

United States District Court

NORTHERN

DISTRICT OF

CALIFORNIA

UNITED STATES OF AMERICA

v.

THOMAS C. TRAUGER

SEP 24 2003 CRIMINAL COMPLAINT

CASE NUMBER:

(Name and Address of Defendant)

NORTHERN DISTRICT OF CALIFORNIA

3 077305

I, the undersigned complainant being duly sworn state the following is true and correct to the best of my knowledge and belief. On or about 10/2001 - 4/2003 in SAN FRANCISCO county, in NORTHERN District of CALIFORNIA defendant(s) did, (Track Statutory Language of Offense)

SEE ATTACHMENT A

in violation of Title 18 United States Code, Section(s) 1517 AND 1519, AND 2

I further state that I am a(n) SPECIAL AGENT OF THE FBI and that this complaint is based on the following facts:
Official Title

SEE ATTACHMENT B

Continued on the attached sheet and made a part hereof: Yes No

Approved As To Form: W.H. Kimball
AUSA: WILLIAM H. KIMBALL

[Signature]
Name/Signature of Complainant: SA JASON E. RICHARDS

Sworn to before me and subscribed in my presence,

9-24-03
Date

at S.F. CA
City and State

JAMES LARSON
UNITED STATES MAGISTRATE JUDGE
Name & Title of Judicial Officer

[Signature]
Signature of Judicial Officer

ATTACHMENT A

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1. In or about and between October 2001 and April 2002, both dates being approximate and inclusive, in the Northern District of California and elsewhere, the defendant THOMAS C. TRAUGER corruptly obstructed the examination of a financial institution, namely NextBank, N.A., a chartered national bank and wholly owned subsidiary of NextCard, Inc., by an agency of the United States with jurisdiction to conduct an examination of such financial institution, namely the Office of the Comptroller of the Currency, in violation of 18 U.S.C. § 1517.

2. In or about and between January 2003 and April 2003, both dates being approximate and inclusive, in the Northern District of California and elsewhere, the defendant THOMAS C. TRAUGER knowingly concealed and covered up a false entry in a record, document, and tangible object, namely certain records and documents related to the annual audits and quarterly reviews of the financial statements of NextCard, Inc. by Ernst and Young, LLP, with the intent to impede, obstruct, and influence the investigation and proper administration of a matter within the jurisdiction of any department and agency of the United States, namely the investigation of NextCard, Inc. by the Securities and Exchange Commission, in violation of 18 U.S.C. § 1519.

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ATTACHMENT B

UNITED STATES DISTRICT COURT)
NORTHERN DISTRICT OF CALIFORNIA) AFFIDAVIT

I, Jason E. Richards, being duly sworn, depose and say:

1. I am a Special Agent with the FBI and have been so employed since September 1998. I am currently investigating white collar crime, including securities fraud. Since joining the FBI, I have conducted numerous investigations into various types of fraud, including money laundering, mail fraud and wire fraud, bank fraud, bankruptcy fraud, and public corruption. In addition, prior to joining the FBI, I had experience in accounting and finance. I was a certified public accountant licensed to practice in the State of Maryland where I worked as a consultant. As a result of my training in accountant, as well as my training as an FBI agent, I am familiar with Generally Accepted Accounting Principles ("GAAP"), with Generally Accepted Auditing Standards ("GAAS"), and with various types of financial fraud, including securities fraud.

2. I have learned the facts contained in this Complaint by, among other things, conducting interviews with current and former employees of Ernst and Young, LLP ("E&Y"), consulting with officials from the Securities and Exchange Commission ("SEC"), and conducting interviews of officials from the Office of the Comptroller of the Currency ("OCC"). I have reviewed sworn testimony taken by SEC officials during the course of their investigation into this matter. I have also reviewed various materials, including working papers and other documents, prepared by E&Y personnel and produced to the United States, both voluntarily and pursuant to grand jury subpoenas. Some of these materials were produced in electronic form. I have also reviewed various public documents, including board minutes, press releases, and filings with the SEC. I have reviewed documents produced to the SEC both voluntarily and pursuant to

1 administrative subpoena. No search warrant has been issued in this investigation and none of the
2 documents described in this Affidavit were obtained through a search warrant. Because this
3 Complaint is being submitted for the limited purpose of establishing probable cause for the
4 issuance of an arrest warrant for the defendant, I have included only facts relevant to that
5 determination. I have not set forth all of the facts known to me regarding the defendant's
6 unlawful conduct. Also, to the extent this Complaint contains references to statements made by
7 others, those statements are set forth only in substance and in relevant part.
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10 A. Relevant Entities and Parties Involved In Investigation

11 3. At all times relevant to this Affidavit, NextCard, Inc. ("NextCard") was a
12 publicly-traded Delaware corporation with headquarters in San Francisco, California. After
13 NextCard completed its initial public offering in 1999, the company's stock was listed on the
14 NASDAQ National Market. NextCard issued credit cards over the Internet through NextBank,
15 N.A, a wholly owned subsidiary and a chartered national bank regulated by the OCC. In
16 February 2002, the OCC forced NextBank to discontinue operations in light of the bank's
17 inability to raise sufficient capital to meet federal regulatory requirements and appointed the
18 Federal Deposit Insurance Corporation ("FDIC") as receiver. NextCard filed for bankruptcy in
19 November 2002 and is currently in liquidation. At all times relevant to this Affidavit,
20 NextCard's fiscal year ended on December 31.
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23 4. At all times relevant to this Affidavit, Ernst and Young, LLP, was an international
24 accounting firm headquartered in New York, New York, with offices throughout the world,
25 including San Francisco. E&Y was engaged as NextCard's independent auditor at all times
26 relevant to this Affidavit and, among other things, performed annual audits and quarterly reviews
27 of NextCard's financial statements.
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1 5. The defendant THOMAS C. TRAUGER is a resident of Berkeley, California, and
2 a certified public accountant licensed in the State of California. TRAUGER was the primary
3 E&Y audit partner assigned to the NextCard engagement at all times relevant to this Affidavit.
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5 6. At all times relevant to this Affidavit, Oliver Flanagan, a citizen of Republic of
6 Ireland, worked as an auditor for E&Y and was assigned to the NextCard engagement. Flanagan
7 reported directly to TRAUGER and acted as the senior manager on the NextCard engagement at
8 all times relevant to this Affidavit. On August 14, 2003, Flanagan pled guilty to one count of
9 obstructing the examination of a financial institution, in violation of 18 U.S.C. § 1517.
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11 Flanagan's guilty plea is currently under seal. Flanagan is cooperating in this investigation. The
12 United States will seek to unseal Flanagan's guilty plea in the event Trauger is arrested pursuant
13 to this criminal complaint.
14

15 B. Summary of Investigation

16 7. My investigation has revealed that beginning in approximately October 2001 and
17 continuing until approximately April 2002, TRAUGER and other members of E&Y's NextCard
18 engagement team destroyed, altered, and falsified both hard and electronic copies of working
19 papers related to E&Y's audit of NextCard's financial statements for its fiscal year ended
20 December 31, 2000, and E&Y's review of NextCard's financial statements for its quarterly
21 reporting periods ending March 31, 2001, and June 30, 2001. Between approximately March
22 2002 and April 2002, TRAUGER assisted in the collection and production of these altered
23 workpapers to the OCC, pursuant to an OCC subpoena addressed to TRAUGER, dated March 1,
24 2001.
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27 8. My investigation has also revealed that, in approximately April 2003, TRAUGER
28 gave sworn testimony in a formal SEC investigation of NextCard and related persons and

1 entities. During his testimony, TRAUGER concealed his alteration and destruction of E&Y's
2 working papers related to NextCard when questioned about his role in the production of
3 documents to the OCC.
4

5 C. Trauger's Involvement in the OCC's NextBank Exam

6 9. Based on my interviews of OCC officials and my review of publicly available
7 documents, I have learned the following: The OCC is a bureau of the United States Department
8 of the Treasury which charters, regulates, and supervises all national banks and maintains a
9 nationwide staff of examiners which conducts on-site reviews of national banks and provides
10 sustained supervision of bank operations. Among other things, OCC examiners typically analyze
11 a bank's loan and investment portfolios, funds management, capital, earnings, liquidity,
12 sensitivity to market risk, and compliance with consumer banking laws. The OCC began
13 performing regular examinations of NextBank after NextBank obtained its charter as a national
14 bank in December 1999. In August 2001, the OCC began a comprehensive examination of
15 NextBank.
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18 10. Based on my interviews of OCC and SEC officials, I have learned that a key
19 indicator of the health of a bank's loan portfolio is the percentage of loans a bank writes off as
20 uncollectible, often referred to as a "charge-off ratio" or a "charge-off percentage." A loan is
21 typically charged off after a customer makes no payments for a certain period of time, often
22 180 days. Among other things, a bank's charge-off ratio is used to determine the size of its
23 allowance for loan losses – a larger charge-off percentage suggests the need for a larger loan
24 loss allowance. Credit card issuers may exclude from their charge-off ratio losses attributable
25 to fraud, typically meaning unauthorized charges that occur when a customer's credit card has
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1 been stolen or in the event of a falsified credit card application.

2 11. Based upon my discussions with SEC officials, I have learned that beginning in
3 early 2000, NextCard began reclassifying certain categories of credit losses as fraud losses,
4 thereby improving the bank's charge-off ratio. Based on my review of the documents that I
5 describe below, I have learned that TRAUGER was aware of, and approved, at least one of these
6 reclassifications. I have also learned that in spite of these reclassifications, the company's
7 charge-off percentage continued to grow throughout 2000 and 2001. The OCC's comprehensive
8 examination of NextBank focused on, among other things, NextCard's methodology for
9 establishing its loan loss allowance and for the securitization of its receivables.
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12 12. Based upon my interviews of E&Y personnel who worked with TRAUGER and
13 on the documents discussed below, I have learned that TRAUGER was aware of OCC's
14 comprehensive examination of NextBank and that he assisted NextCard in addressing various
15 concerns raised by the OCC during the course of the examination. For example, I reviewed an e-
16 mail which appears to have been sent by TRAUGER to NextCard's Controller, dated October 4,
17 2001, in which TRAUGER forwarded a proposed draft of the company's written response to
18 concerns raised by the OCC. In the e-mail, TRAUGER also offered advice on how to respond to
19 questions raised by the OCC.
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22 13. I have also reviewed TRAUGER's sworn testimony before the SEC, taken on
23 April 30, 2003. In his testimony, TRAUGER recalled attending at least one meeting with OCC
24 officials relating to E&Y's review of NextCard's financial statements for the company's third
25 fiscal quarter, ended September 30, 2001.
26

27 14. According to TRAUGER's testimony, TRAUGER learned during this meeting
28 that the OCC believed that NextCard would likely experience greater loan losses in the future as

1 a result of their issuing credit cards to customers that were increasingly less creditworthy.
2 TRAUGER also testified that he learned from the OCC – not from NextCard – about
3 “operational decisions” made by NextCard during the third quarter that the OCC believed would
4 result in increased loan losses at NextCard. TRAUGER testified that, while he initially
5 questioned the OCC’s criticism of NextCard, he later came to believe the OCC’s opinion had
6 some merit.
7

8 15. Based on my interview of a junior E&Y auditor, I have learned that, in
9 approximately October 2001, during E&Y’s field work for its review of NextCard’s third fiscal
10 quarter, TRAUGER told several members of the NextCard engagement team that the OCC had
11 challenged the sufficiency of NextCard’s allowance for loan losses as well as E&Y’s audit
12 procedures for NextCard.
13

14 D. Trauger Alters A Document Produced To The OCC in October 2001
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16 16. Based upon my interviews with Flanagan, I have learned the following: During
17 approximately October 2001, TRAUGER told Flanagan that the OCC had requested certain E&Y
18 working papers from its audit of NextCard’s 2000 fiscal year. Flanagan told me that he believes
19 TRAUGER may have said that the OCC also requested working papers from E&Y’s quarterly
20 reviews for NextCard’s first and second fiscal quarters in 2001. Flanagan gathered the requested
21 documents and gave them to TRAUGER for his review before their production to the OCC. In
22 Flanagan’s presence and while reviewing a spreadsheet included in the 2000 audit working
23 papers concerning NextCard’s securitization of loans, TRAUGER added a short handwritten note
24 of explanation to the top the spreadsheet. According to Flanagan, the text of TRAUGER’s note
25 came from a separate memorandum that had been included in E&Y’s 1999 working papers.
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27 TRAUGER initialed but did not date his handwriting.
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1 17. According to Flanagan, because TRAUGER had altered an original working paper
2 that had been carried forward and included in the working papers for subsequent reporting
3 periods, TRAUGER instructed Flanagan to photocopy his handwritten note and to cut and paste
4 the text on all subsequent versions of the spreadsheet that appeared in E&Y's working papers for
5 later periods. After making these changes, on approximately October 22, 2001, TRAUGER and
6 Flanagan personally delivered various documents to the OCC by hand, including the altered
7 documents.
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10 E. NextCard's October 31, 2001 Press Release

11 18. Based on my review of a press release issued by NextCard dated October 31, 2001
12 (the "October 31 release"), I have learned the following: On October 31, 2001, NextCard issued
13 a press release containing the company's results for the third fiscal quarter, ending September 30,
14 2001. In the October 31 release, NextCard announced, among other things, that the company
15 was significantly undercapitalized pursuant to federal banking regulations. The company also
16 announced that it had withdrawn its prior earnings guidance for all future reporting periods and
17 had hired an investment banking firm to seek opportunities for the sale of the company in light of
18 its inability to meet regulatory capital requirements.
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21 19. In the October 31 release, NextCard also announced several significant accounting
22 and operational changes "as a result of discussions" with the OCC and the FDIC. Among other
23 things, NextCard announced that its banking subsidiary, NextBank, would increase reserves,
24 including its allowance for loan losses, and tighten its lending requirements. The bank would
25 also reclassify certain loan losses totaling \$12 million as credit losses that had previously been
26 classified as fraud losses, including losses on certain loans sold through the bank's securitization
27 activities.
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1 20. As a result of these and other reclassifications required by the OCC, the bank's
2 available capital decreased dramatically. The October 31 release stated that NextBank was now
3 considered "significantly undercapitalized" under applicable federal banking regulations and
4 would be subject to "prompt corrective action" under federal banking laws, requiring the bank to
5 submit a capital restoration plan acceptable to the OCC and to be subject to heightened
6 regulatory scrutiny.
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8 21. Based on my review of relevant trading records, I have learned that shares of
9 NextCard's common stock lost approximately 80% of their value immediately following the
10 October 31 release.
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12 F. E&Y's Document Retention Policy And AWS Files

13 22. I have reviewed a document created by E&Y which describes the firm's policies
14 and procedures in effect during all times relevant to this Affidavit for retaining and discarding
15 both hard copy and electronic firm documents. In general, the policy calls for all working papers
16 for audits, in hard copy or electronic form, to be maintained for six years. The policy also notes
17 that in the event of pending government investigations or threatened litigation, E&Y personnel
18 should consider whether working papers should be maintained beyond six years.
19

20 23. Based on my interviews with E&Y employees, including individuals who have
21 developed and maintained an electronic storage system for E&Y's working papers, and my
22 review of documents provided by E&Y which reflect the firm's policies and procedures in effect
23 during November 2001, I have learned the following: E&Y working papers include both hard
24 copies and electronic copies of documents. Some working papers are maintained only in
25 electronic form. E&Y maintains electronic copies of audit working papers in a database
26 developed for E&Y known as the Automated Workpaper System ("AWS"). E&Y personnel
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1 frequently refer to electronically stored working papers as "AWS files."

2 24. Based on my review of a document produced by E&Y which describes the firm's
3 policies and procedures in effect in November 2001 regarding AWS files, I have learned the
4 following: AWS files were to be "archived" at the end of an audit engagement after procedures
5 and documentation for the audit were complete. The partner in charge of the audit was to
6 authorize the final archive procedures. The archive process should have been completed within
7 approximately one month of end of the audit engagement. In the event E&Y's client filed a
8 Form 10-K with the SEC, AWS files for an audit were to be archived within approximately a month
9 of the filing of the Form 10-K.
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12 25. The document also states that, after the final archive is complete, the working
13 paper copy of the archive should be restored only when creating the next year's audit working
14 papers, when creating a copy of the archive for use by a third party, or when using the prior
15 year's working papers in a subsequent audit. Most significantly, in the event that any work is
16 necessary to complete the documentation of E&Y's procedures for the original audit year after
17 AWS files have been archived, the work must be done in hard copy, dated contemporaneously,
18 and filed in separate sections of the working paper binder for that audit.
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21 G. Trauger Questions NextCard's Accounting During The OCC Exam

22 26. Based on my review of the e-mail described below, I have learned the following:
23 On November 2, 2001, another E&Y partner, who was not a member of the NextCard
24 engagement team but was consulted on the engagement, sent an e-mail to TRAUGER
25 suggesting, among other things, that E&Y begin "retrospective review procedures" to determine
26 whether NextCard's loan loss provisions had been recorded in the correct reporting periods in
27 2001.
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1 27. I have also reviewed an e-mail which appears to have been sent by TRAUGER on
2 Sunday, November 11, 2001, to several NextCard executives, including, among others, the
3 company's Chief Executive Officer, Chief Financial Officer, and Controller. In the e-mail,
4 TRAUGER offered various comments that were "meant to mitigate risk given the events which
5 have occurred since the press release went out." The e-mail suggested that TRAUGER had
6 reviewed the allegations contained in lawsuits filed against NextCard as a result of the October
7 31 release. TRAUGER noted that "from our perspective, the most troubling allegations in the
8 shareholder suits relate to comments like 'the Company ... purposely mischaracterized its true
9 loan loss levels.'" TRAUGER also noted that he had spent "a fair amount of time" with
10 NextCard's Controller discussing the issue of whether or not the change in the definition of fraud
11 losses required by the OCC would require a restatement of NextCard's financial statements from
12 prior reporting or whether the change could be handled prospectively, without a restatement.
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16 28. TRAUGER concluded the e-mail by stating, "One negative factor from my
17 perspective is the ever broadening definition of fraud. Until Friday, the only change I was aware
18 of was the Q1 2001 change made re: non-payment default. I didn't realize other changes had
19 been made." TRAUGER copied the e-mail to Flanagan, who forwarded it to the audit manager
20 on the NextCard engagement (the "Audit Manager") the following day.
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22 29. I have also reviewed an e-mail which appears to have been sent by TRAUGER on
23 Sunday, November 11, 2001, to Flanagan asking him to collect all of E&Y's working papers
24 from the 2000 audit and from the first two quarters of 2001 relating to NextCard's allowance for
25 loan loss and fraud losses. TRAUGER wrote that NextCard had been "broadening its definition
26 of fraud for some time (back to Q2 2000) and the changes are material." TRAUGER concluded,
27 "We should have picked this up." The e-mail indicates that Flanagan forwarded the e-mail to the
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1 Audit Manager the next day and asked him to collect the documents that TRAUGER requested.

2 30. Based on my review of relevant minutes from the Audit Committee of NextCard's
3 Board of Directors, I have learned the following: The minutes of the Audit Committee meeting
4 for July 23, 2001, state the following: "Mr. Trauger was comfortable with the company's
5 decision to categorize first payment defaults as fraud losses." However, based on my review of
6 TRAUGER's April 2003 SEC testimony, TRAUGER testified that he had no recollection that he
7 made this statement and, further, that he had "no recollection of fraud classification ever being
8 discussed" at any Audit Committee meeting that he attended.
9
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11 H. Trauger Directs Documents To Be Altered

12 31. Based on my interviews with Flanagan, I have learned the following: In
13 approximately November 2001, while the OCC examination was still ongoing, TRAUGER told
14 Flanagan that he wanted to review E&Y's work on NextCard's 2000 audit in order to "beef up"
15 what was in the working papers to make it appear that E&Y was "right on the mark" all along.
16 According to Flanagan, TRAUGER told Flanagan that he wanted to go back and make sure that
17 everything in the NextCard files would not be second-guessed by "some smart-ass lawyer" in the
18 event the files were ever subpoenaed. TRAUGER asked Flanagan to come in on a Saturday in
19 approximately November 2001 in order to help him review the NextCard working papers.
20 TRAUGER also instructed Flanagan to research the issue of how AWS files could be modified
21 after the files had been archived in the firm's AWS database.
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24 32. Based on my review of the e-mail described below, I have learned the following:
25 On November 2, 2001, the Audit Manager, who reported to Flanagan, appears to have sent an e-
26 mail to Flanagan and TRAUGER regarding the modification of archived AWS files. The Audit
27 Manager's e-mail forwarded research done by a staff accountant, informing TRAUGER and
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1 Flanagan that after AWS files for an engagement have been archived, the copy of the archive
2 maintained on E&Y's nationwide server could not be modified. The research attached to the e-
3 mail reiterated E&Y's policy that any additional documentation obtained after the archive of
4 AWS files "should be done in hard copy and filed in a separate section of the hard copy working
5 paper file."

7 33. However, according to the e-mail, "in rare circumstances and with the approval of
8 the engagement partner," changes may be made to AWS files maintained on a local server and
9 then re-archived, deleting the previously archived AWS file. Portions of the text of the e-mail
10 were bolded for emphasis. The research concluded that "in cases of re-archiving, no record will
11 be maintained of the original archive file." In his e-mail to TRAUGER and Flanagan, the Audit
12 Manager wrote, "I am not sure what we want to do. The 2000 workpapers are essentially frozen.
13 I think we should discuss in person."

16 34. Based on my interviews with Flanagan, I have learned the following: TRAUGER
17 and Flanagan met at E&Y's offices in San Francisco on a Saturday in November 2001 in order to
18 alter working papers from the NextCard engagement. Flanagan used his laptop computer to
19 access AWS files stored on a local E&Y server. According to Flanagan, as TRAUGER and
20 Flanagan reviewed all the AWS files relating to the 2000 audit, TRAUGER directed Flanagan to
21 make various changes to working papers. Specifically, Flanagan recalls that TRAUGER directed
22 him to make changes to working papers that concerned NextCard's allowance for loan losses and
23 its securitization of receivables, among others.

26 35. According to Flanagan, TRAUGER also directed Flanagan to alter the date on his
27 laptop computer in order to give the appearance that their changes to various documents had been
28 made at the time of E&Y's original work on the audit. After the Saturday meeting, TRAUGER

1 told Flanagan that he wanted to review additional NextCard files from E&Y's 2000 audit as well
2 as working papers related to the quarterly reviews performed for NextCard in 2001. TRAUGER
3 told Flanagan to request the Audit Manager's assistance in their effort to collect the various
4 documents requested by TRAUGER.
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6 36. Based on my interviews with Flanagan, I have learned the following: Soon after
7 the Saturday meeting described above, in approximately November 2001, TRAUGER, Flanagan,
8 and the Audit Manager all met on a weekday evening in E&Y's San Francisco offices.
9 According to Flanagan, TRAUGER, Flanagan, and the Audit Manager used the Audit Manager's
10 computer to access AWS files on a local server. The three E&Y auditors then reviewed and
11 altered working papers from NextCard's 2001 quarterly reviews as well as working papers from
12 the 2000 audit. Flanagan told me that he explained to the Audit Manager how to change the
13 clock on his laptop to make their alterations appear to have been made at the time of the creation
14 of the original document. During this meeting, TRAUGER reviewed the AWS files and wrote
15 down changes that he wanted made to the various documents. Among other changes, Flanagan
16 told me that he recalls altering working papers concerning NextCard's allowance for loan loss
17 and NextCard's securitization of receivables. According to Flanagan, the Audit Manager typed
18 in the changes suggested by TRAUGER. The Audit Manager was unable to connect to E&Y's
19 network that evening in order to e-mail copies of the altered documents to Flanagan.
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23 37. I have reviewed an e-mail dated November 21, 2001, which appears to have been
24 sent by the Audit Manager to Flanagan, attaching copies of a Summary Review Memorandum
25 ("SRM") from the 2000 audit and a memorandum Analyzing NextCard's Loan Losses. Both of
26 these documents were originally created as part of E&Y's 2000 audit of NextCard. In the e-mail,
27 the Audit Manager wrote, "Here are the memos we discussed, sorry I could not e-mail them to
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1 you last night.” In the same e-mail, he also wrote, “Let me know when you would like to sit
2 down and discuss if there are other items, I would like to delete the AWS for NXCD 2000 on my
3 hard drive. Also there is a back up disk in the 2000 workpapers we should remove.”
4

5 I. Trauger Directs Meeting with Former E&Y Auditor

6 38. Based on my interviews with Flanagan and a former E&Y auditor, as well as my
7 review of relevant documents, I have learned that in approximately November 2001, TRAUGER
8 directed Flanagan to meet with a former member of NextCard’s engagement team as part of their
9 effort to alter one of E&Y’s working papers. The former auditor acted as a manager on the 2000
10 NextCard audit and left the firm in approximately April 2001. According to Flanagan, he met
11 with the former E&Y auditor outside E&Y’s offices in order for her to copy handwritten notes
12 that she had originally written on a securitization working paper into a new version of the same
13 document that had been altered by TRAUGER. According to the former E&Y auditor, Flanagan
14 her that TRAUGER said that these actions were appropriate because the working paper was
15 simply being “recreated.”
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18 J. Trauger Directs Document Destruction After OCC Subpoena and SEC Inquiry

19 39. As noted above, in February 2002, the OCC forced NextBank to discontinue
20 operations in light of the bank’s inability to raise sufficient capital to meet federal regulatory
21 requirements and appointed the FDIC as receiver. Based on my interviews with Flanagan and
22 my review of the relevant documents described below, I have learned the following: On March
23 1, 2002, the OCC sent a subpoena to TRAUGER concerning NextCard that called for the
24 production of documents relating to NextCard. The OCC subpoena, sent to E&Y care of
25 TRAUGER, specifically requests that E&Y list any responsive documents that were previously
26 destroyed and explain the reasons for the destruction of the documents.
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1 40. On March 5, 2002, the San Francisco office of the SEC sent a letter to an E&Y
2 attorney informing the firm that the SEC was conducting an investigation of NextCard and
3 asking E&Y to preserve certain documents, including all working papers prepared in connection
4 with E&Y's audit work for NextCard in 1999, 2000, and 2001. On March 15, 2002, TRAUGER
5 appears to have sent a letter to members of the NextCard engagement team, including Flanagan
6 and the Audit Manager, informing them of the OCC subpoena and the SEC request to preserve
7 NextCard documents. In the letter, TRAUGER stated that "the scope of the subpoena is very
8 broad and includes all workpapers, desk/person files, and emails in your possession."
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11 41. Based on my interviews with Flanagan, I have learned that soon after E&Y
12 received the OCC subpoena, TRAUGER asked Flanagan to collect various NextCard documents
13 in order to respond to the subpoena. TRAUGER also told Flanagan to destroy all e-mails or
14 documents on his computer that related to the altered NextCard working papers. Flanagan told
15 me that he deleted at least two e-mails concerning the alterations. Flanagan later found a
16 computer disk belonging to the former NextCard audit manager that was plainly labeled as
17 containing material related to NextCard. Flanagan gave the disk to TRAUGER. After looking at
18 the disk, TRAUGER told Flanagan to destroy it. Flanagan, without telling TRAUGER, kept the
19 disk and has provided a copy to the government. I have reviewed this disk and confirmed that,
20 among other things, the disk contains NextCard materials prepared during the course of the 2000
21 audit.
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23
24 K. Altered Documents Are Produced to the OCC in 2002
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26 42. Based on my review of relevant documents, and interviews with OCC and SEC
27 officials, I have learned the following: On April 5, 2002, E&Y produced documents in response
28 to the OCC subpoena dated March 1, 2002. As explained more fully below, I believe that E&Y

1 produced documents to the OCC that had been altered or destroyed by TRAUGER, Flanagan,
2 and the Audit Manager.

3 L. Altered Documents Are Produced to the SEC in 2003
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5 43. Based on my interview of the former E&Y auditor who acted as the NextCard
6 audit manager, I have learned the following: In approximately January or February 2003,
7 TRAUGER telephoned the former NextCard audit manager and asked her to meet him at E&Y's
8 offices in San Francisco. During this meeting, TRAUGER showed the former auditor NextCard
9 working papers, including working papers related to NextCard's loan loss allowance and the
10 company's securitization of loans. According to the former auditor, TRAUGER said that he had
11 to explain some of the documents to E&Y's attorneys. TRAUGER became angry when the
12 former E&Y auditor was not able to identify or explain one of the documents that TRAUGER
13 said she had written, which she did not recall. TRAUGER also told the former auditor that he
14 had a meeting scheduled with the SEC.
15
16

17 44. Based upon my interview of an in-house attorney for E&Y and my discussions
18 with SEC officials, I have learned the following: In connection with the SEC's investigation of
19 NextCard, E&Y personnel voluntarily met with SEC officials at the SEC's San Francisco offices
20 in approximately January 2003. At the meeting, E&Y distributed binders containing certain
21 NextCard working papers for discussion purposes. SEC officials have informed me that these
22 binders contain at least some of the altered documents that were previously produced to the
23 OCC. According to SEC officials, TRAUGER attended this meeting and was present at the time
24 the altered working papers were distributed to the SEC officials.
25
26

27 45. Based upon my review of the relevant documents described below, and my
28 discussions with SEC officials, I have learned the following: On April 21, 2003, the SEC sent a

1 subpoena to TRAUGER requiring him to appear for investigative testimony and to produce
2 certain documents relating to NextCard. Prior to the date of TRAUGER's subpoena, SEC
3 officials and counsel for E&Y reached an agreement that documents produced by E&Y to the
4 OCC need not be produced again to the SEC, as the SEC could obtain the documents directly
5 from the OCC. Based upon my conversations with SEC officials, I have learned that the SEC
6 obtained documents from the OCC that were altered by TRAUGER. I have described below my
7 basis for believing that specific alterations were made to documents that were produced to the
8 OCC and the SEC.
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11 46. On April 30, 2003, TRAUGER appeared for SEC testimony and, while under
12 oath, described the steps that he took in 2002 to comply with the OCC subpoena to E&Y.
13 Among other things, TRAUGER testified that he undertook an "extensive" search for responsive
14 documents. TRAUGER also testified that he "walked the halls for the people in San Francisco"
15 to make sure that all responsive documents were collected in response to the OCC subpoena.
16 TRAUGER concealed his destruction of documents in response to, or in anticipation of, the OCC
17 subpoena.
18

19 **M. Trauger Admits Altering Working Papers**
20

21 47. In approximately June 2003, TRAUGER was interviewed by attorneys for E&Y
22 as part of the firm's internal investigation into the possible alteration of NextCard working
23 papers. I have interviewed an E&Y in-house attorney who participated in the interview of
24 TRAUGER. Based upon my interview with this attorney, I have learned that TRAUGER
25 admitted to the attorney that he made changes to certain NextCard working papers after the
26 documents had been finalized. According the E&Y attorney, TRAUGER also attempted to
27 minimize the significance of the changes he made to E&Y's working papers.
28

1 M. Specific Alterations In Documents Produced to Government

2 48. Based on my interviews of E&Y personnel with knowledge of the firm's AWS
3 database and its information systems, including an individual who maintains the AWS database,
4 my interviews of OCC personnel, and my review of relevant documents, including electronic
5 documents and AWS files, as described below, I have learned the following: E&Y has no record
6 of NextCard's 2000 audit working papers being archived in the firm's AWS database until
7 November 26, 2001, over seven months after NextCard's Form 10-K for its 2000 fiscal year was
8 filed with the SEC on April 2, 2001. E&Y's policy, as explained above, would have required the
9 NextCard AWS files for the 2000 audit to be archived by approximately May 2001, one month
10 after NextCard's Form 10-K was filed.

13 49. One junior E&Y auditor assigned to the NextCard engagement told me that she
14 recalls archiving AWS files for the 2000 audit, along with AWS files for the 1999 audit,
15 sometime in the summer of 2001. However, as noted above, E&Y has no record of AWS files
16 for the 2000 audit being archived until November 26, 2001, and the firm has no record of the
17 1999 NextCard audit ever being archived. Based upon my interviews with Flanagan, I believe
18 that the AWS files archived on November 26, 2001, had been altered by TRAUGER, Flanagan,
19 and the Audit Manager during November 2001.

22 50. Based on my review of a summary and analysis of documents provided to me by
23 E&Y, and E&Y personnel who prepared the summary and analysis of those documents, I have
24 learned that, on July 19, 2001, a copy of the AWS files for E&Y's 2000 NextCard audit was saved
25 onto the hard drive of the laptop computer of a junior member of E&Y's NextCard audit team. I
26 have interviewed the junior auditor, who told me that, although he does not recall copying the
27 AWS files onto his laptop, he may have obtained the AWS files for the 2000 audit either because
28

1 he needed the documents to assist in the quarterly review for NextCard's quarter ended June 30,
2 2001, or because he was responsible for "migrating" the AWS files of several clients, including
3 NextCard, into a new software program during the summer of 2001.
4

5 51. Based on my interview of the junior auditor, I believe that the AWS files saved
6 onto the junior auditor's laptop computer in July 2001 are copies of the original AWS files from
7 E&Y's 2000 audit that existed at the completion of the engagement. I have compared versions of
8 documents contained in the July 2001 AWS files found on the laptop computer with versions of
9 the same documents contained in the AWS files that were archived on November 26, 2001, and
10 later produced to the OCC and the SEC.
11

12 52. As explained below, I have found significant differences in several documents,
13 including, but not limited to, the following: (i) a memorandum dated December 31, 2000,
14 containing an analysis of NextCard's loan loss allowance (the "2000 Loan Loss Memo"); (ii) the
15 Summary Review Memorandum for NextCard's 2000 Audit, dated December 31, 2000 (the
16 "2000 SRM"); and (iii) a memorandum describing NextCard's securitization of credit card
17 receivables, dated September 30, 2000 (the "Third Quarter 2000 Securitization Memo").
18

19 N. The 2000 Loan Loss Memo
20

21 53. The following chart compares the July 2001 version of the 2000 Loan Loss Memo
22 with the version that was archived on November 26, 2001, and later produced to the OCC and
23 the SEC. This chart is derived from my review of a summary and analysis of documents
24 provided to me by E&Y. I have added italics in order to illustrate some of the differences in the
25 two versions.
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July 2001 Version	Version Produced to OCC/SEC
<p>“In December 2000, NextCard began to apply a different accounting treatment for its delinquent loans. As stated above, the Company began to charge off loans once they be became more than 90 days delinquent. However, <i>in order to reduce its allowance for loan losses, decrease its loan loss allowance expense, and clean its portfolio for securitization purposes</i>, the Company began to remove these accounts from its portfolio.”</p>	<p>“In December 2000, NextCard began to sell delinquent loans prior to the time of charge-off.”</p>
<p>“Reserves as a percentage of loans” for NextCard at 12/31/00: 4.61%</p>	<p>“Reserves as a percentage of loans” for NextCard at 12/31/00: 4.76%</p>
<p>“Delinquencies as a percentage of loans” for NextCard at 12/31/00: 4.23%</p>	<p>“Delinquencies as a percentage of loans” for NextCard at 12/31/00: 3.92%</p>
<p>“Charge-off rate” for NextCard at 12/31/00: 4.99%</p>	<p>“Charge-off rate” for NextCard at 12/31/00: 3.10%</p>
<p>Cross reference in a chart comparing NextCard with Industry Ratios: “NextCard ratios for 9/30/00 have been calculated at E.5. NextCard ratios for 12/31/00 have been calculated at E7.6A.”</p>	<p>Deleted</p>
<p>“Percentage of accounts 60 days and greater” for NextCard: December 31, 1999: 1.36% September 30, 2000: 3.13% December 31, 2000: 5.35%.</p>	<p>Deleted</p>
<p>“Net charge-offs as a percentage of average loans (<i>on-balance sheet</i>)” for NextCard: December 31, 1999: 0.16% September 30, 2000: 1.93% December 31, 2000: 8.43%.</p>	<p>Deleted</p>
<p>“Net charge-off as a percentage of average loans (<i>off-balance sheet</i>)” for NextCard at December 31, 2000: 4.99%</p>	<p>“Net charge-off as a percentage of average loans (<i>off-balance sheet</i>)” for NextCard at December 31, 2000: 3.10%</p>

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<p>“We have noted that the Company’s average receivable life is approximately <i>8 months</i>. However, the lagged coverage periods as of year-end 2000 are less than the expected life of the receivables. Per discussion with the client, the short coverage periods are conservative given the fact that the client expects to securitize most of its loans in 2001.”</p>	<p>“We have noted that the Company’s average receivable life is approximately seven months. As such, the lagged coverage periods as of year-end 2000 are equal to the expected life of the receivables. In addition, the Company has told us they plan to securitize approximately \$300 million receivables in the first quarter of 2001 (i.e. no allowance would be needed to cover months after March 2001). The Company also expects that their new collections process will increase their number of recoveries beginning in Q1 2001.”</p>
<p>“We have discussed with the client the fact that given the nature of the economy, there will need to be close monitoring in the 1st quarter 2001 to ensure that the reserve amounts are reasonable given shifts in the economy. Furthermore, since the client has reduced its roll rate percentages based on its implementation of rigorous collection policies, <i>the impact of these policies will need to be checked at first quarter 2001 to ensure that these policies are effective and to assess if the client’s loan loss reserve analysis requires further adjustments.</i>”</p>	<p>Deleted</p>

54. In addition to the deletions and changes noted above, the version of the 2000 Loan Loss Memo produced to the OCC contains additional information, including new charts, that was not included in the July 2001 version.

O. The 2000 SRM

55. The following chart compares the July 2001 version of the 2000 SRM with the version that was archived on November 26, 2001, and later produced to the OCC and the SEC. This chart is derived from my review of a summary and analysis of documents provided to me by E&Y. I have added italics in order to illustrate some of the differences in the two versions.

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July 2001 Version	Version Produced to OCC/SEC
<p>“Industry practice with respect to DAC [deferred acquisition costs] upon sale is mixed. However, most companies offset these amounts against the gain on sale. As of December 31, 2000, no amounts were backed out of deferred acquisition costs for securitized loans. We performed an analysis of the impact of these potential adjustments and noted that the amounts were immaterial to the financial statements. <i>However, going forward the client will reverse these amounts as it securitizes its portfolio.</i>”</p>	<p>“There is diversity in practice in the industry with respect to the treatment of DAC upon securitization of balances with some companies offsetting these amounts against the gain on sale. The Company like most of its peers continues to account for DAC subsequent to securitization as only customer balances vs the relationship is sold in a securitization. This is supported by EITF 92-5 and FAS 91.”</p>
<p>“Consistent practice among most other companies in the credit card industry is to remove all capitalized debt issuance costs related to off-balance sheet securitizations, upon recognition of the gain on sale. (Bank One does not follow this practice.)</p>	<p>Deleted</p>
<p>“NextCard has retained all capitalized debt issuance costs for its securitizations on its balance sheet. Some contend that since the receivables and the corresponding debt facility for the receivables are sold and transferred off-balance sheet, the related capitalization of prepaid debt issuance costs should also be taken off the balance sheet and included as part of the transaction cost of the securitization.”</p> <p>“Others however, contend that on a theoretical basis the Company will still obtain benefits from the securitized portfolio in terms of recognizing replenishment gains throughout the life of the securitization, and therefore that the costs of the facility are still associated with the ongoing benefits to the client. We have accepted the client’s position that the capitalized debt issuance costs have ongoing benefits and these are properly stated at 12/31/00. <i>We have indicated to the client</i></p>	<p>[The first block of text remains unaltered]</p> <p>[The second block of text is deleted and the following text is substituted in its place:]</p> <p>“GAAP, however, provides that these costs should be capitalized on a theoretical basis as the Company will still obtain benefits from the securitized portfolio in terms of recognizing replenishment gains throughout the life of the securitization, and therefore that the costs of the facility are still associated with ongoing benefits to the client. We concur with the client’s position that the capitalized debt issuance costs have ongoing benefits and are properly stated at 12/31/00.”</p>

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that their practice is not consistent with the majority of its industry peers."

P. The Third Quarter 2000 Securitization Memo

56. The following chart compares the July 2001 version of the Third Quarter 2000 Securitization Memo with the version that was archived on November 26, 2001, and later produced to the OCC and the SEC. This chart is derived from my review of a summary and analysis of documents provided to me by E&Y. I have added italics in order to illustrate some of the differences in the two versions.

July 2000 Version	Version Produced to OCC/SEC
Under heading listing securitization issues to be addressed during year-end audit for 2000: <i>"Due to new requirements under FAS 140, the Company will need to make certain disclosures in the footnotes (such as a sensitivity analysis) to its financial statements."</i>	Deleted
Under heading listing securitization issues to be addressed during year-end audit for 2000: <i>"Review and assessment of reasonableness of accounting for new term trust including the assumptions used."</i>	Deleted
Under heading listing securitization issues to be addressed during year-end audit for 2000: <i>"Reversal of deferred acquisition costs per FAS 91 for receivables in the trust that have been sold through securitizations."</i>	Deleted

1 2 3 4	Under heading listing securitization issues to be addressed during year-end audit for 2000: “Reversal of capitalized transaction costs for facilities that are taken off the balance sheet in relation to securitized loans.”	Deleted
5 6	One paragraph section with heading “Reversal of Deferred Acquisition Costs.”	Deleted
7 8	Two paragraph section with heading “Reversal of Capitalized Transaction Costs.”	Deleted

10
11 57. As a result of these and other deletions, the version of the Third Quarter 2000
12 Securitization Memo that was produced to the OCC was less than half the length of the July 2001
13 version. Further, a four-page memorandum entitled “Securitization Accounting” was produced
14 to the OCC and is included in the AWS files archived on November 26, 2001. This
15 memorandum purports to have been “prepared during the course of second quarter review
16 procedures for NextCard” and was “included in our year-end workpapers as a source of
17 reference.” This memo, purportedly created in mid-2000, does not appear in the AWS files
18 saved in July 2001 and recovered from the junior auditor’s laptop.

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21 Q. Other Changes to 2000 Audit Working Papers

22 58. In addition to the changes described above, my comparison of the July 2001 AWS
23 files with the AWS files produced to the OCC and the SEC revealed alterations in additional
24 working papers for the 2000 NextCard audit, including a memorandum regarding Financial
25 Accounting Standards Bulletin (“FASB”) 91, a debt issuance spreadsheet, and a consultation
26 memorandum.
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1 R. Alterations In 2001 Summary Review Memoranda Produced to OCC

2 59. Based on my interviews with E&Y personnel, members of the SEC's enforcement
3 staff, and OCC personnel involved in the OCC's examination of NextBank, and my review of the
4 relevant documents described below, I believe that documents related to E&Y's reviews of
5 NextCard's first and second fiscal quarters in 2001 were also altered prior to their production to
6 the OCC.
7

8 60. I have reviewed an e-mail sent on October 25, 2001, to TRAUGER and the Audit
9 Manager by a junior E&Y auditor on the NextCard engagement, attaching E&Y SRMs for
10 NextCard's 2001 first and second quarter reviews. The second quarter SRM begins with the
11 following notation: "Highlighted and bolded text refers to Tom Trauger's questions."
12 Throughout the document, questions and comments appear in text that has been bolded and
13 highlighted. The junior auditor recalls that he added this text at TRAUGER's request but made
14 no other changes to the document before forwarding it to TRAUGER and the Audit Manager.
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17 61. I have compared the SRMs attached to the October 25 email with versions of the
18 same SRMs recovered by E&Y from the Audit Manager's computer which were last revised in
19 February 2002. The versions of the SRMs found on the Audit Manager's computer are identical
20 to the first and second quarter SRMs that were produced to the OCC and the SEC.
21

22 S. The Q1 2001 SRM

23 62. The following chart compares the SRM for the first quarter of 2001 which was
24 attached to the October 25, 2001 email with the version recovered from the Audit Manager's
25 computer which was last revised in February 2002 and later produced to the OCC. This chart is
26 derived from my review of a summary and analysis of documents provided to me by E&Y. I
27 have added italics in order to illustrate some of the differences in the two versions.
28

October 25, 2001 Version	Version Produced to OCC/SEC
<p>In the "Allowance for Loan Losses" portion of the SRM, a table contains the following characterization of the Company's assumptions for its loan recovery rate:</p> <p><i>"Aggressive"</i></p>	<p>In the same table, the recovery rate is characterized as:</p> <p><i>"Conservative"</i></p>
<p>"Per review of the different scenarios being used for the reserve analysis, we have noted that the Company remains <i>at the low end of the acceptable range</i> for its reserves."</p>	<p>Deleted</p>
<p>"There were several off-balance sheet securitizations that took place in the 1st quarter as indicated above. <i>Many of the client's assumptions changed in booking the gain on these securitizations.</i> The include the following:"</p>	<p>There were several off-balance sheet securitizations that took place in the 1st quarter as indicated above. The gain on the sale/interest only strip of the valuation assumptions used by the Company were as follows:</p> <p><i>[A column in table was deleted which reflected certain assumptions regarding NextCard's loan securitization at 12/31/00.]</i></p>

T. The Q2 2001 SRM

63. I have also compared the SRM for the second quarter of 2001 which was attached to the October 25 email with the version recovered from the Audit Manager's computer which was last revised in February 2002 and later produced to the OCC. In general, the version produced to the OCC and recovered from the Audit Manager's computer appears to have incorporated the comments and suggestions made by TRAUGER that were bolded and highlighted in the version of the SRM attached to the October 25 email. The section titled "Allowance for Loan Losses," was revised significantly.

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U. The Counts Charged in the Criminal Complaint

64. Based on the facts set forth above, as applied to the applicable law, I believe there is probable cause to conclude that THOMAS C. TRAUGER committed one count of obstructing the examination of a financial institution in violation of 18 U.S.C. § 1517 and one count of falsification of records in a federal investigation in violation of 18 U.S.C. § 1519. As a result, I am seeking a criminal complaint that charges TRAUGER with the following two counts:

(a) COUNT ONE: The United States charges that, in or about and between October 2001 and April 2002, both dates being approximate and inclusive, in the Northern District of California and elsewhere, THOMAS C. TRAUGER corruptly obstructed and attempted to obstruct the examination of a financial institution, namely NextBank, N.A., a chartered national bank and wholly owned subsidiary of NextCard, Inc., by an agency of the United States with jurisdiction to conduct an examination of such financial institution, namely the Office of the Comptroller of the Currency, in violation of 18 U.S.C. § 1517.


(b) COUNT TWO: The United States charges that, in or about and between January 2003 and April 2003, both dates being approximate and inclusive, in the Northern District of California and elsewhere, THOMAS C. TRAUGER knowingly concealed and covered up a false entry in a record, document, and tangible object, namely certain records and documents related to the annual audits and quarterly reviews of the financial statements of NextCard, Inc. by Ernst and Young, LLP,

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with the intent to impede, obstruct, and influence the investigation and proper administration of a matter within the jurisdiction of any department and agency of the United States, namely the Securities and Exchange Commission, in violation of 18 U.S.C. § 1519.

Dated: 9/24/03



JASON E. RICHARDS
Special Agent
Federal Bureau of Investigation

Subscribed and sworn to before me this 24th day of September 2003.



JAMES LARSON
United States Magistrate Judge