenditures.

6 '*Qui tam pro domino rege quam pro se ipso in hac parte sequitur*' means 'he who sues for the King also sues for himself'.

7 FCA, *supra* note 1 at § 3730.

8 *Ibid* at § 3730(d)(4)(B)(h).

9 *Federal Enforcement Recovery Act* 31 USCA §§ 3729(a)(2) and (a)(7) (2009).

10 US Department of Justice, "Fraud Statistics, Overview October 1, 1986 - September 30, 2008 Civil Division" online: < http://www.justice.gov/opa/pr/2008/November/fraud-statistics1986-2008.htm> [Fraud Statistics].

11 *Ibid*.

12 US, A*n Overview Hearing before the ad hoc subcommittee on contracting oversight of the Committee on Homeland Security and Governmental Affairs United States Senate* 111th Cong (2009) at 2.

13 *Ibid* at 19.

The monetary rewards for relators, some of who may fear retaliation and severe financial loss, provide the additional incentive to come forward. This has been achieved through a delicate balancing of interests that attempts to encourage whistleblowing while deterring frivolous or parasitic claims. Where civil or criminal proceedings have already commenced against the relator for involvement in fraud, the relator himself is not permitted to bring forward a qui tam action.[14] In addition, the relator must be the 'original source' of the information, that is, information must be obtained independently and it must not come from publicly disclosed sources.[15]

Weaknesses

It may be problematic to let private parties conduct actions on behalf of the government in so far as personal gain, through reward incentives, is the principle driving force. Prosecutors must consider multiple factors when conducting a suit: whether to bring forward a novel legal argument, what the cost-benefit analysis of the case is and what the long-term implications for society are. The FCA delegates near absolute power to the relator to undertake an investigation, file a lawsuit, determine the factual and legal theories to assert, and decide whether *and on what terms* to settle to the relator. As a result, a relator may aggressively pursue a defendant regardless of whether the harm itself is low or whether the social harm resulting from the prosecution will outweigh the potential recovery. Most problematically, novel arguments used by private parties have widened the grounds for a defendant's liability, and arguably, do not serve the public interest. Michael Rich reveals the need for government involvement when new legal theories are advanced since the type of liability may potentially change or broaden as result. He describes cases where prosecutors have lost control of the expansion of FCA liability by allowing relators to advance novel legal theories without government oversight - to detrimental effects.[16]

Furthermore, there is an uneasy overlap of criminal and civil law in the FCA and qui tam actions, which may contravene the basic tenets of the legal system. Since a corporation is an artificial legal entity, civil damages become indistinguishable from criminal sanctions (such as fines, restitution, community service, corporate reform programs). In effect, remedies under the FCA are the same and sometimes more severe than some Criminal law statutes. The FCA, however, has greater enforcement power, a broader scope of liability and fewer procedural hurdles for plaintiffs than criminal law (in 1986 the burden of proof for civil suits was lowered to "preponderance of evidence").[17] Sharon Finegan argues the FCA has many of the sanctions of criminal law with none of its procedural protections.[18]

The different goals of the government (public interest and monetary recovery) and the private citizen (personal monetary gain) may create an abusive system. For example, private citizens have been known to demand Corporate Integrity Agreements (CIAs), which are overburdensome, haphazard and not necessarily in the public interest. Moreover, both these CIAs, as well as settlements obtained, are not subject to judicial or prosecutorial oversight.[19]

The qui tam provisions seem to have been particularly effective in, or, from another perspective, detrimental to the healthcare industry. The number of new healthcare fraud cases grew from 15 in 1987 to 288 in 1997. Conversely in the defense industry, in 1987 there were 258 new fraud cases but by 2008, only 71 new cases were brought forward.[20] Any number of factors may have mitigated these differences, as these trends remain unexplained. It is worth noting that depending

14 FCA, *supra* note 1 at § 3729(a)(2)(C).

15 *Ibid* at § 3730(e)(4)(B).

16 Michael Rich, "Prosecutorial Indiscretion: Encouraging the Department of Justice to Rein in Out-Of-Control Qui Tam Litigation Under the Civil False Claims Act" (2008) 76 U Cin L Rev 1233 at 1266-73.

17 *US v Gainey*, 389 US 63, 79 (1965).

18 Sharon Finegan, "The FCA and Corporate Criminal Liability: Qui Tam Actions, Corporate Integrity Agreements and the Overlap of Criminal and Civil Law" (2007) Penn St L Rev 625 at 668-71.

19 *Ibid* at 655-668.

20 Fraud Statistics, *supra* note 10.

on who initiates an investigation may disproportionately impact different sectors.[21] Pointing to the increase in fraud cases since the 1980's, commentators note that this is not so statistically important, suggesting that the Department of Justice always had the means to investigate fraud, but they have simply lost their incentive due to the success of qui tam provisions.[22]

Conclusion

The FCA has become a potent and effective tool for combating fraud, especially since the introduction of qui tam provisions. However, it may be responsible for disproportionately targeting certain industries and allowing private litigants to bring abusive suits that go against the public interest.

II. United States Department of Justice

A. Criminal Division - Deferred Prosecution Agreements

Objectives

A Deferred Prosecution Agreement (DPA) is a way for prosecutors, who have enough information to indict a corporation, to impose terms of probation before a conviction. DPAs originated in the 1960s in juvenile and low-level narcotics cases to allow wrongdoers to reform their behavior and avoid the stigma of a criminal record. The prosecutor charges the defendant with a particular crime, but agrees to defer the trial until the defendant has taken certain remedial measures. The first DPA used in a corporate criminal case in the United States was in 1992.[23] DPAs can be used in any variety of contexts, and do not aim to regulate any specific type of economic crime. Following the Enron Scandal of 2001-2002, DPAs have been on the rise in the United States. Arthur Andersen, the company that oversaw Enron's accounting, was charged with securities fraud, and this charge caused the company's reputation to implode - the entire company collapsed and 28,000 jobs were lost.[24] Since then DPAs are seen as a way of creating corporate reform and imposing penalties without the devastating effects of corporate ruin.

Most DPAs contain the following: the defendant admits to sufficient facts to ensure conviction should it fail to comply with the terms of the DPA; defendant agrees to voluntarily waive the attorney-client privilege and the work-product doctrine and disclose the results of its internal investigation to the government; the defendant agrees to cooperate with ongoing investigations conducted by the Department of Justice (DOJ) or other federal agencies; the defendant terminates or disciplines culpable employees, regardless of rank within the corporate hierarchy; and/or the defendant agrees to undertake remedial compliance measures.[25] This often involves the defendant paying for an independent monitor to oversee the company's compliance.[26]

Policy Guidelines

To date, DPAs have gone unregulated and have therefore been allowed to develop in an ad hoc fashion. It was not until 1999 that the DOJ first attempted to streamline the content of DPAs in the Holder Memo.[27] It set out a list of 8 guidelines for when a prosecutor should press charges against a

21 Christina Orsini Broderick, "Qui Tam Provisions and the Public Interest: An Empirical Analysis" (2007) 107 Colum L Rev 949.

22 *Ibid* at 982.

23 John A Gallagher, "Legislation is Necessary for Deferred Prosecution of Corporate Crime" (2010) 43 Suffolk UL Rev 447 at 458.

24 Joan-Alice M. Burn, "United States v. Stein: Has the 'Perfect Storm' Led to a Sea Change?" (2007) 32 Del J Corp L 859 at 863.

25 Robert Ridge & Mackenzie A Baird, "The Pendulum Swings Back: Revisiting Corporate Criminality and the Rise of Deferred Prosecution Agreements" (2008) U Dayton L Rev 187 at 198.

26 For a list of DPAs see <http://judiciary.house.gov/issues/issues_deferredprosecution.html>.

27 Memorandum from Eric H Holder Jr Deputy Attny Gn to All Component Heads of US Attys on Federal Prosecution of Corporations (16 June 1999) available at <http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html>.

corporation, which included the seriousness of the offence, the corporation's history of wrongdoing, and its efforts at remediation. Most importantly, the Holder Memo asked prosecutors to evaluate whether a corporation was 'cooperating' with the government by looking at its willingness to waive attorney-client privilege, work-product doctrine, and to disclose the results of internal investigations.

The Thompson Memo, published in 2003, made the Holder guidelines mandatory and added that prosecutors could take into account whether a corporation was covering the legal costs of their employees in assessing the degree of cooperation.[28] However, following extensive criticism of these memos and several court decisions, which rendered certain aspects unconstitutional, Attorney General McNulty sent a memo to prosecutors in 2006, which acknowledged the fundamental importance of attorney-client privilege for defendants and removed its waiver as a prerequisite for assessing corporate 'cooperation'.[29] Instead, the McNulty memo created restrictive guidelines for when prosecutors could request a waiver of attorney-client privileges. It divided privileged information into two categories: category I was purely factual information relating to misconduct and Category II was non-factual attorney communications related to work-product.[30] Under the McNulty memo, only in the rarest circumstances could prosecutors obtain Category II information, and if so, only after filing a written request to the corporation and obtaining the Deputy Attorney General's approval. Later, the Filip Memo (2008) stated that prosecutors are no longer allowed to consider waiver of attorney-client privilege in deciding whether to charge a defendant and are no longer allowed to consider a corporation's advancement of legal fees to employees in their determination of cooperation.[31]

As for the regulation of corporate monitors, Rule 53 of the Federal Rules of Civil Procedure allows special masters (monitors) to perform duties consented to by the parties, hold trial proceedings, make or recommend findings of fact, address pre-trial and post-trial matters that cannot be addressed efficiently by a regular judge.[32] This rule does not, however, provide guidelines on what the scope of the monitor's powers are, and instead, the parties decide these terms through negotiation.

In 2009, two pieces of legislation, which received widespread approval were tabled before Congress, but have not become law: the Attorney Client Privilege Act of 2009 (ACPA) and the *Accountability in Deferred Prosecution Agreements Act* 2009 (ADPAA).[33] The ADPAA would define the rules of selection of independent monitors, provide examples of what constitutes cooperation, explain the process that constitutes breach of a DPA, and bring transparency objectivity and consistency to DPAs.[34]

Strengths

There are strong incentives for the prosecutor and the defendant to enter a DPA. For prosecutors, they avoid the expense and energy required to mount a legal case, while ensuring that extensive penalties are nonetheless exacted. Defendants benefit because they avoid the distraction, risk and devastating

28 Memorandum from Larry D Thompson, Deputy Attny Gn to Heads of Dept Components and US Attys on Principles of Federal Prosecution of Business Organizations (20 January 2003), available at <http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm>.

29 *United States v Stein*, 541 F3d 130 (2d Cir 2008); United States v Stein, 495 F Supp 2d 390 (SDNY 2007); Stein et al. v. KPMG, LLP, No. 06-4358-cv (2d Cir 2007) [KPMG Trilogy].

30 Memorandum from Paul J McNulty, Deputy Atty Gen to Heads of Dept Components and US Attys on Principles of Federal Prosecution of Business Organisations available at <http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf>.

31 Memorandum from Mark Filip Deputy Atty Gen to Heads of Dept Components and US Attys on Principles of Federal Prosecution of Business Organizations (28 August 2008) available at <http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf>.

32 USCS Fed Rules Civ Proc § 53(a).

33 Rachel Delaney, "The Next Step for Corporate Deferred Prosecution Agreements" (2009) 93 Marq L Rev 875 [Delaney].

34 John A Gallagher, "Legislation is Necessary for Deferred Prosecution of Corporate Crime" (2010) 43 Suffolk UL Rev 447.

consequences of a criminal conviction, which can sometimes result in complete corporate collapse.[35] Effectively, DPAs allow businesses to continue functioning, while simultaneously reforming them from within and each agreement requires extensive cooperation with the authorities.

These agreements are inherently flexible and allow prosecutors to innovate and adapt agreements to the underlying circumstances of each case without the time constraints of the court system. They can also produce substantive reform and thus reduce the number of 'paper' or 'compliance' reform, where a company appears to be making changes, but essentially remains unchanged.[36]

Corporate monitors can also work effectively to encourage compliance by keeping the organizations accountable, and, in well-defined DPAs, makes the consequences of breach clear and immediate. Often monitors become embedded in the organization to learn how it works and make recommendations and rules about how to reform, yet they are accountable to the government.[37] Cristie Ford points out that "a well-chosen monitor brings vital expertise and an outside perspective that can be more effective in working through persistent cultural problems."[38]

Weaknesses

DPAs, if left unregulated as they are, have a wide potential for abuse. Prosecutors have untoward leverage against risk-averse corporations that will often accept any terms to avoid a criminal conviction. Prosecutors also have sole discretion to decide whether a DPA has been breached, who themselves are only subject to the internal DOJ memos, which do not have the force of law. A DOJ memo can be revised at any moment, so that the department is only subject to its own authority. According to Rachel Delaney, abuse in DPAs can result in four ways:[39]

1. Punishments of businesses may be unrelated to the crime that precipitated the DPA (the Bristol-Myers Squibb DPA had a term forcing the company to endow a chair at the Attorney General's law school)[40].
2. If attorney-client privilege is waived, unfairness may result if the government considers a privilege waiver as an element of cooperation, thereby giving businesses an incentive to blame employees and find scapegoats within their ranks.
3. Unfairness arises if a company is pressured to cease contractually promised payment of legal fees for specific employees (such pressure was found unconstitutional in *United States v. Stein*)[41].
4. Selection of a monitor to watch over a business as it implements its reforms is unregulated, monitor compensation is often expensive for a business, monitors may be inexperienced in the business world and monitor selection may not always align with the best interest of the business. For example, there was widespread criticism when United States Attorney Christopher Christie appointed his former boss John Ashcroft to be a corporate monitor.[42]

In effect, despite the Filip Memo, the Holder and Thompson Memos are thought to have created

35 Peter Spivack & Sujit Rama, "Regulating the 'New Regulators': Current Trends in Deferred Prosecution Agreements" (2008) 45 Amer Crim L Rev 160.

36 Cristie Ford, "Smart enforcement: trends and innovations for monitoring, investigating and prosecuting corporate corruption" in Transparency International, *Global Corruption Report 2009: Corruption in the Private Sector* (Cambridge: Cambridge University Press, 2009) at 127.

37 *Ibid*.

38 *Ibid* at 129.

39 Delaney, *supra* note 33 at 2.

40 Deferred Prosecution Agreement between the United States Attorney's Office for the District of New Jersey and Bristol-Meyers Squibb Company (15 June 2005), available at <http://judiciary.house.gov/hearings/pdf/deferredprosecution/BMSDPA050615.pdf>.

41 KPMG Trilogy, *supra* note 29.

42 Philip Shenon, "Ashcroft Deal Brings Scrutiny in Justice Department" *The New York Times* (10 January 2008) online: nytimes.com <http://www.nytimes.com/2008/01/10/washington/10justice.html?pagewan>.

a 'culture of waiver'[43] where a corporation with little to no leverage is willing to waive attorney-client privilege to demonstrate cooperation. This has pitted corporate employees (low-level as well as executives) against the corporation and has fostered an environment of secrecy which is counterproductive to uncovering wrongdoing.[44] Moreover, commentators have suggested that DPAs, as unregulated instruments, do not in fact produce the corporate and ethical reform that is required of them.[45] For example, in 2004 AIG entered a DPA on allegations of aiding and abetting securities fraud. Nevertheless in 2008 increased fraud may have caused a liquidity crisis, which largely contributed to the financial crisis.[46] The same employee who entered the DPA in 2004 is alleged to be responsible for the 2008 crisis.[47] To a large extent, there is consensus that the DPA process is not transparent enough. Public accountability cannot be ensured, since DPAs are not required by law to be published. As a contracted agreement, it is negotiated and consented to without judicial oversight. Furthermore, only the prosecutor may determine whether the agreement has been breached and there is no legislation that imposes maximum fines or penalties. The Department of Justice, with respect to DPAs, has no oversight and is not answerable to Congress.

Conclusion

DPAs have been described as giving "all of the punishment, [with] none of the guilt."[48] They have been effective tools to sanction corporate wrongdoing, while imposing reform as the business continues to operate, thereby avoiding the costs and consequences of indictment. As yet unregulated however, DPAs require legislation, transparency, and judicial and public oversight to be as effective as possible.

B. Antitrust Division – Corporate Leniency Program

Objectives

Within the marketplace, corruption in the private sector has the potential "to undermine fair competition, fair prices, and efficiency worldwide".[49] Since the 1980's, 'a new and potent wave of globalised cartel activity' such as price-fixing cartels and other collusion schemes have implicated well-known brand names and have hit key market sectors, "from food and vitamins to infrastructure projects, from anti-malaria medicines to the most sophisticated high-tech products and consumer services".[50] The enormous scale of this issue is reinforced by the immense economic power of corporations today, "the top 200 businesses in the world represent more than a quarter of global economic activity, and their total sales surpass the GDP of the entire planet, excluding the nine most industrialized countries".[51]

A cartel can be defined as an 'explicit form of collusion' among firms in an oligopolistic industry where members may agree on such matters as prices, total industry output, market shares, allocation of customers or territories, big-rigging, establishment of common sales agencies and the division

43 William R Lucas, Howard M Shapiro & Julie J Song, "The Decline of Attorney-Client Privilege" (2006) 96:2 J of Crim L and Criminology 621.

44 Colin P Marks "Corporate Investigations, Attorney-client Privilege, and Selective Waiver: Is a Half-Privilege worth having at all?" (2006) 30:155 Seattle U L Rev 155. See also *ibid*.

45 Delaney, *supra* note 33.

46Deferred Prosecution Agreement Between the United States Department of Justice, Criminal Division, Fraud Section, and AIG-FP Pagic Equity Holding Corp. (Nov. 30, 2004), available at <http://www.law.virginia.edu/pdf/faculty/garrett/aig.pdf>.

47 Delaney, *supra* note 33.

48 Eugene Illovsky, "Corporate Deferred Prosecution Agreements: the Brewing Debate" (2006) 21:2 Crim Justice 36.

49 "Executive Summary" in Transparency International, *Global Corruption Report 2009: Corruption in the Private Sector* (Cambridge: Cambridge University Press, 2009) at xxiv.

50 Pradeep S Mehta, "Corruption in Market Competition: Collusion and Cartels" in Transparency International, *Global Corruption Report 2009: Corruption in the Private Sector* (Cambridge: Cambridge University Press, 2009) at 26 [Mehta].

51 S Anderson & J Cavanaugh, *The Top 200: The Rise of Global Corporate Power* (Washington DC: Institute for Policy Studies, 2000), cited in Oscar Lanza "Leveraging consumer Power for Corporate Integrity" in Transparency International, *Global Corruption Report 2009: Corruption in the Private Sector* (Cambridge: Cambridge University Press, 2009) at 145.

of profits or any combination of these.[52] Experts estimate that as few as one in three or one in six cartels is uncovered.[53] Of the 283 private international cartels that were exposed between 1990 and 2005, their aggregate sales amounted to $1.2 trillion causing over $300 billion in direct economic losses to consumers through overcharges.[54] Price increases have ranged from 10 percent for thermal fax paper, 25 percent for vitamins, and 100 percent for stainless steel.[55]

In the United States, the goal of antitrust laws is to provide rules that identify and prohibit anticompetitive business practices with the aim of promoting economic welfare.[56] If firms collude to create artificial scarcity in their products in order to drive prices above competitive levels, such behaviour is presumably inefficient (in the potential Pareto sense of efficiency).[57] Since efficiency is an important social value, it follows that antitrust policy is *prima facie* justified on this ground.[58] It also implies such justification is limited by goals that run antithetical to efficiency; antitrust laws are 'an inapt vehicle' for helping small business as compared to tax breaks for example.[59] The U.S. Supreme Court, with cases dating back to the 1970's, has consistently favoured an economic approach to antitrust - to protect competition in the sense of efficient business practices, rather than in the sense of rivalry amongst competitors.[60] Ultimately, antitrust enforcement requires effective sanctions and an institutional structure that enables violations to be determined with reasonable accuracy and at a reasonable cost.[61]

Legislation

In the United States, Congress passed the first antitrust law, the Sherman Act[62] in 1890, and subsequently, both the Clayton Act[63] and the Federal Trade Commission Act (FTC Act)[64] in 1914. Today, they continue to form the core federal antitrust laws. The Sherman Act prohibits all contracts, combinations and conspiracies that unreasonably restrain interstate and foreign trade.[65] This includes agreements to fix prices, rig bids and allocate customers, otherwise known as cartel violations, which are the most destructive forms of antitrust violations.[66] The Sherman Act also outlaws monopolizing, attempting to monopolize, and conspiring to monopolize.[67] Such violations are criminal felonies and only the U.S. Department of Justice is able to bring prosecutions under the Sherman Act.

The Clayton Act is a civil statute, which carries no criminal penalties and is focused primarily on preventing anticompetitive practices that may substantially lessen competition, with provisions that pertain to mergers and acquisitions[68], price discrimination[69] and sale of goods[70]. It also bars directors or officers from serving in any two corporations at the same time.[71] Persons injured by the

52 OECD, *Glossary of Statistical Terms* (Paris: OECD, 2002).
53 OECD, *Hard Core Cartels: Recent Progress and Challenges Ahead* (Paris: OECD, 2003), cited in Mehta, *supra* note 50 at 28.
54 Mehta, *supra* note 50 at 29.
55 Y Yu, "The Impact of Private International Cartels on Developing Countries" (2003) Honors Thesis, Standford University, CA, cited in Mehta, *supra* note 50 at 29.
56 Richard A Posner, *Antitrust Law*, 2d ed (Chicago: University of Chicago Press, 2001) at ix [Posner].
57 *Ibid* at 2.
58 *Ibid*.
59 *Ibid*.
60 *Ibid* at 262-3. See *Matsushita Electric Industrial Co v Zenith Radio Corp*, 475 US 574 (1986).
61 *Ibid* at 266.
62 *Sherman Antitrust Act*, 15 USC §§ 1-7 (1890) [Sherman Act].
63 *Clayton Act,* 15 USC §§ 12-27 (1914) [Clayton Act].
64 *Federal Trade Commission Act*, 15 USC §§ 41-58, (1914) [FTC Act].
65 Sherman Act, *supra* note 62 at § 1.
66 US Department of Justice, "Antitrust Enforcement and the Consumer", online: <http://www.justice.gov/atr/public/div_stats/211491.htm> [US DOJ, "Consumer"].
67 Sherman Act, *supra* note 62 at § 2.
68 Clayton Act, *supra* note 63 at §§ 18, 18a.
69 *Ibid* at § 13.
70 *Ibid* at § 14.
71 *Ibid* at § 19.

conspirator[72], as well as the United States[73] and any State[74] may bring civil actions under the Clayton Act. The Federal Trade Commission, established under the civil statute of the FTC Act, is tasked with preventing 'unfair methods of competition' and 'deceptive acts or practices'.[75]

Penalties for violating the antitrust laws are severe and can be imposed on both corporations and individual employees. Under the Sherman Act, the maximum fine for a corporation is $100 million and for individuals the maximum is $1 million and/or a maximum jail term of 10 years.[76] These sanctions were substantially increased in 2004.[77] The former maximum limit was $10 million for corporations and $350,000 for individuals with a maximum jail term of three years. These changes were brought on as the result of a series of convictions since 1996, whereby corporations were fined beyond the statutory limits (twenty-one out of twenty-six firms received fines over $10 million).[78] A few factors led to this increase. Convictions on multiple counts increased the maximum fines, as did the use of the alternative maximum fine[79] where the maximum fine can increase to twice the gross gain or twice the loss suffered if either amount is higher than the statutory maximum. Subsequent revisions under the Sentencing Guidelines[80] established a figure of 20 percent of the 'affect volume of commerce' to replace the time and cost of determining actual gain or loss under the alternative maximum fine[81].

Following a criminal conviction, a private civil suit may be brought against the conspirator under the Clayton Act, whereby "conviction serves as a *prima facie* evidence".[82] In these civil suits, the plaintiff is entitled to treble damages (three times their actual damages), litigation costs and attorney's fees.[83] The Antitrust Criminal Penalty Enhancement and Reform Act of 2004 which substantially increased sanctions under the Sherman Act, equally provided for the de-trebling of damages for amnesty applicants thereby limiting exposure to follow-on civil suits.[84]

Corporate Leniency Policy

As an initiative of the Department of Justice, Assistant Attorney General, John Shenefield, first announced its leniency policy in October 1978; the Antitrust Division would not prosecute if a corporation willing came forward to report its illegal conduct *prior to*any investigation and agreed to fully cooperate.[85] Exercising prosecutorial discretion, the Division would decide the issue according to a seven-factor test, premised on rewarding the corporation that is first to come forward.[86] Between 1978 and 1993, only seventeen corporations applied for amnesty, and as few as ten were granted amnesty.[87]

72 Clayton Act, *supra* note 63 at § 15.

73 *Ibid* at § 15a.

74 *Ibid* at § 15c.

75 FTC Act, *supra* note 64 at §§ 41-43, 45.

76 Sherman Act, *supra* note 62 at §§ 1-3.

77 *Antitrust Criminal Penal Enhancement and Reform Act of 2004*, Pub L No 108-237, 118 Stat 661 § 215 (codified as amended at 15 U.S.C. § 1-3 (1890) [Antitrust Reform Act].

78 US, International Competition Policy Advisory Committee to the Attorney General and Assistant Attorney General for Antitrust, *ICPAC Final Report* (Washington DC: US Department of Justice Antitrust Division, 2000) at ch 4.

79 *Criminal Fine Enforcement Act*, 18 USC § 3571(d) (1994) (whereby fines may be equal to twice the gross gain or twice the gross loss resulting from the offense).

80 USSG § 2R1.1(d)(1) (Nov. 1991) (as amended Nov. 2005).

81 Bruce H Kobayashi, "Antitrust, Agency, and Amnesty: An Economic Analysis of the Criminal Enforcement of the Antitrust Laws Against Corporations" (2000-2001) 69 Geo Wash L Rev 715 at 724 [Kobayashi].

82 Clayton Act, *supra* note 63 at § 16. See also *ibid*.

83 *Ibid*.

84 Antitrust Reform Act, *supra* note 77 at § 213.

85 John H Shenefield, "The Disclosure of Antitrust Violations and Prosecutorial Discretion" (Address by the Assistant Attorney General before the 17th Annual Corporate Council Institute, 4 October 1978), cited in Donald C Klawiter, "Corporate Leniency in the Age of International Cartels: The American Experience", Antitrust 14:3 (Summer 2000) 13.

86 Anne K Bingaman, "Antitrust Enforcement: Some Initial Thoughts and Actions" (Address by the Assistant Attorney General, Antitrust Division US Department of Justice before the Antitrust Section of the American Bar Association, 10 August 1993) at 7 [Bingaman].

87 Gary R Spratling, "The Experience and Views of the Antitrust Division" (Address before the United States Sentencing Commission Symposium, "Corporate Crime in America: Strengthening the 'Good Citizen' Corporation", 8 September 1995) [Spratling, "Experience and Views"]

With limited success, several aspects of this policy were criticized from within the Division: the refusal to offer amnesty to anyone once an investigation has begun was viewed as too rigid, as was the inability to guarantee amnesty (meaning no fines or imprisonment) if certain criteria were met.[88] In 1993, the policy was improved in three ways. First, it ensured that amnesty is automatic if a corporation meets all six conditions including being the first to come forward, if the Division had not received information about the illegal activity from any other source.[89] Second, amnesty can be granted *after* an investigation had begun, at the Department's discretion[90] provided it is the first to come forward and the other alternate conditions are met[91]. Third, if amnesty were to be approved, then all directors, officers, and employees cooperating with the prosecution would receive automatic amnesty.[92] The revised policy maintains that only one company per investigation may receive amnesty and it is contingent upon being the first to self-report.

Between 1993 and 2008, there were efforts towards clarification of the policy. For example, it was made clear that an applicant would be disqualified if it had been the singular organizer or ringleader of the cartel activity.[93] Furthermore, the Division promised not to disclose to foreign antitrust agencies information obtained from an amnesty applicant, and equally, it extended the scope of amnesty to cover conduct that was discovered as the investigation unfolded.[94] In 2008, the Division issued a comprehensive resource on recurring issues concerning the leniency program.[95] The revised amnesty policy has been described as the Division's "most effective investigative tool".[96] This is demonstrated by the increased numbers of corporations coming forward in the 'race to the prosecutor' to obtain amnesty – prior to August 1993, the Division received on average one amnesty application per year and under the new policy, the rate increased to two applications per month.[97]

Strengths

In 2010, the Antitrust Division brought 60 criminal cases, charging 84 defendants and obtained over $550 million in fines, $24 million in restitution, and prison terms totaling over 71 years.[98] Following the success of the U.S. Corporate Leniency Policy, it is estimated that there will be criminal cartel enforcement on six continents, and an overall increase in leniency programs worldwide in 35 countries.[99] This adoption by major jurisdictions reflects the growing awareness to address the international character of cartel activities and the need for coordinated government cooperation and enforcement globally. Moreover, if a company involved in international collusion

88 Bingaman, *supra* note 86.

89 Spratling, "Experience and Views", *supra* note 87. See US Department of Justice, *Corporate Leniency Program*, (Washington DC: Department of Justice, 1993), online: <http://www.justice.gov/atr/public/guidelines/0091.htm> [US DOJ "Leniency"].

90 Bingaman, *supra* note 86 at 8.

91 US DOJ, "Leniency", *supra* note 89.

92 Spratling, "Experience and Views" *supra* note 87. See *ibid*.

93 See Gary R Spratling & D Jarrett Arp, "The International Leniency Revolution: The Transformation of International Cartel Enforcement During the First Ten Years of the United States' 1993 Corporate Amnesty/Immunity Policy" (Paper delivered at the American Bar Association Section of Antitrust Law 2003 Annual Meeting, 12 August 2003) at 5-7.

94 *Ibid*.

95 Scott D Hammond & Belinda A Barnettt, "Frequently Asked Questions Regarding the Antitrust Division's Leniency Program and Model Leniency Letters (November 19, 2008)", online: US Department of Justice <http://www.justice.gov/atr/public/criminal/leniency.html>.

96 Scott D Hammond, "Cracking Cartels with Leniency Programs" (Address by the Deputy Assistant Attorney General before the OECD Competition Committee Working Party No 3 Prosecutors Program (18 October 2005).

97 Scott D Hammond, "An Update of the Antitrust Division's Criminal Enforcement Program" (Address by the Deputy Assistant Attorney General before the ABA Section of the Antitrust Law Cartel Enforcement Roundtable delivered at the 2005 Fall Forum, 16 November 2005) [Hammond, "Update"].

98 Christine A Varney, "Vigorously Enforcing the Antitrust Law: Developments at the Division" (Address by the Assistant Attorney General before The Chamber of Commerce, 24 June 2011) at 17.

99 See Gary R Spratling & D Jarrett Arp, "Making the Decision: What to Do When Faced with International Cartel Exposure, Developments Impacting the Decision in 2010" (Paper delivered at the 2010 Competition Law Spring Forum, 17 May 2010), online: Canadian Bar Association <http://www.cba.org/cba/cle/PDF/SpComp10_Spratling_paper.pdf> [Spratling, "Making the Decision"].

decides to apply for amnesty in the U.S., it will almost always report swiftly in other jurisdictions that equally recognize a 'first in the door' policy such as Canada, the European Union and Japan as well as others.[100] At times, the difference between full amnesty and substantial criminal fines and imprisonment for executives has been shown to be a matter of minutes.[101]

Over the years, it has been uncovered that firms engaged in cartel activity in one sector are more likely to be engaged in, or at least aware of, cartel activities in other sectors.[102] This has led to three areas of expanded cooperation in the disclosure of additional cartels: Amnesty Plus, Penalty Plus, and the Omnibus Question in connection with witness interviews.[103] When a company is under investigation and cooperates with the investigation by self-reporting its participation in another 'unrelated conspiracy' to which the government is unaware, it can obtain what has been termed 'Amnesty Plus' – receipt of amnesty for its participation in second offence and a 'substantial additional discount' by the Division for fines pertaining to the first offence.[104] If Amnesty Plus can be viewed as a 'carrot', Penalty Plus is the 'stick.' Companies that choose not to take advantage of Amnesty Plus assume the risk that if they are subsequently investigated for their activity in another cartel, they face even harsher penalties than they would otherwise merit.[105] A complimentary 'cartel profiling' technique used to obtain evidence is known as the 'Omnibus Question' whereby key players such as executives are subpoenaed to provide testimony under penalty for perjury.[106]

While the formula for a successful policy has hinged on the race to the prosecutor's office, these three strategies, in particular Amnesty Plus, have been instrumental for companies that are second in the door. Large financial advantages are available in such cases as compared to being third or forth or even last.[107] The three key factors used to assess the cooperation discount for second-in firms are: the timing of the cooperation, the value and significance of the information provided, and whether the company brings forward any evidence of other 'collusive activity' to obtain the benefits of Amnesty Plus.[108] Firms involved in international conspiracies that decide to plead guilty and cooperate but are not first or second in the door typically pay fines ranging from 25 to 35 percent of the volume of their sales affected by the conspiracy.[109]

The cracking of the worldwide vitamin cartel brings together some key elements of the Corporate Leniency Policy. First, French-based Rhone-Poulenc was granted amnesty and paid no fines for being the first to come forward.[110] Thereafter, Swiss-based Hoffman La Roche (HLR) and German-based BASF Aktiengesellschaft (BASF) immediately came forward to provide valuable cooperation.[111] Even though they paid $500 million and $225 million respectively, fines were significantly reduced to the equivalent of roughly 15 percent of the volume of their sales.[112] However the fourth and fifth companies, Japanese-based Daiichi Pharmaceutical Co., Ltd. and Takeda Chemical Industries, Ltd. each agreed to plead guilty but their fines represented 26 percent and 20 percent of their respective

100 *Ibid* at 6-7.
101 *Ibid* at 7.
102 Catherine Roux & Thomas Von Undern-Sternberg, "Leniency Programs in a Multimarket Setting: Amnesty Plus and Penalty Plus" (2007) CESIFO Working Paper No 1995 at 2.
103 Spratling, "Making the Decision", *supra* note 99 at 66.
104 Hammond, "Update", *supra* note 97.
105 *Ibid*.
106 Scott D Hammond, "Cornerstones of an Effective Leniency Program" (Address by the Director of Criminal Enforcement before the ICN Workshop on Leniency Programs, 22-23 November 2004) [Hammond, "Cornerstones"]
107 Gary R Spratling, "Detection and Deterrence: Rewarding Informants for Reporting Violations" (2000-2001) 69 Geo Wash L Rev 798 at 801-806 [Spratling, "Rewarding Informants"].
108 Scott D Hammond, "Measuring the Value of Second-in Cooperation in Corporate Plea Negotiations" (Address by the Deputy Assistant Attorney General before the 54th Annual American Bar Association Section of Antitrust Law Spring Meeting, 29 March 2006).
109 Spratling, "Rewarding Informants", *supra* note 107 at 804.
110 Scott D Hammond, "Detecting and Deterring Cartel Activity Through and Effective Leniency Program" (Address delivered at the International Workshop on Cartels, 21-22 November, 2000) [Hammond, "Detecting and Deterring"].
111 Spratling, "Rewarding Informants", *supra* note 107 at 803.
112 *Ibid*.

volumes of commerce, the latter receiving an additional benefit through Amnesty Plus.[113]

While the incentive for Amnesty Plus is remarkable, the threat of severe sanctions in tandem with the increased risk of detection must outweigh the potential rewards for continued cartel activity. HLR had been previously fined $14 million for its role in the citric acid cartel, and at that time, denied its role in the vitamin cartel.[114] It refused the benefit of Amnesty Plus undoubtedly due in large part to the insufficient deterrence of expected penalties at that time. To date, HLR has incurred well over a billion dollars in criminal and civil settlements due to its role in the vitamin cartel.[115] Out of all existing jurisdictions with leniency programs, since 2006, the European Commission (EC) has "consistently imposed the largest cartel fines in the world", estimated at well over five times the fines collected by the U.S. Antitrust Division in the same period.[116] Since the EC does not have criminal powers, it relies on the heavy threat of civil or administrative fines for deterrence and is seen as a model of success for jurisdictions that do not have criminal sanctions.[117]

Weaknesses

In his economic analysis, Bruce H. Kobayashi suggests the leniency program creates the most incentives for members of cartels with low expected future profits and for already soon to be detected cartels.[118] However, the effects on 'viable non-detected cartels' is less clear.[119] He proposes that the existence of expected high penalties may act as a disincentive in a firm's decision to self-report, which will have the perverse effect of rendering the cartel more stable, resulting in increased expected cartel profits.[120] Additionally, if arbitrarily large penalties rise above the social harm caused by the crime, this will induce excessive investment by the corporation to monitor, and prevent crimes committed by its agents.[121] Overcompliance will in turn lead to increased production costs and higher prices to consumer. The irony here, as Kobayashi points out, is that high prices and welfare losses are precisely the effects that the criminal antitrust laws are intended to prevent.[122] Moreover, the advantages of corporate criminal liability are also not clear. There is little evidence that corporations suffer from 'stigma' when convicted of antitrust crimes.[123] Corporate managers and shareholders also have a comparative advantage "by substituting lower cost private resources for higher cost public resources" making corporate liability more efficient.[124]

Many commentators, including Kobayashi, have criticized the procedure to calculate criminal fines; the current 20 percent figure is simply an assumption that was made so as to avoid the time and cost of calculating the actual overcharge.[125] In April 2007, the Antitrust Modernization Commission recommended that Congress encourage the Sentencing Commission to reevaluate the 20 percent 'harm proxy' (and revise if necessary), and suggested amendments to the Sentencing Guidelines that any proxy (used to calculate gain or loss resulting from violation) may be rebutted "by proof by a preponderance of the evidence that the actual amount of overcharge was higher or lower, where the difference would materially change the base fine".[126] Gary R. Spratling argues that the

113 *Ibid* at 804.
114 Hammond, "Detecting and Deterring", *supra* note 110.
115 *Ibid*.
116 See Spratling, "Making the Decision", *supra* note 99 at 17 -19.
117 Hammond, "Cornerstones", *supra* note 106.
118 Kobayashi, *supra* note 81 at 739-742.
119 *Ibid*. at 742.
120 *Ibid*.
121 Barry D Baysinger, "Organization Theory and the Criminal Liability of Organizations" (1991) 71 BU L Rev 341 at 341-344, cited in Kobayashi, *supra* note 81 at 736.
122 Kobayashi, *ibid* at 737. See also Michael K. Block, "Optimal Penalties, Criminal Law and the Control of Corporate Behavior" (1001) 71 BU L Rev 395 at 400, 409 [Block].
123 Block , *ibid* at 412.
124 Kobayashi, *supra* note 81 at 737. See generally William M Landes & Richard A Posner, "The Private Enforcement of Law" (1975) 4 J Legal Stud 1.
125 Kobayashi, *ibid* at 722-728, 737.
126 Antitrust Modernization Commission, *Report and Recommendations*, April 2007 at 19, cited in Spratling, "Making the Decision", *supra* note 99 at 113-114.

disconnect between the criminal and civil process needs to be addressed - sentencing in criminal cases is wholly divorced from the assessment and imposition of damage awards in civil litigation.[127] In view of the fact that civil exposure often arises from diverse claims under different laws, the aggregate civil damages exposure is subject to 'no limiting principle' and "can amount to a number in excess of trebled actual damages" as a result.[128] Spratling suggests the consolidation of all federal and state court actions and, following criminal and civil liability outcomes, the federal court could then assess aggregate damages from the conspiracy in one process.[129]

On this key point, Spratling reinforces how follow-on civil litigation and unpredictable damages act as deterrents for companies assessing whether or not to apply for amnesty and cooperate with antitrust enforcers. In the Epson Imaging Devices Corporation case, it was caught between cooperating with the TFT-LCD criminal investigation by the Antitrust Division and an ongoing LDC-TFT civil class action brought against another Epson entity.[130] The failure on the part of the Antitrust Division to include a restitution penalty in the $26 million plea agreement it secured with Epson Imaging Devices Corporation[131] could only be resolved, according to the courts, when the entity actually entering the guilty plea was specifically named as a defendant in the civil class action[132].

Conclusion

Antitrust laws promote efficient business practices and economic welfare that are integral to a healthy and vibrant economy. The U.S. Corporate Leniency Policy, premised on a race to the prosecutor's office, has achieved successful outcomes in combating cartel activity by granting automatic amnesty. In recent years, international cartels have grown to become powerful forces within the private sector. The 1993 revisions made numerous changes to its amnesty program and enhanced transparency resulting in a significant increase in amnesty applicants. Expanded cooperation strategies like Amnesty Plus serve to temper the effects of being second-in-the-door. Suggestions have been made to consolidate criminal and civil liability to reduce the disincentive effects of follow-on civil damages exposure for amnesty applicants. The increasing numbers of jurisdictions worldwide that have adopted similar leniency programs offer the potential for increased cooperation and coordination to combat antitrust violations, especially cartel activities.

III. United States Department of Treasury

A. Internal Revenue Service

Objectives

As an agency of the U.S Department of Treasury, the Internal Revenue Service (IRS) is responsible for tax collection and tax law enforcement. Its role is "to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply, pay their fair share."[133] The traditional approach to deterrence includes increased sanctions and calls for increased enforcement. Deterrence theory suggests that while this may effectively deter 'new' or potential offenders, such traditional approaches might equally cause current offenders to expend

127 Spratling, "Making the Decision", *ibid* at 114.

128 *Ibid*.

129 *Ibid* (This was first recommended in 2001 by the American Bar Association Section of Antitrust Law, *Report of the Task force on the Federal Antitrust Agencies: The State of Federal Antitrust Enforcement – 2001*' at 23-24).

130 *Ibid* at 115.

131 Plea Agreement, *United States v Epson Imaging Devices Corp*, No CR 09-0854 SI (ND Cal Oct 23, 2009) at para 12, cited in *ibid*.

132 See Transcript of Proceedings at 25:16-19, *United States v Epson Imaging Devices Corp*, No CR 09-0854 SI (ND Cal Oct 16, 2009), cited in *ibid*.

133 US, Internal Revenue Service, *The Agency, Its Mission, and Statutory Authority* (Washington, D.C.: United States Department of the Treasury, 2009) online: IRS <http://www.irs.gov>.

more resources to cover up their crimes, to pay for their increased risk exposure, and thus do more harm.[134] According to Miriam H. Baer, alternative enforcement strategies, such as tax amnesty programs, are most successful in drawing out current offenders when the likelihood of detection or sanctions appears to be on the verge of significant increase.[135] In support, Craig M. Boise suggests that amnesty may "ease the transition to a new legal regime or signal an impending change in enforcement activities."[136]

When applied to the current IRS regime, we see newly implemented and pending diverse strategies, which address the behaviour of both potential and current offenders, through the 2011 Offshore Voluntary Disclosure Initiative, the newly enacted Foreign Account Tax Compliance Act (FATCA) as well as the recently formed IRS Whistleblowers Office. In particular, there has been a concerted effort to tailor new legislation and strategies to combat offshore tax evasion and require third party information reporting or withholding requirements.

1. 2011 Offshore Voluntary Disclosure Initiative

In February 2006, the IRS released updated compliance estimates that showed the 'gross tax gap' was $345 billion in the fiscal year of 2001.[137] Key characteristics include: 70 percent of the gross tax gap relates to individual income tax, 80 percent of this gap was due to underreporting of tax, with about half this amount due to underreporting of net business income by individuals where noncompliance is highest among taxpayers whose income is not subject to third party information reporting or withholding requirements.[138] This represents a significant loss of tax revenue incurred yearly by the U.S. government.

If tax evasion can be defined as the avoidance of taxes, which cost governments significant amounts of revenue, tax amnesty programs typically offer a grace period that temporarily reduces or abolishes penalties for delinquent taxpayers in exchange for voluntary disclosure.[139] An earlier amnesty ended in 2009, which resulted in 15,000 voluntary disclosures.[140] This result was no doubt precipitated by the IRS's the lengthy pursuit of Swiss banking giant UBS. In February 2009, UBS entered into a deferred prosecution agreement[141] with the U.S. Justice Department incurring criminal fines of $780 million and handed over data on more than 250 secret accounts for their part in helping Americans evade tax. The following day, the U.S. Justice Department petitioned the U.S. District Court to enforce the IRS's John Doe summons against UBS to provide names and records of over 52,000 U.S. accountholders.[142] On August 19th 2009, the United States, the IRS, and UBS entered into a settlement agreement to oblige the disclosure of 4,500 account holders.[143] On July 15th, 2011 a Swiss court upheld the Swiss government's decision to force UBS to hand over client data, citing "virtually uncontrollable economic repercussions for Switzerland" if it had not done so.[144]

134 Miriam H Baer, "Linkage and the Deterrence of Corporate Fraud" (2008) 94 Va L Rev 1295.

135 *Ibid*.

136 Craig M Boise, "Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty" (2007) 14 Geo Mason L Rev 667 at 700.

137 US, Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap* (26 September 2006) at 3 online: Department of the Treasury <http://www.treasury.gov>.

138 *Ibid*.

139 Elliot Uchitelle, "The Effectiveness of Tax Amnesty Programs in Selected Countries" (1989) Autumn FRBNY Quarterly Rev 48 at 48.

140 IRS, News Release, IR-2011-14, "Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 deadline IRS" (8 February 2011) [IRS, "Second Disclosure"].

141 *United States v UBS AG*, US District Court for the Southern District of Florida, Case No 09-60033 (18 February 2009).

142 *United States v UBS AG*, US District Court for the Southern District of Florida, Case No 09-20423 (19 February 2009).

143 United States of America v UBS AG, Case No 09-20423-CIVGold/McAliley (stipulation of dismissal filed). See also C Mollenkamp, L Saunders & E Perez, "UBC to Give 4,450 Names in Settlement," The Wall Street Journal (19 August 2009), online: Wall Street Journal <http://online.wsj.com/article/SB125068571743342973.html>.

144 Chris V Nicholson, "Credit Suisse Discloses US Inquiry over Taxes" *DealBook, The New York Times* (15 July 2011), online: DealBook New York Times <http://dealbook.nytimes.com/2011/07/15/credit-suisse-discloses-u-s-investigation-over-private-banking/?scp=1&sq=US%20tax%20evasion&st=cse> [Nicholson].

In February 2011, the IRS announced its 2011 Offshore Voluntary Disclosure Initiative (OVDI) that expires on August 31, 2011 offering a similar mitigation of penalties and escape from criminal prosecutions but is less favourable than the 2009 program. Those who come forward will have to pay back-taxes and interest going back 8 years, as well as pay accuracy-related and/or delinquency penalties, plus a penalty of 25 percent of the highest total amount in their foreign bank accounts at any time between 2003 and 2010.[145] However, it introduces new initiatives. Taxpayers whose offshore assets never exceeded $75,000 in the 8-year period will be charged penalties of only 12.5 percent. In a few cases, foreign residents who did not know they were liable to U.S. taxation may qualify for a special 5 percent rate in lieu of the 25 percent penalty. IRS Commissioner Doug Shulman said this second amnesty is "the last, best chance for people to get back into the system."[146] This announcement comes as the U.S. continues to make headlines with its pursuit of Americans believed to be hiding wealth offshore along with foreign financial institutions, which are thought to have helped towards this end.[147]

2. Foreign Account Tax Compliance Act

The 2011 OVDI appears to be the last incentive before the Foreign Account Tax Compliance Act (FATCA) provisions included in the Hiring Incentives to Restore Employment Act (HIRE)[148] take effect in 2013. Under FATCA, U.S. taxpayers holding financial assets outside the United States with an aggregate value exceeding $50,000 will have to report those assets to the IRS (beginning with assets held in taxable years ending March 31, 2011 or later). Failure to report these assets will result in a penalty of $10,000 (and a penalty up to $50,000 for continued failure after IRS notification). Moreover, underpayments of tax attributable to non-disclosed foreign financial assets will be subject to an 'additional substantial understatement penalty' of 40 percent.[149]

FATCA will also require foreign financial institutions (FFIs) to report directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. This reporting regime applies to payments made by foreign financial institutions to covered accounts on or after 1 January 2014. Each FFI will need to enter into a special agreement with the IRS by June 30, 2013.

Each participating FFI will be obligated to identify accountholders and undertake due diligence with respect to accountholders, report relevant accountholders annually to the IRS and withhold and pay over to the IRS 30 percent of any payments of U.S. source income, as well as gross proceeds from the sale of securities that generate U.S. source income, made to a) non-participating FFIs, b) individual accountholders failing to provide sufficient information to determine whether or not they are a U.S. person or c) foreign entity accountholders failing to provide sufficient information about the identity of its substantial U.S. owners. Therefore, in order for non-participating FFIs to access U.S. capital markets without being subject to a 30 percent U.S. withholding tax, those foreign entities would have to enter into a written agreement with the U.S. government and annually disclose information on their U.S. account holders. In effect, this legislation requires the automatic exchange of information of U.S. persons with foreign financial accounts.[150]

Currently, some foreign financial institutions have voluntarily agreed to provide information on

145 US, Internal Revenue Service, *Summary of Key FATCA Provisions*, (Washington, DC: United States Department of the Treasury, 2009) online: IRS <http://www.irs.gov> [FATCA Provisions].

146 IRS, "Second Disclosure", *supra* note 140.

147 Nicholson, *supra* note 144. See also Lynnley Browning, "HSBC is Said to Be the Focus of a Tax-Evasion Investigation" *The New York Times* (26 January 2011), online: New York Times <http://www.nytimes.com/2011/01/27/business/global/27hsbc.html?_r=1>.

148 Pub L 111–147 § 501-563, 124 Stat 71 (2010).

149 FATCA Provisions, *supra* note 145.

150 David Spencer, "Tax Justice Briefing: Memorandum on the US Foreign Account Tax Compliance Act" *Tax Justice Network* (April 2010) at 5, online: Tax Justice Network <www.taxjustice.net/cms/upload/pdf/FATCA_1004_TJN_Briefing_Paper.pdf> [Spencer].

the U.S. assets of U.S. account holders as part of the "Qualified Intermediary" (QI) program since 2000.[151] FATCA identifies two main problems with the QI rules with regard to U.S. persons: the QI rules do not require reporting of foreign (non-U.S.) source income and the rules do not apply to foreign entities (such as corporations, partnerships and trusts) owned by U.S. persons.[152] As such, FATCA will significantly increase the arsenal of tools available for IRS investigations to combat offshore tax evasion, primarily through FFI information reporting, induced by otherwise pejorative withholding requirements for non-participating FFIs.

Strengths & Weaknesses

FATCA in effect constitutes automatic exchange of information, not by a foreign government to the U.S. government, but by FFIs to the U.S. government.[153] It is expected that FFIs will comply with these disclosure and reported requirements in order to avoid the U.S. withholding tax and maintain access to U.S. capital markets.[154] In the process towards more efficient international tax cooperation, FATCA will prove to be a significant step toward automatic exchange of information internationally. As IRS Commissioner Doug Shulman explained in a Senate Hearing in 2009, prior to the enactment of FATCA, traditional bilateral agreements between countries, such as the Tax Information Exchange Agreements, have limitations. The model U.S. treaty has 30 provisions covering a broad range of sectors that deal with tax treatment however the sole enforcement provision is ineffective:

> [T]he only provision for enforcement, article 26, is generally designed... [y]ou have to name the account and go after them. So, while treaties are useful, they do not necessarily spontaneously produce the kind of information the [IRS] would like to get. That is why we use a variety of other tools…where we have other leavers, and clearly the kind of legislation that this committee is considering are levers that we could use.[155]

There are nonetheless questions and concerns that remain with respect to the implementation of FATCA. Firstly, will other countries also be able to negotiate and require automatic exchange of information and how will this unfold?[156] Secondly, senior bank executives from numerous countries around the globe are urging for modifications to FATCA in so far as they will undoubtedly incur enormous costs due to the required due diligence for reporting as well as conflicts with domestic privacy laws.[157] In a statement made on July 14th 2011, IRS Commissioner Shulman announced plans to phase in the requirements in order to give adequate time to FFIs to build the systems needed to fully comply with FATCA.[158]

3. IRS Whistleblower Office

What is now 26 U.S.C. § 7623(a)[159] has been in force under the Informant Claims Program since 1867 and allows the IRS to pay an award for information that leads to the collection of an underpayment of tax, regardless of what the motive was on the part of the taxpayer in underpaying the tax in the first place. That is, an award is not contingent upon a finding of fraud in the tax sense. This distinguishes it from other types of whistleblower action based on fraud such as the qui tam provisions of the False Claims Act. The Tax Relief and Health Care Act of 2006[160] contains the most significant

151 *Ibid* at 2.
152 *Ibid*.
153 *Ibid* at 5.
154 *Ibid*.
155 US, *Tax Issues Related to Ponzi Schemes and An Update on Offshore Tax Evasion Legislation: Hearing before the Committee on Finance United States Senate*, 111th Cong (17 March 2009) at 24.
156 Spencer, *supra* note 150 at 1.
157 T Braithwaite, V Houlder, N Tait & J Wilson, "Banks Battle over US Tax Law" *Financial Times* (12 June 2011).
158 IRS, News Release, IR-2011-76, "Treasury and IRS Issue Guidance Outlining Phased Implementation of FATCA Beginning in 2013" (14 July 2011).
159 26 CFR § 301.7623-1 (1867).
160 Pub L 109-432, § 406, 120 Stat 292 (2006).

changes to the IRS program in the last 140 years. It added new section 7623(b) whereby awards are no longer discretionary – if the IRS uses the information disclosed, the whistleblower shall receive 15 to 30 percent of the collected proceeds for disputes exceeding $2 million. Additionally, awards are subject to whistleblower appeal rights in the U.S. Tax Courts. The IRS was also mandated to establish a Whistleblower Office to pay rewards.

Strengths

In December 2010, the IRS published its report to Congress on the use of section 7623. In the fiscal year of 2009, the IRS received 460 submissions[161] that appear to meet the criteria for section 7623(b), which is the mandatory award program for multi-million dollar cases. These submissions identify 1, 941 taxpayers and the report provides that these whistleblowers claim to have inside knowledge of the transactions they are reporting, and often provide extensive documentation in support of their claims.[162] On April 7th, 2011, the Whistleblower Office issued the first-ever whistleblower reward of $4.5 million, representing 22 percent of the collected proceeds for tax fraud, under the new mandatory provision enacted over four and a half years ago.[163] Setting an example for success in other areas, recent legislative reform has subsequently required the Securities and Exchange Commission to create a similar whistleblower program modeled on the IRS's current program.[164]

Weaknesses

Critics have expressed their frustration that only one award has thus far materialized under the new program, due to red tape, delays and the 'closed process'.[165] With the IRS and its Whistleblower Office under strict confidentiality standards[166], exacting measures to ensure privacy and confidentiality makes the IRS's 'closed process' difficult to operate and as some legal counsel have suggested, "stuck in some review process"[167]. Allegedly, the aforementioned whistleblower, after submitting his claim and not hearing back from the office for two years, brought counsel on board to pursue his claim.[168] Former IRS chief counsel Donald Korb points out that IRS cases usually take from 6 to 8 years.[169] This may have a chilling effect upon whistleblowers coming forward with claims being held 'in limbo' for years.[170] Increasingly, the use and abuse of whistleblowers has become the subject of much debate, framed by Korb as "a system in America where one neighbor is encouraged to turn in his neighbor to the IRS."[171]

Further, the program itself may create a 'catch-22' under section 7623(b)(3); to provide worthwhile information to the IRS, you need detailed knowledge of the scheme, however, having that knowledge could disqualify you from the award.[172] American Bradley Birkenfeld, a former UBS private banker exposed how UBS enticed wealthy Americans to hide their wealth from the IRS, and, with a

161 IRS, News Release, "FY 2009 Annual Report to Congress on the Use of Section 7623" (13 December 2010).

162 *Ibid*.

163 Maryclaire Dale, "IRS gives Accounting $4.5 Million in its 1st Whistleblower Award" *The Associated Press* (8 April 2011) [Dale].

164 Michael Hudson, "IRS Red Tape, Old Guard Slow Whistleblowing on Corporate Tax Cheats"The Center for Public Integrity, iwatchnews (22 June 2011), online: iwatchnews <"http://www.iwatchnews.org/2011/06/22/4979/irs-red-tape-old-guard-slow-whistleblowing-corporate-tax-cheats> [Hudson].

165 *Ibid*.

166 26 USC § 6103 (confidentiality and disclosure of returns and return information).

167 Hudson, *supra* note 164.

168 Dale, *supra* note 163.

169 Hudson, *supra* note 164.

170 *Ibid*.

171 *Ibid*.

172 See US, Internal Revenue Service, *Internal Revenue Manual*, Chapter 25.2.2.2 (06-18-2010), online: <http://www.irs.gov/> (Under 26 USC § 7623(b)(3), if the whistleblower 'planned and initiated' the actions that led to the underpayment of tax, or to the violation of the internal revenue laws, the Whistleblower Office may reduce the award. If the whistleblower is convicted of criminal conduct arising from his or her role in planning and initiating the action, the Whistleblower Office shall deny any award).

pending claim at the Whistleblowers Office, could be entitled to a share of the $580 million[173] the IRS recouped as part of the federal government's $780 million deferred prosecution agreement with UBS in 2009. However, he has since been sentenced to 40 months in prison for his low-level role in UBS's scheme, and as of June 22, 2011, no status of an award has been communicated.[174] Thus, the 'stick' to disqualify a whistleblower's award due to his role in a scheme ought to be weighted against the benefits of the information provided, namely a substantial fine against a leading bank that subsequently led to the release of data of over 4,500 U.S. accountholders.

Conclusion

If we examine recent enforcement strategies by the IRS, we see a diverse approach towards facilitating legislative and policy reform aimed at ensuring that the minority who is unwilling to comply, pays their fair share. With compliance estimates that indicate a gross tax gap amounting to $345 billion for the fiscal year of 2001, it is clear that the U.S. government has committed resources towards securing lost revenue. With stepped up efforts aimed at bringing to justice both delinquent taxpayers and foreign banking giants, the 2011 OVDI will undoubtedly recoup significant revenue by current tax evaders, especially in view of FATCA's pending entry into force in 2013. Equally, the significant threat of FATCA will undoubtedly serve as an effective deterrence for new and potential tax evaders. While there remains significant challenges left to resolve with respect to FATCA's implementation, especially for participating FFIs regarding information reporting, FATCA is a bold and unprecedented global effort towards combating the billions of tax revenue dollars lost every year due to offshore tax evasion.

IV. The 2008 Financial Crisis and Legislative Reform

A. Factors that Contributed to the 2008 Financial Crisis

Introduction

Deregulation is the reduction or removal of rules or laws or authorizing entities to engage in new, unregulated activities.[175] Desupervision can be described when rules remain in place but they are not enforced or are enforced more ineffectively.[176] Many commentators such as William K. Black have suggested that these two interrelated elements are among the principal forces that effectively drove the 2008 financial crisis in the United States.[177] Some of the key factors that touch upon these two concepts will be examined and portrayed as both interlinked and interdependent events and conditions that led to the financial crisis. This examination, however, is by far not an exhaustive account.

New financial products, or securitizations, that emerged in the financial sector demonstrate not only the degree of complexity and innovation but also the ways in which they served to drive the agents who impacted the crisis. Eric Helleiner describes the evolution of these new products in a clear and precise way. Mortgage-backed securities (MBSs) were pioneered in the 1970's by government sponsored Fannie Mae and Freddie Mac, which had issued simple bonds backed by packages of mortgages they held.[178] In the early 1990's, the volume of MBSs grew rapidly as private firms entered the market to offer securities structured in increasingly complex ways, bundled together and sliced up into distinct risk profiles that were sold and traded worldwide.[179] In turn, these MBSs

173 Hudson, *supra* note 164.

174 *Ibid*.

175 William K. Black, "Analysis: How Wallison is Blind to Accounting Control Fraud", *Global Economic Intersection* (10 February 2011), online: Global Economic Intersection, <http://econintersect.com/wordpress/?p=5809> [Black].

176 *Ibid*.

177 *Ibid*.

178 Eric Helleiner, "Understanding the 2007-2008 Global Financial Crisis: Lessons for Scholars of International Political Economy" (2011) 14 Annu Rev Polit Sci 67 at 70 [Helleiner].

179 *Ibid*.

themselves began to be divided and repackaged together into new collateralized debt obligations (CDOs) whose cash flows derived from the other bonds.[180] Trading credit risk in this way was not isolated to mortgages but included other asset-back securities such as credit cards and car loans.[181] Further, this process normally involves the creation of a separate legal entity, which is a special purpose vehicle or special investment vehicle (SIV) whose sole function is to hold the underlying mortgages (as collateral) or to purchase the CDOs and issue claims (bonds) against itself.[182]

Moreover, in addition to dividing up and trading credit risk through these new instruments, credit risks were also hedged by the creation of new kinds of derivatives, namely credit default swaps (CDS).[183] Invented in 1991, this product insured the holders of bonds against the risk of default by offering to pay the buyer of the CDS contract the full value of the bond on which the CDS contract was written, in the event of default.[184] However, most buyers of CDS contracts were not the owners of the underlying bonds but were in fact, simply speculating on the likelihood of default on the specific bonds.[185] By the end of 2007, the gross nominal value of the CDS contracts had reached $60 trillion, thereby surpassing the world's overall gross domestic product.[186] Over the last two decades, the enormous growth of CDSs and other derivatives involved what is termed 'over-the-counter' (OTC) products, which were negotiated privately on a bilateral basis as between the buyer and seller.[187]

This brings us back to the mortgage lenders. As they increasingly passed on the mortgages they originated, generating fees by selling ever larger volumes of loans, prudential concerns and due diligence became increasingly overlooked. This decline of discipline in the mortgage loan origination market saw a similar laxity among underwriters in the capital markets. As John C. Coffee Jr. states, "irresponsible lending in the mortgage market appears to have been a direct response to the capital markets' increasingly insatiable demand for financial assets to securitize".[188] Coffee aptly points out that if underwriters were willing to "rush deeply flawed asset-back securities to the market", mortgage loan originators had no rational reason to resist this demand.[189] So why did underwriters buy them? Coffee points to the confluence of both private and public influences. Structured finance offered a level playing field for investment banks to compete with commercial banks and they were thus driven by high profits in this area.[190] Moreover, as due diligence standards slackened, the underwriting community equally took its cue from the Securities and Exchange Commission (SEC). In 2005, Regulation AB[191] reduced the due diligence obligation of underwriters by eliminating any need to assure that assets included in a securitized pool were adequately documented.[192]

As credit risk became increasing detached from the original source and bundled into increasingly complex instruments, its quality equally became more obscure. The originate-to-distribute model is a method used to break down the process of credit extension described as origination (the asset created as the borrower's obligation), packaging (asset is sold to another financial institution) and repackaging (assets merged to create marketable security).[193] Structured security is then broken into

180 *Ibid*.
181 *Ibid*.
182 Emilios Avgouleas, "The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy" (2009) 9 JCLS 23 at 36 [Avgouleas].
183 Helleiner, *supra* note 178.
184 *Ibid*.
185 *Ibid*.
186 Financial Services Authority, *The Turner Review* (London: Financ Serv Author, 2009) at 81 (although the net exposure was lower since the CDS contracts offset each other), cited in *ibid*.
187 Helleiner, *Ibid*.
188 John C Coffee Jr, "What Went Wrong? An Initial Inquiry Into the Causes of the 2008 Financial Crisis" (2009) 9 JCLS 1 at 6 [Coffee].
189 *Ibid*.
190 *Ibid* at 6-7.
191 Securities Act Release No 8518, "Asset-Backed Securities" (7 January 2005), 79 FR 1506.
192 Coffee, *supra* note 188 at 7.
193 Avgouleas, *supra* note 182.

pieces, or tranches, of varying seniority and credit quality where each tranche is rated separately by one or more credit rating agencies (CRAs).

Much has been written about the poor performance of CRAs as gatekeepers and in turn their degree of responsibility for the 2008 financial crisis, "the consensus being that they inflated their ratings in the case of structured finance offerings."[194] Lacking a full understanding of these instruments, as well as the quality of the loans underlying ABS, reliance on credit ratings by investors was critical. In simplistic terms, the issuance of overly positive ratings by CRAs has been justified on similar grounds, "because they too found it difficult to evaluate risks accurately".[195] However, the 'Big Three' CRAs (Moody's, Standard & Poor's, and Fitch Ratings) were each granted regulatory licenses by the SEC, thus making their ratings a virtual precondition to the purchase of debt securities by many institutional investors.[196] With an 'issuer pays' model, CRA revenues were derived from the companies they rated which undoubtedly increased pressure for positive ratings.

From these considerations, Coffee distills two key factors that led to inflated ratings of these products. The first factor points to the exponential rise of structured finance and the change in relationships that it produced between CRAs and their clients, the issuers. Structured finance turned CRAs "from marginal, break-even enterprises into immensely profitable enterprises" to become their leading revenue source and, in effect, tilted the balance of control onto the five investment banks that were shopping these products.[197] The second and interrelated factor that coincided with the rise of structured finance, points to the rise of Fitch Ratings, which broke Moody's and Standard & Poor's shared duopoly by the late 1990's. A study by Bo Becker and Todd Milbourn suggests that increased competition from Fitch may have impaired the "reputational mechanism that underlies the provision of good quality ratings".[198] As firms became "more client-friendly and focused on market share"[199], competition amongst CRAs increased dependence on their clients, the issuers, with resulting increased agency costs for investors.[200]

The bank that had advanced the original loan, in the end, had transferred most of this risk to the buyers of asset-backed securities. However, institutional investors normally did so using money borrowed from the commercial banks and in this way, the risk of the securitized loans returned to the banks instead of moving away from them.[201] The effect of this practice not only increased the overall leverage of the financial system, it intensified the financial instability throughout the crisis.[202] This is the primary means through which the losses associated with the sub-prime mortgage defaults spread through the financial system.[203]

Securitization increased the number and significance of financial actors who fell outside of traditional regulations covering commercial banks. The United States had five major investment banks: Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers, and Bear Stearns. In 2004, each of these investment banks entered the SEC's Consolidated Supervised Entity (CSE) Program.[204] Coffee suggests that this program was motivated by the adoption in Europe of the

194 Coffee, *supra* note 188 at 7.
195 Helleiner, *supra* note 178.
196 Coffee, *supra* note 188 at 7.
197 *Ibid* at 8-9.
198 B Becker & T Milburn, "Reputation and Competition: Evidence from the Credit Rating Industry", (2008) Harvard Business School Working Paper No 09-051, online: <http://hbswk.hbs.edu/item/6247.html>.
199 See "Ratings Game–As Housing Boomed, Moody's Opened Up", *The Wall Street Journal* (11 April 2008) at A-1.
200 Coffee, *supra* note 188 at 10.
201 Avgouleas, *supra* note 182 at 37.
202 *Ibid*.
203 *Ibid*.
204 Securities Exchange Act Release No 34-49830, "Alternative New Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Entities" (21 June 2004), 69 FR 34428.

Financial Conglomerates Directive[205], which sought to enhance regulatory oversight of financial holding companies.[206] The purpose of the legislation was to ensure regulatory supervision at the parent company level of financial conglomerates. It also contained an exception for foreign financial conglomerates that were regulated by their home countries in a way that was deemed 'equivalent' to that envisioned by the directive. For major U.S. commercial banks, exemption status avoided the reach of European regulators. However, U.S. investment banks were caught as the SEC has no similar oversight over their parent companies.

The CSE Program permitted investment banks to adopt an alternative and more relaxed net capital rule governing their debt to net capital ratio. A broker-dealer was subject otherwise to fixed ceilings on its permissible leverage – which for most brokers stood at 15 to 1 debt to net capital ratio.[207] Notwithstanding this 'mistake' in the rule to relax these standards under the CSE Program, and as investment banks were taking greater and greater risks with leverage, the issue was equally SEC's failure to monitor the participating investment banks closely or to demand specific actions. If Basel II[208] promulgated a regulatory framework that involved close monitoring and supervision, which correspondingly influenced the framework of the CSE Program, the SEC was woefully understaffed to meet these objectives. A team of only 3 SEC staff was assigned to each CSE firm and a total of only 13 individuals comprised the SEC's Office of Prudential Supervision and Risk Analysis to oversee this monitoring.[209] If the SEC could not perform its monitoring duties, it was hardly in the position to obtain the voluntary compliance over questions of maximum permissible leverage, especially if the firms, per Basel II, could choose and devise their own individualized methodology to assess risk.

SEC Chairman Christopher Cox has been vocal over the need for explicit authority where it is needed and urged that reform legislation should steer clear of voluntary regulation, in his testimony regarding the challenges of negotiating leverage and risk management practices with CSE firms during a Senate Banking Committee in September 2008.[210] In hindsight, what has been made clear is that the SEC lacked both the power and the expertise to restrict leverage by the major investment banks, which coincided with each bank generating its own risk model that placed it in a stronger bargaining position in negotiations with the SEC. With no oversight and due to the opacity of the instruments themselves, few red flags were raised.

Much has been said about the incentives for a short-term compensation system, or as Black terms, accounting control fraud, within the finance industry.[211] It creates perverse incentives for short–term gains at the sake of long-term sustainability. Similarly, Coffee describes a climate "motivated by stock market pressure and the incentives of a short-term oriented executive compensation system" whereby executives and senior management effectively converted the process into self-regulation.[212] By 2008, the uniform collapse of the five major investment banks led one into bankruptcy (Lehman Brothers), two merged at the brink of insolvency with larger commercial banks (Bear Stearns and Merrill Lynch) and two converted into bank holding companies under pressure from the Federal

205 Council Directive 2002/87, Financial Conglomerates Directive [2002] OJ L35 of the European Parliament and of the Council of 16 December 2002 on the supplementary supervisions of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives.

206 See JE Vinuales, "The International Regulation of Financial Conglomerates: A Case Study of Equivalence as an Approach to Financial Regulation" (2006) 37 California Western Int'l Law J 1 at 2-4.

207 See Rule 15c3-1(a)(l)(i); 17 CFR § 240.15c3-1)a)(l); Rule 15c3-1(a)(l)(ii); 17 CFR § 15c3-1(a)(l)(ii), cited in Coffee, *supra* note 188 at 13.

208 Published in 2004, Basel II represents a comprehensive set of reform measures that form the global regulatory framework for capital and liquidity. It is issued by the international body, the Basel Committee on Banking Supervision, which has since released Basel III. See online: Bank for International Settlements <http://www.bis.org/bcbs/basel3.htm>.

209 US, Securities and Exchange Commission, Office of the Inspector General, "SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Entity Program", Report No 446-A (25 September 2008) at 2.

210 Christopher Cox, "Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions" (Testimony before the Committee on Banking, Housing and Urban Affairs, United States Senate, 23 September 2008).

211 Black, *supra* note 175.

212 Coffee, *supra* note 188 at 16.

Reserve (Goldman Sachs and Morgan Stanley).[213]

Conclusion

Enacted in 2010 in response to the 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act[214] serves to mitigate some of the outdated strategies and regulatory frameworks that gave rise to the 2008 financial crisis. More regulation, more oversight and increased accountability frame this piece of legislation as a whole. These issues, namely the lack of transparency of securities and derivatives, the lack of due diligence by mortgage brokers and underwriters, inflated credit ratings, voluntary rather than mandatory compliance by investment banks, along with the perverse incentives of short-term gain by executives and senior management came together to create a perfect storm within the United States that led to the 2008 financial crisis. Certainly these are not the only factors but they nonetheless demonstrate a climate of reinforced systemic and regulatory weaknesses brought on by extraordinary innovation within the financial sector, outdated rules and regulation, and understaffed regulators unable to perform oversight and monitoring.

B. Consumer Financial Protection Bureau

Objectives

The following legislative reform points to significant changes that are currently underway within the financial regulatory framework. While the aforementioned examination into the 2008 financial crisis made indirect mention of the predatory practices by mortgage lenders, it is clear in hindsight, the failure to protect consumers equally lies at the heart of the 2008 financial crisis. Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act created the Consumer Financial Protection Bureau (CFPB) as the means to mitigate some of the risky behavior that is believed to have caused the 2008 financial crisis. Its mandate is to protect consumers from abusive, deceptive and unfair financial products and ensure that consumers are provided financial services that are fair, competitive and transparent.[215] This agency will probably have the broadest reach of any agency in Washington to date.[216]

The CFPB has wide jurisdiction over persons who provide financial products or services, it calls these "covered persons". This includes:

> [C]onsumer credit (extending, servicing, acquiring, purchasing, selling, or brokering); consumer leasing; real estate settlement services and appraisals of real and personal property; deposit taking and money transmitting; stored value (selling, providing, and issuing, with exceptions); checks (cashing, collecting, guaranteeing); financial data processing; financial advisory services, including credit counseling, debt management, and debt settlement; consumer reporting ("collecting, analyzing, maintaining, or providing," with exceptions); debt collection (if related to a consumer financial product); and any other financial product or service.[217]

The Act expressly excludes merchants, retailers, insurance companies, and real estate brokers among others.[218]

213 *Ibid*. at 10.

214 *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub Law No 111-203, 124 Stat 1955 (2010) [Dodd-Frank].

215 *Ibid* at §1021(a).

216 Peter J Wallison, "The Dodd-Frank Act: Creative Destruction, Destroyed" (2010) AEI Financial Services Outlook at 2 online: <http://www.law.yale.edu/documents/pdf/cbl/Dodd_Frank_Wallison.pdf > [Wallison].

217 Julie R Caggiano, Jennifer L Dozier, Richard P Hackett & Arthur B Axelson "Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform Under the Dodd-Frank Act" (2011) Bus Law 457 at 458-459; See also Dodd-Frank, *supra* note 214 at §1002 15(A).

218 Dodd-Frank, *ibid* at §1029.

Legislation

The CFPB's mandate is to investigate any violation of the federal consumer financial protection laws.[219] Its reach is extensive and includes the consolidation of various consumer financial agencies, and provides broad investigative powers and strong enforcement. It is equally responsible for doing analyses of market risk, education outreach programs and setting up an advisory board and complaints commission. Strong whistleblowing legislation has also been introduced for those consumers who wish to report a complaint about wrongdoing within their organization.[220]

The CFPB has been created as an arms-length body that is partially sheltered from political control. Unlike other agencies, its funding is not dependent on yearly votes from Congress, but instead it receives a yearly percentage (not more than 12 percent) of Federal Reserve funds.[221] In addition, the director will be appointed by the President with consent from the Senate on a 5 year fixed term basis, so as to shelter the director from making decisions based on fear of losing his position or political retaliation.[222] The CFPB will be an independent bureau within the Federal Reserve System, itself an independent agency; it will operate entirely on its own.[223] The CFPB is subject to certain internal and external standards, for example it must take into account the cost to consumers of implementing rules, possible restrictions on access to consumers, and impact on consumers, and it is required to consult with prudential regulators, and other federal regulating agencies before making any decisions.[224] Furthermore, prudential regulators and other agencies may make written objections to a CFPB decision, which the CFPB must take under consideration.[225]

The CFPB's investigative powers include the ability to issue subpoenas or civil investigation demands that require witness testimony, written responses to questions and production of documents. A failure to comply with any of these demands can lead to contempt proceedings. It may institute cease and desist proceedings against any covered person, as well as restraining orders.[226] The CFPB cannot institute criminal investigations, but it can collect information that it can then submit to the Attorney General's office for the purpose of a criminal investigation.[227] In addition, only the government can take civil action, there are no qui tam provisions.

The penalties and remedies available to the CFPB include: rescission or reformation of contracts; of moneys or return of real property; restitution; disgorgement of unjust enrichment; damages or other monetary relief; public notification of violations, including costs of notification; limits on the activities or functions of the person; civil money penalties.[228] The civil monetary fines include the following:

1. Any violation of a law, rule or final order or condition imposed in writing by the Bureau: up to $5,000 a day for each day during which the violation continues.
2. Reckless violation of a consumer financial law up to $25,000 a day (for each day during which the violation continues).

219 These laws are Alternative Mortgage Transaction Parity Act; Consumer Leasing Act; Electronic Fund Transfer Act (with certain exceptions); Equal Credit Opportunity Act; Fair Credit Billing Act; Fair Credit Reporting Act (with certain exceptions); Home Owners Protection Act of 1998; Fair Debt Collection Practices Act; Federal Deposit Insurance Act (only section 43(b)-(f)); Gramm-Leach-Bliley Act (only section 502 through 509, except section 505 as it applies to section 501(b)); Home Mortgage Disclosure Act; Home Ownership and Equity Protection Act of 1994; Real Estate Settlement Procedures Act; S.A.F.E. Mortgage Licensing Act of 2008; Truth in Lending Act; Truth in Savings Act; Omnibus Appropriations Act of 2009 (only section 626); Interstate Land Sales Full Disclosure Act.

220 Dodd-Frank, *supra* note 214 at §1057.

221 *Ibid* at §1017(a)(2)(A)iii).

222 *Ibid* at §1011(5)(1).

223 *Ibid* at §1017.

224 *Ibid* at §1022(b)(2)(A)(i-ii).

225 *Ibid* at §1022

226 *Ibid* at §1052.

227 *Ibid* at §1056.

228 *Ibid* at §1055.

3. Knowing violations of a Federal consumer financial law up to $1,000,000 a day.
There are no exemplary or punitive damages.

The CFPB will assume all the powers of the Board of Governors; the Federal Deposit Insurance Company; the National Credit Union Administration; the Office of Comptroller of the Currency; the Office of Thrift Supervision. It will work together with the Federal Trade Commission as well as the Department of Housing and Urban Development and the Attorney General for any investigation falling within the mandate of these agencies and departments.[229]

The CFPB will have exclusive power to oversee 'nondepository' institutions such as those who provide brokerage or servicing loans secured by real estate, which are used by consumers, and the CFPB can investigate any complaints on a 'larger market' institution, which may impact or pose a risk to a consumer product.[230] The CFPB has also primary supervisory power of depository institutions (banks) and credit unions with assets over $10,000,000,000.[231] In this instance, the CFPB must work closely with prudential regulators, but retains primary authority. However, in the case of banks and credit unions with assets of less than $10,000,000,000, the prudential regulators have the authority to enforce the consumer protection financial laws.[232]

Strengths & Weaknesses

One of the major strengths of the CFPB is that its broad powers are backed up by meaningful sanctions.[233] As with any new legislation, this Act has been embroiled in an ideological conflict about the nature and scope of government regulation. Some believe that this legislation will discourage innovation, is overly burdensome on businesses and will drive up costs. They believe that the very rules that exist to ensure that the Bureau remains independent are equally ways to avoid public oversight and congressional scrutiny.[234] Others argue that the CFPB's political and financial independence are the key to its success as a regulator, and its mandate to mitigate risk strikes the right balance between discouraging wrongdoing and encouraging legitimate business practices.[235]

Any government agency that has a mixture of broad power and relative independence must be scrutinized for abuses of power. To offset potential abuses, the CFPB is subject to an annual independent audit of its operations and must appoint an ombudsperson to deal with any complaints and "act as a liaison between the Bureau and any affected person with respect to any problem that such party may have in dealing with the Bureau, resulting from the regulatory activities of the Bureau".[236]

This piece of legislation is as yet untested, as it is due to come into being on 21 July 2011. It is already facing a setback, because the Bureau's power to assume the authority of transferring agencies is dependent on a director being appointed, and to date, the Senate has not consented to any of the candidates brought forth by the president. Until a director is appointed the Bureau will remain under the Department of Treasury rather than transfer to the Federal Reserve, thus it has yet to realize the full potential of its powers and independence as intended in the Act.[237]

229 *Ibid* at §1061.
230 *Ibid* at §1024.
231 *Ibid* at §1025.
232 *Ibid*.
233 Martin Bishop ,"Regulatory: The Consumer Financial Protection Bureau: The bureau's bark is backed up by its ability to bite" Inside Counsel (29 June 2011) online: Inside Counsel <http://www.insidecounsel.com>.
234 Wallison, *supra* note 216 at 5-6.
235 Martin Bishop, "Regulatory: the Consumer Financial Protection Bureau" Inside Counsel (4 May 2011) online: *Inside Counsel* <http://www.insidecounsel.com>.
236 Dodd-Frank, *supra* note 214 at § 1013 (a)(5)(B)(i).
237 *Ibid* at §1066.

Conclusion

This report has examined key economic activities and the innovative regimes, which regulate them. The qui tam provisions of the False Claims Act provide the means for whistleblowers to stand in on behalf of the State and pursue accountability while obtaining rewards for such efforts. Deferred Prosecution Agreements allow the Criminal Division of the Department of Justice to sanction corporations for wrongdoing while reforming governance from within as businesses continue to operate, thereby circumventing the devastating costs of indictment. Many commentators press for greater transparency and the need for legislation and oversight pertaining to these agreements. Equally useful has been the Corporate Leniency Policy under the Antitrust Division of the Department of Justice. Extended cooperation under Amnesty Plus seeks to encourage voluntary disclosure of cartel activity in multi-markets by offering additional terms of amnesty, while wielding the threat of increased penalties for non-disclosure under Penalty Plus. Multi-strategies have been used within the Internal Revenue Service as a layered approach towards combating tax evasion, underreporting and underpayments by U.S. taxpayers. The 2011 Offshore Voluntary Disclosure Initiative, the Foreign Account Taxation Compliance Act as well as the IRS Whistleblower Office serve as diverse and innovative mechanisms to achieve these goals. An examination into the U.S. factors that led to the 2008 financial crisis demonstrates the interconnectedness of both deregulation and desupervision as key contributing elements facing regulation within the finance industry with its outdated tools, regulatory gaps and understaffing. Lastly, the newly formed Consumer Financial Protection Bureau consolidates various financial agencies and provides for broad investigative and enforcement powers to protect consumers from abusive, deceptive and unfair financial products. It represents a swift and decisive commitment by the U.S. government to provide more oversight and increased consumer protection. However, as the 2008 financial crisis demonstrates, while rules and authority are necessary, agencies themselves require adequate technology and resource capabilities to regulate effectively. Today, the Internal Revenue Service is one such agency that leads the way both within the United States, but also on the global stage.