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Banks Must Watch Out For Fraud Revelations Amid Pandemic

By **Jon Hill**

Law360 (April 14, 2020, 10:23 PM EDT) -- When markets tanked in 2008, Bernie Madoff's $65 billion Ponzi scheme finally blew up. As the economy begins to tumble under the weight of the COVID-19 pandemic, could more hidden frauds be waiting like land mines to detonate? And what fallout might financial institutions face?

On Tuesday, the International Monetary Fund said it expects the coronavirus pandemic to spur the worst global recession since the Great Depression, with worldwide economic output projected to shrink by far more this year than it did after the 2008 financial crisis.

The dark forecast comes as U.S. markets have already hit a series of grim milestones since the virus struck, including the end of the longest bull market on record, the sharpest one-day drop in stock prices in more than three decades and the most new unemployment claims ever filed in a single week.

Given the economic devastation already on the books and the likelihood of more to come, attorneys told Law360 that the conditions are right for more Ponzi schemes to unravel just as Madoff's did more than a decade ago.

"Ponzi schemes are often discovered when investors seek to redeem their investments and learn that the money's not there," said Amanda Kramer, a partner in Covington & Burling LLP's white collar defense practice and a former assistant U.S. attorney in Manhattan. "As we saw in the wake of the 2008 financial crisis, a loss of confidence in the stock market often causes investors to ask for their money back with much greater frequency than when the market is doing well."

And when redemptions pick up, so too must fraudsters' efforts to pull in new money so their schemes don't collapse. But economic downturns have a way of making investors more tight-fisted and less inclined to believe in the eye-popping returns that fraudsters may promise.

"Without that new capital to pay those purported returns and give redemptions where they're being requested, the jig is up," Kramer said. "The risk of an increase in detection of Ponzi schemes, given where the economy is now, is significant."

The current crisis is also arriving after a decade in which interest rates stayed at historically low levels, which Morgan Lewis & Bockius LLP partner Elaine McChesney noted can make it easier for fraudsters to continue attracting yield-hungry investors and stay undetected for longer. The increased scrutiny given to the financial industry after 2008 is also seen by some as having eased in recent years, McChesney said.

“The general rule of thumb is that the less regulatory oversight, the greater the opportunity for fraud and the greater the opportunity for it to succeed,” McChesney said.

But McChesney and other attorneys said banks have become more vigilant about fraud than they were before the Great Recession and are using more sophisticated technological tools to combat it, putting countervailing pressure on would-be Ponzi schemers.

“To the extent that we do see these fraud vehicles being exposed, my general sense is that it will not be, dollar-wise and volume-wise, as bad as it was in the financial crisis,” McChesney said.

Gerald Hodgkins, a Covington partner and former enforcement official with the U.S. Securities and Exchange Commission, added that regulators responded to the Madoff scandal by writing new rules around investment advisers’ custody practices and taking other steps to enhance fraud detection and prevention.

“That hopefully will lessen the possibility of another major Madoff-type Ponzi scheme,” Hodgkins said.

The Risks Facing Banks

Madoff’s scheme made headlines as the biggest in U.S. history when it was uncovered in late 2008, but it was ultimately just one of many financial frauds that the Great Recession laid bare. According to data compiled by Ponzitracker.com, more than 150 Ponzi schemes came to light in 2008 and 2009 alone.

Those schemes ate up billions of dollars in investor money, but they also proved costly for the banks through which the money was moved. In addition to victim lawsuits accusing them of aiding and abetting fraud, negligence and other misconduct, banks faced heat and hefty fines from regulators for allegedly failing to spot and report suspicious activity in their accounts.

Similar risks could again materialize for banks if the pandemic reveals a new wave of fraud, attorneys told Law360.

“A financial institution can be held liable for its role in providing services to a Ponzi scheme,” said Scott Wortman, a Blank Rome LLP consumer financial services partner. “Banks are always going to be tempting targets, especially when you have innocent victims looking for where they can get back their money.”

Holland & Knight LLP partner Brian Hayes said banks should likewise expect regulators to be paying close attention to their anti-money laundering and anti-fraud programs in the coming months.

“This is going to be on the regulators’ minds, definitely,” said Hayes, who leads his firm’s Midwest white collar defense and investigations practice. “That’s why this is a good time for banks and other financial institutions to recognize this is an area law enforcement and regulators are going to be interested in and begin taking some steps.”

What Banks Should Be Doing Now

Banks have had their hands full in recent weeks as the pandemic has put stress on their balance sheets, scrambled branch operations and left financially struggling customers desperate for assistance.

But attorneys told Law360 that not losing focus on compliance with anti-money laundering and know-your-customer requirements will be crucial for banks as they enter a period when Ponzi schemes may start to break down and emerge from the shadows.

“As some of these schemes unravel, you're going to be seeing a change in patterns of activity. You're going to be seeing a change in the nature of the relationship you have with your clients,” said Daniel Tehrani, a Morgan Lewis partner and former federal prosecutor in Manhattan. “You have to be on alert for what you already know about your clients and how that is changing in this particular environment.”

Banks should also be mindful that spotting these signals may be complicated by the upheaval of the pandemic, Kramer advised. While a sudden shift in an account’s transaction patterns might stand out as a red flag in normal times, stay-at-home orders tied to the virus have caused dramatic changes in how, when and where people spend their money.

“Monitoring and the metrics that are in place have to be tweaked to identify what is unusual activity for a given customer today, as opposed two or three months ago,” Kramer said.

Hayes similarly recommended that banks undertake reviews of their transaction monitoring protocols to ensure they’re properly calibrated. Taking time to remind front-line staff of fraud indicators to look for and the importance of escalating them for follow-up can further demonstrate a bank’s commitment to fighting fraud proactively, Hayes added.

“That’s going to be important to regulators,” Hayes said.

Jeffrey Alberts, who co-heads Pryor Cashman LLP’s financial institutions group, said such compliance refreshers can be particularly useful now, when employees are contending with a range of other personal and business distractions. The additional training may also help a bank earn credit with regulators if criminal activity does ever end up being uncovered in its accounts.

“If a bank went out of its way to try to ensure that its employees were able to identify risks to the bank or risks to the financial system such as violations of sanctions or anti-money laundering laws, it will always be looked on favorably,” Alberts said.

And while the pandemic’s disruptions to day-to-day operations may slow the usual processes that a bank uses for investigating suspicious activity once uncovered, Kramer cautioned against waiting too long to report that activity to the relevant authorities.

“Financial institutions should be aware of the potential that regulators or prosecutors will not be forgiving of a delay in reporting because the internal investigation that an institution wanted to conduct took much longer than it would have taken had we not been under shelter-in-place orders,” Kramer said.

--Editing by Jill Coffey and Emily Kokoll.