PacificCPE

COURSE
11457B

Banking Misconduct, Investment Fraud, and Options Backdating

Misconduct within financial institutions takes many forms—from governance failures in the boardroom to fraud by investment managers and manipulated stock option grants. This course examines all three, offering a comprehensive look at how internal bad actors operate and what enables their behavior. You'll explore the role of boards of directors in preventing banking misconduct, how investment manager fraud unfolds, and the mechanics and shareholder impact of options backdating. These topics are highly relevant for CPAs involved in audit, forensic accounting, or executive compensation work.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the three main U.S. banking supervisory authorities.
- Identify the characteristics that have a positive relation to fraud.
- Identify the types of corporate misbehavior also associated with the practice of option grant backdating.

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Chapter 1: MISCONDUCT IN BANKING: GOVERNANCE AND THE BOARD OF DIRECTORS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the three main U.S. banking supervisory authorities.

11.1 INTRODUCTION

The reputation of banks for professional and ethical conduct has come under pressure. Over recent years, regulators have taken out a record number of enforcement actions against banks that require banks to take corrective measures against identified cases of misconduct. For example, JPMorgan faced several recent enforcement actions related to credit card fraud, money laundering, and internal accounting controls.[1] Likewise, Wells Fargo received a high-profile enforcement action in 2018 over a misconduct case that involved the opening of millions of bank and credit card accounts without the consent of its customers. Box 1 provides some detail on this case. In this and other cases, regulators view a lack of effective monitoring of senior management by the board as one of the causes of misconduct.

Illustrative Example: The Wells Fargo Account Fraud Case

September 2016: Press reports indicate that Wells Fargo (WFC) charged consumers unauthorized fees and opened up to 3.5 million retail customer accounts without their clients' consent between 2011 and 2015. While initial reports blame individual WFC branch workers, the focus later shifted to senior management pressuring branch staff to open as many accounts as possible.

29 September 2016: John Stumpf, then CEO of WFC, testifies in front of the House Finance Committee. In the hearing, Congressman Randy Neugebauer raises concerns over whether WFC's board was sufficiently objective when monitoring senior executives. It was revealed that, although Mr. Jumpf had been aware of problems related to consumer accounts in 2013, the board was not informed until two years later. This allegedly highlighted an overly comfortable relationship between the board and the senior management at WFC.

2 February 2018: Regulators issue a formal cease-and-desist order against WFC. Well Fargo's stock plummeted nearly 10% (the equivalent of $2.5 billion and significantly greater than the $1 billion fine levied by regulators).

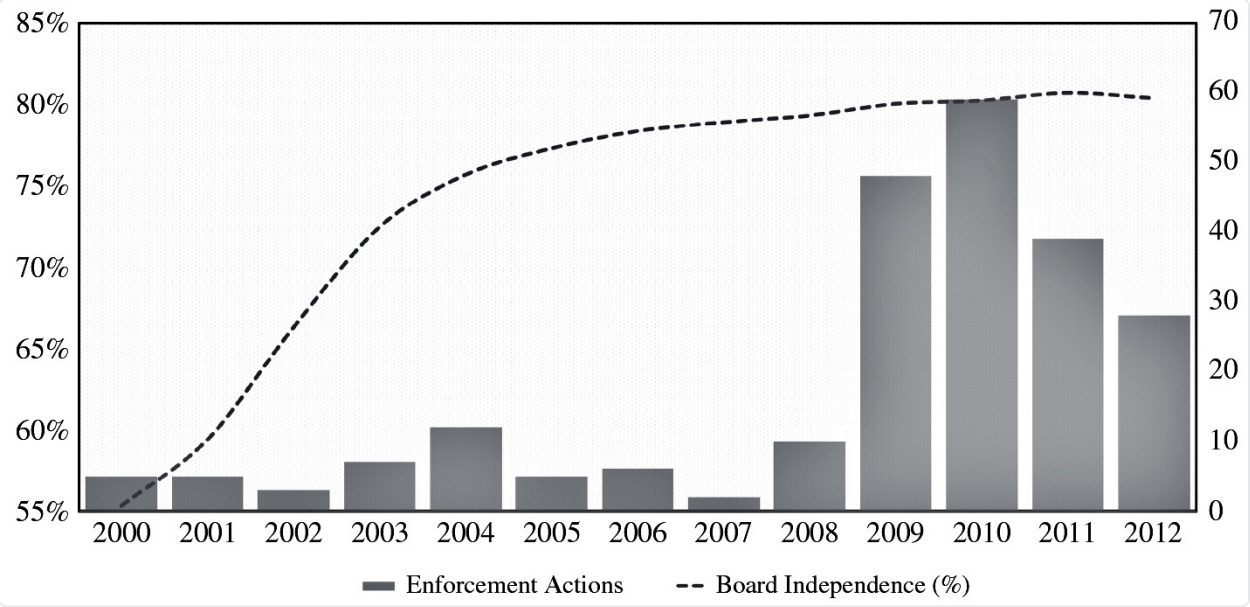
Illustrative Example: The Wells Fargo Account Fraud Case (continued)

- In the enforcement docket, the OCC (WFC's main regulator) emphasizes the need to improve oversight of WFC's senior executives: *"The Board shall submit a written plan to further enhance the Board's effectiveness in carrying out its oversight and governance of WFC, [. . .] including holding senior management accountable for implementing and maintaining the Firm's strategy in accordance with Board direction."*
- On the same date, the Board of Governors of the Federal Reserve System sends a formal letter to WFC's board of directors, stating that *"WFC's board's performance of this oversight role did not meet our supervisory expectations."* The letter also emphasizes the need to improve communications between the board and senior executives: *"The board should have received more detailed and concrete plans from senior management on such a critical issue."*

20 April 2018: WFC agrees to pay $500 million in penalties to each the OCC and the Consumer Financial Protection Bureau (CFPB). More importantly, the bank also submitted to an unprecedented order that gives the OCC the right to remove WFC's senior executives or board members at the discretion of the OCC.

In some ways, the recent surge in bank misconduct cases is surprising. By most accounts, oversight and monitoring of CEO decision-making has improved markedly in recent years. Data from RiskMetrics show that eight out of ten US bank board members were classified as independent in 2012, up from around half in 2000. With increasing levels of independence, one would expect bank boards to be more effective in preventing misconduct. However, far from a declining trend, the number of yearly enforcement actions has increased from 5 to 28 between 2010 and 2012. The apparent contradiction between progressively more independent bank boards on the one hand and an increasing number of regulatory enforcement actions against banks on the other hand is illustrated by Figure 11.1.

FIGURE11.1 THE PERCENTAGE OF DIRECTORS CLASSIFIED AS INDEPENDENT ON US BANKS AND THE NUMBER OF ENFORCEMENT ACTIONS RECEIVED BY US BANKS.



One explanation for the rise in bank misconduct cases is that true board independence is difficult to achieve and not accurately reflected in established measures of board independence (e.g., see Coles et al. 2014; Lee et al. 2014). Established matters of board independence, that result from the rules of public exchanges on which firms list their stocks, view a director as independent if she or he is not a (former) employee, is not related to a (former) employee, and does not have other financial dealings with the firm.

However, this type of board independence can be undermined if CEOs exert intangible influence over independent directors. One way in which a CEO could yield intangible influence is by capturing the board through director appointments (Khanna et al. 2015). Since the CEO is typically involved in the process of recommending directors to the board, directors appointed during the tenure of the current CEO have an incentive to return the favor (Coles et al. 2014; Khanna et al. 2015). Under these circumstances, independent directors may reciprocate the CEO's requests and agree to side with the CEO to support, engage in, or conceal wrongdoing. Therefore, only directors appointed before the current CEO's tenure are free from this type of intangible influence and are therefore capable of objectively monitoring the CEO. In this chapter, we propose a new measure of the quality of board monitoring as the fraction of directors who are appointed before the current CEO takes office.

To identify cases of bank misconduct, we employ a large data set of regulatory enforcement actions issued by the three US supervisory bodies – the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) – against banks that engage in unsafe, unsound and illegal banking practices which violate laws. We find that

banks are less likely to engage in misconduct as the fraction of directors who have been appointed before the CEO increases.

To illustrate this point, banks where all directors have been appointed before the CEO takes office have a 27% lower probability of committing misconduct and a 35% higher probability of detection (conditional upon misconduct having occurred) than a bank where all directors have been appointed under the current CEO. This finding is robust to a set of variables that control for bank, board, and CEO characteristics, including the proportion of independent directors on boards. Importantly, traditional measures of board monitoring have little or no power to explain bank misconduct.

This chapter makes two important contributions to ongoing discussions. First, it contributes to debates on the determinants and economics of corporate misconduct. Previous work has linked misconduct to a lack of monitoring by the board (Khanna et al. 2015), outside investors (Wang et al. 2010) or various other parties (Dyck et al. 2010; Kedia and Rajgopal 2011). We find that while monitoring is required to deter all sorts of misconduct, advising plays a clear role in preventing misconduct of a more technical nature. Second, this work is related to the debate on governance and risk-taking in the banking industry (Ellul and Yerramilli 2013; Minton et al. 2014). Relative to other bank risk measures studied in the literature, enforcement actions provide a suitable identification of the effectiveness of internal governance. This is because enforcement actions provide an unambiguous external indicator of undesirable conduct in the industry.

11.2 LITERATURE REVIEW

There is a growing body of literature on the drivers of and the impediments to professional misconduct. While studying misconduct cases in detail may require significant contextual knowledge about the particular profession or discipline in question, one can draw some general lessons from existing research. For example, studies have linked professional misconduct to misconduct in earlier life, such as cheating at school and college (Simkin and McLeod 2010; Sims 1993). Another important question is concerned with the impediments to the detection of misconduct. In other words, why do whistleblowers come forward relatively rarely? Biaggio et al. (1998) argue this is mainly due to three obstacles: (i) reluctance to take action against colleagues and institutions where there are ties of loyalty, (ii) avoiding the personal costs of taking action, and (iii) insufficient understanding about the misconduct in question.

The focus of this chapter is on the banking profession. Misconduct cases are costly to bank investors with the fines imposed often outweighed by substantial reputational losses for offending banks. There are also concerns that repeated instances of misconduct erode public confidence in the safety and soundness of the banking sector as a whole. What banks can do to prevent misconduct is therefore an important question. Arguably, a bank's board of directors, in its capacity to monitor

and advise the CEO (Adams and Ferreira 2007; Fama and Jensen 1983), should play a key role in the implementation and oversight of controls to mitigate the risk of misconduct.

Bank boards that are more independent in the sense that they are not psychologically captured by the CEO should be more willing to monitor the CEO than less independent boards. This type of board independence is therefore likely to prevent misconduct. This is grounded in social influence theory, which posits that individuals rely on principles of reciprocity, a nearly universal code of moral conduct, when making decisions (Gouldner 1960). Theory suggests that most people exhibit a psychological aversion to over-benefiting or under-benefiting from social relationships (Fehr and Schmidt 1999).

As the CEO is typically involved in appointing and recommending directors to the board, directors appointed by the CEO tend to feel indebted to her and thus have a natural tendency to return the favour (Coles et al. 2014; Khanna et al. 2015). Consequently, these directors are averse to monitoring the CEO, which creates an environment conducive to misconduct, makes detection of misconduct difficult, and reduces a CEO's expected costs of committing misconduct. Therefore, one can expect that directors appointed before the current CEO are psychologically independent and in a position to objectively monitor the CEO in a way that prevents wrongdoing. As a result, we measure a board's *Monitoring Quality* using the fraction of the board appointed before the current CEO.

The second plausible expectation relates board advising to bank misconduct. While early studies suggest that boards monitor and give advice to the CEO (e.g., Mace 1971), the focus of much subsequent study has been on the monitoring role of the board. Coles et al. (2012), Field et al. (2013), and Dass et al. (2014) highlight the role of board advice for firms. Therefore, better board advice should prevent corporate misconduct. For instance, some misconduct cases may occur because the CEO is unaware of the illegality of a certain activity (Khanna et al. 2015). In banks, some CEOs may lack the technical expertise to successfully oversee regulatory provisioning and reserve requirements – and breaches of either could result in regulatory enforcement actions. Therefore, a board with a higher capability to give advice to the CEO will facilitate more informed decision-making and thus lower the instances of misconduct.

In this context, director connections can be used as an indicator of board advising. Fama and Jensen (1983) argue that connections are a signal of director quality. In a competitive labor market, only high- quality directors receive additional board seats. In addition, better-connected directors are likely to have had experience with a variety of issues that firms face, and they can also lever their network to access better information (e.g., Coles et al. 2012; Field et al. 2013). To this end, a board's *Advising Quality* can be measured using the total number of directors to whom board members on the board are collectively connected, scaled by board size.

11.3 RESEARCH DESIGN

11.3.1 Data

We gather data on regulatory enforcement actions issued by the three main US banking supervisory authorities (FDIC, FRB, and OCC) for the period 2000–2013 from SNL Financial.[2] Our sample encompasses all severe enforcement actions, including (i) formal agreements, (ii) cease and desist orders, and (ii) prompt corrective actions.

Formal (written) agreements are agreements between the bank and the regulator that set out details on how to correct conditions that provide the basis for the agreement. *Cease and desist orders* prohibit the bank from engaging in certain banking activities. They also require the bank to take corrective actions to improve on areas that provide the basis for the order. *Prompt corrective actions* are imposed on undercapitalized banks. They require the bank to restore adequate levels of capital and demand submission of a capital restoration plan within a predetermined period.

Next, we obtain bank accounting data from the FR Y–9C reports for the period of 1999 to 2012. We then merge FR Y–9C report data to market data obtained from Center for Research in Securities Price (CRSP), corporate governance data from BoardEx, and enforcement actions data from SNL Financial.[3] If there are multiple enforcement actions related to a single case of misconduct, we group them together so that only one case is identified. Our final sample contains 4,072 bank-year observations of 533 unique banks and 244 enforcement actions.

Table 11.1 provides descriptive statistics on the enforcement action sample. It shows that enforcement actions were taken against banks in every year with a surge following the 2007 global financial crisis. The table also shows that our sample is comprehensive. That is, our sample contains nearly 80% of all enforcement actions issued against the listed US banks during our sampling period.

TABLE 11.1 TIME DISTRIBUTION OF BANKS RECEIVING ENFORCEMENT ACTIONS.

This table reports the number of regulatory enforcement actions in our sample over the period 2000-2013. We also display the number of enforcement actions in our sample as a percentage of all enforcement actions issued against listed US banks. We also report the total assets of banks receiving enforcement actions in our sample as a percentage of the total assets of all listed US banks that receive enforcement actions.