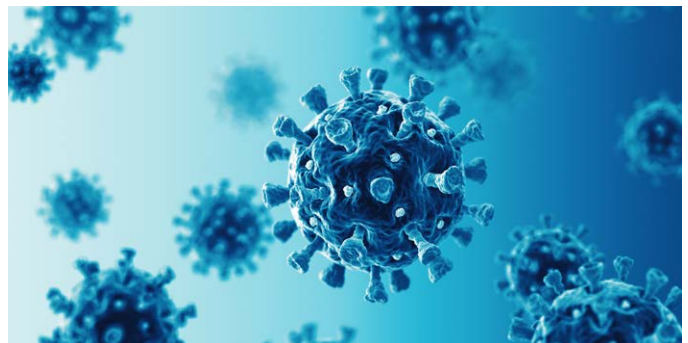


# Clean Your Room: Historical Corporate Misconduct and The Post-COVID Era

## The Eye of the Storm

It will take some time before we can gauge the full breadth of social and economic damage caused by the coronavirus (COVID-19) outbreak. In the meantime, regulators have undertaken various actions in a collective effort to shore up the economy and limit the fallout from the pandemic. To that end, several state and federal regulatory agencies have issued statements announcing temporary relief guidance and a loosening of compliance requirements.

For instance, the U.S. Securities and Exchange Commission (SEC) recently announced that it is providing “temporary, conditional relief for business development companies (BDCs) making investments in small and medium-sized businesses.”<sup>1</sup> Similarly, on April 3, 2020, the Federal Reserve, Consumer Finance Protection Bureau (CFPB), Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), and the Conference of State Bank Supervisors (CSBC) issued a joint statement announcing their decision to relax supervision and enforcement over mortgage servicers. Finally, the Financial Industry Regulatory Authority (FINRA) announced on April 6 that, due to difficulties stemming from the ongoing pandemic, member firms would be granted extra time to respond to open inquiries, investigations, or upcoming filings.<sup>2</sup>



But this lull in regulatory scrutiny will not last. Once the gears of the economy finally begin to turn, the new landscape will bring legal actions and regulatory enforcements throughout many industries, targeting corporate misconduct with fines, penalties, disgorgements, judgments, and criminal convictions. What does recent history tell us about the regulatory landscape we are likely to see in the post-COVID-19 era?

This article attempts to examine some recent historical crises and market downturns, as well as to offer key insights into the most likely areas of concern once the pandemic finally recedes. In that light, we offer several recommendations to help firms “clean their room,” so as to ensure profitability, growth, and compliance in the months and years to come.

<sup>1</sup> <https://www.sec.gov/news/press-release/2020-84>

<sup>2</sup> <https://www.acacompliancegroup.com/blog/finras-pandemic-related-business-continuity-planning-guidance-and-regulatory-relief>

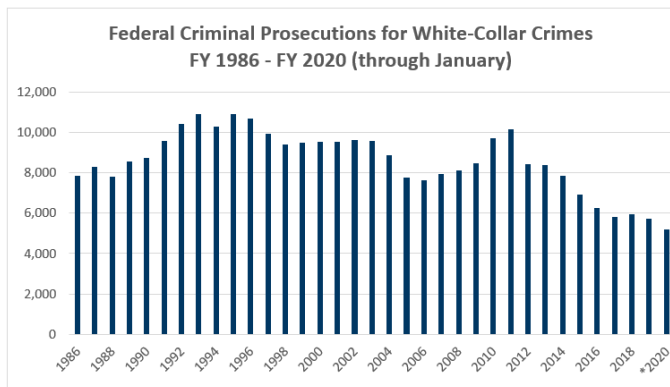
## Corporate Misconduct & Its Aftermath

History tells us that this lull in regulatory enforcement actions will come to a swift end as the economy begins to pick up steam. While the enforcement landscape will have peaks and valleys, the attention and resources allocated to enforcement will vary depending on the industry, company size, category of sanctions, agency budget, and the severity of violations that emerge in the post-pandemic era. However, history also tells us which areas are most likely to experience a significant spike in enforcement activity. As such, some firms and industries are more likely than others to fall prey to such violations and their attendant sanctions and enforcement actions.

While not exhaustive, we illustrate major trends in the legal and regulatory enforcement landscape with relevant historical crises and misconduct that ensued.

### Corporate Criminal Investigations & Prosecutions

There are numerous types of criminal investigations and prosecutions that emerge amid major crises and market downturns. Notwithstanding a downward trend in total cases filed by the U.S. Department of Justice (DOJ) in recent years, a significant number of corporate criminal cases (against both individuals and companies) relate to fraud, corruption, and bribery, which often dominate the post-crisis legal and regulatory landscape.



Source: Transactional Records Clearinghouse, “Corporate and White-Collar Prosecutions At All-Time Lows”; TRAC Reports, Syracuse University, 3 March 2020, <https://trac.syr.edu/tracreports/crim/597/> \*2020 data is projected

## Fraud

As Bruce Dorris, the president and CEO of the Association of Certified Fraud Examiners (ACFE), has stated in his letter on April 10, 2020; “During the recession, we can expect not only more fraud to occur, but also more existing fraud to be discovered.” Corporate criminal investigations, both federal and state, frequently involve criminal statutes pertaining to fraud, whether against investors, shareholders, or the public. Of the myriad fraud schemes that have been investigated and prosecuted at the state and federal levels, the most notable types include, among others, securities fraud, fraud against the government, mail and wire fraud, disaster relief fraud, and financial fraud.<sup>3</sup>

“During the recession, we can expect not only more fraud to occur, but also more existing fraud to be discovered.”

The Great Recession of 2008 produced a substantial increase in observable fraud throughout multiple sectors of the economy, according to 80 percent of fraud professionals surveyed by the ACFE at the time. The bulk of these professionals also expressed a belief that “fraud levels increase in times of economic distress.” Given that the COVID-19 pandemic has already sent shockwaves through the domestic and global economy, today’s market circumstances closely parallel those following the 2008 financial crisis.<sup>4</sup>

Recent history particularly highlights the rackets that often emanate from disaster fraud, “a deliberate act to defraud individuals or the government after a catastrophe.” Disaster fraud typically falls into five categories: “charitable solicitations, contractor and vendor fraud, price gouging, property insurance fraud, and forgery.”<sup>5</sup>

Following the Great Recession of 2008 there was a substantial increase in fraud throughout multiple sectors, including a +200 percent increase in total FCPA-related enforcements.

<sup>3</sup> <https://www.nortonrosefulbright.com/-/media/files/nrf/nrfweb/imported/20160101---trends-in-federal-white-collar-prosecutions.pdf>

<sup>4</sup> <https://www.acfeinsights.com/acfe-insights/coronavirus-pandemic-is-a-perfect-storm-for-fraud>

<sup>5</sup> <https://www.fraud-magazine.com/article.aspx?id=4294967697>

Hurricane Katrina elicited a spike in disaster fraud that includes charitable solicitations, contractor and vendor fraud, price gouging, property insurance fraud, and forgery.

Following **Hurricane Katrina**, which in 2005 wreaked havoc on Southern Louisiana and much of the Gulf Coast region, the DOJ established the Hurricane Katrina Fraud Task Force aimed at “detering, detecting, and prosecuting unscrupulous individuals who try to take advantage of the Hurricanes Katrina, Rita, and Wilma disasters.” The Task Force charged 768 individuals in connection with fraud schemes around relief funds earmarked for disaster victims and Gulf Coast reconstruction efforts.<sup>6</sup>

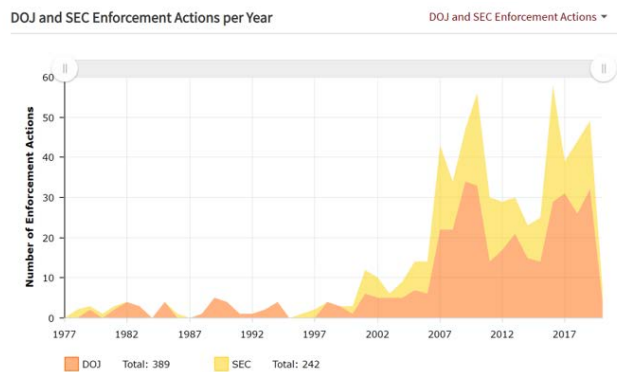
*While distinct from major recessions or natural disasters, from a fraud perspective the current global pandemic has characteristics of both.*

While distinct from major recessions or natural disasters, from a fraud perspective the current global pandemic has characteristics of both. On the one hand, fraud schemes blossom during major recessions and economic instability, as many firms and their employees succumb to pressure to falsify financials under pressure from shareholders and would-be financiers.<sup>7</sup> On the other hand, like with natural disasters, the current crisis has brought potentially exploitable relief funds destined for protecting public health, stimulating economic activity, and shoring up consumer demand. If history is any guide, the coming months and years will likely bring a swath of criminal convictions related to coronavirus fraud.

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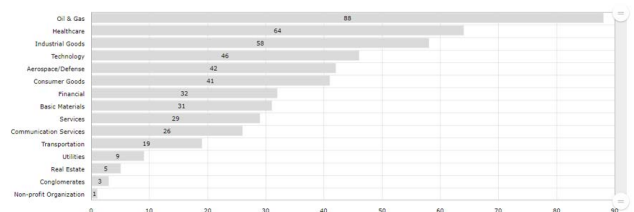
### Foreign Corrupt Practices Act (FCPA) Enforcements

The enactment of the FCPA in 1977 was followed by 30 years of relatively sparse prosecution and enforcements. But suddenly, more or less concurrent with the onset of the **Great Recession**, there was a spike in legal and regulatory scrutiny in the U.S., including a roughly 200 percent increase in total FCPA-related enforcements from 2006 to 2007 (to 43 from 14). Since then, total enforcements for corruption and bribery violations have waxed and waned but have remained well above the numbers seen in the first three decades followings the law’s enactment.<sup>8</sup>



Source: Stanford Law School Foreign Corrupt Practices Act Clearinghouse, DOJ and SEC Enforcement Actions per Year <http://fcpa.stanford.edu/statistics-analytics.html>

Since the law took effect, roughly two-thirds of FCPA enforcements (related to bribery or corruption involving foreign officials) have fallen into just six industry classifications: oil and gas (with 88 matters); healthcare (64); industrial goods (58); technology (46); aerospace/defense (42); and consumer goods (41). The other third notably includes finance (33) basic materials (31), and general services (29), among others.<sup>9</sup>



Source: Stanford Law School Foreign Corrupt Practices Act Clearinghouse, Industry Classifications of FCPA Matters <http://fcpa.stanford.edu/statistics-analytics.html>

<sup>6</sup> <https://www.justice.gov/sites/default/files/criminal-disasters/legacy/2012/07/30/09-04-07AG2ndyrprogrpt.pdf>

<sup>7</sup> <https://www.acfeinsights.com/acfe-insights/coronavirus-pandemic-is-a-perfect-storm-for-fraud>

<sup>8</sup> <http://fcpa.stanford.edu/statistics-analytics.html>

<sup>9</sup> <http://fcpa.stanford.edu/statistics-analytics.html?tab=9>

The hydrocarbons industry appeared to be headed into financial hardship even before the outbreak of COVID-19. Following the Great Recession, interest rates plummeted to near-zero percent. At this point, energy companies took on substantial debt in order to finance thousands of multi-million-dollar wells whose production boomed from 2009-2014 and quickly busted. In 2019 alone, 42 debt-ridden oil and gas companies sought bankruptcy protection,<sup>10</sup> even before the coronavirus pandemic decimated demand and cast a dark forecast over the industry's global growth prospects.<sup>11</sup>

As it did after the Great Recession, the Federal Reserve appears to be positioning itself to shore up lending to the industry,<sup>12</sup> including new lending options to small and medium-sized businesses.<sup>13</sup> Companies may feel tempted to take on new financing deals in order to purchase distressed assets. Foreign acquisitions will bring corruption and bribery risks that, if unmitigated, may cause a swell of new FCPA cases down the road. The same may be said about other industries which have historically been the focus of FCPA-related investigations and enforcement actions.

## Securities Enforcements

### Securities and Exchange Commission (SEC)

#### *Post-Crisis Enforcement Agenda*

In May 2001, Commissioner Isaac C. Hunt, Jr., offered public testimony outlining the focus of the SEC in light of the so-called **dot.com bubble**, “a period of soaring stock prices and exuberant speculation on new Internet companies” that quickly imploded after its mid-2000 peak, causing tumultuous ripple effects throughout the economy.<sup>14</sup>

In response to worrisome trends following a period of soaring stock prices and exuberant speculation on new Internet companies leading to the dot.com bubble, the SEC turned its focus to the quality of financial reporting process and overall market fairness.

The commissioner described the parallels between the 1920s stock market crash and the dot.com crash as “extremely worrisome to any regulator,” adding that in 2000, as the Nasdaq composite index fell by 60 percent, stock recommendations of “sell” or “strong sell” comprised less than 1 percent of all recommendations. In response to these worrisome trends, the SEC adopted two areas of focus to ensure consumer protection in securities markets: [1] “the importance of the quality of the financial reporting process and [2] market fairness.”<sup>15</sup>

The recently announced focus on financial reporting would encompass detailed reviews of companies’ audited financial statements to identify evidence of:

- Manipulation of reported profits (“earnings management”)
- Dissemination of idealized versions of performance metrics (“‘pro forma’ information”)
- Motivating customers to purchase sooner by offering major discounts (“channel stuffing”)
- Improper revenue recognition
- Asset overvaluation
- Deliberate oversight of accounting irregularities by internal and external accounts

Conversely, the SEC’s newfound focus on market fairness involved the adoption of Regulation Fair Disclosure, which “was designed to end the problem of [selective disclosure, when] a company’s executive officers or other representatives provide material information to a selective few before disclosing such material information to the general public.”<sup>16 17</sup>



<sup>10</sup> <https://www.explorebigsky.com/covids-killing-the-oil-industry-and-it-may-not-come-back/34182>

<sup>11</sup> <https://oilprice.com/Energy/Crude-Oil/Are-Mandatory-Output-Cuts-The-Only-Way-To-Save-US-Oil.html>

<sup>12</sup> <https://electrek.co/2020/05/01/egeb-us-federal-reserve-oil-companies-relief-orsted/>

<sup>13</sup> <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200430a.htm>

<sup>14</sup> [http://www.nbcnews.com/id/37740147/ns/business-stocks\\_and\\_economy/t/historic-bear-markets/#.Xm-lKahKiUk](http://www.nbcnews.com/id/37740147/ns/business-stocks_and_economy/t/historic-bear-markets/#.Xm-lKahKiUk)

<sup>15</sup> <https://www.sec.gov/news/speech/spch497.htm>

<sup>16</sup> *Ibid.*

<sup>17</sup> See also, <https://www.reuters.com/article/us-sec-ipos-idUSTRE75R6OJ20110628>

In 2019, SEC enforcements reached their highest recorded level with 862 actions.<sup>18</sup> The bulk of enforcements comprised issues related to investment advisory (36 percent), securities offerings (21 percent), and reporting/accounting and auditing (17 percent), broker-dealers (7 percent), insider trading (6 percent), and market manipulation (6 percent). Enforcements and related proceedings in 2019 resulted in “a total of \$3.248 billion in disgorgement of ill-gotten gains [and \$1.101 billion in imposed penalties].”<sup>19</sup>

### *Post-COVID Landscape*

Looking ahead, the SEC’s regulatory posture following the economic fallout from the COVID-19 pandemic will likely parallel that of the post-dot.com bubble. The SEC’s 862 enforcement actions filed in 2019, “the most actions filed in the past 10 years,”<sup>20</sup> broadly reflected the agency’s five core principles:

- **Principle 1:** Focus on the retail investor.
- **Principle 2:** Focus on individual accountability.
- **Principle 3:** Keeping pace with technological change.
- **Principle 4:** Pursuit of remedies that most effectively further its enforcement goals.
- **Principle 5:** Constant assessment of the allocation of the Division’s resources.<sup>21</sup>

As we enter the post-COVID landscape, we should expect the SEC’s enforcement agenda to continue for the foreseeable future. That includes, among other things, a focus on investment advisors, the misuse of digital assets and cybersecurity, the targeting of not just companies but individuals, and broad discretion over disgorgement and penalty amounts.<sup>22</sup> In particular, the regulator will focus on the finance, insurance and real estate industries, which received the most (58 percent) of enforcement actions historically.<sup>23</sup>

## Post-Crisis Civil Litigation

### Class Action Suits

Many claims arise following major market downturns and crises, including the widely reported class actions suits following the residential mortgage-backed securities bubble that imploded during the Great Recession of 2008.<sup>24 25</sup> In the case of Brazil, **Operação Lava-Jato** (“Operation Car Wash”), the largest and most high-profile corruption scandal in Brazilian history, resulted in the prosecution of many government officials and executives from private and public companies,<sup>26</sup> in addition to other corollary legal actions.

These corollary legal actions include a major class action suit against state-owned oil company Petrobrás, which in early 2018 paid nearly \$3 billion to settle a class action corruption lawsuit, the largest by a foreign entity in U.S. history. Although Petrobrás denied any wrongdoing, the class action suit was precipitated by facts which came to light during the investigation by Brazilian authorities, in which Petrobras itself appears to have been a victim of systemic bribery and corruption.<sup>27</sup>

Operação Lava-Jato (“Operation Car Wash”), the largest and most high-profile corruption scandal in Brazilian history, led to a number of white-collar legal actions, including a major class action suit against state-owned Petrobrás.

### *Burgeoning Signs of Class Action*

The market downturn and uptick in criminal investigations and regulatory enforcements following the COVID-19 pandemic are likely to expose further instances of corporate misconduct that may come to light in the coming months and years. We are already seeing signs of this phenomenon.

<sup>18</sup> <https://www.dlapiper.com/en/us/insights/publications/2019/11/sec-issues-fy2019-enforcement-report/>

<sup>19</sup> <https://www.sec.gov/files/enforcement-annual-report-2019.pdf>

<sup>20</sup> <https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-FY-2019-Update>; <https://www.law.com/corpcounsel/2019/11/20/number-of-sec-enforcement-actions-at-highest-in-10-years/>

<sup>21</sup> <https://www.sec.gov/files/enforcement-annual-report-2019.pdf>

<sup>22</sup> <https://www.whitecollarlawandinvestigations.com/2020/01/06/white-collar-year-in-preview-sec-enforcement-trends-in-2020/>

<sup>23</sup> <https://www.law.com/corpcounsel/2019/11/20/number-of-sec-enforcement-actions-at-highest-in-10-years/?sreturn=20200327172810>

<sup>24</sup> <https://www.americanbanker.com/opinion/a-decade-on-crisis-era-litigation-still-bedevis-banks>

<sup>25</sup> *Ibid.*

<sup>26</sup> <https://www.ftijournal.com/article/A-Clear-Cut-Victory-for-Brazils-Next-President>

<sup>27</sup> <https://www.reuters.com/article/us-petrobras-classaction/petrobras-to-pay-2-95-billion-to-settle-u-s-class-action-over-corruption-idUSKBN1ES0L2>

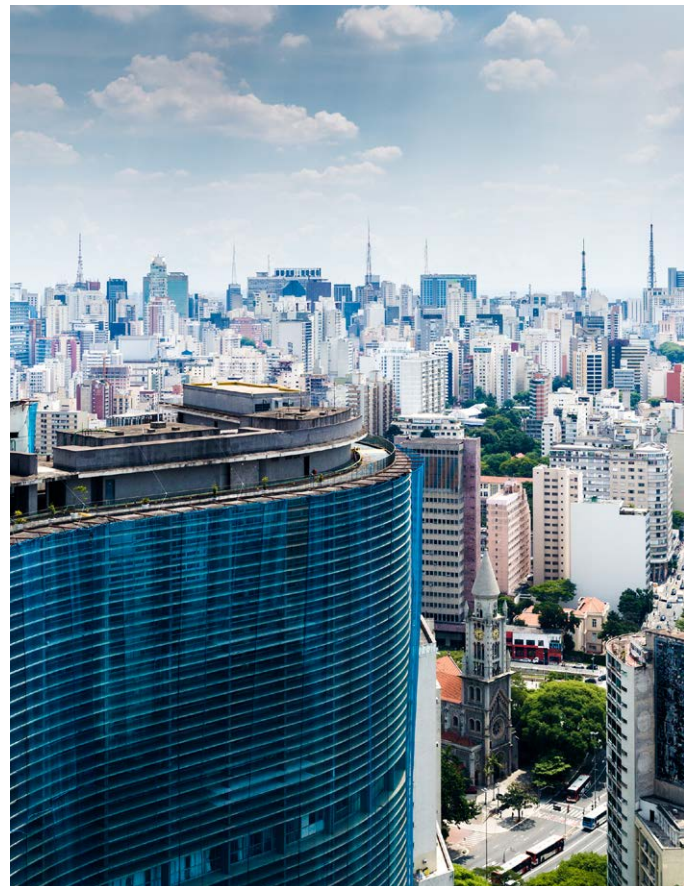


As of this writing, class action suits have been filed against Bank of America, Chase Bank, U.S. Bank, and Wells Fargo alleging that these financial institutions prioritized large-dollar loans in its disbursement of funds related to the Trump administration’s small business emergency loans program, the Paycheck Protection Program (PPP).<sup>28</sup> Another class action suit was filed against Inovio Pharmaceuticals for making “misleading statements about the company’s development of a purported vaccine for the novel coronavirus, artificially inflating the company’s share price and resulting in significant investor losses.”<sup>29</sup>

### Other Relevant Enforcement Trends

Several other areas of the regulatory landscape will likely see a spike in enforcements in the post-COVID landscape, including, but not limited to, banking, finance, and environmental protection. One notable area of concern relates to regulatory actions related to public health amid the COVID-19 outbreak.

Enforcements by the Food and Drug Administration (FDA) have been consistently declining over the past decade, with no obvious spikes in severe regulatory enforcements (e.g., injunctions and criminal prosecution and fines) following major crises or market downturns. However, the regulator has largely shifted from outright enforcement actions to other available tools that it uses to encourage or compels compliance with existing regulations, including Form 483s, warning letters, and seizures.<sup>30</sup> The bulk of warning letters in 2019 pertained to drugs and medical devices, namely for adulterations to finished pharmaceuticals, medical devices, and active pharmaceutical ingredients (API).<sup>31</sup> In the first two months of 2020, 35 warning letters were issued that largely related to these regulatory areas, addressed to both domestic and foreign entities.<sup>32</sup>



However, the agency recently signaled that it will likely pursue more aggressive actions in some areas in response to the COVID-19 pandemic, particularly as it relates to cannabidiol (“CBD”) products. The FDA and the Federal Trade Commission (FTC) recently issued a series of warning letters directed at several CBD manufacturers and sellers that allegedly published “dubious” messages pertaining to the efficacy of CBD products in treating symptoms related to the virus, which included at least one temporary restraining order and an injunction against a California-based marketer of hemp-derived products.<sup>33</sup> These actions suggest heightened concern over COVID-19-related marketing and portend further regulatory scrutiny in the coming months for the cannabis industry and adjacent sectors.

<sup>28</sup> [https://www.bloomberglaw.com/document/X4DBMEU8000000?udv\\_expired=true](https://www.bloomberglaw.com/document/X4DBMEU8000000?udv_expired=true)

<sup>29</sup> *Ibid.*

<sup>30</sup> <https://www.crowell.com/NewsEvents/AlertsNewsletters/all/FDA-Enforcement-Trends-Reflecting-on-2019-and-Looking-Onward-to-2020>

<sup>31</sup> <https://www.crowell.com/NewsEvents/AlertsNewsletters/all/FDA-Enforcement-Trends-Reflecting-on-2019-and-Looking-Onward-to-2020-1556131>

<sup>32</sup> *Ibid.*

<sup>33</sup> <https://harrisbricken.com/cannalawblog/cbd-claims-federal-enforcement-actions-are-no-longer-limited-to-warning-letters>

## Now Is the Time to Clean Your Room

In light of this historical view of major crises and market downturns, it is paramount, now more than ever, for organizations to ensure compliance with financial, governmental, and operational regulations. In the post-COVID era, your organization's legal and compliance departments should endeavor to mitigate the risk of fraud, bribery, corruption, and other forms of corporate misconduct within the organization, and do so while driving cost savings wherever possible.

In short, now is the time to clean your room. Firms should act swiftly to design and implement strict compliance controls and detection mechanisms in order to avert the looming white-collar prosecutions and regulatory snafus, as foreshadowed by the recent market history outlined above. We would like to share the following recommendations to help orient companies across myriad sectors toward getting their regulatory and compliance house in order.

*It is paramount, now more than ever, for organizations to ensure compliance with financial, governmental, and operational regulations.*



### Recommendations

- Take steps to continue to reaffirm your organization's positive tone, emphasis on legal and policy compliance, and ethical conduct during times of crisis;
- Many organizations are operating in a virtual manner, with many employees working from home. Thus your compliance and legal departments would gain better governance if they identified ways to modify or flex their management team, as well as compliance and ethics oversight structure;
- Enhance your standard risk assessment and due diligence processes so that they can continue to be implemented in a virtual or remote manner, in order to help identify any new risks as a result of COVID-19 issues;
- During this period of remote work, develop or update codes of conduct, policies, and procedures that track key risk areas within the organization, as well as address any new risk areas related to COVID-19;
- Develop and update ethics and compliance training protocol and communications programs to cover the current crisis;
- Confirm that your organization's whistleblowing or ombudsman program, along with any channels for employee reporting, are well-communicated and operating as intended, and remind employees of the importance of asking questions and raising concerns;
- Assess and ensure that back-end case management and investigations programs are poised to handle potential increases in employee reporting;
- Develop or revise your organization's auditing and monitoring strategy to include data analytics capabilities that address key areas of risk during and after this pandemic, such as bribery, corruption, kickbacks, theft, asset misappropriation, fraudulent financial reporting, and cybersecurity;



- To address any disruption of supply chains due to COVID-19, organizations should enhance their due diligence processes to manage supply chain related risks; and,
- As organizations are mandated to run their compliance and risk units with increased operational and cost-effectiveness, now is the time to assess and evaluate your data analytics platforms, tools, and talent pool. Compliance, legal, and risk departments should leverage data quality, advanced analytics, and artificial intelligence in a cost-effective fashion to help reduce manual processes and false positives while increasing the capability to detect relevant outliers and anomalies for further investigation.



*Firms should act swiftly to design and implement strict compliance controls and detection mechanisms in order to avert the looming white-collar prosecutions and regulatory snafus.*

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**AUTHORS**

**OZGUR VURAL**

Managing Director  
+1 646.453.1235  
ozgur.vural@fticonsulting.com

**MIGUEL SALCEDO**

Senior Consultant  
+1 213.452.6476  
miguel.salcedo@fticonsulting.com

**LAUREN LINN**

Director  
+1 303.689.8859  
lauren.linn@fticonsulting.com



Learn more at [fticonsulting.com/covid19](https://www.fticonsulting.com/covid19)