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Using Fraud Investigations as an ERM Tool



The Institute of Internal Auditors
New York Chapter

Calyon, Credit Agricole CIB - Auditorium
1301 Avenue of the Americas
New York, NY 10019

Introduction

Fraud is recognized by the regulators and private sector as a major issue. Achieving our goal, elimination of fraud, is dependent on effectively implementing all compliance programs. Taking the insights and knowledge from fraud experiences and embedding it into the ERM strategies deployed within the enterprise will ensure ongoing successes against fraud

Meeting Objectives

- ⌘ Review current regulatory landscape focusing on fraud elimination highlighting areas of intersection and interest
- ⌘ Open discussion about trends in fraud and best in class practices regarding investigation processes
- ⌘ Identify ways that fraud investigation results can be utilized in risk, audit and compliance programs to create institutional knowledge and improve compliance programs and operational procedures
- ⌘ Wrap up

We have just obtained the following from a fraud consultant, who must remain nameless!



S.P.E.C.T.R.E.
Annual Meeting Report

Special Executive for Counter-Intelligence, Terrorism, Revenge and Extortion

Ernst Stavro Blofeld
Founder, Absolute Chief & No. 1

(All copyrights acknowledged)



Record results !

- ≡ £420m in credit card fraud in UK
- ≡ €76m in commercial fraud in France
- ≡ € 50m in signature fraud in Netherlands
- ≡ Insurance fraud schemes estimated per year at \$27.6 billion
- ≡ Identified banks with poor procedures and laundered an estimated \$926bn
- ≡ Developed major money laundering networks including stolen and fraudulent checks
- ≡ Identity theft is fastest growing crime (+40% last year in some regions)
- ≡ Significant damage to reputation and market value of our corporate victims

- ⌘ External fraud is an industry which is showing significant upward trends against both public and private companies. Understanding and predicting fraud is a critical element for any Enterprise Risk Management program
- ⌘ Regulators are focused on mitigating and controlling the impact of fraud by addressing various key aspects from the individual regulator's perspective
 - ⌘ SOX focuses on financial reporting
 - ⌘ SEC/NASD and Foreign Corrupt Practices focus on business practices
 - ⌘ Basel II focuses on capital adequacy
 - ⌘ Patriot Act, Anti-Money Laundering and Office of Foreign Asset Control focus on government and political policy
- ⌘ Defined compliance programs typically contain:
 - ⌘ A system of internal controls
 - ⌘ Independent testing for compliance
 - ⌘ The designation of an individual or individuals to coordinate and monitor day-to-day compliance
 - ⌘ Training of appropriate personnel
- ⌘ Insight from fraud investigations should identify inefficient or ineffective internal controls; lack of institutionalized feedback into the ERM process increases corporate exposure

Fraud Is A Fact Of Life In Business

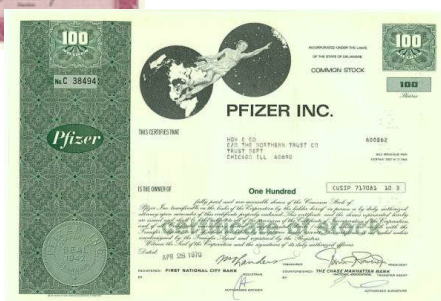


Whistle Blower- Peter Scannell and Market Timing Scandals

Civil fraud charges against Putnam, the resignation of its CEO, Lawrence Lasser, and the withdrawal of more than \$20 billion from its funds.

Whistle Blower –
Dr. David Franklin

Pfizer Inc. settled in
2004 and paid \$430
million in fines.



The New York Times

Witness at Fraud Trial Says He Was a Conduit for Data

- Elgindy and the former FBI agent, Jeffrey Royer, are on trial for racketeering, securities fraud, and other crimes in an alleged scheme to manipulate the stock market.

By BLOOMBERG NEWS

Published: November 3, 2004



DOW JONES

Breaking News

Marsh & McLennan Ousts CEO, Averts Criminal Case

Published: October 26, 2004



The Breadth Of Fraud Is Pervasive And Growing

- ⌘ 45% of companies worldwide have fallen victim to economic crime in the past two years – an 8 percentage point increase on our previous survey*
- ⌘ The number of companies reporting incidents of fraud has increased in every category since 2003
 - ⌘ 71% increase in the number reporting corruption & bribery
 - ⌘ 133% increase in the number reporting money laundering
 - ⌘ 140% increase in the number reporting financial misrepresentation
- ⌘ Despite the growing confidence that the corporations surveyed have in their risk management systems*
 - ⌘ Most fraud (34%) is still detected by chance (e.g., through tip-offs)
 - ⌘ Internal audit is the single most successful control/process for detecting incidents of fraud (26% of cases)
- ⌘ The Coalition Against Insurance Fraud estimates the loss to be \$80 billion per year and Medicare estimates fraud in its system costs the government \$179 billion per year

Sarbanes-Oxley

Fraud prevention and detection programs are the law under Sarbanes-Oxley

- ⌘ A report recently classified 12 types of fraud and 57 sub-categories*
 - ⌘ Aiding & abetting
 - ⌘ Asset misappropriation
 - ⌘ Manipulation of assets, A/R, expenses, goodwill, liabilities, reserves, investments and revenue
 - ⌘ Bribery and kickbacks
 - ⌘ Improper disclosures
- ⌘ This same report indicated revenue recognition fraud schemes are most prevalent
- ⌘ This finding is consistent with earlier studies and reinforces the need for focus on this area
 - ⌘ Recording fictional revenue is the most common type of revenue-recognition fraud
 - ⌘ Next was recognizing inappropriate revenue from swaps, “round-tripping,” or barter arrangements
- ⌘ Manipulation of various financial statement items account for more than a third of all fraud schemes identified

* **Source:** Ten things about financial statement fraud: A review of SEC enforcement releases, 2000-2006, Deloitte Forensic Center, June 2007

SEC/NASD

- ⌘ Individual exchanges have numerous rules and regulations designed to protect investors including theft and/or fraud
- ⌘ NASD Rule 2120 states that brokers may not effect any transaction or induce the purchase or sale of any security by means of any manipulative, deceptive or other fraudulent device or contrivance
- ⌘ Numerous instances of fraudulent conduct have been reported by the NASD
 - ⌘ Discretionary Accounts - Transactions in discretionary accounts that are in excess of or without the actual authority from a customer
 - ⌘ Unauthorized Transactions - Causing the execution of unauthorized transactions or sending confirmations of orders to a client to cause the customer to accept a transaction that was not actually agreed upon
 - ⌘ Misuse of Customers' Funds or Securities - Unauthorized use or borrowing of customers' funds or securities
 - ⌘ Forgery, non-disclosure or misstatement of material facts, manipulations and various deceptions

Basel II

- ⌘ One of the key changes in Basel II is the addition of an operational risk measurement to the calculation of minimum capital requirements
- ⌘ Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, such as exposure to fines, penalties and private settlements
- ⌘ Operational risk events having the potential to result in substantial losses:
 - ⌘ Internal fraud – intentional misreporting of positions, employee theft, and insider trading
 - ⌘ External fraud – robbery, forgery, check kiting and damage from computer hacking
 - ⌘ Employment practices and workplace safety – workers compensation claims, violation of employee health and safety rules, organized labor activities and discrimination claims
 - ⌘ Clients, products and business practices – misuse of confidential customer information, improper trading activities on the bank's account, money laundering, and sale of unauthorized products
 - ⌘ Damage to physical assets – terrorism, vandalism, earthquakes, fires and floods
 - ⌘ Business disruption and system failures – hardware and software failures, telecommunication problems, and power failures
 - ⌘ Execution, delivery and process management – data entry errors, incomplete legal documentation and unapproved access given to client accounts

Operational Loss Data Showing Total Loss Frequency By Event Type

- External fraud, execution, delivery and process management, employment practices account for the highest number of losses as tracked by the Operational Risk Data Exchange

KEY		Internal Fraud	External Fraud	Employment Practices and Workplace Safety	Clients, Products and Business Practices	Disasters and Public Safety	Technology and Infrastructure Failures	Execution, Delivery, and Process Management	Malicious Damage	% of Total Number of Losses
	0% - 1%									
	1% - 5%									
	5% - 10%									
	> 10%									
Corporate Finance	0.01%	0.06%	0.11%	0.24%	0.00%	0.01%	0.14%	0.00%	0.57%	
Trading and Sales	0.12%	0.09%	0.35%	0.55%	0.02%	0.52%	8.71%	0.00%	10.36%	
Retail Banking	3.95%	30.31%	9.81%	5.79%	0.69%	1.23%	12.52%	0.06%	64.36%	
Commercial Banking	0.18%	2.17%	0.44%	1.20%	0.04%	0.21%	3.13%	0.00%	7.37%	
Clearing	0.05%	0.38%	0.14%	0.09%	0.01%	0.09%	1.00%	0.00%	1.76%	
Agency Services	0.02%	0.01%	0.06%	0.13%	0.00%	0.06%	1.98%	0.00%	2.26%	
Asset Management	0.06%	0.13%	0.16%	0.56%	0.01%	0.09%	2.17%	0.00%	3.18%	
Retail Brokerage	0.09%	0.10%	0.50%	1.69%	0.01%	0.02%	0.84%	0.00%	3.25%	
Private Banking	0.28%	0.33%	0.14%	1.74%	0.02%	0.06%	2.32%	0.00%	4.89%	
Corporate Items	0.04%	0.13%	0.63%	0.29%	0.18%	0.02%	0.71%	0.00%	2.00%	
% of Total Number of Losses	4.80%	33.71%	12.34%	12.28%	0.98%	2.31%	33.52%	0.06%	100.00%	

Source: © Operational Riskdata eXchange Association (ORX) (2007)

Operational Loss Data Showing Distribution Of Total Number And Loss Amount Across Event Type For Each Business Line

- External fraud, client products and business practices account for the highest percentage number and amount of losses as tracked by the Operational Risk Data Exchange

KEY		Internal Fraud	External Fraud	Employment Practices and Workplace Safety	Clients, Products and Business Practices	Disasters and Public Safety	Technology and Infrastructure Failures	Execution, Delivery, and Process Management	Malicious Damage	% of Total Number of Losses/ Loss Amount
	0% - 1%									
	1% - 5%									
	5% - 10%									
	> 10%									
Corporate Finance	0.01% 0.12%	0.06% 0.42%	0.11% 0.14%	0.24% 22.47%	0.00% 0.00%	0.01% 0.00%	0.14% 0.23%	0.00% 0.00%	0.57% 23.38%	
Trading and Sales	0.12% 1.43%	0.09% 0.16%	0.35% 0.27%	0.55% 7.61%	0.02% 0.00%	0.52% 0.26%	8.71% 8.57%	0.00% 0.00%	10.36% 18.30%	
Retail Banking	3.95% 2.09%	30.31% 7.39%	9.81% 2.80%	5.79% 6.23%	0.69% 0.38%	1.23% 0.69%	12.52% 6.94%	0.06% 0.01%	64.36% 26.53%	
Commercial Banking	0.18% 1.43%	2.17% 0.93%	0.44% 0.22%	1.20% 3.64%	0.04% 0.02%	0.21% 0.12%	3.13% 2.56%	0.00% 0.00%	7.37% 8.92%	
Clearing	0.05% 0.03%	0.38% 0.11%	0.14% 0.03%	0.09% 0.38%	0.01% 0.01%	0.09% 0.05%	1.00% 0.29%	0.00% 0.00%	1.76% 0.90%	
Agency Services	0.02% 0.03%	0.01% 0.02%	0.06% 0.08%	0.13% 3.08%	0.00% 0.00%	0.06% 0.02%	1.98% 1.01%	0.00% 0.00%	2.26% 4.24%	
Asset Management	0.06% 0.07%	0.13% 0.05%	0.16% 0.16%	0.56% 3.98%	0.01% 0.01%	0.09% 0.03%	2.17% 0.85%	0.00% 0.00%	3.18% 5.15%	
Retail Brokerage	0.09% 0.20%	0.10% 0.13%	0.50% 0.18%	1.69% 1.10%	0.01% 0.01%	0.02% 0.00%	0.84% 0.29%	0.00% 0.00%	3.25% 1.91%	
Private Banking	0.28% 0.71%	0.33% 0.11%	0.14% 0.13%	1.74% 3.22%	0.02% 0.01%	0.06% 0.02%	2.32% 0.78%	0.00% 0.00%	4.89% 4.98%	
Corporate Items	0.04% 0.04%	0.13% 0.07%	0.63% 0.42%	0.29% 1.94%	0.18% 1.96%	0.02% 0.01%	0.71% 1.25%	0.00% 0.00%	2.00% 5.69%	
% of Total No. of Losses	4.80%	33.71%	12.34%	12.28%	0.98%	2.31%	33.52%	0.06%	100%	
% of Total Loss Amt	6.15%	9.39%	4.43%	53.65%	2.40%	1.20%	22.77%	0.01%	100%	

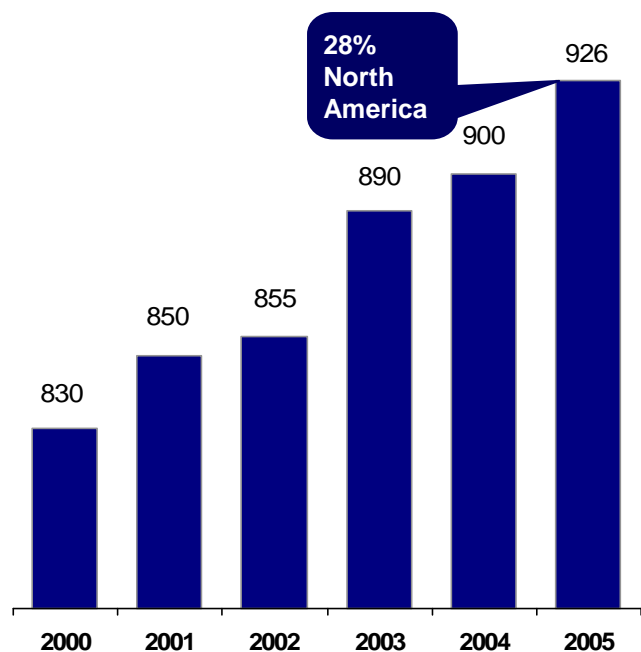
Anti-Money Laundering

- ⌘ An AML Program must be in writing and must include:
 - ⌘ The development of internal policies, procedures and controls
 - ⌘ The designation of a compliance officer
 - ⌘ An ongoing employee training program
 - ⌘ An independent audit function to test programs
- ⌘ It applies to:
 - ⌘ Mutual Funds
 - ⌘ Operators of a credit card system
 - ⌘ Money service businesses
 - ⌘ Broker-dealer members of the National Association of Securities Dealers (NASD)
 - ⌘ Broker-dealer members of the New York Stock Exchange
 - ⌘ Insurance companies
 - ⌘ Investment advisers
 - ⌘ Dealers in precious metals, stones or jewels

Money Laundering Is On The Rise

Total Funds Laundered Worldwide

US \$ Billions



Source: Celent Research

Spending Implications

- Increased spending on personnel and systems to manage growing problem
- Increased risk of fines from regulation

Spending on Anti-Money Laundering Solutions by US Financial Institutions



According to Tower Group, up to 30% of IT compliance spending is "waste." Its recommendation: "Integrated compliance systems that attack AML comprehensively"

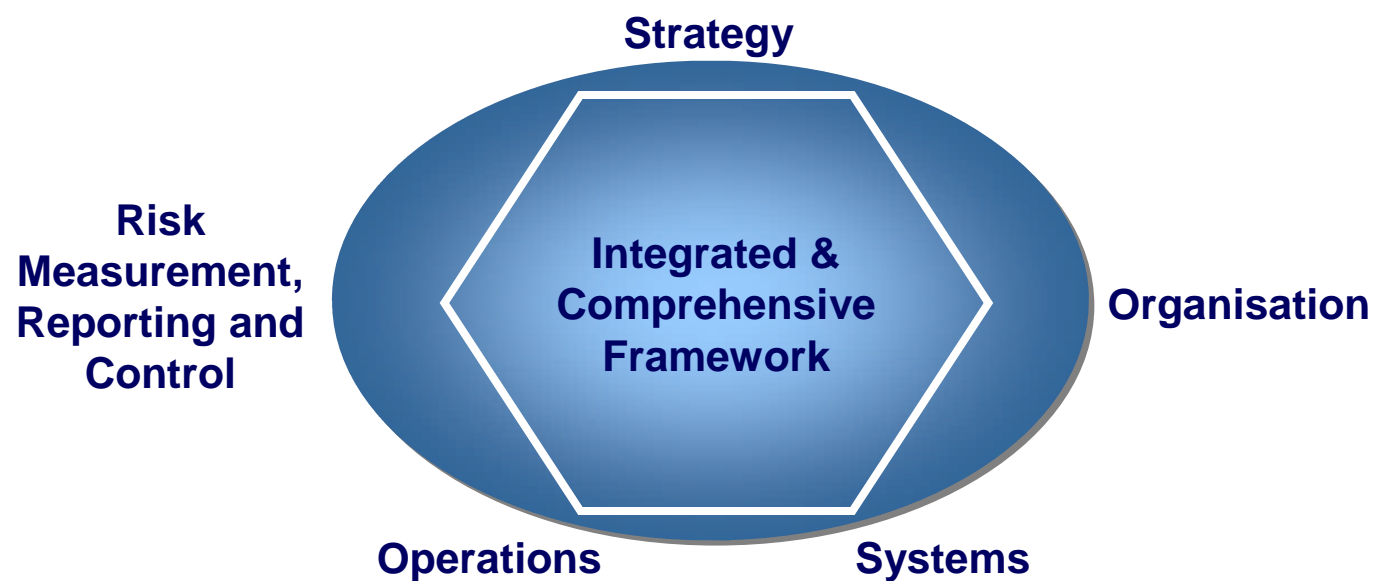
Office of Foreign Asset Control

- ⌘ All U.S. persons must comply with OFAC regulations, including all U.S. citizens and permanent resident aliens regardless of where they are located, all persons and entities within the United States, all U.S. incorporated entities and their foreign branches
- ⌘ OFAC publishes a list of Specially Designated Nationals and Blocked Persons ("SDN list") which includes over 3,500 names of companies and individuals connected with the sanctions targets
- ⌘ The keys to maintaining an effective OFAC compliance program include:
 - ⌘ Developing and implementing written policies and procedures
 - ⌘ Conducting training
 - ⌘ Designing and maintaining effective screening programs
 - ⌘ Conducting periodic independent testing of the program's effectiveness
- ⌘ U.S. underwriters, brokers, agents, primary insurers, and re-insurers and U.S. citizen employees of foreign firms in the insurance industry are prohibited from engaging in transactions not licensed by OFAC
- ⌘ All property, including insurance contracts, in which there is a direct or indirect interest of any Specially Designated Nationals and Blocked Persons list is considered blocked or "frozen"

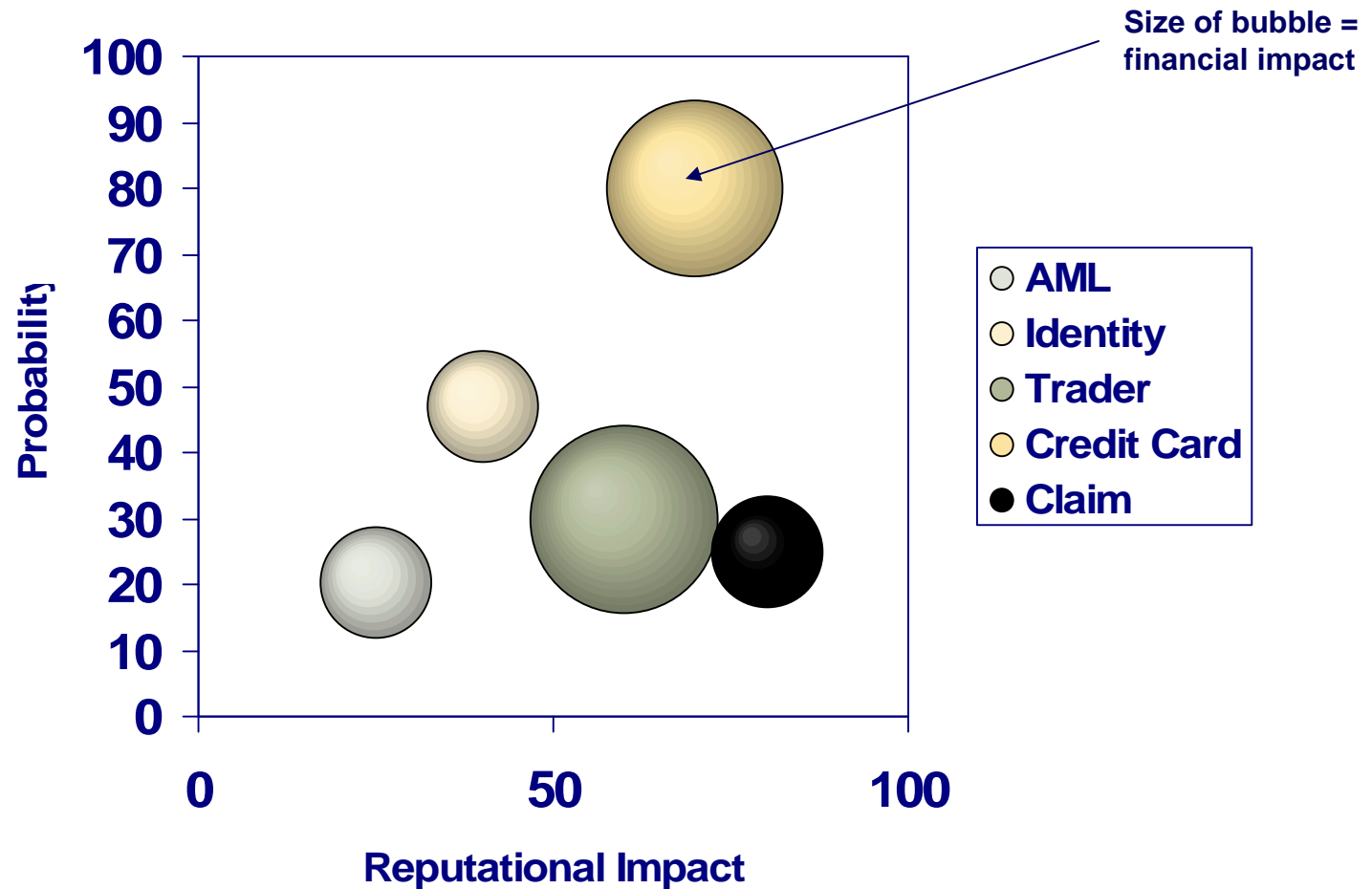
Foreign Corrupt Practices Act

- ⌘ In the wake of a series of overseas and domestic bribery scandals involving 400 major corporations, the Foreign Corrupt Practices Act (FCPA) of 1977 was enacted to:
 - ⌘ Prohibit making improper payments to foreign officials, parties or candidates in order to assist a company in obtaining, retaining or directing business
 - ⌘ The FCPA prohibits corrupt payments through intermediaries. It is unlawful to make a payment to a third party, while knowing that all or a portion of the payment will go directly or indirectly to a foreign official. The term "knowing" includes conscious disregard and deliberate ignorance
 - ⌘ Impose record-keeping and internal controls requirements on all companies subject to Securities and Exchange Commission (SEC) jurisdiction
 - ⌘ Corporations and other business entities are subject to a criminal fine of up to \$2,000,000; officers, directors, stockholders, employees, and agents are subject to a fine of up to \$100,000 and imprisonment for up to five years
 - ⌘ The Attorney General or the SEC, as appropriate, may bring a civil action for a fine of up to \$10,000 against any firm as well as any officer, director, employee, or agent of a firm, or stockholder acting on behalf of the firm, who violates the anti-bribery provisions

Five Elements Of A Best Practice Program For Regulatory Compliance And Risk Management

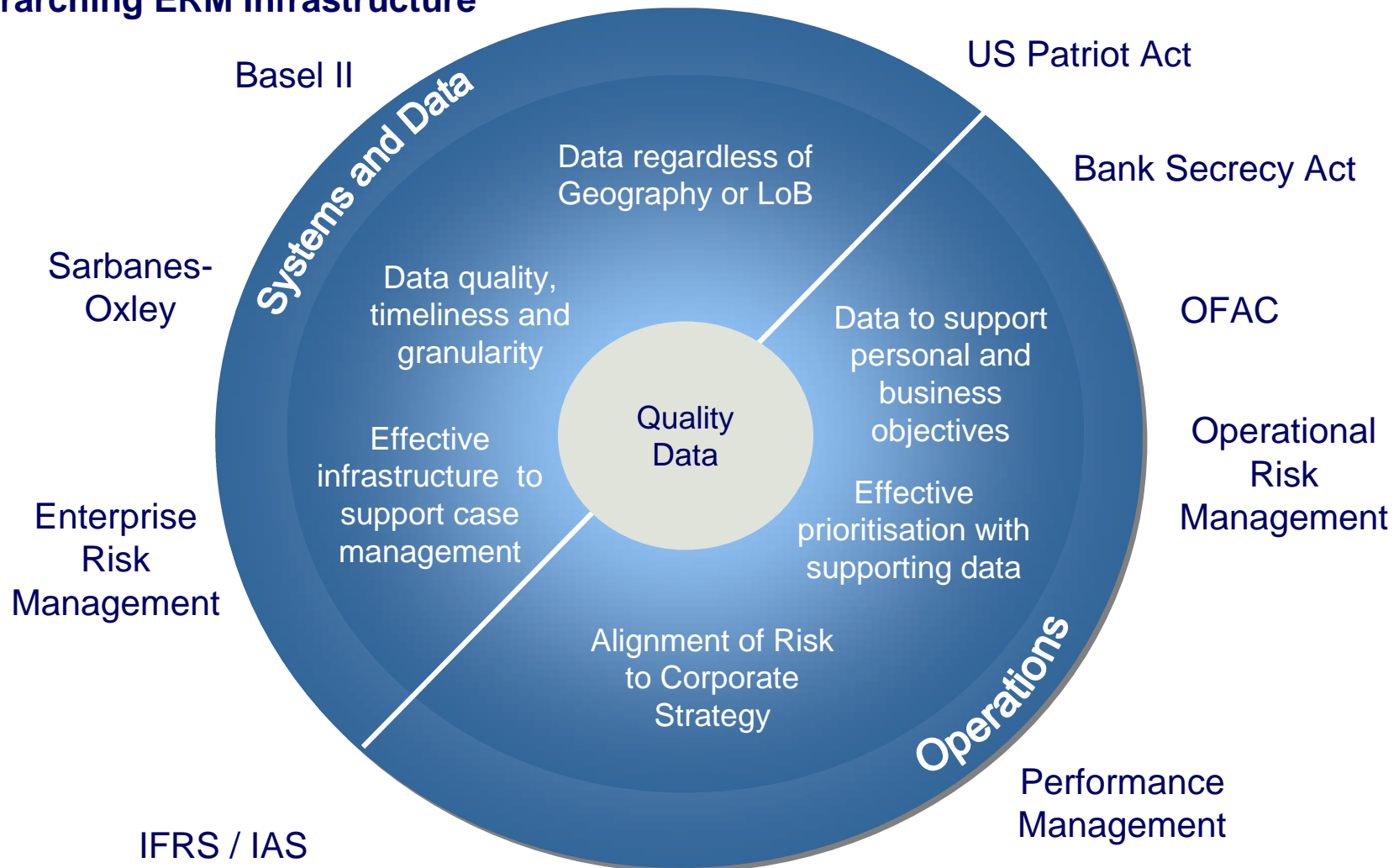


Risk And Regulation Strategy: The Creation of Priority Grid

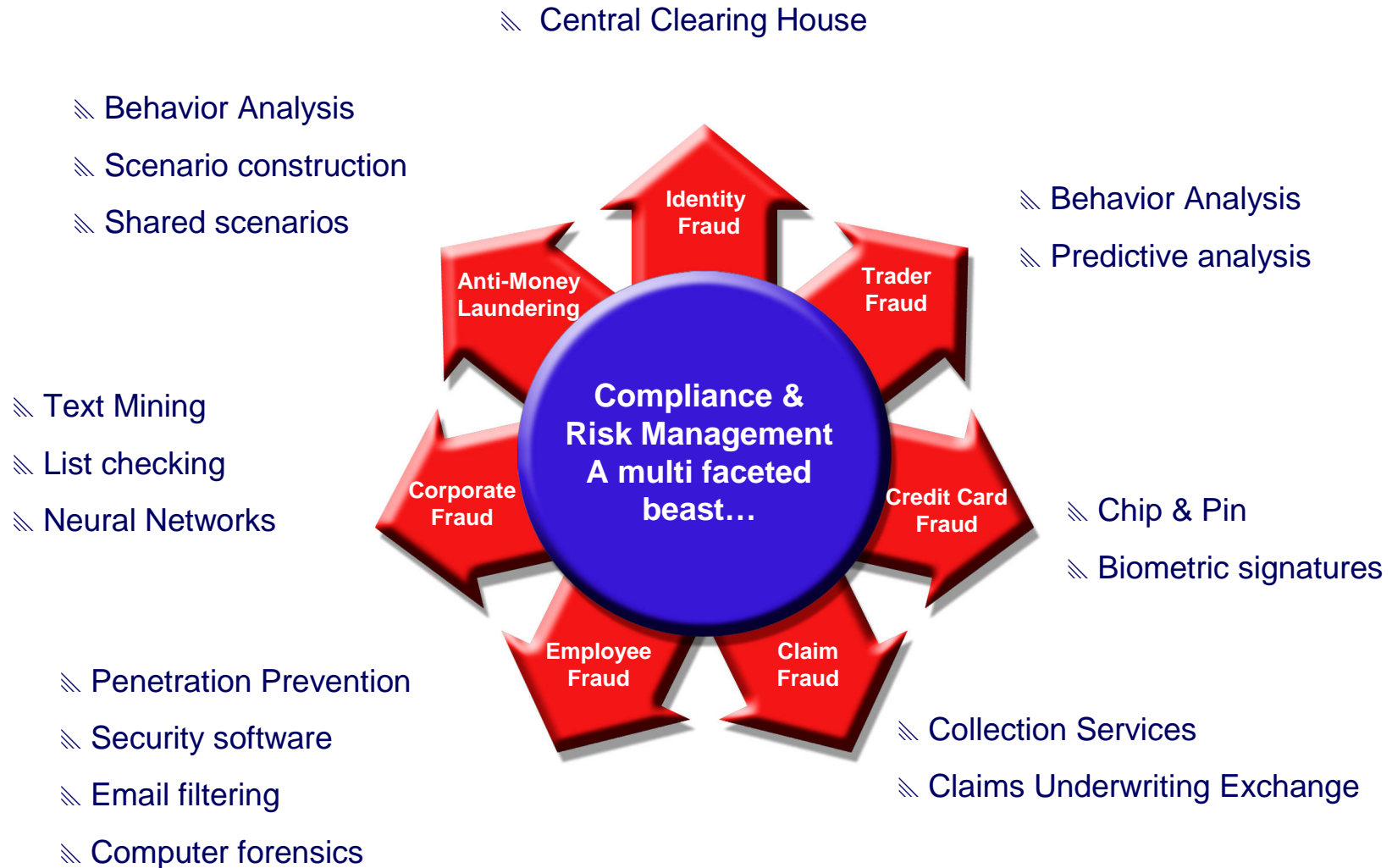


Fraud Investigations Can Provide Critical Data Points Specific To Their Company Which Identify And Focus On Ineffective Controls

Overarching ERM Infrastructure



Regulatory Compliance Tools: The Choice Of Weapons Are Many



To Integrate Fraud Management Into A Best Practice ERM Framework

The management challenge is to recognise the ...

Strategy

- ⌘ What are the fraud risks of the business activities?
- ⌘ How much capital do you need to support these risks?

Organisation Structure

- ⌘ Who is ultimately responsible for managing each type of fraud risk?
- ⌘ Where will fraud risk management reside in the organisation?
- ⌘ How do we integrate financial, operational, legal and other risks into the risk management framework?
- ⌘ How will risk management responsibilities be distributed?

To Achieve A Best Practice Solution...

...you must include operational controls and systems that measure the impact that will allow you to predict on an enterprise basis

For Risk Measurement

- ⌘ Are your fraud risk measurement methodologies consistent across business products and business areas?
- ⌘ How is fraud risk management information communicated to appropriate levels of management?
- ⌘ How can disparate fraud risks be aggregated across the organization to provide senior management with a single view/understanding of prioritised exposures?
- ⌘ Is your limit structure, for all risk/exposure types, consistent with your risk strategy?

For Operations/Systems Management

- ⌘ Is your fraud control framework appropriate to support your business activities?
- ⌘ Do appropriate checks and balances exist to control fraud risks?
- ⌘ Do your current systems meet the management information and operational requirements?
- ⌘ Does the existing segregation of responsibilities satisfy requirements for independence of control?

Thank you

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Background

Mr. Simmons is a senior executive and cross-functional business manager with a record of developing, executing and producing high performance strategic and tactical business results. He has a unique background with Fortune 50 financial service companies and start-ups. Skilled in all areas of executive direction and control; developing and launching products focusing on customer centric solutions, building premier processing and customer care centers, possessing a reputation for leadership, expertise and innovation within global, emerging, mature, and extremely competitive markets.

Relevant Experience

Mr. Simmons is a co-founder of Board Advisory Services, Inc., conceptualizing, assembling the key partners, creating and launching this unique forward-looking strategic advice and high performance solutions cooperative.

Formerly, as President/CEO and board member of LockStar, Inc., a software company focused on integration and security. He revitalized this stalled and capital strapped company, leading the turnaround effort. Earlier, Mr. Simmons was Senior Vice President responsible for the strategic planning, product management, marketing and sales efforts for CertCo, Inc. Mr. Simmons was a driving force behind "Identrus", a global identity management solution.

Prior, a Managing Director for Citigroup responsible for the business processes, regulatory compliance, P&L and strategies for a \$280 million business supporting F500 clients with responsibility for \$80B a day of financial transactions. Jay has held senior management positions in trade finance, global treasury management and corporate finance.

Mr. Simmons is recognized expert on payment and settlement systems, regulatory compliance, security, risk management, and technology. A speaker at well over 300 global conferences and client events including the Comptroller of the Currency, Federal Reserve Banks, Assoc. of Financial Professionals and the Organization for Economic Co-operation and Development (OECD).

Education

Pennsylvania Military College – BA, Behavioral Science, Organizational Dynamics
New York University -- Business and Financial Management Program
Association of Financial Professionals – Certified Cash Manager

Sample Clients

- MetLife
- Pfizer
- Chevron
- Prudential
- CIGNA
- Microsoft
- Skadden Arps
- Citigroup
- ABN-AMRO
- PhRMA
- Nestle
- EDS
- IBM
- Federated
- BofA
- GM

Work History

- BAS
- LockStar, Inc.
- CertCo, Inc.
- Citigroup
- BofA
- Chase
- JP Morgan

Background

As a highly qualified senior executive and enterprise program manager, Ms. Simmons offers dynamic, focused, and decisive leadership. A record of developing and executing business strategies within emerging, mature, global, and extremely competitive business markets. Demonstrative expertise in team building and achieving significant business results. Delivering increased sales, comprehensive market strategies against a wide variety of market segments, deeper market penetration, differentiated product positioning, messaging and collateral across multiple distribution channels, highly effective and measurable sales strategies, increased customer care levels, substantial financial P&L improvements, and insured regulatory compliance.

Relevant Experience

Ms. Simmons has functioned as an executive in number capacities delivering business value through line of business leadership for mission critical transaction businesses, development of de novo consulting organizations within fortune 500 firms, establishing professional services capabilities in a turnaround situation, and business evaluation and implementation of emerging technology based business propositions seeking venture capital.

Established distinctive product, market, and pricing strategies focusing on key opportunities both domestically and globally. Evaluated, selected, and implemented various technology platforms for the development and deployment of ecommerce and Internet based products and businesses.

Ms. Simmons is a frequent author and speaker on business strategy and management related topics.

Ms. Simmons is active in her community serving on the board of Shotgun Productions.

Education

University of California, Los Angeles – BA in History with a minor in Business
Columbia University – Financial Management Program

Sample Clients

- MetLife
- MasterCard International
- Deutsche Bank
- Morgan Stanley Dean Whitter
- Goldman Sachs
- Pepsi
- Bankers Trust Co
- Chase Manhattan
- Bank of America
- Aventis
- AIG
- Microsoft

Work History

- BAS
- Dimension Data
- Qualcomm
- Deloitte Consulting
- Chase Manhattan
- Bankers Trust Co.