Contemporary Financial Crimes of Employee Embezzlement and Insider Trading

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Abstract: This paper analyses the frauds of employee embezzlement by Gary Foster (Citigroup) and insider trading by Raj Rajaratnam (Galleon Group) both in 2011. By comparing to the notorious cases of Enron and WorldCom, it is found that the contemporary frauds tend to be committed through a diversified scheme rather than accounting manipulation. Fraudsters tend to take advantage of their positions to override strict rules and regulations. Shareholders and related stakeholders including governments will suffer the financial losses and ineffective macro-economic control, which may even result in the encouragement of other frauds. Therefore, it is strongly recommended that management, educators and regulators should jointly work on the prevention of frauds. Management should be highly aware of importance of fraud prevention and detection, with the assistance of regulators to prosecute criminals. Educators, on the other hand, should normalize the decisions under the challenges of ethical dilemma.

Keywords: Employee Embezzlement, Insider Trading, Enron and WorldCom, Contemporary Frauds

1. Fraud Occurrence and Investigation

1.1 Cases Insights

1.1.1 Fraud Identification

Fraud One: Employee Embezzlement - Gary Foster (Citigroup)

On September 6, 2011, an ex-Citigroup vice president, Gary Foster, pleaded guilty to bank fraud (FBI 2014). The fraud was conducted since September 2003 to June 2011, with the estimated embezzled amounts being almost $23 million. Foster concealed his activities by making false accounting entries to transfer money from various Citigroup accounts to his account at JPMorgan Chase & Co. (JPM). The fraud was detected by the internal audit of the treasury department, and Foster was arrested by Federal Bureau of Investigation agents at Kennedy Airport after returning from a trip to Europe and Asia (Dash, 2011). Under nonbinding sentencing guidelines, Foster was sentenced to 97 months in prison for his embezzlement.

Fraud Two: Insider Trading - Raj Rajaratnam (Galleon Group)

On October 13, 2011, the chief of the Galleon Group hedge fund, Raj Rajaratnam, was sentenced to eleven years in prison, the longest sentence in the U.S. history for insider trading. Prosecutors charged

Rajaratnam with fourteen counts involving stock-tipping cases, with five of conspiracy and nine of securities fraud (Glovin, Hurtado & Voris, 2011). The violation of insider trading takes advantage of information asymmetry and relies on the non-public information relevant to the company to manipulate share price. Rajaratnam controlled Galleon to trade on inside information from his social network over seven years. One representative case is the $1.2 million earnings from buying Goldman Sachs stock after confirming the confidential tips about Warren Buffett's investment in the bank. The judge ordered Rajaratnam to pay a $10 million fine and forfeit $53.8 million (Pulliam & Bray, 2011).

1.1.2 Red Flags (Symptoms)

The occurrence of crimes can be indicated by unusual changes or suspicious behavior (Albrecht et al. 2012). In the Foster's case, red flags can be marked obviously for his luxury lifestyle. The fact that his salary is less than $100,000 per annum can hardly match with the ownership of several properties. Marzulli (2012) noted that Foster has an apartment in Midtown Manhattan, two luxury apartments in Jersey City, a $1.35 million house in Tenafly, N.J. and a $3 million home in Englewood Cliffs, N.J. that has a $500,000 entertainment system and bathroom mirrors that turned to video screens when touched. Besides, he even owns several vehicles including Maserati Gran Turismo and BMW 550xi, with a Ferrari on order. He also buys Autos for his mother, step-father and brother. However, Foster was just the accounting graduate from Rutgers University in 1998 and joined Citigroup in 1999. He followed his grandma, Joan White, immigrated to the USA from Jamaica in 1987, living in poverty. Such background cannot support obvious changes in personal behavior, which raises extra attention on the occurrence of fraud. However, indicators are not always easy to identify. In the case of Rajaratnam, his position and business make it harder to determine the fraud. He justifies that the success of Galleon relies on the high quality research, even during the credit crunch period (Pulliam & Bray, 2011). Insider trading essentially needs a sophisticated social network and social engineering skill. Hence, the excessive familiarity with the key managements of companies inherently increases the risk of collusion. The blasting fuse of the investigation is because of one text message from Roomy Khan, the former Intel employee, saying '*Do not buy Polycom's stock until I get guidance'*. Therefore, in this case, symptoms are so obscure that investigators rely on the use of wiretaps later to gather evidences.

1.1.3 Fraud Triangle Insights

Cressey (1973) proposes the 'Fraud Triangle Model' which indicates that the coexistence of incentive, opportunity and rationalization is the premise of a crime. Most of the financial fraud happens due to manager’s opportunity, rationalization and incentives.

1.1.3.1 Incentives

Cupidity is the origin of the financial crime, which is then transformed into a sense of jealous, envy and avarice (Farrugia, 2002). Forster was unfortunate when he was young. His father left when his mom was pregnant, and after immigrating to the USA with his grandma, he started to fit the American dream that he strove for (Morley & Writer, 2012) However, his ambition in career ended his marriage in the early 2000s, and his ex-wife, Joannelys Foster, commented that he focused much more on the work instead of family, with endless motivation to go ahead in career. In his statement, he confronted that he wanted to prove that a minority with nothing could also stand on the top of the world eventually. Moreover, it is found that one of the co-worker that he had trained earned $10,000 more than him, which pushes him to go further in the embezzlement scheme. Simpler than Foster. and emigrated to England in 1971. Afterwards, he studied engineering in the University of Sussex, followed by a MBA degree at University of Pennsylvania's Wharton School in 1983. Based on the Forbes ranking, Rajaratnam was the 236th richest American in 2009 with estimated net worth being $1.8 billion. He also would like to interpret his name as 'king of kings' (Pulliam & Bray, 2011). The company was found later in an extravagant and bawdy culture that employees had massages at the office on Thursdays, a mansion was rented on exclusive Star Island in Miami beach for $250,000 a week and they visited large shower for all-female sex show etc. The personal behavior and greed push him to widen his network and live on the inside information.

1.1.3.2 Opportunity

Internal control system is a good and effective way to prevent, detect and investigate fraud within the company. However, most frauds occurring in financial institutions indicate the implementation problem but not the system design (Merchant & Van der Stede, 2012). What happens in Citigroup proves the weakness in employee management. Foster has been working in Citigroup for over ten years and in the position of vice president at treasury finance department. He is given more reliance and responsibility including the supervision of derivatives and swaps. However, Foster falsifies accounting entries in Citigroup's records, with the support by fraudulent contracts or deal number put in the reference line of wire-transfer instructions. For example, from July to December 2010, about $900,000 from interest expense account and $14.4 million from debt adjustment account were moved to the bank's main cash account and Foster wired eight separate transactions into his personal account (Dash, 2011). Because of his knowledge in the business operation and fake audit trail, internal audit spent one year to uncover the actual losses.

Nevertheless, the initial trial of commitment was between 2002 and 2003 when Foster took over the assignment of balance reconciliation (Morley & Writer, 2012). He realized that there was a leftover balance from the fourth quarter of 2001 and account records were in disarray. The amounts were much insignificant in the Citigroup's total assets, so Foster transferred them to his personal account. He confronted that the success of first trial. To him, implied that no one would care about it and he could live the life he wanted. Comparatively, Rajaratnam's insider trading scheme relies on his social network. After graduation, Valley's Indian expatriate community, using them to meet other top management (Guth & Scheck, 2009) Since that moment, Rajaratnam started to exchange the tips based on his good socialization skill. For example, some major players alleged with him involve Rajat Gupta (former director at Goldman Sachs and partner of McKinsey Consulting), Kamal Ahmed (Morgan Stanley Investment banker), Anil Kumar (partner of McKinsey Consulting), Rajiv Goel (managing director at Intel) and Robert Moffat (senior executive of IBM). The complicated network enables him to exchange tips and manipulate share price through participating in financial market.

1.1.3.3 Rationalization

Fraudsters always justify their wrongdoing by 'reasonable' grounds. A common justification given is '*no one cares and nobody will get hurt*'. From the perspective of Foster, he rationalizes his embezzlement as a small piece to the Citigroup, so no one would notice it. Moreover, when he found the co-worker that he had trained earned $10,000 more than him, he might consider that Citigroup owed him and he was just taking what he deserved. However, the rationalization for insider trading could be supplemented by an interesting topic - If insider trading is ethical and legitimate. Some advocates, based on the utilitarianism theory and rights-based approach, propose that insider trading is a victimless crime as shareholders are the primary service objects for company and it triggers the market efficiency and productivity by increasing information transparency (McGee, 2009; Beck, 2009). In plain words, Rajaratnam rationalizes that the market needs him.

1.1.4 Fraud Investigations & Legal Procedures

In January 2011, Gary Forster voluntarily quit Citigroup without giving any reason. But Dash (2011) noted that an internal audit was conducted within the treasury department where Foster worked and had detected the fraud after his resignation. On discovering the fraud, Citigroup immediately contacted law enforcement officials to for further investigations and strengthened its internal control environment. As the evidences detected by internal audit through wire transfers were handed over to the FBI, Foster was arrested in June 2011. Unlike Foster, the Rajaratnam case is more complicated involving conspiracy and securities fraud. Prosecutors may use circumstantial evidences to prove the existence of conspiracy, including Roomy Khan to Rajaratnam, which started to reveal the whole story. The whole investigation takes32 months, and the government obtains massive evidence from telephone records and other written communications. Conventional investigative procedures are insufficient to provide the evidences, so the government calls for a necessity for the wiretap to uncover a significant amount of information detailing the complex network. Finally, on October 13, 2011, Raj Rajaratnam was sentenced to eleven years in prison.

1.2 Emerging Issues

1.2.1 The Collapse of US Giants - 'Enron' & 'WorldCom'

The origin of Enron can be dated back to the year 1985 in which Houston Natural Gas merged with InterNorth and formed Enron, creating the longest pipeline network in the country (Thomas, 2002). Later in 1994, the executives applied for government deregulation and granted subsequently. which enabled Enron to maintain the 'special purpose entities' to hide the true performance. By misrepresenting earnings reports, executives embezzled funds from existing and potential investors. In 2000, the California energy shortage causes sporadic blackouts and electricity prices soared. Enron was accused of being one of the culprits of the crisis. Executives kept embezzling funds over the years and on November 8th 2001, Enron admitted that it had over-stated profits over the past five years by $586 million. The greed and organizational culture and control contributed to this notorious scandal. It is undeniable that accounting standards become a critical factor in the Enron case. The Mark-to-Market accounting (*Fair Value Accounting*) techniques give high discretion to Enron in the consideration of their long-term futures contracts in commodities such as gas, which has no quoted prices in the market. Moreover, executives with elite knowledge in financial reporting had sophisticated skills to apply the 'Special Purpose Entities'. With the external pressure from credit rating agencies such as Moody's and personal pursuits in wealth, the fraud occurred. Comparatively, the techniques used by WorldCom are more straightforward than Enron. Starting from a small Mississippi provider of long distance telephone service, WorldCom continued their expansion by a series of mergers and acquisitions (M&As). Similar to Enron, in 1996, deregulation boosted the WorldCom's fraud (Stefano, 2005). With the clear business strategy of impressive, however, the economic recession in telecommunication industry and Wall Street's expectation of double-digit growth for WorldCom fostered the tragedy. WorldCom admitted that $3.8 billion in payments for line costs were capitalized (Lyke & Jickling, 2002).

1.2.2 Evolution of Financial Crimes

1.2.2.1 Fraud Elements

Table 1: Comparison of Financial Frauds

	Enron	WorldCom	Gary Foster	Raj Rajaratnam
Fraud Type	Financial Statement Fraud	Financial Statement Fraud	Employee Embezzlement	Insider Trading
Perpetrator	Management	Management	Individual	Individual
Victim	Shareholders and Stakeholders	Shareholders and Stakeholders	Citi Group	Stakeholders
Accounting Manipulation	SPEs; Mark-to-Market Accounting	Capitalization of Certain Huge Accounts	Simple wire transfers together with transactions	-
Regulatory Environment	Deregulation	Deregulation	Strictly Regulated	Strictly Regulated
Perceived Pressure	Greed ; Meet agencies' expectations	Strategy ; Greed; Meet agencies' expectations	Greed ; Extravagant Lifestyle	Greed ; Extravagant Lifestyle
Perceived Opportunity	Corporate Governance	Corporate Governance	Internal Control System	Social Network
Detector	Whistle-Blower	Whistle-Blower	Internal Auditor	FBI

The collapse of Enron and WorldCom hit the bell for regulators to review the regulatory environment and importance of corporate governance. The approval of Sarbanes-Oxley Act, which prescribes the duties for management and regulations regarding corporate governance, has been seen as the biggest reform as a consequence of the corporate failures (Hefendehl, 2004). Moreover, accounting standards and disclosure requirements are improved further and reinforced by regulators to strengthen the information transparency. Therefore, the failures of Enron and WorldCom start a new era of the need for sound business environment Comparatively, the pattern of recent financial crimes has been somewhat changed. The macro environment has been strengthened by regulators, especially in the finance industry due to the high risk nature. Nevertheless, the fraud types have been extended from financial statements to a wide range of individuals' crimes. The occurrences of accounting frauds are reduced as a consequence of risk-based auditing, which highlights the auditor's sensitivity and responsibility to frauds (Bowlin, 2011). However, one of the ongoing concerns is the legitimization of whistle-blower protection. Section 806 of the Sarbanes-Oxley Act is the only source of whistle-blower protection for private-sector employees prior to the Dodd-Frank Act in US (King, 2011). The need for whistle-blower protection aims to relieve them from retaliation by employers. From the cases of Gary Foster and Raj Rajaratnam, frauds are detected by chance and internal control. However, based on the ACFE's report (2012), the prevalent trend in fraud detection is by tips, which mainly comes from employees. Considering the effectiveness of whistle-blowing, the perfection and implementation of relevant regulations must be done.

1.2.2.2 Implications on the Business

Financial institutions trade on reputation. Investors' confidence in the company is established on the institutions' immunity to frauds. In the case of CitiGroup, the primary goal of business is to maximize shareholder wealth. However, Galleon Group should also be responsible for the public interests. The commitment of frauds would directly result in a series of negative consequences.

(A) Reputational Loss

Right after the sentence of Gary Foster in September 2011, the share price fell by about 50% (Nasdaq 2014). Galleon Group had to be faced with bankruptcy after investigation. The vulnerability to frauds indicates weak control systems and high risk exposure of the financial institutions, which frustrates other stakeholders to continue the co-operation (McDowell & Novis, 2001). Extra costs might be raised to audit the nature and source of each transaction and the entry costs to world financial markets will be required regarding the scrutiny of control systems.

(B) Shareholder Loss

Shareholders as the primary investors have to suffer the loss from financial crimes. Financial penalties and fall in stock prices are concluded as direct costs. Comparatively, the indirect costs such as agency costs and revival of reputation can be much higher (McDowell & Novis, 2001). Management needs to review existing internal control systems and tries to recover from the losses, which might result in an extra investigation costs. Therefore, the shareholder wealth would be diluted greatly by financial crimes.

1.2.2.3 Implications on the Society

Considering the nature of the frauds, the impact of employee embezzlement will mainly be reflected from the public confidence in CitiGroup. However, insider trading involves an extensive scale, which has a great impact on the stability, reliability and efficiency of the financial market. Therefore, the negative consequences of resource misallocation and unethical behavior encouragement should raise regulators' awareness.

(A) Financial Market and Social Resources Misallocation including Regulatory Reform

Taking advantages of the information asymmetry enables fraudsters to reap their unethical earnings. As their intervention into the financial markets results in the chaos of social monetary resources, for government, macro-economic control will be ineffective. Aluko and Bagheri (2012) argue that money laundering has a negative impact on the market competition, which also applies to insider trading. The economic distorts lead to the decrease in overall productivity and unethical economic environment. Even though the regulations of insider trading across jurisdictions are similar and require faithful and transparent disclosure, they are still not identical in the market (Grankvist 2005). It is expected to achieve the convergence in respect of the regulatory affairs.

(B) Encouragement of Unethical Behavior

The efficiency of capital market is based on the fair trading. However, Fishe and Robe (2004) identify that the insider trading activates the incentives of fraudsters. To meet the expectations of information holders, management manipulates earnings through activities rather than the accrual accounting. From the case of Raj Rajaratnam, related parties are most senior management within the companies, which exposes an ethical dilemma to the decision-making. The silence to insider trading will then provide an 'inspiring' environment for others to commit crimes.

2. Organizational and Social Efforts against Frauds

Combating fraud is usually expensive and requires the involvement of highly-skilled professionals. However, these extra costs could be avoided by the organizational and social efforts if certain fraud prevention system is effectively carried out. Considering the changes in business environment, it is strongly recommended that companies, educators and regulators should work together to fight against frauds.

2.1 Organizational Efforts

2.1.1 Awareness in Sound Corporate Governance

In the consideration of effectiveness and efficiency, fraud prevention system will be the foundation for companies to build. A solid and sound corporate governance is usually the first line of defense. The notable 'COSO Framework' provides a sophisticated structure for companies to follow, covering five layers of control environment, control activities, information and communication, monitoring and risk assessment. However, the continuing occurrences of fraud indicate a weak awareness of fraud prevention importance among management.

Following the collapses of Enron and WorldCom and litigation of the Walt Disney Company, Olson and Goodman (2005) review the governance practices within these companies and propose thirteen practice guidelines. The guidance mainly focuses on the directors' responsibilities as board service presents greater liability risks. Before accepting the board role, directors are required to explicitly understand the corporate culture and governance practices. The ethical tone at the top is the guarantee of the sound operations. Moreover, Forte (2009) notices that there is always a murky relationship between corporate code of conducts and its real performance. Many companies believe they are immune to insider fraud because they have dealt with such case and established relevant codes. However, they fail to understand the fraud is ongoing and shifting, which evolves from time to time. The poor implementation of control system could be concluded as the main driver in frauds. For the Citigroup and Galleon Group cases, the ethical tones at the top and management awareness are critical to the fraud prevention. The ignorance of control systems allows their fraudulent activities to last for several years.

It is believed that a signed acknowledgement statement of board responsibilities to fraud before board members accept the offer could effectively raise their awareness and prevent the occurrence of frauds.

2.1.1.1 Responses to Fraud

Since there is zero tolerance of fraud within the companies, three phases should be adhered to in an anti-fraud scheme. The prevention phase should focus on the due diligence, while detection stage should provide channels for whistle-blowing and conduct forensic data analysis. Finally, the response stage emphasizes on the further investigation and follow-up legal issues (KPMG, 2006). The adherence to such procedures under management's strong awareness of fraud could effectively eliminate the perceived opportunities. On the other hand, Geyt, Cauwenberge and Bauwhede (2013) indicate that high-quality corporate disclosure is effective in combating insider trading. It is critical for management to disclose all the related parties, which is able to enhance the transparency and reliability of the management integrity. Regular review and verification of related parties are strongly recommended in the contemporary business, supported by an effective external whistle-blowing system.

2.2 Social Efforts

2.2.1 Education in the Contemporary Business World

The past scandals make an urgent call for the ethical business environment. The emerging trend of financial crimes indicates a diversification of criminal types. However, since the root of business is the strong faith in ethics and morality, educators should play a key role before and even after student's campus life. The business ethics course should focus more on practical ethical dilemma situations and build a positive business image.

Comparatively, considering the vulnerability of financial area to frauds, international accounting and forensic techniques are expected to be incorporated into accounting-related curriculum. Daniels, Ellis and Gupta (2013) recognize that most business schools do not include a specific fraud-related unit, and Langmead, Sedaghat and Unger (2010) suggest most business-related curriculum do not cover international accounting even though the International Financial Reporting Standards (IFRSs) have been widely adopted. Education could be an effective monitoring system which motivates the public to oversee the corporate behavior.

2.2.2 Co-operation between Regulators and Large Companies

Business scandals undoubtedly hit the regulators for their negligence. By reviewing the frauds occurring in the past decade, financial institutions are more vulnerable to frauds. Notwithstanding the regulators have put more efforts on financial intermediaries, it is obvious that compliance practice cannot be adhered to. The existing regulations are expected to be modified to adopt an aggressive enforcement approach. For industries like financial institutions, regulators should take a compulsory review of business operation and performance regularly rather than the disclosure requirements solely. The aggressive prosecution aims to build an example for the public that no fraud is tolerated. Therefore, the intervention of external regulators could effectively strengthen the business operating environment.

3. Conclusion

This paper analyzed the recent financial crimes of employee embezzlement and insider trading. Compared with the Enron and WorldCom frauds, it is concluded that emerging types of financial crimes have been diversified. However, shareholder wealth and corporate reputation are usually eroded by frauds. A solid and sound corporate governance is the foundation for fraud prevention, while the most critical factor is the management's awareness of it, which might result in the poor implementation of control system. On the other hand, to keep pace with changing world, education should be more empirical and real world-based. The guide to deal with ethical dilemma situations should be normalized during and after student's campus study, and it is recommended that investigative techniques should be formally set up in the business-related curriculum. Regulators are also responsible for the stricter prosecution procedures and expected to assist companies to prevent frauds. It is believed that the joint efforts by management, educators and regulators could effectively eliminate the occurrence of fraud.

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