Before the

UNITED STATES SENTENCING COMMISSION

Public Hearing

Wednesday, March 13, 2013

Federal Judicial Center

Thurgood Marshall Federal Judiciary Building

One Columbus Circle

Washington, DC 20002-8002

The hearing was convened, pursuant to notice, at 8:42 a.m., before:

JUDGE PATTI B. SARIS, Chair

MS. KETANJI BROWN JACKSON, Vice Chair

CHIEF JUDGE RICARDO H. HINOJOSA, Commissioner (By Teleconference)

MS. DABNEY FRIEDRICH, Commissioner

MR. JONATHAN W. WROBLEWSKI, Ex Officio Member of the Commissioner

PANELISTS:

Panel I: Economic Espionage: Part I

(Executive Branch Panel)

JOHN LYNCH, Chief Computer Crime and

Intellectual Property Section

Criminal Division, U.S. Department of Justice

THOMAS P. REILLY,

Counsel to the Assistant Attorney General

National Security Division

U.S. Department of Justice

LOUIS E. BLADEL, III

Section Chief, Counterintelligence Division

Federal Bureau of Investigation

STANFORD K. McCOY, Assistant U.S. Trade

Representative for Intellectual

Property and Innovation

Office of the U.S. Trade Representative

Panel II: Economic Espionage: Part II

JOHN W. POWELL

Vice President and General Counsel

American Superconductor (AMSC)

Panel II (Continued):

DAVID DEBOLD, Chair

Practitioners Advisory Group

DAVID HIRSCHMANN

Senior Vice President

U.S. Chamber of Commerce

Panel III: *Setser*/3E

CHARLES E. SAMUELS, JR., Director

Bureau of Prisons

VIJAY SHANKER

Senior Counsel to the Assistant Attorney General

Criminal Division, U.S. Department of Justice

LISA HAY,

Assistant Federal Public Defender

Portland, Oregon

Panel IV: Pre-Retail Medical Products

JOHN ROTH, Director

Office of Criminal Investigations

Food and Drug Administration

DENISE C. BARRETT

National Sentencing Resource Council

Federal Public and Community Defenders

Panel IV (Continued):
DAVID DEBOLD, Chair
Practitioners Advisory Group
Panel V: FDA/Counterfeit Drugs/
Counterfeit Military
JOHN ROTH, Director
Office of Criminal Investigation, FDA
JOHN LYNCH, Chief, Computer Crime and
Intellectual Property Section, Criminal Division
U.S. Department of Justice
DENISE C. BARRETT, NSRC,
Federal Public and Community Defenders
Panel VI: Tax
KATHRYN KENEALLY, Assistant Attorney General,
Tax Division, U.S. Department of Justice
REBECCA SPARKMAN, Director of Operations
Policy and Support, Criminal Investigation
Division, Internal Revenue Service
DAVID DEBOLD, Chair, PAG
TERESA BRANTLEY, Chair
Probation Officers Advisory Group
RICHARD ALBERT, New York Council of Defense Lawyers

P R O C E E D I N G S

(8:42 a.m.)

CHAIR SARIS: Good morning to everyone. Welcome to the hearings today on our guideline amendments. I was saying earlier as I was smoozing with all the future speakers and people who have attended today's hearing, this is an unusual hearing in the sense that so many of the areas are highly specialized, areas that we really do need information about, whether it is about economic espionage, or trade secrets, or counterfeit military parts, or drugs. These are important areas which the Congress has addressed in the last session, and it told us to do guidelines about.

So we read with interest all of the testimony, and we are looking forward to it. We tend to be a hot bench, so I think the way we've got it is the red lights go off after 10 minutes? Is that so? All right, so it is like in the First Circuit, the hook comes at about 10 minutes. So if I start getting ansy, that is my first sign. And then if I cut you off, please don't take it personally but it

is just so that we can — we will read all of your written comments, and then we will ask questions.

But before we get going, a few things. You may think, in case you get bored you are going to be allowed to watch television. That is not the case. The reason we have the screen up there is Judge Ricardo Hinojosa could not attend today, so he is going to be coming in at some point — I think probably for the second panel.

Before we get going, I want to introduce Ms. Ketanji Jackson who has served as the vice chair of the Commission since February 2010. She was a litigator at Morrison & Foerster, and was an assistant federal public defender in the Appeals Division of the Office of the Federal Public Defender in the District of Columbia. And while it is not in her official bio yet, I have to brag that she has been nominated to be a federal district court judge, and she is through the Judiciary Committee and "on the Floor," as they say. So who knows, she could get a call any minute.

(Laughter.)

CHAIR SARIS: Next, Judge Hinojosa, who will be joining us from Texas later this morning. He served as chair and subsequently acting chair of the Commission from 2004 to 2009. He is the chief judge in the United States District Court for the Southern District of Texas, having served on that court since 1983. We were privileged to go down for our last meeting to the border court and see the amazing caseload that they have and the challenges they have in both the immigration and the whole area of guns going across the border. And so he has maybe 800 cases a year, which is quite an astonishing number of criminal cases.

Dabney Friedrich has been on the Commission since December 2006. She served as an associate counsel at the White House, as counsel to Chairman Orrin Hatch of the Senate Judiciary Committee, and an assistant U.S. attorney in the Southern District of California and the Eastern District of Virginia.

And our ex-officio, or ex-officio, if you are going to do it in Latin, Jonathan Wroblewski, a

member of the Commission — I went to Girls Latin, so I just always have to do that.

(Laughter.)

COMMISSIONER WROBLEWSKI: — Cardinal.

(Laughter.)

CHAIR SARIS: — representing the Attorney General of the United States. Currently he serves as director of the Office of Policy and Legislation in the Criminal Division of the Department of Justice.

You may notice that we seem smaller. We are. We've got three vacancies on the Commission. We are hoping for a nomination soon. And so we are missing very much Vice Chair Will Carr, whose term ended, and Judge Beryl Howell.

So why don't we bring the first group up so I can introduce all of you who are going to teach us about this growing new field of economic espionage.

All right, John Lynch is currently the chief of the Computer Crime and Intellectual Property Section, which I am told is CCIPS — right? I've got

it? — in the Criminal Division of the Department of Justice. During his over 15 years in CCIPS, Mr. Lynch has — 15 years — has also served as trial attorney, senior counsel, and deputy chief. Mr. Lynch received his J.D. from Cornell Law School.

Thomas Reilly is currently counsel to the assistant attorney general for National Security, where he supervises all espionage-related matters in the Counterespionage Section of the National Security Division and provides advice and counsel regarding the application of the Classified Information Procedures Act.

Louis Bladel III serves as section chief of the FBI's Counterintelligence Division, leading the FBI's national counterespionage program. He has previously served in a number of positions with the FBI, and has conducted or overseen numerous high-profile espionage investigations. Mr. Bladel — am I pronouncing that correctly?

MR. BLADEL: Yes.

CHAIR SARIS: Good. — earned a Bachelor of Science in Criminal Justice Sciences from

Illinois State University.

And Stanford McCoy is the assistant U.S. trade rep for the intellectual property and innovation at the Office of the United States Trade Representative where he serves as the chief policy advisor on intellectual property and trade issues. He is a graduate of DePaul University and the University of Virginia School of Law.

Welcome to all of you, and thank you so much for coming. Why don't we start with Mr. Lynch.

MR. LYNCH: Madam Chair and distinguished members of the Commission:

My name is John Lynch, and I am the section chief of the Computer Crime and Intellectual Property Section of the Department — of the Criminal Division of the Department of Justice.

Thank you for inviting the Department to present testimony today on the problem of trade secret theft and economic espionage, and the Commission's response to the Foreign and Economic Espionage Penalty Enhancement Act of 2012.

Trade secrets underlie American innovation

in virtually every area of manufacturing and technology. This theft costs the United States an estimated billion of dollars each year. This theft can undermine our economy, and impose risk to our national security interests, particularly in cases targeting sensitive technologies or suppliers of components for defense, security, and critical infrastructure applications.

For these reasons, investigating and prosecuting corporate and state-sponsored economic espionage is a top priority of the Justice Department.

I appreciate the opportunity to present our views on this important issue. My testimony will present an overview of the Department's views on trade secret theft enhancements, while my colleague, Thomas Reilly of the National Security Division will focus on threats where a foreign state actor is involved.

The category of trade secrets encompasses an array of commercially valuable information. These can include many types of information, such as

technical, scientific, and engineering data, business records or economic and financial information, as long as the information is not known to the public, the owner has taken reasonable measures to keep it secret, and the information derives economic value from its secrecy.

Trade secrets might include a tire-maker's process for a polymer that is more durable or less expensive than others on the market, a manufacturer's proprietary process for improving the efficiency of its factories, or the design of network hardware used in military applications.

From innovative technological advances to sensitive business information, trade secret information represents the lifeblood of many American businesses. As a world leader in innovation, our businesses are a prime target for trade secret theft.

In this regard. U.S. businesses can not only face financial devastation if their trade secrets are stolen, but the threat of foreign and domestic corporate espionage also imposes significant

ongoing costs on businesses for extra security measures to protect them.

Today, 17 years after Congress passed the Economic Espionage Act of 1996, the threat of economic espionage and trade secret theft remains and continues to grow.

The Federal Bureau of Investigation has seen an overall increase in these cases, doubling the number of arrests associated with trade secret theft over the past four years. The number of prosecutions has also grown substantially during that period.

This rise in cases reflects in part a focused effort by U.S. law enforcement to target trade secret theft. Those efforts, however, are themselves a response to the rapid growth in the incidence of trade secret theft and economic espionage, which has been spurred and facilitated by the increasingly global reach of business and trade and continued rapid growth in the use of digital networks and storage.

In light of the increasing threat and complexity of the ongoing theft, in February the

White House announced the Administration's strategy on mitigating the theft of U.S. trade secrets.

The strategy takes a government-wide, multi-faceted approach to combatting trade secret theft. Criminal enforcement against trade secret theft is a critical part of that strategy and one to which the Department is committed.

It is also important that criminal penalties deter trade secret theft and reflect the significant harm that such offenses inflict on individual businesses and the economy.

For this reason, in its white paper on intellectual property enforcement legislative recommendations the Administration recommended increasing the penalties for trade secret offenses in areas that I will outline in a few moments.

In enacting the Foreign and Economic Espionage Penalty Enhancement Act, Congress largely adopted the white paper's proposals relating to the sentencing guidelines, recognizing that additional enhancements for certain trade secret thefts may be warranted to account for the seriousness of such

offenses.

The Department believes that the existing guidelines applicable to trade secret offenses do not adequately account for the seriousness of many aspects of such crimes, and we support several potential changes discussed in the Commission's proposed amendments to the sentencing guidelines.

We believe that these changes will more appropriately address the harm posed by trade secret theft and economic espionage, provide more effective deterrence against these crimes, and bring the guidelines applicable to those offenses in line with other intellectual property offenses and similar economic crimes.

First, the Department recommends that the Commission amend the guidelines to provide a two-level enhancement for simple misappropriation of a trade secret. That is, for any offense involving the criminal theft of a trade secret under either section 1831 or 1832.

Under the existing guidelines, the base offense level for these offenses is guideline 2B1.1

is 6. Unlike trade secret theft, most other intellectual property offenses are referenced to 2B5.3, which provides a base offense level of 8.

The government regards criminal offenses involving trade secrets as no less serious, and in certain circumstances even more so, than other forms of intellectual property crime. Providing a 2-level enhancement in section 2B1.1 for simple trade secret theft, even without other aggravating factors, would bring its offense level in line with the base offense level for other intellectual property offenses, and more appropriately affect the relative seriousness of trade secret theft offenses.

Second, the Department recommends that the guidelines should continue to provide an enhancement for trade secret theft for the benefit of a foreign government, instrumentality, or agent.

My colleague, Thomas Reilly, will discuss this in more detail, but our view is that the current enhancement for economic espionage is justified not only by the seriousness of the offense, but also by the need to deter such foreign entities from

exploiting difficulties in investigating crimes with a foreign component. It should be maintained.

Third, the Department recommends an additional guidelines enhancement in cases in which a defendant sends or attempts to send stolen trade secret information outside the United States.

The harm that trade secret theft can inflict on U.S. competitiveness and other national interests, and the investigative difficulties presented when relevant evidence and witnesses are located abroad, are not limited to economic espionage cases under section 1831.

Many cases prosecuted under section 1832, particularly in the last several years, have involved some sort of foreign nexus. This includes involvement of a foreign competitor in the theft or subsequent exploitation of the trade secrets, or the uploading or sending of stolen trade secret data to recipients or computer servers overseas.

As recent news reports have highlighted, U.S. companies are also the targets of frequent cyber attacks, many of which focus on valuable commercial

data, including trade secrets.

Even in cases where a defendant convicted of trade secret theft does not know or intend that the theft will directly benefit a foreign government or instrumentality, or where such knowledge or intent cannot be readily proven, the transmission of stolen trade secret data outside the United States nevertheless poses many of the same dangers to the U.S. economy that economic espionage offenses do, as well as many of the same investigative challenges.

The Department therefore recommends that the guideline include a 2-level enhancement for offenses under either section 1831 or 1832 when they involve the transmission or attempted transmission of stolen trade secrets outside the United States.

The Department further recommends that the enhancements that I have outlined should be applied cumulatively. Moreover, because of the heightened risk of harm and increased investigative difficulties presented by economic espionage and other trade secret offenses involving foreign transmission of trade secrets, we also recommend that a minimum

offense level of 14 should apply in any such case.

The Department believes that the adoption of these additional enhancements will result in guideline sentences that better reflect the severity of the harm inflicted by trade secret theft, particularly offenses involving a foreign nexus, and provide more effective deterrence where it is most needed.

The enhancements I have outlined would not only address the concerns Congress raised in the sentencing directive but would also help fulfill Congress's original desire in enacting the Economic Espionage Act to more effectively confront the threat posed by theft of trade secrets.

In closing, I would like to thank the Commission once again for the opportunity to share the Department's concerns and views. We welcome the opportunity to work with the Commission, and we appreciate the effort and expertise that the Commission has devoted to this important subject.

Thank you.

CHAIR SARIS: Thank you. Mr. Reilly.

MR. REILLY: Good morning, Madam Chair, members of the Commission:

Thank you for having me here today. I want to explain a little bit about how the National Security Division factors into prosecution of trade secret theft.

We house the trade secret theft component of NSD in the Counterespionage Section, and we have supervision over all cases that would involve violations of 18 USC 1831. That is theft of a trade secret with knowledge or intent that the theft would benefit a foreign government, foreign agent, or a foreign instrumentality.

I have been there for about 11 years now. I have been involved in 8 of the 9 cases that have actually been charged under 1831. We work with U.S. Attorneys' offices, our colleagues in FBI, and other law enforcement investigative divisions, colleagues in the Criminal Division, to investigate and prosecute these cases. So we take a really holistic view of it. We don't go in thinking this is going to be an 1831, this is going to be an 1832, this is

going to be some other kind of trade secret theft property case. We try to use whatever tools we have available to address the threat.

And I want to talk a little bit about what the threat is and the challenges we face when we investigate this threat.

The threat that this poses to the national security is a lot of trade secrets are held by private companies, obviously. Private companies develop materials, technologies, processes, that relate to critical infrastructure in the United States, weapons systems, other items that some day we would use for national defense. While they are "in development," while companies are working on them, they are not classified. They are not part of the U.S. government owned and protected information.

So we don't have the tools available to protect the national defense information that we have under espionage statutes. So we look to other statutes, which include 1831.

So when people from other countries target these items, they are targeting not the U.S.

government but the companies. And just because they are a company doesn't mean that threat is any less serious to our national defense.

So we take it as a huge priority to protect those items, and protect the national defense, by looking at trade secret theft through the same lens we use to protect our own U.S. government classified national defense information.

One of the big challenges we have is that when a nation state is involved you have a criminal foe that is well resourced, well supported, and well trained. They can use the tools that they use to collect our national defense information and target us on a national level against companies that do not have the resources the U.S. government has to protect that information.

They can use their existing infrastructure of intelligence collection activities, either be it agents, technology, support, to enhance their ability to collect this economic information.

So when we come up against these criminals who are trying to steal these trade secrets, we are

not just up against a criminal network; we are up against a criminal network that could be supported by a foreign intelligence network that could be very sophisticated and have existing technology and support in place to allow them to steal the trade secrets, and we may not even know it.

Therefore, we have to encourage greater deterrence to deter foreign nation states from supporting that activity, and supporting those criminals.

Obviously, when foreign nation states are involved there's going to be evidence overseas. And getting that evidence when you are challenging a country, and when we are charging 1831, you are involving that foreign nation state in that theft by alleging that that theft was intended to benefit them.

Then, going to them and asking them to help support you in your prosecution of that case and asking for evidence obviously presents significant challenges.

When you involve a foreign nation state's

intelligence network, that could implicate our own efforts on intelligence collection and our own efforts to gather intelligence across the world. So we have to be cognizant of those issues as well when we charge these cases and when we investigate them, that we don't trip over ourselves in terms of what we are doing with our own intelligence services.

The threat in recent years has grown by the ability of criminals to use cyber-enabled activities to steal the trade secrets. The reason that poses a great threat is because a lot of that activity can be conducted outside of the United States, avoiding our jurisdiction and avoiding our ability to use traditional law enforcement tools that we have to investigate these cases.

So that is a greater challenge for us to reach actually the criminal that is conducting the theft of the trade secret. And when you do a cyber-enabled theft, it is not necessarily going to be apparent to the victim until much later that they actually were the victim of a theft.

If the thief is successful in stealing the

stuff through the computer network, then the victim may not know it. That leads to expiration of evidence, our ability to actually act quickly to get up on people and use criminal tools to investigate these cases, and grab things before more damage is done, is a great threat that we face by cyber-enabled theft of trade secrets.

The greater threat that we also face is not just to the victim of the trade secret and the economic loss that they face, but the economic loss that the country faces, and allowing other nation states to use these intelligence-enabled cyber-enabled activities to steal our trade secrets and conduct these operations here, to use their trade craft that they use for intelligence collection, it's the same challenges we face when we try to deter other countries and people from conducting espionage in this country. And it is why this component of criminal law enforcement is housed in the Counterespionage Section, and why we believe a greater deterrence is needed to try and get these nation states to stop doing this and make it harder

for them to recruit agents to do this, make it harder for them to use their networks and jeopardize their networks by doing this, by greater sentences up front that make it harder for them to do this activity.

Therefore, we support, and I join my colleague, John Lynch, in recommending the continued enhancements that already exist, and the new enhancements that have been proposed.

Thank you very much for the chance to talk to you today. I look forward to any questions.

CHAIR SARIS: Thank you. Mr. Bladel.

MR. BLADEL: Good morning. My name is Lou Bladel. I am the section chief for the Counterintelligence Division's Counterespionage Section at FBI headquarters.

Counterintelligence is evolving beyond the asymmetrical foreign established based threats. What we face today is much more than the FBI following known intelligence officers as they leave diplomatic establishments. Today's symmetric actors are growing — asymmetric actors are a growing threat with nontraditional, noncover, official intelligence

collectors operating not only against government agencies but more extensively against America's companies, hospitals, universities, and research facilities, collecting not only classified information but our nation's most valuable trade secrets.

The Economic Espionage, or EE Unit, housed in the Counterespionage Section that I direct is the tip of the spear fighting against this asymmetric assault to steal America's technology.

My director has said that there is substantial concern that China is stealing our secrets in an effort to leap ahead in terms of its military technology, but also the economic capability of China. It is a substantial threat that we are addressing in the sense of building our program to address the threat.

While the caseload of my other units has remained relatively stable, the caseload of our Economic Espionage Unit is exploding. In fiscal year 2011, we had a total of 108 cases. This year alone we have 147, which is a 50 percent increase in just

two years.

In fiscal year '11 we had 7 arrests, 16 searches, and 9 indictments. In fiscal year '12, 12 arrests, 13 searches, and 26 indictments. And in this year, 1 arrest, 12 searches, and 4 indictments.

A special emphasis should be placed on the fact that we have almost matched our fiscal year 2012 for searches and are not even midway through this current year.

As a former assistant special agent in charge of our Washington Field Office, I can tell you that the resource-intensiveness and meticulous nature of the searches cause us to spend many hours processing documents and digital evidence, and that's the easy part.

A long road of evidence review and work with the victim entity to identify trade secrets amongst the evidence then begins. It is also worth noting that the arrests documented above, only 2 in fiscal year 2011, and 1 in fiscal year 2012, were for the offense of economic espionage under 18 USC 1831. All other arrests were for the lesser charge of theft

of trade secrets under 18 USC 1832.

As the counterespionage Section chief for the FBI, I can definitively state that economic espionage and the theft of trade secrets represents the largest growth area in recent years, and it is my assessment that the threat will grow exponentially in the near term and thereafter.

Recent loss data gives us the metric to measure the threat. In fiscal year 2012, victim companies from cases in my Economic Espionage Unit reported losses totalling $13 billion U.S. dollars. Viewed as a calendar year for 2012, the loss amounts to a reported $19 billion from the companies.

These account for research and development expenditures, as well as the projected revenue of the affected companies.

The history of the Economic Espionage statute from 1996 reflects an understanding of economic security as national security. The 104th Congress noted: Threats to the nation's economic instruments are a threat to the nation's vital security interests.

In 1996, then-Director Louis Freeh testified about concerns over state-sponsored targeting of America's trade secrets. I would like to update in testimony today that foreign-based targeting of American trade secrets is continuing, but that state-sponsored — that the state sponsorship of the targeting has been difficult to show in open court.

Since the passage of the Economic Espionage Act, we have only seven convictions under economic espionage statute 1831 which requires showing the corporations and researchers of a foreign government that would steal our secrets as the agents or instrumentalities of a foreign power. Often the recipient of stolen trade secrets is a foreign university or a foreign company, a convenient veil for a foreign power.

Therefore, many of the cases end up being prosecuted under 1832 as theft of trade secret cases and retain a foreign nexus, but the sentences do not reflect the severity of the offense.

The victims are varied and of extremely

high value and importance. Automotive, financial, high science and chemical companies, cleared defense contractors, pharmaceutical, renewable energy, agriculture, medical, preclassified emerging technology, USG agencies, and more.

As our caseload grows, I want to take a moment to describe a few examples of the profound damage caused by the worst form of this offense.

In San Francisco we have the DuPont titanium dioxide case. According to a February 2012 indictment, several former employees with more than 70 combined years of service to the company were recruited to sell trade secrets to a competitor in the PRC.

Entities owned by the PRC government sought information —

CHAIR SARIS: "China"?

MR. BLADEL: China, excuse me, yes. Entities owned by — of the Chinese government sought information on the production of titanium dioxide, a white pigment used to color paper, plastics, and paint.

The Chinese government tried for years to compete with DuPont, which holds the largest share of the $12- to $15 billion annual market in titanium dioxide. Five individuals and five companies were commissioned by the Chinese state-owned enterprises to collaborate in an effort to take DuPont's technology to the PRC and build competing titanium dioxide plants, which would obviously undercut DuPont's revenues and business.

Thus far, three co-conspirators were arrested, and one additional co-conspirator pled guilty in federal court. This case is one of the largest economic espionage cases in the FBI's history.

In Chicago, Hanjuan Jin began working for Motorola in 1998. She took a leave of absence in February of 2006. Without Motorola's knowledge, Jin returned to China and worked for Sun Kaisens, a PRC telecommunications company linked to the PRC military, on military projects from November 2006 to February 2007.

Jin returned to the U.S. from China in

February 2007 and told Motorola she was ready to end her medical leave and return to work. Over a two-day period, on February 26th and 27th in 2007, immediately after returning to work at Motorola, Jin downloaded numerous technical documents, twice returning at night to remove hard-copy documents and other materials from her office. Many of the documents concerned Motorola's proprietary push-to-talk iDEN technology.

Prosecutors argued Motorola had invested hundreds of millions of dollars in developing iDEN, which in turn was a prime source of revenue for the company.

Jin was sentenced to four years in prison and fined $20,000 by a U.S. district court judge in the Northern District of Illinois. Although Jin was not convicted on three counts of economic espionage, the judge who sentenced her said, quote, "She raided Motorola's information to steal technology and demonstrated a willingness to betray her naturalized country."

The court concluded that, though Jin had

Chinese-language classified tasking documents, her employment was with the Chinese company Sun Kaisens and therefore Sun Kaisens did not represent an arm of the PRC government, even though it was supported by the communications architecture of the People's Liberation Army. It is estimated that the misappropriated trade secrets were valued at $1.2 million.

From Minneapolis, another case. Kexue Huang, a former scientist of two of America's largest agriculture companies pled guilty and was sentenced to 87 months for one count of 18 USC 1831, economic espionage, and one count of theft of trade secrets.

While at Dow AgroSciences and later at Cargill, Huang accessed extremely valuable and sensitive research on a patented-protected organic insecticide product. Huang attempted to remove compact disks which contained significant proprietary information on his last day of employment.

A review of Huang's work laptop revealed he downloaded large volumes of proprietary information which Dow had previously been unable to

locate.

While employed at Dow AgroSciences, Huang misappropriated trade secrets, transported the trade secrets to the PRC, and directed university research to further develop the trade secrets with the objective of producing a product in the PRC.

Huang submitted two grant applications and then subsequently received funding from the National Natural Science Foundation of China, an organization directly affiliated with the State Council for the management of the National Science Foundation.

Huang expressed the protracted goal to develop and produce the misappropriated products in China. It is estimated that his criminal conduct caused Dow and Cargill $100 million.

I want to close with a recent case that may help document why we in the FBI are concerned about what appears to be a weak deterrent in the theft of trade secret cases.

In the Kansas City Pittsburgh Corning case, PRC-based subjects were targeting Foamglas, the trade secrets relating to insulation in the

manufacturing process. As a result of the cooperation between Kansas City and the victim — FBI Kansas City and the victim company, on August 4th, 2012, Pittsburgh Corning introduced a trusted employee as a human source to respond to a classified ad.

The source exchanged a series of e-mails with the conspirators in the PRC. The PRC-based subjects, Huang and Qi, agreed to pay $100,000 for this stolen trade secret information relating to Foamglas with an initial payment of $25,000 when they met our source.

The source and the PRC conspirators scheduled a first meeting for September 1st, 2012, in Kansas City. Huang and Qi arrived in Kansas City on September 1st, 2012, and met with our source at a hotel restaurant. The FBI recorded the meeting on audio and video. The source explained to Huang and Qi that the information they were requesting was confidential and could result in the company going out of business, and could get our source arrested.

Huang and Qi replied that that is what

they are looking for and would take care of our source and provide him full employment. The source promised to meet the men again after going back to the Pittsburgh Corning plant to steal the documents they had requested.

The next day, Huang and Qi met our source in a hotel room covered by FBI video and audio surveillance. Huang and Qi displayed $25,000 in cash and our source displayed the documents, pointing to the "trade secret" markings on the documents.

The FBI investigation and subsequent arrest thwarted the potential loss of $270 million, according to Pittsburgh Corning officials. They could have ruined the company. The factory in Missouri alone has 500 employees.

On January 25th of this year, Huang and Qi were sentenced. Huang was sentenced to 18 months in prison without parole after pleading guilty to conspiracy to commit theft of trade secrets from Pittsburgh Corning. Huang was ordered — also ordered to pay a $250,000 fine.

Qi, a translator assisting Huang who

served as a key cooperative witness for us, was sentenced to time served and ordered to pay a $20,000 fine and self-deport within 7 days. Huang and Qi were in custody since September 2nd, 2012, after they were arrested.

At the FBI we ask ourselves: Does this sentence reflect the seriousness of this crime? I do not believe that it does. Despite the conviction and a prison sentence, actors in the PRC are not deterred and they try again.

Pittsburgh Corning came back to the FBI last month, February of 2013, after a guilty plea and advised that they found on Craigslist the exact same ad offering an adventure to China for engineers with expertise in Foamglas, offering to pay them $120,000 U.S., provide them with a personal driver and translator, and pay for flights back and forth from China to the U.S., as well as having their insurance covered.

The ad concludes: You will enjoy your stay here, and you will make plenty of new friends and experiences. We really need to find this one

perfect piece and continue moving forward, and we are willing to go the extra mile.

Foreign-based actors trying to steal America's most valuable trade secrets are getting more bold and brazen in their attempts.

The FBI thanks the U.S. Sentencing Commission for evaluating the seriousness of this threat and for producing possible sentencing guideline enhancements that will increase the deterrence effect.

Thank you very much. If you have any questions, I can talk about the cases.

CHAIR SARIS: Thank you. Mr. McCoy.

MR. McCOY: Madam Chair and members of the Sentencing Commission, thank you very much for the opportunity to speak about the perspective of the Office of the United States Trade Representative on trade secret theft in the international trade context.

USTR is responsible for developing and coordinating U.S. international trade commodity and direct investment policy and overseeing negotiations

on these issues with other countries.

USTR is part of the Executive Office of the President and provides trade policy leadership and interagency coordination on its major areas of responsibility including, among many others, trade-related intellectual property issues.

As assistant U.S. trade representative for intellectual property and innovation, much of my job involves encouraging other governments to take protection of intellectual property rights seriously, and to enforce intellectual property rights, including those of U.S. companies, creators, and innovators with the same vigor and effectiveness with which the United States protects the intellectual property assets of both domestic and foreign companies, creators, and innovators here in our market.

It is often the case in these discussions that our own actions are our best argument. All sectors of our economy rely on intellectual property, including trade secrets. As you have heard and read today and in the Administration's strategy on

mitigating trade secret theft, criminals, competitors, and even governments are deliberately targeting the trade secrets and other confidential information of U.S. companies.

This hearing is intended to assist the Commission in its consideration of guidelines that reflect the seriousness of trade secret theft, take into account potential and actual harms, and provide adequate deterrence.

In USTR's experience, it has been difficult for U.S. companies to obtain relief against those who have benefitted from misappropriation or theft of trade secrets, despite compelling evidence demonstrating such actions.

Many cases involving U.S. companies and foreign competitors go unreported because U.S. firms fear the cost and likelihood of failure of pursuing these cases through legal channels, as well as the possible commercial repercussions for bringing such cases to light.

There are many barriers or potential barriers to prosecution of intellectual property

crimes overseas, including, among others, local protectionism and corruption.

When intellectual property theft is actually prosecuted overseas, one of our most persistent concerns is that judges, prosecutors, and other actors in foreign criminal justice systems underestimate the gravity of these offenses, resulting in punishments that are minimal and therefore fail to provide effective deterrence.

As we work to respond to that concern, the U.S. domestic sentencing guidelines that you develop through this rigorous process can provide an important and well-respected touchstone for our trading partners abroad.

There is no question that trade secret theft poses a serious threat to U.S. industries engaged in international trade. Trade secrets are often among a company's core business assets, and a company's international competitiveness often depends both on its capacity to protect such assets and to prevent trade in goods and services by others that embody the company's stolen or misappropriated trade

secrets.

Important trade secrets of U.S. firms have been stolen by, or for the benefit of, foreign companies and governments. The theft of proprietary information by unscrupulous foreign actors has in some cases left U.S. exporters scrambling to salvage major portions of their international business, a consequence that is particularly unacceptable given the Administration's goals of increasing U.S. exports.

Of course the need for trade secret protection and the threat of economic espionage are not new issues. But new circumstances have arisen. Demand for information is growing as overseas industries climb the value chain and enter into new and more advanced fields of technology.

Unscrupulous actors seeking to meet that demand have new tools at their disposal, including cyber intrusions. Consequently, intellectual property theft is also climbing the value chain, bringing to the forefront concerns about the protection of high-value proprietary information held

by U.S. companies as trade secrets.

Our office has been active in responding to these concerns on many fronts. In the Trans-Pacific Partnership negotiations, our negotiators are working to address this issue decisively and raise the standards of protection of trade secrets, and thus serve as a model that is responsive to this bolder and more subtle form of theft that can destroy entire enterprises.

Trade secret theft is one of the focal points in our ongoing work with China, including through the U.S.-China Joint Commission on Commerce and Trade Intellectual Property Rights Working Group, as well as through senior level government engagements.

During the 2012 Strategic and Economic Dialogue, as a result of U.S. efforts China affirmed that the protection of trade secrets is an important part of the protection of intellectual property rights, and that China would intensify enforcement against trade secret misappropriation.

We are urging China to proceed as quickly

as possible with its plan to revise the anti-unfair competition law which governs the protection of trade secrets to provide several specific and stronger protections.

The 2012 Revised Model Bilateral Investment Treaty text contains binding treaty obligations to prohibit the forced transfer of technology, as well as the forced use of domestic technology. USTR and the Department of State will work on the basis of this text in concluding Bilateral Investment Treaty negotiations with China.

As part of the Administration's recently announced trade secret strategy, USTR's Special 301 Report, which is our annual review of the state of intellectual property rights' protection and enforcement by trading partners around the world will be devoting even more attention to this important issue.

As part of this Administration's initiative, we will be increasing our work on action plans, out-of-cycle reviews, and other tools to

gather and, where appropriate, act upon information about trade secret protection and enforcement by U.S. trading partners.

We hope that our bilateral work will, among other things, encourage our trading partners to strengthen available remedies for trade secret theft as, for example, Taiwan did with recent amendments to its Trade Secrets Act.

Taiwan's amendments provide for longer prison terms and higher fines for domestic violations, and still higher penalties if the trade secret is misappropriated with the intention of using it outside of Taiwan.

In addition to the work that I previously noted, we also seek through our trade and investment agreements to prohibit governments from requiring investors to transfer proprietary knowledge such as trade secrets as a condition of doing business in the market, and we seek to constrain excessive requirements for technology transfer, localization, or other measures that may make it difficult for a U.S. company to maintain control over trade secret

investment.

By pursuing heightened standards through trade negotiations, through our Special 301 Report, and through our constant bilateral engagement on this issue, this Administration shows our trading partners that the United States expects strong protection of trade secrets and deterrent punishments for those who would steal the innovation of others to secure unfair commercial and national advantages.

Our trading partners need to know that permitting or promoting misappropriation of trade secrets is unacceptable. The United States protects the trade secrets of foreign countries in our markets, and we insist that our trading partners protect trade secrets in their markets.

American ingenuity is our competitive advantage, and the more we develop and promote the best practices to secure intellectual property assets in the United States, the more persuasive we can be to other countries.

In that regard, my office is grateful for your engagement on this subject, and for your

interest in the international trade policy perspective, and I stand ready to answer any questions you might have.

CHAIR SARIS: Thank you, very much. That was very interesting.

We have an enhancement, as I know you're aware of, in I think it's B5, which involved the misappropriation of a trade secret and the defendant knew or intended that the offense would benefit a foreign government, foreign instrumentality, or foreign agent, increase by two levels.

So it is in there in a sense already. Has that been applied in these prosecutions that you have been describing? Or if not, why not? Is it a proof problem? What's happening with that?

MR. LYNCH: It has been applied in 1831 cases certainly. It comes up often in those cases. It also is applied — it's not tied to a particular offense. So we have been able to show it in other types of cases — I think 18 USC 666 cases, and in other places.

It is being applied where we can. It is a

difficult — it is a difficult area for us to show that this was actually — got to the foreign government and was intended to get to the foreign government.

Mr. Reilly —

CHAIR SARIS: So in a sense, you are seeking to — because of the proof problems of proving it really is China — the one you've mentioned most frequently — it really is China, you'd really like to add something that just deals straight out with a trade secret, or straight out with shipping a trade secret abroad so that it sort of tiers? Is that what you are trying to do?

MR. LYNCH: The Department would like these to apply cumulatively. So we would have a base trade secret theft, whether it's to benefit a domestic company or a foreign company. Then that would be a 2-level increase for that.

That would bring us equal, or even with other intellectual property offenses.

CHAIR SARIS: Just the plus two for a trade secret?

MR. LYNCH: Just the plus-two. That would

bring us to the same type of — or the same offense level as copyright infringement, trademark infringement, and so forth, which would be under 2B5.3. So that would apply.

We would ask for the continuation of the current — the current enhancement for benefitting a foreign entity or government. And then, finally, an additional enhancement, a two-level enhancement, where it would be, where something is sent outside the United States.

CHAIR SARIS: So but would that be duplicative?

VICE CHAIR JACKSON: The additional enhancement is the thing that is troubling me a little bit. I guess I am not appreciating the —

MR. LYNCH: The one where it's sent out of the United States?

VICE CHAIR JACKSON: Transmitting it out of the United States. You say in at least your written comments that in virtually all of the situations in which it is intended to benefit a foreign government, we will have this transmission

outside the United States.

So I trying to understand the distinction between those two. Why would they be cumulative? And aren't they duplicative, in a sense?

MR. LYNCH: Well, from a — and Mr. Reilly may be able to add a bit to this — I think that demonstrating the benefit to the foreign entity and actually getting that a foreign government or a foreign agent actually used it is a big proof problem.

Showing something that has left the United States gives us the opportunity to capture some of that harm and some of the damage, because that would be a bit I think easier to prove. We can show that it has left the United States.

And it is unquestionable, as Mr. McCoy pointed out, that once information has left the United States the harm to American businesses and the economy is heightened, and from our perspective the proof, you know, our ability to get proof and get cooperation from those foreign entities to show what the damage was, how much it has been used by the

beneficiary of the trade secret theft becomes much, much harder because we're dealing with governments that are often hostile or trying to protect their domestic businesses.

CHAIR SARIS: Commissioner Friedrich.

COMMISSIONER FRIEDRICH: Just following up on that, can't you make that argument in virtually any criminal case that involves part of the crime being committed overseas? And I don't know that we have that enhancement with respect to every offense that could entail overseas evidence and such.

So I get your argument that it's difficult to prove the foreign entity's involvement, and for that reason you want an additional enhancement even when you can't quite make it, but as Mr. Debold who will testify this afternoon has pointed out, one concern is that the theft of trade secrets within the United States in many cases can be every bit as damaging as in a case where it happens to move overseas and a foreign government isn't involved.

Perhaps you think the number of cases that involve overseas transmission without the involvement

of a foreign government are very small, or none, I don't know. Can you comment on that?

I understand the difficulties in proving that, and why you want a lower threshold, but we also need to be concerned about not targeting this to the offenses that you are concerned most about and not creating proportionality issues with offenses that would be committed within the United States and just as egregious, simply because it involves the transmission of a trade secret overseas.

MR. REILLY: I think we do look at it as a tiered approach in the sense that if we charge 1831, we are then in the realm that we can get that two-level enhancement for the intent to benefit.

Not every 1831 is actually successful in sending an item overseas. We can — in a case up in Massachusetts, we actually inserted ourselves into the process and nothing actually got sent because we did an undercover operation.

There are cases, though, where even though for whatever reason we can't prove the intent to benefit the foreign government, the item still goes

overseas to an entity that does raise the same threat and concerns that we experience of the 1831 realm of the foreign government involvement but, for whatever reason, be they classified information reasons, or other evidentiary reasons, we can't show that the theft was intended to benefit the foreign government, agent, or instrumentality.

That to us doesn't differentiate the threat posed by the trade secret is actually going overseas to be used by a foreign government or by the foreign entity in a way that threatens our security, economic or national security, or other threat to the country.

So by approaching it as a tiered approach, it does lower the threshold in the sense that we don't have to prove the intent to benefit the foreign government. All we have to prove is that it actually left the United States —

VICE CHAIR JACKSON: Although that's not what the tier said. So would you object to us taking "attempted" out of it?

In other words, I hear you saying the

second tier is the trade secret actually left the United States, and that there is independent harm in that. But the tier says "transmitted or attempted to transmit." So I would assume in your situation in which you had the undercover agent who inserted himself so it actually didn't leave the United States, you would get the economic espionage but you would also seek, I would assume as prosecutors if we had the current wording, the two for "attempted" as well.

MR. REILLY: Absolutely. I think it should still be under the "attempt," because to show the attempt they would actually have to take the steps, as in like an export control case, to take the steps to actually attempt to —

VICE CHAIR JACKSON: Well we wouldn't have the harm because it wouldn't have actually — I mean I understand the second tier standing alone in a situation in which the harm occurs because the trade secret actually leaves the United States.

MR. REILLY: In the sense that the harm actually occurs. But the threat is the same, that

the item was ready and the criminal actually attempted to send it overseas. Whereas, in some cases they may steal it and hold onto it waiting before they actually try to send it. So that they haven't taken those steps that would show the attempt to send it overseas.

So in a case like *United States v. Chung*, where the defendant actually got a very serious sentence, he did not actually take — while he misappropriated the trade secrets with the intent to benefit the foreign government — didn't actually take steps at that point to attempt to send the trade secret overseas.

VICE CHAIR JACKSON: So he would only get —

MR. REILLY: So you do have a case where there is a differentiation between he has misappropriated the trade secret but not taken that step. So it is a — the threat is greater when it actually gets sent overseas, but we wouldn't want to have less deterrence just because we are better at stopping it from going overseas.

If they actually take those steps and they make the attempt to send it, to us that is still a greater threat. We have to then be involved in a greater role to interdict the transmission of the trade secret.

MR. BLADEL: In working with the companies, that is one of the biggest things that they want us to make sure happens, that it doesn't get overseas.

We have a case with DuPont right now where, another Chinese case where they're trying to steal hybrid corn seed. And what they've been able to do is — I don't think they understand our laws, but what has happened is DuPont is cooperating with us and we've been able to interdict the Chinese before they leave the States with the seed.

The last attempt was this last fall where they had stuffed the corn seed in their underwear, and then they were trying to leave the country. And we searched them at the border, basically on more of not an economic espionage issue but more of a, you know, like taking fruits and vegetables overseas.

And we did that because we want to kind of get them all on the conspiracy in the springtime when they come back and try to steal the corn when it gets planted.

And so one of the big concerns for DuPont was they would lose the seed, meaning it actually gets overseas and it's already lost. And so they are very happy that we were able to interdict, but it is very difficult to do that. I mean, we really had to go through their personal items to get to where the seed was.

CHAIR SARIS: Commissioner Wroblewski.

COMMISSIONER WROBLEWSKI: Thank you. I have got two quick questions.

First of all, Mr. Debold from the Practitioners Advisory Group is going to be testifying and he pointed out that the Administration is seeking additional legislation relating to trade secrets and economic espionage, and suggested that the Commission should wait.

Could you describe what else the

Commission is looking for — what the Administration is looking for? And if the Commission goes forward with your proposals, are you going to be back here a year from now asking for something else?

And my second question is: It would seem that the loss table would drive sentences to very, very high levels. And yet at the same time, you are describing cases where the sentences are modest.

Could you explain why that's happening? And where is the disconnect? Because the impression I am getting is that these thefts involve assets that are tremendously valuable, and you would think that the loss table would drive the sentences very, very high.

MR. LYNCH: To answer your first question, the problem of trade secret theft and economic espionage is something we have been dealing with for almost two decades, and there have been continual attempts by various parts of the government, the FBI, aspects of the Administration — economic parts of the Administration, and the Administration as a whole represented by the IP enforcement coordinator, to

address this issue.

So I expect that the government is going to continue to use all of the tools of the state to address and continue to try to address with our foreign partners, and through prosecution, economic espionage and trade secret theft.

That said, I think the time for us, and the proposals that the Department is coming forward with right now reflect a response to a specific congressional directive. We think they are the right thing to do now, and I don't think that, you know, if these were to go through we would be back in a year on the sentencing issue.

The Administration continues to explore different ways to address the threat. The FBI can talk, if it chooses, about how we are continuing through the National Cyber Investigative Joint Task Force to collect our law enforcement investigative capacities, our intelligence capacities and, you know, through involvement with the Department of Justice, the prosecution tools to address the issue.

And as I say, that is going to continue.

But I think for today the Department's proposals on trade secret theft and economic espionage, these are the things that we believe are the right tools now.

Places with — I will give one slight caveat, and it relates somewhat to your second question. You know, we do see in cases low sentences. And I think a lot of that has to do with the difficulty of valuation.

I don't think the Department has an exact proposal today for dealing with that issue, but that is something that we continue to struggle with in front of judges, and in fact in the course of the investigations. In many cases, the companies find it difficult to evaluate the enormity of the harm that's been caused.

The harm can actually — because it involves competitiveness and it may involve a foreign competitor suddenly entering the marketplace with technology that had been developed by the United States, or a United States company at great expense. That harm may go on for decades, and it may harm our competitiveness for all of that time.

So I think valuation continues to be a very difficult issue for us to deal with in our cases, and it is certainly something the investigators and prosecutors struggle with. And I think judges do, as well, in trying to grasp — you know, you can evaluate — somebody steals the Hope Diamond, you can have somebody come in and say the Hope Diamond is worth X.

If somebody steals a process that suddenly makes a competitor better, a foreign competitor or a domestic competitor, better at doing something without having invested the research and development into developing that process, that can be a very, very difficult thing to evaluate over time.

CHAIR SARIS: Commissioner Friedrich wanted to follow up.

COMMISSIONER FRIEDRICH: On your answer to the loss issue, calculating loss, I understand the difficulties with sometimes there's no research and development costs, and it is difficult to assess how much the value has gone down as a result of the trade secret being stolen.

A couple of folks have suggested that we do expand the definition of "loss." I think one proposal we've received has said to include "gain" as an additional factor.

Senator Whitehouse has suggested broadening the definition. The Department just at this point is not in a position to take any position at all on that issue?

MR. LYNCH: I think that is correct. At this time, we are not — we would want to look at this more carefully, and we would want to talk within the Administration and within the Department to take a formal position on that.

COMMISSIONER FRIEDRICH: But you have to understand that that does give us some pause in terms of what we do now, because certainly if that definition were to in the future expand dramatically, that could affect very much how these enhancements play out as a whole. And that might weigh in favor of deferring any action by the Commission.

MR. LYNCH: I understand that.

CHAIR SARIS: Let me ask, though much

of your testimony is about the concern about China, and I'm sure there may be other countries down the line, but right now the concern is China, and I just wondered, in general though you have asked us to enhance a plain old trade secret violation.

How many prosecutions are there for that? And in your view does the — going back to the loss issue, does that not encompass well enough the harm created by a theft of a trade secret domestically?

MR. LYNCH: Trade secret prosecutions under section 1832, there have been about 235 or so prosecutions over the life of the Economic Espionage Act.

So we have some experience with that. And as I think both Mr. Bladel and Mr. Reilly indicated, in many cases we charge an 1832 in circumstances where an 1831 might have been contemplated. But the proof problem, we encounter proof problems. And in fact we have to make very, very careful balancing on our intelligence equities and other equities before charging an 1831 violation.

So in fact some of our international

cases, and cases that might involve, or we strong suspect involve a foreign entity, end up being charged under the 1832 rubric.

CHAIR SARIS: No, but just talk about domestic espionage for one minute. How many successful prosecutions have you had in the last five years, or whatever the time period you may have in front of you, of just one American company stealing from another American company?

MR. LYNCH: I don't have the information specifically on a domestic versus foreign basis.

CHAIR SARIS: Because you're asking us, and maybe it's correct to bring parity. You're asking us to increase by two levels a straight-up trade secret, two competitors in the car industry in Detroit. Right?

MR. LYNCH: Right. And that would be the base, simple increase of two levels would bring it into line with other intellectual property offenses like copyright or trademark right now, because trade secret is referred to 2B1.1. It is, the base starts at 6. This would then bring it up to the 8, the

[2B5.3] has in its place.

CHAIR SARIS: And so — go ahead.

VICE CHAIR JACKSON: I am still struggling with the tiers and the tiered approach, and the extent to which we have different levels of conduct and culpability. And I get that the simple theft of a trade secret is the first tier.

What I can't wrap my mind around, given what you have already said, is which is the next tier? Is it that the defendant knew or intended that it would go to a foreign government? And then the most culpable conduct is that it actually either took steps to get it out of the United States or attempted to get it out of the United States? Or is it the other way around?

MR. REILLY: It's the first tier — the first step would be the simple theft of the trade secret. The next is the actual transmission or attempted transmission of the trade secret outside the United States.

The final step would then be the enhancement for doing all of that with the intent to

benefit a foreign government, agent, or instrumentality.

VICE CHAIR JACKSON: So the final tier is also the transmission out of the United States with the intent?

MR. REILLY: No, it's that the theft was done with the intent to benefit the foreign government, agent, or instrumentality. So again, that can be divorced from the transmission or attempted transmission of the trade secret.

So I can steal a trade secret today with the intent to benefit the foreign government —

VICE CHAIR JACKSON: And in your view that is the most culpable conduct, even if I don't get it out of the United States?

MR. REILLY: Correct. It is the malicious intent of intending to benefit a foreign government, agent, or instrumentality during the theft.

COMMISSIONER FRIEDRICH: And for that offense the economic espionage, you're suggesting a floor — well, it's in effect +6, correct, with the graduated enhancements? And a floor of 16? Am I

right about that? Is it 14 or 16? 14? Okay.

MR. REILLY: A base offense level of 14.

COMMISSIONER FRIEDRICH: Can you just help me understand? I mean, having looked at the espionage and related offenses and the base offense levels for those in section M, 2M, way off the chart compared to this. So I'm just interested in your thinking in terms of how this offense will be proportional with other espionage offenses?

How have you come up with that floor of 14? What is your thinking? That the loss is going to kick in and you're going to be up? You've said there are difficulties in proving loss. If you can just explain how it is that you've come up with these levels of graduation, and with the floor of 14?

MR. REILLY: The 14 floor would apply across for the trade secret theft, not just for —

COMMISSIONER FRIEDRICH: Even the simple?

MR. REILLY: Yes.

COMMISSIONER FRIEDRICH: All right.

MR. LYNCH: Not just for 1831.

MR. REILLY: Not for — only when there is a

transmission —

COMMISSIONER FRIEDRICH: For the top two.

MR. REILLY: Right.

COMMISSIONER FRIEDRICH: And how, again, if this — if you can prove economic espionage, in effect a spy offense for a foreign government, why is it so low?

MR. REILLY: Well the next — the loss table would then kick in, you're correct. And in addition to the enhancements. And it's not targeting the national defense information specifically.

COMMISSIONER FRIEDRICH: Well it could, though. It could be military-related, right?

MR. REILLY: It could relate to that, and in the *Chung* case the judge actually applied the 2M sentence guideline in calculating the sentence. So there's not a distinction between — the distinction is that in 2M you have national defense information, which is U.S. government information. So in intellectual property offenses you have the difference of it's not controlled by the U.S. government.

So you have a — you start out with the 14 brings it closer in line to something akin to the IEEPA export offenses. And then you can add on for the greater amount of the loss.

So that's essentially how you would get up to where you are approaching the 2M offenses. But I don't equate them in terms of national defense information and trade secret information. Some trade secret information can pose a threat to the national defense. Not all trade secret information does, though.

So your question, I apologize that I'm sort of — I don't want to link those two together —

COMMISSIONER FRIEDRICH: Oh, no, I understand.

MR. REILLY: — sentencing guideline, or compare them. The threat in the sense is similar in that if a trade secret does relate to national defense, or could pose a threat to our national security, that would go up to that level.

But they are intended to cover separate offenses. I think the 14, though, where we're going

with that was the IEEPA export control, it brings it to parity with that where you are exporting an item that then could be used — is controlled for national security reasons.

CHAIR SARIS: Can I — we're coming close to the end of our session, but I did notice that Judge Hinojosa is now here, and I didn't know if you had any questions?

COMMISSIONER HINOJOSA (By Video): No, I'm sorry I am a little late. But, no.

CHAIR SARIS: Okay.

COMMISSIONER HINOJOSA (By Video): I appreciate the written testimony.

CHAIR SARIS: All right. Thank you, very much.

(First panel excused.)

CHAIR SARIS: We will move on to the next group.

(Pause.)

Ready? Thank you very much for coming. Part II, the other side of the story, to some extent. I am going to introduce the panel: John Powell is

vice president and general counsel and secretary of, it says AMSC, but the full name is?

MR. POWELL: It's American Superconductor Corporation.

CHAIR SARIS: Perfect. And how do you like the company to be called, by its initials?

MR. POWELL: AMSC.

CHAIR SARIS: AMSC. All right. You oversee legal, human resources, and communication functions. You have worked at Raytheon and Motorola. We have just heard about some of those issues. As well as in private practice as a patent attorney. You hold — Mr. Powell holds a law degree and a B.S. degree in electrical engineering both from, my neck of the woods, the University of New Hampshire. Welcome.

MR. POWELL: Thank you.

CHAIR SARIS: David Debold is well known to the Commission and is a partner in the firm of Gibson Dunn in Washington, D.C., and chair of our Practitioners Advisory Group, we sometimes call the PAG. Previously he served as an assistant U.S.

attorney in Detroit, and was on detail to the Commission. Mr. Debold received his J.D. from Harvard Law School, and frequently testifies always valuable information.

David Hirschmann is the senior vice president of the U.S. Chamber of Commerce — we got your testimony — the president and CEO of the Chamber's Global Intellectual Property Center, and president and CEO of the U.S. Chamber of Commerce for Capital Markets Competitiveness. Previously he worked as legislative director for former Congressman Toby Roth, and a graduate of Duke University.

So welcome to all of you. You provide different perspectives on this question. Mr. Powell?

MR. POWELL: Thank you for inviting me to speak here today. I really appreciate it.

I would like to first give some background on our company and the situation that we ended up getting into, and I will provide a couple of comments on the sentencing guidelines.

AMSC is a 25-year-old energy solutions provider that has invested nearly a billion dollars

into its technology portfolio. As of March 31st, 2011, these investments were paying significant dividends. But it was at that point that our business abruptly changed.

Our then-largest customer for our proprietary wind turbine electrical control systems was China-based Sinovel Wind Group, a partially state-owned enterprise.

We began working with Sinovel in 2005, and through our collaboration Sinovel became the second-largest wind turbine company in the world. On March 31st, our relationship with Sinovel changed drastically when it refused to accept $70 million worth of contracted shipments.

Following an investigation, we learned that Sinovel had gotten access to AMSC's wind turbine control software source code and was actively using this trade secreted information within its wind turbines.

The evidence is indisputable. It includes clear documentation of the actual trade secret transfer. Sinovel has upgraded thousands of wind

turbines in China, and a confession and conviction of a now-former AMSC employee.

AMSC is currently engaged in civil and criminal actions against Sinovel in China and elsewhere around the world. As a result of this crime, AMSC has suffered millions of dollars in loss. Its annual revenues have fallen by 75 percent. Its stock price has plummeted by 90 percent, and it has been forced to reduce its employee workforce by 70 percent.

Moving onto the sentencing guidelines, the threat of trade secret theft is very real and the impact can be devastating. Therefore, I urge the Sentencing Commission to ensure that the sentencing guidelines be strengthened to the greatest extent possible to appropriately reflect the seriousness of trade secret offenses.

I have provided my full comments to the Commission in my written testimony. However, today I will only focus on two important points which I believe the Commission should carefully consider.

The first is considering the loss to the

victim rather than the value the defendant company has avoided by misappropriating the trade secret.

The second point is the potential difficulty of producing evidence that the crimes were committed to benefit a foreign government.

I will briefly address each point.

The Commission should consider the potential and actual loss to victims in the sentencing guidelines to ensure that victims of these crimes are adequately compensated.

The amended trade secret statute, 1831, section 1830 — 18 USC § 1831, rather, calls for the penalty to be related to the value of the trade secret to the defendant company, including the costs avoided by misappropriating the trade secret, rather than the actual loss suffered by the victim.

In the case of AMSC, we estimate the cost to reproduce the trade secret to be in the several tens of millions of dollars. In stark contrast, the actual loss suffered by AMSC due to trade secret theft by Sinovel is in the hundreds of millions of dollars — in addition to the $1 billion in losses to

AMSC shareholders.

By setting the fine according to the value of the trade secret to the defendant company, victims of trade secret theft will, in many cases, including the case of AMSC, be left far short of being made whole.

I believe this issue must be addressed in order to have effective penalties for trade secret theft.

The second point is foreign government involvement. Given the rise in state-sponsored trade secret theft in recent years, the potential impact on U.S. companies and the U.S. economy is significant. Therefore, I certainly agree that if trade secret offense was committed for the benefit of a foreign government, a sentencing enhancement should be structured to provide a significant differential sentence.

However, I am concerned that it will be difficult to obtain sufficient evidence to prove the defendant intended or knew the offense was committed for the benefit of a foreign government and the

enhancement would therefore not apply.

Accordingly, I recommend that the Commission consider specifying in the sentencing guidelines that if the defendant is employed by a foreign corporation which is a state-owned enterprise, that the requisite intent would be presumed.

Further, I recommend that the Commission define "state-owned enterprise" as "a foreign entity in which at least a defined percentage of the ownership of the entity — for example, greater than or equal to 20 percent — is owned directly or indirectly by a foreign government, a foreign instrumentality, or a foreign agent."

Thank you for this opportunity to provide comments on this important topic. I am grateful to the Commission for its efforts to help protect against trade secret theft. I hope the Commission will consider my comments and increase the penalties for trade secret theft, in particular that which is done for the benefit of a foreign government. Thank you.

CHAIR SARIS: Thank you. Mr. Debold.

MR. DEBOLD: Good morning, Judge Saris and Members of the Commission. Thank you once again for the opportunity to appear before the Commission and offer the views of the members of our Practitioners Advisory Group.

I certainly do not question that a good deal of the conduct that you have been hearing about both in the written and oral testimony today, which does fall within the definition of "Economic Espionage," can be very serious, very disruptive, and certainly deserving of stiff penalties that will reflect the seriousness of the offense and deter future conduct.

The issue here is whether the current guidelines already adequately account for those problems and those factors, and if not whether the ways in which they do not account for them in individual cases justify the Commission taking action before the end of next month based on the information that is currently available.

We offer a number of reasons in our

written testimony, which I will review right now, why we believe the Commission should not be adding specific offense characteristics or making other systemic changes to the sentencing guidelines based on the trade secret or economic espionage offenses.

The first is very simple. There have been very few sentencings that have involved this kind of conduct. We note in our written testimony that in fiscal year 2011 there was not a single case where the primary offense was section [1831], which is the more significant of the two offenses.

I think you heard testimony this morning that there had been a handful of prosecutions or investigations involving that particular statute. The number of cases for section 1832 is not a whole lot higher.

So the Commission is now looking at a very small number of cases, case studies, where it will have to make decisions about what to do about prosecutions in the future, which we are being told will probably be a significantly larger number based on the way in which these offenses have been

committed.

The second reason, and probably the most important reason, to be cautious in this area is that we have few if any examples in the testimony today or elsewhere of sentences that have been imposed where we can answer all of these questions: Was the sentence too low? And if it was too low, what was the reason why it was too low? And if we the reason why it was too low, is there something the Commission can do and should do across the whole spectrum of trade secret offenses in order to account for that problem? Or is it something that is peculiar to particular cases and may be addressed more appropriately through upward departures, including current upward departures?

What I would expect to see in these kinds of cases, and what I would expect to hear from the government in particular, is examples of cases where the sentences were low.

We did hear a couple today which, as I understand it, were guilty-plea cases, one of them involving significant cooperation. What we would

like to know is why those offenses, why those cases, were pled guilty at those lower sentence levels? What is the reason why the sentence came out so low?

Was it because the guideline range was too low, because the offense did not adequately, or the loss associated with that offense was not adequately accounted for in the guidelines?

Was it because there was some factor that was present in the case that the guidelines simply didn't account for?

And is that a factor that we are seeing in other cases such that we should have a systemic change to the guidelines to account for that factor?

What I heard mostly was that there are actually very stiff sentences in these cases. Our newest — one of our newest PAG members, Dave DuMouchel from the Sixth Circuit, was involved in the Yu case which is mentioned in the government's written testimony, where a sentence under a guilty plea of 70 months was imposed for theft of trade secrets involving the Ford Motor Company. That, to me, to us, sounds like a very stiff punishment, and we

haven't heard any reason to believe that people will be more deterred from helping foreign governments if the sentence is 90, or 100, or 120 months.

So we don't really have the good examples to look at and say here's a sentence that's too low. Why is it too low? If it is too low, is there something we can be doing about it?

We don't even know if judges are getting to those lower sentences, to the extent they exist, by varying downward, which is a problem the Commission is not going to be able to solve by making changes to the specific offense characteristics.

I noticed in the other written testimony, and the Department of Justice letter, there's a case from General Motors where the harm, the loss it caused is over $40 million. Well that would lead to a sentencing range of 78 to 97 months with no other enhancements. Again, no reason to believe that that is not a significant sentence that would deter others were that sentence imposed.

To Mr. Powell's credit, his letter notes that there are, in simple theft of trade secret

cases, when you get to the higher dollar amounts, you are looking at real time that people are facing because of that loss amount.

To the extent that the loss is not adequately accounted for in the guidelines, we need to know why that is the case, especially because in the current guidelines under the application notes that are mentioned in the Commission's own issue for comment, in the case of proprietary information such as trade secrets the cost of developing the information, or the reduction in its value that resulted from the offense, is also part of the loss.

So certainly I would expect in Mr. Powell's case that the significant harm that he has discussed before you today would certainly be something that a sentencing judge could take into consideration, and probably would take into consideration, in setting the loss amount where there is successful prosecution of the individuals in that case.

The fourth reasons why we are urging caution is that a lot of these cases involved a

peculiar factor that is not present in a number of other fraud cases, which is the involvement, the explicit involvement, of foreign governments and other foreign instrumentalities.

I have not heard any evidence or any explanation for why China, the government of China, would be deterred from trying to recruit people to steal trade secrets and have them benefit the Chinese economy and the Chinese government simply because the penalties for individuals who may be recruited to help them go up. There is just no reason to believe that those penalties (a) are too low as it is now, or (b) that increasing those penalties is going to cause people to refuse the Craigslist invitations that we heard from in the earlier testimony.

Also, the other reason why this is an important factor is that as recently as Monday the U.S. government was encouraging, and actually chastising the Chinese government, for not taking a proactive role in preventing companies within China from misappropriating trade secrets.

And so this is a problem that can be

addressed from a number of different angles, not just from the angle of increasing the penalty should the case be prosecuted.

Also related to that, we've heard a lot of evidence, or a lot of discussion about how these offenses often occur in foreign countries, or the actors are acting outside of the United States. Again, you already have an enhancement that deals with that factor. It's the sophisticated means enhancement which specifically addresses when a significant amount of the conduct occurs outside of the United States.

Now there may be some tweaks that are appropriate that we would be willing to consider to address some of the peculiar circumstances of trade secret theft, but again no reason to believe that we don't already account for that factor adequately with a two-level enhancement.

The fifth factor, and the final factor, is that the guideline that would be amended here, 2B1.1, is itself overdue for what we believe to be a very major overhaul. And the Commission has actually

embarked on a multi-year effort to re-examine that guideline.

It makes little sense to us to add more specific offense characteristics when in our view one of the biggest problems with the fraud and theft guideline is the proliferation of specific offense characteristics that, as the Commission's own issue for comment notes, often overlapped with one another and create this aggravated form of increase where you have multiple factors accounting in large part for some of the same conduct.

To us, making that change now, adding more specific offense characteristics would be like putting a lot of time and money into adding a floor to a building while neglecting the urgent need to repair the foundation of the building before you make any other improvements to it.

In our view, there is a better way to approach this. The Congress has asked the Commission to study this and determine whether changes are needed. Based on the evidence to date, we don't have enough information to make that change.

The Commission could simply add to the commentary of 2B1.1 a summary of Congress's directive. It could state the Commission realizes that there is a large potential for variability in these kinds of cases, and that some of them can cause some very serious harm to the U.S. and to U.S. companies.

It could state that the current 2-level enhancement is not meant to capture all of that type of harm; that there could be other kinds of harms that would be caused that would be more serious than the current enhancement allows for. And it could therefore encourage judges, through their sentencings, and through their statements of reasons for sentences, to communicate to the Commission where it is that they see the problems with the guidelines and why they may have needed to vary or depart upward in order to account for those characteristics.

Once the Commission has that additional data, which we are told is going to occur because of the increase in prosecutions in this area, the Commission can better make a decision about what

changes are needed to the guidelines versus what changes can be accomplished through the judges in the rare cases where the guidelines are inadequate can then enhance the sentence for those factors.

Thank you very much.

CHAIR SARIS: Thank you. Mr. Hirschmann.

MR. HIRSCHMANN: Chair Saris, Commissioners, thanks for including the U.S. Chamber in today's discussions.

I lead the U.S. Chamber's Global Intellectual Property Center. It's a group that was formed when a collection of industries came to us five years ago and said that the theft of intellectual property was increasingly a threat, not just a nuisance, not just a loss to the business, but a threat to the entire enterprise.

If we've learned anything in the last five years, it's that the list of enterprises threatened by intellectual property theft and trade secret thefts is never ending. It is not just in the business to consumers base, it's clearly in the

business to business base. And so I think Congress has responded appropriately by passing the Economic Espionage Act.

Today I would like to make really three points:

First, or maybe reinforce three points that have been made by others. First is, trade secret theft is on the rise and it is rampant.

Second, it is hard to detect and hard to value.

And, while we agree with Mr. Debold that, as this Commission always does, it should proceed with caution and based on evidence, we do think the deterrent level penalties need to be enhanced — not just for our own purposes, but also to send the right signal as the USTR indicated earlier today, as we move to elevate the standards internationally.

Our Intellectual Property Center believes that the combination of right rules to right enforcement, and probably equally important is — if not more important — the right self-help from companies. We do not believe enforcement is the only part of the

answer, but it clearly is an important part of an effective response to the growing threat of intellectual property theft.

So on behalf of the broader business community, I am here this morning to urge you to adopt appropriate deterrent-level penalties for trade secret theft, including minimum penalties that include some amount of imprisonment.

These are necessary to deter the crimes that threaten American business and competitiveness and the jobs of American workers.

Trade secrets have been well described this morning, but I think it is important to re-emphasize just the variety and the types of trade secret thefts that may be almost anything from the formula to a popular soft drink, to a manufacturing technique, to a computer algorithm, and it doesn't even begin to describe the significance to the companies that hold them.

It has been estimated that on the S&P 500 alone, 81 percent of the market value is derived from their intangible portfolios. And we heard one very

stark example on this panel.

Trade secrets are often the crown jewels of a company because that formula may make their drink uniquely appealing. That technique may lower their cost of production, or that algorithm may make their service superior.

Trade secrets are nothing short of a company's competitive advantage in the marketplace. It is the basis on which our country competes globally, and the basis on which our country succeeds internationally.

And that is precisely why others covet them, including even some foreign governments. Unfortunately, the theft of trade secrets has reached epidemic proportions, as I mentioned. Measured by the number of civil cases in federal courts, trade secret theft has grown exponentially and even more quickly over the last 10 years, certainly with no sign of slowing down.

Translating that increase into estimates of business losses is staggering. From hundreds of millions of dollars by individual companies to

$13 billion lost by a group of companies collectively over a period of 6 months, to over $1 billion lost by a single company in a matter of only days. This is a scenario that makes executives wake up in the middle of the night in a cold sweat.

The reality is understood not only throughout the business community but in Congress and the Administration as well. The law that brings us here today, the Foreign Economic Espionage Penalty Enhancement Act has enjoyed bipartisan support in Congress, was supported by the Administration, and was lauded by the Chamber.

As you know, the Administration's intellectual property enforcement coordinator recently released an enforcement strategy particularly directed to reducing the theft of trade secrets from American companies.

I don't think there is one simple solution here, and we are not going to be done with finding the right answers to address this problem, but I think it would be a mistake by the Commission not to respond to this growing consensus and broad consensus

as it considers its appropriate next step.

The advent of digital technology and the interconnectedness of the Internet have been incredible boons to companies and consumers alike. They have brought us new services, innovation, creativity, and opened new markets.

To put it simply, the Internet is creating all kinds of new businesses, and it is 99 percent wonderful, as one of our members described it. We strongly agree with that. And we should certainly be very cautious in doing anything that would interfere with that. But criminals also abuse this system, and the theft is growing at an unprecedented scale.

Deterrence is the goal. We seek to reduce the amount of trade secret theft by intimidating the potential thieves away from that course of action. Once the theft has occurred and the crown jewels are out the door, seeing the thief prosecuted is surely justice but that is scant consolation for the people laid off because the company lost its competitive advantage. And that competitive advantage cannot simply be regained by paying a penalty.

We recognize that deterrence is also formed involving risk of detection and the risk of convention. Both of those are we believe factors in favor of effective penalties. As has been in the case in other contexts, those engaged in the theft utilizing the latest technology are difficult to track down and thus have a degree of confidence that their crimes will not be detected.

In addition to the low risk of being detected and caught, thieves may indulge their hopes because of the low risk of prosecution and the high standard of evidence sufficient to reach the level of proof needed from criminal convictions.

The final variable in the deterrence equation of course is the potential profitability of the crime. As discussed above, the value of trade secret theft is tremendous. That of course translates into incredibly high profit potential for the thief.

In fact, we have seen many examples where criminal enterprises have moved away from other types of theft and other types of crime, specifically

intellectual property crime, because it is so much more profitable.

This is almost a perfect storm of high potential profits and low chances of detection, and successful prosecution means that to achieve deterrence severe penalties must also be available and applied.

Intellectual property, trademark patents, copyrights, and trade secrets are the foundation of a tremendous part of the economy. Collectively, IP-intensive industries provide over 55 million American jobs, over $5 trillion in output, and 74 percent of the American exports.

It is no wonder that these industries and their valuable IP are the envy of the world and a target for thieves. Companies spend untold millions fighting to protect their innovation, and we always believe that the business community should start by doing self-help wherever it can by protecting its systems, by pursuing civil, but we cannot do it alone. Law enforcement is a partner here and has a critical role.

We urge you to provide the right rules for criminal trade secret theft, to protect American companies' competitiveness, and our economic wellbeing. Thank you.

CHAIR SARIS: Thank you very much. Let me ask this. One of the things we have been hearing about is the difficulty in proving that a foreign entity or instrumentality is the person who is receiving this trade secret.

What do you think, Steve, about creating a definition along the lines that Mr. Powell suggested, some definition of a state-run university, or a 20-percent ownership by a foreign entity?

MR. DEBOLD: We are not aware of that being the problem, that we can't adequately define what the foreign instrumentality, agent, entity is; that the issue that we have heard — and again we don't see a lot of information about it — but we have heard the government talk about how the problem is showing that that entity, whatever it is, which meets whatever the definition is, is actually the intended beneficiary of the information.

We don't have a problem with coming up with factors that a court might consider to deal with the question that you specifically asked about. I don't know that we would want to set a rigid rule that says it is always a foreign entity if it has this particular attribute to it.

But not seeing a problem with that particular issue, we don't have — we don't see a lot of need to make it a definitional type of change. But if one were to be considered, we would not recommend doing one that has, you know, a hard and fast rule of if it's 20 percent, ignoring all other factors, then it's a foreign entity.

We would certainly be willing to consider that kind of a factor as one among many to be considered in deciding whether it's a foreign instrumentality.

CHAIR SARIS: So just following up, Mr. Powell, you seem to think it was a problem in your case, understanding who the beneficiary was?

MR. POWELL: Yes. I mean, I don't know for sure but, you know, if the — in our case it was

state-backed, the theft. But with the state-owned enterprises, they are quasi-commercial, quasi-state owned. And I think it will be, you know, I'm sure in the end it will benefit, has benefitted the state. Because in our case, Sinovel is the sort of golden child for the state of China in terms of the wind turbine industry.

CHAIR SARIS: Well did China own 20 percent of it?

MR. POWELL: Yes. There is a state-owned enterprise called Dahlean (phonetic) Heavy Industries that is 100 percent state-owned, and they own 20 percent of Sinovel.

CHAIR SARIS: That's where you got that number from, is from your case?

MR. POWELL: Yes. So you can see how they can set these enterprises up so they may not appear to be state-owned, but in fact they do have state ties and state ownership interest.

MR. DEBOLD: And my fear in having a set number like that is, then if people are really paying attention to what you do, which I think by and large

they do, that, you know, then they'll set it up to be 19 percent, but they'll have some other factor that gives them control.

CHAIR SARIS: You may not want to say —

MR. DEBOLD: It's hard to, you know, draw the lines very clear because then you encourage people to evade them. A totality-of-circumstances type of approach is usually better.

VICE CHAIR JACKSON: I am interested in the testimony regarding — oh? Did you —

CHAIR SARIS: Oh, did you have something Judge Hinojosa?

COMMISSIONER HINOJOSA (By Video): Yes. Mr. Powell, in your written testimony, as well as what you have said today, you have mentioned that there are cases in China in both civil and criminal courts, and what is the status of those cases?

MR. POWELL: They are proceeding extremely slowly. We have been — on the IP cases, we filed them over a year-and-a-half ago and we haven't even gotten out of the procedural phase. Sinovel is taking the

approach that the cases don't belong in court, they belong in arbitration.

We have submitted all the evidence, all the clear-cut evidence, but we are just moving along very slowly. I don't have any real feeling that the cases will — the speed of the cases will increase. I think it is a very slow, drawn-out process and it is intentional.

COMMISSIONER HINOJOSA (By Video): And the reason there is no civil action in the United States is what?

MR. POWELL: We are considering other avenues that I can't really speak about at this point, but we are — you know, we are looking at civil actions, but that action has been delayed so far due to other avenues that we are pursuing.

COMMISSIONER HINOJOSA (By Video): And is there any criminal action that's in the works in the United States?

MR. POWELL: I can't speak to that.

VICE CHAIR JACKSON: A common theme that has come up in the testimony of people who are

encouraging the Commission to act, and encouraging greater penalties in this area, is deterrence. And I know, Mr. Hirschmann, that is a central theme in your testimony.

And I am just wondering the extent to which greater imprisonment penalties on individuals who are prosecuted for these kinds of crimes are going to influence, you know, the activities of either rogue nations, or these enterprises, the quasi-state enterprises, as Mr. Debold mentions this, and it is something that is a little troubling to me in the sense that we ordinarily try to influence corporate action through fine rather than, you know, increased penalties on individuals in the imprisonment area.

And so I am just wondering if you can comment on whether we are going to be able to achieve the kinds of deterrence that you think is necessary with increased imprisonment?

MR. HIRSCHMANN: That's a good question. And the first order, I think what I would urge the Commissioners to consider is that there's something

about cyber theft that people tend to come to believing that it's a victimless or a harmless crime to begin with. We're not asking that the penalties here be greater than in the physical world, but certainly we need to understand that that is the case and make sure that our penalties keep up with changes in technology.

I do think that there is a — you know, in the first order the deterrence is going to be on the individuals. And because sometimes the size of the valuation is hard, that we do have to marry it with effective penalties.

But in the second order, I think, you know, Assistant U.S. Trade Rep McCoy made a good point, which is we do hope that the leadership would provide on this issue in the United States will then be adopted elsewhere, and that ultimately that will have an impact on foreign governments.

So it's a second order, but it is not an "either/or". You know, what you do here today probably will not immediately deter foreign governments, but then it will be used to strengthen

the rules internationally.

VICE CHAIR JACKSON: What about domestic corporations? I know that in your testimony you talk about your member companies identifying three different sources of the trade secret theft. So there are the individuals, the hackers, et cetera; and then there's theft by competitors.

Do you see — is that a big part of this problem, where corporations are actually sending people out to engage in this kind of conduct?

MR. HIRSCHMANN: Well I think that that certainly isn't the part of this that is growing — it is certainly a problem. It is a piece of it. It is not the part that is growing the most dramatically.

What is different about this is that there are state-sponsored actors who are equipped with incredible technology depth and ability. It is the capability that is so much greater when it is a state-sponsored effort.

VICE CHAIR JACKSON: Thank you.

CHAIR SARIS: Thank you. Did you have —

COMMISSIONER FRIEDRICH: I do, but —

CHAIR SARIS: Go ahead.

COMMISSIONER FRIEDRICH: Mr. Debold, why doesn't DOJ have a point that, just for simple theft of a trade secret, for that basic offense, why we don't need increased penalties to bring this offense — these offenses, which are sentenced under 2B1.1 in line with those copyright and trademark and other intellectual property offenses that are sentenced now under 2B, what is it?

CHAIR SARIS: 5.3.

COMMISSIONER FRIEDRICH: 5.3. Tell me, and under that guideline, as I'm sure you know, there's a plus-2 enhancement for items entering the stream of commerce, as well as the loss table.

So I am just curious. Don't they have a point, putting aside the more serious economic espionage offenses, just with respect to the enhancement that now exists in 2B1.1, should it be simplified? Should there just be simple theft would be sufficient for two-level increase?

MR. DEBOLD: Well we have not studied what

the sentences are like under 2B5.3, but my concern would be that unless you take the most simple approach, which would be just to send all of these offenses to 2B5.3, and then think about whether 2B5.3 needs something that is peculiar to trade secrets versus infringing copyrights and infringing trademarks, the problem with bringing 2B1.1 two levels higher is that you now have all these other specific offense characteristics in 2B1.1 that don't appear —

COMMISSIONER FRIEDRICH: Which ones in particular are you concerned about with these offenses that will kick in, other than the Loss Table?

MR. DEBOLD: Well you have the current trade secret one, where you have the intent —

COMMISSIONER FRIEDRICH: Right.

MR. DEBOLD: — or the actual —

COMMISSIONER FRIEDRICH: But if that were changed, if that were simplified, what other SOCs?

MR. DEBOLD: The ones that we point out in our written testimony where you have a potential for

duplication, there's the sophisticated means Enhancement, which will often deal with some of these foreign — the conduct that originates in a foreign nation, or is intended to benefit a foreign nation.

You've also got the — in the business of receiving stolen property enhancement. You have — and I have not gone through the full list here, but there are a number of — there are a greater number of enhancements in 2B1.1, and we would definitely want to think about whether you are effectively taking 2B5.3 and adding more enhancements to that as a substitute for either putting the offense in 2B5.3, or looking at whether 2B1.1 is sufficient as it currently operates but may need some adjustments to account for some of the things that I mentioned that require more data, which is: Are there peculiar harms that are happening in these trade secret cases that you don't see in the copyright and infringement cases, that you don't see in a typical fraud case where we just don't know if they're happening often enough to warrant an additional enhancement within 2B1.1.

CHAIR SARIS: Jon.

COMMISSIONER WROBLEWSKI: Thank you. Mr. Debold, I have really a three-part question. There are three parts because it is the way I summarized for myself your testimony that the Commission should not act because the Commission doesn't know enough about these things. Number two, it can't deter China. And number three, there should be multiple approaches to this beyond just criminal enforcement.

On the first one, I just want to ask sort of a philosophical question. The Commission deals with certain crimes where the government prosecutes thousands, or even tens of thousands a year — so immigration, and drugs, and certain kinds of fraud — where there are thousands and thousands of cases, but the government also prosecutes certain crimes that happen actually very infrequently, thank goodness: terrorism, civil rights, adulterated drugs, espionage, even in the federal system homicide is prosecuted pretty rarely.

Just as a philosophical matter, the first

part of my question is: When do you think the Commission should address those? And when do you think the Commission shouldn't address those?

So, for example, if there are only handfuls of espionage cases, should there be an espionage guideline for a handful of those cases?

Second, on the deterrence issue, I found it interesting that you thought that the Commission shouldn't make any definition because you thought it would change the conduct. Yet, at the same time, you think that deterrence — that if they raise the penalties there won't be deterrence.

So I am curious if you can try to reconcile for that.

And then also, obviously the primary goal here is not necessarily to deter the government of China, but it is to deter individuals who might answer the classified ad and respond and then work on behalf of China. So if you could address that.

And then finally, the multiple approaches. There was testimony, and I'm sure you are familiar with the White House's White Paper on Intellectual

Property, and it obviously has multiple approaches to this, enforcement being only one of them. So if you can try to reconcile those things for me, I would appreciate it.

CHAIR SARIS: Would you repeat that, please?

(Laughter.)

MR. DEBOLD: I may need that, but let me start with where you started. Which is, you've got other examples where there are few offenses but the Commission obviously has to deal with them. But our main concern, which was I think my second point, is that in addition to the fact that there are very few prosecutions to date and sentences to date, is that we are now going to a guideline that does apply to a very broad number of offenses.

And we are dealing with a type of offense, economic espionage, trade secrets, et cetera, where the conduct, although it does not occur very often and is not prosecuted very often, could cover a very broad range of activity.

And so our concern is to go into a

guideline, 2B1.1, that applies to a very large number of offenses and to start adding specific offense characteristics that are meant to address a small universe of cases, and then an even smaller universe of circumstances, could have unintended consequences for other cases that arguably are covered by that new specific offense characteristics.

COMMISSIONER WROBLEWSKI: Could you give me an example? Because if the Commission defines these enhancements as they are proposing, or they are thinking about trade secrets, foreign governments, what other kind of fraud cases could be swept in?

MR. DEBOLD: Well trade secrets is a very broad concept. Stealing proprietary information from a company could cover a very broad category of behavior. And our main concern is that we have only had a very small number of prosecutions under the statutes in which they are specifically addressed, 1831, 1832, and a few others.

If there are one or two cases where the current 2B1.1 doesn't capture a particular characteristic, our view — and this is also in terms

of keeping the guidelines simple, or not overly complicating them — that if we have that coming up in one or two cases, that is a departure factor. That is not something that requires the Commission to go through and make changes and make the guideline more complicated.

That is really our main concern, is that you do not have enough information to know, are these special circumstances requiring the much higher sentences, are they occurring often enough that we need to encapsulate them in a specific offense characteristic, rather than taking advantage of what we already have in the application notes, which is that if the amount of loss — which is the primary driver in 2B1.1 — understates the seriousness of the offense, then a judge should articulate why that requires a higher sentence.

As for the deterrence point, I was simply making the observation that when you try to create a bright-line rule for whether something is a foreign entity or not, you do run the risk that if people are paying attention to that definition then they are

going to be incentivized, whether they follow it or not, but they will be incentivized to then manipulate things so that they don't fall under that definition.

I was taking as a given that people are paying attention to that. I don't know that they necessarily would. But I think as a general proposition, the Commission should be careful not to come up with a rigid definition of something where the factor that you are focusing on here, percentage ownership by a state entity, may not be the only reason why you would consider an entity to be state-owned or state-run or state-influenced.

In terms of taking the multi-faceted approach, our point there is that this is a type of offense where there's probably going to be more that can be done to influence the real drivers behind this conduct, which in many cases are foreign governments, by working at a diplomatic level.

And one of the things that the report that you referred to says that we really do agree with is that the U.S. government can get a lot of attraction by encouraging other countries to enhance their

enforcement mechanisms so that they match the mechanisms we already have in place in this country. It doesn't require us to raise the penalties in a small number of cases for us to be able to tell other countries, look, this is the kind of law you should have. These are the kind of penalties you should be getting.

People are getting 70-month sentences, 80-month sentences in the United States already. We don't need to make them 100, 120 months, or whatever, in order to make that point in terms of dealing with the diplomatic side of things.

CHAIR SARIS: You know, I've been a judge since 1986. It's hard to believe — and I've had innumerable civil trials dealing with theft of trade secrets, everything from customer lists, to chocolate chip cookie recipe, to really serious source code kinds of issues. And so they come up all the time in the civil context. And I think I've never had a criminal case for theft of trade secrets.

So I am trying to draw on my civil experience to think how difficult it would be to

calculate loss, just thinking about the kinds of testimony that I hear.

Am I hearing you say that maybe what we should do is have a separate guideline that maybe deals directly with trade secret, rather than pack it all into 2B, which as you say we're studying, and maybe deal directly with the issue of, all right, there are going to be more prosecutions for trade secrets. It's now become a priority. It's now something that we should think about just the way we think about criminal infringement of trademarks, or criminal infringement of copyright.

Maybe we should have a separate guideline that deals with trade secrets, deals with the difficulties in calculating loss and gain and these kinds of things, and deals directly with these issues of state-sponsored espionage. Would that be a better approach, from your point of view?

MR. DEBOLD: We would be very open to that, because it would allow you to then focus in on what the real underlying offense is and write a guideline that was specific to that.

And you do have the benefit of the fact that you already have 2B5.3, which gets at the same kind of conduct, albeit a different statutory violation, but you're dealing with the property of a company in terms of a trademark or a copyright.

It's a similar concept. We definitely would be willing to look at that as a way to deal with this, as opposed to adding more specific offense characteristics to 2B1.1 and then hoping that those capture what the government is really concerned about in a handful of cases where the penalties are feared to not be significant enough, again in the face of no evidence to our knowledge of any particular case where the penalties have been insufficient.

CHAIR SARIS: It's just the theft of trade secret at Level 6 seems very low, I mean because sometimes they can be very serious offenses. So that seems not proportional to what's happening in criminal infringement of copyright or the like.

And yet you also have these loss tables that drive it up —

MR. DEBOLD: Right.

CHAIR SARIS: — and we're hearing that the loss tables are so hard to apply that we don't even have proposals how to fix it.

MR. DEBOLD: Well we're hearing that, but I haven't seen specific cases where somebody has been able to say this is why we can't apply the loss table to this kind of — especially when you have the application note that takes into account in determining loss the cost to develop the information in the first place.

If a company like Mr. Powell's company spent as much money as he has told you developing the proprietary information that was necessary for this technology, that certainly is something that a judge would take into account if there were a criminal prosecution in that case.

I just haven't heard any examples of cases where the government has been unable to do this. And the examples they keep throwing at us in the written testimony are examples where they identify the harm and tell you it's a big problem because of the financial impact it has had on the victims of the

offense.

So we are just not seeing — for us, there is a disconnect between the complaints about how serious this offense is and what the current guideline would do those offenses.

COMMISSIONER FRIEDRICH: But we have heard from the government that in some of these cases there are no research and development costs. We've heard that, if not in the written testimony in some comment. And also, you can see how when the stock price falls how you tie that to the theft and is a very hard calculation to make.

I mean, it seems to me, regardless of whether we have that example in the materials, it is an obvious point that in those cases where there aren't significant research and development costs and the stock takes a big dive, it is going to be very difficult for a court to tie that directly to this theft in all cases.

So it's —

MR. DEBOLD: Right. I have heard the government say that there are cases where you can't

quantify, or at least show a lot of R&D costs. But I would really like to look at that individual case, or those individual cases, and see what it is that's really going on there and why is it that if it's a serious problem, a serious harm to the victim, why isn't the loss amount, including intended loss which is a very broad term, why isn't that loss amount capturing it?

And if it's not capturing it, is it because of something very unique to that case that means that's an upward departure versus changing the guidelines to have a 6-level enhancement in the aggregate for, you know, a large number of cases? Or is this something that maybe we do need to build into the guideline?

But I just haven't seen enough information for the Commission to take that leap.

MR. HIRSCHMANN: I would just add to the loss, the point I think was made earlier, which is when something is stolen you can replace it. You can calculate that. But the cost of regaining competitive advantage in a global marketplace is very

difficult to calculate, and very unpredictable to achieve.

COMMISSIONER HINOJOSA (By Video): Mr. Hirschmann and Mr. Debold, both of you mentioned the international aspect of this. And so my question is: Obviously other countries have dealt with this, are either one of you familiar with anything in what other countries have done?

You have mentioned how the United States should take the lead here, but is there anything in what other countries have done that you feel is something that we should look at from the standpoint of a solution to this issue?

MR. DEBOLD: I have not looked at that, and I'm not familiar with what other countries have done in this area, so I'm not able to answer that.

MR. HIRSCHMANN: Assistant Trade Rep McCoy in his testimony mentioned what Taiwan has done. It's still early in the stage there, but clearly it is something that many of our trading partners are trying to deal with. But I don't think anybody has a complete answer yet.

CHAIR SARIS: Any more questions?

(No response.)

CHAIR SARIS: All right, well thank you very much. This was useful. A lot of food for thought. We will take our break and come back in 15 minutes or so. We're a little ahead here.

(Whereupon, a recess is taken.)

CHAIR SARIS: I think we have got the whole panel. Whether other people are outside, I don't know, but we are onto a very different subject right now with the Supreme Court case *Setser*, how do you go about calculating prison sentences, and 3E1.1, very important issues on acceptance of responsibility.

On this panel I would like to introduce Charles Samuels, Jr., who is the director of the Federal Bureau of Prisons, and who has served in numerous positions in BOP. Mr. Samuels has a B.S. in social and behavioral sciences from the University of Alabama in Birmingham, and graduated from Harvard University Executive Education Program for Senior Managers in Government.

I want to welcome you back. Mr. Samuels has been very generous with his time in helping us on many issues, including the prison overcapacity issue. So thank you, very much.

Vijay Shanker is the senior — now why do I have — is the senior counsel to the assistant attorney general. Previously he has worked in private practice in the areas of white collar criminal defense, complex civil litigation, and appellate litigation. He graduated cum laude from Duke University and received his J.D. from the University of Virginia School of Law. Welcome.

And last but by no means least is Lisa Hay, an assistant federal public defender in Portland, Oregon. She is a graduate of Yale University and Harvard Law School, and I am very proud to announce that she served as my law clerk. So I know the quality of her work firsthand as outstanding.

And I am embarrassed. I'm looking at you, and I don't have another name here to introduce you.

MR. SAMUELS: Madam Chair, I would mention

that Craig Pickles is here with me from the Bureau of Prisons, and he is my subject matter expert relative to sentence computations, and he is joining me as well.

CHAIR SARIS: All right, so just his full name again is?

MR. SAMUELS: Craig Pickles.

CHAIR SARIS: Pickles?

MR. PICKLES: Yes.

CHAIR SARIS: Thank you, and welcome as well.

So we will begin with you, Mr. Samuels.

MR. SAMUELS: Thank you, Madam Chair.

Madam Chair and members of the Sentencing Commission:

I appreciate the opportunity to appear before you today to discuss the Bureau of Prisons. I want to start by thanking you for working with us over the years on a variety of issues.

I look forward to our discussion today about the proposed amendment issued in response to the U.S. Supreme Court's decision in *Setser vs.*

United States. I cannot begin this testimony without a brief mention of the two tragedies the Bureau of experienced two weeks ago.

Officer Williams was killed by an inmate at the United States Penitentiary in Canaan, Pennsylvania. Lt. Alvaroti was shot and killed on his way home from work at the Metropolitan Detention Center in Guaynabo, Puerto Rico. It was the saddest moment in my 25-year career with the Bureau of Prisons.

We are doing all we can to support the families and staff during this difficult time. We are working closely with the Department of Justice regarding the investigations to bring the perpetrators of these crimes to justice. While we will never forget these tragedies, of course we must move forward as an agency.

I would like to give you a brief overview of the Bureau. We are responsible for incarcerating approximately 217,000 inmates. Systemwide, the Bureau is operating at 36 percent over rated capacity. Crowding is 53 percent at high security

facilities, and 44 percent at our medium security facilities.

We expect the inmate population will continue to increase for the foreseeable future. Leadership at the Department of Justice, Members of Congress, and all of you are interested and concerned about this trend and its impact on the Bureau of Prisons and the federal budget.

We want to do all we can to encourage and support your efforts to try and address these problems. The most direct and immediate way to reduce prison expenditures is to reduce the total number of inmates incarcerated or the number of years to which they are sentenced.

Another way that is effective in the long term is strengthening and building upon our efforts to help reduce recidivism rates for federal offenders.

Forty percent of former federal prisoners are re-arrested or have their supervision revoked within three years after release, and approximately 10,000 former federal prisoners return to our prisons

each year as supervised-release violators.

The Bureau provides programs for inmates to acquire the skills, treatment, and training they need so when they return to the community they can be law abiding and productive citizens.

We are continually looking for new and innovative ways to enhance and expand re-entry programs, and we welcome your ideas and ways to address the issue of recidivism.

Now let me address the proposed amendment to section 5G1.3 of the United States sentencing guidelines.

The proposed amendment classifies section 5G1.3, which provides guidance about undischarged state terms of imprisonment, and also applies to cases in which a state term of imprisonment is anticipated but has not yet been imposed.

The Bureau supports and appreciates this amendment, as we hope judges will be more apt to specify how they want the federal sentence to be run, concurrent or consecutive, to anticipated state terms.

Currently, if the federal court is silent about an anticipated state term of imprisonment, the Bureau runs the terms consecutively consistent with Title 18 U.S. Code § 3584. If the inmate requests his or her federal sentence be run concurrent with the state sentence, the Bureau contacts the sentencing court and inquires as to the court's intent.

Often this results in a delay, and sometimes the court simply indicates it is not opposed to whatever determination the Bureau makes. In such cases, if the offender is in state custody the Bureau can designate the state facility for service of the federal term, in essence concurrent to the state sentence.

Absent such a designation, the federal sentence commences upon completion of the state term. In essence, the term runs consecutively.

The *Setser* decision clarifies the importance of judicial intent regarding anticipated state terms of incarceration. In this way it is helpful to the Bureau as we believe it is preferable

that the court make their intent known so that we can efficiently compute the federal sentence.

As such, we recommend a statement in the commentary encouraging sentencing courts to indicate their intent on a judgment and commitment order as to whether any anticipated state sentences should be served concurrently or consecutively to a federal sentence.

This concludes my prepared remarks. Judge Saris, Vice Chairs Carr and Jackson, and Commissioners, thank you for the opportunity to speak before you today. I am pleased to answer any questions you may have, and I have with me, as I mentioned earlier, Mr. Pickles who is our sentencing computation expert, who is also available to help address more detailed technical questions that you may have. Thank you.

CHAIR SARIS: Thank you. Mr. Shanker.

MR. SHANKER: Thank you. Madam Chairwoman and members of the Commission:

Thank you for the opportunity to share the

views of the Department of Justice on the Commission's proposed amendments to the sentencing guideline regarding acceptance of responsibility, section 3E1.1.

My name is Vijay Shanker and I am senior counsel to the assistant attorney general for the Criminal Division, serving on detail from the Criminal Division's Appellate Section.

I have been involved in cases involving the interpretation of the Acceptance of Responsibility guideline and I appreciate the Commission's effort to address the ambiguities in the guideline, ambiguities that are encapsulated by two circuit conflicts involving the circumstances under which a defendant is eligible for a third-level of reduction under subsection (b) of section 3E1.1.

Subsection (a) of the guideline provides for a 2-level decrease in offense level for a defendant who clearly demonstrates acceptance of responsibility for his or her offense.

Subsection (b) provides for an additional 1-level reduction where, (i) the defendant

qualifies for a 2-level decrease under subsection (a); (ii), the offense level determined prior to the operation of subsection (a) is Level 16 or greater; and (iii), the government has moved for the reduction, stating in that motion that the defendant has assisted authorities in the investigation or prosecution of his own misconduct by timely notifying authorities of his intention to enter a plea of guilty, thereby permitting the government to avoid preparing for trial and permitting the government and the court to allocate their resources efficiently.

The first circuit conflict is over whether the sentencing court has discretion to deny the third level of reduction when the government has filed a motion under subsection (b), and the defendant is otherwise eligible.

The Seventh Circuit held in *United States v. Mount* that an additional 1-level reduction is mandatory once the government determines that the criteria in section 3E1.1(b) are satisfied and the government makes the necessary motion.

Whereas, the Fifth Circuit held in *United*

States v. Williamson that the district court retains the ability to decide whether the section 3E1.1(b) criteria have been met.

The Commission has proposed an amendment that would recognize that it is within the court's discretion to grant or deny the government's motion. Specifically, the amendment would amend Application Note 6 to section 3E1.1 by adding the following statement:

"The court may grant the motion if the court determines that the defendant has assisted authorities in the investigation or prosecution of his own misconduct by timely notifying authorities of his intention to enter a plea of guilty, thereby permitting the government to avoid preparing for trial and permitting the government and the court to allocate their resources efficiently. In such a case, the 1-level decrease under subsection (b) applies."

The Department supports the proposed amendment which generally adopts the approach followed by the Fifth Circuit. Ultimately, the

decision whether to grant the additional level of reduction is the sentencing court's, not the government's. A government motion under Section 3E1.1(b) is a prerequisite to a third-level reduction, but the sentencing court retains independent authority to determine whether the section's requirements have been satisfied.

One of those requirements is that the court was able to allocate its resources efficiently, and the court is in the best position to make that determination. An amendment stating that the court "may" grant the government's motion after making its own determination would be consistent with the discretion already provided to the court and would clarify the Commission's intent and eliminate the circuit split.

The second circuit conflict is over whether the government has discretion to withhold making a motion under subsection (b) when there is no evidence that the government was required to prepare for trial.

The Fifth Circuit, for example, held in

United States v. Newson that the government may decline to file a motion based on interests other than the preservation of trial resources; while the Fourth Circuit held in *United States v. Divens* that if the government determines that the defendant's assistance relieved it of preparing for trial, the defendant is entitled to the reduction.

The Commission has called for comment on whether it should resolve this circuit conflict, and if so, how.

The Department believes that the Commission should resolve the circuit conflict and provide clarify on the scope of the government's discretion in filing motions under section 3E1.1(b) so that this provision of the guidelines is fairly and evenly applied in the federal courts.

The Department recommends resolving the conflict in the direction of the majority of the circuits through an amendment clarifying in an application note that the government may decline to file a motion under subsection (b) even if it was not required to prepare for trial.

Specifically, the Department recommends adding a sentence at the end of Application Note 6 to section 3E1.1 stating that, quote, "The government may decline to file such a motion even if it was not required to prepare for trial if in the government's determination it was otherwise unable to allocate its resources efficiently."

The requirement that the government file a motion before a defendant may receive the third-point reduction was inserted by Congress in 2003 when it amended section 3E1.1 as part of the 2003 PROTECT Act.

Before the amendment, a defendant with an offense level of 16 or greater was entitled to receive the additional 1-level reduction if he had assisted authorities in the investigation or prosecution of his own misconduct by taking one or more of the following steps:

One, timely providing complete information to the government concerning his own involvement in the offense; or

Two, timely notifying authorities of his

intention to enter a plea of guilty, thereby permitting the government to avoid preparing for trial and permitting the court to allocate its resources efficiently.

As a the Second Circuit has said, the PROTECT Act altered that rule by amending the subsection and adding the further element of a prosecutor's motion, thereby making qualification for an additional reduction under subsection (b) more difficult.

The application notes to section 3E1.1 now make clear that a government motion is a prerequisite to the grant of the additional point, stating, quote: "Because the government is in the best position to determine whether the defendant has assisted authorities in a manner that avoids preparing for trial, an adjustment under subsection (b) may only be granted upon a formal motion by the government at the time of sentencing.

Section 3E1.1(b) states the necessary criteria that a defendant must meet to be eligible for a government motion in support of the 1-level

reduction. It does not, however, state that if those minimum requirements are met the government must file the motion.

That interpretation of section 3E1.1(b) follows from *Wade v. United States* in which the Supreme Court held that the government may refuse to move for a downward departure for substantial assistance under both 18 U.S. Code § 3553(e) or sentencing guidelines section 5K1.1, even if the defendant has provided substantial assistance.

The court stated that, although a showing of assistance is a necessary condition for relief, it is not a sufficient one because the government may validly base its decision not to move on its rational assessment of the cost and benefit that would flow from moving.

As a result, mere evidence that the defendant had provided substantial assistance to the government would not be sufficient to trigger further inquiry by the court into the government's decision not to file a motion.

Rather, a defendant is not entitled to

relief unless the prosecutor's refusal to move was not rationally related to any legitimate government end. For instance, if it was based on an unconstitutional motive such as the defendant's race or religion.

When Congress amended section 3E1.1(b) in the PROTECT Act after *Wade* was decided, it inserted language that is identical to that used in section 5K1.1. Upon motion of the government stating that the defendant has assisted authorities, the defendant is entitled to a third-point reduction.

Congress is presumed to have intended the Supreme Court's interpretation of section 5K1.1 in *Wade* to apply to the identical language it inserted in section 3E1.1(b). As a result, section 3E1.1(b) confers, as the court said in *Wade*, a power, not a duty, to file a motion in support of a sentencing reduction.

Although meeting the criteria specified in section 3E1.1(b) is necessary to receive the third-point reduction, it is not sufficient. The government is entitled to refuse to file a motion as

long as its refusal is rationally related to a legitimate government end.

The government's refusal to file a motion can be rationally related to a legitimate government end even if the government was not required to prepare for trial. Before Congress enacted the PROTECT Act, section 3E1.1(b) provided that a defendant would qualify for a third-point reduction if he timely notified authorities of his intention to enter a plea of guilty, thereby permitting the government to avoid preparing for trial and permitting the court to allocate its resources efficiently.

In the PROTECT Act, Congress amended section 3E1.1(b) to provide that a defendant qualifies for a third-point reduction only if his timely notice of his intent to plead guilty permits the government to avoid preparing for trial, and permits both the government and the court to allocate their resources efficiently.

The amended version of section 3E1.1(b) does not include the term "trial resources."

Instead, it explicitly identifies a broader government interest in allocating its resources efficiently that is distinct from the government interest in avoiding trial preparation.

I would again thank the Commission for this opportunity to share the views of the Department of Justice. By resolving these two circuit conflicts, the Commission will promote the fair and evenhanded application of the Acceptance of Responsibility guideline in the federal courts.

Thank you.

CHAIR SARIS: Thank you. Ms. Hay.

MS. HAY: Thank you, Judge Saris, and distinguished members of the Commission:

I appreciate the opportunity to testify on behalf of the Federal Defender and Community Public Defenders. I have worked for the last 15 years in the Federal Public Defender for the District of Oregon, so I hope during the questioning I can give you some examples from my cases on how the topics we are going to discuss actually apply in the deep dark trenches of a case where perhaps commissions don't

always have an unobstructed view. So I look forward to your questions on these.

Let me summarize the positions on both issues that have been raised today.

On *Setser*, the Defenders oppose the proposed amendment to 5G1.3. The Commission's proposed amendment would place an undue burden on the district courts, probably result in confusion, and significant inefficiencies which we all know we can't afford right now.

The issue is this: If the guidelines are amended to require a consideration of unimposed but anticipated sentences, district judges who are trying to apply that guideline will take seriously their responsibility to look at the facts presented about anticipated sentences. They'll try to review what that sentence might be. They'll try to reach a determination. But the reality is, this is often going to be speculation.

The parties are not going to know enough about the anticipated sentence to make this a worthwhile hearing. For example, we won't know which

facts in a state court might determine the sentence. We won't know if the defendant would be guilty of every fact that might come out.

There are a lot of factors that are not decided about an anticipated sentence. So adding that to the guideline will cause the district courts to have to look at all these, but the end result might be the court saying we just don't have enough information.

The amendment is not necessary because the status quo is working right now. The Supreme Court's decision in *Setser* interpreted two federal statutes. It didn't address this guideline at all. So you don't need to amend the guideline.

The status quo right now is that 5G1.3 applies to already imposed sentences, and that makes sense because it is a known fact we can look at. If there is an anticipated state sentence that warrants the district court's consideration, the parties can bring that to the court's attention now under *Setser*, and say *Setser* also allows the court to have the discretion to make a decision about this

anticipated state sentence.

So we would ask the Commission to leave the guideline as it is without changing it because the *Setser* case is brand new. We haven't seen an outcry from the courts asking for assistance on this, and asking district courts to actually make a decision about an anticipated state sentence will result in wasted resources.

If the Commission wants to acknowledge *Setser*, I included some proposed language for the commentary in my written submission.

On the question of acceptance of responsibility, the Commission proposed no amendment to address the serious split within the circuits about this misinterpretation of 3E1.1, Acceptance of Responsibility guideline.

The serious split is about what 3E1.1 actually means. And I would ask the Commission to take action to clarify that 3E1.1 means exactly what it says; that the prosecutor must file a motion for the third-level reduction if a defendant by a timely guilty plea allows the government to save and

allocate resources instead of using them for trial.

That is what the guideline says, and courts who have expanded 3E1.1 beyond that are violating Congress's directive that the 3E1.1 not be changed, not be altered.

The central issue on this Acceptance of Responsibility, the government framed it as does the government have to have expended resources for trial preparation? But I think the central issue is actually what acts of a defendant may a prosecutor consider when deciding whether to apply for this third-level reduction.

The guideline is clear that the only act required of the defendant is the timely notice to enter a plea of guilty. That's the only act the defendant is required to do.

But in many circuits now prosecutors are being allowed to require other acts of a defendant. For example, they can require that the defendant not file a motion to suppress evidence; that the defendant not seek pretrial relief — release; that the defendant not raise issues at sentencing; that the

defendant not appeal.

So these are all actions that prosecutors now are requiring in order to get that third-level reduction, when the guideline itself specifically states the defendant's act has to be timely notice of intent to plead guilty.

In effect, in some circuits 3E1.1 now functions as a sentencing slush fund; that the prosecutor has a 1-level reduction they can hand out or take away to defendants depending on what actions they take or don't take. And this is a terrible result for the guidelines and really contravenes the Sentencing Commission's purposes of transparency and honesty and fairness in sentencing.

It creates a disparity cross the country because prosecutors are handling this 3E1.1 discretion differently in different districts. So I would ask the courts — or the Commission to clarify that 3E1.1 means exactly what it says; that by a defendant's timely notice of intent to plead guilty, if he thereby permits the government to save resources from trial, then that motion should be

granted — that motion should be made.

The confusion about this motion stems from the PROTECT Act, which added the government-motion requirement, but also took away some of the factors that could be considered by the government when it is deciding to make that motion.

Previously, the PROTECT Act included also the defendant had to timely provide complete information to the government concerning his own actions. That was one thing the defendant could do. The PROTECT Act eliminated that and left only this timely notifying authorities of his intention to enter a plea of guilty.

So it couldn't be clearer that what Congress was requiring the defendant to do is only one thing. The courts that have allowed the government to extend that to request other actions of the defendant have far exceeded the guideline.

The government referred to the *Wade* decision from the Supreme Court, and that decision is about the 5K1 guideline, which is actually a policy statement about departures.

The discretion given to the prosecutors under 5K1 is very different from discretion — or from the motion filed under 3E1.1. And in fact the statute is very different.

In the 5K1.1 policy statement that was authorized by 18 USC 3553(a), it says: Upon motion of the government, the court shall have the authority, et cetera, et cetera, to depart. So it is offering the discretion to the court. It is not a requirement that the government file the motion, and the court has discretion whether to follow it.

3E1.1 uses the "upon motion of the government" statement, but it says: Upon motion of the government, if certain factors are met, decrease the offense by one level. It uses the imperative form of the actual guidelines, decrease or increase. So it doesn't include the same discretion for the courts.

The government also refers to the need to avoid preparing for trial, and says that's not the only issue that should be considered; that the government should be able to consider any other use

of resources.

I believe that is a misreading of the guideline as well, because the guideline does not say "avoid preparing for trial or [efficiently] allocate resources," it says "avoid preparing for trial and [efficiently] allocate resources." Before the PROTECT Act, that always had been interpreted to mean trial preparation; that a timely plea of guilty saves trial preparation resources.

After the PROTECT Act, the word "the government" was added in. The government and the courts allocate their resources. But nothing in the PROTECT Act showed that they were intending to extend this beyond trial preparation resources. And in fact the commentary that was added by the PROTECT Act refers specifically to the government avoiding trial preparation.

So to add on the additional benefit that the government can hold off this third level for acceptance of responsibility if the defendant causes other resources to be spent is not within the guideline. So we would ask the Commission to please

clarify the guideline means exactly what it states.

On the last issue for the guideline, we oppose the Commission's proposal to follow the case law and the lone circuit, the Fifth Circuit, that says the district court has discretion to deny the government's motion.

So really we had two issues here. The first is what the government can look at to file a motion, and the second is whether the court has discretion to deny the motion.

This again, the courts have been following the *Wade* rules which refer to 5K1.1, which allows discretion. That's different here. This guideline uses the exact imperative language that all of the other guidelines do. If certain enhancements are found, increase the guideline. If certain enhancements are found, decrease the guideline. That imperative, "increase/decrease," is exactly what is in 3E1.1.

If the Commission were to amend the guideline and say well that's discretionary, that would conflict with every other guideline

interpretation, which says no, when it says increase or decrease, that's an instruction to the district court.

So we would ask the court not to — the Commission not to amend the guideline in the way presented in the published materials, but instead to clarify it in the way the Defense set forth in its written submissions.

Thank you.

CHAIR SARIS: Thank you. I would like to start off asking Mr. Shanker a question. When I first did the research and saw the research on this, I was really surprised because in Massachusetts, to my knowledge, the government has never refused to move for the third point simply because someone failed to agree to a waiver of appeal rights, or that sort of thing.

And I am told in other parts of the country now that that's routine practice. So have you done the research? How many circuits — how many U.S. Attorneys follow one practice versus another practice? And how disparate is it across the

country?

MR. SHANKER: Your Honor, I have not done the research on that specific question. We accept that in Ms. Hay's submission that there is some disparity among the U.S. Attorneys' offices across the country. Obviously U.S. Attorneys' offices have a wide amount of discretion as to how they prosecute their cases.

I think that the real issue here is the legal matter of what the guideline actually contemplates and what Congress contemplated.

CHAIR SARIS: So just to jump in, you agree there is disparity in terms of different U.S. Attorneys' offices following very different practices?

MR. SHANKER: I'm not sure I would agree, necessarily, that it is a wide disparity. I just haven't done the research on that. There is some disparity, and certainly the policy considerations of what the Department wants the Department as a whole to do in terms of what it wants to tie the third point to, that is a policy consideration that the

Department can and should and will consider to try to achieve some uniformity, perhaps consider the appellate waiver issue. All of those are policy considerations.

But we would submit that within the Department and the government's discretion, the issue here respectfully is the interpretation of the guideline as a legal matter. And as Congress wrote the guideline, and as the Supreme Court has said in *Wade*, it is within the government's discretion.

And as the Seventh Circuit said in the *Deberry* case, Judge Posner, this is an entitlement for the government. This is within the government's discretion.

Now the government can't exercise that discretion unconstitutionally or arbitrarily, but as long as its reason for exercising the discretion is rationally related to a legitimate government end then it has exercised that discretion appropriately.

VICE CHAIR JACKSON: Can I follow up by asking you: Must the discretion be rationally related to the end of the allocation of resources?

As I understood your testimony, you said that your proposed amendment would have this notion of allocation of resources being the thing that the government is concerned about, trial preparation being one aspect of that, but then there are other things that go to allocation of resources.

But as I read Ms. Hay's submission, in at least some districts the government is requiring the defendant to agree to things that really don't even go to allocation of resources; that its refusal to stipulate to how the guidelines will apply in a particular case for example.

MR. SHANKER: Well a broad argument could be made that all of those things do relate to the allocation of government resources to the extent that the government has to debate these issues with the defendant. But as a broader point, under *Wade* the government has discretion that is only limited by the Constitution or the limit of — the requirement that it be a legitimate government end.

So it need not necessarily be tied exactly to the guideline's language of allocation of

resources. The Supreme Court said in *Wade* that even though the defendant there had provided substantial assistance, the government was entitled to decline to file a motion because it did not do so for an unconstitutional purpose.

So I think really —

CHAIR SARIS: Are you saying it doesn't even have to be tied to any allocation of resources?

MR. SHANKER: As a legal matter, Your Honor, I think following *Wade*, which applies here because the language is identical, the limits on the government's discretion are really the Constitution and the legitimate — a legitimate government end.

Now as a policy matter —

COMMISSIONER HINOJOSA (By Video): But, Mr. Shaker —

MR. SHANKER: — the government is certainly open to limiting its own discretion as it sees fit, and would explore tying it to the allocation of resources. But as a legal matter, the interpretation of the guideline is governed by *Wade*.

COMMISSIONER HINOJOSA (By Video): But, Mr. Shanker, isn't *Wade* not the appropriate comparison here? Because when it comes to substantial assistance, yes, the government has total discretion, but those have been limited to determining whether there was substantial assistance.

Certainly you don't mean that you could refuse the 5K1.1 because somebody didn't waive their right of appeal, or something like that? The cases that involve substantial assistance and the government's discretion are all related to the assessment of the substantial assistance itself, as opposed to something that had nothing to do with substantial assistance. And so I don't know that that's necessarily a good analogy.

Whereas, the analogy here is the preparation for trial and therefore permitting the court and the government to allocate their resources, as opposed to some of these other waivers of appeal that had nothing to do with the trial.

MR. SHANKER: Your Honor, I would

respectfully disagree. The Supreme Court in *Wade* stated that all parties and the Court acknowledged that the defendant there had provided substantial assistance.

The government's refusal to file the motion was not related to its assessment of the defendant's substantial assistance, the government conceded that the defendant had provided substantial assistance, but it still declined to file the motion. And the Supreme Court held that that was proper and appropriate because the government's refusal was not based on an unconstitutional or invidious basis.

COMMISSIONER HINOJOSA (By Video): What was the government's reason? Was it that it wasn't substantial, as opposed to assistance?

MR. SHANKER: The reason in *Wade* — I will have to refresh my recollection —

COMMISSIONER HINOJOSA (By Video): Because I could understand the difference between "substantial" and just "assistance," and everybody may have — that often happens, that the government for example in court here says there was assistance but

not to the level of substantial assistance as we've used substantial assistance.

But I have never heard them say, because we just felt like not doing it because there wasn't a waiver of appeal, or something like that. It's usually connected to their assessment of the assistance itself.

MR. SHANKER: I respectfully submit that that is not what *Wade* says. *Wade* limits the government's discretion only on the grounds of unconstitutionality or an invidious or illegitimate purpose.

COMMISSIONER HINOJOSA (By Video): But it may well be that it does say that, but not because there was any question as to it wasn't related to assistance, and the government's determination of what substantial assistance is, as opposed to other factors that have nothing to do with assistance.

MR. SHANKER: Again, the Court accepted, and all parties accepted in *Wade*, that the defendant provided substantial assistance. So that was —

COMMISSIONER FRIEDRICH: So what was the

issue in *Wade*?

MR. SHANKER: I'm looking again, Your Honor, at the case right now.

CHAIR SARIS: I remember in oral arguments doing that speedread to get —

MR. SHANKER: Yes, exactly.

(Laughter.)

MS. HAY: Can I comment on *Wade* while he's —

CHAIR SARIS: Yes, why don't you, while he's doing the quick read.

MS. HAY: The reason I believe *Wade* is not the right analogy is, as Judge Hinojosa brought up, it is a different context. 5K1.1 is about departures, which are already discretionary.

It is part of the policy statements. And the language is not in fact exactly the same. It does say "upon motion of the government," but 5K1.1 says upon motion of the government, the court shall have the authority. So it is not mandatory. It is much more permissive.

Whereas, 3E1.1 says "upon motion of the

government" that certain things are fixed, decrease the offense level by the third level. So the instruction to the district court is not "shall have the authority"; the instruction to the district court is "upon motion of the government . . . decrease the offense level."

So I think just the structure itself is set up to be less permissive. In addition, the idea in *Wade* is that there is a cost/benefit analysis that the government can do because it is suggesting — it is making that subjective assessment of whether the defendant has assisted or not.

So the government can make a cost/benefit assessment of did they assist us enough to make it worth it to reduce the sentence. But in 3E1.1, the things the government has to look at are much less subjective. The government has to just look at did the defendant qualify for the 2-level adjustment in part (a)? Was the offense level 16 or higher? And did the defendant by a timely notice of an intent to plead guilty help the government save trial resources and allocate those resources.

So those are not so subjective. Only the last one is a little bit subjective.

COMMISSIONER FRIEDRICH: But the problem with your interpretation is the second phrase that says in addition to "permitting the government to avoid preparing for trial," there's this other phrase, "and permitting the government and the court to allocate their resources efficiently."

So "resources" isn't qualified for either, for trial, point one. And then point two, your point about this is different than 5K because the statute is different and that 5K1.1 says the court "shall" have the authority, and this provision doesn't give that sort of discretion to the court. It's hard to accept that when, I mean the court and the court alone can determine whether its resources have been allocated efficiently. The government can't possibly do that.

So in a role reduction where the court says if there's a minimal role it's going to reduce two, the court is still making that finding: Was there a minimal role reduction?

Similarly here the court has got a — you can't expect the government to know what the court has done in terms of civil cases and other things. So that goes to does the court have the discretion. But the other point is just this phrase. It seems bigger than just trial resources.

VICE CHAIR JACKSON: But not as big as government can do whenever it wants to, without regard to allocation.

COMMISSIONER FRIEDRICH: Well I'm wondering if there are post-*Wade* cases where, if not *Wade* itself, where the government has pointed to other specific things, apart from was there cooperation? And was it substantial? That have driven the decision that the court deemed rational but not unconstitutionally motivated? Are there any cases that you can cite, if *Wade* doesn't go there, that would support your broad interpretation?

MR. SHANKER: Right. Well first, on *Wade* I knew there was a reason I didn't know why the government didn't file. It's because the opinion doesn't say, actually. It just says that the

government declined to file.

And with respect to Ms. Hay, the Court did not say that it was an issue about the government's assessment of whether these assistance was substantial or not. To the contrary, it said that it was based simply on the government's rational assessment of the cost and benefit that would flow from moving.

In other words, the government's assessment of it, the benefit of the bargain that it would obtain by moving, which means that because this is within the government's discretion it is up to the government to determine the costs and benefits that it would gain by basically granting, allowing the court to grant this third level reduction.

But, Commissioner Friedrich, I haven't looked specifically at post-*Wade* cases on section 5K1.1.

COMMISSIONER HINOJOSA (By Video): I've got one question. But, Mr. Shanker, that's the cost and benefit of the assistance itself. The reason there's probably no cases is because everybody has

assumed that that 5K1.1 means what it says, and so does the statute itself with regards to how it is written; that it has to be related to substantial assistance.

And, yes, the government has the right to assess whether it is assistance and whether it is substantial, but there probably are no other cases where the government goes beyond assistance to try to deny it, because it's pretty clear in the statute, as well as in the guideline, that it is related to assistance.

Some would argue that here in 3E1.1 it is related to saving resources for preparation for trial, and I think that is why there are probably no other cases other than *Wade*.

MR. SHANKER: Your Honor, *Wade* stands for the proposition that even if there is substantial assistance and all parties agree, and the government simply decides not to file a motion under 5K1.1, that is unreviewable by a court unless the defendant has made a proffer that the government's decision was unconstitutional or invidious.

VICE CHAIR JACKSON: Mr. Shanker, why —

COMMISSIONER HINOJOSA (By Video): Well you just missed the point that I've made, though, that the only issue there was assistance. And the government's determination as to whether it applies or not, as opposed to any other side issue like has developed with 3E1.1(b) as to whether it is related to the trial, as opposed to preparation for trial and resources for trial, as opposed to other issues.

And, yes, it would be open to debate as to whether some of these qualify or not for that, and that is why I think we have cases that go different ways than we do with 5K1.1.

CHAIR SARIS: Let me jump to Commissioner Wroblewski. We have a good half-hour left, so we have plenty of time here and lots of questions.

COMMISSIONER WROBLEWSKI: Ms. Hay, I have one question of *Setser*. You say that everything is working okay, that what's happening is the parties, if there is an anticipated sentence, state sentence or other sentence that might be imposed, that they

bring that to the attention of the court and the court can make the decision.

Isn't that precisely what this guideline amendment is really trying to do, just telling the court if there is an anticipated sentence, say something?

And then my second question, related, is: If the court doesn't say anything, given what the Supreme Court said in *Setser* that it is the court's responsibility, the statutes do not apply to anticipated sentences as have pointed out they apply to previously imposed sentences, what is the Bureau of Prisons supposed to do?

MS. HAY: So on the first point, I understand the guideline is trying to do essentially what we are hoping is happening already. That is, anticipated sentences are brought to the court if there are sufficient facts.

But the guideline, because it includes the words "anticipated sentence," without clarifying that you know something about it, is going to require that judges, every time there is a possibility of an

anticipated sentence, to try to look at that.

I think in my experience in Oregon, for example, we have many cases where defendants have done what we call "mailboxing," where they go smash mailboxes through a number of different counties —

COMMISSIONER FRIEDRICH: No way.

(Laughter.)

MS. HAY: — steal the mail, try to do identity theft or something like that, right? So the federal prosecutor might come in and prosecute this as possession of stolen mail, and that eases up the burden on the counties so you don't have four different counties with four different district attorneys all prosecuting theft or vandalism. And so there may be no state sentence.

In my view, the federal sentence is high enough and there is none. So we anticipate there could be, but we don't know.

In addition, some of those DAs might want to have a prosecution because there's actually a victim whose mailbox was ruined and they want their day in court. And so one county might want a state

prosecution. But again, we're not going to know what that victim is going to say, if the defendant is going to be able to offer money in advance to pay for the mailbox, if there's going to be some cooperation in the state. So the state sentence is still an unknown.

CHAIR SARIS: But isn't the worst-case scenario the one that Mr. Samuels presented, which is what is going to happen if we say nothing, and he calls us up? It's years afterwards. You barely remember it. And then you say, you know, what are you going to do? I'm going to go, huh? And essentially it's all behind the scenes. It's not transparent. We may not have you to be able to present what would be a fair result.

And so, you know, I am sort of —

COMMISSIONER WROBLEWSKI: Because under the law the judge cannot formally change the sentence. I mean, all we can do is ask for this informal process, which seems — it seems the best we can do. That goes to my second question, of what's the Bureau of Prisons supposed to do?

MS. HAY: I think if the Bureau of Prisons looks at what the second judge says, that would be helpful. Right now if the second judge is a state judge, my understanding is the Bureau of Prisons doesn't necessarily honor what the state judge says.

So if the federal judge first doesn't know anything, enough about the anticipated sentence to make any ruling one way or the other, consecutive or concurrent, you just don't know, then the second judge, the state judge, will have a chance to know: I know what the federal sentence was. I know what my victim is. And the state judge might say: I want this to be concurrent. Or, I want this to be consecutive.

COMMISSIONER WROBLEWSKI: No, but if he is serving the sentence — let's say he is in county jail.

MS. HAY: Right.

COMMISSIONER WROBLEWSKI: And the sentence is imposed in federal court. He is told to come back in 60 days and report to the federal prison.

During those 60 days, he goes to state court and the state judge says I want you to serve 30

days. I want you to serve 30 days right now, and I want that to be concurrent. Right?

MS. HAY: Right.

COMMISSIONER WROBLEWSKI: Okay, he goes into the 30 days. Okay, he gets out after the 30 days. He walks over to the federal prison. How is the federal prison authorized to give him credit for those 30 days?

MS. HAY: That's where the Bureau of Prisons uses I think it's 18 USC 3621, their ability to designate the place of service of imprisonment. and the Bureau of Prisons does now do post hoc designations to say the place where the defendant served his state sentence will be considered his federal sentence. And that means he will get credit for that time.

So the Bureau of Prisons does do that. They have the authority, as they have read the statute, to do that. And I think what is missing right now is, when the state judge says I want it to be concurrent, the Bureau of Prisons doesn't always listen to that. And they have said, no, we can't

because the federal judge was silent.

So what really needs to change, I believe, is how the Bureau of Prisons addresses this before we try to have the federal courts jump in and make some kind of decision about a sentence that we don't know that much about.

COMMISSIONER WROBLEWSKI: But wasn't the whole point —

CHAIR SARIS: Can I just jump in and ask the Bureau of Prisons whether or not you agree with that, that that's one of the options you have right now is to simply designate the state 30 days, given Commissioner Wroblewski's example?

MR. PICKLES: Yes, ma'am. That is one of the options we have. But one of the factors that we weigh in making that decision is contacting the federal court to find out if they are okay with that.

CHAIR SARIS: I see. So you would never do that on your own?

MR. PICKLES: No.

MR. SAMUELS: No.

CHAIR SARIS: And you want us to —

COMMISSIONER HINOJOSA (By Video): Do you really have that option, if they've already served the 30 days?

MR. PICKLES: Yes, sir, Your Honor, if it was after the federal sentence was imposed, and in the scenario he gave he was pending voluntary surrender to a federal facility. So it would have been post-sentencing.

We could have started his sentence when he was locked up by the state. But the problem in this situation is —

COMMISSIONER HINOJOSA (By Video): But the judge in that case would of had to have given a voluntary surrender, although he was in custody, and he wouldn't have just been turned over on a writ, I guess?

MR. PICKLES: Well I think in the scenario you presented, he was on bond waiting to voluntarily surrender to the federal authorities for service of his sentence. And during that time, he got picked up on state charges.

Now the problem with that scenario is,

once he finished those 30 days in his scenario, the state facility released him to the street to go voluntary surrender later. There is an issue with the intermittent time between there that would cause us difficulty, to start his sentence and then stop it after he was released by the state, and then start it back up once he arrived at his federal facility.

CHAIR SARIS: But you say your practice would be to call us, right, and say what do you want to do?

MR. PICKLES: Yes, Your Honor.

CHAIR SARIS: And then do you feel required to follow it?

MR. PICKLES: More often than not, yes.

CHAIR SARIS: That's a different answer.

(Laughter.)

CHAIR SARIS: But let's say I say give him the credit, do you follow that?

MR. PICKLES: Yes, ma'am. Yes, Your Honor.

CHAIR SARIS: And so that basically —

COMMISSIONER HINOJOSA (By Video): Director Samuels and Mr. Pickles — I'm sorry.

CHAIR SARIS: No, go ahead.

COMMISSIONER HINOJOSA (By Video): — I have a question.

Let's say somebody gets picked up by the state on a drug trafficking offense, for example. Then they also then get charged in federal court with regards to some of the same matters that are in the state court case.

They get brought to the federal court on a writ. So they continue to be in state custody. By the time the federal judge imposes the sentence, there has been no state sentence yet.

If the judge does not take that into account and then sentences and recommends that it run concurrent, but then there's a state sentence afterwards that gives him credit from the entire time that he was in the state court period, doesn't that mean that in the federal system he will not get credit for let's say the six months that he was in

the federal system unless the judge makes some credit for less six months because it was relevant conduct that might have affected the new case?

MR. PICKLES: Let me make sure I understand the scenario correctly, Your Honor.

The state arrested him first?

COMMISSIONER HINOJOSA (By Video): Right. And in their custody —

MR. PICKLES: And then before the state imposed the sentence —

COMMISSIONER HINOJOSA (By Video): They didn't —

MR. PICKLES: I'm sorry.

COMMISSIONER HINOJOSA (By Video): They did not impose the sentence yet. It hasn't been pled guilty or tried in the state system. It gets only brought to federal court on a writ, on a new federal charge that has some of the same relevant conduct as the state court case.

The federal judge then sentences the defendant. If the federal judge says I recommend that it run concurrent, the state judge runs it

concurrent, but there was a period of time that our sentence doesn't really begin until we have imposed the sentence on the federal side. Doesn't he lose those six months that he was serving and getting credit for in the state system unless the federal judge makes some adjustment at the time of the sentencing?

MR. PICKLES: Not necessarily, Your Honor. The fact that the federal sentence was imposed first, and it was ordered to run concurrently, we would start at the day it was imposed.

COMMISSIONER HINOJOSA (By Video): But let's say it wasn't ordered to run concurrent; that the federal judge recommends that it runs concurrent and leaves it up to the state judge?

MR. PICKLES: If the federal judge recommends it to run concurrently, we're going to make it run concurrently.

COMMISSIONER HINOJOSA (By Video): From the very start?

MR. PICKLES: Yes, from the day that it is imposed, Your Honor.

VICE CHAIR JACKSON: So we are dealing here with a situation in which the federal court doesn't say anything? Is that what — I mean that's really the —

MR. PICKLES: Yes, ma'am.

VICE CHAIR JACKSON: — crux of the issue. Can I just clarify, Ms. Hay? In your mailboxes example, I understood you — and perhaps misunderstood you — to say that one of the objections was that in that situation we wouldn't even know whether the defendant was going to be prosecuted in state court?

So you're thinking — you are reading "anticipated" as even "anticipated litigation" with respect to this criminal charge, and not just a scenario in which we know there's going to be state sanction, and we just don't know what it is yet?

MS. HAY: Right. Because often the situation is, as Judge Hinojosa was saying, the defendant hasn't been found guilty in the state system even. So we can anticipate that, yes, most likely he is going to be guilty, most likely there's going to be a sentence, but you never know. And in

some cases, there's a reason for there to be some discrepancy between what might happen in the state and what might happen in the federal system.

VICE CHAIR JACKSON: Could we carve that out in the guidelines? Could we somehow deal with that? Because that seems different to me than one in which he has already been adjudicated guilty in the state court and we're just waiting for the sentence.

MS. HAY: Right. Once we try to identify and define "anticipated sentence" in a way more narrowly than the *Setser* decision did, then I think the guidelines get more confusing because then it seems — *Setser* referred to "any anticipated state sentences," and the problems with the proposal that the Commission has are two.

One is that if you define "anticipated sentences" more narrowly to only if the defendant is already guilty, that will be narrower than *Setser* and will cause some concern if it's not consistent.

And second, the Commission's proposal right now isn't limited to just state sentences. The *Setser* decision is just about anticipated state

sentences, and they specifically hold off on deciding what about federal sentences.

So the way the Commission has proposed it now, there is going to be confusion if you have say two federal prosecutions. We have bank robberies in the State of Washington and in the State of Oregon often sentenced together, pled together, but we might have a global deal but the defendant might still go back to Washington and plead guilty and get, we expect, concurrent time.

CHAIR SARIS: So you would suggest carving out federal?

MS. HAY: Well I think it — my suggestion is not to try to amend the guideline right now at all. Because if you don't carve out federal, then you are going to have one federal judge telling another federal judge how their sentence should be, concurrent or consecutive, before it is even imposed. And you just don't know enough about that other sentence to make that decision, I don't think.

If you carve out federal, then I think it is disrespect for the dual sovereignties — you know,

the separate sovereignty of the state that the federal judge is only making a decision about state sentences. Why is that sort of logical or fair?

The Supreme Court in *Ponzi* said we are supposed to offer respect to dual sovereignties, and the state is an equal sovereignty. So I don't think we should in this guideline distinguish between the state and the federal. I think what we should do is let the case law develop under *Setser* and see if it works out.

The main issue would be for the Bureau of Prisons when there's no decision by the federal judge, but the later state judge does say concurrent, for the Bureau of Prisons to respect that without even needing to call the federal judge and say what do you think? That the second decider can say that it is concurrent or consecutive.

CHAIR SARIS: But that's —

COMMISSIONER FRIEDRICH: Sorry to interrupt. Am I misunderstanding? I thought the statute, the default for BOP in that case was to run it consecutively, where the federal judges said

nothing. Regardless of what the state judge says, that they believe their statutory duty is to run it consecutively? Am I correct?

MR. PICKLES: Yes.

COMMISSIONER FRIEDRICH: Do you disagree with that?

MS. HAY: The statute says that if there are multiple convictions and the judge is silent, then the rule of construction is consecutive. We don't consider that a presumption that it should be consecutive. It's more a rule to help decide, if nobody says anything, how it should the sentences should be construed.

CHAIR SARIS: Can I say, no, you don't construe it that way because you're calling up and saying what do I do?

MR. SAMUELS: Yes, Madam Chair.

CHAIR SARIS: So you're automatically doing that, right?

MR. SAMUELS: Yes, Madam Chair. Our position is in support of the proposed amendment. We would prefer to know the intent of the judge on the

front end telling us how they would like for the sentence to be computed and administered by the Bureau of Prisons.

CHAIR SARIS: The federal judge.

MR. SAMUELS: Yes.

COMMISSIONER FRIEDRICH: Ms. Hay, our motivation here was to protect the *Setser* defendant in those cases where the federal judge just hasn't thought about this, but probably would want to run it concurrently. And now under *Setser* it is clear that BOP cannot make that determination.

And I am a bit surprised. Perhaps it's just that there are so few cases that you're not that worried, but your position is basically rely on the litigators, the good defenders, to bring it to the attention of the court.

And then secondly, rely on BOP to make that follow-up call. To me — and I look at your proposed language which is basically to say nothing in this guideline alters the court's authority as described in *Setser* to specify whether the sentence should be concurrent or whatever, what we want is

some flag to the judges, something beyond you being a good advocate — because maybe not all will be — and BOP doing the right thing that's going to protect those handful of defendants.

That was I think the primary goal of this. And we don't mean to overly complicate things. Is that a more precise way, more than just flagging *Setser* in the notes, that we can do that, that will do more than just rely on them and the advocates to do —

MS. HAY: Make them call.

COMMISSIONER FRIEDRICH: — well, and the calling thing is odd because it is completely not transparent, and it is a behind-the-scenes call. I am just surprised that you all are not more concerned.

Is it just because there are so few cases?

MS. HAY: I think maybe the concern is just if it's added to the guideline now before we know how this is going to play out after the Supreme Court decided *Setser*, it may become something where

there is increased work where any anticipated state sentence has to be brought, or anticipated state or federal sentence, has to be brought to bear at the first federal sentencing. And often there is just not enough information, and we just do not want to complicate the first federal sentencing by bringing the second in.

And so —

COMMISSIONER FRIEDRICH: I get the rationale. I mean Breyer makes great points in the dissent. But now we're working with what the Court has held, and what do we do to protect that handful of defendants who are going to be in this little quagmire? That's the motivation.

And to the extent we have gone too far, you know, draw that to our attention.

MS. HAY: We could try to submit some other language where perhaps the word "anticipated sentence" could be included in the commentary that we suggested, but without requiring that the court — without adding it to the actual guideline so it doesn't appear to be a requirement that the court

must do it.

I think that is our concern right now, that there is so much that we do not know about that that we do not want the district courts to feel they must do it. And often it has worked out by the parties —

COMMISSIONER FRIEDRICH: But when they don't have the "must," the default is that it has to be consecutive, unless these guys make the call. And you are just putting a lot of faith that they are — and you're good, I know, but that is an odd position for defenders to take when so much can be at stake.

MS. HAY: Right. So we would believe that if the state judge, or the later judge says that it should be concurrent, that that is something that the BOP should honor —

COMMISSIONER FRIEDRICH: But they're not.

MS. HAY: Well that's something to be litigated, then, against the BOP, not something for the Sentencing Commission to put into the guideline.

COMMISSIONER WROBLEWSKI: But under what authority? Because that statute that you pointed to,

the statute that exists, as you said, and as the Supreme Court said in *Setser*, only deals with undischarged terms that have already been imposed.

And the Court said, okay, that's all that deals with. And they said in *Setser*, we have something else, something different, which is an anticipated, something that has not happened yet. And the Court said these statutes do not apply.

And we argued in front of the Supreme Court, well, BOP has the authority to make the call on their own. And the Supreme Court said, no, we don't. It is the — it lays with the federal judge.

So that is why I am saying, you want the BOP to make a call that the Supreme Court seems to be saying it can't make without a new statute. And that is why I don't get. I know you would like it if the state court says I'd like it to run concurrently —

MS. HAY: Right.

COMMISSIONER WROBLEWSKI: — but if the person has already served and the BOP doesn't feel it has the authority, it is going to run it consecutively.

CHAIR SARIS: Did you want to respond?

MS. HAY: I think my only point on that is we agree that it is not that clear. There are some areas where there might be something the Commission could help with later, but we believe at this point this should be left so that we can see how it develops in the cases. And I think some of the litigation is going to be against the BOP to ask them to interpret the statute differently. It is something the Commission can't alter.

So we would ask the Commission not to change this now.

CHAIR SARIS: Moving back to three — Did you have a question there?

COMMISSIONER HINOJOSA (By Video): A real quick one.

Director Samuels, and Mr. Pickles, us throwing in "anticipated" here doesn't in any way encourage judges any different than the present guideline, does it? I mean, we still have the same rule, and you will still probably have to be calling

judges that decide not to say anything, right?

MR. SAMUELS: Yes, Your Honor.

CHAIR SARIS: I would like to move back to 3E1.1. As you can tell, when we're talking about waiver of appeal rights, or things that are not trial preparation, I hold back, but I've also been thinking about the motion to suppress, where that's the whole name of the game.

You know, if I deny the motion to suppress, it's guilty. Drugs, often. So suppose the motion to suppress hearing itself is like a trial? And I think, and the government thinks, and I agree, that it is basically a week long motion to suppress that would overlap with what any trial would look like, why wouldn't that be sort of synonymous with "trial resources"?

MS. HAY: Well I think there are two reasons, or several, really. One is that in a motion to suppress of course the Rules of Evidence don't apply. It's not really like a trial. You don't have all of the witnesses you need to subpoena, and all of the issues that have to come in. So preparation for

a motion is less than a trial, even if a lot of the issues overlap.

The second reason is that when the Commission first considered giving benefit of sentence reduction for people who pled guilty, there was a lot of discussion about the constitutionality of that and whether you were unfairly requiring the waiver of a constitutional right to trial in order to get this benefit.

And the way the Commission and the courts resolved that was to say, well, the district court judge is in charge of that reduction for acceptance of responsibility, and you can get it if you go to trial sometimes, too. So it's not a complete waiver of your trial right.

And so that's how the constitutional tension was resolved. Now that the PROTECT Act amended the 3E guideline and added the government in there, that protection is no longer in existence. And so I think it needs to be narrowly construed to avoid the constitutional problem, which exists if the prosecutor is able to punish a defendant who raises a

motion to suppress. Your motion to suppress raises very valuable rights of liberty for all of us, not just the defendant.

It is important to not have the government have the ability to keep that information from the public and the courts just by offering this level — this sentence reduction. So a motion to suppress, first I think there's a constitutional problem with having the government be given the power to keep those out.

In addition, I think there is a really practical reason why the timely notice of the intent to plead guilty is the — it makes sense to offer the reduction for that timely notice.

The issue is, when you are counseling a defendant they have the right to decide whether to go to trial or to plead guilty. That is one of the things that they control. And so in Oregon in the state system, for example, defendants will routinely go to the day of trial before they say, okay, I am going to plead guilty. And all of those resources are wasted. Witnesses come. The jury is called.

The officers are subpoenaed. And the defendants decide the morning of trial, I'm going to plead guilty.

And that is not — it's an understandable human reaction. You don't really want to make that decision, and it's the defendant's decision to make. So they delay, and they delay, and they delay, hoping it might get better.

And we don't have that problem in the federal system because we have this third level that is for a timely notice of intent to plead guilty. So it is not a third-level for waiving your trial rights. It's about the timing of the notice.

And so in the federal system, I can go tell a defendant when I meet with him, okay, you get to decide. Are you going to plead guilty or are you going to go trial? If you plead guilty by this date, you are going to get a sentence based on my guideline calculations, including the third level.

If you cannot decide by this date, and you keep waiting, your sentence is going to go up. You are going to lose that level. So what do we need to

talk about to get to that point. And it's a very logical reason to give a benefit for a timely notice. And that does not apply in the motion context because the attorney of course controls the motion. And no attorney would ever file a motion to suppress evidence, get all the way to the day of the hearing, and say to the judge, never mind.

I mean, if they get to the day of the hearing and they do that, the judge would certainly scold them. So it is not the same kind of problem.

VICE CHAIR JACKSON: And I think that interpretation also gives meaning to the language "thereby permitting the government to avoid preparing for trial and permitting the government and the court to allocate their resources [efficiently]."

The thing that troubles me a little bit, Mr. Shanker, about your interpretation is that I don't know what that language is doing in your interpretation. In other words, it seems to render that superfluous if really all the government can do is make the motion, or not, just based no its own discretion without any constraint relative to

resources, or trial, or anything else.

MR. SHANKER: Well, Commissioner, I would disagree. I think the "thereby" language actually helps to clarify what timely notifying authorities of his intention to enter a plea of guilty does for the government.

So it contemplates, the "thereby" language contemplates that a defendant who does timely plea might still not permit the government to allocate its resources efficiently.

There is, in addition to "thereby permitting the government to avoid preparing for trial," there is a second part of that sentence: "and permitting the government and the court to allocate their resources efficiently." That sentence contemplates a situation where a defendant does timely plead, but has not — but has still not allowed the government and the court to allocate their resources efficiently.

And I think the perfect example is the one that Commissioner — Chairwoman Saris gave, which is a defendant who litigates a suppression motion which is

basically the end game of the trial, and the government has expended all of these resources, and in that situation that is exactly what Congress contemplated when it gave the government the discretion to file a motion.

It contemplated situations where a defendant has pleaded guilty timely, but the government determines that it is not in its interests to move. Otherwise —

CHAIR SARIS: But the flip side of it is, the guy comes in day one, I'm guilty as sin but I don't agree to the loss amount, and I want to challenge that in sentencing.

Or, I don't want to waive ineffective assistance of counsel. Or I don't want to waive an appeal, if I think the judge got the sentencing wrong. You know, but he has pled guilty on day one. He walks in: I'm guilty.

So I mean you are taking away any mooring in the allocation of resources, anything. You're just basically saying that the government has this incredible force that you've got to waive the sun,

the moon, and the stars before you get that third point.

MR. SHANKER: Well, Your Honor —

CHAIR SARIS: That's a tough position for you to take.

MR. SHANKER: Well the examples you gave are moored to allocation of resources. The government has to expend resources on litigating loss amount at sentencing, things like that, is required to allocate its resources in a less efficient manner, and that is why Congress gave the government the discretion.

Otherwise, Congress could have dispensed with the motion requirement and simply said that a defendant who pleads guilty in a timely manner is entitled to an additional one-point reduction.

Now I would also disagree with Ms. Hay's characterization of this as being punishment for the exercise of constitutional rights. It is well settled that defendants can waive constitutional and statutory rights, and they can do so based on their assessment of the costs and benefits of doing so.

A defendant is not entitled —

CHAIR SARIS: Take away ineffective assistance of counsel?

MR. SHANKER: That is an issue — whether the government should tie that to the additional point is one that is a policy consideration for the Department. But it's not — it doesn't infringe on a constitutional right to have a defendant waive that claim.

And a defendant is not entitled to a reduced sentence. So the government's motion here is within the government's discretion.

MS. HAY: May —

CHAIR SARIS: I think we're probably- -oh, did you want to make one more point? Because we're at the end of the session here.

MS. HAY: Sure. I just want to quickly comment on the statement about this is a government policy decision within the DOJ on whether they should, for example, use this third level to keep out post-conviction rights, or the right to appeal.

I don't agree that this should be a DOJ

policy decision. Because when Congress amended the PROTECT Act they specifically amended the guideline directly, and they said the Commission may not alter it. The guideline includes the single act the defendant must do by a timely plea of guilty. And that is where the government has lost that mooring when it argues any resources can be considered. It has to be based on the defendant's timely plea of guilty that saves the trial resources. And I agree that it's trial resources and other resources, but it doesn't say trial resources "or" other resources, which is how the government is interpreting it. They're saying any other resources that we have to expand, we can use this third level. It doesn't say that. It says trial resources and other resources — or trial preparation and resources. And that phrase had been interpreted before the PROTECT Act always to mean trial preparation.

When Congress amended the PROTECT Act, in the commentary they referred to that as "trial preparation."

So I think the connection between trial

preparation and resources is established in the case law. Congress knew it when they amended the Act, and they didn't change that.

So to avoid confusion, the best thing to do is to clarify that 3E1.1 means what it says; that it has to be a defendant's timely plea, and then has to save trial preparation resources. And if that is clarified, the third point will be used in the way that benefits the system the most.

CHAIR SARIS: Thank you. I think we have hit the end of this session. This has been incredibly helpful and lively. The way it works is, we're going to have our break from 12:00 to 1:30, and then we come back for pre-retail medical products, counterfeit drugs and military goods, and, oh, the one at the end is the one that got a lot of sizzle, which is Tax. Maybe it's the time of year.

So see you at 1:30.

(Whereupon, at 12:01, the hearing was recessed, to reconvene at 1:30 p.m., this same day.)

AFTERNOON SESSION

(1:37 p.m.)

CHAIR SARIS: Thank you, everybody, for coming back. Commissioner Friedrich has just a slight family issue for two seconds. She's going to be stepping out, but she will be back in one second. Thank you, very much.

This is the panel on pre-retail medical products. I am sure we're going to learn a lot about supply chain drugs.

Beginning the panel is John Roth, who currently serves as the director of the Food and Drug Administration's Office of Criminal Investigations, where he leads a nationwide group of federal law enforcement agents. Previously he was a criminal prosecutor with DOJ, serving for 25 years — 25 years — in positions ranging from an AUSA, assistant United States attorney, to high-level policy and leadership posts.

Denise Barrett, who testifies a lot as the wonderful National Sentencing Resource Counsel — Your comment are always excellent — for the Federal Public

and Community Defenders, where she coordinates the Defenders' commentary on the Commission's work. She obtained her J.D. from the University of Baltimore School of Law, and holds a master's degree in social work from the University of Maryland's School of Social Work.

And last but not least David Debold, well known to us all, as the chair of the PAG, Practitioners Advisory Group.

So let's start with — you know, I hate to have Commissioner Friedrich miss — she should be back in about two minutes, and I just hate to hold any longer, so why don't we get going.

MR. ROTH: Madam Chair and members of the Commission, thank you very much for the invitation to appear before you today to testify regarding the Commission's proposed guideline amendments to the SAFE DOSES Act.

When Congress enacted SAFE DOSES, it recognized that the genuine risk of the thefts of medical products pose to the public health. Offenders who steal medical products rarely take the

time or make the effort to ensure that the products are stored and handled properly.

Improper storage may compromise sterility or otherwise damage the stolen products. Offenders may delay the resale of stolen medical products to evade detection, causing the medical products to expire or have diminished safety or efficacy by the time that they are reintroduced into commerce.

Likewise, they are able to change the labels, including the expiration dates, on some of these drugs which can cause significant issues.

These concerns [are] not merely hypothetical. In 2009, a truck carrying 129,000 vials of Levemir, which is a long-acting insulin product, was hi-jacked in North Carolina. Insulin in Levemir can be comprised if it is unrefrigerated or exposed to heat or direct light for significant periods of time.

Several months after that, the vials of stolen insulin started to appear in pharmacies and medical facilities. Some of the stolen vials were dispensed to patients, and FDA had received multiple

complaints of patients suffering adverse events as a result of using the Levemir that had clearly been compromised.

More recently, in May 2011, Boston Scientific reported the theft of medical devices that had been labeled as sterile. Because the devices were stolen while en route from Boston Scientific's sterilization facility, the devices had actually not yet been sterilized, notwithstanding the label that was on the packages.

Despite the "sterile" label, if reintroduced into the supply chain and later used these could pose significant risk of infections to patients. Other reported thefts have included products such as infant formula, blood glucose monitoring products, and asthma medications.

The actual harm to the public health that has resulted from these thefts is impossible to quantify, although we have seen a number of instances in which this has occurred as FDA cannot determine with certainty if and when the stolen products re-entered the supply chain and the adverse events

attributable to compromised products might not be reported or linked to the theft itself.

We support the Commission's proposal to amend the guidelines to refer a violation of the SAFE DOSES Act to 2B1.1, and add a new specific offense characteristic to address the aggravating factors enumerated in the SAFE DOSES Act.

We have a couple of additional recommendations for the commissioners' consideration.

First, in answer to the Commission's question as to whether the statutory definition of "pre-retail medical product" is sufficient for purposes of the guideline, we believe that it is not.

We think that limiting the application of the new specific offense characteristic to "pre-retail medical products" will lead to a disparate and inconsistent treatment of similar conduct.

We believe that the enhancement should include all conduct involving the theft or diversion of pharmaceuticals and other medical products where

the intent of the theft is to at some point later in the future re-introduce those products back into the supply chain.

The DOJ has prosecuted numerous cases involving the re-introduction of previously dispensed medicines into the supply chain.

Recently, three individuals were indicted in the Middle District of Tennessee for allegedly obtaining over $58 million worth of drugs from street collectors in New York and Miami, and selling those re-packaged drugs to independent pharmacies, as if the drugs were purchased from legitimate wholesale distributors. This is the *U.S. v. Edwards* case in the Middle District of Tennessee. It was indicted in January of 2013.

In Puerto Rico, 23 individuals and 3 corporations were indicted under a prescription drug diversion scheme involving over $440 million worth of pharmaceuticals which were diverted from unknown sources, then introduced into the supply chain using a variety of methods, including documents to establish the authenticity of the drugs known as

pedigrees, which were falsified.

In such cases, the defendants often purchase dispensed prescription drugs from patients, repackage the drugs or use solvents to clean packaging and remove evidence of the prior dispensing; then resell the drugs to wholesale distributors or pharmacies that then dispense the drugs to unwary consumers.

Often the offenders repackage the drugs under filthy and uncontrolled conditions that can lead to dangerous product mix-ups or contamination of the drugs.

In fact, in one recent case the FDA testing indicated that one of these re-packaged tablets, for example, had blood on it and FDA has identified numerous instances in which the solvent that had been used to remove the labels, which is often lighter fluid, leaches through the plastic bottle right into the product itself. So when you test the product, in fact what you get as a result is lighter fluid.

These diversion cases present the same or

greater public health concern as cargo thefts that motivated the passage of the SAFE DOSES Act.

Moreover — and this is significant — these large-scale dirty wholesalers don't really care where their pharmaceuticals come from. They can come from, for example, cargo thefts. They can come from large-scale diversion street-purchase schemes. Or they could come from illegitimate, illegal foreign supplies.

They are omnivorous when it comes to these kinds of things and they will take it from any place they can get.

I have some graphics here that I would like to show you —

CHAIR SARIS: I've been wondering what those were.

MR. ROTH: Yes. And let me see if I can get this to ensure that Judge Hinojosa can see this, as well.

These were taken from an FDA OCI case that is one of the typical drug diversion cases that we see. What happens is, as I stated, they get drugs

from a variety of sources, from the street, from thefts, from pharmacies, stealing drugs, any place they can get it, and they'll put it into a central location like this.

And you can see the kinds of conditions that are typically — we see in these kinds of cases. I actually spared the Commission some photos that are far filthier than this, but you get the idea of how bad this is.

So then what do they do? They simply take all the drugs off and just simply take them out of the packages themselves. So here you see some evidence of the drugs —

CHAIR SARIS: Can you see this?

COMMISSIONER HINOJOSA (By Video): Yes. Very clearly. It's kind of scary.

MR. ROTH: Yes, yes.

(Laughter.)

MR. ROTH: And so what you see is all the drugs are simply poured out of these bottles. And you'll see here, too, and if they have the package inserts, and a lot of times either the package

inserts don't make it back in, which are the instructions for use. So it's a fairly significant thing. Or sometimes they lose it and they'll simply reproduce fraudulent or counterfeit package inserts for this.

And you can see again sort of the debris strewn all over. And we have seen cases like this as we go. Then what happens is they will take lighter fluid and, again this is simply a scene from one of the cases that we've seen, we've actually gone into search warrant locations where there's bottles and bottles of lighter fluid.

So you have the lighter fluid. You have the toilet paper. You have the bottles. You're going to strip the label off the bottle. You will use lighter fluid to get all the glue off the bottle. And then what you'll do is you will then reproduce.

And what you have here are the labels that someone printed up. This isn't a wildly sophisticated operation but, you know, they've printed up labels that are falsified. This is a — I think it's an antiviral for HIV.

What you will notice down here are these printing plates. And what they'll do then is they'll stamp the expiration date, which is of course completely fictitious, as well as the lot number on the bottles themselves. So completely cutting off any ability to trace bottles, to recall bottles, to ensure that the medicines within there are safe and haven't expired.

So that's what we see. And that's why we think that the definition that the Commission ought to consider when they're talking about applying the SAFE DOSES needs to encompass every aspect of the schemes that we're seeing on the street.

Second, we recommend changes to the proposed specific offense characteristic. We recommend that offenses that result in an actual serious bodily injury or death should be subject to a separate 4-level enhancement, and a minimum offense level of 18.

This recommendation obviously reflects the congressional action in this matter under the statutory scheme: An offense that results in serious

bodily injury or death is subject to a maximum of 30 years in prison, regardless of whether any of the other aggravating factors is present.

Including an injury enhancement within the specific offense characteristic that encompasses other aggravating factors without a cumulative effect we believe would not provide the kind of just and proportionate punishment or adequate deterrence that we believe that the statute requires.

Moreover, it is appropriate to distinguish between offenses involving a risk of harm and offenses involving actual harm. We think that the enhancement for actual harm should be cumulative to the existing enhancement in 2B1.1(b)(14), the conscious risk of death or serious bodily injury.

We believe that the Commission should consider increasing that from four levels from the current two levels where it is now, with a minimum offense level of 16.

Lastly, we urge the Commission to add an enhancement to 2B1.1 to account for the increased statutory maximum penalty for defendants who are

employed by or are an agent of an organization within the supply chain. We don't think that the adjustment that is contained within 3B1.3 adequately addresses the aggravating factors of the defendants who are so situated.

Many of the mid- and lower-level employees of an organization's supply chain are going to lack the substantial education or training or professional or management discretion needed to qualify for an adjustment under Chapter 3B1.3.

Nevertheless, these employees will be subject to the enhanced statutory penalties and we believe they should therefore be subject to the guideline enhancement.

In closing, I would like to thank the Commission for the opportunity to testify. I would be happy to answer any questions that you may have.

CHAIR SARIS: Thank you. Ms. Barrett.

MS. BARRETT: Good afternoon, Judge Saris and commissioners. It is actually a pleasure to be here. I am usually behind the scenes, and this is

the first time I have actually had an opportunity to appear —

CHAIR SARIS: Are you nervous?

MS. BARRETT: — in front of you. Actually, I am a little nervous because I realize that, you know, other than doing training, it's been about four years since I've done anything like this. I'm a little rusty. After 20 years of practice in front of the Fourth Circuit, I'm hoping I can handle it.

My written testimony has an extensive discussion of a lot of the FDA regulations and whatnot regarding these, and kind of the scope of what we mean when we're talking about pre-retail medical products.

And while these are the kinds of cases that we are seeing now in terms of prescription drugs, there are also other things that can be a subject of cargo theft that is technically a "medical product" that can be as simple as latex gloves that do not present the same kind of risks.

So I think we need to be careful about how

broadly we sweep in a lot of these offenses. Our analysis is essentially — and considering really any new offense — that the Commission ought to be really asking itself four essential questions.

The first is: What are the essential elements of that offense? And what are the kinds of harms associated with it?

Once we've identified that, then: What are the existing guidelines to be able to account for those harms in that offense?

The third would be if the guideline then is not deemed adequate, what can be done to amend it?

And fourth would be: What are the costs and benefits of that amendment in terms of issues like complicating the guidelines, factor creep, any of the other myriad problems that we know can exist in terms of creating unnecessary litigation.

When we look at those four questions with regard to pre-retail medical products, we don't get past the second question, which is that the guidelines under 2B1.1 are adequate to cover and impose high sentences for these particular cases.

Starting with the first question, the essential nature of the offense, I mean Congress in the SAFE DOSES Act — notwithstanding the issues of diversion that have been discussed — Congress was specifically concerned with the theft of pre-retail medical products. Namely, cargo theft, meaning tractor trailers being stolen. And warehouse break-ins.

There have been very few reported cargo thefts in this past year. There's actually, if you look at the FDA website in terms of the number of cargo thefts that actually resulted in products being stolen that merited any kind of warning, there's only 5 reported in 2012. And there were 10 reported in 2011.

What we have learned is that the industry has actually gotten much better at preventing cargo theft because of new technology and GPS tracking when a tractor trailer gets stolen and they are able to either find it, or the thieves realize they are in trouble and they've actually dumped it and left the trailer on the side of the road to be recovered and

the items never work their way into the supply chain.

On the second question as to the adequacy of the current guidelines, when we went through this we actually found eight different enhancements and five invited upward departures that would cover these offenses.

The enhancement for loss alone under 2B1.1 is sizeable. We have heard about a $58 million case. Well we know — I don't have the book in front of me — that the offense level increase is for $58 million is substantial.

Even on the other smaller cases, I believe it's either the FDA website or the FreightWatch International website, says the average wholesale value of loss in 2012 of cargo theft of medical products was $168,219. Well that alone is a 10-level increase under the guidelines.

There is a recent theft of infant formula that had a retail value of $654,000 for a tractor trailer full of infant formula. That is a 16-level increase.

So the loss alone is getting us up there. There's also a special rule that would cover these diversion cases. Under Note 3 under 2B1.1, Application Note 3, if the defendant has committed a fraud by circumventing a regulatory process, he doesn't get any offset for any gain or anything else. And that rule was put in place because the Department and others thought — knew that there were certain products that would put consumers at risk by evading the regulatory process. And that's been there. And it is available, again, to increase the loss amounts.

We know that there is an enhancement and a minimum base offense level for cargo theft alone. There is a 2-level enhancement again that applies to diversion as well for receiving stolen property and being in the business of receiving stolen property.

There's a 2-level enhancement and a minimum offense level of 14 for risk of conscious or reckless risk of theft or serious bodily injury, which the case law — I'll talk a little bit more about this on the next panel — it really is such a liberal

standard, a relaxed standard for the government to meet that it only applies — it applies where a reasonable person should have been aware of the risk. It is not even that you need a subjective awareness of the risk.

There's sophisticated means. There's a 2-level enhancement if the theft is from another person, which is likely to be the situation if there is indeed use of violence [or] a threat of violence. It's likely to be because there's another person there involved.

If it's CDS, we get a cross-reference to the drug guideline, and we know how high those can be. The only one that we might be willing to concede where there might be a little wiggle room, but we don't even see the necessity of it, is with regard to the Chapter Three adjustment for abuse of position of trust.

There will certainly be people within the supply chain who don't quite meet that Chapter Three. But our suggestion is — and the Commission has done this elsewhere in the guidelines — is let the court

know that is an appropriate consideration to determine where within the range you get sentenced.

So if you are a low-level player in the supply chain, and you have tipped the cargo thieves off, then you get a sentence — you can recommend that you get a sentence toward the higher end of the guideline range. You don't necessarily need a specific enhancement for that.

Five invited upward departures. The guideline itself has a specific Note 19 on, where it caused — contemplating substantial nonmonetary harm like a physical harm. There's an upward departure for death. There's an upward departure for physical injury. There's an upward departure for use of a possession of a weapon. There there's an upward departure in [5K2.14] for endangering public health or safety.

It is all there. So given all of those enhancements, we reached the conclusion: Is this necessary to really accomplish what we're trying to get? And I've not heard really of any case where a sentence was too low, where the government has

complained that the sentence was too low under the guidelines for what they have gotten.

Some of them have maxed out at what was then the statutory max. Rodriguez, the case in Florida, he got 10 years. His guideline was I think 262 at the low end; 262 months is a fairly hefty sentence for a diversion case.

The last point I would like to make is, even if we think some tweaking is necessary in terms of kind of the cost/benefit analysis, and David made this point earlier, is the Commission is undertaking a multi-year review of 2B1.1. And there's I think a lot more proposals that will be coming forward from the defense bar, and hopefully others, in terms of what can be done with that guideline. And our suggestion is, we are having so few cases let's wait before we go adding more into 2B1.1 and see what can be done.

Thank you.

CHAIR SARIS: Thank you.

MR. DEBOLD: Thank you, Judge Saris. One thing that you may not have been aware of, it wasn't

mentioned in the introduction, is that Mr. Roth and I go back a number of years. We were classmates in college, and actually were roommates for a year.

CHAIR SARIS: Now where was that again?

MR. DEBOLD: Wayne State University. And so we may want to go into closed session before I bring out my photographs.

(Laughter.)

MR. ROTH: He's got a lot of Giglio, but we're not going there.

(Laughter.)

CHAIR SARIS: I don't have you under oath or I'd ask you about one another.

(Laughter.)

COMMISSIONER HINOJOSA (By Video): Do you retail photographs?

(Laughter.)

MR. DEBOLD: Yes, some of them are, as a matter of fact, Judge. No, but seriously, this is a serious matter. It's a serious type of offense, and it is a new offense. So the Commission obviously is

faced with a somewhat different situation than the one I testified about this morning where we have a pre-existing — some pre-existing track record and the question is whether we need to make changes in light of what has happened.

Here the Commission has a bit tougher decision, as you're taking a new criminal offense. You're divining what Congress was really trying to get at. You're trying to figure out where it best fits and what adjustments might be appropriate.

And so distilling that down, the question we believe is whether, if we put this in 2B1.1, which is our recommendation, as the primary guideline for these offenses, is it going to result in sentences and sentence ranges that are sufficient to capture the various types of conduct that might fall within the scope of these new section 670 prosecutions?

As we say in our written testimony, we are open to the idea of having a cross reference in the case where death results to the Involuntary Manslaughter guideline under 2A1.4.

The question that we've come up against,

though, is what about cases where there is a risk of death or injury that can't necessarily be prosecuted as a death resulting, and there's a lot of uncertainty in these cases about what will happen, and there's a lot of risk that's being created by some of the conduct that you heard testimony about today.

But what we come back to is the question of, if we take some of the existing cases that are being investigated, or that have been prosecuted already under other statutes like the case that we heard about involving the Levemir product, the question becomes what do the current guidelines produce in terms of a guideline range?

And as Ms. Barrett pointed out, those ranges can be quite high where the value of the product that is taken — that is stolen or obtained by fraud is itself a significant number.

So the question is: What do you do in cases where you may have a smaller value? Some of these products may not cost as much money, but the health risk may be quite severe.

We know that we already have enhancements available in 2B1.1. You heard Ms. Barrett talk about them. One in particular is creating a conscious risk of serious bodily injury or death, or a known risk of those things, which will lead to an enhancement and a minimum offense level.

What I am not hearing is examples of cases where we can say this is what has been going on in the community. This is the offenses that have been occurring that would be prosecuted under the statute if they had occurred after the statute went into effect. What is the guideline range that those offenses are creating or generating? And if it's too low, what is it about them that is too low?

I think this is one area where again we need to be careful not to stack on a lot of different new specific offense characteristics when we don't know exactly what we are going to be dealing with in these prosecutions.

As we say in our written testimony, we think that the current specific offense characteristics are adequate. However, if the

Commission does choose to make some changes that are specific to the statute, and if it's not willing to rely on the current specific offense characteristics, there are two ways to go.

One is similar to what I mentioned this morning, is to make it very clear that the Commission has not yet seen the cases where there may be some aggravating circumstances that are not captured by the specific offense characteristic at (b)(14), the conscious or known risk of death or serious bodily injury. Make explicit in the guideline that there may be a gap here and that courts ought to be aware of that when they are deciding whether to sentence within the range.

The other option, which is one that the Commission is asking for comment on, is to create a new specific offense characteristic. And it has some variations on how that might operate.

If the Commission were to go in that direction — this is the new proposed Application Note No. 14 — we would recommend that the Commission include the bracketed language and basically make the

specific offense characteristic to a large extent parrot the new aggravating offense factors that go into section 670 under Title 18.

That is, if the offense involved the use of violence, force, or the threat of other, or a deadly weapon, that would result in the increase. Or if it resulted in serious bodily injury or death, that would result in an increase in the offense level. Or if the defendant was employed by an agent in the supply chain.

The third one is the one that we have the most trouble with. It is our sense that Congress — and we have not seen legislative history on this so it is very hard to figure out what exactly was the intent behind that — obviously a higher statutory maximum will apply if a person is in the supply chain, employed in the supply chain, but doesn't meet the requirements for abuse of position of trust, or use of special skill.

One likely explanation for that is that Congress wanted a very clear line. They don't want juries to have to decide whether somebody has a

position of trust before a higher statutory maximum is triggered. We don't really know for sure.

But our experience has been in other statutes where you are trying to decide what kind of enhancement a person observes because of the position they play within an organization, including a company, that we think the Commission has drawn the line correctly. Which is, you look at people who have a special fiduciary relationship to their employer or to another organization, or they have abused a special skill in order to facilitate commission of the offense.

We do not see a problem with having a larger group of people who are subject to a higher statutory maximum than the people who will actually receive an enhancement to their sentence as a result of being in that position.

We don't, for example, see a reason why a truck driver for CVS, as we say in our written testimony, should be treated differently than a bank teller, or a hotel clerk, or other people who are employed in positions where they have the opportunity

to help facilitate an offense that is unique to their position but nonetheless don't rise to the level of abusing a position of trust, fiduciary relationship, or use of a special skill.

We also are concerned about the government's suggestion that if we do add these specific offense characteristics such as the one that the Commission has proposed, that these should be cumulative to the existing specific offense characteristics.

We are particularly troubled by the idea that if somebody is eligible for what is now (b)(14), their offense involved a conscious or reckless risk of death or serious bodily injury, they would get a 2-, or under the government's proposal a 4-level increase under the current provision, and another 4-level increase if the offense actually resulted in the thing that they consciously risked, or that they knew might happen.

As I read the government's proposal, they are proposing an 8-level increase for conduct that right now would receive a 2-level increase. And we

don't see the justification for putting that kind of a significant increase in the offense level for people who admittedly are doing bad things and should be punished for them, but separating them out from anybody else who also commits a fraud offense or a theft offense, and causes a conscious or reckless risk of death or serious bodily injury. It is going to create a dichotomy and a disparity between those defendants, and we just don't see the rationale in terms of what we are predicting the guideline ranges would be for people without these very serious enhancements.

So we do recognize that the Commission has a difficult job here whenever it faces a new statute with new penalties and new offenses, frankly, because we don't know exactly what is going to be prosecuted under the statute, but we do think that the Commission should be careful not to load up with more specific offense characteristics at least until we have a better sense of what actually gets prosecuted under the statute, and also a better sense of what the actual penalties will be in the cases under the

existing guidelines which may be sufficient or, if they're not, courts certainly can adjust to them in the interim.

Thank you, very much.

CHAIR SARIS: Thank you. I actually get a fair number of these cases in Boston, because of the hospitals and that sort of thing. So I was thinking of one of the cases I had and how you would think this would all apply.

A low-level guy in a supply closet — you know, the supply room — stealing the drugs. He's part of the supply chain. Not clear if the drugs are part of a retail chain because it's in a hospital. Stealing the drugs, and then giving it to, I forget who it was, who would then resell them.

So first of all, I think Congress was trying to target that person, right? He's not — it would not in any way be a fiduciary or abuse of position of trust. He's a low-level guy who puts stuff on shelves.

On the other hand, I imagine the defense attorney would argue minor role. He wasn't a major

player in the conspiracy. And I'm not sure, looking at the FDA, whether this is part of the retail chain because it was going to be used in the hospital. In other words, as I — at least I'm thinking in my case, it wasn't actually going to be "sold," but it was going to be used on real people in the hospital.

So I'm just trying to think about how — I've had other ones where it's sold on the street, and I've had other ones maybe would go to the pharmacy at the hospital. But just even trying to understand the complexity of the supply chain in a hospital.

And maybe I can turn first to Ms. Barrett. Does that guy get minor role?

MS. BARRETT: I think it depends on the —

CHAIR SARIS: This is like law school, right?

(Laughter.)

MS. BARRETT: Well I think it depends on the overall nature of the scheme. And I would want to know some more facts. For example, his gains. You know, his gain.

CHAIR SARIS: I think Congress would want to say, no, he never does. In other words, regardless of whether you get the plus-2 for abuse of position of trust, it would never want him to be the minor role guy. They're saying he's the guy we're trying to deter, right?

MS. BARRETT: Well I actually think that if you look at the legislative history of the SAFE DOSES, they are actually talking about much bigger things than what you've just described.

They are talking about massive theft of tractor trailers full of drugs and warehouse break-ins. I mean, a warehouse break-in to Eli Lilly was the impetus behind this legislation. And those kinds of folks often — I'm guessing it's CDS involved in that case, too, controlled substances, right?

CHAIR SARIS: Yes. Well let me ask —

MS. BARRETT: And those people get sentenced under 2D1.1.

CHAIR SARIS: So you're saying not only should they not add to, you're saying the person gets minor role?

MS. BARRETT: I said I needed more information to be able to make the argument as to whether or not they get minor role in that case or not.

COMMISSIONER WROBLEWSKI: But do you think — can I just follow up just a little bit?

CHAIR SARIS: Yes.

COMMISSIONER WROBLEWSKI: Do you think — do you agree with Mr. Roth and what I think Judge Saris is saying, which is this division between pre-retail cargo and diversion cases, that at least for purposes of the guidelines don't seem to make a lot of sense? That it's about stealing these drugs, diverting them, having them back in the supply chain and causing danger. And whether they were stolen from the initial warehouse, from the retail warehouse, from the truck, or from the supply cabinet in the hospital, what does that matter?

I'm just curious if you agree with that, that this division pre-retail seems, at least for the guidelines not to make sense?

MS. BARRETT: Well based upon our

analysis, which is that the guidelines are sufficient to cover both, we wouldn't — our analysis doesn't distinguish between those two scenarios. Our analysis says you apply the guidelines as they are in existence.

If there is a risk of death as a result of whatever product that is stolen, you get the enhancement.

VICE CHAIR JACKSON: Let's assume —

MS. BARRETT: If your — you are also the fence, you get a 2-level enhancement. You also have the special rule for calculation of loss that is directly addressed to that situation in Application Note 3 of 2B1.1 that is going to drive up the loss amount.

VICE CHAIR JACKSON: But if we disagreed with you, if we rejected that analysis and we said we want to do something in the guideline, would you be pushing for a distinction between defendants who stole from the original warehouse before it ever got into the stream of commerce and the person who is in the supply closet at the hospital?

I mean, you would want the pre-retail distinction drawn, I would think, if we're going to have any enhancement at all related to this, because it would apply to a smaller number of people.

MS. BARRETT: Well if the statutory max is to have anything, and you're going to drive up the guidelines for things that have a greater statutory max, then you certainly want the people who are not in the pre-retail chain who are facing the lower statutory max to all of a sudden always cap out.

So, you know, it's difficult because we're hypothesizing to see what those cases look like, but I could see that scenario happening where you have this person who suddenly is reaching a 10-year max because the guidelines have piled on, and piled on, and piled on, when they really should be aiming at the pre-retail medical products.

CHAIR SARIS: Did you have a question?

COMMISSIONER FRIEDRICH: Just following up on this pre-retail issue, which the government thinks is too narrow, that's from the statute, right? Do

you have any background with this? It's defined in the statute, right?

MR. ROTH: It is. And for purposes of 670, obviously, we would be limited to that if we were prosecuting a case.

I guess our larger concern are these kinds of cases in which —

COMMISSIONER FRIEDRICH: It's not clear.

MR. ROTH: — these things are stolen and re-introduced. We are not a hundred percent sure where they're stolen, whether it was retail, pre-retail, whether or not they were —

COMMISSIONER FRIEDRICH: I understand, but why did Congress restrict it so? Was there —

MR. ROTH: The legislative history on this is not clear to me.

COMMISSIONER FRIEDRICH: Was it an inartful term they used to try to capture what they viewed in their hearings, which was the broader —

MR. ROTH: I mean, candidly, I think it was inartful, if I can say that. Judge Saris's hypothetical, for example, that is not a retail

product ever —

CHAIR SARIS: Right.

MR. ROTH: — and never gets to a retail organization. So did Congress intend to reach that conduct? Did it not intend to?

I would submit that what they were worried about is the fact that in the re-introduction the kinds of harms that we were talking about here. If, for example, in Judge Saris's hypothetical the person stole it and then used it. It was a controlled substance, or some other thing where it was simply consumed. And so what you have is a straight economic kind of a crime.

Candidly, we are less concerned about those kinds of cases then the situation in which we are walking into a drug store and we have no idea what the provenance of the drugs that we're buying is.

COMMISSIONER FRIEDRICH: Right. Well the whole statute is unique, to say the least, in the idea that you have five different maxes ranging from 3 to 30 based on 5 different factors, sometimes

overlapping, one of which is the defendant's status as an employee.

I'm not aware of any other federal statute that draws these kinds of distinctions in that way, particularly with respect to the employee.

But one other statutory question. Defenders have made an important point I thought about the breadth of the term "medical products." Do you agree that if we're going to act in this area that we need to streamline that?

And they I think raised an interesting point about for example Class I medical products, latex gloves, adhesive tape. Surely you wouldn't want to capture that with this, if we were to make an amendment, an amendment to the guidelines. And should that be a mitigator, or should "medical products" be defined in a way that will differentiate between Class I, II, and III products?

MR. ROTH: A couple things. Latex gloves is probably actually a bad example because you can have sterile latex gloves. If they're held for too long, they lose their ability. But in any case,

let's say it's ice packs, or bedpans, or —

COMMISSIONER FRIEDRICH: Or adhesive tape, or whatever.

MR. REILLY: — whatever medical device under the FDCA.

CHAIR SARIS: "Defective bed pan" I don't even want to think about it.

(Laughter.)

MR. ROTH: Yes. In any event, I think, one, there is very little motive for individuals to do that. Again, the harm is the re-introduction into the supply chain. I am unaware of cases in which there is a black market for diverted bed pans.

COMMISSIONER FRIEDRICH: But we don't want to inadvertently capture, as Mr. Debold says again and again and is right, this class of defendants that we —

MR. ROTH: We completely agree. And either in an application note for a departure, or some other language, I certainly understand. I would hesitate tying this to the Food, Drug and Cosmetics Act types of recalls. I think that becomes

unworkable very, very quickly in any kind of litigation that you would have on that.

CHAIR SARIS: Could you explain that? Do you mean Class III?

MR. ROTH: Right. There are certain classes of recalls, the highest I believe being Class I and the lowest being Class III, unless I've reversed that —

MS. BARRETT: That's right.

MR. ROTH: — depending on the harm that's involved in this. And that's something that the FDA would take a look at in determining whether or not there ought to be a recall. But there are a lot of factors that go into that that perhaps would not be relevant in a sentencing consideration.

Certainly I think during a sentencing the government is able to produce evidence of risk of harm, or whatever other kinds of issues that are out there. But I guess my answer to your question is —

COMMISSIONER FRIEDRICH: "Be careful."

MR. ROTH: Right. I mean, one, I don't think there's the scope of what we're talking about

is that broad.

Two, we would invite an application note that invites a downward departure in those rare circumstances in which that occurs.

MR. DEBOLD: If you were to take your language, your proposed (b)(14), and left out the enhancement applying to those who were employed by or an agent of the one we expressed some concern about, you would effectively be avoiding that problem because you would only be dealing with violence, threat of violence, and risk of serious bodily injury or harm.

If you tie it to what the consequence might be, or how the crime was committed, then you get around your problem of, you know, ice bags versus actual risk of harm from drugs, for example, being relabeled.

MR. ROTH: I mean the difficulty with that is that it doesn't encompass the risk of serious bodily harm. So, you know, it's going to be the rare case in which we are able to prove that in fact a device or a medicine that was stolen pre-retail in

fact harmed an individual person to the satisfaction I think of a sentencing court.

What we are looking at here is the significant risk that it involved by this behavior.

VICE CHAIR JACKSON: And I understand risk as a separate prong, but the cumulative nature of it is a little troubling.

So in the situation in which you could prove that a theft of a pre-retail medical product actually harmed someone, doesn't that carry with it necessarily the risk? Why should the person be — you know, my understanding of your testimony was that such a person would get both the risk enhancement and the harm enhancement.

MR. ROTH: Right. And I think it reflects the difficulty in proving the actual harm. It's essentially a place-holder for —

VICE CHAIR JACKSON: Right. But you don't need cumulativeness in order for us to account for that, I guess is my —

MR. ROTH: I see your point.

CHAIR SARIS: Would you agree that if

you are valuing the loss under 2B for the drugs, that you would look at the wholesale price? That came up in, I forget whose testimony, how to value it. It's a very complicated thing.

MR. ROTH: It is a complicated thing. We would argue for the retail value of it. But again —

CHAIR SARIS: Based on what? Retail based on what? The average wholesale price?

MR. ROTH: Correct. I mean —

CHAIR SARIS: The average sales price?

MR. ROTH: I think that's probably what you would have to do. But again, the difficulty with talking about loss in circumstances like this is it doesn't encompass the risk and the harm that we're trying to capture here.

CHAIR SARIS: We always hear from the probation officers how very difficult it is, and I'm sure that's true for the prosecution and defense attorneys, too. And once again I'm coming back to my Boston experience.

I came off of a 10-year multi-district

litigation on how to price drugs. It actually is an extraordinarily complex matter, and I am wondering whether we do a service to everyone if it is pre-retail, if we stuck with that. That sounds like wholesale. And at least give somebody a benchmark as to how to think about the case in terms of loss.

Is there a strong position? I'm not sure if I remember you addressed this issue —

MR. ROTH: We did not address it.

CHAIR SARIS: So you don't have a strong feel one way or another?

MR. ROTH: Correct.

CHAIR SARIS: I forget. I think it was Ms. Barrett or Mr. Debold, I'm not remembering —

MS. BARRETT: Actually I think it was the Probation Officers Advisory Group.

CHAIR SARIS: Okay. So —

MS. BARRETT: You'll see her later.

CHAIR SARIS: Yes, I'll see you later. She's sitting back there grinning that I picked this up.

(Laughter.)

CHAIR SARIS: Is that something that any of you would have a suggestion, sort of opposition to?

MR. ROTH: It makes sense to me. I hadn't thought about it until I saw their letter. And given the pre-retail status of these —

CHAIR SARIS: I mean if we stuck with that distinction?

MS. BARRETT: And I assumed, and again I hate to keep going back to the Application Note 3 in the diversion context, which are post-retail. There's already a loss rule on that, that it's essentially I think going to count the retail value, essentially. And in the case of pre-retail, wholesale seems to be the sensible breakpoint.

MR. ROTH: I mean if I can, again, the difficulty that you are going to run into is being able to trace back the drugs to their original origin in a large percentage of these cases where you won't actually be able to understand how they got diverted, whether they got diverted through street sales, retail, whether they got diverted pre-retail, whether

they were imported illegally — you know, purchased and imported illegally —

VICE CHAIR JACKSON: Is that because you just arrive at a place when you find the scenario that you've shown us photos of and you don't really know how they got there?

MR. ROTH: That's exactly right.

VICE CHAIR JACKSON: Yeah.

MR. ROTH: That's exactly right. Either we're able to do it, either through the import side, through the theft side, or through the street side, which you sort of work your way up the chain, you're unaware of those other chains until you get there. And then by then it has been co-mingled, which is the whole point behind doing this, of course, is to try to break that chain.

And that is of course where the harm comes in, as well. You're breaking that chain, so you don't know where those drugs have come from. Independent of the storage issues, recall issues, obviously expiration date issues.

So that is why we are sort of very

heartfelt in this idea that you would have to broaden it. And it actually answers a lot of the problems that you have in trying to figure out, you know, Judge Saris's hypothetical about something that is not retail ever.

CHAIR SARIS: You would say "never"? Because if you go into a hospital, the drugs are in the hospital or warehouse or that sort of thing, or headed towards a hospital, would never be pre-retail because if it's distributed to patients it's not considered "retail." So that's the concern? But if it were going to, for example, the hospital pharmacy, maybe it is. And you're saying that's just too unclear?

MR. ROTH: And that is a distinction without a difference when we're talking about the harm that we're attempting to address.

VICE CHAIR JACKSON: Do you agree with —

COMMISSIONER HINOJOSA (By Video): And it's not retail if you're charging the patient?

MR. ROTH: I mean that's certainly the argument I would make if I were the government, that

it's pre-retail —

CHAIR SARIS: You are the government.

(Laughter.)

MR. ROTH: That's a good point. If I were in the AUSA like I used to be, right. I mean, that's the argument I would certainly make, is that at the moment that it title passes or whatever sort of construct you'd use, that the patient then owns it because it is purchased at the time that it's dispensed.

That would be the argument I'd use, whether —

COMMISSIONER HINOJOSA (By Video): Probably at a higher price than retail.

MR. ROTH: I'm sorry?

COMMISSIONER HINOJOSA (By Video): Probably at a higher price than retail, if you look at your hospital bill.

MR. ROTH: Right. Exactly right.

VICE CHAIR JACKSON: Do you agree with Ms. Barrett that the heart of the legislation here really goes to cargo thefts, and warehouse thefts?

Is that most of — when you do follow the theft aspect of this, is that most of the cases that you see?

MR. ROTH: I think it is large-volume theft. Whether I would characterize it as "cargo" or "warehouse," as opposed to, you know, a UPS shipment. I mean, some of these drugs come in tractor trailers, but some of these drugs, very expensive drugs, are going to be delivered by FedEx. So I would not sort of limit it to sort of the conveyance and where it's housed, or the conveyance that's being used.

And again, you know, go back to the harm that we're trying to fix here, which is theft and then reintroduction. So really any volume of theft I think is something —

VICE CHAIR JACKSON: But you mostly see these big cases. It's not really the person in the stock room?

MR. ROTH: The nature of federal law enforcement is that, you know, those are the kinds of cases that we would address.

CHAIR SARIS: These ones you showed us the pictures of? That's what you're worried about

mostly?

MR. ROTH: You are always worried about the greater harm. That is absolutely right. And again, you know, the thefts where somebody steals a couple dosage units out of a pharmacy, or out of a hospital, it's not something that we typically spend our time on, simply because of, well, candidly, the guidelines and everything else it's simply not worth the federal investigative resources.

COMMISSIONER FRIEDRICH: As currently drafted, the proposed amendment is not conviction-based. Some of the other 2B1.1 enhancements are. If we are concerned about this inadvertently causing issues in other cases, double-counting et cetera, would it not be the type of case where we should require a 670 conviction for these enhancements to apply?

MR. ROTH: I think that again gets into difficulties of proof, if that's what you do, simply because it is almost impossible to trace back in many of these cases the source of the drugs that were diverted.

COMMISSIONER FRIEDRICH: So you would prosecute them as, what?

MR. ROTH: We would prosecute them as mail fraud, wire fraud, health care fraud; as a violation of ITSP, false statements. The Prescription Drug Marketing Act has these very specific requirements that there has to be a pedigree that is attached to every drug so you understand where it has come from in the supply chain.

So those are the kinds of statutes we —

CHAIR SARIS: What is ITSP?

MR. DEBOLD: Interstate Transportation of Stolen Property, or property obtained by fraud.

CHAIR SARIS: Go ahead.

MS. BARRETT: I am a little troubled by the detour that this whole process is taking. And I would ask that, if the Commission is going to do that then we wait and we look and see what's happening —

CHAIR SARIS: You mean —

MS. BARRETT: Well we're talking — because the proposed amendment and the issue for comment is specifically dealing with the directive relating to

this new offense of 18 USC § 670.

We now have diverted things that are not pre-retail and a whole host of other issues related to pharmaceuticals potentially being injected into this guideline. And quite frankly that is not an opportunity that, you know, the Defenders have even had an opportunity to look at those cases, and aren't going to between now and the time of our comment period.

COMMISSIONER WROBLEWSKI: But you are about to testify in a couple of minutes —

MS. BARRETT: On counterfeit —

COMMISSIONER WROBLEWSKI: — about another law.

MS. BARRETT: Counterfeit drugs, adulterated drugs, which are different than diverted drugs.

COMMISSIONER WROBLEWSKI: Right. And so that's where my question is. I mean, should the Commission try to reconcile all of this? Or do we address it one statute at a time, and really defer to Congress?

You know, Congress has said here are the enhancements, but it's just for pre-retail. Okay, now we're going to get into counterfeiting and adulterated, and here is our laws on that. How much do we defer to that? Or how much do we try to make sense of what's really happening, what's really being investigated and the fact that I think for many of us it is hard to see the difference for sentencing purposes of one versus the other, despite the fact that Congress made this line called "pre-retail"?

I am just curious what you think the role of the Commission should be.

MS. BARRETT: I think that the Commission can serve a valuable role in looking at all of these together, and to try to come up with proportional sentencing that really encompasses the various harms.

I just think that the way we have gone about it in terms of trying to, well, we have this directive and we have this offense, and we have this directive and we have this offense, it's difficult to do that.

And from the Defenders perspective, it is

difficult, too, because outside the context of Viagra counterfeiting, we are not seeing these cases, really. That's the cases that we see, and the cases that Judge Saris is talking about. But often — and it's interesting. The people that I, when I ask about counterfeit drugs, most of them were controlled substances that were going to 2D1.1 anyway, the theft from the hospital pharmacy on the street. And that's a different issue, of course.

CHAIR SARIS: Did you want another question? Are you done?

COMMISSIONER WROBLEWSKI: Yes.

COMMISSIONER FRIEDRICH: Okay, I'm just curious. Why doesn't the government support a cross-reference to the Involuntary Manslaughter guideline, which would put you at a Level 30? Instead, you have this floor of 18. I'm just curious. Is that because the SOC is already in there and you want to build on that? What's the thinking there?

MR. ROTH: I think that's right. I mean, I think at the end of the day it just depends on how the sentence gets driven.

So if the sentence, for example, if we have the enhancements that we believe that we ought to have in this — and again, this comes down to the inherently risky nature of medical products being stolen. At some level, we have to understand that stealing medical products is a fundamentally different crime than stealing tennis shoes, and it ought to be treated as such, regardless of whether it is part of cargo, or in some other part of the — which is why we are serious about the enhancements, the 8-level enhancements that we're talking about for actual harm and risk of harm that we are recommending.

So if we get those enhancements, of course then we don't need the cross-reference. If it's a lower guideline level, then of course we would want the cross-reference.

COMMISSIONER FRIEDRICH: But your floor in death would be at 18. You just are so confident that you get a whole bunch of other enhancements under 2B1.1 that that's —

MR. ROTH: If it involves reckless

conduct, I guess that's correct. That is correct. So you'd have 6 plus 18 —

COMMISSIONER FRIEDRICH: Plus 30.

MR. ROTH: Right.

CHAIR SARIS: We need to move on, but the one thing I would ask you is, so that we don't pick up the bed pans and the latex gloves, if we decided to go to do something in response to this directive but we didn't want to capture all these things that are I think the heartland of what you are talking about where you showed us that picture of. You know, a picture is worth a thousands words and not, what did you call them, Class I and II, I forget the —

MR. ROTH: Class I, II, and III, yes.

CHAIR SARIS: It would be useful to find out how you would define, if we had an application note, the more serious offenses that you would be able to say, you know, an employee shouldn't get minor role, or should get plus-2, or however we decided to do it because you may feel differently about the different kinds of products that we're

talking about.

MR. ROTH: Got it.

CHAIR SARIS: And it's primarily drugs you're talking about, right?

MR. ROTH: And some devices, as well.

CHAIR SARIS: Okay. All right.

MR. ROTH: The devices from Boston Scientific, for example, were.

MS. BARRETT: There's actually — if I could just have one minute?

CHAIR SARIS: Yes.

MS. BARRETT: There's actually two — the class — and I am not an expert on FDA regulations other than the three-week expert that I've become — but the way I understand it is, the medical devices are by class.

The recall warnings I think are also worth the Commission looking at. Because on a lot of these, there's not a recall. It's just a warning that said make sure it's not tampered with. And if it's not tampered with, you can use it. And that's really a lot of the times what happens with the

infant formula.

And that is a very different kind of issue than what we're talking about when seeing these pictures, which really would be prescription medications that are potentially adulterated and they're likely to result in an actual recall that says don't use this drug.

CHAIR SARIS: But he had said that some involved these devices like Boston Scientific, so you would have to make it broader than —

MS. BARRETT: Well I'm saying, you know, I think that there's a difference between the mitigating factor for a Class I medical device versus the drugs, even, or the infant formula, or the other host of things that are considered — like antiperspirant, even, and there have been reported instances of antiperspirants and sunscreen cargo thefts of those things.

That is not as bad as a prescription drug that's been diverted, because it results in a different kind of warning.

CHAIR SARIS: All right, we need to

move on to the next panel. And you should not go anywhere.

MS. BARRETT: I won't. He's not, either.

(Laughter.)

CHAIR SARIS: Both of you are the same. All right.

MS. BARRETT: We're stuck.

CHAIR SARIS: Thank you, very much.

(Background banter as panel is being seated.)

CHAIR SARIS: Mr. Lynch is back. It's almost like musical chairs here.

Well, we will move right on to our next — it is really related. It's good to have these panels back to back — set of issues: The Food and Drug Administration/Counterfeit Drugs and Military Goods. So it combines both of the issues.

John Roth, whom I've already introduced. John Lynch, whom I've already introduced. And Denise Barrett, whom I have already introduced. So there we are, and hopefully we can — Mr. Roth, I don't know whether you I think are supposed to begin the second

time around.

MR. LYNCH: I think mine has more of just sort of a broad overview.

MR. ROTH: I think it would probably make more sense for Mr. Lynch to go.

CHAIR SARIS: All right.

MR. LYNCH: Thank you very much.

Thank you for the opportunity to appear before you once again today, this time to share the Department's views on the Commission's proposed amendments regarding counterfeit drugs and counterfeit military goods and services.

The manufacture and sale of counterfeit drugs is one of the most alarming forms of counterfeiting. It is unfortunately a problem that has grown rapidly in the last several years.

Counterfeit drugs not only undermine confidence in legitimate drugs, but also pose serious health and safety risks. More sophisticated methods of manufacturing, packaging, and distribution have created unprecedented opportunities for criminals to traffick in dangerous counterfeit drugs.

The drugs look real, but they rarely function as genuine pharmaceuticals should. In many cases they contain few or none of the active ingredients of genuine drugs, resulting in patients receiving ineffective treatments.

In other cases, they may contain too much of an active ingredient, leading to dangerous health consequences. Counterfeit drugs may be loaded with cheaper substitute ingredients that lack any of the tested therapeutic benefits of legitimate drugs, and some contain harmful ingredients, including toxic chemicals or biological contamination.

Indeed, there have been instances where consumers became seriously ill or even died from ingesting counterfeit drugs.

The problem is compounded by a variety of factors. Counterfeit drugs are cheap to make and have high profit margins, especially counterfeits of expensive name-brand drugs.

Labels and packaging can be made to look more convincing than ever. The small physical size of drugs makes them easy to ship and import, and the

counterfeit nature of a drug is often difficult to detect without sophisticated chemical analysis.

In addition, counterfeiters often target markets that are especially susceptible by offering their products through nontraditional or untrusted sources like fraudulent Internet pharmacies.

Congress recognized the growing threats with the increased sale of counterfeit drugs in the Food and Drug Administration's Safety and Innovation Act, FDASIA, which I know you've been talking about up till now, and added a new subsection doubling the maximum statutory penalties for trademark counterfeiting offenses involving a counterfeit drug.

Of the three options by which the Commission proposes to address the amendments to section 2320, the Department strongly supports the approach of Options 1 and 2 that would maintain the existing reference to 2B5.3, counterfeit drugs trafficking under section 2320(a)(4) that maintains the existing reference to 2B5.3, I'm sorry.

Counterfeit drug trafficking under section

2320(a)(4) remains a trademark counterfeiting offense. That, like other 2320 offenses, is driven primarily by profit motive and impacts trademark owners as well as purchasers and consumers.

Maintaining a reference to 2B5.3 would provide consistency with other 2320 offenses and avoid sharply disparate sentences between counterfeit drugs crimes and other counterfeiting cases that may pose similar dangers to health and safety such as counterfeit automobile airbags, electrical components, or safety equipment.

At the same time, trafficking in counterfeit drugs poses dangers to public health and safety that are similar in many respects to those posed by drug tampering offenses that carry a much higher base offense level.

Therefore, we would urge the Commission to consider modifying its proposals somewhat to provide for higher enhancements and related minimum offense levels.

We support a 4-level enhancement rather than two levels for counterfeit drug offenses, even

absent any showing of consciousness or recklessness with regard to the risk of injury.

Because drugs are intended to be ingested, injected, or otherwise applied to address medical conditions, the mere involvement of counterfeit drugs presents an inherent risk.

This creates a significant aggravating factor in section 2320(a)(4) offenses, as compared to some other types of 2320 offenses involving products with less potential for injury.

Moreover, that counterfeit drugs of any type present at least some risk of injury is or should be obvious to a defendant, even absent any additional specific indications that the counterfeit drugs in question pose a health risk.

In this regard, in cases were additional indications of a risk of serious injury or death actually do exist, that would be an aggravating penalty that we would recommend warrants a higher penalty.

We recommend increasing the enhancement for such conduct to four levels, and also raising the

minimum offense level in such cases to 16. This could encompass situations in which a defendant is aware or has a reason to believe that a counterfeit drug contains a harmful ingredient, lacks an effective dosage of an active ingredient, and is intended for the treatment of a serious condition, or it would be marketed to particularly vulnerable victims such as seniors or children.

With these increased penalties in mind, the Department prefers the approach of Option 1 which would add a separate specific enhancement for counterfeit drugs.

We would also recommend additional language to clarify that the enhancements for counterfeit drugs and conscious or reckless risk or death or serious bodily injury are to be fully cumulative, given the distinct purpose for each enhancement as I described.

Finally, we also support changes to the guidelines that would take into account actual harm resulting from counterfeiting offenses. The current section [2B5.3(b)(5)] enhancement applies where there's

a risk of serious bodily injury or death, but the existing guidelines do not adequately address when such risks are borne out and the crime actually does result in significant injury or death.

We support amending the guidelines to take actual injury into account, either through additional specific offense characteristics providing for significant enhancements, or through the inclusion of additional commentary regarding an upward departure in cases where serious bodily injury or death actually results.

Shifting from the subject of counterfeit drugs, I would like to briefly provide our views on the Commission's proposals with regard to a different but also troubling aspect of trademark counterfeiting, trafficking in military goods and services.

The potential for counterfeits to do harm is heightened in the military context where the goods or services involved may be deployed in sensitive applications, and the lives of military personnel may literally depend on the integrity and reliability of

a product.

The enormity of the defense supply chain can attract unscrupulous providers seeking to profit from high-volume sales of counterfeits, while the complexity of that supply chain can make it difficult to hold traffickers and counterfeiters accountable.

Both these factors weigh in favor of the need for increased deterrence against military counterfeits. The Department has prosecuted cases under section 2320 involving counterfeit military products, including counterfeit integrated circuits falsely marked as "military grade" which were sold to the U.S. Navy, and counterfeit network hardware intended for use by the Marine Corps to transmit sensitive data in Iraq.

The National Defense Authorization Act for fiscal year 2012 amended section 2320 to provide a greater deterrence against this type of counterfeiting, and to reflect the seriousness with which Congress, like the Department, regards counterfeit products that pose a danger to our military and our nation's security.

The Administration shares this concern, as reflected in its *White Paper On Intellectual Property Enforcement Legislative Recommendations*.

Of the four proposed amendments under consideration by the Commission on this point, the Department favors Option 1 because it would result in enhanced penalties for trafficking in military counterfeits while appropriately limiting its use to offenses that posed heightened risks.

The statutory language reflects Congress's recognition that not every sale of counterfeit goods or services to the military will necessarily pose heightened risk warranting significantly enhanced penalties.

By limiting application of the enhancement to violations of the offense conduct specified in the statute, Option 1 would reserve the enhanced penalties for the cases of greatest concern, while treating counterfeit offenses with a merely incidental military connection as ordinary, albeit still sometimes still serious, trademark counterfeiting offenses.

The Department would also support the approach of Option 3, which incorporates language similar to the existing enhancement in section 2B1.1(b)(17) for offenses under the Computer Fraud and Abuse Act involving computers integral to the critical infrastructure, or used in national security or law enforcement applications.

Under this approach, the enhancement could be extended to counterfeiting of products that pose risks to a broader range of interests than enumerated in the military counterfeits offense.

Again, though, we believe the guideline enhancement should be tailored to address those cases of greatest concern. And therefore we would recommend that if the Commission chooses the Option 3 approach, the language proposed by the Commission should limit application of the enhancement to the offenses in which the connection between the counterfeit products and critical infrastructure or national security is clear and more than incidental.

In closing, I thank the Commission for the opportunity to present our views on these topics, and

we would be happy to address any questions you may have.

CHAIR SARIS: My court reporter would have had trouble.

MR. LYNCH: I'm sorry.

(Laughter.)

CHAIR SARIS: There was a lot of information. Thank you. Mr. Roth.

MR. ROTH: Thank you, Your Honor, and members of the Commission:

Again I appreciate the opportunity to speak to you. I am going to focus the initial remarks on the intentional adulteration aspects of this, which was enacted by FDASIA, which addressed a significant shortfall in the penalty for intentionally adulterating medicines.

The increases in penalties here are significant. The maximum penalty for adulteration with a reasonable probability of causing serious adverse health consequences or death was increased from 1 year, or 3 years if we could have proven an intent to defraud, to 20 years. So we are talking

about either a 20-fold, or an over six-fold increase in the statutory maximum penalties.

FDASIA was passed in part as a result to the serious incident involving the contamination of a drug called heparin which is a blood thinner, with a substitute. In 2007 and 2008, heparin was imported from China and linked to significant issues, including lower blood pressure, breathing difficulties, vomiting; there were a number of health problems reported, and many of them very seriously, including a number of deaths that were reported as a result of this heparin incident.

The FDA investigated this and determined that the heparin was adulterated with a substance that had been substituted during the manufacture in China, because the normal product that they would use was derived from pig intestines and there was a drastic reduction of the pig population in China.

Adulteration can also occur when finished drug products are intentionally diluted. We had a case in 2004 of a Rhode Island physician who was convicted of adulteration and tampering with consumer

products after he diluted vaccines for a number of things and administered them to patients.

We had in 2002 a pharmacist who was convicted of adulteration and tampering, diluting various drugs, including chemotherapy drugs, before dispensing the drugs to consumers in this pharmacy.

Investigation there indicated that some of the drugs were diluted to less than 10 percent of their original strength, and over 4,000 people may have received the diluted drugs.

A drug may also become adulterated if it is stored or handled improperly. We had in 2012 the case of James Newcomb who was sentenced to prison for conspiring to distribute adulterated drugs. He was an individual who would purchase foreign prescription drugs and sell them to the U.S. doctors at significantly lower prices than is normally charged for FDA-approved drugs.

Among the drugs that he would sell were these oncology or cancer medications that require what they call cold-chain storage, that require constant cold storage all the way through the supply

chain, but were received by customers in compromised and unrefrigerated condition.

Adulteration can rarely be detected by the naked eye. In many cases, it takes sophisticated analysis to identify the nature of the adulteration. When the drug is intended for treatment of serious or chronically or terminally ill patients, adverse consequences, diminished effectiveness caused by the adulteration can be incorrectly attributed to the underlying illness itself and go unreported for months, or not even reported at all. That has been the case in a number of the oncology cases that we have seen, which are basically life-extending drugs for very sick patients who have cancer.

With regard to the proposal with regard to adulteration, we support Option 2, which refers the offenses for intentional adulteration to the tampering guideline, which is 2N1.1.

There are a number of reasons why this makes sense. First, tampering and intentional adulteration are highly similar, both in the conduct that was involved, the risk of harm to the public, as

well as the penalties. Each has similar statutory penalties for similar conduct.

Many of the cases that have been charged under the tampering provisions that have probably also been charged under the intentional adulteration statute had the offense existed at the time.

As a result, having similar penalties for the two offenses promotes consistency and minimizes disparity based on charging decisions.

Second, Option 2 reflects the congressional recognition that the offense is a serious one. Strong penalties are needed to protect the integrity of the U.S. supply from intentional threats. The dramatic increase in the penalty that we're talking about. Again, either a 20-fold or a 6-fold increase, depending on the offense, highlights the significance of the issue.

We think that Option 2 is far less preferable for a couple of reasons. First, we don't think that an offense level of 14 reflects the seriousness of the offense and the consequent congressional action to take the statutory

penalties.

The prohibited conduct involves intentional action where there's a reasonable probability of serious adverse health consequences.

And second, meaningful enhancements are really only possible if you have a large fraud loss. You would have to cross-reference to 2B1.1, which is based on actual or intended pecuniary loss, which is really intended to cover economic crimes. And this is not an economic crime, it's a public health crime Congress enacted as a public health crime.

The monetary loss that is suffered by the individual victims is incidental and doesn't represent sort of the public health risk involved.

I have more graphics, if I may show.

This is a tale of two adulterated drugs. The first is something called Alli — this is also counterfeit and I'll talk about it briefly when I talk about the counterfeit. This is a weight loss drug. It's nonprescription, over-the-counter weight loss drug.

Here is the authentic one. This is the counterfeit one. This is based on an OCI case that in fact we were able to do an undercover operation and actually get to the manufacturer. This cost $50 for a bottle of 120 capsules.

We are also engaged in investigations involving oncology medications. This one is a bottle of Altuzan and there is Avastin, which is the U.S. brand oncology medicine. Again, it's a life-extending drug that is used in combination with chemotherapy.

This contains water, by the way. And in fact not even sterile water. It was water that had mold particulate and a few other things in it, as well.

This bottle costs between $2,500 and $3,000 for a bottle. So the difficulty we have, one of the difficulties we have with tying adulteration to an economic loss are that these would be treated in fundamentally different ways. Excuse my reach here. Notwithstanding the fact that the harm —

CHAIR SARIS: Can you just make sure

Judge Hinojosa —

COMMISSIONER HINOJOSA (By Video): I can see them.

MR. ROTH: Okay, notwithstanding the fact that the harm is very, very similar — and we can have some kind of an argument as to whether it's more depraved to counterfeit cancer medications as opposed to weight loss medication, but in any event the harm is very serious.

I should note that that Alli case involved, it was contaminated with something called Sibutramine, as well as a number of other drugs. That was a weight loss drug that was taken off the market I think in 2010 as a result of a higher incidence of heart attacks and strokes. And in fact in the sentencing in that case, we were able to produce evidence of an individual who have taken that and suffered a stroke as a result.

Let me turn briefly to counterfeit drugs. Mr. Lynch talked about the Department's position, the government's position with regard to that. I just want to talk about the kinds of cases that we're

seeing so the Commission gets an idea.

It is basically —

CHAIR SARIS: What was —

COMMISSIONER FRIEDRICH: Military goods —

MR. LYNCH: Adulteration.

MR. ROTH: That was adulteration, what I was talking about here. And now I am going to move to sort of counterfeiting.

The offense is different. You know, adulteration talks about basically something that is not as pure as it is represented, or contains other filth, impurities, or it contains some other kind of an adulterant, as the name suggests. So that was one penalty that's within Title 21, § 331.

The counterfeiting, again, is pointed at economic loss. Mr. Lynch talked about the fraud table and loss table. That is obviously the unified government position on that.

But again what I would like to simply talk about are some recent cases. We have the *United States v. Zhou* case, which was a 2010 case that involved the counterfeit Alli containing the

Sibutramine where we had actual individuals who had actual physical harm as a result of that.

In February 2010, we issued an advisory regarding the counterfeit versions of Avastin and Altuzan that doesn't contain any active ingredient, it only contains water. So these patients were not receiving any treatment when they thought they were, and paying a significant price for this treatment.

The FDA issued similar notices in 2012, and again in February 2013, regarding these counterfeit products. It currently appears that there are at least two separate entry points into the U.S. supply chain for these kinds of drugs. It is obviously something we take very, very seriously and are moving on as quickly as we possibly can.

While the FDA assesses the drug supply in the U.S. to be far safer than any other country in the world, we do think that it is going to require constant vigilance and deterrence of this activity through meaningful penalties. The only way to ensure that is to have significant penalties.

So the kinds of counterfeiting that we see

in other countries — and the Department of Justice letter talks about the kinds of things that we have seen with bottles of a counterfeit diabetes [drug] that caused significant harm and widespread harm.

I think the only way that we are able to ensure that that does not happen in the U.S. is this constant vigilance that hopefully we have.

We appreciate the opportunity to testify and will answer any questions.

CHAIR SARIS: Thank you. Ms. Barrett.

MS. BARRETT: Thank you, again.

I am actually going to confine my remarks to counterfeit drugs. Our testimony talks about counterfeit and adulterated drugs, and we will be submitting comments on military goods.

The reason we are choosing counterfeit drugs is because there are a small subsection of those clients who are actually Defender clients. And as I mentioned before, a lot of those people are young men, or middle-aged men who are getting from overseas or elsewhere counterfeit Viagra and Cialis.

And sometimes they're selling them on the Internet, and sometimes they're selling them on the street.

And the sentences in those cases are governed by 2B5.3 because they are prosecuted as counterfeiting offenses. Some of them are prosecuted under 2320, the counterfeit statute, which has been amended now; but some of them are prosecuted under the FDA statute.

And there are various results in terms of whether or not the prosecution charges it as a misdemeanor under 21 USC 331 or prosecutes it as a felony. Our concern is that this felony for counterfeiting that is designed to cover these more serious counterfeit cases are going to capture a lot of these folks who are selling these illicit drugs that are typically, if they're adulterated in any way or seem to be — there's no evidence of any harm being associated with these, and there's no evidence of — they're probably more placebo than anything, meaning they're not doing anything one way or the other.

One of the things that struck us as we looked at the congressional report on this and the

directive to the Commission that suggests, well, review and amend if appropriate, but should reflect congressional intent that the penalty should be increased, we're like what was really congressional understanding of the penalties for counterfeit drugs? Because it's difficult to tease out because the 331 statute has — lumps a lot of different offenses together, and the generic counterfeiting statute lumps offenses together.

And what they did is actually they apparently relied on data that looked at counterfeit goods cases where they said, well, the mean was 10 months, and the median was 17 months in counterfeit good cases, and that is too low for counterfeit drugs cases.

Well based upon what we have looked at, and some of this is cited in the testimony in terms of 87, 78, 33, 24 month sentences being imposed in counterfeit drug cases, we think that some of that statistical evidence might have been skewed in terms of what congressional understanding was.

We know, just looking at 2B5.3 which is

what we're talking about in terms of referring these, we pulled data — and this isn't in my testimony and I apologize for that, but it will be in my written testimony next week, comments next week — we pulled five years of data from 2006 to 2011 under 2B5.3, and we see that 24 percent who are sentenced under 2B5.3 receive a 5K departure.

That is twice the average from the Commission's latest fiscal quarter release of 5K departures. So they are getting a lot of cooperation in these counterfeiting cases. So that doesn't seem to be a factor that Congress was kind of considering necessarily when they thought that these cases were too low because they're not factoring in the reason they're low is because the government is asking for departures.

So 5.4 percent, aside from the 5K, received a government-sponsored below-range sentence. And then here's where the number really jumps: 34.6 percent received a non-government-sponsored below-rate sentence, which again, compared to the last quarter statistics across the board for all offenses

for non-government-sponsored below-rate is 17.7.

So that data suggests that the courts are saying the counterfeiting is too high — too low — I mean, too high — too high — let me get it right; it's getting late in the day — too high, not too low.

Now it is difficult to break out. Again, we're just looking at all counterfeit good cases, but we do know that there is a chunk of those that are counterfeit drugs prosecutions. And unfortunately the Commission are the only folks who are in the position to actually look at those presentence reports and pull that out and figure out what the exact sentences are, but again our suspicion based upon, you know, you have a drop shipper who basically is getting the drugs and then shipping them out to someplace else, you know, who is getting two years and ordered to pay $324,000 in restitution.

And this restitution, a lot of these restitution amounts are going to Eli Lilly and Pfizer in our particular cases.

But, so I think that we have to be careful about trying to figure out what did really Congress

mean, and what was it understanding as to what was too low for a counterfeit drug case versus what is too high.

The other point that I would like to address here is I am really kind of curious about the government's position. I think it's an example of let's keep going up and up and up.

Two years ago, in two separate reports, one the counterfeit pharmaceutical inter-agency report, signed on by every government agency including the Department, and ICE, and the FDA, Intellectual Property, and the Administration's white paper on intellectual property enforcement, they specifically said that the enhancement should be two levels for counterfeit drugs, with a minimum offense level of 12, a 4-level increase for reckless risk of serious bodily injury, and a minimum offense level of 14.

Now, today, as far as I know nothing has really changed in those two years since this white paper has been done, they are asking for four levels for counterfeit drugs, four levels for serious bodily

injury, and a minimum offense level of 16.

So even at the minimum, just for the counterfeit drug, in two years we have gone from 12 to 16. It seems completely arbitrary to us as to what really is driving this.

And what we look at, what we are really concerned, too, is that back in the early 2000s the Commission made a specific amendment to 2B5.3 to add serious risk, or reckless risk of serious bodily injury or death. And it was specifically directed at counterfeit goods that could present a harm.

And in the reason for amendment, and in the Commission's staff working report, they talk specifically about counterfeit pharmaceuticals. So we have a guideline that actually is taking into account this risk, and it's not a hard standard to meeting.

It doesn't require actual harm. It only requires some risk, it doesn't have to be small. This is from the case law interpreting this. It only has to be obvious to a reasonable person that there is such a risk.

In the health care fraud context, this guideline also applies because there is a similar guideline with a 2-level increase in 2B1.1, as it is in 2B5.3. Dispensing a medically unnecessary prescription, or providing medically unnecessary treatment that keeps the person from getting proper treatment has been sufficient grounds in the health care fraud context for that adjustment to apply.

So we think really to get a 2-level enhancement and minimum offense level of 14 for counterfeit drugs, all they really need to show is that a reasonable person would have known that the drugs could have an adverse effect or cause people to get the treatment — to forego getting treatment.

So what we fear is, we already have a guideline that was designed for this type of offense. We want to pile on another one? And what we fear is that this year it is going to be counterfeit drugs, and two years from now it's going to be lead tainted counterfeit toys that really aren't Hasbro toys, that are really not Sponge Bob. It's made in China. It's got lead paint on it.

Or, another problem, counterfeit electrical products like extension cords that have an inherent risk of fire. You know, when are we going to stop? I think it becomes a slippery slope for the Commission that's already carefully crafted a guideline dealing with reckless risk of serious bodily injury that's generic enough to apply in any of those situations when need be, that is also specifically crafted to be proportional to the 2-level increase in 2B1.1, when all of a sudden we're talking about we're going to have counterfeiting, and we're also going to have serious risk of bodily injury, and we're going to have actual harm, and then all of a sudden all the attempts that the Commission has made to make 2B5.3 and 2B1.1 proportional, which by the way 2B5.3 was increased from a Minimum Offense Level of 13 to 14 precisely because the Department wanted it proportional in terms of 2B1.1 and 2B5.3, that again a couple of years from now they're going to be coming back and saying, oh, well, you made the four under 2B5.3, now you need to make it four under 2B1.1.

So we think at bottom again there's enough there, and it's another example of kind of just upward ratcheting that ultimately, given the high departure rate and variance rate in this guideline, is actually just going to result in more below-range sentences rather than within-range.

CHAIR SARIS: Thank you. Did you want to ask a question?

VICE CHAIR JACKSON: Yes. In light of your testimony, Ms. Barrett, the Defenders support language in 2B5.3 that would clarify that the conscious risk of death or serious bodily injury that is already there applies in situations in which there was a counterfeit drug?

MS. BARRETT: I don't think it needs clarification, but actually I don't think we would have any objection to that. Because I looked at a lot of cases, and the case law seems pretty clear that it's a very, very loose standard

CHAIR SARIS: I have a question with respect to the military. We have this concept of critical infrastructure, which when you actually look

at it it is extremely broad.

I think it refers to everything from delivery of justice systems, to gas and oil. Do you have any way of sort of — how do you address the option that deals with the infrastructure?

MR. LYNCH: We haven't come to specific language on that issue. We have — we do recognize that that use of the critical infrastructure in this area, that is a relatively broad definition. And the harm from making, you know, for producing or selling counterfeit toner to a JAG's office which administers justice but probably is not going to kill anyone, is going to be significantly different from, you know, bullets, or, you know, or communications equipment that could malfunction and cause injury to a military service member, or, you know, cause a possible compromise of communications. That sort of thing.

We are willing to work with the Commission to try and cabin that, but one of the Department's concerns here is that we look to risk of — you know, that there be actual risk of harm to the service members, to military members, and that the higher

application of — the greater application of an offense level increase be done in those circumstances where we have —

CHAIR SARIS: So you don't like this Option 3, basically?

MR. LYNCH: We like the — we prefer Option 1.

CHAIR SARIS: Option 1? Okay.

VICE CHAIR JACKSON: I get Option 1, but I'm so curious about that, because I just see this as a totally different approach than the approach you take with respect to counterfeit drugs, right?

I mean, if you are concerned about the risk in the military context, what you've done in other situations, including the counterfeit drugs, is you've made that a separate prong.

So you have counterfeit drugs. You get a 2-level enhancement. And then the conscious risk is something else.

MR. LYNCH: Right.

VICE CHAIR JACKSON: Whereas, in this context for military I would have thought that you

would have wanted Option 2 because it's a counterfeit military product. And then if you also think that the risk is something significant, then you would want a separate enhancement for risk.

So can you just maybe help me to understand why this isn't a different approach than you've taken in the —

MR. LYNCH: I mean I think you're talking about different — I mean, you know, counterfeit drugs, you know, because of the nature in which they are used, that they're by nature being applied, injected, you know, given to somehow affecting a person. And so there are inherent risks in there.

Counterfeit military products, the supply chain is just enormous. And some products are going to be, you know, have a very, very serious risk of being placed into conditions where, you know, they are malfunctioning, or their risk of use is going to cause a big problem, and we recognize that in some circumstances they're not, but it's still a problem.

It is still an economic problem. It is still something we are concerned about. But I think

we would want to be careful that we don't overapply the guideline just sort of across the board as we would, you know, as I think Option 3 set alone would do.

COMMISSIONER FRIEDRICH: Can I follow up on Option 1, which as I understand it just tracks the statutory language? Is that correct?

MR. LYNCH: That's correct.

COMMISSIONER FRIEDRICH: Okay. So one prong of that is, it's likely to cause serious bodily injury or death. Those are guideline terms that courts can apply easily. But it goes on to include "or other significant harm to" and one of the phrases is "to a member of the armed forces." So you can have serious bodily injury or death to anyone, but what is the difference with this "other significant harm"?

Are we better off striking that? I mean, what is captured by that that is not covered by the other? And is it going to be confusing for courts to apply in just a normal case?

What is the "other significant harm to a

member of the Armed Forces" that is not "serious bodily injury"?

MR. LYNCH: I am not exactly positive what Congress had in mind on that.

COMMISSIONER FRIEDRICH: But why should we incorporate it if it is confusing and you can't —

MR. LYNCH: I mean, I think "other types of harms" may be, you know, that the person is not, you know, put in direct risk of, you know, in direct risk of line-of-fire type harm where they're using a product and it's sort of a defective bullet.

You may have things like we've seen where we have, you know, communications equipment, which if compromised, or more easily compromised. And we certainly have in this area situations in which the communications equipment can be compromised and there could be harm that is not, you know —

COMMISSIONER FRIEDRICH: But that —

MR. LYNCH: — their life.

COMMISSIONER FRIEDRICH: But this is not a risk. This is "causes other significant harm to a member of the Armed Forces." That's the phrase that

I'm struggling with. I mean, it's actual harm to — is it inconvenient?

MR. LYNCH: Not inconvenience, but, you know, it could put them in greater danger of capture. It could put the military, you know, the upcoming military movements, you know, could be disclosed. And that could cause harm to a — that could cause a more generalized harm —

COMMISSIONER FRIEDRICH: It's a risk.

MR. LYNCH: — that doesn't put —

COMMISSIONER FRIEDRICH: It's a risk of —

MR. LYNCH: It's a risk of harm, but you could — once an adversary knows our upcoming plan, that does put — it may put them at risk of bodily harm.

COMMISSIONER FRIEDRICH: No, I get that it says "significant harm to a combat operation." That's kind of covering what you're talking about.

MR. LYNCH: Right.

COMMISSIONER FRIEDRICH: It's this other phrase, to me, that's just — I get it, it's coming from the statute, but I just could see courts

struggling with is it something short of serious bodily injury that is meant to be captured by that? And if so, what is it? It's just we don't —

MR. LYNCH: I can do a little bit more research and see if I can come up with something in additional comments, if that's —

COMMISSIONER FRIEDRICH: One followup. If one of you could just address Ms. Barrett's points about the government papers, you know, a year or two ago, recommending a floor of 12 and plus-2, rather than where you are today, what's changed?

MR. LYNCH: I think — I mean, I'll defer to Mr. Roth, as well. I mean, I think we've just seen a continued, you know, increase in the overall problem and the overall danger.

Outside of, you know, the adulteration context, we see, you know, even in these Viagra cases, you know, these purchases and so forth are being done outside the normal chain of medical doctors and obtaining the necessary disclosures and so forth that go along with, you know advising doctors, which is the reason why we have —

CHAIR SARIS: But can you just — I do get it. I see these horrible pictures dealing with, you know, water instead of chemotherapy drugs. And, you know, everything in you is "get those guys." But then you hear about the Viagra cases where you think that, you know, that seems — not that it's not important, but, you know, just of a different magnitude.

So what do you think? Would a 14, or a 12, you're not so worried about that?

MS. BARRETT: Well we think they already, in some of these cases they're already getting to this level because they're getting the — first of all, there's a cross-reference to 2B1.1, which is again driving it up because there's a fraud involved.

And then you have some of the cases, not all of them, it depends on whether or not they're getting an additional enhancement for risk —

CHAIR SARIS: A 12 to 10 to 16, that's not — assuming for a minute it's not something that is tainted with something that causes serious bodily injury, as I'm understanding how this works,

if you did it at a 12 at 10 to 16 months, and at a 14 it's 15 to 21 months —

MS. BARRETT: Which is why —

CHAIR SARIS: — isn't that what people are getting anyway?

MS. BARRETT: Well actually that's why I think the guideline is too high in these cases. Because if you look at the footnote, there is a footnote in my testimony that actually talks about the Viagra cases. It's a list of them.

CHAIR SARIS: What are people getting?

MS. BARRETT: They're getting anywhere from 24 months to probation. And even, probation — one of the disparities in the practice, again, is whether or not prosecutors are charging it as a misdemeanor under 21 USC 331, or charging it under the felony under 2320.

And there have been prosecutors in Minnesota who had the good sense to say to two 20-year-olds who had no prior history, who were selling counterfeit Viagra, that said, you know what, we

don't want you to have to have a felony conviction and walk through life with a felony conviction. We'll let you plead to the misdemeanor.

CHAIR SARIS: Okay, but putting that aside —

MS. BARRETT: So what's happening is, aside from that you have these scenarios where prosecutors are recommending below-range sentences, or court are imposing below-range sentences to probation, recognizing that, you know, even in terms of the fraud if you're going on Craigslist and you're buying Viagra, you know you don't have a prescription and you know it could be counterfeit.

So even for the consumer risk, it is not the same category at all as going to chemotherapy and thinking that you're getting one treatment for cancer. It's fundamentally different.

CHAIR SARIS: What do you think?

MR. ROTH: I mean, I guess I have a couple of things. One, you know, sort of this tongue-in-cheek humor about the fact that these are erectile dysfunction drugs, I mean these are drugs that are

made in India and China under horrifying conditions. They may have the right amount of active pharmaceutical ingredient — in other words, they do not fall within the "adulteration" statute that we're talking about — but they are made under horrifying conditions that will emit a significant health risk to people.

You know, why did the government's position change? I can't speak for the entire government, but what I would speculate is, one, FDASIA was passed and there was a clear congressional mandate that the maximum was doubled from 10 to 20 years. So I mean that is the significant thing that I think we needed to take into account.

Two, we are getting killed on the Internet. I mean, just killed on the Internet. And third, sort of this popular notion that it's okay, you can just go and order the stuff and you'll be fine.

And you won't be fine because this is dangerous stuff that requires a prescription. It requires a prescription for a reason. The FDA has an

entire regulatory structure to determine whether a medicine should be prescription or nonprescription.

This completely circumvents that. We think it is inherently risky, which is why we are asking for the four levels.

One more picture that I wanted to show you, I wasn't sure I was going to get it in, but —

CHAIR SARIS: Viagra?

MR. ROTH: — this is not Viagra. This is not Viagra, but it is — I believe this was cholesterol medication —

CHAIR SARIS: Now you're getting close to home.

MR. ROTH: Yes, exactly right. This was a case —

COMMISSIONER HINOJOSA (By Video): That is the scariest one of them all.

MR. ROTH: This was a lab that was in Costa Rica that, these were U.S. people, persons who were involved, and this photo was taken at the lab, I guess, and then found during the execution of the search warrant.

If you'll notice the kinds of conditions that we're talking about here, with the hairy arms, and the actual pharmaceutical ingredient. So even if they get lucky and get the right API, the right active pharmaceutical ingredient, in the right thing with the right fillers and the right binders and the right delivery mechanism so it's not adulterated, this is still not things that we should — this is not a trivial offense.

So why do we do it? That's why we do it. Now will I say that as a matter of priorities we understand sort of the buyer beware mentality, and FDA has a fairly rigorous sort of consumer education program that may or may not be effective to 20-year-old males who buy this stuff off Craigslist. But in any event, that's only part of it.

We do have to have a deterrence here, because again as I said in my testimony, overseas is awash in this stuff. And we need to have some kind of deterrence here.

VICE CHAIR JACKSON: Can I ask you a question, Ms. Barrett — I'm sorry, I didn't know if

you wanted to respond?

MS. BARRETT: Well I kind of take issue with whether or not that would be adulterated, actually, because one of the definitions of adulterated is filthy conditions.

MR. ROTH: And if we could prove that it's filthy conditions, I suppose – absolutely we can. If you seize a tractor trailer load full of counterfeit Viagra, can we prove filthy conditions without going to India? No.

COMMISSIONER HINOJOSA (By Video): Can you put the microphone closer to yourself?

MS. BARRETT: Absolutely.

COMMISSIONER HINOJOSA (By Video): And there is a new Pope from Argentina.

VICE CHAIR JACKSON: Oh, we have a new Pope? Oh.

COMMISSIONER HINOJOSA (By Video): From Argentina.

MS. BARRETT: That didn't take long.

COMMISSIONER HINOJOSA (By Video): No. Sorry you changed the subject.

(Laughter.)

VICE CHAIR JACKSON: I wanted to ask about the directive in the statute related to counterfeit drugs; that the Defenders position, as I read it, is that the Commission shouldn't really make any amendments because the current structure is sufficient to address the problem of counterfeit drugs.

But we seem to have language in the directive that goes beyond Congress's usual exhortation that the Commission should just review and, if appropriate, amend, to include in order to reflect the intent of Congress that such penalties be increased in comparison to those currently provided by the guidelines and policy statement.

MS. BARRETT: It is, admittedly, a very unusual directive. And I think it conflicts, because it says "review and amend if appropriate," which means that if the Commission finds it is not appropriate they don't need to amend it.

My whole statistical piece that I presented with regard to 2B5.3 actually spoke to how

is the Commission — you know, what's the benchmark? Congress said, even if you accept for a minute that you have a directive "increase beyond what is currently provided," we can say well what did Congress understand was currently provided?

The only reference that I can find in any legislative history to this Act says that the mean sentence that they understood for counterfeit goods was 10 months, and the median was 17.

So if you accept that as the benchmark, okay, they're telling us to raise it above that. I would submit that if the Commission goes and looks at 2320 prosecutions for counterfeit drugs, based upon my nonscientific survey, you're getting sentences of 87, 78, 23, and 20, we're well above what congressional understanding was of what the appropriate penalties were for counterfeit drugs.

COMMISSIONER WROBLEWSKI: Can I follow up on that?

CHAIR SARIS: Yes.

COMMISSIONER WROBLEWSKI: I'm not sure I read the directive the same as you, that we can start

from just "all counterfeiting" as opposed to — which is what you're suggesting we do —

MS. BARRETT: It was the only information they had.

COMMISSIONER WROBLEWSKI: I understand that's all we've got, except of course the words in the statute. But my question to you is:

Let's assume a situation where Congress — forget this particular crime — just in some crime, that only 30-some percent of cases are being sentenced within the guidelines, and judges are sentencing 34.6 percent below whatever nongovernment-sponsored departures, and then there's 5 percent government-sponsored departures. And Congress sees that and they don't like it. And they think that the penalty should be higher. Isn't this exactly what they're supposed to do, is tell the Commission we want them higher than what they are right now?

MS. BARRETT: Well actually I think that it's tough for Congress to do that because they can't — they are assuming that it's a problem with the guidelines and not a problem with the way prosecutors

are agreeing to nongovernment-sponsored departures, or 5K departures. And so I think what the Commission as an expert body can do is they find that they have a directive that it's unclear as to whether or not Congress had a full picture, is to go back and give Congress the full picture.

COMMISSIONER WROBLEWSKI: I know, but the full picture — it seems to me they have —

MS. BARRETT: We've done it before. You've done it before.

VICE CHAIR JACKSON: Don't we assume that Congress knew what it was talking about when it used the language "increase the penalties to greater than what the guideline prescribes right now"? I mean —

MS. BARRETT: But we don't know what the guideline prescribes for counterfeit drugs. We can't tease it out. They had no information whatsoever in front of them on what counterfeit drug cases were getting.

COMMISSIONER WROBLEWSKI: Are you certain about that?

CHAIR SARIS: Yes, sometimes they

make requests of us, I don't know.

MS. BARRETT: The request that I understand that the Commission gave was under 2B5.3 counterfeit goods. Unless there's information not in the public —

CHAIR SARIS: Do you think they thought it wasn't covered at all by that?

MS. BARRETT: No, I don't think it — they weren't saying it wasn't covered by 2B5.3. All I'm saying is that the data that was cited was the data for counterfeit goods.

CHAIR SARIS: The 10 and 17.

MS. BARRETT: Not counterfeit drugs. And if drugs ended up being higher than what Congress thought, I think that especially why did they put in "review and amend if appropriate"? They gave the Commission some discretion with regard to that language.

COMMISSIONER WROBLEWSKI: I mean you can ask the same question: Why did they put that in and now that's their standard language, but this actually is different than their standard language because it

says "if appropriate to reflect". It's "if appropriate" for what purpose? To reflect that we want the penalties higher.

I mean, all the words have to have meaning. I understand that. But it's "if appropriate" to get to where they want to go.

Anyway, but let me ask you about two other things, because you didn't say anything about military counterfeits. Do you agree with the approach that the government is suggesting that we differentiate between those military goods that have some inherent dangerousness and those goods that don't have an inherent dangerousness?

And do you agree that adulterated drugs cases should go to 2N1.1?

MS. BARRETT: On counterfeit military goods, I think that the examples that they are giving are too narrow in terms of what really presents a harm. I mean, there are lots and lots and lots of counterfeit goods in the marketplace, and we are just beginning to tease out and hope to have to you by next week a more thorough list of the kinds of

examples that might fall — that probably ought to fall into that exception that are not nearly the same kind of caliber.

For example, a faulty extension cord, you know, in an office is quite different than an integrated circuit that's going into an airplane. So I think that it is again going to be a problem of the example being more limiting, rather than simply just being an example. And there's going to have to be great care in how that's worded so that we are not sweeping in too many things.

COMMISSIONER WROBLEWSKI: Right, but the principle of differentiating —

MS. BARRETT: I think the principle of differentiating, if we're going to have an enhancement, then we ought to get at the things that really deserve enhancement, which would be integrated circuits in an airplane, and not other things that are used on the ground that don't present these kinds of harms.

On adulterated drugs, I think that there's actually — our recommendation, because again there are

not a lot of these prosecutions, and because it's a new offense with a different kind of mens rea, that it may be worth taking the more modest approach of giving it the, I think it's offense level 14. In the general FDA regulatory, I think it's 2N2.1, not the tampering.

And the reason for that is because tampering is a little bit different. And the elements of the adulterated drug offense, obviously there's going to be some judicial gloss put on that, but it's possible that that offense really does address negligence and recklessness in a different way than tampering.

Tampering requires a reckless disregard for the risk of death or bodily injury, and under circumstances manifesting an extreme indifference to such risk.

The adulterated drug offense, it's almost your knowledge, the way the statute is worded. Your knowledge does not necessarily have to go to the risk.

So it's not like you're knowing the risk.

And, you know, again I mean this is not — I mean, this is probably more an interest in PAG, but I mean I was reading on some blogs of some FDA lawyers who were representing certain pharmaceutical companies that they're worried about what kind of power this new criminal offense will have in dealing with what are essentially now regulatory offenses and trying to get drug companies to clean up their act.

Because as my testimony talks about, there's a lot of cases where the FDA is working with manufacturers in this country who have problems with adulteration and they want to move them along.

Well this gives them a really huge stick to move them along in a way that it might be that the fact that it's a new criminal offense, that it's considered, you know, a more strict regulatory offense under the guideline that covers the regulatory offense is better than treating it as tampering where somebody is deliberately replacing morphine for an elderly patient with sodium chloride —

COMMISSIONER WROBLEWSKI: Right, but —

MS. BARRETT: — which is tampering.

COMMISSIONER WROBLEWSKI: Right. But let me, I think that the elements of this crime are knowingly and intentionally adulterating drugs such that there's a reasonable probability of causing serious adverse health consequences.

That's a little bit more than "a regulatory," don't you think?

MS. BARRETT: I think — but the examples that they're using, I mean there was a case where there is a — I think close to being a prosecution of getting some leverage for a company that is more — the adulteration might be "knowing" but the risk — that's the part, the risk may not be knowing is the thing.

I'm not sure what that "such that," I'm not sure about the interpretation of the "such that" and I'm not conceding one way or the other for defense lawyers, but I think it's a problem.

CHAIR SARIS: But it's not part of what you're talking about today, is that right? You're not here to oppose the reference to —

MS. BARRETT: We suggested that the

reference go to the regulatory offense, and start out low. If it needs adjustment, adjust it. Otherwise — if it's tampering, if it's true tampering, then they can prosecute it as tampering.

VICE CHAIR JACKSON: I'm going back to military goods because I see a policy — I'm still fascinated by the government's interest in the limitation on the option —

CHAIR SARIS: At 3:30 in the afternoon —

(Laughter.)

VICE CHAIR JACKSON: I'm fascinated.

MR. LYNCH: I'll do my best.

VICE CHAIR JACKSON: I am just wondering whether, even though this doesn't seem to be totally captured by the legislation because, granted, Congress put in, you know, counterfeit military goods and serves, and they used malefaction and function, so they limited it to some degree.

I could see a policy argument that would be made along the lines of selling counterfeit goods to the military is a problem. You know, so even if

it's a faulty extension cord that's likely to burst into flames, you know, that we could treat that differently as a matter of punishment when it is sold to a military base than what it's, you know, just in the regular chain of commerce.

And that would support an option, whatever it is, 2, just "counterfeit military goods and services." And I'm just wondering if you have any — and, by the way, that would be easier, I would think, to apply at sentencing from the practical standpoint. Because I'm now worried about the court trying to tease out the use, malfunction, and failure of which, and thinking does it have to be airplane circuitry, or could it be a faulty extension cord? And why wouldn't we just say counterfeit military goods and services?

MR. LYNCH: Right. And I think it reflects a trying to figure out how we are going to take this huge market for military goods and services, which is going to include, you know, toner, and paper, and things that will go into operating the government, or operating the military.

And some of that — and you can't really define it based upon what type of thing it is. It could be a metal sprocket, and if the metal sprocket is intended to go in a laser printer, and it's just cranking the paper out, it's probably not going to be an important thing.

If that metal sprocket goes into the middle of an airplane engine, it's a completely different situation even though to some extent they are both defined as part number XP843, metal sprocket, and military specification.

And so I think in our thinking about this, we are trying to make sure that, you know, we're not over-penalizing this; that is somebody happens to buy something, you know, that was defined and is marketed to the military, that's a serious — I don't want to understate, but that's still something serious — but I do think that we should make sure that we reserve the higher penalties for a situation in which the product is really going to cause some harm.

And I understand Commissioner Friedrich's question about exactly how we define that harm, and I

will try to get as much information as I can to the Commission, if there is any additional information on that.

But however we define that harm, I think I agree that there is this other policy argument that you can say just in the military, but without wanting to sound too soft on it, I think we're trying to make sure that this applies reasonably so that we differentiate between, you know, selling sprockets that are going to go in airplane parts and are defined as a certain military specification, and that people are relying on, versus something that may be a more commercial good and may be not put into that kind of mission-critical state.

CHAIR SARIS: What does this do for the knock-off good? I once had a case where there was a — it was supposed to be a Sun Microsoft chip, but it was a knockoff, which was by all the evidence equally as good but it was counterfeit.

So would this, if you limit it to the "caused significant bodily harm," but it was the exact same product, just a knockoff, that this

wouldn't apply, right?

MR. LYNCH: Well the statute, you know, we could prove per the statute that there would be an extra enhancement that I think we're looking for.

CHAIR SARIS: Right. You're not looking for the bump-up for the one that's the equivalent, but it's a counterfeit.

MR. LYNCH: Well, you know, sometimes with these knock-offs it can be very difficult to tell. It can be very difficult to tell the difference, and on an integrated chip it can — a small change could mean the difference between having a vulnerability that could be exploited by an adversary and —

CHAIR SARIS: No, I get that. But it would make this distinction, which is exactly her point.

MR. LYNCH: Right.

CHAIR SARIS: Anything else? I have to finish early, but we are finishing early. Anything, Judge Hinojosa? We've got 15 minutes to explore.

COMMISSIONER HINOJOSA (By Video): No.

CHAIR SARIS: All right, so I think we will take an early break. Now if the folks are here from the Tax Department, we will get going at quarter to 4:00. But otherwise, we will just have to wait until 4:00 o'clock.

(Whereupon, a recess is taken.)

CHAIR SARIS: Our last panel of the day, welcome to all of you. This is on Tax, appropriately for this time of year. Yes, we're in the right order. Kathyrn Keneally is the assistant attorney general for the Tax Division. Previously she was a partner at Fulbright & Jaworski. She received a B.S. from Cornell University, a J.D. from Fordham, and an LLM in Taxation from New York University School of Law. Welcome.

Next is not Edward Cronin.

(Laughter.)

CHAIR SARIS: Instead, filling in graciously is Rebecca Sparkman, director of operations, policy, and support, Criminal Investigation Division, Internal Revenue Service. Ms. Sparkman currently serves as director of

operations, policy, and support in the Criminal Investigation Division of the IRS. In this role, she is responsible for providing policy, support, and guidance to the Criminal Investigation's 25 field offices nationwide. Thank you. And I understand you have prepared quickly to deal with this emergency situation, so thank you for coming.

David Debold, who we've introduced before.

Teresa Brantley, who I have seen smiling from the back of the room.

For those who weren't in here, chair of the Practitioners Advisory Group. This is his third panel. I am just impressed that he's still sitting up straight.

(Laughter.)

CHAIR SARIS: Ms. Brantley is the chief of the Commission's Probation Officers Advisory Group, or POAG, in contrast to PAG, if you follow these initials. She is a supervisory U.S. probation officer in the Presentence Unit of the Central District of California, and has worked for U.S. Probation for over 12 years. Previously she served

as a practicing civil law attorney and a manufacturing engineer. And I always look forward to the down-to-earth questions she asks like: So how are we going to do this?

(Laughter.)

CHAIR SARIS: Help us here.

And then Mr. Richard Albert is a principal of Morvillo, Abramowitz, Grand, Iason & Anello, where he concentrates on white collar criminal and regulatory matters and complex civil litigation and arbitration. He was a criminal prosecutor in the U.S. Attorney's Office for the Southern District of New York — the District — and he is a graduate of Harvard Law and Wharton School at Penn.

So welcome to all of you. I think most of you were not sitting here earlier, except for Mr. Debold, so let me just say the red light goes after about 10 minutes. You have the green light on for the 10 minutes, then there's a yellow warning, and then the red, and then the hook. So we want to make sure there's enough time for Q&As, and we've been asking questions so we want to make sure there's time

for that.

Ms. Keneally.

MS. KENEALLY: Is this on? Judge Saris and members of the Commission:

Thank you for the opportunity to share the views of the Department of Justice on the Commission's proposed Amendment Four regarding the proper calculations of tax loss under the sentencing guidelines.

Prior to becoming the assistant attorney general of the Tax Division, I represented taxpayers in both civil and criminal tax matters, and I was a member of the Commission's Practitioners Advisory Group.

I very much appreciate the Commission's commitment to soliciting input from practitioners and the tax enforcement community in this particular issue. This dialogue can only improve our shared goal of seeking the fair and uniform administration of justice.

On March 8th, the Department submitted a letter discussing our views on the proposed Amendment

Four to the commentary to section 2T1.1 of the guidelines. Today I will take a few moments to highlight our perspective on the impact of the proposed options on fair and effective criminal tax enforcement.

The synopsis of the proposed Amendment Four states that it is addressed to a circuit court conflict over whether a sentencing court, in calculating the tax loss in a tax case, may subtract the unclaimed deductions that the defendant legitimately could have claimed if he or she had filed an accurate return.

Three options are set forth for comment.

Option 1 would require the determination of tax loss to include an allowance for unclaimed deductions. This is not the law in any circuit.

Option 2 would preclude deductions that were not claimed at the time of the offense. As the Commission recognized, Option 2 reflects the majority view and reflects the law in six of the eight circuit courts of appeals that have considered the issue.

Option 3 would prohibit unclaimed

deductions unless the defendant demonstrates by contemporaneous documentation that the defendant was entitled to the credit deduction exemption. Option 3 resembles but is different from the approaches adopted by the Second and Tenth Circuits.

The Department urges the Commission to adopt Option 2 and to reject Option One and Option 3.

Current definition of "tax loss" has been part of the guidelines for 20 years. "Tax loss" under the guidelines is distinct from a "tax deficiency" in a civil tax case, or an order of restitution, which I will discuss shortly.

Tax loss, by definition, should address the entirety of the harm intended by the defendant, including for example the harm caused by concealment through omitting certain deductions.

Fundamentally, to allow the defendant to raise unclaimed deductions as part of tax loss calculation will inappropriately turn sentencing hearings into the equivalent of tax examinations.

Please allow me to emphasize: At issue here are potential deductions that the defendant did

not include on an original return, a return that has been proven false through criminal prosecution, a subsequent attempt to figure out what tax positions the defendant would have taken had the defendant filed an honest return, and a determination as to whether there is both a factual basis and legal support for the previously unclaimed deductions.

The Tax Division has extensive experience with attempts by defendants seeking the benefit of unclaimed deductions at sentencing hearings. Our letter contains illustrations of cases in which defendants have asked the court to speculate as to whether investors in a tax scam would have claimed unreported losses and received capital loss treatment, whether a defendant who did not report income from one business would, if given a do-over, have reallocated the unreported income and expenses across multiple businesses, and whether doing so was the proper tax treatment; and whether a defendant with a secret Swiss bank account should obtain the benefit of an unclaimed deduction for a charitable donation of property, the valuation of which turned

on the application of state law and capital gains rules.

We submit these are not the types of determinations we should require our sentencing courts to make.

Further, both Options 1 and 3 would accord criminal defendants who have either pled to or been found guilty of tax crimes greater rights than taxpayers who are merely subject to examinations by the Internal Revenue Service.

In civil tax examinations, the taxpayer bears the burden of claiming and substantiating deductions, and the IRS determinations are accorded a presumption of correctness, fundamental principles that are not incorporated into Options 1 or 3.

Also, the very speculative nature of determining whether a defendant would — what a defendant would have done had the defendant filed an honest return opens the door to contentions that have been rejected in criminal cases.

For example, when the existence of a tax deficiency is an element of a criminal tax charge,

courts have rejected assertions by defendants that subsequent events such as a retroactive election or a loss carryback should reduce the deficiency.

The problem of fundamental fairness is not solved by limiting the allowance of unclaimed deductions either to those that relate to the offense or by requiring contemporaneous documentation.

Most often, the decision by the defendant not to take certain deductions is part of the criminal scheme. To take the deductions would reveal the related tax offense, and the omission of the deduction is itself an act of criminal concealment.

Also, the deductions themselves may relate to other uncharged tax crimes. For example, a defendant who has unclaimed deductions for cash payroll or supplies bought with cash was likely facilitating federal and state tax evasion by off-the-books employees and suppliers.

Finally, there are three distinct concepts in tax enforcement that should not be conflated: a tax deficiency, tax loss under the sentencing guidelines, and restitution.

The IRS may collect only what it can establish to be the tax deficiency. In doing so, the IRS will consider, and courts will review, whether deductions may be properly taken.

"Tax loss" as defined by the guidelines encompasses the total amount of the loss that was the object of the offense, which the majority of our courts have concluded means the loss intended by the false return that was filed, not the tax deficiency that would have resulted from an honest return that was never intended to be filed.

The concept of tax loss provides a measurement for the seriousness of the intended criminal conduct for those cases that are within the heartland of tax crimes to accord justice and to foster deterrence.

An order of restitution falls between these two concepts. It is intended to provide the IRS a tool through the sentencing process to aid in the collection of a tax deficiency.

Like a tax deficiency, it is intended to allow for the collection of not more than the tax

due. Although a restitution order may be part of the sentencing proceeding, it need not be.

While the computation of tax loss fundamentally must precede sentencing in the criminal case, a restitution hearing may be deferred until after the sentencing and the imposition of a restitution order may be declined in its entirety when a determination of the potential tax liability would unduly complicate or prolong the sentencing process.

Moreover, neither the tax loss computation nor a restitution order alters the ability of the IRS subsequently to make a separate determination of the actual tax deficiency.

Each of the concepts of tax deficiency, tax loss under the guidelines, and the restitution serves a different purpose and as a result a determination of each may vary one from the other.

In sum, the Department submits that the majority position as set out in Option Two currently best reflects fundamental principles of tax enforcement, meets the sentencing guidelines' goals

of measuring harm by tax loss, and serves justice and judicial economy.

Thank you again for the opportunity to provide the Department's perspective on this issue, and I look forward to answering any questions that you may have.

CHAIR SARIS: Thank you.

MS. SPARKMAN: Judge Saris, and members of the Commission:

My name is Rebecca Sparkman and I serve as the director of operations, policy, and support, Internal Revenue Service, Criminal Investigation.

I appreciate the opportunity to appear before you today to discuss the Commission's proposed Amendment Four to the sentencing guidelines regarding the inclusion of previously unclaimed deductions in tax loss.

I am here today on behalf of Ed Cronin, division counsel and associate chief counsel, Criminal Tax, who was unable to attend for medical purposes.

Over the past 25 years, I have held

numerous positions within IRS Criminal Investigation, including that of special agent, supervisory special agent, and special agent in charge of the Washington, DC, Field Office. Prior to my selection as director of operations, policy, and support in 2012, I held other executive positions.

In my current position, I am responsible for providing policy and support and guidance to Criminal Investigation's 25 field offices nationwide.

IRS Criminal Investigation works closely with the Department of Justice and U.S. Attorney's offices around the country to bring criminal tax offenders to justice. Criminal tax enforcement is a crucial component of the IRS's overall effort to encourage voluntary compliance.

From the perspective of the IRS, allowing convicted tax offenders to introduce previously unclaimed deductions at sentencing would undermine the government's efforts to deter unlawful tax evaders.

As the Sentencing Commission has

recognized, voluntary compliance with the tax laws requires meaningful punishment for those who willfully evade their tax obligations.

As noted in the Commission's proposal, the majority of circuit courts that have addressed the issue have held that a defendant cannot reduce the tax loss at sentencing by asserting previously unclaimed deductions. The following reasons illustrate why the IRS agrees with the majority position.

First, under the guidelines the purpose of determining tax loss is to measure the gravity of the offense, not to calculate the amount of the defendant's civil tax liability.

The difference between criminal and tax cases is underscored by the fact that late payment of taxes reduces civil tax liability but has no effect on a defendant's criminal liability.

Also, the amount of tax loss for sentencing purposes may be different from the amount of restitution that is ordered, because the purpose of restitution is to repay the taxes owed to the IRS

as a result of the crime, not to determine the gravity of the offense.

Second, in many cases a defendant's decision not to claim deductions on the original return is an integral part of the crime. An example provided by the Commission, a business owner who under-reports gross receipts and pays employees in cash under the table, would likely choose not to deduct those cash payments because doing so might reveal his or her unreported income.

In such a context, the decision to file a return that did not claim deductions for cash payments would be an essential step in the criminal scheme, and it would be unjust to allow the defendant to redo the crime at sentencing.

The implications of such a re-do of the crime after the fact may be far-reaching. The defendant would effectively be sentenced on the basis of a new return, and thus escape the full consequences of the return he or she originally chose to fraudulently file.

Another important consideration I would

like to emphasize is that the IRS is often unable to determine the full extent of a criminal defendant's unreported income, particularly where cash payments and other forms of concealment have been used.

Reducing the tax loss figure by previously unclaimed deductions without knowing the full amount of unreported income would likely result in a sentence that did not adequately reflect the seriousness of the crime.

In addition, allowing previously unclaimed deductions to reduce tax loss would potentially provide a benefit for defendants who waited until sentencing to expose previously unknown criminal conduct.

In the example provided by the Commission, had the government been aware of the cash payments and double set of books, the investigation may have pursued numerous other violations such as charges based on the submission of false employer's quarterly federal tax returns, forms 941, to the IRS; as well as the issuance of false wage and tax statements, forms W-2 to employees.

Moreover, the defendant's cash payments might have facilitated under-reporting by the employees or vendors. Allowing the defendant to mitigate the gravity of the offense without simultaneously addressing these potential uncharged violations could provide a windfall to the defendant and undermine the goal of deterrence.

For these reasons, the IRS strongly opposes the minority position as reflected in both Options 1 and 3. In practice, the application of either Option 1 or 3 would lead convicted tax evaders to introduce evidence in court such as records of under-the-table cash payments to employees, and a double set of books in order to reduce their exposure to prison time.

Allowing such evidence to result in more lenient sentences would minimize the seriousness of this type of conduct and reward convicted defendants for affirmative acts of concealment and compromise the sentencing guidelines' fundamental goal of deterrence.

We therefore strongly urge the Commission

to reject Options 1 and 3 and to adopt Option 2.

Thank you again for your consideration.

CHAIR SARIS: Thank you.

MR. DEBOLD: Thank you, Judge Saris, and members of the Commission:

The PAG approaches this question that was put out for comment by the Sentencing Commission with two general principles in mind, which we agree with, and I think we agree with a number of people at the table on this.

One is that whatever the Commission does, it should not overly complicate the sentencing process, including obviously in the tax cases that we're looking at here. And I think that is a major theme that we saw in POAG's letter.

The second principle that I think the Commission should be very mindful of is the need for the promotion of like treatment of like offenses, a proportionality between people who commit offenses and consistency in the treatment of offenses that are the same, and different treatment for offenses that are different.

As to the first issue, which is the complication issue, we already have a wealth of experience under 2B1.1, which we have talked about a lot today, about the need for judges to consider whether or not the calculation of a loss amount, or credits against a loss, will unduly complicate the sentencing proceeding.

We have no objection whatsoever to putting extending that guidance to the Tax guideline, if there is any doubt about the fact that when a court does what it is supposed to be doing in calculating the tax loss it need not go through an extremely complicated process and come up with a precise number, which is a phrase that I see a lot in the letters that the IRS and the Division presented to the Commission.

The second thing that occurred to me, though, when I was thinking about this complication of the process was that the Second Circuit has had the rule that we are advocating, or very close to that rule — they have the option that has some limitations on it — for a number of years. And I

would have expected to have heard of cases in the Second Circuit where courts were basically forced on a death march through a long sentencing proceeding in order to deal with unclaimed deductions. But I'm not hearing of that happening.

I see some examples that are cited in the letter from the Tax Division, but I don't see those as presenting the huge problem that we are hearing about.

The third thing in terms of complicating the proceedings is a very important one, which we mention in our letter, and which is also mentioned in the government's submissions, and that is that the rules for restitution in tax cases have recently changed.

Under a statute that was enacted in 2010, after every single one of the other circuits that has gone in the other direction on this issue, a sentencing judge does need to consider what the amount of tax due and owing is as part of the restitution determination. And a defendant just defend against that, because when a judge makes that

restitution determination as a condition of supervised release, for example, that is binding on the defendant. He may not challenge it at any future proceeding.

So courts already are going to have to be looking at these issues of what is the amount of tax that is due and owing? And the subset of it that we're looking at here, which is unclaimed deductions and whether the person who is paying tax for restitution purposes would have had these unclaimed deductions available to him.

So I don't see the complication issue as being one that we need to worry about. The thing that is most of concern to us is the second principle I mentioned, which is the need to make sure that we are consistent in treatment of different tax cases, and in treatment of tax cases in comparison to cases under other guidelines.

Let me give you an example. Suppose a defendant owes $20,000 in income from a side project that he has that has no associated expenses, and he simply fails to report the $20,000 in extra income.

That would be the tax loss in that case.

Take a second defendant who himself has $100,000 in extra income, but he incurs $90,000 in expenses because he's running a legitimate business with legitimate expenses, and so his net income is $10,000.

Which of those two defendants is more culpable? I think you can make a strong argument that the first one who gains a $20,000 reduction in his taxable income, and then of course obviously does not pay the tax on that, is the one who has committed the more serious offense.

But under the approach advocated by the government, the second defendant would be given a $100,000 tax loss figure, or 28 percent of that figure for the tax itself.

There is no rational basis for distinguishing between the two if you can get beyond the complication of sentencing proceedings and proof issues that I've talked about already and we'll talk about it again in just a minute.

Also, if you compare it to how we treat

cases under 2B1.1, we take a net approach to loss. When we have somebody selling stock that is worth 20 percent of what he claims the stock to be, we do not call the loss the total face value of the stock that is sold. We take into account what the stock is really worth. We do a net loss approach.

In bribery cases, under 2C1.1, Application Note 2 — or, I'm sorry, Application Note 3, when somebody obtains a contract through bribery and the contract nets them, or grosses them $150,000 in income, the guideline specifically says that if there were expenses associated with that contract and the net profit were, for example, only $20,000, that would be the loss, or that would be the value obtained in that case for purposes of the table dealing with the measure of the financial value of the crime.

We take a net approach in other areas; we see no reason not to take a net approach here.

We also give credit for unclaimed deductions in failure-to-file cases. There was a specific note in 2T1.1 that says in a failure-to-file

case — obviously there's no return to look at, so we have to figure out what is the tax due and owing. And when we do that, we look at what the deductions were that the person could have claimed, and a calculation goes into effect.

Why should we treat somebody who files no tax return at all as a less serious offender than somebody who files a tax return and claims they have no income? They could be in exactly the same position, yet the second person would have a much higher tax loss figure because we wouldn't allow them to get credit for unclaimed deductions.

Now we do agree that there are situations where the Commission may want to be careful in terms of what it allows people to do.

For example, we do not oppose sort of a backstop to prevent people from engaging in 20/20 hindsight, basically looking back and saying, oh, if I had taken my depreciation in this way rather than in another way, based on how things have developed over the subsequent years, I could have had a lower tax. We don't have a problem with a rule that

prevents people from basically getting to the result purely through 20/20 hindsight.

We also don't oppose a situation where somebody is prevented from saying, oh, well, if I had taken the income in year one when I paid my taxes, instead of in year two when I didn't pay my taxes — and that's the tax year that the IRS is looking at — we agree that there should be ways to avoid people from manipulating the system to somehow create a nontax situation in years where they committed a tax offense.

But those are in the details, things that need to be addressed and looked at. We have some concerns with how the Commission proposes in one of the options to limit those things.

The contemporaneous documentation requirement to us would be an unclear requirement. It would be one that you might want to include among factors for the court to consider and whether or not it is a credible or reliable unclaimed deduction, but we don't think that you should set up a rule that says that the documentation had to exist at the time

of the offense.

For example, you may have somebody who in years one and two properly filed their taxes and had a contemporaneous documentation for those years, and then in years three and four they stopped recording the income and stopped obviously deducting the expenses.

What would the contemporaneous documentation rule say in that case, since it's not really contemporaneous, it's from the prior years, but they could show that they did indeed have legitimate expenses?

What would you do in a case where it was reversed? In the first two years they failed to report the income and failed to take the deductions. But in years three and four, before the IRS caught on, they actually did start reporting the income and did have legitimate expenses, which they reported.

I think both of those cases are examples where you have credible evidence, reliable evidence, of what their unclaimed deductions might be.

What about a case where you have an

employee who can testify that there were legitimate expenses to the business, but that they did not maintain the records? And you know it's the type of business where they had to have legitimate expenses.

A court should look at that as an issue of the weight of the evidence and credibility, not as an either/or proposition of it's not contemporaneous so we have to ignore it, or it is contemporaneous so we have to consider it. So we oppose that kind of a limitation.

In terms of how the system that we're advocating relates to what the guidelines ask you to account for, what is the actual tax loss, or what is the intended tax loss? And you take the higher of the two.

Our approach looks at what the actual tax loss is. When a person evades income tax, or files a false return, they are not intending to cause a loss to the government that is greater than the income minus the expenses. They are intending to pay as little tax as possible, which just about everybody intends to do; it's just that the people in tax cases

do it in an unlawful manner.

So why should we say that their intended loss to the government is somehow greater than what they would have paid had they filed a proper tax return? But that is the position that the government is taking here, and it is the position that we oppose.

In terms of "intended loss," it is the same analysis. Nobody intends to pay more than their actual taxes due and owing. And the approach that we advocate only requires them to pay what tax would have been due and owing had they filed a lawful tax return. That is why we support the option that gives the courts the ability to consider that type of evidence.

Thank you.

CHAIR SARIS: Thank you.

MS. BRANTLEY: Good afternoon, and thank you again for the opportunity to provide to you comments that came from the Probation Officers Advisory Group, and in turn from the districts that they each serve.

My comments are really very brief. We asked only that we could come here and address you to be able to tell you the two things that came out, mostly the two themes that came out in our comments.

Turning the sentencing process, or at least the guideline computation process, into something burdensome and cumbersome is a theme you have already heard. And really the only thing I want to add to that is the idea that when we see these cases, it was our collective experience that we don't see these cases happening in one year. They may be only charged in one year, but relevant conduct brings in the kind of tax evasion for multiple years.

And so we looked at this as being a problem in terms of if we had to go back and re-do the taxes and figure out what their actual tax liability would have been, we faced the prospect of doing it in multiple years with differing tax rules and regulations from one year to the next.

And so in addition to making it a cumbersome process and asking the court and probation officers to become experts in taxes, which we don't

advocate, we would have this additional problem of multiple years and differing kinds of regulations.

The other theme that came out was the idea that at least under 2B1.1 in theft and fraud offenses there's this idea that a defendant cannot reduce his or her loss by paying back monies after the offense has been detected.

And so there was this idea from the probation officers collective that thought that going back and re-doing a tax return to reduce the liability sort of had that kind of an effect. And in that way we might be treating offenders from those two guidelines a little bit differently.

We also recognize, finally, the idea that adopting Option 2, which is what we advocate, could also have a disparate effect on those who failed to file a return. We thought that the people who failed to file a return, similarly to Mr. Debold's comment just now, could be disproportionate.

What we recommended is this idea that maybe an application note be included to acknowledge that. And we do have some basis for that in the

2B1.1 guideline where there is an application note that talks about departure issues for things to consider for upward departure. And there is also one for downward departure.

So we might carry over that kind of language to acknowledge that using a flat, whatever they filed, whatever the four corners of their document was at the time they committed the offense, that that might create a higher loss than intended for failure to file situations, and that might be something for the court to consider for departure purposes.

Short and sweet. This is mainly the comment that drew the most response from officers, as well, which is another reason we're afraid that we might start entering into an area where we are sort of on this nice edge here where we might take a process that generally is working and create a problem that isn't intended.

Thank you, very much.

CHAIR SARIS: Thank you.

MR. ALBERT: Thank you, Judge Saris, and

members of the Commission.

On behalf of the New York Council of Defense Lawyers, I appreciate the opportunity to testify before you here today.

We respectfully submit that a categorical rule excluding unclaimed deductions from the computation of tax loss where those deductions are legitimate and supported by relevant evidence undermines the credibility of section 2T1.1 of the guidelines and, by extension, the guidelines generally.

First, ignoring applicable deductions and other offsets is simply not computing tax loss. As anyone who actually deals in the world of tax cases, from prosecutors, to defense counsels, to IRS agents, to the defendants themselves, understands the concept of tax loss.

It is contrary to the way practitioners on the ground are addressing tax loss on a daily basis. Now perhaps my view of this is a little bit skewed because I practice mostly in the Second Circuit where we function under that rule.

And just in response to some of the comments that have been made, it's not like all hell is breaking loose in the Second Circuit. We have been functioning under this rule for quite a long time, and the IRS agents I am dealing with come from all over the country. And an IRS agent looking at a case doesn't ignore basic, straightforward losses, deductions, offsets, on a daily basis. That's just not the way it's normally happening.

I will get to in a minute how I think there is a little bit of a break between what the circuit courts are seeing and what is actually happening on a day-to-day basis in actual practice.

Further, ignoring deductions is contrary to the basic notion that the severity of the crime depends on the magnitude of the impact on the Treasury. That is just a core concept very fundamental to tax offenses.

A rule requiring that deductions be ignored is contrary to the basic logic and spirit of section 2T1.1 which in a variety of ways sprinkled

throughout the application notes, is directed toward reasonably approximating the actual tax loss. We address this in more detail in our written submission, but it is throughout the application notes to 2T1.1 as it stands.

A categorical rule against considering deductions also overstates the severity of the criminal conduct at issue. And finally, it treats, as Mr. Debold said, it treats different cases alike for sentencing purposes, which by its nature tends to result in unfair sentences.

Now the unfairness of this rule is illustrated in a very simple hypothetical that's a little bit repetitive, but I'm just going to walk through it again.

Take a defendant who has a regular job. He also has a little business operating a hot dog stand on the side. His hot dog stand has an annual gross revenue of $100,000. But of course he's got expenses in operating it. He has the cost of the hot dogs. He's got the cost of the buns. He's got wages for an employee who's operating it when he's not

there. He's got total expenses of $60,000 annually, and he keeps detailed receipts. We see this in the cases.

He files his tax return, but he omits his income, and of course he omits his expenses from the hot dog stand. Now if you assume a 30 percent tax rate, a rule that refuses to consider his basic deductions for cost of goods sold and wages would calculate the tax loss at $30,000, just looking at the $100,000 gross revenue, even though the real tax loss in the case is obviously $12,000. That's the difference between a guidelines offense level of 12 and an offense level of 10 which, assuming no criminal history, is the difference between a guidelines range in Zone C that would require imprisonment and one in Zone B that wouldn't.

There is just no justification for treating that case as if there's a tax loss of $30,000. What we're talking about, and what you see when you look at the cases in this area, really is that the concern is the strength of the evidence of the deductions.

That is an issue that courts are used to dealing with. They know how to deal with, and they can deal with. And to impose a rule that we just across-the-board categorically don't consider deductions, exemptions, losses, is throwing the baby out with the bathwater by worrying about the case where someone is going to be fabricating deductions and there's going to be some speculation, and requiring injustice to be done when the amount is reasonably obtainable and the deductions are clearly there, as in the hot dog stand example.

And this factual scenario is something that we see. A number of people have mentioned that you are going to expect someone not to include the deductions when they don't want to include an entire category of activity. They want to hide the category of activity from the IRS, so they don't include the deductions in their tax return.

Okay, so they've committed a crime. But what's the magnitude of the crime? That's what tax loss is about. So we're not saying that they should get a medal for filing a false tax return. The

question is, should we treat the income as $100,000? Or should we treat it as what it really is in the example I just gave, of $40,000?

You see an example of this in the Seventh Circuit case, Psihos, which is a 2012 decision where the defendant was a restaurant owner who had unreported income, and at sentencing he attacked the tax loss computation for ignoring deductible expenses, including amounts he said that he paid to DJs, and amounts he paid in cash wages, et cetera. And even in that case where the Seventh Circuit was purporting to apply the categorical rule against considering unclaimed deductions, the court noted with approval that both the district court and the government in their loss calculation had already given the defendant credit for cash payouts that had been listed on envelopes. There was evidence in the record that the cash payouts every day were written down on an envelope, and those were credited.

That is, even in the Seventh Circuit credit was given, as it should have been, as logic dictates it should be, when the evidence was clear

and the court and the government in that situation were satisfied with it.

Now in that case, the court rejected claims for additional deductions because there just wasn't evidence substantiating it. This to us is a very reasonable way to approach the cases. And I think that *Psihos* illustrates that even in circuits that purport to apply the categorical rule against looking at unclaimed deductions, the logical pull of doing so when you're calculating something called tax loss is very hard to resist.

In the experience of the members of the NYCDL, this fair and logical approach to consider unclaimed deductions when they are legitimate and they are proven is consistent with the prevailing actual practice on the ground among government investigators, prosecutors, and defense counsel, and the district courts in looking at tax loss.

Now I would like to give you another example. In the recent rash of offshore bank account cases that are being processed through the criminal justice system and the IRS, the primary evidence of

income, it's typically income in the offshore account, is the bank statements for the offshore account. And in these cases, if you had a categorical rule against deductions and offsets, you would be directing courts to accept the income in those bank statements, but to ignore on the face of the same bank statements, ignore losses, investment expenses, foreign tax credits that appear right in black and white in the same bank statements.

No decent first-year accountant or IRS agent would ignore those patently valid offsets. But that's what the rule that is being urged here would require be done.

Again, it is an issue of the strength of the evidence, the categorical rule that you have to put blinders on to obvious facts that go to the gravity of the offense, just doesn't make a lot of sense.

Briefly, a comment on amendment, Option 3, which would allow unclaimed deductions to be considered only when substantiated by contemporaneous documentary evidence.

We think, as counsel previously stated, that rule poses a real risk of unfairness where there is other evidence, like a clear track record of claiming certain specific identified deductions in other tax years — not contemporaneous but other tax years, before or after — might well demonstrate that these unclaimed deductions are legitimate.

Courts are more than capable of evaluating the strength of evidence of unclaimed possible deductions. That is the kind of fact-finding they do all the time. They do it under 2B1.1 all the time. And there's just no valid basis in logic or experience to restrict the evidence that courts can consider to one particular category in determining what tax loss is.

Just briefly as to the subsidiary issues for comment regarding considering deductions unrelated to the conduct at issue, and whether the defendant must demonstrate that he, quote, "would have claimed the deduction" to be considered, we believe that the only necessary or appropriate restriction on consideration of any deduction should

be that the deduction be legitimate and proven to the satisfaction of the sentencing court.

The court is free to reject an unrelated deduction, or a deduction that just doesn't make sense in the circumstances of the case under the circumstances of the particular case. But to prevent the court from looking at relevant evidence of what the tax loss actually is, what the deficiency actually is, we submit is not a good policy.

In sum, we strongly urge the Commission to adopt amendment Option 1, and we respectfully refer the Commission to our written remarks for a more complete statement.

CHAIR SARIS: Let me start off by just, thank you very much. It is a very difficult issue. It got very intense comment.

(Laughter.)

MR. DEBOLD: It's late in the day.

CHAIR SARIS: Not just here. In the papers. This was the sleeper that suddenly sort of flowered.

So let me just ask this. I don't

understand this new restitution statute. So what is going to be — first of all, has it started yet? And second of all, what is it that the government is planning on introducing at trial to form the basis for the restitution order? And do you expect it to be a full-blown hearing? Or is it going to include all these exemptions and deductions and credits and the like?

MS. KENEALLY: Thank you, Judge Saris.

Yes, in answer to has it started.

CHAIR SARIS: It has started? Yes.

MS. KENEALLY: Yes. The statute has been in effect, don't hold me to this, but I think about a year-and-a-half or so. And what it fundamentally did was change the collection agent.

Restitution has always been there. It could always be ordered as a condition of probation. What the restitution statute did was make the restitution order an immediate assessment.

This shifted collection from the FLU units of the U.S. Attorney's offices to the Internal Revenue Service. It means the IRS does not have to

take the extra step of reducing the restitution to a tax assessment before it can use the tools of the IRS to collect.

So fundamentally that is what the restitution order did, the restitution statute did. Restitution is intended not to have a collection greater than the actual liability.

CHAIR SARIS: You're giving the courts a number, like this person owes $50,000 in taxes?

MS. KENEALLY: Correct. And I think overwhelmingly in our experience it is an agreed-upon number. But by the time you get to the restitution phase, it is an agreed-upon number, partly because the government accepts that the government actually gets a second bite at the apple. Because the IRS is free after that to come in and determine the deficiency, and reduce that to an assessment, and seek to collect a higher amount.

So the concerns of the government are somewhat lessened at that point to come to some resolution or to be conservative in reaching that

restitution number.

Separately from that, there are just fundamental concepts of things that will be allowed in determining the restitution number that would have no role in tax loss.

CHAIR SARIS: No, but so I'm obviously asking the question for that reason. When you come up with a number — one of the biggest concerns everyone has is you don't, and being a trial judge I certainly share it, you don't want every sentencing to turn into tax court. So no one wants that. I certainly don't.

But if in fact you've done the work, and you're coming up with a number that you're willing to live with, at least without prejudice to coming back, why isn't that going to alleviate the concern about tax court?

MS. KENEALLY: Because the number for restitution simply doesn't measure the harm of the offense. It doesn't do that.

CHAIR SARIS: That's a legal argument.

MS. KENEALLY: But I mean the reason we can't agree that the number that we — I mean, let me step back again. As I said in my opening comments, the court is not required to enter a restitution order. It is not an essential part of every sentencing. It doesn't have to happen prior to the imposition of the sentencing.

If the court wishes to order restitution, more time can be given to sort out these issues. And the government has a motive to reach an agreement because the government has a chance to come back later.

And there are themes that are fundamental in restitution. For example, if the defendant pays after the commission of the crime, then the defendant gets credit for that in restitution. You're not going to collect twice.

But you're not going to reduce that tax loss under any circumstances —

VICE CHAIR JACKSON: All right, but don't you have to start with something? I mean, even if the — I'm sorry — even if the file number that you

negotiate for restitution purposes is one that is compromised and negotiated and doesn't capture the full extent of the tax loss, doesn't the government start with what the full extent of the tax loss is when they sit down to negotiate the final restitution number? And why couldn't that be the basis for our consideration — the court's consideration of tax loss?

MS. KENEALLY: Because likely you are not going to get to the full measure of the tax harm done by the conduct.

If you allow me to go back to his hot dog stand example, or the restaurant example, when you look at those examples what they're talking about are unclaimed tax deductions. If you have unclaimed tax deductions for payroll, that's cash payroll. Because there's no way to have an unclaimed tax deductions for a reported payroll. I mean, you're going to have filed all the taxes — all the forms, and done all the withholding.

You have the fundamental problem — and I think this is what's really driving us here today more than anything else. The heartland of our cases,

to use the standard language here, the heartland of our cases, one of the biggest issues we have to face in tax enforcement all the time is what to do about the cash economy.

And when you look at the kinds of cases where they want to take deductions, you are talking about deductions that were for cash payroll, went to vendors for cash, where if you were to trace out all of that harm you would find further tax crimes.

CHAIR SARIS: Can I ask, when you do your restitution order are you taking into account the hot dog man? Are you subtracting those expenses?

MS. KENEALLY: No, because you are only looking at what this taxpayer, what this defendant owes as a taxpayer for his own tax liability. You are not looking at the added harm that he caused.

MR. DEBOLD: I think you are talking about two different things.

COMMISSIONER FRIEDRICH: You're deducting his —

CHAIR SARIS: Are you deducting his salary account?

MS. KENEALLY: Maybe I need to slow it down.

CHAIR SARIS: Yes.

MS. KENEALLY: Maybe I need to slow it down. When you look at restitution, you are looking at the question of what does this individual owe? What should this individual pay?

It is the same question you are looking at when you are looking at the deficiency. What does this individual owe?

When you are looking at sentencing, you are looking at what harm did this individual intend? And when you get out to the further impact of what he did, then you are looking at something greater.

CHAIR SARIS: I understand your legal argument, I am just asking what the hot dog guy, when you're doing the restitution, are you subtracting out the $90,000 he's paying for his expenses?

MS. KENEALLY: Would we be subtracting that out —

COMMISSIONER FRIEDRICH: For restitution.

CHAIR SARIS: For restitution —

MS. KENEALLY: For restitution purposes, if he's paying those expenses. Yes, if we are getting then to also go after all of the rest of that liability. And usually that's just not going to happen.

COMMISSIONER HINOJOSA (By Video): But isn't the point that Mr. Debold and Mr. Albert made, in order to indict somebody for filing a false tax return, the government has already determined, and many times because of cash transactions, that the income was a certain amount? It isn't just that cash is paid out. Cash is deposited and comes in and there's no sign of where it's coming from.

So it isn't that simple to begin with to determine that you're going to charge somebody on a false tax return, other than you've already made all these determinations of other income that has come in. In many ways, income that was hidden and difficult to take. Because many of these prosecutions really don't come right away. It's several years afterwards, as long as they are within the statute of limitations and has required a lot of

work, also. And it actually becomes a debate within the court itself as to what the amount is. Because you have to decide the amount for the tax table from the guidelines as presently written.

So this added, as Mr. Debold said, step of one factor to try to determine the actual amount that he would have had to have paid, or she would have had to have paid, is just one other step in a complicated process to begin with, isn't it?

I don't understand this whole complication argument. Leave aside the restitution amount, because most of the time, like you say, those are agreed upon. But it was difficult to begin with to determine what the actual income was in the first place.

MS. KENEALLY: I think at that point I would agree with you, that the prosecution has taken responsibility to prove beyond a reasonable doubt to establish that there is an under-reporting of income, and now we get to the question: What are you going to allow against that?

You know, we'll be up front that in order

to meet our responsibility of proving the income very often in that process there will be credit given. I know one of the questions that the Commission has, and I gather this is some of what you're asking, is in the ordinary process do we allow for expenses that are verifiable along the way?

And obviously if proving a deficiency is an element of the crime, you are going to consider that, if only to persuade a jury and to make your case, and to make sure that you have a deficiency, you are going to take that into consideration.

But when you get to the sentencing phase, and what you are talking about is somebody who comes along at that stage and says thank you for working so hard and discovering what you discovered, and I'm grateful for what you didn't figure out, and now I want credit for all of these expenses, much of which were paid in cash, which I didn't report the first time because if I'd done it the first time you would have caught me sooner and you would have figured out my scheme, and now I want a do-over and I want to correct my returns, that's where we have a problem.

And where we have a problem is that that is in essence taking away a lot of the deterrent effect to actually engaging in this conduct. And it is failing to recognize the harm that these crimes are causing.

We look at his hot dog guy, and his hot dog guy, by running that business, in cash and off the books, is putting his competitor across the street out of business. And it is how to vindicate that interest. And that is why we think the tax loss should not give credit for something that really was part of the concealment and really also just fueled the problem of the cash economy that is what we are always trying to fight.

MR. ALBERT: May I just respond? We're talking about issues that are pretty far away from "tax loss." We're worried about the competitor across the street, and that's something to think about but it has nothing to do with figuring out what the tax loss caused by the hot dog guy is.

These arguments I'm hearing about, oh, well, you shouldn't give them credit because, you

know, they probably hid this because, you know, we would have found out that they had engaged in even more crime, so they're breaking it out for the first time at sentencing. Well, if a defendant puts forward evidence at sentencing and the government sees it and says, wow, this means that you've been evading taxes in three other businesses in seven other tax years, they are certainly free to bring that to the sentencing judge's attention as part of their calculation that the tax loss should be larger.

So, you know, the issue is are we entitled, or should we be telling the judge to put a blinder on to the actual economic activity that's going on here? Or should we look at the real activity?

CHAIR SARIS: Dabney.

COMMISSIONER FRIEDRICH: So, Mr. Albert, you highlighted the Seventh Circuit case, and I think there are others that are similar in circuits in which they have the bright-line rule, and yet it does appear that the courts are kind of using a common-

sense approach, and they are looking at some of these unclaimed deductions. But I think in the case law they're denying them because they are not verifiable, or they are not trustworthy. They're not taking a defendant's word that I paid all these salaries in cash to these people.

So my question is: It's really hard to craft a rule that is going to cover all the contingencies. You all both don't like our rule, our proposed rule, that talks about contemporaneous, and some of the other limitations we've put on it.

Doesn't this cry out for the common-sense solution, which is we have the bright-line rule, and we have, as Ms. Brantley has suggested, a really clear invited departure to let the courts do this, but that we have as a threshold matter a bright-line rule. But it doesn't bar those cases where the defendant can come forward and convince a judge, I mean it seems like even in the circuits that are saying they have the bright-line rule, they are still considering it.

Isn't that the best approach to use?

MR. ALBERT: I think it's not, because you've put out this concept out there called "tax loss." You call it "tax loss." It's not "tax loss."

VICE CHAIR JACKSON: And that may be the problem. I mean, that's what I'm starting to think about, is whether the problem is that we use this phrase "tax loss"; that it has sort of a commonly understood meaning; that it incorporates the deductions and the exemptions; and that what really the government is trying to say is, notwithstanding the tax loss in that sense, at sentencing as opposed to restitution we're really trying to get at something more than that.

MR. ALBERT: But the problem is, you want to try to get at the gravity of the offense. In other words, we could come up with many different things that would be really easy to administer, but the concept of tax loss gets at the gravity of the offense, if it's administered faithfully in the Second Circuit and Tenth Circuit rule.

And by the way, just to respond further to your question, even in the Second Circuit and the

Tenth Circuit the couple of cases that are the ones that stand for the rule that we agree with, the defendant's additional claimed deductions were not allowed because the court found that they were not sufficiently substantiated.

So the courts — in those cases, the courts know to look with a degree of skepticism if there's no real supporting evidence for the claimed deductions. But the problem is, the guidelines don't just have an effect in the litigated case where the case goes all the way through and we're on appeal in the Second Circuit. They are being used as a guideline every day in all the cases that are resolved.

And in those cases that are resolved in a daily basis, certainly where I practice in the Second Circuit, and I think throughout the country, you can't — an IRS agent is not going to look you straight in the face and say, oh, in this offshore bank account case where you had in this year $100,000 in interest but $60,000 in investment loss, your income that year was $100,000.

CHAIR SARIS: Would you say that to his face?

(Laughter.)

CHAIR SARIS: No, I'm asking you. Here you are, you're sitting here.

MS. SPARKMAN: If I could back up, I think it might be good for you to understand the investigative process, because I think that's where it gets at the heart of what we do in criminal investigation and how we prove our case, and what comes to trial.

Because when we're proving our cases, we have to prove a financial investigation from the ground up. Obviously the defendant has a Fifth Amendment privilege. Therefore we assume we get nothing from them. So we have to use techniques, and interviews, and literally interview hundreds and hundreds of witnesses, and many times over years, to build a financial investigation in a tax case.

And I think there is an illusion that a receipt is like the end-all. The receipt is the beginning. A book and a record is the beginning. We

have to look behind it. We have to see where that came from, as you well know. We have to backtrack the evidence. We have to have witnesses.

And the government and the IRS, when we're investigating our cases, we are looking at what is the material, and what is the substantial tax loss? And we want to ensure that there is actually substantial tax loss or materiality.

So when we are investigating these cases, let's take an example where we have a bank account and we have cash coming in and out. We can't assume, just because it's cash, it is income. We have to prove that that is income. We have to have a witness that says this is income.

If I see the cash going out and coming back in, it could be the same cash. We take that into account in our investigation, and we give the credit there because we can't prove beyond a reasonable doubt, and recommend prosecution to our attorneys that we'll be able to prove that later in a court of law beyond a reasonable doubt.

So we give that credit and we continue

forward. And we ensure that we have a material and substantial case after doing hundreds of witness interviews, after bringing all of these to the court, and everything is proved up in the court beyond a reasonable doubt.

My concern is when you bring the records in afterwards. And you come in and you say, oh, here's these records that I didn't tell you about. And all these cash payments I didn't tell you about.

First of all, I may have already taken that into account in my investigation because I may have already given them credit by saying, okay, I saw cash coming in and out, I couldn't prove it was income, therefore I gave it to them.

So I may have that. I'm going to have to do an investigation at that point, and I've got to determine whether it's credible at that point, at least to present to you.

COMMISSIONER HINOJOSA (By Video): But we're missing the point here, that this issue of amounts [is] not just in tax cases, and "beyond a reasonable doubt"? Really, there's only like 3

percent of the cases that go to trial, and most people plead guilty, including in tax cases.

And so whether it's number of aliens that you're transporting, or whether it's the amount of drugs and the type of drugs, or whether it's the amount of fraud in any other fraud case, that's always an issue at sentencing.

And there are some very complicated issues, because many of these immigration cases — transporting aliens cases are over a long period of time that there's a big debate between the investigation, and everybody has a Fifth Amendment privilege, so it isn't like you get the full story from any defendant, to begin with.

So this is a common problem. And I realize that when you deal with the tax cases it becomes very complicated, but it is complicated on all the cases that we have at sentencing where we face many issues involving amounts and relevant conduct, which I don't know why we would treat the tax cases differently just because it's something that came up as a defense in a sentencing portion of

the case.

CHAIR SARIS: Can I ask you, when you do — what about the unrelated expense and the standard deductions: how many children you have, what's your mortgage interest, you know, the kinds of things that are not related to his hot dog business, to continue that hypothesis. Do you oppose giving those for the failure-to-file cases?

MS. SPARKMAN: Those are considered when we look at the overall materiality in our investigations. We look at what the tax return would look like, which would include standard deductions.

CHAIR SARIS: So for tax loss, you're not opposed — somebody made a suggestion to include the standard exemptions that are unrelated.

MS. KENEALLY: Yes, I think the standard exemptions are routinely given. But there's an example in one of the cases, though, that I just want to point out because when you're talking about failure-to-file, first of all you're talking about misdemeanors.

Second, yes, the standard deductions are

routinely given in failure-to-file. But what we're talking about here is a do-over for anything a taxpayer may think they should have done.

And one of the cited cases — and I can give you which one — has this very simple example: He filed his return as a joint return. After he was convicted, he figured out that he would have done better if he had been filing separately. He asked, please let me have a do-over on that standard.

I mean, that's a simple example of something that really isn't fair to let somebody do at that point.

The examples we give you in the letter, and the examples we see routinely, are far more complicated than that, where somebody comes in and says we've got to do this whole — you know, if I really had intended to file an honest tax return, then I would have structured my business as a partnership instead of a corporation, and I would have done this thing, and I would have done that thing.

I mean, those are the arguments that we

see. And, you know, those are the arguments that we're dealing with. And the courts are dealing with them, you know, and they're rejecting them. But to build into the guidelines that they have to look at that is something that we are opposed to.

CHAIR SARIS: Our examples keep saying — we give these examples, and then we say "unless sufficient information is available to make a more accurate assessment of the tax loss." So you want us to take those out? Is that essentially it?

I know we create presumptive ways, for want of a better word, certain examples of how you should do it, and then we add in "unless there's sufficient information available to make a more accurate assessment of the tax loss."

So in essence you want us to even move back from that?

MS. KENEALLY: Well the majority courts have read that as not allowing unclaimed deductions. The majority of the courts have read that as addressing whether there's a better tax rate, and we do give a better tax rate if the 28 percent —

CHAIR SARIS: So you think it's limited to tax rate?

MS. KENEALLY: We do. We do not think that that allows these deductions.

And I do want to come back to this concept that we are getting hung up on the words "tax loss." But the guidelines, the guidelines are intended to get at the harm that the defendant intended by the conduct.

VICE CHAIR JACKSON: And they say the harm is the tax loss.

MR. DEBOLD: The amount of tax they should have paid that they didn't pay.

MR. ALBERT: This is addressed by —

MS. KENEALLY: But that's not —

VICE CHAIR JACKSON: But I want to hear that.

MS. KENEALLY: That's not our view of the harm.

VICE CHAIR JACKSON: Okay.

MS. KENEALLY: And when you're talking about the kinds of cases that we see, where the

deductions that they're looking to take are deductions that continued that harm, I mean first you're talking about deductions that were not taken to conceal.

So to say to somebody, we're going to put you on equal footing with somebody who actually reported his business and reported his deductions, we're going to put you on equal footing when we determine the harm that you did here, is fundamentally unfair.

And when you look at the fact that one of the hardest things we have to deal with are businesses that are run in the cash economy and businesses that, because they are run in the cash economy ripple out to the rest of the cash economy, that is something where you need to measure a greater harm.

And allowing someone to take those deductions really undercuts that.

CHAIR SARIS: Would you support a departure or a variance the way that Commissioner Friedrich asked? In other words, let's say you had

his hot dog man, and he was really only making $10,000 worth of income when all was said and done, have a bright-line rule but then allow a variance or a departure downward if tax loss overstates the seriousness of the offense? Would you support that?

MS. KENEALLY: We believe the court already has that ability to vary, for the variance.

CHAIR SARIS: Yes, they do, but you're trying to —

COMMISSIONER FRIEDRICH: — invited departure.

CHAIR SARIS: How about an invited one?

MS. KENEALLY: Again, we think that that is going to undercut the deterrent effect of the guidelines; that that is going to further complicate sentencing proceedings; that that is going to diminish getting at the true harm in tax cases.

And one thing — and I remember, and was defending tax cases before we had the guidelines, and there was a perception then that nobody went to jail for this. And the guidelines were intended to create

a level of sentencing so that we took seriously tax crimes.

And we are really talking about some of our most serious challenges.

VICE CHAIR JACKSON: Let me ask about that. In the way we deal with the guidelines in the economic scheme, that you have loss as one aspect, but in situations in which we feel like the loss does not adequately capture all the harms, then you have SOCs that address the specific offense characteristics.

So I am not wondering whether, because the government's position is that the tax loss as divined traditionally, which would encompass these exemptions, is not getting at the harm, whether it should be restructured in a way that the tax loss is defined as tax loss is traditionally defined, and then we figure out a way to capture the additional harms that you are now saying is really what is at the heart of this?

MS. KENEALLY: We would be happy to work with you on that. We are not here saying that the

tax loss definition as interpreted by the majority of the courts isn't working for us.

We are satisfied with the majority rule.

VICE CHAIR JACKSON: But only if we don't allow the exemptions.

MS. KENEALLY: That's right. That's right. And if there's a desire to define tax loss as something other than it has been defined as by the majority of the courts for the last 20 years, then we will work with you on how to put back in getting at the harm. But it has been working for the last 20 years.

And there is one comment I want to make in response to the comment that everything is going fine in the Second Circuit, because this was brought to my attention this afternoon.

First of all, we actually do try — we have looked at your statistical report, and we see that we actually try — absolutely the vast majority of cases plead — but we try more cases than most other crimes. Our average of going to trial is higher.

In the Second Circuit, both the median

sentence and the mean sentence is lower than the national average.

CHAIR SARIS: For everything.

(Laughter.)

CHAIR SARIS: Don't take it too personally.

(Laughter.)

COMMISSIONER FRIEDRICH: Do you disagree with the statements that even in those courts that apply the bright-line rule that the reality is that they kind of are looking at these unclaimed deductions and trying to fashion a fair sentence, whether it's because of 3553(a) or whatever? Is your impression that there is just no end of story?

I mean, it does sound like, the court decisions we've read, they are looking beyond. They are not just stopping at the bright-line rule.

MS. KENEALLY: There are certain of the decisions that do stop at the bright-line rule. I mean, I can go through the cases and tell you which ones. There are certain of the cases that just simply say it's a bright-line rule, we're not going

to consider this further.

There are certain of the decisions that say there was evidence before the district court that was considered. There were certain allowances for deductions, as Ms. Sparkman described, and I described, that in proving up the tax deficiency, or proving up materiality, that some deductions were taken into consideration. And the courts do acknowledge a certain amount of that was already built into the sentence, and you do see that language in the cases.

And then there are cases that say, even if we didn't have the bright-line rule, these arguments don't fly. And our concern is, you're going to bog every sentencing hearing down with arguments that don't fly.

MR. ALBERT: Can I just make comment? It has come up a couple of times in the comments that have been made right here, and it is in the cases, as Commissioner Friedrich pointed out.

The rule that they really are putting forward is it's okay to give credit if we do it. You

know, in the course of our investigation we did it. We, the IRS, we did all this work and, yeah, we did it. We gave you credit for those. But we don't trust you, the court, to look at other ones that the defendants are arguing for, and we don't trust you to make the determination.

We know how to look at the records, and we will give you some credit. That's what happened in *Psihos*. And that's what I'm hearing is being done. That's just what Ms. Keneally just stated, and what the witness for the IRS also stated: We can do it, but we're not — we don't think it's okay for the district judges to do it.

CHAIR SARIS: Maybe all of you have studied this case law, and I think I need to go back and study it some more, but our application notes seem to provide say the probation office and the government with a presumptive way of doing things, so it's simple, and straightforward.

And then, it seems to allow defendants to say, well, no, a more accurate assessment can be made. Now you say that that has only been applied to

rates. Do you remember the case that says that?

MS. KENEALLY: The majority of cases have rejected the argument that that language allows unclaimed deductions to be taken.

CHAIR SARIS: I see, so —

MS. KENEALLY: And I can — I can give you the cases.

CHAIR SARIS: I'm sure our excellent team can get them. So you're saying they've just rejected the argument that our language allows you to look beyond —

MS. KENEALLY: That's right. The earliest case that does it and analyzes it is the *Chavin* case in the Seventh Circuit. And I think the most recent case is the *Yip* case in the Tenth Circuit that goes back. The *Yip* case actually pulls together the history of what has been done and analyzes both and reiterates that conclusion.

COMMISSIONER FRIEDRICH: Do you disagree with Mr. Albert's claim that what you're really doing is saying we know when they're verifiable, and we'll make that determination, and we'll give you credit,

defendant, but the courts can't go there? Is that fair?

MS. KENEALLY: I think that's not fair. I think that's not a fair description of what we do. What the IRS does, and what we do, is marshal the evidence to make our case. And we do that in a conservative way.

Because we do have a variety of tools, and we can bring civil cases, and we can do a number of things. To bring a criminal case, if it's a tax evasion case we need to prove omitted income, or we need to prove a deficiency. We need to prove a deficiency. And if it's a false-return case, we need to prove materiality of willfulness.

There will be a conservative effort by the prosecution and by the IRS to make sure that we can prove that. And if we're going to be met with arguments that that's not the true income amount, the true omitted-income amount, the true tax liability, we're going to be conservative there.

And the consequence is, they're getting credit.

COMMISSIONER FRIEDRICH: And that's a charging decision because you're charging a certain amount of loss based on your conservative estimate.

MS. KENEALLY: Right. That's the charging decision, and that's the proof of crime — proof at trial. And very often what you're going to see in the majority cases, which are going to be pleas, that those are the numbers we're going to work with, is the conservative, careful approach that Ms. Sparkman described. That is ultimately how we're going to get to our numbers.

And to the extent that that carries over to sentencing, the defendant benefits. But that's not — it's only if you prove it to us.

MR. DEBOLD: But it's like roulette. I mean, there are some people who the government happens to catch everything, and so we say, okay, fine. But with some people they don't catch everything. They don't catch everything that's in the defendant's favor and we're just sort of — in the example I gave where somebody has a lot of income and a lot of expenses, we are punishing that person as if

they had a lot of income, period.

Whereas, somebody who has a lot of income but no expense, or little income but no expenses, we're punishing them at a much lower level. And it's just pure arbitrary.

CHAIR SARIS: Commissioner Wroblewski has a question.

COMMISSIONER WROBLEWSKI: I have a couple of questions.

Mr. Albert, if this was called "culpability" instead of "tax loss," do you recognize that at least in some cases where all the expenses are paid in cash, that there are other losses to the government that are related to the case, that are spurred on by this business that is involved both on the income and expense side in the cash economy, but that are not part of the restitution or tax loss?

MR. ALBERT: Of course. And I think Vice Chair Jackson pointed out how in many other areas we have other ways to take that into account, if appropriate.

You have, you know, sophisticated means

enhancements, you have other enhancements. Two points. Not 27 points because I'm going to compute — I'm only going to look at the gross dollars in the door, and I'm going to be very rough and arbitrary and say I am not allowed to look at any of the other dollar amounts. So I am going to be very rough and say 27 extra points because the tax loss is $14 million, and that's the way I'm going to get at the problem.

COMMISSIONER WROBLEWSKI: I've got it. So maybe we have to —

MR. ALBERT: If you want to go that route —

COMMISSIONER WROBLEWSKI: I've got it. You will have to redo the whole thing. I'm with you.

MR. ALBERT: — for that, but not by just being arbitrary about how you compute tax loss.

COMMISSIONER WROBLEWSKI: Right. The second question is, in your example involving the contractor, you make it sound like it is all going to be very simple: cost of goods sold for the hot dog stand, no expenses for the contractor. But if you

were the contractor's lawyer, the guy who is running the consulting business, you would find lots and lots of deductions.

I just wrote a few down as I was thinking here: loss carryover, computers, Internet, phone, construction related to this construction business. I mean, there's a lot of things. And if we put a rule in — and then I'm going to ask my final question, I promise — but if we put a rule in that says, open it up, let it go, you actually have an ethical obligation to bring all that stuff in.

And if there's no written stuff and we're going to have witnesses, because you don't like Option 3, either, we are going to see witnesses on all of this.

MR. ALBERT: Well actually in my hypo, no, because he's got a business. He's got a contracting business. He's already taking all of his deductions. That's the hypo. He's taking all of his deductions. This is the hypothetical I presented in my written testimony.

COMMISSIONER WROBLEWSKI: Well, anyway —

MR. ALBERT: But the point of that is that he doesn't have any more. And you are equating him, who actually has got $100,000 of extra money in his pocket, with the poor guy who is running the hot dog stand. The reason that is unfair is because this rule, when it closes its eyes to deductions, is just arbitrary.

And, yes, the facts are going to matter, but they matter in all of these cases.

COMMISSIONER WROBLEWSKI: Okay, let me ask, and this is my final question, and the gist of the question is, do you actually think the Commission should address this at this time? Not knowing how we're going to come out, do you think it should be addressed?

(Laughter.)

COMMISSIONER WROBLEWSKI: And the reason I ask that is because it doesn't seem like you think the world is broken. I'm not sure if the —

MR. ALBERT: I can speak only for the Second Circuit.

COMMISSIONER WROBLEWSKI: I'm not sure the

assistant attorney general thinks it's broken. These are advisory guidelines. The courts in tax cases are very willing to depart and to vary, as you can see from the statistics that the Commission has put out there.

The reality is that even the courts that allow deductions, in cases they actually don't. They theoretically allow them, but they don't actually allow them. You've pointed that out. Why should we resolve this at all?

MR. ALBERT: Well you have a circuit split. I mean, we are supposed to be having a national — I mean, the tax system, and I'm sure that the Department of Justice would believe this — the tax system, the national tax system is supposed to be relatively uniformly enforced across the country.

So when you have a circuit split, I mean frankly I think that these other circuits went astray in the way —

(Laughter.)

COMMISSIONER WROBLEWSKI: But even in the circuits you think decided it correctly, I mean you

point out, I mean *Hoskins* is the case, right? But even there the court said, no, you don't get the deductions. So my point is, it seems, at least from the reported cases, it doesn't really matter.

COMMISSIONER FRIEDRICH: Was this a DOJ-recommended circuit split? I can't remember.

MR. DEBOLD: You have identified a split. You have put it out there for comment. For you to then say: Figure it out yourself, district judges, because you can read the case law in your circuit, and maybe you can find a way to do it in some cases but not in others —

COMMISSIONER HINOJOSA (By Video): Are you sure, Jonathan, this isn't one that you all presented to us as a circuit split?

COMMISSIONER WROBLEWSKI: No, I don't think so.

MR. DEBOLD: I'm sorry?

COMMISSIONER FRIEDRICH: We identified this on our own.

CHAIR SARIS: Yes.

COMMISSIONER HINOJOSA (By Video): This

may have come from DOJ as a circuit split.

CHAIR SARIS: Can I ask the defense bar? Would you be willing to live with the restitution number? That's not something you've recommended here.

MR. DEBOLD: Well we agree, first of all, that if you have paid taxes after the IRS caught you, that that's not deductible for purposes of sentencing, because that was one of the points that was made earlier. You pay back the money after you're caught; that's not a reduction in your tax loss.

But if you put that issue aside so you don't get credit for that, I think if you go with restitution purposes, especially when you have this new statute, that binds the defendant but not the government, the defendant is bound, cannot challenge the restitution amount in a later proceeding. Although apparently the government has a second bite at the apple. I think there's a strong incentive for defendants to raise those issues. And as long as you make it clear that that is what the operational

system will be, I don't see any reasons why you wouldn't go with the same number, putting aside what I said this morning.

VICE CHAIR JACKSON: So you would do the restitution first?

MR. DEBOLD: You are doing just about the same thing —

CHAIR SARIS: You can do that at the same time, or you can kick it over 90 days, or you can do it simultaneously.

MR. DEBOLD: And the judge can say I'm not going to do it because it's too complicated, which mirrors our approach to what you would do with the tax loss issue.

If the judge says this is just way too complicated, I don't have to come up with a precise number, I'm not going to go through all this exercise, we're okay with that because that's the way it operates under 2B1.1.

CHAIR SARIS: Has anyone actually tried a case where there was a restitution number that the government came up with where there was an

issue about what the tax loss was?

MR. ALBERT: Yes.

CHAIR SARIS: And what happened?

MR. ALBERT: We actually — it was one of the tax shelter cases, and we pointed out 27 reasons why the government's recitation of what the loss was for tax purposes wasn't right. And the judge ultimately decided — this was a huge case. This is one of the big tax shelter prosecutions in New York, Ernst & Young version of the *KPMG* case. And the judge ultimately decided that it was too complicated in that particular case to determine —

CHAIR SARIS: That was my instinct as you were discussing it.

(Laughter.)

MR. ALBERT: But I just wanted to respond to one last point. Is there a problem that should be — I think there is. I mean, I thought what you were saying, and sort of some of the things that we said was, it's only not such a terrible problem in the other circuits that have the "we may not look" rule because they are not really applying it.

I mean, that's a little — you know, if they are not applying their own rule, and that is the only reason why it is okay, that does not seem to me the best situation.

The Commission should clarify that you can look at it. If they want to say courts should have a right to be skeptical about deductions that are brought on after the fact and should look at the evidence closely, but we trust district judges to do that, I think that's by far the best result. That's the way it's working —

VICE CHAIR JACKSON: So "may."

MR. ALBERT: "May" would be —

VICE CHAIR JACKSON: We don't go with the — there was some concern about requiring a court in every case to bring in all the evidence. So perhaps the part of the problem is that there is a "shall account for."

MR. ALBERT: I think "may" would be fine. And I want to actually get to, there was a case that Ms. Keneally mentioned, it's actually the *Clarke* case where the defendant said, oh, oh, I would have done

better if I would have done married filing jointly rather than married filing separately.

I think it is fully — and we say this in our written statement — it is fully within the discretion of the district judge to say, listen, you can't after the fact say you might have done it that way. There actually are benefits. There are actually reasons why people do married filing separately at the time. And you can't after the fact reconsider that and get the benefit of a lower tax loss.

CHAIR SARIS: So —

MR. ALBERT: Judges can do that in their assessing whether this deduction is credible and legitimate. They can say that one, no, I'm not going to give you because you had reasons for doing it that way and I'm not going to do it. So we think that district judges can make those judgments.

CHAIR SARIS: Anything else?

MS. KENEALLY: Well in terms of all the do-overs that people will try, and if you say "may," you are going to see attempts to do-overs in taxpayer

cases. You can see attempted do-overs in identity theft cases. You are going to see them in tax shelter cases, and you are going to see them in the cash economy cases. But what they want in all of their examples is an attempt to do-over in cases where the reason that the deductions were not on the return to begin with was to hide from us what was going on.

And to be able to say we're going to — I'm going to conceal that, I'm going to conceal this whole business that I've got, or I'm going to make my business look smaller so that you don't come look for my omitted income. And then to say, oh, now that you're caught, now you can have a do-over and get those deductions that's what we have a problem with.

MR. DEBOLD: But the concealing is why they're standing in front of a judge facing the criminal sentence. I mean, they broke the law. There's no question in all these cases we're talking about people who broke the law and presumably tried to hide that they broke the law. Most of my tax defendants do a pretty good job of trying to hide

it.

MS. KENEALLY: And we're asking for sentences that reflect the magnitude of that harm.

MR. ALBERT: And that's what the defendants as asking for, also.

CHAIR SARIS: You guys are very lively for 5:20.

(Laughter.)

CHAIR SARIS: Let me just ask, are there any —

MS. SPARKMAN: We weren't here all day.

(Laughter.)

MS. SPARKMAN: I just wanted to say, the expense you're talking about the do-over with is also more harm to the government if it's another crime, like an employee who didn't report their wages because they were paid cash under the table and that's the expense they bring. So there is greater harm to the government.

CHAIR SARIS: Thank you. Any other questions from the commissioners?

(No response.)

CHAIR SARIS: I just want to thank you very much for the quality of the comments on this, how difficult — I was sitting at home like even asking my husband, what do you think?

(Laughter.)

CHAIR SARIS: It is a very difficult issue, and I have been thinking a lot about it and I am sure we will as a Commission. So thank you.

(Whereupon, at 5:21 p.m., Wednesday, March 13, 2013, the hearing was adjourned.)