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PROLOGUE

Arthur Levitt, Chairman United States Securities and Exchange Commission, Chicago Illinois, May 6 1996:

“There will always be incentives to act in ways that are not in investors’ interests. If not policed, then over time, people in the industry can come to develop an ethical blind spot, and even form a new ‘ethic’ that makes it OK to cheat.” (Levitt 1997:2)

“There have been too many instances of so-called ‘rogue traders’ causing millions, or even billions of dollars in losses – not to mention the demise of some well-known institutions. In my view, there would be no ‘rogue traders’ if every firm had good internal controls and risk management systems” (Levitt 1997: 6).

Nick Leeson commenting on the morality of, and duplicity in, financial markets:

“...all of the procedures are wrong, morally and perhaps criminally, some more clearly than others...” (Annexure A)

“If the codes of practice were standard, not ‘when suits’ ...perhaps the current ambiguity would be removed” (Annexure A).

“Belita Ong, a former managing director and senior derivatives saleswoman at Bankers Trust, believed that Bankers Trust had developed “an amoral culture.” She said, “You saw practices that you knew were not good for clients being encouraged by senior managers because they made a lot of money for the bank.” (Partnay 2003: 55)

A derivatives trader of 25 year standing was quoted as follows, “Fund managers are performance junkies. Like athletes, there is a significant incentive to cheat. Derivatives are the steroids and growth hormones of investment management.”(Das 2006: 83).

INTRODUCTION

Few incidences of extreme opportunism in financial markets have gripped the imagination of the general public more than those attributed to the actions of “rogue” traders. Very often, blame for spectacular collapses and billion-dollar losses are quickly attributed to the actions of one individual or a small team of individuals and, once the culprits are dealt with, it is back to business as usual. Explaining this type of behavior away as an “aberration”, “a deviation from what is normal” or “a mental or moral lapse” (Oxford Dictionary 1994: 1) has a number of very important implications that can easily be overlooked. The most important of all is that it absolves all those around the culprit, including society at large, from any responsibility and implies that nothing could have been done to prevent such behavior. There are therefore strong incentives for opportunistic behavior to be labeled as “rogue”. The problem is that opportunistic behavior appears to become more and more prevalent, affecting not only the high-flying shareholders of investment banks but ordinary pensioners and individuals who entrust their savings to mutual funds. If this is indeed true, it is crucial to develop a better understanding of opportunism, extreme and otherwise, in order to effectively manage its effects.

However, research into this phenomenon has its unique challenges. In the first instance, extreme opportunism is called by many names. Some may refer to it as deviant behavior, while others call it criminal behavior. Depending on one’s point of view, the same behavior may be applauded by some while condemned by others. Statistical data of the prevalence of this

type of behavior in the financial markets is therefore highly questionable. There is great uncertainty over when opportunism must be regarded as extreme and when it can be regarded as deviant or criminal. Even if we focus on behavior that is regarded as criminal, the problem of underreporting and lack of enforcement all skew the picture provided by statistics. Efforts to accurately measure the prevalence of behavior that can be described as extreme opportunism in financial markets is therefore fraught with danger.

According to the Oxford dictionary, an opportunist is "...one who grasps opportunities, often in an unprincipled way". Unprincipled, on the other hand, is described as "... without good moral principles, unscrupulous." (1994: 564, 879). For the purposes of this thesis, the term "opportunistic behavior" will refer to "**vigorous individual and group pursuits of self-interest, through the use of questionable means**". The cases that will be analyzed are all incidences where employees, executives and even regulators used "deceitful" methods to advance their own self-interest. This pursuit of self-interest was to the detriment of the clients, staff and shareholders of the relevant firms, and often the general public (Abolafia 2001:4). Extreme opportunism therefore would refer to extreme versions of such behavior and has more to with the effect of behavior than the behavior itself. Both these terms will therefore be used to describe the same type of behavior.

Most forms of opportunistic behavior are, however, hidden from the public eye and are very difficult to prove, while "rogue" traders dominate news headlines. Such was the impact of Mr Leeson and others labeled as "rogue" traders, that surveys conducted among bankers, customers, regulators and observers from numerous countries by the Centre for the Study of Financial

Innovation showed that, during 1996 and 1997, the threat they posed to the banking industry was rated the fourth and third from a list of 30 of the most serious in the two years (CSFI 2003: 8). James J. Puplava (2000: 4) identifies the “rogue trader” as “One of the biggest problems risk managers face...”. He defines a “rogue” trader as “...one whose behavior is intentionally inconsistent with the aims of management or its shareholders.”

This research will seek to determine if “rogue” traders are really the problem and if the behavior of those involved was inherently substantially different from the behavior expected and promoted by financial services executives in order to meet the demands of their shareholders. M. Y. Abolafia did some extensive research into the phenomenon of opportunism in financial markets. His research covered different areas of financial markets from 1979 to 1992. Abolafia first questioned the apparent universal display of opportunism by, for example, participants in the US bond market (2001:1-12). He posed the question; “Are these individual decisions or community norms?”. Abolafia rejects the notion that opportunism is merely “...the sum of individual actors' individual preferences.” Through the use of his “cultural” approach, which argues that financial markets are the result of continuous social construction, Abolafia comes to the conclusion that opportunism in financial markets is not attributable to the moral or psychological inclinations of individual traders, but to the social conditions on the trading floors. Abolafia does, however, recognize the very important role of individuals and groups in the creation of their own market arrangements that suit their interests. He also concluded that opportunism is inherent to the Wall Street environment, but argues that it is possible for the financial market participants to restrain themselves in order to preserve their

domain. One of his key examples of such restraint, (discussed in detail from the bottom of page 9), was the market specialists that operate on the New York Stock Exchange (NYSE). Abolafia observes that “Having passed through their own periods of high opportunism and increased surveillance, the market makers at the New York Stock Exchange (NYSE) have transformed themselves and their market arrangements into models of restraint.” (2001: 12). This apparent restraint seems to have been little more than a façade, as the revelations of 2005 proved. In short, it was revealed that up until 2005 NYSE market specialists were extreme opportunists rather than models of restraint. The work of Abolafia does, however, provide a very useful framework and vantage point for the study of opportunism in financial markets. It also provides us with an indication of the limitations of empirical research that relies too heavily on the input of research subjects. This is one of the reasons why I will use as wide a range of sources as possible to avoid excessive reliance on research subjects that may be trying to protect themselves. I also hold the view that opportunism is much more universal than Abolafia wants to believe, and that self-regulation does have severe limitations. One of the key differences between the role players in financial markets is their ability to hide their opportunism. Through the use of their positions of power and political influence, and the use of more and more innovative and sophisticated measures, large firms are notoriously difficult to prosecute. It is therefore important to stress that my work differ fundamentally with the work of Abolafia in at least two key aspects.

- a) I firstly believe that over reliance on self regulation as suggested by Abolafia, is extremely dangerous, especially in the high stakes financial markets arena. In my view Fligstein’s emphasis on the influence of

governments and regulation, which is underemphasized by Abolafia, is a more practical and realistic approach.

(b) I secondly believe that my analysis will clearly show, that financial markets do not have a natural tendency towards equilibrium and do not have an inherent abhorrence of opportunism and its extreme manifestations. In reality successful opportunistic behavior, by especially powerful players, is quickly copied. Efficient oversight, monitoring and effective regulation are essential for the effective management of opportunism in financial markets.

If one considers the fact that many of these spectacular collapses were triggered by chance events like the Kobe earthquake, which had a negative impact on Mr Leeson's positions, it is clear that this type of behavior is very difficult to detect. One can only but wonder what would have happened if the markets moved in line with the gambles of some of these traders. Mr Leeson was, however, not the first and will most certainly not be the last to be labeled as a "rogue" trader. As we have seen with the Enron and WorldCom collapses, extreme opportunism is not limited to rogue traders. In this thesis we seek the answer to a simple but very important question. "Were these spectacular events of extreme opportunism really only due to the actions of a handful of dishonest or unprincipled individuals, or is institutionalized opportunism, facilitated by structural and other factors, a major contributor?" In order to prove that extreme opportunistic behavior is not limited to a few isolated incidents, but that it can at least in part be attributed to a larger corporate culture within the firms these individuals worked in, and, the markets they operated in, one has to show that such a culture indeed existed in their respective companies and markets. In order to

achieve that, I will also seek to determine if the behavior they displayed was also displayed by other similar firms operating in the same markets, as well as individuals they worked with/for at the time or worked with/for in the past. If similar behavior was displayed by others, it is possible that such behavior was commonly accepted in the relevant sub-cultures, and that they may have learned their behavior and the techniques they used, from others. If behavior we term as “rogue” is learned, then the term does not apply.

The next logical step is then to focus on the presence of factors that facilitate opportunistic or deviant behavior and the presence of factors that inhibit such behavior, in the financial markets and in the companies in which the so-called rogue traders operated. One factor would be the influence of a growing dehumanization of financial markets due to globalization and the advent of multinational mega companies and advances in computer technology. Secondly, the actions and methods employed by these individuals will be analyzed to determine if they used unique products or methods, or if they used existing products and existing techniques that they could have learned from others. In the last instance, the role of individual and group motivators, such as addictive personalities and self-preservation will be considered. Although not the primary focus of this research, the very important role of products with extreme gearing potential will also be taken into consideration. Our overall objective is to determine under which circumstances the manifestation of extreme opportunistic behavior is most likely to occur.

Is research into this phenomenon really important and necessary, one might ask? If it only affects the super rich shareholders and clients of investment

banks, why should we bother? In reality, most of us are dependent on the financial markets for our retirement and as a wealth enhancement mechanism. If opportunistic behavior is present to any extent, it can have a seriously negative impact on our ability to manage our financial affairs and retire in comfort. If this behavior is indeed learned behavior, condoned and even encouraged by those in positions of authority at the firms where this behavior manifests itself, measures need to be put into place to not only detect such behavior, but also manage and control it if it cannot be prevented. In order to further underline the need for research into opportunistic behavior in financial markets, let's look at recent history.

In April 2005, market specialists on the New York Stock Exchange (NYSE) made the news headlines. Individuals from seven specialist firms were systematically and deliberately front running their clients. The disciplinary actions against these firms resulted in penalty and other payments of around USD 247 million (NYSE 2005: 1-2). How do you get to a situation where specialists from all seven firms are involved in what the NYSE termed "... interpositioning and trading ahead of customer orders..."? Is it possible that this type of behavior became the norm among those insiders/participants and that the new entrants learned this behavior from established players, or was it a deliberate strategy developed and executed by this group of traders to protect their interests, (their virtual monopoly over who may act as intermediaries on the NYSE), that are under severe threat? The answer probably includes influence from both, facilitated by poor oversight and a culture of greed at the top structure of the NYSE. On 17 September 2003, the then chairman of the NYSE had to resign after it became public that he was awarded a USD 187 million remuneration package. This is

notwithstanding the fact that complaints were leveled at him for failure to take action after reports of inappropriate “market specialist” behavior were made to him as early as 2002 (Weidner 2003: 1-3).

Empirical research conducted on the mutual fund (unit trust) industry and the options markets in the United States provides clear evidence that the manipulation of prices of stocks not only exists but is happening on a large scale. Research on the existence of market manipulation in the mutual fund industry published in 1999 showed that “Equity mutual funds earn large positive returns on the last day of the year, and large negative returns on the following day. The same applies on a smaller scale at quarter-ends that aren’t month-ends. Empirical evidence from a variety of sources, including portfolio disclosures and intra-day equity transactions, supports the hypothesis proposed in Zweig (1997) that a subset of fund managers deliberately cause the price shifts with buy orders, intending to move return to the current period from the next.”(Carhart, Kaniel, Musto & Reed 1999: 2,7). In other words the year end valuations are manipulated to benefit the asset managers. Subsequent research conducted over the behavior of 4394 optionable stocks (stocks over which options are written) in the United States and 12001 non-optionable stocks between January 1996 and August 2002 provides clear evidence of price manipulation (Ni, Pearson & Potoshman 2004: 1-7). The researchers calculated that “On expiration date, the returns of optionable stocks are altered by an average of at least 16.5 basis points, which translates into aggregate market capitalization shifts on the order of \$9 billion.” The researchers attributed this shift to “...hedge rebalancing by option market makers and stock price manipulation by firm proprietary traders...” and show that the firms that hold the larger option

positions are the most likely manipulators (2004:23). Optionable stocks refer to those securities over which options are written. Both the buyers and sellers of options have an incentive to manipulate the price of the underlying security over which the option is written. The seller of the option would be trying to avert losses when options are exercised against him, while the buyer of the option would try and manipulate the security over which the option is written to make it profitable for him to exercise the options he holds.

This type of conduct was, however, not new. Salomon Brothers, one of the largest Wall Street bond trading firms, admitted in August 1991 that its traders manipulated the bond market over a period of time. The firm paid a \$290 million fine and its senior employees also had to pay fines. However, no individual went to jail. What is of interest to this thesis is the comment of the chairman of the Securities and Exchange Commission (SEC) on the day he announced the fines of those involved in the Salomon incident. The SEC investigation revealed that 98 other banks and investment houses, virtually 100% of the firms active in a particular segment of the bond market, were involved in manipulating the bond market on an organized basis. According to the SEC chairman, the fraudulent activities became "... part of the organizational routine..." (Abolafia 2001: 1-2). In 1993, many Wall Street firms, including Salomon Brothers, began to pay more attention to risk management systems (Partnoy 2003:94-95). During an eighteen-month investigation conducted by a team of more than forty Salomon employees, it emerged that more than USD 250 million worth of hidden losses, built up since 1989, lay undetected in New York and London. The accountants for Salomon, Arthur Anderson, had no idea of these losses. Lax oversight was,

however, to the advantage of John Meriwether's traders at Salomon in two ways. It firstly allowed them to take larger bets more quickly when they spotted an arbitrage opportunity and, secondly, in the absence of strict controls, positions could be left in position longer, allowing for convergence to take place between price discrepancies. This was a major plus, as forced liquidations by nervous managers often resulted in losses from positions that, if left in place, would have been profitable. At the time John Meriwether was head of the Arbitrage Group at Salomon (Partnoy 2003:83) and he later became one of the key figures in the collapse of Long Term Capital Management LTCM, a very large US hedge fund (Lowenstein 2002: 19). This type of conduct is also not limited to the United States, as clearly demonstrated by the fact that in 1997 Japan's four giant securities firms Nomura, Daiwa, Nikko and Yamaichi all admitted to paying blackmail money to an extortionist to prevent embarrassing information about their firms to be aired at board meetings (Business Times. 1997: 1-4). In 1998, ten of the largest financial institutions in Japan were indicted for bribing officials working for the Japanese financial authorities (FSA Japan 1998: 1-2).

Opportunism is most certainly not limited to the investment banks of the roaring nineties and their swashbuckling millionaire traders, as some may claim. According to Lori Richards from the SEC in the US, they are concerned about the relationships between pension plan consultants and the service providers, such as asset managers they recommend to the pension plans they consult to (Crenshaw 2005: 1-3). If an incestuous or generally corrupt relationship exists between an asset manager and the asset consultant who is supposed to oversee his transactions, the violation of rules can easily

become a widespread and acceptable practice. Therefore, there is sufficient evidence to suggest that factors conducive to extreme opportunism do exist on a substantial scale in the financial services industry and this affects the community at large. In 2006, research conducted by Erik Lie from the University of Iowa into malpractices around the backdating of stock options to executives of around 8000 US companies (Treanor 2006:1-2), revealed that an estimated 30% of firms that granted stock options to their executives between 1996 and 2005 "...manipulated one or more of these grants in some fashion.", in order to boost the remuneration of these executives in an unauthorized manner (Lie 2006b: 1-13). This research provides very strong support for the argument that opportunistic behavior may indeed be a much wider phenomenon than previously thought.

Abolafia (2001: 2) asks the question, how is it possible that the violation of rules became so "diffuse" and "routine" in so many firms? He argues that when extreme acts of opportunism exceed the levels of tolerance of powerful stakeholders inside and outside the markets (when someone gets caught), pressures rise to restrain the extremes (the prey were spooked and need to be coaxed back by a false sense of security). This creates the ebb and flow of opportunism and profitability. As restraint increases, opportunism decreases until everyone is relaxed again and the tide of opportunism rises again as restraint and vigilance is relaxed (Abolafia 2001:9-11). In this thesis I will argue that what we mistakenly refer to as "rogue incidents" are merely the tip of the proverbial iceberg of extreme opportunistic behavior commonplace in financial markets. The rogue phenomena could probably be attributed to a combination of sensationalism and blame shifting. It was Tartuffe who said "And there is no evil till the act is known / It's scandal, Madam, which

makes it an offense / And it is no sin to sin in confidence” (Ardut 2005: 222). In view of this background, I will also argue that the extreme opportunistic behavior so frowned upon and quickly labeled as deviant once these big scandals erupt is in actual fact “normal” behavior or “legitimate business strategies” developed to serve the interests of powerful actors and groups of actors in most financial markets and corporations. This behavior is perpetuated as new entrants into the financial markets learn this behavior from the established players around them.

Research Methodology

In order to construct a theoretical framework I have used two sets of theoretical works. In order to analyze extreme opportunism as a form of deviance I drew from the rich source of sociological works that cover this phenomenon. As my focus is on extreme opportunism that manifest in the financial markets I drew from more recent works that developed in an area of the sociology commonly referred to as economic sociology or the sociology of markets. From these theoretical perspectives I extracted a framework of factors that motivate, facilitate and inhibit opportunistic behavior. This framework not only provided some structure to my analysis of the different case studies I also used it as a vantage point for the development of a triangle of opportunistic probability that can be populated from a comparative matrix. The comparative matrix and the triangle of opportunistic probability provide a visual representation of the forces at work in the phenomenon referred to as extreme opportunism in financial markets.

The approach I followed can be described as a deductive, comparative case study analysis, of highly publicized incidences of extreme opportunism in financial markets occurring over the last two decades. Although I used a theoretical framework as guidance, each case study was approached with an “open mind” allowing for interaction between theory and reality to occur. These incidences were often labeled as “rogue” events or uncontrollable anomalies that occur from time to time. My approach can also be termed a collective case study approach, a useful methodology for the investigation of a phenomenon that may be more widespread than what is generally accepted (Punch 2005:142-148). One of the common criticisms against the use of case studies is the representativeness of the case studies used (Ragin 1994: 85-88). Due to the fact that a lack of representativeness would clearly influence the usefulness of generalization, this matter received specific attention.

The sampling technique used in this study can be described as a bounded multiple case approach (Miles & Huberman 1994: 27-30). Although the universe of opportunistic behavior is unknown a concerted effort was made to ensure that the incidences selected were sufficiently representative.

- a) The events analyzed were primarily the best publicized and largest events, from a monetary perspective, attributed to the actions of “rogue” individuals or small groups of individuals. The two South African events, although not comparable in monetary terms to the international events, were chosen because they were the most highly publicized financial market trading events that took place in recent history and were attributed solely to the actions of “rogue” individuals.

- b) The cases analyzed were all cases that reached conclusion after extensive evidence were tested in courts of law and were subjected to extensive public debate. Those implicated as well as those affected all had ample time to question the available evidence.
- c) The relevance of the case studies selected was further confirmed by evidence of the presence of other similar cases in the environments of the main cases. Evidence of other incidences of opportunistic behavior largely emanated from unsolicited sources. This fact enhances the reliability of such supporting evidence. I believe my sampling technique of focusing on extreme cases while taking the presence of other similar cases in consideration, adds to the relevance and quality of my study as it inhibits bias as far as possible.

In order to make a thorough analysis of these incidences of extreme opportunism in recent history, a range of sources was used. These sources are primarily documentary in nature and include academic works, newspaper and other articles, government investigations, the findings of boards of enquiry and court records, as well as empirical research through interviews with individuals directly involved in incidences of extreme opportunism. As all these events ended up in some form of prosecution of the “rogue” individual, one has to make provision for the fact that the relevant individuals might try to justify their behavior, which is a disadvantage of over-reliance on interviews with rogue traders themselves. On the other hand, one must also make similar provision when analyzing findings of investigations instituted by the companies these individuals worked for, the regulators who had to oversee their activities and the auditors who were

auditing their trading. All these institutions had, to a greater or lesser extent, a responsibility to have either prevented or detected the activities of the “rogues”. These institutions can, to a large extent, absolve themselves of any guilt if a suitable scapegoat can be found. One has to look long and hard to find a more suitable scapegoat than the enigmatic “rogue” trader. Given the interests of these institutions, to absolve themselves of blame, it is therefore necessary to find a diverse range of sources in order to reflect a balanced perspective of these events.

The cornerstone source used in this research is court records containing evidence and testimony, while the second most important source of information is evidence gathered by official boards of enquiry. These sources are augmented with the extensive use of newspaper reports and other commentary published. Published interviews with some of the “rogue” traders provided valuable insight, while books written with the direct assistance of those implicated helped in getting access to the views of a number of so-called “rogue” traders. I have made a concerted effort to interview the rogue traders themselves for the purposes of this study. Requests for assistance from three of the NAB accused failed and Mr Greg Blank, contacted through an intermediary, also declined to participate. Efforts to gain the assistance of Mr John Rusnak failed and I was advised by a Prison Official, Councillor Eargle, at the Federal Correctional Institution at Elkton in the USA that Mr Rusnak declined to assist with this research. Numerous efforts to solicit a response from Mr Mike Milken were also unsuccessful. Mr Nick Leeson, however, graciously agreed to assist with this research. Mr Leeson was interviewed over a two day period in his home town of Galway Ireland, where he is an executive with a soccer club. Even

though Mr Leeson admitted his wrongdoing and accepted responsibility for it and served a lengthy jail sentence for his fraudulent activities, a thorough analysis of his activities, his motivation and the environment in which he operated, provided an invaluable insight into the so-called rogue trader phenomenon. I chose to use a semi-structured approach to the Leeson interview as I believe that many important facts can remain hidden in a very structured question and answer session. By allowing Mr Leeson to tell his story I could not only gauge his candidness by comparing his version with other sources, It also allowed him to be as open and forthcoming as he chose.

I also augmented my analysis of the two South African case studies by making use of analysis of stock exchange and other trade data using proprietary software “THE ELECTRONIC TRUSTEE” developed by myself and Mr Colin Smit. This in combination with unsolicited commentary by respected market participants, helped me to determine if there is factual evidence supporting claims by, among others, Greg Blank (Gibson 1997: 83-84) and Grawie Botha (Dispatch online 27/11/98), that the manipulation of stock exchange prices by powerful players, such as the large insurers, was and still is prevalent.

Although I cannot claim that all possible sources were exploited, I am convinced that the diversity of primary and secondary sources used for this thesis provides sufficient protection against the possible presentation of a one-sided view. As mentioned before, these cases were chosen primarily because of the publicity they received. Evidence gathered from the sources used during my research suggests that these incidents were by no means

isolated. I do, however, believe that the events investigated can safely be classified as the most significant events we know of attributed to the actions of “rogue” traders in recent history. It is important to stress the fact that the aim of this investigation is not to determine what percentage of events of extreme opportunism can be attributed to “rogue” behavior, as it is quite possible that numerous incidents are never reported. We can, however, analyze these events and determine the similarities between them. Through individual testimony of market participants and other empirical research, we can also determine if this behavior is unique or widespread in specific firms and subcultures. If it is widespread and not unique, it cannot be “rogue”. I am confident that the sheer magnitude of quality evidence presented here, derived from diverse sources, covering a substantial number of case studies, guided by focal points derived from a sound theoretical base, makes this research very relevant and defensible.

Structure

In chapter 1, extreme opportunism is placed in theoretical perspective by analyzing the social structure of behavior. The sociological foundation for this thesis is laid down through the work of, among others, Robert Merton, Edwin Sutherland, Talcott Parsons and Neil Smelser. Nicos Mouzelis provides us with invaluable insight into the shortcomings of the structural functionalists and guides us into recognizing the important role of individual actors and groups of actors in their efforts to create an environment that will serve their interests. The “cultural” approach, developed by Mitchel Abolafia, focuses on the “social construction” of financial markets, and balances the role and interests of the individual actors and groups of actors,

with the needs of the social system as a functioning whole. His work will be primarily used to construct a theoretical foundation through which extreme opportunism can be analyzed. One of the fundamental issues highlighted in this chapter is the role of factors that promote and facilitate or inhibit opportunistic behavior and the importance of learnt behavior in financial markets. Traders and other role players carry with them their “bag of tricks” or behavior that they learned at previous firms. Through trial and error, they build up a set of skills to survive and be successful. Once they enter a new firm or a new market, they are also not entering a vacuum. There is once again an existing culture - a set of formal and informal rules. It is through the interaction between the traders and their environments that markets are constantly formed and changed. The role players are constantly developing new rules, roles and relationships to best serve their own goals. One of the key focus areas is therefore a thorough analysis of the environments in which these traders operated. This would include the environments in their own companies and the companies they were dealing with, as well as the local and global markets they operated in. Attention would be given to the role of the digital age that fueled greater globalization and the advent of mega companies that is conducive to the development of more and more dehumanized financial markets. My theoretical discussion will culminate in the introduction of a new approach to interpreting and understanding the factors that underlie extreme opportunistic behavior in financial markets. I propose that our focus should be on the role of structural and other factors as motivators, inhibitors or facilitators of extreme opportunism. The fact that its origin might be normative or interest based, although relevant, is not the primary concern. With motivation as the basis of a triangle of opportunistic

probability, the two sides, comprising facilitating factors and inhibiting factors, will be crucial in determining if balance or extremism is probable.

In Chapter 2, I discuss the well publicized case of Greg Blank, a South African stockbroker who was prosecuted in the early 90s after pleading guilty to charges of market manipulation and front running. His case will be put into a South African perspective by also analyzing a later incident involving an employee of a large South African asset manager who claimed that “window dressing” was prevalent at the firm he was working for and that the acts of market manipulation he was accused of were instructions from his superiors that he was executing. These two events are further put into perspective by reports that support their claims, by demonstrating that opportunistic practices are widespread in the South African retirement fund industry.

In Chapters 3-7, five major events will be analyzed. The first will be the activities of two copper traders employed by Sumitomo - at the time the dominant force in the physical copper market. The activities of the two traders spanned a period of more than ten years from 1985 until 1996 and resulted in losses of more than USD 2.5 billion. In Chapter 4, I will look at the activities of a government bonds trader, Toshihide Iguchi, who worked for Daiwa Bank. Mr Iguchi’s activities also spanned a ten-year period between 1984 and 1995 and resulted in losses to Daiwa of more than USD 1 billion.

My fifth chapter is dedicated to one of the more bizarre dramas on Wall Street, the events that surrounded the activities of one Joseph Jett, a STRIPS trader for Kidder Peabody. At the time, Kidder Peabody was seen by many

as one of the jewels in the crown of General Electric's enigmatic chairman, Mr Jack Welch. Under the veneer of a technological leader, there appears on closer inspection to be little more than headlong pursuit of profit through cost cutting and risk taking. In the sixth chapter, the events surrounding one of the most well known corporate collapses will be analyzed. With the gracious assistance of Mr Nick Leeson, the events that led to the collapse of England's oldest bank, will be analyzed. Mr Leeson's activities took place over a three-year period between June 1992 and February 1995 and resulted in an estimated loss of nearly USD 1 billion. In Chapter 7, we shift our attention to the activities of Mr John Rusnak, a trader employed since 1993 by a subsidiary of Allied Irish Banks in the United States, called Allfirst. During 1997 and 2002, Mr Rusnak's activities resulted in losses of nearly USD 700 million to his employer. My research into the activities of Mr Rusnak will be augmented by an analysis of the activities of a former colleague. Mr Victor Gomes, whose activities at Mr Rusnak's former place of employment, Chemical Bank, give us an important perspective on all our case studies. While Mr Rusnak was engaging in his extremely opportunistic activities, a team of Australian currency traders were also testing the boundaries of extreme trading. In Chapter 8, the activities of a four-man team employed by National Australia Bank come under the spotlight. In a period ranging from 2000 to 2004, these traders engaged in activities that resulted in losses amounting to more than USD 277 million. An interesting feature of this case study is the fact that the environment of "extreme opportunism" in which these traders operated was accepted as a mitigating factor by a court of law during sentencing.

In Chapter 9, the U.S. Savings and Loans crisis, the Enron incident and the Shell “overstatement of reserves” will be analyzed. The U.S. Savings and Loans collapse will be viewed from two distinct angles. In the first instance, the role of regulators and their political masters will be investigated and, in the second instance, the influence of Mike Milken and his firm Drexel will be analyzed. The moral essence of the actions of Mike Milken will be compared with those of certain Enron and Shell executives in order to determine if there are any similarities. The treatment meted out to these individuals will be compared in a similar fashion to determine the level of consistency in the application of formal and even informal restraints and sanctions in one of the most sophisticated regulatory environments and oldest democracies in the world. In this chapter, research conducted by Erik Lie into manipulation of Executive Stock Options in the United States will also be discussed in order to support my contention that opportunistic behavior is more widespread than generally accepted, even among those who have limited exposure to the financial markets, such as executives from non-financial services companies.

In my final chapter, I will demonstrate the relevance of the structural and other factors underlying extreme opportunism in financial markets. By utilizing a probability matrix to visually display the different categories of variables, I will show that, in each of the cases of extreme opportunism analyzed, an extreme imbalance existed that allowed the manifestation of extreme opportunistic behavior. This approach allows the observer to get an overall view of the findings of my research. By using this matrix to populate my triangle of opportunistic probability my results becomes even more striking. Extreme opportunistic behavior is clearly no aberration or isolated

anomaly, but a manageable phenomenon caused by an observable imbalance between the three main factors that influence opportunistic behavior.

Managing this phenomenon is, however, not always an easy task and I will touch on the importance of Sarbanes Oxley legislation introduced in the US and the vehement opposition to it from vested interests. I will also look at the role of shareholders and clients as agents of informal and formal control. After a discussion of some of the other stumbling blocks in the way of the efficient control of opportunism, I will also put forward a number of cost and time efficient strategies that can be employed to manage and control opportunism and the extreme version thereof in financial markets.

CHAPTER 1

A SOCIOLOGICAL APPROACH

1. INTRODUCTION

The creation, accumulation and preservation of wealth are the core focus of the financial markets. Very few of us are not directly or indirectly influenced by financial markets. To most, financial markets are the primary vehicle through which provision is made for their future, whether to provide for the education of children or for a comfortable retirement. However, if the extent and intensity of opportunistic behavior reaches unacceptable levels, it should concern us all. The exponential growth in the world financial markets is strikingly demonstrated in the notional value of over-the-counter (OTC) derivatives outstanding in 1992 of around USD 20 trillion, that grew to a staggering USD 128 trillion in 2002 (Fenton-O'Creedy, Nicholson, Soane & Willman 2005: 15-16). This figure is nearly four times greater than the gross domestic product (GDP) of the entire world. In this thesis, a sociological approach will be used in order to reach a better understanding of opportunistic behavior in financial markets. My theoretical foundation has two distinct elements I believe necessary for this research. In the first instance I will use the rich sociological theories of deviant behavior in order to analyze extreme opportunistic behavior and in order to facilitate a better understanding of financial markets will use the more recent theoretical works of economic sociologists. As opportunistic behavior and its extreme variants are often labeled as deviant these theories is essential reaching a thorough understanding of this phenomenon. As a starting point Merton's

sociological framework constructed to explain the social and cultural sources of deviant behavior is used. From there I move on the substantial contribution made by Edwin Sutherland towards our understanding of the role of sub-cultures in the transfer of deviant behavior patterns. Talcot Parsons although not as fashionable as he used to be is in my view still very useful in understanding the prevalence of deviant behavior in certain subcultures. This is followed by a discussion of the work of Niel Smelser that provides very useful insights into the forces that act as social controls over behavior. Harry M. Johnson provides us with tool set of what he refers to as facilitators and inhibitors of deviant behavior. This set of tools is very important in our efforts to understand extreme opportunism on a practical level.

The theoretical foundation frameworks provided by these sociologists is however criticized for their lack of emphasis on the concept of agency i.e. the role of the individual and his/her free will. To remedy this situation Nicos Mouzelis with his social and system integration approach is invaluable. Mouzelis argue among other that although norms and values are important factors influencing human behavior we can not underestimate the role of interests. These theoretical perspectives all contributes to a more thorough understanding of deviant behavior and extreme opportunism. My focus in this thesis is the role of structural factors underlying incidences of extreme opportunism in financial markets. In order to achieve this it is crucial to not only understand how financial markets operate but also how it is formed, maintained and how they change or evolve.

Over the last two decades a rich body of theoretical work has emerged that focus on the sociology of economics. These theories provide remarkable insights into the anatomy of markets, including financial markets. Some, like Donald Mackenzie even suggest that social sciences such as economics and economic sociology, I believe one can add, have moved beyond merely describing financial markets and has the potential to shape the financial markets it describes (Mackenzie & Millo 2001:5). In order to gather the insights necessary to understand financial markets, I will analyze the theoretical perspectives provided by Niel Fligstein's "political-cultural" approach and Mitchel Abolafia's "Social Construction" theory that uses a cultural approach. I will also draw on the very practical insights into how currency traders affect their markets and are affected by the markets they are constantly trying to redefine, provided by Knorr Cetina & Bruegger. By combining the insights provided by all these theories I extrapolated an "Opportunism Potential" matrix that provides a practical and effective method to gauge opportunism potential on a micro or macro level.

In most of the civilized world, the pursuit of money is a socially acceptable goal. However, the way one goes about achieving this goal is the concern of this thesis. As the sociologist Merton (1957:141) argues, we should ask what features of our social structure predispose individuals to employ deviant adaptations (means) in order to achieve this socially acceptable end. He further states that, at what he calls "top economic levels", in other words where the rewards are greatest, the line between right and wrong is often blurred. In matters of business, Merton (1957: 141) quotes Veblen who observed that "It is not easy in any given case – indeed it is at times impossible until the courts have spoken – to say whether it is an instance of

praiseworthy salesmanship or a penitentiary offense". The use of terminology like "rogue", "deviant" or "criminal" is therefore always subjective and can become a hindrance in our understanding of opportunism if not placed in perspective. In this thesis we focus on the "**extreme pursuit of self-interest by individuals and groups**" or **extreme opportunism**. The methods employed in such pursuits may be referred to as "rogue", "deviant" or even "criminal", even if the actions are exactly the same. The use of such labels is therefore always subjective, at least to some extent.

It must also be clearly stated that the manifestation of opportunistic conduct is mostly limited to the work environment of the opportunistic actor. It is not surprising that the so-called "rogue" traders are often described as "normal" everyday people. John Rusnak, for example, was a typical family man with a dog called Barney. Within this work environment one also finds that opportunistic conduct by groups like the NYSE market specialists were primarily directed at their clients and not at other market actors they were in contact with. Thus opportunism may not necessarily be generalized but directed at particular, more vulnerable parties. Traders from competing firms would however not hesitate to take extreme advantage of their peers to the level where the trader and his firm are financially ruined. It is also noteworthy that extreme opportunistic conduct is seldom reported by competing firms, but is often emulated. The driving force between these actors and groups of actors is, however, the pursuit of a common goal or the preservation of personal and group interests.

In order to explain extreme opportunism in the financial markets and the rogue trader phenomenon as an example of such opportunism, a sociological

framework will be used. The aim of this research is not to predict when a particular actor will display extreme opportunistic behavior; our aim would be to determine under which circumstances it is most likely to manifest, and if it is possible to manage such behavior. If extreme opportunistic behavior is indeed an unpredictable “rogue” event this would be a near impossible task. Sociologists like Mitchel Abolafia (1998:69-72) however argue that new entrants into financial markets are socialized, by older more powerful, players who construct social identities, defining appropriate behavior and interaction. Powerful actors and groups of actors therefore play an important role in the construction of markets and defining the local rationalities of the particular market culture. Markets are therefore created through internal and external forces. Internal forces may be the interests of a small sub culture, while external forces may be the interests of society at large. These forces, and the role they play, is of great importance in our understanding of financial markets, as speculative booms and collapses are too regular, repetitive and too widespread to be accidental (Galbraith 1992: 9). The interests of the management of Long Term Capital Management (LTCM) a very large US hedge fund was to maximize their profits, the interests of society at large was the preservation of a functioning economy. When these two forces were out of balance we had a collapse of mammoth proportions (Lowenstein 2002). A balance between countervailing forces appear from casual observation to be an important element of financial markets.

In this thesis I will as a basis use Robert K. Merton's structural approach, the social control approach and the differential association approach, all useful in explaining opportunistic behavior, labeled as white collar crime. I do not believe there is at present one all-encompassing “right” theory; I do however

hold the view that there are a number of useful elements present in these approaches which, when used together, will allow us to forge a better understanding of opportunistic behavior in financial markets. Nicos Mouzelis (1974: 395-407) alerts us to certain shortcomings in the too restrictive theoretical focus of the functionalist approach. He also provides us with useful insights into how one should augment the functionalist approach, which focuses mainly on institutions with other approaches that focus on the individual actors and groups of actors. The social construction approach used by Abolafia emphasizes the role of actors and groups of actors in the construction of financial markets through the production of institutional arrangements. According to Abolafia “Individual and institutional processes mutually influence each other.” It is this “...complex interplay between these levels that gives each market its unique institutional configuration.” (Abolafia 2001: 9-11). Abolafia provides us with a useful theoretical model that blends the functionalist explanation of deviance with its focus on the role of sub-cultures with the work of Mouzelis that focus on the role of individual and group interests. He argues that “Trader’s construction of their culture does not occur in a vacuum. There are important structural conditions that shape the trader’s strategies and are, in turn, shaped by the continued use of those strategies.” (2001:32). These structural conditions are “... the variables most likely to cause changes in the strategies and rules on the trading floor.”. As is clear from the title of this thesis, the focus of this thesis will be on these structural aspects.

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1.2 FUNCTIONALIST THEORISING

1.2.1 ROBERT K. MERTON

According to Merton, the control of man's biological urges was a key element of early sociological theory. As the social sciences advanced, the impact of social structures on the frequency, shape and pattern of deviant behavior was accorded greater prominence in social theory. Merton started to construct a sociological framework with which to analyze the "...social and cultural sources of deviant behavior" (1957: 131-132). According to him, we could find that in certain social groups behavior viewed by some sectors of society as deviant and unacceptable may be totally acceptable and will therefore be quite prevalent. If this is proven to be true, Merton argues that we can, to a large extent, rule out biological motivations as primary to deviant behavior. Our focus as sociologists should not be on the mere incidence of a certain type of behavior, but rather on how it varies between different social structures. We therefore find that central to Merton's theory is a clear understanding that we cannot simply equate "functional" with "ethically good" or vice versa, and we would be at fault if we wanted to equate "conformity" with "good" or "deviance" with "bad" (Johnson 1971: 554).

We would also find, that if the prevailing culture in a particular society places a high value on financial success and the acceptable (normatively defined) avenues to achieve such a cultural goal are limited in certain structures in that society, "stress" will develop in those social structures. In reaction to such stresses, a number of options are available, namely

conformity, innovation, ritualism, retreatism and rebellion (Merton 1957: 140-157). These options vary in their results for the individual. If he conforms, he will try to achieve his cultural goal through institutionalized means. Ritualism, as an adaptation, refers to those who follow the institutionalized means, but have given up hope of achieving the cultural goal of being rich. Retreatism refers to those who not only gave up hope of being rich, they also gave up on the institutionalized means and start to exist on the fringes of society often labeled as “vagrants”. Rebellion, as an adaptation, refers to those individuals who not only want to change the cultural goals, but also the institutionalized means, and want to create a new order. The most important form of adaptation, to this research, is when an individual pursues the cultural goal with great conviction but discards the use of the institutionalized means of achieving it, and finds or develops new ways of achieving his goal of being very rich. If an individual finds himself as an actor in the financial markets, where the “raw material” for alternative methods of becoming very rich very quickly is abundant, this form of adaptation is a very attractive one. One example of such adaptation is what Edwin Sutherland called “white collar crime”. However, if the goal becomes all important in a particular social order, Merton (1957: 157-158) warns, the means could become more and more irrelevant; this could lead to a state of “anomie”. If a particular sub culture values financial success as the only yardstick of status and acceptability with little concern for how such wealth is achieved the pressure to play by the rules will have to be from a source external to that group. The development of the term “anomie” is attributed to Emile Durkheim and refers to a state of “...relative normlessness in a society or group” (1957: 161-194). It must be emphasized that, in the cases of extreme opportunism in financial markets, the “relative normlessness”

would be very specific and apply virtually exclusively to how these individuals or groups pursue their goal of financial wealth and the prestige that goes with it.

Merton acknowledges that anomie could be caused by an unknown number of factors; however, he identifies two: the first, as has already been indicated, is when members of a social system are expected to achieve a culturally legitimate goal without having sufficient legitimate means and, secondly, he identifies “role conflict” (Johnson 1971:558). In the NAB event, for example, one of the traders involved claimed that it was impossible for them to achieve the profit targets set by management without breaching the daily limits set by the same management. If this is indeed true those who set the targets must carry some of the blame. Those setting the targets are, however, also influenced by the demands of the board of directors and shareholders of the relevant firm. The setting of a performance target and the determination of what amounts may be exposed to risk on a daily basis in order to achieve it (daily limits), do not just happen. By keeping the official daily limits down, an appearance of risk adversity is created; by not enforcing such limits, the opportunity for breaking them is provided. Another example of reaction to the stresses caused by a lack of legitimate means was Mr Mike Milkens use of “junk” bonds. Mr Mike Milken claimed that he started using junk bonds to finance acquisitions, because traditional sources of finance were not accessible to entrepreneurial companies. He claimed that corporate takeovers are necessary because large traditional companies managed by layers and layers of entrenched and inefficient managers were stifling economic growth. These management cores do, however, exert tremendous influence, as they channel campaign

contributions to political parties that support their interests through legislation. In this instance, politicians and vested interests created a need for innovation on an extreme level.

A practical example of role conflict is when a trader has to execute an unlisted share purchase transaction for his client at the best possible price to keep the client satisfied. His company happens to own a number of the particular shares and wants to sell it at the highest possible price. The moral dilemma the trader is faced with is clear. Although so-called "international best practice" prescribes that the client should receive preference, if the trader's company doesn't make sufficient profit, he may not get his bonus or may even go bankrupt and be without work. However, if the particular firm the trader works for, or the industry his firm is part of, promotes the practice of teaching its traders that the interests of the firm come first, the trader will experience conflict. If he knows that there is little or no enforcement of "international best practice" and that he will be handsomely rewarded for putting his firm first, he will in all probability conform to his local rationality. International best practice would be in line with the societal norm of fairness that is propagated as more or less universal. However, the local rationalities of trading firms require profit at all cost, with little time for a nicety like fairness. Merton (1957: 182-184) crystallizes his theory by emphasizing that "...those located in places in the social structure which are particularly exposed to such stresses are more likely than others to exhibit deviant behavior".

Merton's work has however been severely criticized, primarily because of its neglect of human choice and the role of the individual, as well as its

perceived assertion that cultural structure alone can explain deviance (Marhwah & Deflem 2006: 5). Dismissing Merton's theories outright is, however, a mistake, as pointed out by Marhwah & Deflem (2006: 1-16). They argue that much of the criticism is based on misinterpretation of Merton's work. They point out that in Merton's "anomie-and-opportunity-structures paradigm" the structural properties and origin of human behavior is not absolute but probabilistic. Therefore, "Aspects of human agency intervene in the actualization and perception of structural opportunities to shape the process through which certain structures will more or less produce certain kinds of behavior at the aggregate level" (2006: 9). Merton therefore never denied the role of social psychological processes that is very important in our understanding of why certain individuals behave differently even though they share their position in the social structure. Why did Mr Mike Milken innovate instead of conform, like many others in his position? Although we can criticize Merton for not giving sufficient attention to the role of human choice, he does make it clear that individuals in the same structural locations, affected by strain, may choose different paths. He therefore acknowledges the importance of "individual attributes and personality characteristics" (2006: 10).

1.2.2 EDWIN H. SUTHERLAND

Edwin H. Sutherland expands on Merton's work and argues that deviant behavior is learned in the sub-culture in which an individual lives and works. The proposition is therefore that it is highly likely for an individual to learn extreme opportunistic behavior if he is exposed to other extreme opportunists on a regular basis. This "...unusual exposure to the influence of

persons and groups who are already criminal” Sutherland termed “differential association” (Johnson 1971:561). What is interesting about this approach is the fact that, where Merton argued individuals may be deprived of legitimate means of achieving their goals, Sutherland expands this and argues that, in order for you to become deviant, you also need to have access to illegitimate means. This would entail other individuals who can show you how to do it. Sutherland identifies a number of prerequisites and steps in the process of becoming a criminal. As the line between what is criminal and what is not is often very vague in the financial world, I want to reiterate that one should guard against getting caught up in the finer nuances of what is criminal and what is extreme opportunism. The forces conditioning people to become both are so similar that one can use Sutherland’s theory with ease to explain extreme opportunism. According to Sutherland (Sutherland & Cressey 1978: 80-83) criminal behavior is learned in interaction with other people through a process of communication. This principally takes place in “small intimate groups”.

According to Sutherland, the learning process not only includes the “techniques of committing the crime” but also “motives, drives, rationalizations and attitudes”. The orientation of “motives and drives” is learned, as the student is orientated towards whether or not legal codes should be observed or not. One example is that, if you work in a firm that believes taxes should be paid, you would be so orientated. However, if you work in a firm that believes taxes should be evaded as far as possible, you would be so orientated. If you therefore have excessive inputs favorable to law violation you would probably violate the law. The process of “...differential association may vary in frequency, duration, priority and

intensity". This implies that a CEO of a firm that is exposed daily to his company's auditors and lawyers telling him that a certain tax evasion technique is safe would probably implement the technique. If a junior staff member tried to influence him to use it, he would probably be less inclined to use it. Sutherland concludes that the process by which we learn criminal behavior is not dissimilar to how we would learn anything else, for example learning that one has to pay taxes is done in the same way as learning the opposite. He also contends that needs and values do not explain criminal behavior, as behavior that is non-criminal expresses the same needs and values.

Sutherland also received his fair share of criticism (Sutherland & Cressey 1978: 87). Some of the shortcomings identified by critics include the inability of the theory to explain the origins of crime and failing to allow for situations where crime is "chosen" out of "free will". Similarly, his theory was viewed as flawed because it didn't distinguish between the "learning" of criminal and non-criminal behavior. As the distinction between brilliant innovation and criminal conduct in the financial markets is often very vague, I believe this applicability to non-criminal behavior is a positive and useful characteristic of Sutherland's theory. Sutherland accepts the fact that his differential association theory does not explain the precise process through which an individual becomes a criminal. The value of his theory, he points out, lies in its ability to account for the distribution of criminal behavior among individuals and groups of individuals (Sutherland & Cressey 1978: 87-96).

1.2.3 TALCOT PARSONS

Talcott Parsons, a contemporary of Merton, argued that deviance must always be viewed as “relative to a given institutionalized value pattern” (1951: 283-284). His emphasis on the fact that all social processes are normatively regulated was the focus of many critics. Mouzelis (1974: 400) quite correctly points out that the normative regulation of social processes can vary substantially from virtually nothing to virtually total. Although criticized for his normative bias, Parsons alerted us to the importance of determining if the deviance is individualized or if there are a number of actors which could be described as a sub-collectivity, that share a pattern of behavior. Sub-cultures do not materialize out of thin air. Members of a sub-culture need to share certain interests and attitudes. There is no sense in appointing a trader, or anyone else for that matter, on a performance-based package if money is not important to him. The pursuit of material things is the goal of a substantial portion of world society. The appetite we have for such material things and the methods we employ to satisfy our particular appetite will, however, vary and will give rise to the development of sub-cultures and within them sub-sub-cultures. The attitudes of individuals who are part of a sub-culture also influence what is acceptable and may vary from time to time. In reaction to such variance, one may find that remuneration packages of executives of listed entities may be constantly adjusted to catch up with what is regarded as “sufficient” at a particular point in a particular sub-culture. The sub-culture is therefore constantly striving to optimize its interests. The “norm”, Mouzelis points out is therefore under constant construction by members of different sub-cultures.

Parsons also makes it clear that these actors may also not be viewed by society as deviant in all aspects, and their “deviant” aspect may indeed be very specific. We may therefore find that what separates one sub-culture from another may, for example, be only their view of what constitutes enough money. To Mr Leeson, his bonus of a few hundred thousand pounds was part motivation to continue his activities, while Mr Milken found his USD 500 million per annum income share to be fair motivation. One will also find a range of attitudes within a particular sub-culture. Top executives of listed companies in the US may, for example, be a sub-culture. As we will show in this thesis, around 30% of the stock options they received in a particular period were manipulated in one form or other. This figure may be lower than the actual figure because of the difficulties in identifying such behavior. We may also find that the actors involved may claim that this conduct conforms to the conduct of those like them and is not deviant at all, or that the definition of what is acceptable conduct is so vague that the actors are in a position to interpret their actions as perfectly legitimate and not deviant at all (Parsons 1951: 291-292). If a sub-culture developed, the effects of “attitudinal sanctions” are severely weakened and other members of the sub-culture would reinforce the belief that what they are doing is “acceptable”. By being organized, such a sub-collectivity can also protect itself from the effects of sanctions imposed by society at large (Parsons 1951: 286). This protection will allow a subculture to pursue their own goals or interests, according to Mouzelis (1974: 399), vigorously even if detrimental to those outside their group. The pursuit of shared interests now becomes the defining element of the sub culture. The form and size of such sub-cultures vary from millions of individuals who all work in the financial services to smaller groups of traders and executives of companies, for

example. Similarly, the powers that can be exercised by such sub-cultures also vary immensely. For example, traders might be quite powerful in their respective firms due to their ability to generate profits, but may have little or no political influence to sway government policy. Top executives, on the other hand, may be able to exercise substantial power over regulators and the political masters of such regulators through their ability to channel campaign contributions.

Although the actions of extreme opportunists, especially those identified as “rogues” by the popular press, is generally viewed as deviant, a thorough analysis of their actions in the context of the environments in which they operated may reveal that, in the sub-culture in which they operated, nothing could be further from the truth. This is not to suggest that in some cases their behavior was not on the edge of what was viewed as normal even in their own sub-culture. It is abundantly clear that behavior should not be viewed in isolation but as relative to others. These “others” may include “persons, groups and institutions”.

1.2.4 NEIL SMELSER

The social aspect of behavior can, however, be analyzed from a “group” or a “structural” vantage point. Typical questions the sociologist would wrestle with when using a group approach is why you chose to become a trader and how the behavior of other traders influences your behavior. When we use a “social structure” point of view, “recurrent and regularized interaction among two or more persons” is our primary focus. Social structure, says Smelser (a student of Parsons) (1976:37), would refer to “...identifiable

patterns of roles organized primarily around the fulfillment of some social function or activity...”. Our focus in this thesis is on a portion of what can generally be referred to as the economic structure of the world. Both these approaches, “group” or “structural”, can be used to explain behavior; what is important is the fact that the primary focus would be on “...forces that operate, with varying degrees of effectiveness, as social controls over behavior” (1976:38).

Three types of control, namely “values”, “norms” and “sanctions”, are of particular importance to the sociologist. “**Values**”, says Smelser, “...legitimize the existence and importance of specific social structures and the kinds of behavior that transpire in a given social structure”. Financial markets can exist and do exist because our value systems allow them to exist. A more specific control is that of “**norms**” that are “... standards of conduct that regulate the interaction among individuals”. These standards of conduct may be formal or informal and may range from formal government regulations to informal arrangements between traders in different firms. One such rule would prohibit traders from “front-running”. The third control we deal with is “**sanctions**”. Sanctions include the proverbial “carrot and stick” and are described as the “...use of various social resources to control the behavior of personnel in social structures”. Sanctions are of crucial importance to this research, as they can not only be used to induce the assumption and performance of roles, they are also of crucial importance to control deviance from what is expected from a particular role. A very wide range of sanctions do exist; the typical one that affects market participants is the massive bonuses they can achieve compared to the loss of their jobs if they do not conform to company expectations.

We should also not disregard the fact that people "...endow their social environment with meaning..." and "...develop attitudes and feelings about it..." and behave accordingly (Smelser 1976: 38). Individuals are therefore not mere innocent bystanders to their lives and their actions. Niel Smelser proposes that we should treat "economic rationality" as an "institutionalized value" rather than a "psychological postulate". If we take the example of the realities facing a bond trader in a large investment bank we can, according to Smelser, argue that his extreme opportunistic pursuit of money may be driven by at least two factors: his own desire to be rich in the first instance, but also the very real threat of "negative social sanctions" that can be very severe and can range from ridicule from fellow traders to losing his job and his ability to care for his family. This institutionalized value is a very powerful social control that affects the actions of a trader and is a reality he has to live with. The fear of negative sanctions like ridicule or exclusion from an elite group and the allure of positive rewards, such as high social status are very real and powerful motivators for choosing extreme opportunism as a means of avoiding failure.

Smelser's model although very useful does have its shortcomings. Mouzelis (1974:404) criticizes Smelser's model for its lack of emphasis on the role of collective actors as "producers" of the social system in which they operate, and his overemphasis on the "...impersonal process of 'structural-functional differentiation' ..." (1974:402).

1.2.5 HARRY M. JOHNSON

Johnson (1971: 573-580) identifies a number of factors that act as “**facilitators**” for deviation from the norm. These factors also have the ability to act as “**inhibitors**”, to prevent or control such deviation. Examples would be strong enforcement of strong sanctions. The presence of a facilitator, like a lack of strong sanctions, presupposes an increase in the likelihood that an actor or actors will display opportunistic behavior. It is not claimed that these factors cause opportunistic or deviant behavior; what is claimed is that, without facilitating factors being present, the likelihood of such behavior being demonstrated is greatly reduced. By implication it would be theoretically possible to influence the probability of the manifestation of extreme opportunistic behavior through the manipulation of these factors. This would in turn imply that we are not dealing with an aberration or “rogue” and unpredictable behavior but a manageable phenomenon.

- “**Faulty or lacking socialization.**” When we use this term, we should immediately add that this all depends from which perspective one evaluates the particular socialization. Faulty to one group may be perfect to another. If we learn over time from socializing agents, (for example our superiors at work), that a certain behavior is acceptable and commendable, we would probably act accordingly, even if an external party or group tells us otherwise.
- “**Weak sanctions.**” This factor, although self-explanatory, cannot be overemphasized. If the reward for certain actions far exceed the negative

sanctions associated with it, the restraining potential of the sanction is severely impeded.

- **“Poor enforcement.”** Poor enforcement is as devastating as weak or no sanctions and is of little or no value as a restraining factor. An inherent danger of this factor is the possibility that clients of firms operating in the financial markets are lulled into a false sense of security by legislation, rules and regulations that exist and should protect them from abuse but are, in reality, seldom or ever enforced.

- **“Ease of rationalization.”** Rationalization, Sutherland (1947: 6) argued, is often learned in the same way that an individual learns how to hide a large trading loss. It is vitally important for an individual who is expressing behavior that he is ambivalent about, to rationalize his actions. This is especially true for “white collar criminals”, but seldom for hardened criminals. With the line between what is legal and what is criminal so blurred in many areas of the financial markets, rationalization of actions is very easy.

- **“Indefinite range of the norm.”** It is normatively acceptable to become rich through hard work. What is fair compensation and what is greed? Mr Mike Milken found out that portions of society (rightly or wrongly) frowned on his USD 500 million per year income. As political groups often justify terrorism under the banner of fighting for freedom, so businessmen often justify obscene salaries as fair compensation.

- **“Secrecy of violations.”** It was Tartuffe who said “And there is no evil till the act is known / It’s scandal, Madam, which makes it an offense / And it is no sin to sin in confidence” (Ardut 2005: 222). With the advent of computerized trading and globalization, the potential for keeping actions secret has increased dramatically, making the negative sanctions following exposure a distant threat. The ability to keep actions secret for extended periods of time may also motivate traders to try and trade themselves out of unfavorable positions, rather than declare the position.
- **“Unjust or corrupt enforcement.”** Corruption in enforcement agencies poses a serious threat to financial markets, as an individual or group that is aware that regulators and enforcement agencies are corrupt has little or no fear of detection and sanction.
- **“Cooperation of the victim.”** The cooperation of victims often seems incredible but, in reality, this phenomenon is a major factor. One example in the financial markets is when boards of trustees that are entrusted with the task of ensuring that pension monies be maximized will allow portfolio managers to rape these funds. Similarly, clients continue to use trading firms although they know that the firm they use is front-running their orders.
- **“Ambivalence of agents of social control.”** Agents of social control need to be consistent in their enforcement if they want to maintain their legitimacy. Allowing one company or grouping to get away with certain behavior while others are punished is a sure way of destroying legitimacy and credibility.

- **“Subcultural legitimization of deviation.”** In any situation where a "them versus us" mentality develops, this factor plays a role. Nowhere is subcultural legitimization more relevant than in the financial markets. Groups of companies are also in a constant struggle with regulators that try to limit their freedom, their actions and often their profitability. As an organized group, these groupings are in a much better position to counter outside influence on a micro or a macro level. An example of such a sub-culture is the market specialists discussed on pages 8 and 9. This group legitimized the deliberate front running of their clients.
- **“Sentiments of loyalty to deviant groups.”** This factor is especially relevant in situations in which individuals are part of a trading team, executive committee or board of directors, for example. Members of trading teams are often dependent on one another for their income and disloyalty to the team could have severe financial and social implications. Very often the members of such a group owe their position to fellow members or feel a sense of common responsibility, making it very difficult for one individual to break ranks, so to speak.

These factors highlighted by Johnson not only sensitize us for our journey into understanding opportunistic behavior it also provides us with a framework of facilitating and inhibiting forces. They alert us to the diverse influence that different role players and their attitudes have on the development or curtailment of opportunism and its extreme forms. Individuals do not simply wake up one morning and decide: “Today I am going to be an extreme opportunist”. We see how weak sanctions, poor enforcement, corruption, duplicitous rules and regulations and ambivalence

of agents of social control, all play a facilitating role in the creation of an environment conducive to opportunism. When we investigate incidences of extreme opportunism, these are all factors that deserve our attention. What Johnson's summary lacks is more focus on the role of individual and group interests in the determination of whether or not extreme opportunistic behavior would be deemed by an actor or group as the most appropriate to satisfy a particular need. Up to now, the theoretical focus emphasized the importance of an actor's position in the social structure, learned behavior, institutionalized norms and factors that act as social controls and countervailing mechanisms. The role of interests and an individual's free will is largely relegated to a position of secondary importance. Nicos Mouzelis, without detracting from the importance of the abovementioned, urges us to augment these theories, through the use of a more inclusive approach.

1.3 SOCIAL AND SYSTEM INTEGRATION

Nicos Mouzelis identifies two focus areas in modern-day sociology. On the one hand, we find those who view individual actors or groups of actors as central to their theory (social integrationists) and, on the other hand, we find those who place individual actors on the periphery and view society as made up of dehumanized parts that either contribute to or detract from basic functional requirements (systems integrationists) (1974: 395-396). He recommends that these two views should be seen as complementary to one another and not as mutually exclusive.

In order to demonstrate his view, he compares how these two approaches would treat the concepts of “bourgeoisie” and “economic institutions”. According to Mouzellis (1974: 397-399), it does not matter if one is viewed as an interest group and the other is viewed as the parts that constitute the economy which, in turn, is a “...subsystem of the social system...”. Both approaches are essentially focusing on the “...social processes, whatever their degree of normative regulation”. Social integrationists see social processes in relation to “... concrete actors or decision making collectives.” Needless to say, the process of making and implementing plans is influenced by normative and non-normative considerations. The focus of this approach is, however, the actors and not the institutions. Mouzelis (1974: 398) emphasize the fact that one cannot ignore institutional arrangements when explaining the process of plan making and plan execution. Both local and societal institutionalized arrangements, such as stock exchange regulations and the institution of private ownership, for example, need to be taken into consideration. The important point is the fact that “...institutions are at the periphery and actors are at the centre...”. To further demonstrate the difference between the two approaches, Mouzelis summarize the focus of a study of the French bureaucratic system conducted by M. Crozier. According to Mouzelis “... Crozier puts more emphasis on actors using, shaping or changing institutions (especially at organizational level) rather than the inverse (i.e., portraying institutions as shaping the activities of actors).” (1974: 398).

The system integrationists on the other hand view social processes more from the outside. The problems of society are system problems that affect the ability of the social system to function as a whole. Little attention is

given to the role of individual traders when, for example, trading abuses need to be explained; the focus would rather be on the regulation of exchanges in general. Mouzelis quotes Parsons, who acknowledged the fact that “...the normative regulation of social processes is never complete...” and Smelser, who concedes that “...the degree of effectiveness of any given norm in any given social structure is always an open question” (1974: 399). These two factors point to the existence of some level of autonomous thinking at the individual level. Mouzelis therefore contends that both “normative and factual considerations” must be taken into consideration if we view “institutionalized action” as “patterned action”. He therefore supports the argument of L. Schneider that, while it is necessary to place emphasis on value orientations (“norms and values”) when we define an institution, we do not have to exclude the role played by “interests”.

In essence, Mouzellis warns us against portraying individuals as mere passive bystanders who are molded by their environment and are mere driftwood in the proverbial river of life. Two examples of theoretical approaches that stand critical to functionalist theories are **social phenomenologists** and **symbolic interactionists** (Mouzelis 1974: 406-407). Both these theories stress the importance of people playing an active role in creating their environments, while accepting the functionalist view that their social world is creating them. Social phenomenologists argue that the roles, statuses and norms emphasized by the likes of Parsons and Smelser, although important, are not abstract entities uninfluenced by individual actors and groups of actors. Symbolic interactionists go one step further and argue that “social actions and interaction is not a mere following of learned norms; it is a much more complicated and risky business” where every

decision, even if roles and norms are followed, has an element of voluntarism and individual construction if their individual reality is constant. However, Mouzellis warns against the failure of this approach to recognize the fact that groups, as entities, do have the potential to act, thereby limiting its use as a tool for explaining individual behavior. However, the social context (social structures that limit or encourage avenues of human behavior) remains a crucial element for explaining human social actions.

1.4 A POLITICAL-CULTURAL APPROACH

In 2001 Niel Fligstein published “The Architecture of Markets”. In this work Fligsten argues that market structures, (including financial markets), “... include a wide variety of elaborated social structures. These relations are shaped by how and when markets are founded, who dominates them, and the social relations among producers and their suppliers, customers, and governments. In order to define the terrain of sociology of markets in modern societies, Fligstein proposes five theoretical questions.

- a) “What social rules must exist for markets to function, and what types of social structures are necessary to produce stable markets?” (2001: 10)
- b) “What is the relation between states and firms in the production of markets?” (2001: 11)
- c) “What is a “social” view of what actors seek to do in markets, as opposed to an “economic” one?” (2001: 13)

- d) “What are the dynamics by which markets are created, attain stability, and are transformed, and how can we characterise the relations among markets?” (2001: 14)
- e) “What are the implications of market dynamics for the internal structuring of firms and labour markets more generally?” (2001: 14)

To answer these questions Fligstein uses his “political-cultural” approach.

The foundation of his approach is the view that social action takes place in “arenas” that can be called fields, domains, and sectors or organised social spaces. In a field there are a collective of actors/role players that try to dominate that space, in order to do so the production of a local culture that “defines social relations” between players is required (Fligstein 2001: 16). These markets are governed by formal and informal rules that determine the boundaries and limits and how rules are made. If these rules are perverted so would the markets they govern. According to the theory of fields the main cause of social structure in markets is the search for “stable interactions with competitors, suppliers and workers” (Fligstein 2001:18). Control or the perception thereof is a solution to the lack of control. Procedures that lead to effective control are quickly copied by role players. (Fligstein 2001: 18). This fact is of crucial importance in understanding opportunistic behaviour of actors in the highly competitive financial markets.

The theory of fields also explicitly links stability with the formation of markets and firms. Governments play an important role in defining the social structure that stabilise markets, because stable markets requires rules

(Fligstein 2001: 19). Fligstein emphasise this point by highlighting the role governments had in the financial crises that plagued the 1990's. According to him “Almost all of the recent crises are the result of unintended or intended governmental policy that was framed around the policies of domestic constituencies. While currency markets may have punished currencies, the penalty usually came after long time lags and extensive policy errors.” (2001: 211). I believe one can justifiably argue that financial crises like “rogue” events do not occur in a vacuum or overnight.

Fligstein concludes by arguing that in the first instance “...economic actors are totally dependent on social arrangement to make profits.” and secondly that “...there is not a single set of social and political institutions that produces the most efficient allocation of societal resources.” The crucial factor for Fligstein “... is to create political and social conditions that produce enough stability to allow investment” (Fligstein 2001: 23). Fligstein’s approach is very useful as it manages to combine micro and macro market phenomena.

“In contradiction to theories of competitive markets, many markets have complex and stable social structures based on repeated interactions of buyers and sellers and on the status and reputations of market participants” (2001:7). These social processes also determine how firms are configured internally. Fligstein questions the premise of most modern economic theories that social institutions would not persist if they are not **efficient**, in his view social institutions that are **effective** will survive even though they may not be efficient (2001: 22). In other words actors will try and reproduce “what works for them”. One striking example of this phenomenon is the

prevalence of bribery and corruption in the international arms trade. I do not believe one can argue that these practices is resultant from efforts to increase efficiency, the fact that these practices is clearly effective is however difficult to question. According to Fligstein (2001: 18) actors in markets will not only quickly become aware of "...successful solutions to the problems of competition..." they will also copy these strategies. The presence of opportunistic role models is thus of great importance especially if they are powerful actors.

1.5 SOCIAL CONSTRUCTION THEORY

Mitchel Y. Abolafia uses a "cultural" approach that focuses on the "social construction" of markets in order to explain variances of opportunism in financial markets. He (2001:6-13) argues that, although economists believe financial actors' behavior (financial maximizing) is driven naturally by what is the most efficient way of generating profits, in reality these actors' behavior is shaped by the institutions and markets they operate in, through a process called social construction. Individuals and groups create market arrangements through the formalization of social relations and cultural norms, in order to "further their interests" (2001:10-11). Abolafia very importantly argues that economic actors construct their own world through norms, scripts and strategies in order to maximize profits in a way that is "rational" in their context. He implicitly affords equal status to the influence of agency and structure in the construction of financial markets.

One sub-culture may however view what is regarded as rational by another sub-culture, as totally irrational in their unique context. According to

Abolafia, these socially and culturally defined strategies will differ between the socially constructed institutions in which these actors operate. Such an institution may be a stock exchange or an asset management company. He argues further that these institutions define the different markets they operate in. Each market is influenced by the political, economic and regulatory environments in which it has to operate. Informal and formal rules and regulations determine what can and what cannot be done. Young actors who enter these institutions do not walk into a void. They walk into a highly structured environment in which they have to learn what behavior is acceptable and what not – they have to learn how to “walk the walk and talk the talk”. Over time, they are equipped with a set of tools that they will have to use in order to survive. The behavior of the individual actor and the market institution he operates in are both created through a process of social construction. The rules, roles and the relationships needed to make the operations of these markets possible do not develop spontaneously; they are created through skilled actors within these institutions in order to shape the environment they operate in, so that their particular interests can best be served. The more powerful the actors, the bigger the potential influences that can be exerted. This influence is exerted in order to create market arrangements that are favorable for the optimization of profits for a specific group of actors and not necessarily for a whole firm. This process of the social construction of markets is therefore a continuous process, similar to the ebb and flow of the oceans.

This tug of war between the powerful players, Abolafia argues, explains why it appears that opportunistic behavior manifests itself in cycles of opportunism due to loosening and tightening of restraint (2001: 10-11). He

identifies a number of structural conditions that play a role in determining levels of opportunism observable in different financial markets. Some of the factors he identified included the efficiency and strength of reputational networks among traders, the ever-changing distribution of power among role players, the presence of institutionalized rules and enforcement of such rules and regulatory intervention or the threat thereof (2001:10). He also alerts us to the fact that although structural conditions may be similar, one will find that, in each culture, levels of tolerance for opportunism and levels of restraint are created and are constantly adjusted. According to Abolafia, financial market participants will construct local rationalities from the resources and conditions in which they are embedded (1998:74). These financial market participants often refer to themselves as “market makers” underlining their perception that they “create” the markets by their own actions (Abolafia 2001: 6).

In summary, Abolafia states that actors in financial markets are bound together in communities that shape their behavior. This behavior takes place in the context of social relationships, cultural idioms and institutions continuously in the process of being created (2001: 8-9) through a process in which powerful actors and groups of actors play a major role. The building blocks of their creations are norms, scripts and strategies all designed to serve individual and group interests, which together determine what their future actions will be. These creations will differ as these activities are embedded in their local contexts. Such different groupings create what we call sub-cultures within the larger financial market culture. These sub-cultures will have their own local rationalities; in other words, what is acceptable and how things are done will vary. This also implies that the

levels of opportunism tolerated in the different sub-cultures may vary. As mentioned before, the “rules, roles and relationships” that are constantly developed by the powerful players are all designed to serve their particular interests (2001:150). Conflict between the interests of the different groups is therefore a constant reality. There is a continuous process of counter-influence between key structural conditions that influence the strategies used by economic actors. The structural conditions are, in turn, influenced by the strategies used by these actors and the two factors need to be analyzed in context with one another and not in isolation. Abolafia (2001:32-35) identifies four primary structural conditions that would be the root determinants for the probability of extreme opportunism; in other words, if these factors are not present, the probability for extreme opportunism in a business or company would be low. **Structural conditions therefore refer to those variables most likely to influence the strategies and rules prevalent in a particular sub-culture.** If these structural conditions are absent, or if they change or are replaced by others, the strategies and rules would also change.

1.5.1 KEY STRUCTURAL CONDITIONS

“**Extraordinary short-term incentives**” is the first of four key conditions identified by Abolafia (2001: 32-35). If one looks at examples of the type of incentives available in the trading and corporate worlds over the last number of decades, it is clear that the incentives are based on short-term performance and are most definitely extreme. In the first instance, traders and executives are seldom, if ever, rewarded for past or future performance; what counts is the here and now. In 1989 Mr John Meriwether, at the time

part of the arbitrage group at Salomon earned, or should I say received, USD 23 million in compensation (Lowenstein 2002: 19). Mr Mike Milken earned a staggering USD 550 million, in one year for his work at Drexel Burnham (Fischel 1995:41). Key executives at large corporations often earn billions of dollars in share incentives and other forms of payment.

The second condition, euphemistically referred to as “**opportunities for information impactedness**”, essentially encompasses what is commonly referred to as a “competitive advantage”. Access to inside information is a prerequisite for insider trading and front-running. These are two examples of opportunistic conduct that relies on such an inside line. In this research, the concept of inside information will include, among other things, special knowledge or insights into financial products, systems and research – all factors that provide the opportunist with the proverbial “inside line”. Information impactedness, I believe, is equally relevant when an actor is deliberately withholding or distorting information. This may be information that investors need to make informed decisions or management needs in order to exercise control.

The third and fourth conditions are “**limited formal and informal restraints**”. Restraints are of little or no value if they are not consistently and even-handedly enforced. Informal restraints normally develop and exist when strong bonds of trust exist and when high value is placed on reputation. In today’s world of computers and the internet, it becomes more and more difficult for informal restraints to develop. Client complaints are often dealt with by public relations departments after they were filtered by computer programs and call centers that may be situated halfway around the

world from where the client is calling. Similarly, larger than ever multinational corporations with anonymous shareholders, often represented by hedge funds and other opaque investment instruments, are not conducive to the existence of restraints based on trust and reputation. It is also important to note that, even if long-term trust relationships do exist, this in itself will not guarantee restraint. Excessive dependence on informal restraints without other means of oversight can often be a recipe for disaster. Research by Knorr Cetina & Breuger (2000: 7) into financial markets indicated that even in today's artificial trading environments, subcultures can still develop. Although these informal groups still have the potential of exerting informal restraint over its members the influence of a few bad apples can encourage rather than restrain extreme opportunism. If the bad apples happen to be very "successful" traders that generate large profits their influence would be disproportionate to their numbers.

Limited formal restraint also can be caused by various factors. The most important factor is if the appropriate formal restraints do not exist. The second and, in my mind, sometimes equally important is when appropriate formal restraints do exist, but are not enforced due to a lack of political will, or a lack of oversight, that allow for breaches of regulation and rules to remain undetected. Similarly, the inconsistent and selective application of sanctions can also render the most well thought-out formal restraints impotent. Corrupt regulators can also render formal restraints useless. The rise of the multinational and the birth of the global village also have a hampering effect on the effective creation and implementation of formal restraints. The sheer size and influence of large corporations allows for extreme pressure to be exerted on regulators. One example is the resistance

against the implementation of Sarbanes-Oxley measures aimed at making corporate executives responsible for the financial conduct of their firms. Abolafia provides us with a number of structural factors that play a pivotal role in shaping financial markets. Where he differs from Johnson is his emphasis on the role of the individual actors and those they closely associate with in their place of work, as the shapers of their own little environment with its own rules and strategies designed to serve their interests. It is this attention to the individual that will help us to understand the modern financial markets actor in his impersonal and fast-paced reality.

1.5.2 OTHER FACTORS

These factors are however not the only structural factors that influence the shape of financial markets on a micro and macro scale. In my view there are a number of other factors that should not be overlooked. An example of such factors is the “**presence of successful extreme opportunists**” in the actor's sub-culture, from which he could have learned his behavior. Another example is the availability of “**financial instruments with extreme gearing potential**” and, although not the primary focus of this thesis, one should also be alert to the existence of evidence that may point to, for instance, the “**prevalence of gambling and other addictive behavior**” among traders. It would be irresponsible of us to ignore the subtle variations in human behavior and response to external stimuli brought about by, among other things, our genetic makeup. Similarly, the “**global and impersonal nature of modern financial markets**” has an undeniable influence on the way that strategies and rules develop in a particular microcosm or sub-culture.

1.5.2.1 THE PRESENCE OF SUCCESSFUL ROLE MODELS

The presence of role models in the environment of an actor in the financial markets is of great importance. In order for behavior to be learned, an actor needs to be exposed to an individual who successfully displays extreme opportunistic behavior. There also needs to be an opportunity for the actor to learn the techniques necessary to be successful. Later in this thesis, I will analyze the Barings collapse in great detail. One of the questions that were asked was why the Singapore staff never reported Mr Leeson's activities. One explanation that can be offered is that they were all inexperienced fresh recruits who learned from him, their superior, how to do what they do. It is quite feasible to suggest that they believed what he was asking them to do was quite normal.

1.5.2.2 PRODUCTS

The further factor I want to address is the availability of products that facilitate opportunistic behavior and multiply the effect thereof. These products are not the cause of opportunism in themselves; they do, however, multiply the effects significantly and facilitate opportunistic conduct. The ease with which large sums of money can be raised through the repo mechanism and the inherent gearing in some financial instruments, such as futures, are prime examples of products that have the potential for mass destruction. This is not to say that extreme opportunistic behavior is not possible with the use of more mundane products, as is clearly shown in the Daiwa incident.

1.5.2.3 A GAMBLING CULTURE

In his book *Liar's Poker* Michael Lewis gives us a vivid account of the prevalence of gambling among certain pockets of financial market participants. Although addiction per se falls into the realm of social psychology and clinical psychology, it is important for us in economic sociology to recognize the inherent dangers of employing individuals with addictive personalities in environments where high-stakes gambling is not only possible but also encouraged and richly rewarded, and where the means to raise staggering amounts of money in an instant are not only available but are used routinely.

1.5.2.4 THE DEHUMANIZATION OF FINANCIAL MARKETS

Knorr Cetina and Bruegger (2000: 1-24) investigate the role of globalization and the alienation that is growing in financial markets. “Open outcry” markets and “pit trading” are replaced by virtual markets that only exist in our minds and in computer data basis. The relationships between business people and their clients, unlike days gone by, are more and more impersonal. If you contact a service provider, your call may be rerouted to a call centre in Malaysia and, if you need technical assistance, you may be transferred to a technician in India. Knorr Cetina and Bruegger argue that this lack of human social relationships is replaced by “object-relationships” between human and non-human entities and those actors may even grow an attachment to these non-human entities. These relationships are referred to as “postsocial” relationships. The relevance of this approach to this study is clear; opportunism and its extreme forms should thrive in a dehumanized world, as

such an environment would reduce the emotional element attached to opportunism. The premise is simple: it is much easier to “steal” from the “state” through tax evasion than to refuse food to a hungry child. The fact that the child is hungry because you didn’t pay your taxes and the child couldn’t receive his state grant is a very difficult connection to make. Knorr Cetina and Bruegger analyzed the “relationship” between currency traders of a Swiss multinational bank with 14500 staff working in 60 offices in 30 countries spread over 6 continents.

Knorr Cetina & Bruegger argue that these traders are in a constant process of constructing the market they operate in: “... traders are engaged in a process of continually defining the market, not only in the sense of trying to read and understand it, but also in the sense of making or articulating it, by testing it, moving it, manipulating it.” (2000:7) Traders also “...view 'their networks' of contacts and relationships...” as a subset of the market. This market does, however, also contain a “...large component of anonymous behavior” and cannot be reduced to “...known groups of players engaging in transparent deals”. One trader, when asked to define the concept “market”, is quoted as saying that “markets are everything”. Similarly, the needs of traders are also constantly being created and amended. Knorr Cetina & Buegger also introduce the concept of “wants” and how the concept comes about. Traders are appointed to make money for the institution they work for and they are given precise performance targets; however this is a primary target. On a secondary level, they aim for performance bonuses that will increase their personal wealth. The need for personal wealth is a “want” that can be fulfilled by qualifying for a performance bonus. As long as you “lack” the required profits, you cannot satisfy your “wants” (2000: 10). The money you

make and the skills attributed to you are the grading criteria on the trading floor. This yardstick also carries additional qualifications with it. For example, the inability to make profits would be a reflection of your inferior character. The monetary and other rewards for making profit are therefore a strong incentive to perform. Traders are constantly measuring their performance on something other than what we would view as success or earning a lot of money. Their yardstick is the performance of the top traders in their business, whose achievements set the benchmark or model behavior that should be emulated. Knorr Cetina & Bruegger quotes a chief trader on how a trader's behavior is shaped. "If you have a dollar-Swiss dealer who behaves like a pig you can be sure that within two months everyone behaves like a pig, because he functions like ...a model...and his behavior affects the whole dealing room." He went on and said that "Because you learn currency trading by watching someone else do it. You don't learn from a book, or from an apprenticeship, but on the job. And how do you learn it? By watching how the other person answers the phone, by overhearing how he talks, by seeing how he takes a position." (2000: 11)

We can therefore summarize to say that financial market traders operate in an environment that is becoming less personal by the day. They have very little, if any, contact with their clients and the market they operate in is "99.99999% anonymous". The human contact they do have is with their fellow traders who, depending on the amount of money they make, have a disproportionate influence on the behavior of "lesser traders". The combination of these factors creates an environment that is extremely conducive to opportunistic behavior. Mr Nick Leeson said "I was living in a hermetically-sealed world where I breathed no fresh air and handled no real

money." He went on to say "...I was going to hide that US \$ 1.7 million just as surely as I'd hide the previous losses. Like the glass bending in the strange world of plate glass, my morals had bent in the unreal world of the trading I was doing. I had become crooked. I'd allowed myself to bend under the pressure to perform, and I was now a step removed from myself." (2005: 106).

1.6 INNOVATION AS A FORM OF OPPORTUNISM

As mentioned before, the use of the term deviant is always very subjective. Abolafia clearly distinguishes between deviant opportunism and deviant innovation, but he acknowledges that both would thrive in a "high incentive/low restraint" environment (2001; 153-154) and would therefore be similarly influenced by the same structural conditions. According to Merton (1957:145), innovation is a response to a situation in which the established values of a culture determine the incentives for those who are successful, but an actor then finds himself in a social structure that limits his ability to achieve success. Innovations therefore result from a situation in which such a high premium is placed on extreme wealth that normative violation is regarded as justifiable by some. When the opportunity to achieve this extreme wealth is limited by, for example, a lack of capital or restrictive rules and regulations, a climate for deviant innovation is created. The main difference between opportunism and innovation is the uniqueness of the behavior. As a form of opportunistic behavior, deviant innovation may take many forms, depending on the toolset of skills that the individual actor has at his disposal. This toolset is learned and built up over time and often includes all or most of the tools, skills and techniques he needs for his

innovation. Being an innovator by implication necessitates personal input, which implies some level of personal choice in how you are going to achieve your objective.

1.7 SUMMARY

It is a matter for debate whether humans are inherently opportunistic creatures or not; some claim that it is this trait that allowed us to fight our way to the top of the food chain. It is a fact that our brains are hardwired in such a fashion that our perceived rationality is largely shaped by our experiences from outside influences, causing us to be emotional beings. Our actions are constantly influenced by norms, values, sanctions and interests that all act as social determinants of our behavior. We therefore do not live or work in vacuums, but we are embedded socially in a network of social relationships with our fellow man and culturally in a system of norms, rules and scripts. A market is therefore constituted through experience. Through repeated interaction we learn what is expected of us, we learn the rules of the game and how we should enact our role in life.

These rules and roles are, however, not static and are constantly in a state of flux as powerful players try and gain the upper hand. In the fast-moving modern financial markets, the role of norms and values is somewhat limited as change is constant and the role of interests is often the guiding light that drives what can and what cannot be done. The rules, roles and relationships are all designed to serve the interests of those players that created them. These powerful players may be successful individuals or interest groups like

the market specialists operating on the New York Stock Exchange, or the chief trader of a Swiss bank.

A particular market culture also does not exist in isolation, but is affected by internal and external pressures like political, economic and regulative influences. These influences may be on a micro or macro level. Political influences may refer to office politics like management jockeying for position or political struggles between political parties. Economic pressures may range from efforts of trading staff to increase their share of the bonus pool to the economic policy of the ruling political party affecting the popularity of government bonds.

What we perceive as a market is merely a reflection of a particular culture's reactions to the influences of a combination of pressures at a particular point in time. Similarly, regulative influences may be formal, informal or anything in between. Social processes are, to a greater or lesser degree, normatively regulated irrespective if one views society from a functionalist perspective that focuses on institutions, or from a conflict approach that focuses on conflict groups. In today's fast-moving and impersonal global markets where billions of USD are made or lost in an instant, norms and values must compete with the immediate needs of "interests" as an influencing factor. Both these views do, however, have a contribution to make in our understanding of opportunism.

By using Abolafia's cultural approach, with its focus on the construction of financial markets, one strives to enlighten not only the processes through which the social system shapes the actions of actors, but also the process

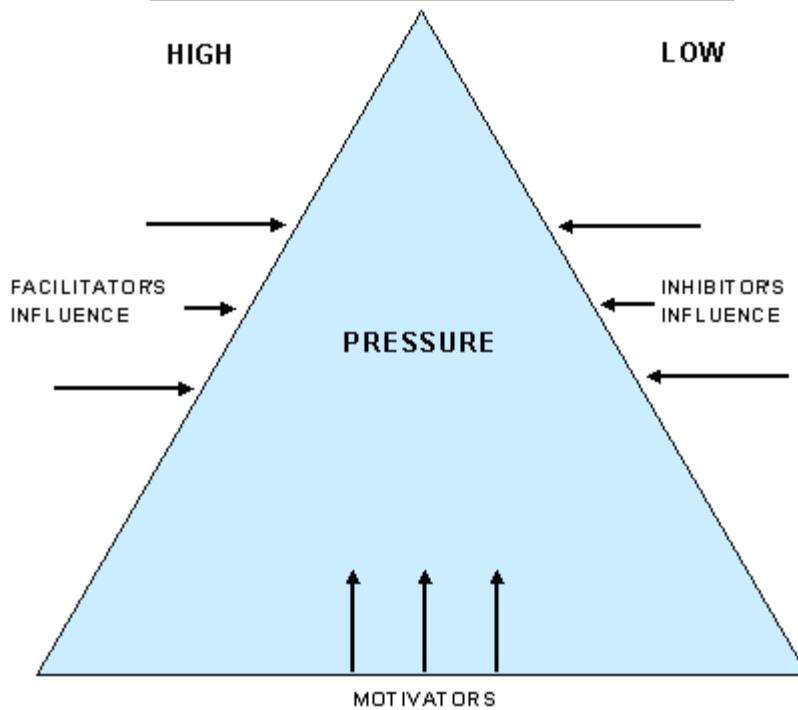
through which the actors shape the social system in which they operate. We are not trying to predict exactly when extreme opportunistic behavior will be displayed, but rather under which circumstances it is most likely to occur. We have seen that there are a number of factors that influence opportunistic human behavior. The term “influence” denotes the ability/potential to generate an effect. Values, norms, sanctions, interests or orientations all have a common denominator of interest to this study – their role as motivators, facilitators or inhibitors of opportunism.

- The term “**motive**” refers to an influence or influences, which induce a certain type of behavior. These forces largely act as positive or negative incentives. Fear and greed are two of the most powerful motivators known to man. Motivators I will show are primarily the pursuit and/or preservation of wealth, future income, status and prestige.
- The term “**facilitate**” refers to those influences that make it easier for a certain type of behavior to manifest. Facilitators would include among other successful extreme opportunistic role models and a weak regulatory environment.
- “**Inhibitors**” on the other hand refer to those influences that make it more difficult for a certain type of behavior to manifest. Inhibitors would include among other strong, consistently enforced sanctions and an efficient risk monitoring and management regime.

A normative basis or group interest basis is not the crucial factor for the purposes of this study; the focus of this study is whether or not the

manifestation of extreme opportunistic behavior is induced, made easier or made more difficult by the influence of certain factors. We therefore need to evaluate the structural and other factors for their influence as motivators, facilitators or inhibitors of opportunistic behavior. The proposition is that motivation is the foundation for extreme opportunistic behavior. Without motivation there is no pressure. Facilitators are also of crucial importance as they are the means to the end. However, even if one has strong motivators and facilitators, the presence of strong inhibitors can ensure balance. This should theoretically prevent the manifestation of extreme opportunistic behavior. Incidences of extreme opportunism could therefore be characterized by a combination of strong motivators and effective facilitators in the absence of effective inhibitors.

FIG 1. OPPORTUNISM POTENTIAL



This is graphically illustrated in fig.1. Motivation forms the basis of a triangle of opportunistic probability while the two sides, comprising of facilitating factors and inhibiting factors, will be crucial in determining if balance or extremism is probable. If the forces that act as facilitators are much stronger than the inhibiting forces the potential for extreme opportunism will increase. If the forces that act as inhibitors are the strongest the potential for extreme opportunism will decrease. This triangle can be populated by a matrix display of variables as shown in my concluding chapter. (See Annexure D).

We should therefore be able to devise ways of managing opportunism in financial markets by manipulating at least one of the three elements. The argument can be made that the pursuit of wealth is a deep-seated element of Western culture and many other cultures, and is a justified and noble pursuit. In incidences where extreme incentives and inherently geared products are justified, inhibiting factors like strong regulation and/or sanctions would therefore be equally justified to ensure a balance, which should prevent or discourage extreme opportunism. The existence of a well developed set of inhibitors in a particular sub-culture will for instance, reduce the probability of a new entrant introducing extreme opportunistic behavior. I therefore share Abolafia's view, that both agency and structure should be awarded equal status, relative to their potential role in the construction of a particular culture. In an unbalanced structural environment, the potential for extreme, agency influences is therefore higher, than in an environment where structural influences are balanced.

CHAPTER 2

GREG BLANK AND OTHERS: A SOUTH AFRICAN PERSPECTIVE

2.1 INTRODUCTION

At 6.30 on the morning of Saturday 17 September 1994, Gregory Lex Blank, a 28-year-old South African stockbroker, started serving an 8-year jail sentence at the Krugersdorp prison in Gauteng province. The gang-infested Krugersdorp prison was purportedly rated by the Red Cross as one of the toughest prisons in South Africa, with an average of two murders per week (Gibson 1997: 127).

2.2 THE CASE AGAINST GREGORY LEX BLANK

The crimes (48 counts of fraud) he pleaded guilty to were summarized (Gibson 1997: 83) by his defense lawyer and accepted by the prosecution as “...having failed to disclose that he had a personal interest in the transactions which he was conducting on the stock exchange for the Old Mutual”, the largest life insurance company in South Africa.

However, Blank didn't act alone; for just over one and a half years he was part of a 14-man conspiracy (1997:239) that systematically, over a period of nearly 7 years, defrauded Old Mutual and, to a lesser extent, the South African Reserve Bank. The fraud was quite simple. Old Mutual insiders would advise an external broker that the company intends to buy substantial quantities of a particular share. The broker would then buy these shares on

behalf of an overseas co-conspirator. This buying normally drives the price of the share up. When Old Mutual executes their buy order, the same external broker would be used, as he would have access to the required stocks. The Mutual would normally pay a higher price than that paid by the conspirators. The difference would be profit to the conspirators and would be divided.

There are however, a few noteworthy elements to the whole case: in the first instance, Blank only became involved in the last 18 months of the fraud. The other interesting point of the case is that, although he wasn't involved in the first five years of the fraud, he was the only one sentenced to jail. The strategy of his defense team was based around the premise that Blank was forced into his actions because of the existence of a culture of corruption (1997: 84). However, his case unraveled because of a purported incident involving the broking firm Martin & Co. According to the State, the firm of Martin & Co was approached by Old Mutual staff to participate in their scam (1997: 88-89). When Martin & Co refused, they were threatened that Old Mutual would take their business away. A visit by a Martin & Co delegation to Old Mutual, at senior level, apparently averted the loss of business for Martin & Co. The judge argued that Blank should have done the same. The problem with this matter was the fact that, two days after Blank was sentenced, Martin & Co published a statement denying that they were ever put under pressure by Old Mutual employees to act improperly (1997: 233). Old Mutual, on its part, published a statement denying that they ever received a delegation from Martin & Co regarding such a matter. Of interest to this thesis is the following: if the incident never took place, one can make a strong argument that the judge in the case erred by using the case as an

example of what Blank should have done. If the incident in fact took place, why would Old Mutual and Martin & Co both be lying? A possible hypothetical explanation for such action could be that Old Mutual could, to an extent, be liable, as they were made aware of the actions of their staff and didn't take the appropriate steps to ensure that it didn't happen again. For Martin & Co, a stock brokerage, it cannot hurt to have the largest life assurer in the country "owing you one".

Blank's defense further argued that Blank believed that 90 per cent of stockbrokers engage in illegal activities (1997: 89-90). As an example, they cited a case involving stockbrokers from the firm of Ed Hern. Kenny Fouche was arrested on the same night as Blank and Andre 'Stompie' Coetzee. Coetzee was in charge of the dealing desk at Ed Hern and Fouche was his second in charge. According to evidence led by Blank's attorney, Clive Cohen (1997: 87), Coetzee and Fouche defrauded five financial institutions by misusing the backdating system in the rules of the Johannesburg Stock Exchange (JSE). Fouche and Coetzee were initially charged with 570 counts of fraud (1997: 72-73) arising from "irregularities in institutional share dealings". However, the Attorney-General of Gauteng (the province where the JSE is situated), Klaus von Lieres und Wilkau, decided to allow the two accused to pay ZAR 200000 each after reducing the charges to 200 lesser charges to which the accused pleaded guilty. The justification offered by the Attorney-General was twofold: in the first instance, he stated it was in return for the offer of the two men to assist with the prosecution of others involved in similar scams and, in the second instance, the cost of a drawn-out trial was cited as a reason for following a more expedient route. These decisions were, unfortunately for Blank, not met with enthusiasm by all. Many

observers saw the government as being soft on white-collar crime. This incident may have played a role in the ultimate decision by the judge to send Blank to jail.

2.3 THE ENVIRONMENT IN WHICH BLANK OPERATED

In 1982, Greg Blank started working at the stock broking firm of Frankel Pollock for a salary of ZAR 1400 per month; anything more would have to come from commission (1997: 34-42). Two years after joining Frankels his package was revised – he would earn 50 per cent of the net (after expenses) brokerage generated from individual (private) clients he developed and 5 per cent of the institutional (large firms) brokerage he, and later his institutional desk, generated. His institutional brokerage income, however, had a hurdle of ZAR 80000 per month that had to be met before his income would come into effect. If Blank had to rely on the existing business of his firm, he would not earn a lot of money. His view apparently was that “As things stand I’ll be lucky if my bosses don’t ask me to put money in the kitty for them” (1997:36). However, Blank did not disappoint his bosses or himself and, in the 84/85 financial year, his firm earned ZAR 1,6 million from institutional brokerage. This rose to ZAR 2,4 million in 85/86, ZAR 3,9 million in 86/87 and, in 1989/90, the firm earned ZAR 6.5 million. If we discard costs completely, Blank could not have earned more than ZAR 283000 from his institutional business ($ZAR\ 6.5\ million\ [brokerage] - 0.96\ million\ [hurdle]\ \times\ 5\% \ [commission] = ZAR\ 0.283\ million$). In that year Blank “took home” from his employers ZAR 1.5 million. In order to earn this, he would have had to earn at least ZAR 1.217 million from his private (individual) clients. To earn this, he only had to make his firm ZAR 2.434 million from private

clients that he developed, as his commission agreement stated that he could retain 50 per cent of such brokerage generated. Blank would, therefore, have benefited from focusing on his private clients, while it would be in the interests of his employer to optimize income from institutional clients. There is also the added hidden benefit of doing business with large institutional clients; if you want to manipulate the market, you need “really big sums”, the type of money you only find by doing business with the biggest (1997: 36-37). At that point in time, Old Mutual was the largest life insurance company in South Africa.

Greg Blank did not walk into the firm of Frankel Pollock with a full set of skills on how the markets worked. He walked into the proverbial dog eats dog world, where the stakes are high, and his initial success was probably not applauded by all. Many of the older brokers in that era did not have a university education, a fact that applied equally to international markets. There were, however, more experienced actors in his firm who assisted him to build up the necessary set of skills to complement his obvious natural talent. It was, therefore, no surprise when in 1986 efforts were made to discredit him with his clients by falsely spreading a rumor that he leaked the intentions of a client to sell a particular share to a third party (1997: 37). One can only imagine what influence an incident like that had on any informal restraint based on feelings of mutual respect and trust. However, he survived this, and he had been building on his set of tools. One strategy that he learned from one of the old hands at his firm was how to please both parties to a share transaction. Normally, for someone to make money someone else had to lose money. Blank was, however, shown a way of pleasing both parties. His first lesson was early in his career when an “insurance giant”

that wanted to buy another company enlisted the help of Blank's firm to assist them. (Essentially the same type of assistance sought by the "insurance giant" and provided by Blank's firm, formed the basis for four out of the six charges to which Mike Milken pleaded guilty in 1990 – see chapter 9). In the normal run of a market, the price of a particular share usually rises when the demand for that share increases significantly. The solution is to buy the required shares you need without anyone knowing. This is, however, not very easy. The "old hand" explained to the young Blank that it is possible to make both parties feel as if they are winners. The trick, he explained to Blank, was to make the buyer believe that he paid less and the seller believe that he received more than they respectively expected. The brilliance of the trick was the realization by the "old hand" that client satisfaction has more to do with client perception than mathematics. In practice, the transaction would work as follows. When approached by a firm that wanted to acquire a large block of the shares of a listed firm, they would approach a stock broking firm with the quantity of shares they needed and a price range they were prepared to pay. If the shares of the firm were trading at ZAR 5 a share, they might be prepared to pay up to ZAR 7 or maybe ZAR 7.50. Once the broker had determined who owned large parcels of the stock, those owners would be approached with an offer of maybe ZAR 6 or even ZAR 6.50. The "wily" owner may demand ZAR 6.75 or even ZAR 7. These transactions were done outside the market and, therefore, did not affect the prices reflected on the board of the stock exchange. The buyer would be very pleased because he paid less than expected, and the sellers would be pleased because they received more than the ruling market price. The buyers must have been amazed at the ability of Blank and his teacher to buy such large parcels of shares without causing the slightest disturbance in

the market. A “small” technical detail that “slipped” the mind of the old hand and “eluded” Blank was the fact that, according to the rules of the JSE, transactions handled outside the market also have to be reported to the market when they occur. By delaying such reporting, the volatility created by large demand for a particular share could be averted long enough for the whole transaction to be completed. Blank summed up his mutually beneficial relationship with the institutions, “I used to stick my neck out for the institutions. I would do what they wanted, which was to get them the best prices. They weren’t interested in how I got them, just as long as I did. I would create a market around the shares, become a buyer, become a seller. And the end result was that they got what they wanted – the best prices. And I got what I wanted. I started getting the business, and the respect and the power” (1997: 39). Blank fulfilled a role similar to the role of the market specialists on the New York Stock Exchange (NYSE).

However, Blank goes further and describes the morality of the environment he was socialized into and operating in. He states bluntly that: “The game of manipulating share prices is one of the oldest in the stock exchange book. It is not considered improper, let alone dishonest, though of course no-one calls it manipulation” (1997: 41). With reference to the unit trust sector, he says “...as any investor in unit trusts should know, share prices are manipulated openly by some of the most respectable organizations in the country – the financial institutions and the insurance giants. They call it ‘window dressing’.”(1997:41). Unit trusts, or Mutual funds as they are called in the United States, is defined by the McGregor’s “Dictionary of stock market terms” as “a form of managed portfolio where the public hands over a lump sum of capital or pays monthly amounts to be invested on their

behalf in the share market. The public, instead of buying specific shares, buy units" (1989: 122).

The practice of "window dressing" in the unit trust industry is not a phenomenon isolated to the South African markets. The unit trust industry is largely dependent on private individuals who use "expert" investment managers to indirectly invest their money. As the name implies, a unit trust investor would buy units in a particular fund; the underlying assets of the fund could be, among others, shares, bonds or cash, or a combination thereof. According to the Association for Collective Investments (ACI), the global Collective Investment Schemes market as at the end of 2005 is estimated at 16.1 trillion USD and the South African unit trust market is an estimated ZAR 391 billion. Unit trust funds have periodic results declaration dates, on which the institutions that manage these funds publish, in essence, the value of the underlying assets in the different funds. In short, the higher the value of the underlying assets in each fund, the better the "performance" or "growth" of the fund. If the institutions can show that the value of the underlying assets has grown (as measured on that particular day) the investor would be satisfied, or as Blank put it "...the little folk that lent it their money will conclude that they have invested wisely" (1997: 41).

This was, however, easier said than done, as markets by their very nature do fluctuate. According to Blank, the institutions often instructed their brokers to "jack up" particular stocks that they were holding in their portfolios to ensure that, on the declaration date, they could show growth. However, the problem with this activity is the fact that the prices of the stocks usually fall back shortly after declaration date. The question of the morality of this

practice is open for debate. There is, however, more to the practice of market manipulation. In order to manipulate a market – even a relatively small market like the Johannesburg Stock Exchange (JSE) – you need a lot of funds. Consider that, at the end of June 1997, the market value of equities held by the unit trust industry in South Africa amounted to ZAR 57 billion (SA FSF 1997:1). If one equates this figure to a percentage of the total market capitalization of the Johannesburg Stock Exchange (JSE), it only amounts to three per cent (3%) of the JSE market capitalization. Another factor that has to be borne in mind is that the shares one has to “lift” the prices of would normally be large capitalization shares, otherwise the effect on the overall performance of a fund would not be significant enough. However, the unit trust managers were mainly owned by the largest financial services companies, who most certainly had the assets to manipulate the market in order to ensure that their unit trusts would shine and draw money into their companies.

2.4 THE GENSEC INCIDENT

It would be easy to disregard Blank’s contentions of market manipulation by the big institutions as the ramblings of a convicted fraudster. However, a bizarre turn of events late in 1998 once again highlighted the issue of market manipulation. On the 14th of September, Gensec asset management suspended one of its traders, Gowie Botha, purportedly on suspicion of “front running” (Die Burger: 29/10/98). Botha had been working for SANLAM Asset Management since 1990 (Business Times 01/11/98). In July of 1998 Gensec effectively merged with SANLAM Asset Management, although ultimate control stayed with SANLAM. Gowie Botha did not take

his suspension lying down. He immediately brought an application in the Cape Town Labour Court and subsequently won an order to have the Bellville sheriff seize tapes of phone conversations between the Gensec equities dealer room and stock brokers on the Johannesburg Stock Exchange (JSE) (Dispatch online 27/11/98). The Dailey Dispatch reported that nearly fifty tapes containing telephone conversations between three or four Gensec dealers and around eighteen member firms of the Johannesburg Stock Exchange (JSE) were seized. Quoting Botha, newspaper reports cited that the reason for this action was to clear his (Botha's) name. According to these reports (Dispatch online 27/11/98; Business Times 01/11/98), Botha claimed that he unwittingly contravened section 20 of the Financial Markets Control Act, 55 of 1989. He further claimed that he never even knew about the existence of this section of the act and that his superiors never made him aware of the act and its implications. Botha was further quoted as alleging that "...most, if not all, the fund managers of Sanlam, made themselves guilty on numerous occasions of this section...". Due to this fact, "It was grossly unfair of Gensec to single me out as a scapegoat in circumstances where I essentially carried out instructions". The Daily Dispatch further reported on the fact that "Sanlam's Prime Growth unit trust peaked close before September 30, considerably higher than the average price of the general equity sector". The paper also reported that two shares out of the top ten largest shares held by the unit trust in question, namely Gensec and African Merchant Bank, "...had surprisingly large increases in value" and that Sanlam had a "dominant" shareholding in both.

The Daily Dispatch also reported that the tapes seized by the sheriff's office were handed to the Office for Serious Economic Offences (OSEO). The

head of this special unit was, however, quoted as saying that “We wouldn’t have the tapes in our possession if we do not plan to listen to them at some stage”. One can only assume this was a response to a question of why he hadn’t “yet” listened to the tapes. Another South African newspaper, the Mail & Guardian (19/12/98), also reported on this matter and highlighted the important question of what the priority of the Investigating Directorate into Serious Economic Offences (IDSEO) should be. According to the Mail & Guardian “...the issue is whether the IDSEO intends to concentrate on whether one dealer acted improperly to benefit himself (front-running), or the extent to which window dressing or price manipulation is commonplace in the South African unit trust industry”. This is a very important point, as a prosecuting authority has seldom found itself in possession of all the evidence relating to a serious offence. What happened after that was interesting to say the least. The tapes of the conversations were handed over to the Auditors of Gensec, following an order by the Labour Court (Business Times 22/11/98). Gawie Botha resigned on 4 December 1998; the reasons cited by his lawyer were “...that the relationship between him and Gensec Asset Management was seriously impaired, and no purpose would have been served in pursuing it” (Business Report 08/12/98). He denied that it had anything to do with a pending disciplinary hearing. On the 23rd of June 1999 two newspapers (Daily Dispatch 23/06/99 and Business Report 23/06/99) reported on a statement issued by the chief executive officer of Gensec, Anton Botha. He was quoted as saying “As a result of those investigations, by the forensic auditing team of PricewaterhouseCoopers, the dealer from Gensec Asset Management’s Cape town offices was suspended on full pay. He resigned in December”; “the matter was referred to the Investigating Directorate: Serious Economic Offences, in whose hands the matter now

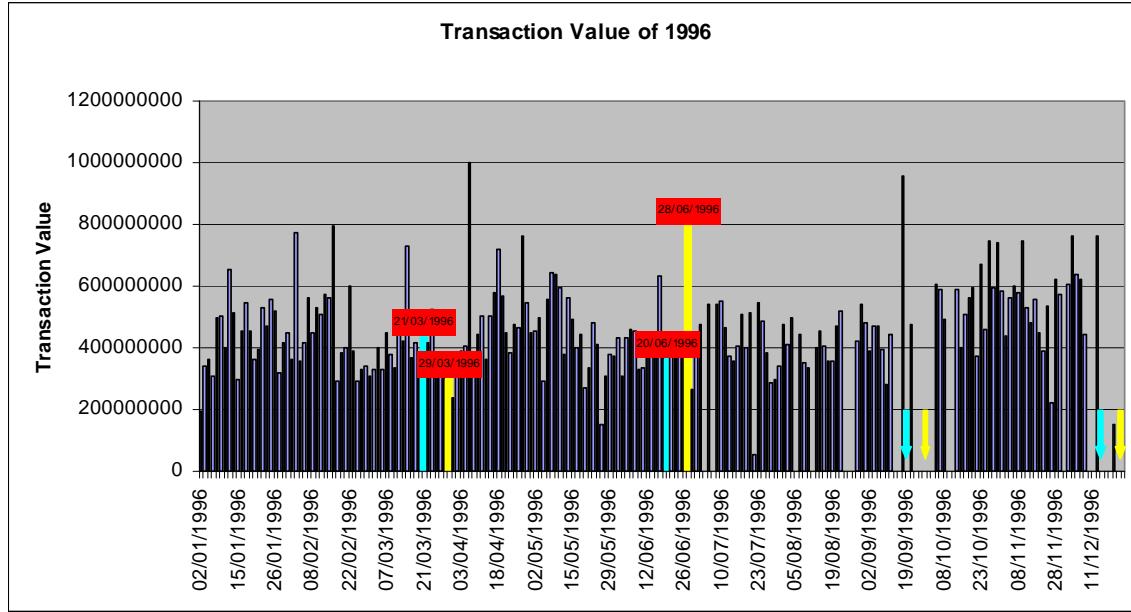
lies. During the investigations, the suspended dealer alleged that Gensec Asset Management was involved in the illegal act of attempting to manipulate share prices”; “Gensec then embarked on a further investigation using PricewaterhouseCoopers”; “The investigation did not find any evidence of false transactions, but did find evidence which suggested that two dealers from Gensec Asset Management could have been involved in ‘window dressing’. An analysis showed that any attempts to influence share prices could only have had a negligible effect on the value of portfolios” (Dispatch Online 23/06/99). It was further reported that: Advocate Burger [the chairman of the internal hearing] found both the dealers involved not guilty of the charges, one on the basis of insufficient evidence, and the other because it could not be proven that he acted unlawfully” (Business Report 23/06/99). The charges brought against these two dealers were “window dressing”.

No evidence could be found that any in-depth investigation into “front-running ” by Gawie Botha or “ window dressing” by Gensec staff was ever conducted by the Investigating Directorate : Serious Economic Offences.

2.5 OTHER EVIDENCE

If window dressing and market manipulation indeed took place in the time that Mr Botha operated, there must be other evidence to corroborate his contentions. Based on data supplied by the Johannesburg Stock Exchange (JSE), the following graph was constructed using the “Electronic Trustee” software, designed to detect anomalous trading patterns.

FIG. 2



The graph shows three anomalous spikes in value traded on the JSE, in the quarters ending March, June and September of 1996. The March spike was shortly after the first quarter and could be consistent with a sell-off. The June quarter end activity was on the day and the September quarter end had activity shortly before the futures close-out and the last day of the quarter. If market manipulation indeed took place, such spikes would be expected. (Unfortunately, the JSE could not supply complete data for the second half of 1996.) Two spikes are however visible just before the third and fourth quarter futures closeouts indicated by the two blue arrows. The yellow lines and arrows indicate unit trust quarter ends and blue lines and arrows indicate futures close-outs. Although this graph does not provide conclusive evidence of market manipulation, it does however reflect market behavior consistent with manipulation, at the time Mr Botha claimed such manipulation took place.

In September of 1997, a year before the Gensec incident, the Dispatch Online published an article in which they reflected comments by stock market dealers. One dealer reflecting on the activities of institutions after a futures close-out and ahead of a unit trust reporting date, is quoted as saying “We may be seeing some sidelining to get the market to come down so that the window dressing we see at the end of unit trust reporting periods is not too expensive” (Dispatch Online 1997: 1). There can be little doubt that, at least in the mind of this trader, window dressing by the institutions is common practice and common knowledge. A futures close-out can be defined as a “...quarterly occurrence in which futures market participants must decide whether to settle their obligations, renew their contracts or close them out. It is the date on which futures contract holders are obliged to either buy or sell a certain quantity of the underlying security at a predetermined price” (Cobbett 2005: 1). Unit trust declaration refers to the date, normally every quarter, when unit trust (mutual fund) managers announce their results for the preceding period.

In February of 1998 Frank Fornasari, a futures and arbitrage trader for Edey, Rogers & Co, purportedly commented on the volatility around futures close-outs in South Africa, by saying that “As these days draw nearer, some of the JSE’s most powerful players may do their level best to manipulate the prices of certain shares so as to make their futures deals most profitable” (Efrat 1998: 1-3). He also very importantly points out that the profits they make from their futures positions more than compensate for the drop in value of their portfolios when the markets that they manipulated upwards fall backwards. If they were to use their clients’ portfolio’s to manipulate the market, their clients would suffer the lower performance. The manipulator

would win all the way. Fornasari also sheds some light on the identity of these manipulators. In the first instance, he points out that "...making an impact requires lot of muscle". Secondly he says "...institutional investors are trying to drive up prices...". Both references support the notion that such manipulation is not the work of individuals.

During 2002, in testimony before an inquiry into the rapid depreciation of the ZAR against major currencies, a former head of foreign exchange trading at Credit Agricole Indosuez's Johannesburg office confirmed the occurrence of opportunistic behavior amongst forex traders in South Africa (Langley 2002: 5-7). He testified that volatility is generated artificially by traders who spread rumors in order to elicit a reaction from the market. Traders from different banks would also collude to push the ZAR in one direction or the other. Similarly, traders from two different banks can also manipulate the price of the currency by booking trades at a particular price and later canceling the trade once the market has reacted. Colluding banks can also hide real market direction by asking one another to execute some of their transactions for them. When asked about the extent of such behavior, he testified that it is limited, but emphasized that it is extremely difficult to prove that such behavior does occur unless it is very blatant. He added that there are a number of banks that do not tolerate such behavior, implying that this behavior is at least tolerated by others. This observation reinforces the fact that it is very difficult to behave in an unethical or opportunistic fashion in an environment that is not conducive to such behavior.

In a transcription of an interview published on the internet by a leading South African financial magazine, more than fourteen years after Greg

Blank was arrested, we also find another indirect reference to manipulative practices. The interviewee was David Schapiro (no relation to the David Shapiro who committed suicide following accusations that he was part of the group that conspired to defraud Old Mutual), at the time employed by the firm of Barnard Jacobs Mellet (BJM), a leading South African stock broking firm. In commenting on activity on the Johannesburg Stock Exchange (JSE) on 15 December 2004, David Schapiro said "...there's a lot of trade between 2.00 pm and 4.00 pm as the futures traders try and, well not manipulate but influence the direction of the market. Manipulate has a sinister meaning against it, so it is not that. They are trading to trade their way out of their positions to the best advantage. So you get a huge amount of activity and, during that period, the market had run up to 2.00 pm and then fell very sharply" (Anderson 2004: 1-4). In an article published on the internet on 15 September 2005 an employee of Nedcor Securities (Nedcor is one of the four largest banks in South Africa and Old Mutual owns more than 50% of its shares), Arthur Buchner, was quoted as being a bit less subtle when commenting on an anomaly on the JSE. He attributed the "spike" to "aggressive buying", apparently ZAR 2.1 billion worth, "by one market player, likely one of the overseas banks". He is further quoted as saying "...the player was a continuous buyer of the top 40 index future over three days before the close-out". Very important to this thesis is the identification of the motive for the buying. According to the article "He explains that by aggressively buying such a large quantity of the underlying index, the player managed to manipulate the market on the upside, and collect a profit on his futures position" (Cobbet 2005: 1). This was the inverse of what happened at Numuro, an incident discussed briefly in the next chapter.

During 2007, nearly ten years after Gawie Botha claimed that window dressing was rife in the unit trust industry in South Africa, the deputy managing director of a South African asset management company had the following to say: “At each quarter-end the share prices tend to spike up, because people want their quarterly return to look good. So they tend to push the price normally of mid-caps to smaller caps, but I’ve never ever seen the need for this, because if you’ve inflated a share price by 5% one day, tomorrow when you disappear as a buyer the price goes back to where it should be. So it goes 5% lower, so the next quarter you’ve got 5% more to catch up in your performance. So I’ve never understood. But there’s not nearly as much [of this] as what there used to be. In fact, I think there are more arbitration players who think this is going to happen each quarter, and who actually go in and buy the shares – and they cause the effect without the actual owners of the unit trusts doing the window-dressing” (McCurrie 2007: 2). What is implied here is that window dressing does occur and was, at least in the past, a common practice. The explanation that the spike effect is created by arbitrage players who try to exploit “expected” market manipulation by institutions is questionable, although there may be those who try to profit from such manipulation. A substantial volume of a share needs to be purchased to influence its price upwards, implying that it has to be the large players who conduct the purchases. This very much in line with Fornasari’s observations, referred to earlier.

The large players are also all unit trust managers in South Africa; if they themselves are also the arbitrage players for their own account, they are essentially guilty of front-running the portfolios they use to manipulate the market. The negative effect of this practice, the 5% drop, can also be negated

by large managers who sell the stock out of the highly visible unit trust portfolio into the pension funds that they manage. By spreading such sales among a large number of funds, the effect is not clearly visible. The unit trust would pocket the profit and the glory, while the pension fund absorbs the loss. Although clearly immoral, channeling losses to pension funds is regarded as less of a problem by financial institutions, because there is less emphasis on pension fund performance over the short term, in the investment community, compared to unit trusts where staff bonuses often depend on quarter end results. This practice is confirmed by claims from a compliance officer referred to in the next paragraph. Research conducted by Carhart, Kaniel, Musto and Reed (Ni, Pearson & Potoshman 2004:23) provided proof that managers of mutual funds manipulate the prices of the stock they hold in their portfolios before the quarterly or year-end reporting of performance. They also point out that the new inflows that normally follow top-performing funds make up for the negative effect on performance that may follow after such manipulation. It must also be remembered that most mutual fund managers have numerous portfolios, which allows them to boost performance on a rotation basis. It is also important to remember that the cost of manipulating the market can be substantial, making those candidates with large option positions and large asset bases the most likely manipulators (Ni, Pearson and Potoshman 2004: 23). This fact on its own cast serious doubt over the validity of claims that market manipulation is limited to small “rogue” companies. Research into the behavior of optionable stocks in the United States between January 1996 and August 2002 provides very clear evidence that the manipulation of the prices of these stocks is a key driver in the anomalous price movements around option expiration dates (Ni, Pearson and Potoshman 2004: 1-7). The writer of an

option has an incentive to let the options he wrote expire worthless while the buyer has an incentive to manipulate the price of the underlying securities so he can exercise the options he bought on expiry date. The following graph from the Washington Post clearly shows the anomalous price movements.

FIG. 3

Happy Expiration Day

Researchers have found an unusual trading pattern for stocks on the days when options on them expire. On these days, stocks more often close at or very near the strike price of one of their options.



Note: Based on options expiration from January 1996 through August 2002.

Source: Sophie Xiaoyan Ni, Neil D. Pearson and Allen M. Poshman

The New York Times

(Thoma 2006:2)

Asset managers are also very creative and have an array of techniques through which they can manipulate performance. In 2002 the compliance officer of a prominent South African asset management company made an appeal for more stringent controls over the way a fund's performance must

be calculated and publicly stated that asset managers “...use creative maths tricks to boost performance figures in the drive to create more investors” (Cameron 2002: 1-3). He named ten of the easiest techniques used by managers, to “ramp” the performance of their funds. These include, among others, “Selective time periods”; “Selective performance calculations”; “Different valuation methods for assets”; “Quietly discarding poor performers”; “Changing benchmarks as performance flags” and excluding the fund you are invested in from the figures they publish. He also exposes a number of more aggressive ways in which fund managers act to the detriment of their clients. Asset managers may move poor performing assets out of their flagship portfolios into less visible funds and may even book their “best bets”, which are potentially very profitable, into the proprietary account of the company they work for. Most asset manager bonuses depend at least in part on the profitability of the company they work for and the return they can show on a particular date, for example at year end. Therefore, the temptation exists to inflate this year’s returns in order to receive a big bonus, even if they have to sacrifice some return in the next year (Carhart, Kaniel, Mustro & Reed 1999:6). In the same vein, asset managers also buy shares from favorite stock brokers at less than favorable prices. Very often this behavior has a strong profit motive, as numerous managers receive a rebate or “kickback” from stock brokers they deal with.

I believe these accounts of the incidence of market manipulation or performance manipulation in South Africa provide a lot of credence to the claims made by Mr Blank and Mr Botha. There is also no apparent incentive for these individuals to lie, as none of them was accused of any wrongdoing and the claims they made were made for public consumption. Claims that

Mr Blank and Mr Botha only made their statements about widespread opportunistic behavior in the financial markets in which they operated in order to justify their own guilt, therefore seem highly unlikely to be true.

2.6 OTHER OPPORTUNISTIC BEHAVIOR

One might ask whether or not extreme opportunism is limited to the investment banks and their wild traders. We have recently seen, in South Africa, that extreme opportunism is also a factor in other financial services sectors. In 2006, revelations of even mundane fund administrators engaging in opportunistic behavior shocked the pension fund industry. Following some investigative journalism by Bruce Cameron, it was revealed that administrators of retirement funds illegally made secret profits for themselves through the practice of bulking. Bulking in South Africa refers to a practice used by pension fund administrators, whereby they would pool the cash assets of their clients in order to negotiate a higher rate of return on the assets, without feeding the higher income through to the clients to whom the cash belongs or getting agreement for the practice from the client (Rose 2006: 1-4). The pension fund registrar in South Africa estimates that 60% of the large administrators in the country participated in this illegal practice. In another article (see Annexure B) Cameron also points out that bulking is only one of numerous illicit ways in which highly respected financial services companies swindle their clients out of their retirement and other savings. Is there a difference between the opportunism pointed out by Lori Richards in the US (see page 12) and that highlighted by Cameron (Crenshaw 2005: 1-3)?

2.7 SUMMARY

The essence of what Mr Blank and Mr Botha are trying to tell the world is that what they did was common practice at the time and that enforcement of regulation is selective. In this chapter, we provided ample evidence from other respected market participants, who support their claims of widespread opportunistic behavior in the form of, among other things, market manipulation and window dressing by institutions. There are also definite indications that the regulatory authorities and the judiciary appear to not always be equally vigilant or even-handed when large institutions are involved, or appear to be involved, in questionable market practices. It is furthermore fairly clear that the actions of these so-called rogues can at least in part be attributed to conduct and behavior that they could have learned at their places of employment. It is quite clear that a culture of opportunism existed in the financial markets in South Africa and that the formal and informal restraints were, at best, ineffective and inconsistent.

David Schapiro also made another comment in the same interview mentioned previously, commenting on a small transaction that went through the Johannesburg Stock Exchange (JSE) at a price twenty five percent (25%) higher than the ruling price. He said “I know that a lot of progress has been made on insider trading, but when you sit in front of the screens the whole day, there are many, many times or instances where we see shares running up well ahead of announcements or results. It still happens. How do you stop it? I don’t know. But I think even small instances like this, where there were only 3,700 shares, they have to start making examples and they have to look

into it. And dig down, so they stop these trades happening" (Anderson 2004: 2). Clearly not a practice limited to a few rogue traders.

The motivation in these cases appears to be money and the power, status, etc. associated with it. On the facilitation side, we can construct an extensive list. The different opportunistic practices in South Africa and abroad are not isolated at all. In the time of Mr Blank, others before him who conducted far worse activities came off with little more than a slap on the wrist. Role models for the potential opportunists were ample and successful, while formal and informal regulations were inconsistent, bordering on the non-existent. Similarly, the criminality of the different opportunistic practices, were not clear-cut at all, fueling an opportunistic culture and allowing opportunists to easily justify their activities. There are very few, if any, strong inhibitors to curtail extreme opportunism. Even the heavy sentence imposed on Mr Blank would have had little effect, as it is still a matter of debate if he would have been found guilty in a fair trial. Enforcement needs to be clear and consistent in order to act as an inhibitor for extreme opportunism. The persistent display of opportunism in South Africa and abroad, among a diverse field of financial market participants, is further evidence of the lack, or ineffectiveness, of inhibitors of opportunistic behavior.

CHAPTER 3

THE SOMITOMO INCIDENT

3.1 INTRODUCTION

From South Africa we move on to the rest of the world to get an international perspective. On the 28th of March 1998, halfway around the world, a group of traders and executives working for the largest stock broking firm in the world, the London-based Nomura International, tried to drive down the value of a basket of shares listed on the Australian Stock Exchange (ASE) by selling a matching basket of shares totaling USD 600 million a few minutes before the market closed. The USD 600 million represented more than the total trading that normally takes place in one day on the Australian Stock Exchange (ASE) (Hills 1998: 1-3). The concept was simple: Nomura amassed a portfolio of USD 600 million in futures contracts that were expiring on the 28th of March 1998. The futures portfolio would increase in value if the All Ordinary Share (All Ord) index of the Australian Stock Exchange (ASE) fell. The USD 600 million in question was apparently the largest futures parcel ever put together on the Australian Futures Exchange. Selling the matching parcel of underlying securities on the Australian Stock Exchange (ASE) would virtually assure a substantial drop in the ordinary share index, increasing the value of the matching USD 600 million futures portfolio. However, as Greg Blank experienced, sometimes the best laid plans don't work out. Due to a combination of factors, Nomura were only able to dump +/- USD 450 million worth of shares, and the index only fell 26 points or around one percent in the last 30

minutes of trading on the 28th of March 1996. Although the profits for Nomura were less than expected, it must still have been substantial as the key players, Channon, Moss and Mapstone, reportedly received several million dollars in bonuses. The Australian authorities reacted strongly against Nomura and on the 11th of December 1998 the Sydney Morning Herald reported that in the Federal Court, Justice Ronald Sackville found that Nomura (International) Plc, the oldest and largest financial conglomerate in the world, was “not simply using accepted or standard market techniques to achieve legitimate commercial objectives” and that “Nomura engaged in deliberately misleading conduct designed to achieve illegitimate ends” (Hills 1998: 1-3).

Nomura was, however, no stranger to controversy. In July of 1997 the company agreed to pay USD 84 million to Orange County, California. Orange County suffered a USD 1, 6 billion loss in December of 1994 resulting from speculation in high risk securities (Bruce 2004: 96-101). In June of 1997 Nomura was also making news headlines for all the wrong reasons. In Tokyo charges were filed against two former senior officials of the bank for apparently paying a racketeer to prevent a shareholder meeting from being disrupted, presumably by unhappy shareholders. Its trading privileges on the Tokyo Stock Exchange (TSE) were also curtailed, resultant from payments made to a gangster. The individual in question was apparently compensated for trading losses (Hills 1998: 3). I believe it is safe to say that a culture of extreme opportunism did indeed exist at Nomura – could it also be found in other international firms? The answer is yes.

On the 26th of March 1998, two years and two months after the massive Nomura positions matured Yasuo “The Hammer” Hamanaka (also known as Mr 5%) was sentenced in a Tokyo District Court to an eight-year prison term (Farukawa 1999: 1-2). From around 1984 until his discovery in 1996, Mr Hamanaka engaged in a range of activities that culminated in a loss of more than USD two and a half billion to Sumitomo Corporation (Tschoegl 2000: 103-121). Sumitomo, at the time, was the world’s largest trading firm in physical copper (Weston 2003: 1-5). In the London Metal Exchange forward market for copper, participating firms would normally have a three-month exposure through the buying or selling of an options contract. These positions could, however, be rolled over, whereby losses or profits could be deferred through deferring the settlement date. The trading team, of which Mr Hamanaka later became the head, traded around 500 000 metric tons of copper per year, a figure that represented approximately 5% of the total annual global demand for copper. The firm of Sumitomo was very proud of their position as the dominant player in the copper market and attributed their dominance to their “...expertise in risk management”. In this case study we will analyze the events that culminated in the eventual loss. By analyzing the evidence led and outcomes of court cases and disciplinary action by regulatory authorities in Japan, the United States and the United Kingdom, as well as relevant newspaper and academic articles, we will construct a model of events that will assist us in determining if this loss could be attributed to the actions of a rogue trader at work or to the culmination of other factors and the actions or inactions of other role players involved.

3.2 THE TRIAL OF YASAO HAMANAKA

Yasuo Hamanaka pleaded guilty to charges of forgery and fraud and, in March of 1998, he was sentenced to 8 years' imprisonment with hard labor less the 400 days he had already served at the date of sentencing (Farukawa 1999: 1-2). During his trial, however, it emerged from evidence given by Mr Hamanaka that during 1985 the head of Sumitomo's copper dealing team at the time, Mr Steve Shimizu, was the one who proposed speculative trading to Mr Hamanaka as a way to recoup pre-existing losses resultant from physical trading activities (Farukawa 1997e: 1-2). Mr Hamanaka testified that Mr Shimizu said that unauthorized futures trading was the only possible way to recoup the copper team's existing losses. Mr Hamanaka also testified that, at that time, he suspected that his superior, Mr Shimizu, was already conducting speculative transactions to recoup losses, as his volumes of trading were "more than normal". By March 1986 the losses of the Sumitomo copper trading team rose to around USD 50 million. At that time the decision was made by Mr Shimizu and Mr Hamanaka not to reveal the losses to their superiors, as they were "too great". At that time fate dealt Mr Hamanaka a cruel blow. Mr Shimizu was to be reassigned to Manila by Sumitomo and he decided to resign, leaving Mr Hamanaka to handle the losses. Mr Hamanaka further testified that, although the task was initially daunting, he was convinced that over time he could make back the losses through careful and cautious futures trading. Mr Shimizu testified that he was well aware of the fact that Mr Hamanaka would be left to shoulder the responsibility for the USD 50 million in accumulated losses. He also suggested a hypothetical limit that would have triggered disclosure to his superiors, by saying that it would probably be around USD 100 million

(Farukawa 1997d: 1-2). Another interesting point that emerged from the testimony of Mr Shimizu was his contention that “all data concerning transactions and contracts were entered into Sumitomo’s computer system”(1997d:1), alluding to the fact that with proper oversight and risk management these transactions should have been detected. During the trial it also emerged that Mr Shimizu set up his own firm, Scat Ltd, which conducted business with Sumitomo. As a result of such transactions, Mr Hamanaka was paid a portion of the profits made by Scat. It appears that the court viewed the acceptance of money without company approval as an indicator of the way Mr Hamanaka conducted his affairs.

According to the 1997 testimony of Yoshio Takeuchi, the then assistant general manager nonferrous metal, chemicals and petroleum group of Sumitomo, there were newspaper articles in the British press that claimed that Sumitomo were acquiring massive positions in copper warrants on the London Metal Exchange (LME) (Furukawa 1997a: 1). This, according to Mr Takeuchi’s testimony, sparked an internal investigation by Sumitomo. The internal investigation, aimed at determining if Sumitomo were manipulating the copper market, found that those allegations of market manipulation were unfounded and untrue. A few weeks later, Mr Takeuchi was on the stand again (Farukawa 1997b: 1). This time he testified to the fact that Sumitomo Head Office in Japan had an agreement with its subsidiaries, like Hong Kong, where contracts that exceeded credit lines could only be approved after a process of mutual consultation. This limit was, in the 1980s, set at USD 1million for the Hong Kong subsidiary but was, however, changed in 1994 after Mr Hamanaka regularly exceeded his limits, in one instance by USD 100 million in a transaction with Credit

Lyonnais Rouse (CLR). Mr Takeuchi testified that the General Manager of credit and controlling was alerted to this transaction, but took no real action other than rapping Mr Hamanaka over the knuckles. Mr Hamanaka's defense proved that all the Hong Kong subsidiaries' transactions were conducted under instructions and with the funding of Tokyo. When confronted with Sumitomo records of numerous transactions conducted by Mr Hamanaka that exceeded his trading limits, Mr Takeuchi responded by saying he could not remember, did not know or that he "...was not in a position to be able to know". These bouts of amnesia also affected other Sumitomo executives.

During the trial, the former credit manager for Sumitomo Corporation, Mr Hiroshi Nishino, was questioned by Mr Hamanaka's defense team on how it was possible that all these massive positions remained hidden from himself and senior management at Sumitomo (Farukawa 1997c: 1). During questioning that lasted nearly two hours, Mr Nishino's standard responses to virtually all the questions that were put to him was either "I don't remember", "I have no memory of it" or "I have no recollection of it" and, when he was shown incriminating documents, he responded with "I have never seen it". Some of the documents related to the huge copper transactions that were shown to Mr Nishino included correspondence between the president of Sumitomo and the president of its Hong Kong subsidiary, clearly indicating their knowledge of at least some of these very large transactions. Similarly, when asked how he as head of credit missed the transactions between Credit Lyonnais Rouse and Morgan Guaranty Trust & Co, in a regime where all transactions by any subsidiary over USD 20 million needed approval from Tokyo, Mr Nishino's memory failed him.

Similarly, Mr Hamanaka's defense also proved that senior management was at least aware of one suspicious transaction of USD 320 million that was detected as an unpaid account during September of 1993. At roughly the same time, credit lines were set for all dealers and brokers with whom Sumitomo was dealing. When questioned on this, Mr Nishino's response was one of denying that such a document was ever sent by his staff to Tokyo on his orders. In 1994 numerous efforts to obtain letters of approval from Tokyo for extraordinary transactions (one can assume executed by Mr Hamanaka) were fruitless. It is clear from the evidence presented by Mr Hamanaka's defense that there were numerous occasions when his transactions could have been detected over an extended period of time. It is, therefore, not surprising that in May of 1998 the United States Commodity Futures Trading Commission (CFTC) took action against Sumitomo Corporation for manipulating the copper market. Sumitomo eventually had to pay the FSA GBP 5 million to cover its time and effort and had to pay the CFTC USD 125 million (Verity 1998: 1). A mere slap on the wrist for the multibillion dollar multinational.

3.3 US & UK REGULATORY RESPONSES

During 1995 both the US Commodities Futures Trading Commission (CFTC) and the Securities Investment Board (SIB) in the UK initiated investigations into the behavior of the international copper price (Tschoegl 2004). These investigations eventually led to action taken against firms in both the UK and USA. The SIB was later known as the Securities and Finance Authority Limited (SFA).

3.3.1 MERRILL LYNCH INTERNATIONAL, INC AND MERRILL LYNCH PIERCE FENNER & SMITH (BROKERS & DEALERS), LTD.

On the 30th of June 1999 the CFTC announced that an administrative enforcement action had been settled with the two Merrill Lynch companies. Without admitting or denying the allegations, the two companies agreed to the order being entered into the CFTC records (CFTC Release 1999:1-2). The order found that, at minimum, these two firms assisted Sumitomo Corporation and other firms in the following respects:

“by providing more than one half billion dollars of credit and finance to the manipulators, which the manipulators used to purchase and hold a dominant position in futures contracts and London Metal Exchange warehouse stocks of copper; by providing trading facilities, accounts and trading capacity through which the manipulators acquired their dominant position in a combination of futures contracts and warehouse stocks, and through which the manipulators sold or lent a small portion of their holdings at artificially high absolute prices and artificially high backward dated spread price differentials; and by providing trading advice which the manipulators used in the execution of their strategy of withholding their copper from the market.”

The CFTC findings also make it clear that “...Merrill (B&D) and Merrill International possessed the requisite knowledge and intent to find that they aided and abetted the manipulators’ violations. In addition, the Order finds that Merrill (B&D) benefited from the manipulation by providing financing, trading facilities and credit to the manipulators, and by earning profits

through its proprietary trading” (CFTC Release 1999:1-2). It is very clear from the wording used by the CFTC that they do not view these actions as a “rogue” event. This was a very clear strategy that was well planned, extensively funded and meticulously executed over an extended period of time. Merril Lynch agreed to pay a USD 15 million penalty to CFTC and a further USD 10 million to the London Metal Exchange (LME). CNN Money (June 30 1999: 1-2) reported that Merrill Lynch claimed they entered into the settlement as it was to avoid the “expense” and “distraction” that a drawn-out court case could entail, after initially dismissing CFTC allegations as groundless.

3.3.2 RUDOLF WOLFF & CO. LTD, TADAYOSHI TAZAKI, WILLIAM HARKER, AND JOHN WOLF

On the first of March 2000 the Securities and Futures Authority in the United Kingdom announced penalties imposed on a number of firms and individuals (SFA 2000: 1-2). These penalties resulted from proceedings instituted during November of 1997, following an investigation into the dealings of these firms with Sumitomo Corporation and Mr Hamanaka, the general manager at the time of the non-ferrous metals department, in particular. Mr Harker and Mr Wolff were both reprimanded and fined GBP 30 000 and GBP 15 000 respectively and had to make contributions of GBP 15 000 and GBP 6 000 to the SFA’s costs. Mr Tazaki lost his SFA registration for a period of seven years, during which he also could not register with the SFA in any other capacity. He was also fined GBP 45 000 and had to contribute GBP 5 000 to SFA costs. Similarly, the firm of Rudolf Wolff & Co. Limited was reprimanded and fined GBP 375 000 over and

above a contribution of GBP 125 000 that they had to make towards the expenses incurred by the SFA. In essence, the abovementioned individuals and firms that were penalized admitted to breaching a number of SFA principles. This included failing to “act with due skill, care and diligence” to “observe high standards of market conduct” and to “organize their affairs in a responsible manner” (SFA 2000: 7).

During the SFA investigation it became clear that the relationship between Rudolf Wolff & Company, as a firm, and some of its staff with Sumitomo was essentially corrupt in nature. A large portion of its business consisted of fictitious “cross trades”, which were essentially accounting entries that created a false perception of turnover. It was furthermore found that SCAT, the company owned by Mr Shimizu, was appointed as a consultant to Rudolf Wolff & Company and, on at least one occasion, money from a Sumitomo account managed by Rudolf Wolff & Company was paid to SCAT under instructions from Mr Hamanaka. No-one ever confirmed that these instructions were authorized. Rudolf Wolff & Company also provided Sumitomo with false trading volume confirmations over a 5-year period between April of 1991 and April of 1996. The information used in the confirmations was information supplied by Mr Hamanaka and was never checked. Similarly, Rudolf Wolff & Company staff provided Sumitomo with month-end confirmations of its copper trading activities without actually confirming that the confirmations sought by Sumitomo tied up with actual transactions that were executed. In essence, Rudolf Wolff & Company provided third party confirmation to Mr Hamanaka of transactions that never took place. Similarly, Rudolf Wolff KK, the Japanese subsidiary of Rudolf Wolff & Company, admitted to providing Sumitomo (usually on the request

of Mr Hamanaka) with numerous false documents over the 5-year period from 1991 to 1996. These false documents included confirmations of the existence of fictitious copper warrants, confirmations of fictitious transactions, as well as false or incorrect invoices and “difference” accounts (SFA 2000: 1-7). An internal memo from Mr Tsukuda, a director for Rudolf Wolff KK, to Mr Tazaki, the managing director, clearly indicated that confirmations of Sumitomo positions were signed without the supporting documentation attached and that both Rudolf Wolff KK and Mr Hamanaka were aware that the warrant holdings that were confirmed referred to non-existent positions. It also made it clear that Mr Hamanaka’s requests for the altering of trade dates and confirmations for non-existent transfers was done without the knowledge of Sumitomo. One possible explanation for the reasons behind the assistance provided to Mr Hamanaka might be found in his authorization of the use of USD 500 000 of Sumitomo’s funds to invest in TAO, a “fund management vehicle”, established by Rudolf Wolff & Company.

3.3.3 THE JP MORGAN LOAN

In April of 2002, without admitting liability, JP Morgan agreed to pay more than USD 120 million to Sumitomo Corporation. This payment resulted from claims by Sumitomo Corporation that JP Morgan assisted Hamanaka in his activities by providing him with a “loan” of more than USD 150 million during 1994 (Killick 2002: 1-4). Sumitomo argued that the “loan” was disguised as a “series of copper transactions” that had an initial premium (the loan) of USD 154 million payable to Sumitomo attached to it. By structuring it in such a way, Sumitomo argued that it was virtually

impossible for their auditors to detect the loan. The effective interest rate charged by JP Morgan was also “hundreds of basis points” more than what Sumitomo would normally pay in the markets for such loans. This led Sumitomo to suspect that those at JP Morgan involved in the transactions had to have guessed that Mr Hamanaka was desperate and acting without authorization. One of the JP Morgan bankers, Ms Kieran Sykes, had done business with Mr Hamanaka at her previous firm, ING. During 1993 she assisted Mr Hamanaka to secure a USD 100 million line of credit from ING. There were, however, one or two oddities around this loan. In the first instance, the banking fees of USD 750 000 for the Sumitomo loan were paid by a UK firm called Winchester Commodities and, secondly, there was no second signature on the Sumitomo request for the loan. When the loan came up for renewal, a senior official from ING was dispatched to Tokyo to secure a signature from a Sumitomo main board director before ING would be prepared to renew the facility. Mr Hamanaka’s response was odd, to say the least, and the official was not allowed access into the Sumitomo building by Mr Hamanaka. In response, ING cancelled the loan, but took no steps to advise Sumitomo of the treatment their banker received. Another interesting twist in this event is the fact that, on the day that the JP Morgan facility was approved, Winchester Commodities made a payment of USD 100 000 to a firm registered in the British Virgin Isles belonging to Ms Sykes. Ms Sykes denied that the two events were tied to one another in any way, thereby denying that she was paid a fee or a bribe.

3.4 HOW DID HE LOSE THE MONEY?

The initial losses incurred by Sumitomo's copper division resulted from the trading of physical copper in the Philippines (Weston 2003:1-5). In order to recoup these losses, Mr Shimizu began speculating on derivatives through the LME. The losses of the copper section had, however, risen in 1987 to USD 58 million and we know that Mr Shimizu had by then resigned.

During 1993 Mr Hamanaka engaged in the unauthorized sale of deep in the money put options, to Morgan Guaranty Trust and lost USD 393 million on the transaction. This method of funding was also used by others, including Mr Leeson and Mr Rusnak, and will be discussed in detail later in this thesis. During 1994 Mr Hamanaka ran out of funds again and this time he started selling a combination of puts and calls in order to raise USD 150 million. Mr Nick Leeson also sold a combination of puts and calls called a straddle. In my interview with him, he confirmed to me that he chose this instrument because of the high premium he could generate out of it. One can only assume that Mr Hamanaka used this combination of instruments for the same reason. In the case of Mr Leeson, his losses resultant from using these instruments greatly contributed to the demise of Barings Bank in 1995. In the case of Mr Hamanaka, the losses that resulted from the sale of these puts and calls amounted to USD 253 million.

In August of 1998 Sumitomo agreed to pay USD 99 million following legal action taken against it in a New York court and followed it up with a payment of USD 42.5 million after similar action in a Californian court. The applicants in these actions alleged that Sumitomo Corporation, with the

assistance of a firm called Global Minerals, manipulated the copper market between 1994 and 1996 (Weston 2003: 1-5). In essence, an artificial copper shortage was created through the purchasing of physical copper, by taking delivery of option and future contracts and storing the copper in LME warehouses. Mr Hamanaka resisted speculators like George Soros, who were trying to short the market by selling copper that they didn't have at lower than market prices, with the hope that they could buy the copper at the time of delivery at even lower prices. Mr Hamanaka, however, used the extensive resources and, more importantly perhaps, credit-worthiness of Sumitomo to buy the other side of these options sold by the speculators, thereby neutralizing the downward pressure created by these sales. When Mr Hamanaka was removed from his position in May of 1995, no-one was countering the short selling and the copper price collapsed. This collapse caused copper prices to drop sharply, causing massive losses resulting from Mr Hamanaka's positions that were dependent on high copper prices. Total losses to Sumitomo eventually rose to the unprecedented amount of more than USD 2.5 billion.

3.5 WERE THERE ANY WARNINGS?

One of the first indications that something was amiss came in 1991, when David Threlkeld, a metal broker trading on the LME, reported a request by Mr Hamanaka for an invoice for non-existent trades (Weston 2003 :1-5). As we know from the trial, Sumitomo was advised but did nothing about it. This was, however, not all. In 1994 the SFA investigated the trading activities of Winchester Commodities and a Chilean trader acting for a firm called Codelco. During this investigation they uncovered the fact that Winchester

made virtually all their profits from their broking activities for Sumitomo. This information was purportedly shared with Sumitomo but elicited no apparent response. The third warning was probably the most compelling. By early 1996 both the UK and USA regulators expressed concerns about the behavior of the copper price. As mentioned earlier, production was outstripping demand by a substantial margin and the price of copper kept on rising. It is difficult to believe that, as the largest player in the copper market globally, the executives of the firm that would have had access to most research on the behavior of the copper price did not seriously question this anomaly, unless they were aware of or at least suspected the reason for it.

3.6 SUMMARY

How is it possible for the executives of a firm that prides itself on being the largest and most dominant player in a particular industry not to know how they attained and maintained their position? Why, even when made aware of very large and repeated transgressions of trading limits, was nothing done? In this chapter, we have seen that Mr Hamanaka was not the initiator of the events that led to one of the largest losses in corporate history. The initial losses were created not by himself, nor did he invent the “solution” to the dilemma his superior created. He learned from his superior how to behave, who in all probability learned from someone else that hiding your losses is an acceptable practice. We also find that, according to the CFTC, some of the largest financial institutions in the world, Merrill Lynch and JP Morgan, were actively involved in assisting Mr Hamanaka in his efforts to manipulate the copper market, an exercise he believed would give him the competitive edge that would allow him to make back the massive losses he was sitting

on. It is also an enigma how Mr Hamanaka's superiors and the board of directors can plead ignorance to how their firm managed a stranglehold on the world's copper market over many years. There is evidence to support the view that Sumitomo was, in all probability, aware of the fact that Mr Hamanaka was trying to manipulate the copper market and also allowed him to operate outside the internal rules and limits with impunity. In what became something of a trademark for many of the events we will analyze in later chapters, we find that Mr Hamanaka incurred very large losses resultant from the sale of deep in the money options. He sold deep in the money options to generate financing for the positions he was holding or wanted to take.

Market manipulation appears to be part and parcel of the strategies employed by financial market operators, in their pursuit of personal wealth and corporate profits. We have seen here a number of different companies, all very successful and "respectable", which operate on a multinational and global level over a range of jurisdictions. The markets are largely impersonal and it is very difficult to identify "victims" of these opportunistic behaviors. It is very difficult to portray Sumitomo or Nomura as typical victims, as they appear to be active participants rather than hapless victims, and are at least as liable as the so-called rogues. Rewards are substantial for those who succeed, while informal and even formal restraints are weak and ineffective. There is a definite imbalance between the facilitator side and the inhibitor side in an environment of very strong motivators like preserving face, especially in the Japanese culture.

CHAPTER 4

TOSHIHIDE IGUCHI AND DAIWA BANK

4.1 INTRODUCTION

On the 13th of July 1995, a mere three months after the arrest in Germany of Nick Leeson, Barings Bank’s “star” trader, the executive vice president of Daiwa Bank’s New York branch, confessed in a letter to the president of his bank the fact that he had, over an 11-year period, lost the bank an estimated USD 1.1 billion. In this chapter we will analyze the events that led up to and followed Mr Iguchi’s confession, with special attention to the corporate environment in which he had to operate. Newspaper and other articles, magazine interviews, court records and Mr Iguchi’s own account of the events at Daiwa Bank will be used to determine the corporate culture at Daiwa Bank at the time of Mr Iguchi’s tenure at the bank.

4.2 HISTORICAL PERSPECTIVE

Toshihide Iguchi was born in Kobe in Japan (coincidentally, the city that was hit by an earthquake during 1995). He became a US citizen and majored in psychology at Southwest Missouri State University in Springfield USA (Jameson 2001b: 1-4). In 1974 he joined the New York branch of Daiwa and in 1977 he was put in charge of the custody department (Nanto, Jackson, Wells 1995: 4). In 1980 he was placed in charge of securities trading and in 1984 was promoted to the position of trader and he started trading in US Government bonds. He however retained his back office duties and went on

to supervise the New York back office up until 1995. In this period of controlling both front and back offices Mr Iguchi, according to his own confession, conducted more than 30 000 unauthorized transactions (TIME 1997: 1). The original loss was incurred in 1984 and amounted to USD 200 000 at the time. However, as Mr Iguchi tried to trade himself out of this loss, it grew to over USD 1 billion in the eleven-year period (Asiaweek.com 1995: 1).

Mr Iguchi was described as a workaholic and, although he was divorced, he was granted custody of his two sons (TIME 1995: 1-3) and stayed in a USD 300 000 house in Kinnelon, New Jersey. The New York office that opened in 1950 initially only dealt in US treasury securities as a service to their pension fund clients. During the 1980s, however, Daiwa became a major player in the US government debt market and the firm was designated as a primary dealer in 1986. A Primary dealer is “a designation given by the Federal Reserve System to commercial banks or broker/dealers who meet specific criteria, including capital requirements and participation in Treasury auctions” (Investopedia).

4.3 THE ROLE OF THE REGULATORS

Mr Iguchi placed a large portion of the blame on the ineptness of the formal regulators, both in Japan and in the USA. He used specific examples to illustrate this. In one case during 1992, an inspection by US Federal Reserve Bank regulators that was supposed to last two days only lasted 15 minutes. Mr Iguchi also claimed that one of the Federal officials smelled strongly of alcohol (Kattoulas 1997: 1). Mr Iguchi also accounts that he believed that

the US Federal authorities suspected Daiwa of improper conduct as far back as 1993 and that Daiwa also made concerted efforts, such as filling his trading room with cardboard boxes, to conceal the existence of his trading room in New York. The failure of the formal regulators was not, however, limited to the US. During 1994 an inspection to the New York offices of Daiwa, conducted by inspectors from the Japanese Ministry of Finance and which was supposed to last a week, was wrapped up in a day – apparently to allow time for the inspectors to fit in a visit to Las Vegas. (Maybe they wanted to see some real gamblers in action.)

4.4 THE ROLE OF MANAGEMENT

During an interview with TIME Magazine Mr Iguchi accounts that, before 1992, there were about six or seven cases of unauthorized trading at Daiwa Bank that led to losses of between USD 100 million and 300 million each. In not one of these cases were those responsible either charged or arrested (1997:1). Another interesting characteristic of the Iguchi affair was the fact that the transactions executed by Mr Iguchi were not intricate derivative transactions. Mr Iguchi was selling and buying the same vanilla type bonds for a period of twelve years and he believed that there were a number of his superiors who had the ability to completely understand exactly what he was doing. The problem in the case of Daiwa, Mr Iguchi pointed out in his interview with TIME (1997: 1), was not a lack or inability to understand, but rather an unwillingness to see. This induced blindness he attributes to the fact that his department accounted for more than 50% of the profits generated by the New York branch of Daiwa and that this dependence on his profits is at the root of the problem.

However, this all changed in 1995 when Mr Iguchi advised the President of Daiwa, Mr Akiri Fujita, of his activities (Kane & De Trask 1998: 19). In a letter in Japanese addressed to the President of Daiwa, Mr Iguchi (in his own words) made an “honest confession” of his activities. This letter, commonly referred to as “the confession letter”, was incidentally sent only a few months after the collapse in February of 1995 and the subsequent arrest of Mr Nick Leeson, the General Manager of Barings Securities Singapore. During the proceedings of a Federal Grand Jury and subsequent court procedures, a tale unfolded itself reminiscent of those we normally find in spy novels (USA v. Daiwa Bank 1995: 1-21).

In evidence led before US courts it was revealed that, over a period of nearly two months, no less than five letters were drafted by Mr Iguchi. The first letter, drafted before July 21 1995, was the initial “confession letter” that started the whole process and was written of Mr Iguchi’s own accord. The fifth and last “revised confession letter” was written on instruction from Mr Iguchi’s General Manager, Mr Masahiro Tsuda. According to evidence led, the first “confession letter” stated that Mr Iguchi, as an employee of the New York Branch of Daiwa Bank, caused losses of just over USD 1 billion from the trading in United States Treasury bonds. Mr Iguchi stated further that he concealed his losses by selling treasury bonds that the bank was holding on behalf of its clients. As the custodian bank for clients, the bank was tasked with the duty of the safekeeping of securities belonging to its clients. In his “confession letter” Mr Iguchi identified the United States Treasury Obligations that he sold from a Bankers Trust account, together with the ultimate owners of the sold securities. Mr Iguchi revealed that,

without authorization, he sold USD 377 million worth of United States Treasury Obligations (USA v. Daiwa Bank 1995: 7).

The owners of the US treasury obligations were entitled to routine coupon payments on their bonds from the Federal Treasury and also the market value of the securities in the event that they sold the US Treasury Obligations they owned or thought they owned. In order to fund the Daiwa customers in the event of a sale or a coupon payment, Mr Iguchi sold the US Treasury Obligations of other clients in order to raise the required amount of cash that he needed. In his “confession letter” Mr Iguchi not only spelled out the losses he incurred – he also warned his superiors against the possibility of detection by the US authorities and states that, without him being present and able to handle the situation, an investigation would be a certainty. This would be triggered by any sale of securities no longer there or a coupon payment due to clients whose bonds he sold to finance an earlier transaction. He went further and warned of dire consequences for the bank if the matter was handled outside the realm of Daiwa and the Japanese authorities, as a result of the “current relationship” between the US and Japan, which we can only assume was not warm. Mr Iguchi did, however, provide a solution to this problem. In the first instance, he made it clear that he needed to be there as the architect of the problem to ensure the unauthorized trades remained undetected over the short term and he also proposed a permanent remedy for the dilemma. He suggested to the powers that be at Daiwa to replace the securities that he sold without authorization to ensure that the loss would not appear on the books of Daiwa’s New York branch and could, therefore, not be detected by the US authorities. In his “confession letter” Mr Iguchi also played his trump card by refreshing the Daiwa President’s memory of

similar events of unlawful conduct at Daiwa including, as he phrased it, a “big accident” that was concealed in the past. This obviously substantial trading loss was concealed through the filing of, among other things, “false documents to US Federal Reserve” and other acts necessary to deceive the US authorities (1995: 8). Mr Iguchi followed this “confession letter” up with a second letter in which he assured the President of Daiwa that, based on his experience, there was no possibility of detection by the US authorities if Daiwa bought back the missing securities.

With this as a backdrop it is, therefore, not surprising that on the 24th of July 1995 Mr Iguchi was contacted by a trio of Daiwa officials via telephone to discuss the two letters that he sent to the President of Daiwa. The trio included no less than the Deputy President of Daiwa, one of the Managing Directors of Daiwa and the General Manager of the International Treasury Division. During this conversation, the state alleged it was made clear to Mr Iguchi that the New York Branch of Daiwa had to be removed from the equation and Mr Iguchi was asked for his assistance and some suggestions on how best to accomplish this and to keep on concealing the loss from detection by the US authorities. This elicited a third letter from Mr Iguchi, dated 25th of July 1995, which was now addressed to the Deputy President of Daiwa, who it appears had taken charge of this matter. In his letter, Mr Iguchi warned against fiddling the books of Daiwa New York, as this would be committing an offense clearly falling under the jurisdiction of the US authorities. It is clear from this warning that Mr Iguchi felt that the only way of mending the situation was to replace the missing securities. In response, the Managing Director involved contacted Mr Iguchi by telephone and arranged for a meeting in New York. This meeting took place around the

28th of July 1995 at the Park Lane Hotel in New York. Present were the Managing Director involved, the President of the Daiwa Trust, the General Manager of the New York Branch of Daiwa and, obviously, Mr Iguchi. During the meeting, the State alleged that the Managing Director involved disclosed that Daiwa intended to announce the loss in late November, after the announcement of the Daiwa half-yearly results scheduled for 30th September 1995. He assured those present that no-one would be prejudiced and he also enquired from Mr Iguchi if he would be willing to accept a transfer to an affiliate of Daiwa in Japan. Mr Iguchi pointed out to those present the interest-bearing nature of the missing US Treasury Obligations, which entitles the rightful owners of these securities to predetermined periodic interest payments. If the missing securities remained secret, it would necessitate the selling of more securities to generate the funds required. The Managing Director involved gave Mr Iguchi the go-ahead to continue selling the necessary securities to ensure that payments could be made to clients, as and when was necessary. He also went further and instructed Mr Iguchi to do whatever necessary to conceal the USD 1.1 billion loss and asked him to also prepare a detailed letter containing the events that surrounded the loss (1995:9).

This meeting was followed by the meeting that took place at the Park Lane hotel in New York around the 29th of July 1995. As instructed, Mr Iguchi had produced a detailed account (the “Fourth Iguchi Letter”), of how he incurred the initial losses and how he covered them up though the unauthorized sale of securities belonging to clients, as well as Daiwa’s proprietary stock and through entering false information into the books of Daiwa New York.

One of the crucial means of deception described in the “Fourth Iguchi Letter” was falsifying the Bankers Trust accounts that reflected the actual holdings of United States Treasury Obligations held on behalf of Daiwa and its clients. Because of the time it took to falsify these Bankers Trust reports by hand (obviously using a typewriter), Mr Iguchi turned to technology and used a word processor, which allowed him to only change the necessary areas once he had the original loaded. Mr Iguchi provided the original Bankers Trust statements to his superiors at the meeting. Through these, they could verify that the extent of the “missing” securities was nearly USD 600 million in short-term United States Treasury Obligations. Of this amount, +/- USD 377 million belonged to Daiwa clients and +/- USD 134 million was the property of Daiwa itself. After satisfying themselves as to the exact extent of the missing obligations, Mr Iguchi was instructed by the General Manager involved to destroy the computer disk on which he prepared his confession letter (one can only assume he referred to all four letters). A few days later, purportedly around the fourth of August 1995, Mr Iguchi once again received instructions from Mr Tsuda. He was, firstly, instructed to draft an undated confession letter in which he only discusses his own fraud, losses and unauthorized activities, and he was also instructed not to discuss any of the omitted issues with anybody. The amended letter (the Fifth Iguchi Letter) was subsequently drafted by Mr Iguchi.

Once in possession of the sanitized letter, the executives of the bank decided it was time to reveal their “problem” to the authorities. On the 8th of August 1995 the President of Daiwa informed the Banking Bureau Chief of the Japanese Ministry of Finance, Mr Yoshimasa Nishimura and, on the 18th of September, the matter was reported to the Federal Reserve Bank of New

York by Daiwa and the Japanese regulators (Krane & Detrask 1998: 19). Mr Iguchi was (according to him) not informed of this decision (TIME 1997: 1-3) and to his surprise he was arrested by the US authorities on the 23rd of September 1995.

4.5 THE DAIWA CULTURE

A collection of US authorities, including the New York State Banking Department, the Federal Reserve Bank of New York, the Board of Governors and the Federal Default Insurance Fund, also jointly issued “cease and desist” orders against Daiwa Bank and the Daiwa Trust Company. These orders not only curtailed the activities of these two entities in the US, but also called for an independent forensic investigation to be conducted by an independent firm. As part of their brief, they had to make a thorough assessment of, among other things, the internal controls and risk management procedures. As it turned out, there was more to the Daiwa incident than Toshihide Iguchi.

On the 2nd of November 1995, the US authorities terminated Daiwa’s operations in the US by instructing the company to wind up its operations by February of the next year (Kane & DeTrask 1998: 24). Daiwa was also indicted on 24 charges that included “conspiracy, mail and wire fraud, obstructing the examination of a financial institution, falsification of bank records, failure to report felonies, and the affirmative concealment of felonies”. Daiwa pleaded guilty to these charges on 28th February 1996 and was sentenced to a fine of USD 340 million. Kane & DeTrask (1998:24) quotes from the sentencing of Daiwa by Judge Kaplan: “Daiwa has

manifested extraordinary culpability both with respect to [Iguchi's] scheme, ... and otherwise ... Daiwa bank has acted with exceptional contempt of US law and US regulatory authority. It has refused to cooperate with US authorities to this date. It has little claim on the sympathies of an American court" (1998:24).

The General Manager who attended the meetings in the hotel rooms with Mr Tsuda was also indicted, arrested and charged with "conspiracy to deceive the Federal Reserve by concealing the bank's \$1.1 billion trading loss, making false statements to the Federal Reserve, making false entries in the books and records of Daiwa, and the misprision of a felony". Mr Tsuda pleaded guilty to one count of conspiracy on the 4th of April 1996, for which he was sentenced during October of that year to a fine of USD 100 000 and two months in prison (1998:24).

In a November 30 report prepared for the US Congress it is claimed that, as far back as 1989, Daiwa officials, including Mr Iguchi, were engaged in actions to mislead officers of the New York Banking Department who were conducting an inspection. Their actions included the relocation of traders and back office staff (Nanto, Jackson & Wells 1995:4). These actions were also employed to deceive auditors conducting a 1992 inspection by the Federal Reserve Bank of New York. When examiners from the New York Federal Reserve Bank became aware of the fact that Mr Iguchi was in fact running the securities trading and custody services, the matter was taken up with Daiwa management. In response, the Daiwa management provided Federal officers with written confirmation that the custodial and trading oversight functions had indeed been split. By November of the next year,

Daiwa was once again cautioned by the New York Federal Reserve and the State Banking Department concerning, among other things, the relocation of traders and audit deficiencies in the accounting function at Daiwa New York. During a joint examination, inspectors from the two regulatory bodies were once again assured that Mr Iguchi was only responsible for custody services, while the trading function resorted under another senior Daiwa official.

After Mr Iguchi's July 17 confession to the Chairman of Daiwa, a number of transactions were executed with the approval of senior Daiwa officials. To prevent detection of Mr Iguchi's indiscretions, this included the filing of a false report to the Federal Reserve. By August the 8th of 1995, the Japanese Ministry of Finance was advised, but did not advise their US counterparts until Daiwa advised the New York Federal Reserve Bank on the 18th of September 1995 (1995: 5). It is important to note that, at the time, the Japanese banking crisis was in full swing and an estimated USD 400 billion of non-performing loans were strangling the Japanese banking industry (Asiaweek.com 1995: 2). One of the inherent causes of this massive accumulation of bad debts was the accounting practices of Japanese banks. Japanese banks never adjusted the market value of property held as security downwards, even after such property became virtually worthless. After Mr Iguchi's arrest on September 24th US officials were also alerted to the losses of nearly USD 100 million between 1984 and 1987 that were concealed by Daiwa through using a Cayman Island subsidiary. Some of these losses were the result of unauthorized trading by Daiwa staff. One wonders if Mr Iguchi would have volunteered this information had he been timeously advised by his superiors of their intention to inform the US authorities of his actions.

4.6 WHAT MOTIVATED MR IGUCHI?

During his interview with Time Magazine (1997: 2) Mr Iguchi provide us with important insights into the “motives” for his actions. Initially he tried to recover a loss he made, through a legitimate and authorized transaction. In his mind admitting to the loss would have caused him to “lose face” and possibly his job. The alternative was to keep the loss a secret for a period of time, trade out of the loss, and all would be well. Mr Iguchi also made reference to an obvious, but often discarded, piece of evidence, “No-one ever goes into the market thinking he is going to lose money”. This often overlooked fact is crucial, as it identifies the fundamental driver to Mr Iguchi. His status, self-worth and security depended on his ability to make money, and lots of it. In fact, Mr Iguchi also felt responsible for the status, self-worth and security of a number of people in his firm. According to him, he was responsible for more than half the profits of the New York office and this dependence, in turn, acted as a blindfold to those who should have supervised him. This is evidence of the role of structural deficiencies inherent in the Bank. These facts should also be seen against the backdrop of the fact that Mr Iguchi believed that, by hiding his loss and trading out of it, he was at the worst in violation of a couple of internal rules. He was further strengthened in this belief by his knowledge of at least half a dozen cases of unauthorized trading in his firm, involving amounts of between USD 100 million and USD 300 million. In not one of these cases was anyone arrested or even charged with a crime. According to Mr Iguchi, he only realized as late as 1993 that making a false statement to a Federal examiner was a crime. It is noteworthy that he still appears not to view his unauthorized activities as criminal.

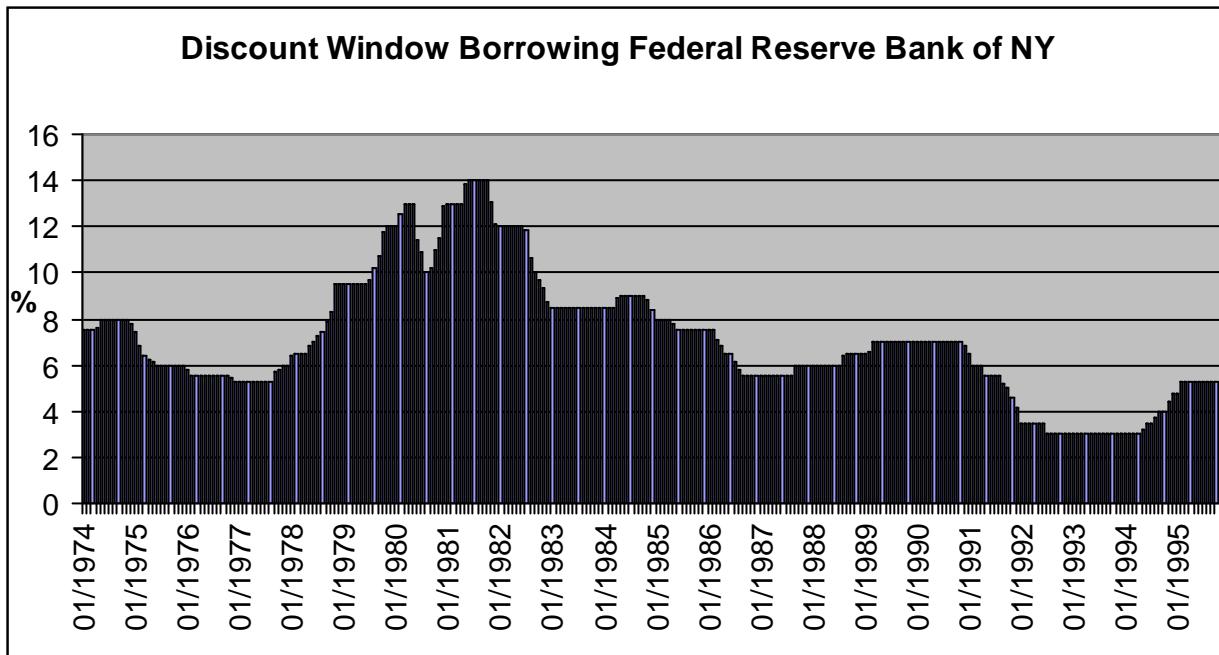
4.7 WHAT PRODUCTS DID HE USE?

There is a school of thought that associates financial collapses with the use of exotic financial instruments. In the case of Mr Iguchi, this appears not to be the case. Mr Iguchi traded US Government Bonds, also known as Treasury Obligations, for twelve years. According to him, there were a number of managers above him who were capable of understanding what he was doing (TIME 1997: 2). There was, however, one report (Asiaweek.com 1995: 1) claiming that Daiwa management admitted to the fact that Mr Iguchi was dealing in derivatives.

4.8 THE MARKETS HE EXPERIENCED

Mr Iguchi primarily traded in US Government Bonds. There is an inverse relationship between the price of a government's bonds and the rate at which that same government is prepared to lend money to its banks through the central bank. This borrowing is referred to as the "discount window" or "repo" rate. In Figure 4 we have a graphic representation of the repo rates of the New York Federal Reserve Bank (Annexure C) from the time Mr Iguchi started working for Daiwa until his confession in 1995. As we know, Mr Iguchi started working for Daiwa in 1974 and became head of securities trading in 1977. He started trading in 1984 and by 1989 he had built up a loss of nearly USD 600 million.

FIG. 4



Mr Iguchi experienced a movement in US interest rates from 7.5% in January 1974 to 5.25% in January 1977, when he became head of securities trading. Thereafter, rates rose to 14% in 1981 before moving to 8.4% in 1984, when he began trading US Government Bonds. From this time onwards, interest rates in the US steadily declined to as low as 3% in 1993/94. If you held the view (we assume Mr Iguchi held) that interest rates will bounce back, you would have lost a bundle over this period.

4.9 SUMMARY

If we analyze the Daiwa event, or should we call it events, it is clear that there was indeed a culture of deceit present in the company. The young Mr Iguchi who started working for Daiwa was learning his trade from those who created that culture and he also learned how to operate in it. Mr Iguchi

experienced events where other traders who engaged in unauthorized trading were actively assisted by Daiwa executives in covering up these indiscretions. Coupled with the advantage he had of being in charge of both the front and back office, as well as his very good understanding of how the company's systems worked, this created an environment conducive to Mr Iguchi conducting his activities undetected for a very long time. It is quite clear that formal US regulations were often circumvented by Daiwa staff. It is also abundantly clear that the accepted procedure of dealing with an irregularity was to hide it, even if it meant going to great lengths to achieve this. There can be little argument that all layers of the firm, up to the Board, not only approved some of these actions but also actively participated in them. There is also evidence to suggest that the Japanese Regulator, the Ministry of Finance, actively assisted Daiwa in keeping their transgressions secret. It is, therefore, no surprise that Mr Iguchi kept his mistakes secret for a very long time, as the fear of losing face and possibly his job was a very strong motivator. I do believe that, at least in part, of Mr Iguchi's motivation for disclosing his deeds to the chairman of Daiwa may have been the arrest and prosecution of Mr Leeson. Mr Iguchi obviously believed that his transgressions would be treated like all the others in Daiwa and he was absolutely correct. Daiwa did act in line with the culture of the company and so did the Ministry of Finance in Japan. It is very interesting that, even while serving his sentence, Mr Iguchi defended Daiwa's decision to try and resolve the matter internally. During his February 10 interview with Time Magazine he also defended their decision not to report the matter to the US authorities, citing the fact that they had to completely understand the nature of the problem and its "...implications to the bank later on" (TIME 2006: 1). Mr Iguchi's biggest gripe with Daiwa was the fact that they didn't warn him

of their intention to eventually disclose the matter to the US authorities, putting him in a disadvantageous position with regard to retaining a lawyer and constructing an appropriate defense.

Mr Iguchi's motivation was a combination of trying to protect his position in Daiwa and his own prestige. This in itself was not an extreme motivation, as he was not earning millions per annum. The Daiwa problem was the strength of facilitating factors like a lack of efficient risk management regimes, such as splitting the control of front and back offices and enforcing adherence to internal and external regulations. On the contrary, management on the highest levels assisted staff in evading regulations (on a number of occasions), rather than insuring strict adherence. As an inhibiting factor, formal regulatory efficiency on both the Japanese and US sides was questionable at best. From Mr Iguchi's perspective there was, therefore, precious little to inhibit extreme opportunism. Even without extreme salary incentives and highly geared exotic derivatives, Mr Iguchi's opportunism was extreme. The billion dollar losses through around 30 000 unauthorized transactions over a more than ten-year period was largely made possible by an overwhelming body of facilitating factors.

CHAPTER 5

JOSEPH JETT AND KIDDER PEABODY

5.1 INTRODUCTION

During the week of April 11 1994 Michael A. Carpenter, the CEO of Kidder Peabody, a highly rated US investment bank, had the unenviable task (Freedman & Burke 2001:5,8) of telling the Chairman of his parent company and longstanding friend that his firm experienced an “accounting glitch” – a euphemistic way of saying “we lost a substantial amount of money”. The parent company was General Electric and its chairman was none other than John F. Welch Jr., better known to most people as “Jack”. The amount of money involved was around USD 300 million in false profits and USD 85 million in hidden losses, according to reports, Mr Welch lost his lunch on hearing the news (Partnoy 2003: 174,181). The losses resulted from a massive overstatement of profits resulting from the manipulation of Kidder’s accounting system by their “star” trader, Joseph Jett.

5.2 THE CULTURE AND STRUCTURE AT KIDDER

In order to grasp the culture at Kidder, it is important to understand the business philosophy of the General Electric chairman. Any business owned by General Electric had to be a sector leader – if not, it had to be “fixed, closed or sold” (Freedman & Burke 2001: 4). After eliminating numerous layers of management at General Electric, a flat structure was implemented. This gave executives of companies in the General Electric stable a lot of

autonomy. Jack Welch was interested in results, and results meant profits. In order to achieve this goal, he gave his executives a lot of freedom and the potential of making large amounts of money for themselves. One observer was quoted by Partnay as saying the “GE’s culture is results oriented, that’s the reason they do well and also break rules. It’s the opposite side of the same coin” (2003: 176). After its purchase of Kidder, General Electric pumped around USD 500 million into Kidder and, after the trouble in the fixed income market, another USD 200 million was required in 1994 (Freedman & Burke 2001: 4). Nineteen ninety-four was not a particularly good year for Jack Welch (Partnay 2003: 176). During January of that year, Kidder’s derivatives vice president was sacked after it was discovered that he was simultaneously employed by Kidder and the US section of a Parisian Bank. The individual in question was also involved in selling an Italian derivative transaction without the required license and, in the process, caused cost overruns in excess of USD 2 million. During the first quarter of that same year another trader had managed to hide losses amounting to USD 11 million after a less than successful bond derivative transaction with NationsBank. This was, however, not all; adding insult to injury, it also became known that yet another Kidder options trader was also less than forthcoming about the fact that he had lost USD 6 million on trading options on French and Spanish government bonds. In April 1994 Neil Margolin was fired for hiding his USD 11 million in losses and, in June of 1994, Peter Bryant was fired for hiding his USD 6 million in losses (Freedman & Burke 2001: 10). These losses, in themselves, are not alarming. Losses are, after all, part and parcel of investment banking. What should have raised the alarm bells was the fact that no-one detected these losses. This clearly indicates inadequate oversight on a wide front, not only limited to Mr Jett.

Part of the problem had been attributed to the hands-off approach followed by the man who built the derivatives business at Kidder. With a Ph.D. in mathematics, Melvin Mullin managed his area in Kidder as Jack Welch managed Kidder: hands-off, with profit as the be all and end all (Partnoy 2003: 176). He was, however, credited as the one responsible for allowing Kaplan to practice unlicensed and for ignoring cautions regarding a transaction that contravened Japanese banking regulations. His wife also worked for Kidder and managed to cost the firm USD 2 million when she, by accident, double-hedged her own portfolio. This in itself is once again not such a big issue, mistakes do happen. The problem was that Mullin appointed and supervised his wife and found it justifiable to approve a USD 900 000 bonus for her efforts. Mullen was, however, transferred to another position in Kidder during February of 1993 and was replaced by none other than Mr Jett as the new Managing Director of the government desk (SEC 2004:8). Mr Jett now reported directly to Edward Curello, who was overall in charge of the fixed income division.

However, there were other problems right from the day that General Electric bought Kidder (Freedman & Burke2003: 3-6). One of Kidders traders was found guilty of insider trading, raising questions about management at Kidder. In response to this and other problems Jack Welch appointed a close personal friend, Michael A. Carpenter, as CEO of Kidder. He had no experience in running a broking firm and was not licensed by the SEC to run a broking firm up until 1993. Under his leadership, Kidder embarked on a massive expansion of its Mortgage Backed Securities (MBS) book through the use of extensive leverage. The firm was so highly geared that outsiders calculated that a 3.2% drop in the value of Kidders assets would have wiped

the firm out. By September 1994 Kidder was the number one underwriter of MBS debt in the US. However, this expansion went hand-in-hand with cost control, which meant that systems and controls were viewed as overheads. This led to inferior systems and the use of inexperienced traders in favor of more experienced staff that usually cost more money. Reporting to Michael Carpenter was Edward Curello who, by all accounts, was a very trusting but capable manager who was largely given carte blanche to run the fixed income division of Kidder. This entailed managing a staff of 750 people who generated USD 1 billion of earnings per annum through executing USD 20 billion worth of transactions per day. To assist him in this process, he employed a dedicated risk and compliance manager, David Bernstein. Although highly respected, he had a policy of getting rid of those who didn't produce, and traders were often underreporting profits in good months to have a reserve in lean months. This saved them from having to tell Curello when they made losses. Curello would apparently go to great lengths not to report losses (Freedman & Burke 2001: 10-11). During the investigation of Walter Mahailovich, a trader accused by Curello of false bookkeeping, former traders reported that Curello would allow traders to "massage" their books by assisting the back office in valuing their positions. There was a definite culture of hiding losses and profits from Curello. If one takes into consideration that Kidder was scrutinized by General Electric's auditors every 18 months, a question has to be raised about the quality of these audits. In the report produced by Gary Lynch, inexperience on the part of auditors was quoted as a contributing factor to the causes of the non-identification of Mr Jett's activities. Another trademark of Kidder's trading strategy was the dominance of proprietary trading executed by their traders relative to trading on behalf of outside clients (Freedman & Burke 2001: 7).

An explanation for this is that proprietary trading is potentially much more lucrative than agency trading. The Chief Financial Officer of Kidder, Richard O'Donnell, was tasked with the responsibility to oversee compliance with internal and external control measures and regulation. In April of 1994 he still believed that the controls at Kidder were better than any of their competitors. On the 22nd of that month another trader who reported to Cerrullo, one Neil Margolin, was also dismissed for hiding losses through improperly valuing his positions. He was also conducting proprietary trading for Kidder and the amount reported to be involved was only around USD 10 million (Laudon & Laudon 2004: 5). These failures in oversight at Kidder were not isolated or new to the company. As far back as 1985, Kidder was involved in a transaction in which Curello participated, when regulatory provisions were breached and a client was severely overcharged (Freedman & Burke 2001: 10). In a transaction with a Texas thrift bank (a bank whose main purpose is to take deposits from consumers and make home mortgages, Investopedia), Kidder exceeded the permissible 5% profit margin by 480% and charged the client 29%. The case was only settled in 1990 through Kidder agreeing to pay USD 3.7 million in order to prevent the case from going to arbitration. During 1988 (Freedman & Burke 2001: 10) both Kidder and Curello were fined by the National Association of Securities Dealers (NASD) for failing to reverse a transaction through which a trader working for Curello, one Ira Saferstein, exploited a pricing error by CS First Boston. Even after the NASD ruled that the profit had to be repaid, Kidder objected strongly. Although Mr Curello was strong on profits, he was apparently not so strong on being on top of how these profits were generated. Comments by outside managers alluded to the fact that those at the top of Kidder did not fully understand the source of their profits (Freedman & Burke 2001:10).

This problem was not unique to Kidder, as illustrated by the fact that it was recently highlighted as one of the most important risks facing companies today. The 2003 report of the Centre for the Study of Financial Innovation (CSFI) on the risks that face banks posted as their largest threat a lack of thorough understanding of “complex financial instruments” (CSFI 2003: 9). The combination of high levels of use and low levels of understanding, in their view, was a lethal cocktail.

5.3 WHAT DID MR JETT DO AND WHAT PRODUCTS DID HE USE?

Mr Jett used STRIPS or the forward reconstitution of STRIPS to create unprecedented “profits” for Kidder. These instruments were largely unregulated at the time, and were viewed as a type of over-the-counter (OTC) derivative that companies need not disclose (Partnoy 2003: 181). Bonds are normally made up of two components: an interest portion that pays an interest payment or coupon at regular intervals, and a principle capital amount payable at the end of the term of the bond. Investopedia describes STRIPS as “An acronym for 'separate trading of registered interest and principal securities'. Treasury STRIPS are fixed-income securities sold at a significant discount to face value and offer no interest payments because they mature at par”. In essence, the non-interest portion of a bond and the coupon payments are all treated as capital only payments at future dates. While interest payments are often heavily taxed, in many tax regimes capital gains is often tax free or taxed at a lower rate, and because of this a lucrative market for created STRIPS developed. Once stripped, the individual capital only future payments trade at a discount to face value due to the time you have to wait before you receive your payment. This period could be six

months or even up to thirty years. If you could buy a STRIP that matures tomorrow and entitles you to receive USD 1 000, you would probably be prepared to pay USD 999 for it. However, if you have to wait six months for your payment, USD 800 might be more palatable. The most important determinants of the price would be the time left till maturity, the ruling interest rates and the risk associated with the issuer of the instrument. However, the pieces of what used to be a Treasury bond, for example, can be reunited and this is referred to as reconstitution. If you have all the necessary pieces, you can go to the Federal Reserve and they will give you a complete Treasury bond. As these pieces all trade at a discount, there is an inherent potential for profit as there may be slight variations in what people would be prepared to pay for the right to receive a capital amount on a future date. An arbitrage opportunity therefore exists, as there can be a price difference between the price of a complete bond and its parts priced individually. These trades are easy and cheap to execute, but margins are always very thin (Partnoy 2003:175-180).

The little bit of “genius” was realizing that the computer system used by Kidder took into consideration the increase in value of a STRIP as it neared maturity when the transaction was entered into the system. The future value was, however, inadvertently interpreted by the system as a current profit. It was, therefore, possible for Mr Jett to record a profit every time he bought a STRIP and entered the transaction for reconstitution at a future date into Kidder’s system. Another problem is the possibility that you might incur a loss on that future date. Such a loss could materialize if there was a sudden change in interest rates; for example, if interest rates rose sharply, the value of your STRIPS and the reconstituted Treasury bond would drop, leaving

you with a loss. The beauty of the scheme, and the part that allowed Mr Jett to evade a lengthy jail sentence, was the fact that all Mr Jett had to do was enter the transaction into the Kidder accounting system and, voilá, there was a profit. There was no need to actually conduct a transaction – it could all be fake. The bulk of his transactions were in reality fake, explaining why it was possible for him to have more holdings in a particular government security than was available in circulation. All Mr Jett had to do to keep his scheme alive was to increase the size of fake transactions into the system in order to generate more fake profits than the fake losses generated by the Kidder accounting system and the actual losses he generated from actual trading. As the fake transactions approached maturity, the price of the STRIP converged with the face value of the instrument, wiping out Mr Jett's illusionary profits. This is demonstrated in TABLE 1, which follows.

TABLE 1.

<i>toward</i>							
<i>trade</i>	<i>→ decreasing recorded profits →</i>						
<i>settlement</i>	<i>date</i>	<i>as a result of accretion</i>				<i>date</i>	
	V					V	
		day 1	day 2	day 3	day 4	day 5	day 6
1st recon entered	\$100	\$ 90	\$ 80	\$ 70	\$ 60	\$ 50	\$ 40
2nd recon entered		200	180	160	140	120	110
3rd recon entered			300	270	240	210	180
4th recon entered			300	270	240	210	180
			
			
Net profit recorded	\$100	\$290	\$860

(Source. SEC 1998: 11)

The pyramid scheme nature of what Mr Jett was doing is clearly visible, as the losses would realize the moment Mr Jett stopped entering new transactions. It is also noteworthy that, although there was a perception on Wall Street that the Kidder accounting system was very advanced, it was in actual fact running on software that was written before 1969 (Freedman & Burke 2001: 9).

5.4 WERE THERE ANY WARNINGS?

In the first instance, Mr Jett had a less than illustrious career up until 1991. He was less than successful during his short spell at Morgan Stanley and was subsequently fired by First Boston, which was his second place of employment (Partnoy 2003 176-177). Similarly, in his first few months of employment at Kidder, Mr Jett was less than spectacular and, at the end of 1991, his performance rating only justified a USD 5 000 bonus. His turnaround was, however, dramatic – a “profit” of USD 32 million earned him a bonus of USD 2.1 million at the end of 1992 and a USD 151 million trading profit at the end of 1993. His performance bonus was a spectacular USD 9.3 million and he was Kidder’s “man of the year”. No-one took the trouble to determine exactly how this miracle was achieved.

One of his co-workers was, however, not dazzled by Mr Jett during the early stages of his career (Freedman & Burke 2001: 9). During 1992 Hugh Bush, a trader who worked closely with Mr Jett, complained to superiors about the way in which Mr Jett was valuing his positions. This complaint was ignored by Dr Mullen and Mr Jett ensured that there would be no further complaints by providing Dr Mullen with recorded evidence that the complainant was

engaging other banks in search of alternative employment. The complainant's "reward" for this dastardly deed was summary dismissal (Partnoy 2003: 179). Cullen refuted the claims that Bush made allegations against Mr Jett. In the same year Scott Newquist, a senior executive and member of the inventory committee at Kidder, also claimed to have raised concerns with Carpenter regarding the positions held by Mr Jett. He complained about the fact that the "inventory committee", which had to keep track of what the company owns, were finding it difficult to get clear answers on what positions Mr Jett held (Laudon & Laudon 2004: 5). Newquist also claimed that Mr Carpenter took no action because, in his view, Mr Carpenter was focused only on profit and nothing else; Mr Carpenter denied these claims. A former Kidder trader, Robert Dickey, also claimed that Mr Jett's predecessors knew about the defect in the system (Laudon & Laudon 2004: 2), which raises the possibility that someone in Kidder might have told Mr Jett about it. During May of 1993 an accountant at Kidder, Charles Fiumefreddo, realized that there was an error in the computer system and recommended that it be corrected (Freedman & Burke 2001: 9). However, Mr Jett objected very strongly and nothing was done. According to Fiumefreddo, the suggested change would have exposed Mr Jett's scam. In the spring of that same year Jim Rizzi, who worked on the repurchase desk at Kidder, noticed something odd (SEC 1998 14-15). As the repurchase desk was responsible for borrowing securities if there was a shortfall, or converting bonds into cash through the repurchase mechanism in the market when cash was needed, they had a unique view of Mr Jett's trading activity. Rizzi noticed that Mr Jett was managing unusually large volumes of transactions and his forward settlements would often not settle, even though the necessary STRIPS was acquired by Rizzi to reconstitute a

complete bond. He also noticed that STRIPS that were reconstituted were promptly stripped again after a few days. Rizzi started to have doubts about whether or not Mr Jett's transactions were actual transactions or mere paper entries. He shared his concerns with his boss, Brian Finkelstein. Finkelstein already had serious doubts about Jett's meteoric rise and frequently questioned the unusual profitability he achieved. He again raised the matter with Bernstein who, at the time, was Currello's confidant. Bernstein apparently responded by confirming that Currello was aware of Mr Jett's trading strategy.

In the early months of 1994, a number of high profile collapses of fund managers dominated news headlines. Early in 1994 Askin Capital wiped out USD 600 million and in April Robert Citron bankrupted Orange County (Partnoy 2003:180-181). Kidder Peabody just happened to be the largest investor in Askin Capital Management (Laudon & Laudon 2004: 5). At Kidder Peabody, however, Mr Joseph Jett was swinging for the fence and recorded a record USD 66 million in "profits". During the same time, the computer system at Kidder started to buckle under the massive volumes of trades (Freedman & Burke 2001: 7-8) and computer specialists were called in to remedy the situation. What they found was astounding. Mr Jett had, in the period he worked at Kidder, entered USD 1.7 trillion in trades into the computer system. Of these transactions, none were ever consummated, allowing for profits to be recorded without any securities actually changing hands. They advised senior executives, including Edward Currello. When he looked closely at Mr Jett's positions, he realized that he was holding an estimated USD 40 billion in forward reconstitutions. At the time it appears that Mr Currello did not fully appreciate the fact that the profits declared by

Mr Jett were false, and all he initially tried to do was to prevent these massive transactions from appearing on the balance sheet of General Electric (Partnoy 2003: 181). It was only when he asked Mr Jett to explain his trading strategy in writing that the realization struck home that Mr Jett's trading "strategy" was a farce and that losses could be substantial. An in-depth audit by David Bernstein (Freedman & Burke 2001: 8), who was responsible for risk management, revealed a USD 300 million anomaly in Mr Jett's trading book. Further investigation revealed that Mr Jett hid nearly USD 85 million in losses and reported around USD 350 million in false profits.

5.5 THE LEGAL PROCESS AND OTHER SANCTIONS

Jack Welch immediately contracted Gary Lynch, a former SEC chairman, to investigate the Jett incident (Freedman & Burke 2001: 13). In August of 1994 the damning report was released and its findings are of great relevance for this thesis. The conclusion of the Lynch Report was summarized as follows "The report concluded that the ultimate problem was the emphasis throughout Kidder on profits and greed." Although "Jett was provided the opportunity to generate false profits by trading and accounting systems," it was his supervisors who allowed Jett to use that opportunity for over two years because they never understood what Jett was doing in his day-to-day trading activity, or the reason for his apparent profitability. "The door to Jett's abuses was opened as much by human failings as by inadequate formal systems," It also said of Mr Jett's supervisors that "Their focus was on profit and loss, and risk-management data provided no insight into the mechanics of Jett's trading."

Subsequent to the Report, Orlando Joseph Jett was charged with fraud amounting to nearly USD 83 million but subsequently, in 1996, he was found not guilty of fraud. A securities arbitration panel also found that Kidder could not prove that Mr Jett engaged in “fraud, breach of duty and unjust enrichment” and ordered the release of a portion of his assets frozen in Kidder accounts. This was, however, not the end and “civil administration” charges were brought against Mr Jett. In July 1998 an administrative law Judge, Carol Fox Foelak, found after two years of deliberation that Mr Jett was technically not guilty of committing fraud, as his actions could not be tied to the physical purchase or sale of securities. However, the Judge found that “...Jett, with intent to defraud, booked hundreds of millions of dollars in illusionary profits through an anomaly in Kidders trading and accounting systems, thereby deceiving the firm about his trading performance and obtaining large bonuses and other benefits” (SEC 2004: 2). He was ordered to pay a civil penalty of USD 200 000 and was “barred from association with a broker or dealer”. He also had to give up USD 8.21 million in money he received through his illegal activities. The judgment was appealed by the Division of Enforcement and Mr Jett. Mr Jett appealed his conviction on “recordkeeping violations” and the finding that he “engaged in a scheme to defraud”. The Division appealed the finding by the judge that, technically, Mr Jett did not contravene a number of antifraud provisions, as his activities could not be tied to the actual purchase or sale of securities. On March 5 2004 the Commission hearing the appeal found that Mr Jett did indeed violate antifraud provisions (SEC 2004:21-23).

Mr Jett was by no means the only one who suffered sanction. On June 22 1994, Michael Carpenter had to resign from his position at Kidder

(Freedman & Burke 2001: 13-14). One month later, he was joined by Edward Curello, whose supervision was questioned by the Lynch Report. He was subsequently charged by the SEC for failure to supervise and had to pay a USD 50 000 penalty to settle the SEC charges. On top of the fine, he was suspended from operating in the securities industry for a year. However, these blows were softened by a USD 9 million settlement that he received from Kidder. A similar fate also awaited Melvin Mullen, who also had to resign on the 3rd of August 1994 after he managed to settle civil sanctions. He paid a fine of USD 25 000 and could not work in the industry for a period of three months. David Bernstein, the man credited by some for exposing Mr Jett (Laudon & Laudon 2004: 1) was demoted but never charged for any wrongdoing.

5.6 WHO IS TO BLAME?

Although there is evidence to suggest that a culture of opportunism existed at Kidder before it was taken over by General Electric, there can be little doubt that the management style imposed by General Electric was a contributing factor that exacerbated the problem. The headlong pursuit of profit had two important elements – cost cutting and high incentives – with little restraint or interference for those making money. The effect was antiquated systems and incentives to take risk in order to get to the profit levels that would generate bonuses. The hands-off management style towards successful traders has the potential of becoming one of the golden threads running through this thesis and, although it might work in other industries (like making light bulbs), it is quite clearly a dangerous way of managing an investment bank. It was also clear that the senior executives at

Kidder, especially those appointed by General Electric, had very little knowledge of the practical workings of an investment bank, especially on operational level. Another important contributor was the misplaced faith that the Chief Financial Officer had in the abilities of the auditors of the parent company and, quite possibly, in his own internal and external audits. The fact that the Lynch Report cited inexperience of the auditors as an excuse for them not detecting Mr Jett's activities cast a grave shadow over the hazard created by executives that rely heavily on audits to identify irregularities. The regulators, in the case of Kidder Peabody, are also not without blame. The massive positions that Mr Jett was building up were reported and should have alerted the regulators.

5.7 WAS HE RESPONSIBLE FOR THE DEMISE OF KIDDER?

Although many would like us to think that the eventual demise and sale of Kidder Peabody could be attributed to Mr Jett, in reality the owners, General Electric and its management, were the only ones to blame for its inability to prevail. The losses at Kidder continued through 1994 (Laudon & Laudon 2004: 9) and at the end of that year total net losses were approximated at nearly USD 1 billion, the worst in Kidder's 129-year history. At that time, General Electric decided to sell the firm to Paine Webber, putting more than 2 200 Kidder employees out of work, but making it possible for General Electric to once again declare record profits for the year. Through this sale, or as some called it a merger, Paine Webber Inc took over a number of business units. In return they received 25% shareholding in Paine Webber, totaling USD 670 million, and a seat on the board of General Electric while General Electric absorbed the ailing Mortgaged Backed Securities (MBS)

book (Freedman & Burke 2001:12). Expert opinion expressed by Professor Roy C. Smith from the Salomon centre at NYU and a follow-up article published in the Wall Street Journal both identified the strain exerted by the massive 12 USD billion MBS book suffering under interest rate hikes in 1994, as the real culprit that paralyzed Kidder Peabody. The strategy to grow its exposure in MBS was conceived and implemented under the leadership of Carpenter and Cerullo (Freedman & Burke 2001: 6). As Kidder financed most of its MBS expansion through debt, it had to be with the consent and approval of General Electric. In fact, Kidder was so highly leveraged that every USD 93 of assets they financed with borrowed money was only supported by USD 1 worth of equity. One implication of this ratio was the fact that the net assets of Kidder could be wiped out by a mere 3.2% reduction in the value of its assets. This aggressive policy propelled Kidder from the number 10 spot in the MBS market in 1990 to the first spot in 1994 when it was the largest MBS underwriter in the US, controlling 25% of the market. This “achievement” meant that they met the criterion laid down by Mr Welch to be either first or second in their sector. This strategy did, however, expose Kidder to some serious risk. As the underwriter of an issued security, Kidder buys the entire issue of such security with the intention of on-selling it to the public. Any reduction in the value of such an inventory of securities will be for the account of Kidder; this is especially relevant in the interest rate sensitive MBS market.

5.8 SUMMARY

There can be little doubt that a number of structural factors were key to the actions of Joseph Jett and the eventual demise of Kidder Peabody. Formal

and informal regulatory procedures were either not in place and/or failed dismally, Joseph Jett had a competitive advantage as he managed to detect and exploit a severe weakness in the Kidder accounting system and the potential for spectacular short-term gain was on everyone's mind in Kidder and its parent company, General Electric. There is clear evidence presented in this case study indicating that the type of behavior manifested by Mr Jett was no anomaly at Kidder. The question then is why were all these structural and other factors present? The answer is fairly straightforward – the Kidder and General Electric culture was one that encouraged profits at all cost and to minimize expenses, even at the expense of proper oversight. If Joseph Jett did not learn this very quickly at Kidder he had to be very stupid, something he undoubtedly wasn't. If your traders and those responsible for managing them know that profit is the sole and only yardstick for success, they will use whatever means necessary to achieve it. If everyone, including managers, is hiding losses and parking profits because they know that showing a loss could cost them their jobs, what prevents them from taking advantage of incompetent and inexperienced managers and antiquated accounting systems? We know that there were others before Mr Jett who were hiding losses without being detected and that even the computer error that allowed Mr Jett to book his phantom profits was also known to people at Kidder before Mr Jett started abusing it. Kidder and General Electric were also known for having scant regard for regulations – why should their staff have a different philosophy?

The environment at Kidder was a very good example of a total lack of balance between factors that facilitate extreme opportunism and those that could inhibit it, in an environment of very strong monetary and status

motivators. General Electric under Jack Welch did not display a balanced approach when it came to making money. Every effort was made to facilitate this goal; if you failed you were severely sanctioned. There is very little if any evidence that any inhibitors like advanced internal audit systems or hands on operations management procedures were implemented to ensure effective oversight of Kidder. In the presence of such a glaring imbalance, the probability for extreme opportunism is very high.

CHAPTER 6

NICK LEESON & BARINGS BANK

6.1 INTRODUCTION

On the 25th of February 1967, a son was born to a plasterer and a nurse in the King Street Maternity Hospital in Watford, on the outskirts of London (Fay 1997: 70-73). The boy was the first of four children born to Harry Leeson, a hardworking self-employed man, and his wife Anne, who by all accounts was a loving mother. The name of this boy is Nicholas William Leeson. As a man, he would first become known in his own firm as a “Turbo Arbitrageur” and a mere two years later he would become internationally known as the man who destroyed one of the oldest banks in the world. The bank was Barings Bank, which could even count HRH Elizabeth Mountbatten-Windsor as one of its clients.

In this chapter we will investigate the events that led up to the collapse of Barings Bank and the eventual arrest of Mr Leeson. The culture and environments in which Mr Leeson learned his skills and operated will be thoroughly analyzed. The sources that were consulted are newspaper and other articles, his authorized biography, as well as unauthorized works regarding the Barings collapse, formal investigations by the Bank of England and the Singapore authorities, as well as court records. These will all be put into perspective by comments from Mr Leeson himself. The activities of Mr Leeson can be divided into a number of categories. We will firstly look at an analysis of his trading strategy and how his losses were

incurred and, secondly, at how he managed to hide these losses. Attention will also be paid to how he funded his activities and what role the corporate culture and organizational structure at Barings played in creating an environment conducive to the events that led up to the collapse of Barings Bank

6.2 THE BARINGS ENVIRONMENT

The office politics in Barings were described as “savage” and Andrew Tuckey, the Chairman of Barings Brothers & Co. and Barings Securities, was quoted as describing the investment banking and securities-brokering as “...‘tension businesses’ run by people who were moving and jockeying, and who were judged by their profits. That is the nature of the investment business...” (Fay1996: 52). What this extract tells us is that personal position and advancement appeared to be the number one priority at Barings, consuming a lot of time that could have been spent on managing the firm.

Mr Leeson was posted to Barings Futures Singapore only in April 1992, to establish the settlements operations for Barings Futures Singapore. This posting came after Mr Leeson managed to clear up a GBP 100 million settlements mess in the Jakarta office. Senior management at Barings was made aware of these problems in the settlement areas of Barings’ Far East offices. The Following extract from a letter to Ian Martin (the then Finance Director of Barings Securities Limited) from Mr Tim Easun a member of Business Development Group of Barings shows that, in September of 1991, at least one senior manager was warned (Singapore Report 1995:65).

“The non-segregated client account has been continually overdrawn over the last few months. Futures and Options cash accounts should never be overdrawn. This factor highlights a fundamental problem. Either margin calls have not been made or collateral balances are not being utilized correctly. Situations which should not occur in an efficiently run operation.”

In another memorandum dated 26 December 1991, we find the cause of this situation and much more. Mr Bruce Benson, Manager of the Agency Sales Team (Japan), sent a memorandum to Mr Andrew Bayliss, (at the time the Deputy Chairman of Barings Securities Ltd) which, according to the Singapore report (1995: 65), reported the following:

“I realize Carl and Lynn have been working very hard, and I greatly appreciate Nick Leeson’s help (even though he has been dying to get out of that area for two years). Nevertheless, I must tell you, that the settlements area is struggling to stay above water. We will lose clients, we will waste more interest income, and we will inevitably incur large trading errors if we do not make this area a top priority (even **more than we are doing now**) ...”. He went further and wrote “...I have found out that ... (2) we never properly collected hundreds of millions of Yen in margin money to begin with (more interest income out the window), (3) there are many other “bigger” “potentially HUGE” problems to be sorted...”. To this he also added “...Andrew, you know how much money we lost in interest income last year. Huge money. Millions of pounds. Do you know that we have a temp handling all our margin money? Do you know that the margin money regularly represents multiples of the net worth of the entire company?” In what can only be described as prophetic words, he concluded with a stern

warning, “...If the back office causes us to lose money and clients from this point forward, it is not their fault, it is our fault for not recognizing how urgently they need help.”

What is clear from these communications is that, at the end of 1991, both the Finance Director of Barings Securities Ltd and his Deputy were made acutely aware of the fact that there were serious deficiencies in the back office capacity of Barings that were already costing the bank millions of pounds every year and had the potential to cost much more. These deficiencies were nothing new to Barings. Stephan Fay (1996: 68) quotes John Guy, the individual who managed settlements at Barings up until the early 1990s, as confirming that settlements were not viewed as a priority by Barings management. No efforts were made to develop computer systems that would allow management to be on top of all their worldwide positions or even to help them manage their risk. “It was all done on the back of an envelope” is how Mr Guy apparently described the Barings back office. The reason why the back office was deprived of well trained and qualified staff is attributed to the focus of Barings management on maximizing bonuses and minimizing overheads. Back office was regarded as an overhead in a culture where “...money became the main, perhaps the sole, standard of judgment of a person’s value...”. In my interview with Mr Leeson he confirmed to me that he was acutely aware of these deficiencies. (He made it very clear to me, in response to two different questions, that he did not set out intentionally or unintentionally to exploit these weaknesses.) According to him, the culture of Barings was to try and be the first to exploit new markets and to do things first. However, Barings concentrated on their research and execution ability, and the administration and settlements areas had to look after themselves. To

underline this, he recounted two incidents that reflected this bias. When the stock market in Jakarta was opening up, Barings apparently decided to open an “office” in Jakarta first; William Daniels was sent to operate from a hotel room with a telex. There he would start in the mornings, getting a telex with 150 trades on it. Six months later, when Mr Leeson was sent to Indonesia to sort out a GBP 100 million in share certificates that couldn’t be delivered to clients Barings transacted with, he was still operating from a hotel room with no effective infrastructure to support him. Mr Leeson also recounted to me that, when he arrived in Singapore, he wanted to recruit someone who was working for Chase Manhattan Bank and with whom he had previously worked at Morgan Stanley. This person, called Stella, was in his view extremely efficient and experienced. However, due to the fact that the salary he wanted to pay this woman was twice the salary those in the equity settlement area were getting, the decision was made by Simon Jones not to employ her. Mr Jones then hired someone fresh out of the National University of Singapore, with no experience, at the lower salary. Mr Leeson did note to me that the decision may have been, in part, Mr Jones flexing his muscles to show him who was boss. Mr Leeson believes that his inexperienced staff, with no template to measure his actions against, was to a large extent moulded by him and would, therefore, not question any of the instructions that he gave them. Mr Leeson identified this lack of having experienced staff in the key settlement areas as a very early cause of the breakdown of control. Without quality staff in the right positions, the right questions were never asked. When those questions were eventually asked in February 1995, he knew his days were numbered. According to him, the means to detect what he was doing was very simple. “There were only two trading accounts, a London and a Tokyo account. You pull up the report

from SIMEX, you compare these two versus the SIMEX report and there is a massive difference.” Mr Leeson ascribes even the most recent rogue trader events as a systems and oversight failure due to a lack of quality people in key positions. Even though the advances in systems can reduce some of the risk, quality people, in Mr Leeson’s view, still remain the key.

One of the most important, and often overlooked, factors is the role of learned behavior. We know that traders, like most young employees in the financial markets, do not walk into their new positions with a fully developed set of skills. They learn how to handle situations and what behavior is deemed appropriate and what is deemed inappropriate from the people they work with and work for. Mr Leeson was taught how to handle mistakes. By his own account, the use of fictitious transactions to rectify errors was a widespread practice (2005:60). It is also of vital importance to stress the fact that Mr Leeson did not invent the 88888 account. When he started trading in Singapore, an error account No. 99905 already existed. Trading errors were booked into this account and were then reported to London, where the losses resultant from such errors, were eventually written off against Barings’ profits. The head of derivatives settlements in London, Gordon Bowser, who was responsible for all derivatives settlements for Barings, requested Mr Leeson to create an alternative error account and asked him to “keep them all in Singapore” (2005: 53), as the errors may draw the attention of the auditors. Mr Leeson was provided with the tool to hide errors and learned how to use it.

6.3 WHAT DID HE DO?

In 2001, Stephen J. Brown and Onno W. Steenbeek produced an analysis of Mr Leeson's trading activities. These can roughly be divided into the categories of authorized and unauthorized.

6.3.1 UNAUTHORIZED ACTIVITY

The now infamous 88888 account was opened on the 3rd of July 1992, a mere two days after Barings became a member of SIMEX. This account was opened on instructions from Gordon Bowser in London, who was responsible for Barings' derivative settlements (Leeson 2005: 52-53). The first transaction purportedly booked into the 88888 account was an error by one of his staff. An inexperienced trader apparently inadvertently sold twenty lots of Nikkei 225 futures instead of buying twenty lots of Nikkei 225 futures. The effect of this error was +/- GBP 20 000. According to Mr Leeson, he felt sorry for the girl and booked the error into 88888 (Fay 1997: 95-98). The Report of the Singapore inspectors indicated that, on the contrary, Mr Leeson started using the account the same day he opened it. According to the Report, Mr Leeson lost GBP 20 000 when he bought and sold 2051 Nikkei futures. This loss was the first entry into the 88888 account. The Report also points out that Mr Leeson apparently gave specific instructions on the 8th of July 1992 that the software of the computer system they used should be changed to ensure that the 88888 account would not be reflected in any market activity reports and would be used solely by them internally to estimate SIMEX margins (Brown & Steenbeek 2001: 5). Towards the end of August, Mr Leeson bought 189 long Nikkei futures

without the appropriate hedge, indicating that he was following a very bold strategy of taking “naked” or unhedged positions or bets on the direction and the way in which the market will move (Fay 1997: 97-101). On the 26th of August, a form BC4 was faxed to SIMEX by Mr Leeson to identify the owner of account 88888 as “Barings Securities London – Error Account”. This was necessary because SIMEX required that all accounts for which more than a hundred contracts were traded be identified. However, this form was “corrected” later in the day with an identical form differing only in the fact that the words “Error Account” were omitted. Fay speculates that this was probably done because Mr Leeson realized that the volume of activity in the account may not tie up with the volumes expected from an error account. Mr Leeson also convinced Mr Gordon Bowser, the Risk Manager at Barings Securities Limited, to provide him with funding for the margin calls of clients that he traded for on SIMEX even before SIMEX had asked for the margins. The reason he gave was that it was difficult to borrow from Japanese Banks when clients needed cash in a hurry to meet margin calls. This practice, although technically illegal, was obviously allowed so as not to inconvenience clients of Barings. By the end of August the losses in the account had risen to GBP 320 000.

During September Mr Leeson’s losses from his futures positions were rising from GBP 300 000 to more than GBP 3 million. In the next month, this figure ballooned to GBP 4.5 million. During October Mr Leeson started selling unhedged options on the Nikkei 225 and quickly ran up a loss of GBP 70 000. This loss was, however, offset by a profit of GBP 75 000 during the month of November. In this month his cumulative losses fell to around GBP 2 million. Mr Leeson apportioned most of the blame on the

inability of the SIMEX system to reconcile all transactions. According to him, system errors often left him with naked positions due to unreconciled transactions from a previous day's trading. It was these errors that initially ended up in the 88888 account, he claimed (Fay 1997: 99). By the end of September, Mr Leeson instructed his staff to credit his 88888 account with an amount of GBP 4 million while debiting a Barings account at Citibank with a similar amount. This transaction was reversed when the next month began, to bring the positions back to where they were. This was done to hide the deficit from the eyes of the Deloitte Touche auditors, who would start with their work after the September 30 year end of Barings. Shortly hereafter, the auditors received a fax purportedly from Gordon Bowser, the Risk Manager at Barings Securities Limited, advising them that account 88888 did not have to be reconciled, as it was an error account with an insignificant balance. Although Mr Bowser could not definitely remember if he, in actual fact, wrote the fax in question, there is evidence to suggest that this fax was indeed Mr Leeson's first forgery. The possibility exists that Mr Leeson took another fax, sent on the 2nd of October by Mr Bowser and referring to account 99002, and altered it to reflect the date as the 7th of October 1992 and changed the account number to 88888 (1997: 101). It is important to remember that the use of fictitious transactions to "balance" the books was a common technique employed at Barings and not something invented by Mr Leeson (Leeson 2005: 60).

During the best part of 1993 the 88888 account was seldom used by Mr Leeson and, as a result of a strong market, he managed to wipe out the accumulated losses in the 88888 account (Leeson 2005: 85). Unfortunately, Mr Leeson reverted back to using the 88888 account the very next Monday

and he acknowledged the fact that, by that time, he was addicted to using the 88888 account to hide his losses (Leeson 2005: 87)

By October of that year he was also promoted to General Manager and Assistant Director. Mr Leeson was now officially in charge of trading and settlements. It must be noted that, to outsiders, it appeared as if Mr Leeson did a very good job of executing trades for the proprietary traders in Tokyo (1997: 106-107). There was, however, a dark side to his “ability” as a trader. He used the 88888 account to absorb smaller losses he incurred by providing false execution prices to the traders in Tokyo. For example, he would sell at USD 100 but would indicate to those he executed for that he sold at USD 101. This bolstered his reputation as a trader. The main purpose of the 88888 account was, therefore, to generate fictitious profits for Barings Securities Limited and Barings Securities Japan. Although a strong market helped Mr Leeson to clear his losses, it didn’t take long before Mr Leeson was back in trouble again. By the end of 1993 the losses in account 88888 once again grew to USD 35.8 million (Brown & Steenbeek 2001: 5-8).

The main problem facing Mr Leeson was the margin calls he had to pay on his futures positions on SIMEX. This problem was overcome by a combination of strategies. In the first instance, unhedged transactions for account 88888 were first booked into accounts of Barings Securities Japan and Barings Securities Limited. However, these transactions were offset with similar and opposite transactions seconds before the close of market. These offsetting transactions were booked to 88888 and gave the appearance of a hedge. The prices of these transactions were once again manipulated to favor Barings Securities Japan and Barings Securities Limited and the

corresponding losses were absorbed into the 88888 account. The second technique used by Mr Leeson was to transfer unhedged positions in the accounts of Barings Securities Japan and Barings Securities Limited to the 88888 account through the entry of fictitious trades. This gave the illusion that no unhedged positions in the accounts of Barings Securities Japan and Barings Securities Limited existed. The third manipulation used by Mr Leeson had the effect of actually fooling the SIMEX margin call system. By instructing his settlement staff to execute fictitious trades in the accounting system just before market closure, and then reversing those same trades the next morning, Mr Leeson was able to reduce the margin payments required by SIMEX.

Not even these elaborate efforts could negate the need for margin payments on Mr Leeson's growing futures positions. Once again a set of "solutions" was used to tackle the problem (2001: 6-8). Mr Leeson convinced London that he was involved in low margin arbitrage, which means that volumes must be high to make the level of profit generated worth their while. As the transactions were essentially "riskless", which it can be if done properly, the amounts involved should not be of concern to Barings. He also explained that, as he was arbitraging across two exchanges, each exchange would require its own margin payments and netting could not be used between the exchanges. He convinced Barings London that, due to market volatility, SIMEX was demanding intra-day margin calls and, as it was difficult for him to get the money from his clients as a result of time zone differences, Barings Securities Limited should finance these on behalf of its clients. Although such funding is technically illegal, the rest of Mr Leeson's stories sound plausible as they all have an element of truth in them. Someone

without any reason to doubt him would probably accept the story at face value.

From October 1992 Mr Leeson was selling options on the Nikkei index. This he managed to do quite profitably using his 88888 account and, at some stages, such as by the end of December 1994, the value of these options totaled USD 178 million. As his futures positions grew, he had to sell more and more options to fund his SIMEX margin calls. The premium he received from selling “in the money options” went directly to fund his margins. By his own account (Leeson 2005: 173), he could not sell options during October of 2004 and resorted to a fraudulent journal entry on the Citibank account to create the perception of a zero balance in the 88888 account. In November he had to attend a “strategy” meeting in Tokyo and didn’t have time to sell options to cover his margin calls and had to, once again, resort to a fraudulent entry in the Citibank account totaling GBP 65 million (2005: 181). The option-selling exercise also exacerbated the doubling strategy followed by Mr Leeson when, after the Kobe earthquake, the USD 178 million profit was converted into a USD 108 million loss by the end of February 1995.

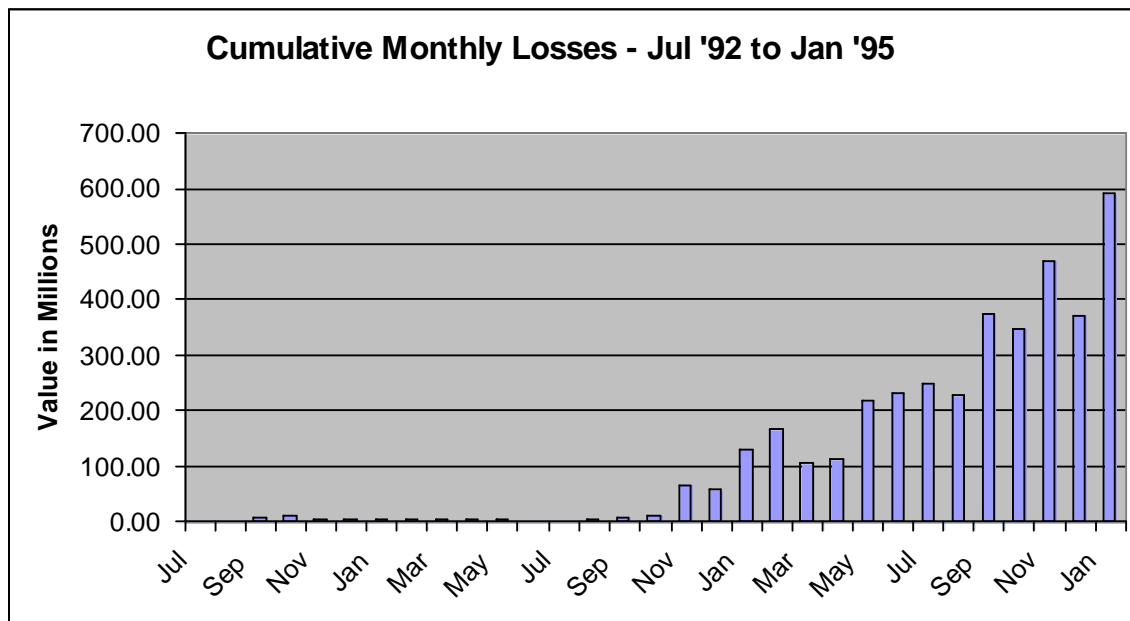
To put this into perspective, it must be understood that the amount of options sold by Mr Leeson had the effect of reducing the volatility in the underlying market of, for example, the Nikkei 225 futures contract over which he was writing options. Fay (1997: 144) quotes Mr Leeson from an interview with David Frost, during which Mr Leeson explained the influence of his options trading on his activities. In essence, the price of an option is largely dependent on the volatility of the market in the instrument over which the

option is written. The higher the volatility, the higher the option premium, that the writer can demand. According to Mr Leeson, in 1992 when he started writing options, the price he could demand due to volatility was 40% to 45% of the price of the underlying security, for example the Nikkei 225 futures contract. As he was selling options every month to offset his losses, over time he was flooding the market, which reduced the volatility by the end of 1994 to ten (10). The effect was that, to achieve the same income, he had to sell four times (4x) the amount of options. Mr Leeson confirmed to me that he primarily started selling the more dangerous straddles in order to gain the higher premium attached to them, in order to counteract the effect of the lower volatility in the market on his income from selling vanilla options. As early as 1993 Mr Leeson was "...attracted to the large premiums from straddles..." notwithstanding the fact that he realized that his losses could be unlimited if the market moved against his view (Leeson 2005: 84-85). He also admitted that he didn't hedge his positions, as he needed his entire premium to cover his existing losses. In the next chapter we will see that Mr John Rusnak was in the exact same position, with very much the same end result.

6.3.2 THE RESULT

As we by now know, the net effect of Mr Leeson's activities was the collapse of Barings Bank. Although this statement is a fact, it doesn't tell us the whole story. In Figure 5 I have used information published in the Singapore Report (1995: 179) to graphically demonstrate the cumulative losses on account 88888.

FIG. 5



(Values in Singapore Dollars)

Excluded from this graph is the eventual tally for the losses as reflected in February of 1995. At the end of this month, the losses rose from the 590.3 million Singapore Dollars to a staggering 2.210 billion Singapore Dollars, which is equal to nearly USD one billion. The main reasons for this dramatic escalation was the 1 000 point drop in the Nikkei 225 on 23 January 1995 after the Kobe earthquake (ERisk 2005:1-3) and Mr Leeson's increase in his exposure in the belief that the market would rebound. According to the Singapore Report (1995: B x), the collapse of Barings could have been averted as late as January 1995. I support this view and, if one looks at how the LTCM event described in "When Genius Failed" was handled, eventual losses may have been drastically reduced if the Bank of England had taken the appropriate and decisive action.

6.4 WAS HE FRONT-RUNNING?

One of the accusations leveled against Mr Leeson was the suspicion that he was generating real profits for Barings by front-running their (his) clients. Ron Baker, Head of Financial Products Group Barings Investment Bank, strongly supported a GBP 130 000,00 bonus for Mr Leeson at the beginning of 1994 (Fay 1997: 135-136). Baker was impressed by the way Mr Leeson, as he termed it, “worked the information curve” (1997: 136). When he received a large purchase order that needed to be executed on SIMEX for a client from the Barings Tokyo office, he would purchase a similar amount of contracts on the Osaka exchange. If the price rose, he would sell the client his own Osaka holding at the higher price; if it fell, he would execute the deal on SIMEX and cancel his Osaka transaction. This strategy would also work in the event of a large sale. At least James Baker, the internal auditor of Barings Securities Limited, was aware of this activity. In his audit report he condoned this conduct as legal, because the “front-running” order was placed on another exchange and should, therefore, be viewed as legitimate arbitrage and not front-running. Although apparently insignificant, this is once again a clear reflection of the “blurred-lines environment” in which traders like Mr Leeson operate. The Report by the Singapore inspectors (Singapore Report 1995: 10-11) questions the whole matter of the so-called “information curve”, which undoubtedly includes the fact that traders who handle both agency and proprietary business would be in an unfair “advantageous” position due to their insider knowledge of the positions that clients intend to take. The report highlights the fact that senior Barings management was aware of this fact and had no ethical difficulties with it. The Head of Barings Group Compliance at the time of the collapse, Ms Val

Thomas, is quoted by the Singapore Report as saying that she was never aware of this “use” of client trading information and comments that it should have raised ethical difficulties inside Barings because it borders on front-running. In his book “Rogue Trader” Mr Leeson, however, denies that Barings were involved in front-running their clients (Leeson 2005: 79). In my interview with Mr Leeson he said to me that, although Barings as an organization was always trying to bend the rules as far as possible, he could not confirm any instances of front-running other than his own. He did, however, confirm that the Singapore office would often receive orders from clients across the world. The clients would be operating in different currencies, and using the exchange rate most advantageous to Barings over the day to settle the executed trade would generate profits for Barings. The client would get a very good execution price, but incur slightly less than the optimum exchange rate for settlement purposes. This activity made the Singapore office GBP 2 million per year. However, Mr Leeson sees this type of conduct as normal for financial organizations similar to Barings. The use of questionable conduct to enhance profits was undoubtedly a skill Mr Leeson learned at his places of employment, rather than something he brought to them.

6.5 WAS HE EVER MAKING PROFITS?

When we look at figures reflected in the Board of Banking Supervision Report, it appears that Mr Leeson overall never made a profit for Barings Bank, even though he was regarded as a “turbo arbitrageur”. Although these figures may be technically correct, they are disputed by Mr Leeson.

TABLE 2

Facts versus Fantasy: Profitability of Mr Leeson's Trading Activities.			
Period	Reported (million)	Actual (million)	Cumulative actual ¹ (million)
1 Jan 1993 to 31 Dec 1993	+GBP 8.83	-GBP 21	-GBP 23
1 Jan 1994 to 31 Dec 1994	+GBP 28.529	-GBP 185	-GBP 208
1 Jan 1995 to 31 Dec 1995	+GBP 18.567	-GBP 619	-GBP 827

1. The cumulative actual represents Mr Leeson's cumulative losses carried forward.

Source: Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, Ordered by the House of Commons, Her Majesty's Stationery Office, 1995.

(Risk Institute: 4)

According to Mr Leeson, the report only looked at the losses he made in the 88888 account without taking into consideration his profitable transactions (Leeson 2005: 337). During our interview, he also pointed out that the mistakes of all the other traders working for him in Singapore all found their way into the 88888 account. It is also important to take note of the fact that, during July 1993, the 88888 account was down to virtually zero (Singapore Report: 1995 179). If Mr Leeson never made profits, this would obviously have been impossible. This is one of the important differences between Mr Leeson and Mr Jett. Mr Leeson managed to generate actual profits from executing actual transactions, albeit very risky transactions and, if not for the

Kobe disaster, may have made a very large real profit for his company. Mr Jett’s “profitable” transactions, on the other hand, were little more than a pyramid scheme based on fictitious entries into an antiquated accounting system. However, Mr Jett used fictitious trades to enhance his income. Why he wasn’t convicted of more serious offences is open for debate.

6.6 THE CHARGES AGAINST HIM

An analysis of the crimes that Mr Leeson committed has two sides to it. In the first instance, we have the charges brought against him by the Singapore authorities and, secondly, we have a set of “crimes” that he himself confessed to and compiled in his efforts to get extradited to the UK for trial. The list of crimes he confessed to in a document provided to the Serious Fraud Office (SFO) can be divided into seven sets of actions (Leeson 2005: 333-334).

6.6.1 “The communication of false information by Mr Leeson to the auditors of BFS in relation to the sum of 7.7 billion yen... This false information was accepted by the auditors and resulted in incorrect financial information being forwarded by them to Barings in London.”

6.6.2 “The exclusion by Mr Leeson of Account Number 88888 from the consolidated record of accounts sent daily to London. In this way the month-end balances could be manipulated by Mr Leeson to hide the losses appearing in that account and thereby give the false impression of profitability to Barings in London.”

6.6.3 “The repeated requests by Mr Leeson to Barings London for further sums to be paid to SIMEX by way of margin. These false requests resulted in sums being provided by Barings in London for one purpose (the payment of margin on authorized trades), that money actually being used in addition for another purpose (the payment of margin on unauthorized trades in the 88888 account).”

6.6.4 “The false indication by Mr Leeson to his superiors in London that he was trading in conformity with the restriction that he maintain no overnight positions.”

6.6.5 “The false indication by Mr Leeson to his superiors in London that his trading was no more than arbitraging through a balanced book between Singapore and Osaka. Barings in London repeatedly and regularly received reports indicating that Mr Leeson’s overall trading was profitable, whilst in reality it was making losses.”

6.6.6 “The entering by Mr Leeson or on his behalf of false prices in relation to account number 92000.”

6.6.7 “The false manipulation by Mr Leeson of the month-end equity balances on 88888 account as communicated to London.”

According to Mr Leeson’s own estimates, the list of charges brought against him by the Singapore authorities were far less complete than the list he provided to the Serious Fraud Office (SFO) and it was clear that the authorities in the UK were not keen to have him stand trial in England. When asked about possible reasons for this inaction, Mr Leeson said to me

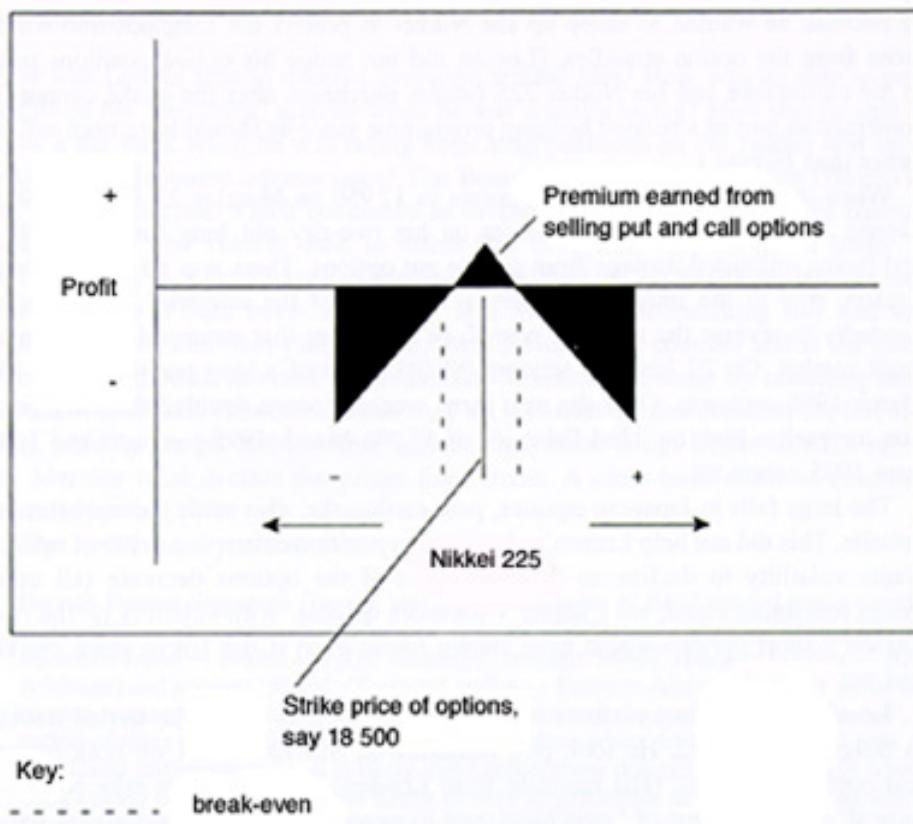
that the powers that be were probably concerned that a jury could have found it difficult to convict him, as happened in the Maxwell case when one of the jurors indicated that he didn't understand the case. He also pointed out to me that the Singapore authorities could have drawn up a much more extensive charge sheet if they wanted to cite each and every transgression. The charges that he pleaded guilty to were, in essence, the result of a plea bargain exercise between him and the Singapore authorities. It was only after this arrangement that he agreed to fly to Singapore for trial, where he then pleaded guilty and was sentenced to the agreed-to jail term. The essence of Mr Leeson's crimes was the fact that he lied about the profitability of his transactions and that he entered into unauthorized transactions on behalf of Barings in order to recoup his hidden losses.

6.7 WHAT INSTRUMENTS DID HE USE?

6.7.1 THE SHORT STRADDLE

One of the favorite transactions used by Mr Leeson was the “short straddle”. This transaction is “an options strategy carried out by holding a short position in both a call and a put that have the same strike price and expiration date. The maximum profit is the amount of premium collected by writing the options” (Investopedia). As mentioned previously, Mr Leeson was writing these options in order to generate money to pay his margin calls from SIMEX (Leeson 2005: 83) as early as 1993. Mr Leeson confirmed that he chose the straddle ultimately because of the high premiums he could gain from selling them. He needed the premiums to meet the margin calls on his other positions (Leeson Interview 2006).

FIG. 6



(Risk Institute: 3)

In practice, the effect of holding these positions can be demonstrated as follows: "If a trader writes a straddle with a strike price of \$25 and the price of the stock jumps up to \$50, the trader would be obligated to sell the stock for \$25. If the investor did not hold the underlying stock, he or she would be forced to buy it on the market for \$50 and sell it for \$25." In reality, Mr Leeson sold more than 370 000 straddles over a period of just over a year (Risk Institute: 3). In Figure 6, the anatomy of a straddle is graphically demonstrated. The illustration clearly emphasizes the fact that the gain to the

writer of the puts and calls can be no more than the premium he received when he entered into the sale transactions. If the market kept within a predetermined band he would gain the premium amount, as the two options would expire worthless, because the price of the underlying security did not breach the upper or lower threshold. However, if the market moved vigorously up or down, the problems would start. This is exactly what happened after the Kobe earthquake, and Mr Leeson's option positions were showing a loss of around USD 178 million by the end of February 1995 (Brown & Steenbeek 2001: 8).

If short straddles were medicine, the leaflet that accompanied them would most probably include a word of caution to those about to use them. The Investopedia Dictionary gives us an idea of what these warnings, in all likelihood, would have looked like. It firstly cautions the reader about the fact that "the short straddle is a very risky strategy an investor uses when he or she believes that a stock's price will not move up or down significantly" and, in the second instance, it warns that "because of its riskiness, the short straddle should be employed only by advanced traders due to the unlimited amount of risk associated with a very large move up or down" (Investopedia). Mr Leeson should have been acutely aware of this fact. Whether or not he had another choice, other than to face the music, is another matter.

6.7.2 NAKED FUTURES POSITIONS

The second, and most devastating instrument used by Mr Leeson, was his naked long positions in Nikkei futures and his naked short futures position in Japanese Government Bonds. It must be remembered that the buyer of a futures contract is under legal obligation to either exercise or close out his position by buying an equal but opposite position. The seller of an option or future is equally under obligation to perform if the options or futures that he sold are exercised. A naked position is “a securities position that is not hedged from market risk. Both the potential gain and the potential risk are greater when a position is naked instead of covered (a covered position is hedged from market risk)” (Investopedia). Once again, a basic source like Investopedia cautions that “whether to have a naked position is rarely a concern for most small investors, but it is a concern for large investment holders and institutions”. The reason is obvious: large unhedged positions in highly leveraged instruments like futures contracts can produce devastating losses.

In Mr Leeson’s case, his positions could only have been described as staggering. The volume traded through the 88888 account grew from a mere 2 051 contracts for July 1992 to 96 121 in September 1994. Mr Leeson held 49% of the March 1995 contract and 24% of the June 1995 contract (Brown & Steenbeek 2001: 7). Mr Leeson also had substantial positions in futures on Japanese Government Bonds. By November 1994 trading trough his 88888 account accounted for 24% of the SIMEX volume for Japanese Government Bond futures. At the time of the collapse, Mr Leeson held an unhedged short position of more than 28 000 contracts (2001: 7). In Table 3 we see a

summary of Mr Leeson's positions shortly before the collapse of Barings Bank. It was clear that Mr Leeson held 85% of the Japanese Government Bonds (JGB) March 1995 contracts and 88% of the June 1995 contracts (Risk Institute: 2). These positions became known in the market and made Mr Leeson extremely vulnerable. It must always be remembered that, for one party to make money, another party must lose the equivalent amount of money. Due to the sheer size of his positions, the counterparties must have included some of the largest investment banks in the world.

The extent of his positions was such that Swiss Bank apparently produced a paper at the end of 1994 in which no less than five potential explanations were put forward as reasons or motivations for Barings' positions in the market. Indicative of the size of these positions was the fact that one explanation that was put forward cited potential cooperation with a Government to support the market (Fay 1997: 145). During January of 1995, numerous individuals at Barings were questioned regarding the size of the Barings positions (1997: 157). It would be wrong merely to assume that these were calls made from individuals with the best interests of Barings at heart. In the cutthroat world of derivatives trading, information is worth gold and anyone working for a firm that was on the other side of Mr Leeson's positions would have been useful to try and find out what they could about the Barings strategy and/or who they (Barings) were trading for. As the Solomon strategy showed us (Lowenstein 2002: 3-5), having deep pockets is often more important than a brilliant strategy. It is, therefore, quite conceivable that these rumors were viewed by Barings management as panic from worried counterparties about to lose a lot of money. The other comforting factor to those attending a Barings Asset and Liability

Committee (ALCO) meeting at the time, was the fact that although large, these positions were supposedly hedged, making them essentially benign. The alarming part of the gossip was the call from the former Barings employee working for the Bank for International Settlements (BIS) in Basle regarding a rumor that Barings missed a margin call in Asia. This type of gossip in a market, whether true or not, could destroy a bank, as public perception dictates the standing of a bank much more than actual capitalization. As the news reached Peter Norris, Mary Walz contacted the Barings traders in Asia, including Mr Leeson, who advised her that she and her team should talk to the press. In hindsight, this instruction may seem odd. In reality, misinformation is a valuable and powerful tool for those operating in financial markets. It is quite possible that the wrong comment made in innocence about, for example, the actual positions of Barings could undo the well-laid plans their star trader, Mr Leeson, put in place to outwit the competition and earn them all spectacular bonuses. At the Barings executive committee meeting EXCO, Peter Norris explained that he instructed the Tokyo positions to be reduced purely for PR reasons and not because he saw any threat in the size of the positions (1997: 158). The problem was that no-one took the trouble of verifying the facts. The following summary in Table 3 clearly reflects the staggering extent of the positions held by Mr Leeson.

TABLE 3

		Fantasy versus Fact: Mr Leeson's positions as at end February 1995.	
		Number of contracts ¹ nominal value in US\$ amounts	Actual position in terms of open interest of relevant contract ²
		Reported ³	Actual ⁴
Futures			
Nikkei 225	30112 \$2809 million	long 61039 \$7000 million	49% of March 1995 contract and 24% of June 1995 contract.
JGB	15940 \$8980 million	short 28034 \$19650 million	85% of March 1995 contract and 88% of June 1995 contract.
Euroyen	601 \$26.5 million	short 6845 \$350 million	5% of June 1995 contract, 1% of September 1995 contract and 1% of December 1995 contract.
Options			
Nikkei 225	Nil	37925 calls \$3580 million 32967 puts \$3100 million	
1. Expressed in terms of SIMEX contract sizes which are half the size of those of the OSE and the TSE. For Euroyen, SIMEX and TIFFE contracts are of similar size. 2. Open interest figures for each contract month of each listed contract. For the Nikkei 225, JGB and Euroyen contracts, the contract months are March, June, September and December.			

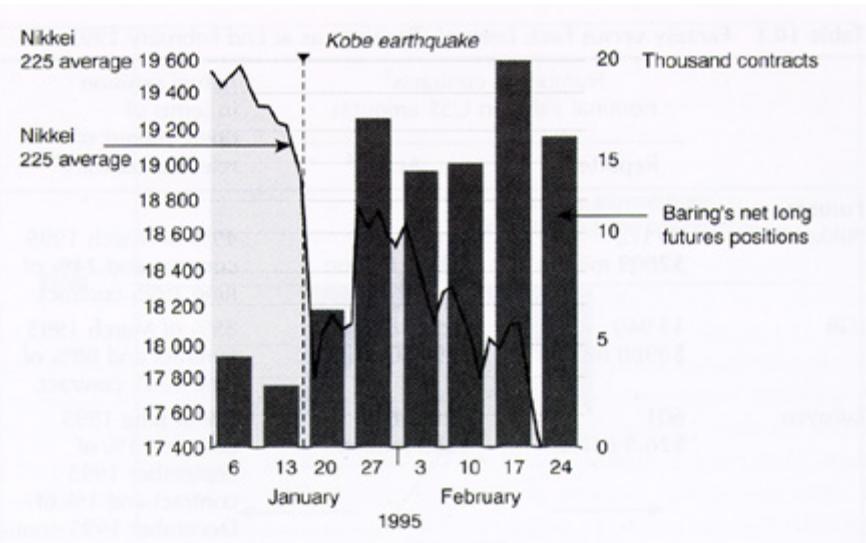
3. Mr Leeson's reported futures positions were supposedly matched because they were part of Barings' switching activity, i.e. the number of contracts on either the Osaka Stock Exchange, the Singapore International Monetary Exchange or the Tokyo Stock Exchange.
4. The actual positions refer to those unauthorized trades held in error account 88888.

Source: The Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, Ordered by the House of Commons, Her Majesty's Stationery Office, 1995

(Risk Institute: 2)

These positions were, however, built up in a relatively short space of time. In Figure 6 it is clearly demonstrated that, after the Kobe earthquake, Mr Leeson embarked on a very substantial strategy to increase his net long futures positions on the SIMEX and Osaka exchanges. As the Nikkei average was falling, the straddles sold by Mr Leeson began showing their true colours (Risk Institute: 3-4). The put options that Mr Leeson sold obliged him to buy the Nikkei 225 average based contracts at a fixed price, even though the underlying value may have decreased substantially on the expiry date. If the market kept on falling, his losses would mount continuously until the expiry date of the contracts. Mr Leeson also had the problem of a substantial rise in the market. As we showed, the call options that he sold as part of his straddles would also become valuable to their holders if the average of the Nikkei 225 showed a substantial rise, breaking out of the 19 000-20 000 range Mr Leeson was hoping for.

Figure 7.



Baring's Long Positions against the Nikkei 225 Average.

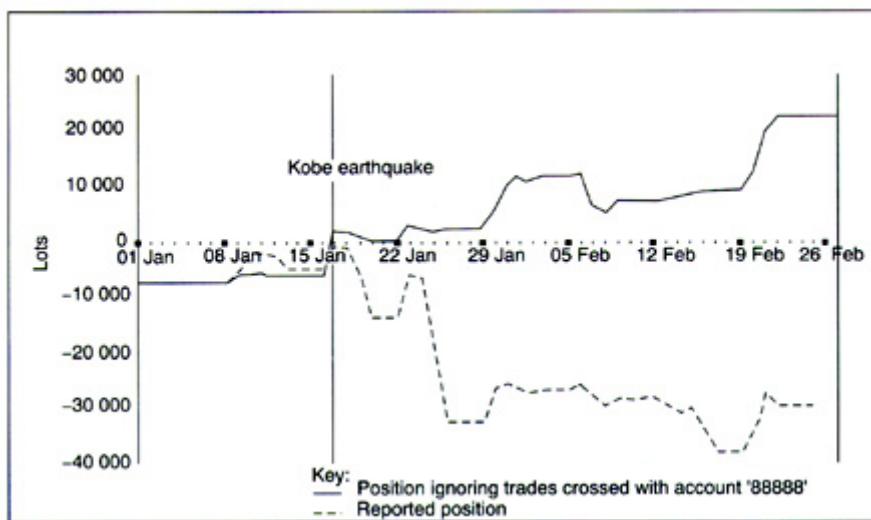
Source: Datastream and Osaka Securities Exchanges

(Risk Institute: 1)

The key to Mr Leeson's ability to create false profits and hide his actual positions could be attributed to a well-used trading transaction called a cross-trade. In order to increase efficiency, a Member of an Exchange that represents both a buyer and a seller from two different accounts, and who have a matching interest (the buy order matches the sell order in price) in the same security, is allowed to execute the transaction on the floor of the Exchange. According to SIMEX rules, he is allowed to cross or execute the transaction after he declares the bid (buy) and offer (sell) prices three times in the trading pit. If no other member wants to take up the transaction, he can execute the transaction at the ruling market price (IFCI Risk Institute: 3-7). Mr Leeson executed a substantial number of transactions between the Barings London-Euroyen Arbitrage account number 98008, the Barings –

London JGB Arbitrage account number 98007, the Barings Securities Japan-Nikkei and JGB Arbitrage account number 92000 and his own 88888 account. In order to create the fictitious profits, the entries into the CONTAC system used by Barings and a number of other SIMEX members, were manipulated. Each cross-trade executed on the trading floor was then broken up into a number of smaller trades. The prices of these smaller trades were then changed to create a fictitious profit in one account and the corresponding losses were booked to the 88888 account. In other instances, he executed smaller switches, in which case he merely changed the prices at which the trades were executed on the floor to create a fictitious profit. It appears that the subdivision of trades was designed to lead Barings Securities Japan into believing that the transactions (and profits) were real. One can only assume the undivided trades were for accounts that were both under his control. A substantial number of transactions were also entered into the CONTAC system, although they were never crossed on the SIMEX floor. These off-market transactions, although legal and perfectly acceptable on many international exchanges, were not permitted by SIMEX. The effect of these actions was twofold: in the first instance, it created false profits while hiding the losses, and the second and ultimately more important implication was the fact that no-one could detect the very large unhedged positions that Mr Leeson entered into on behalf of the bank. This latter implication is clearly reflected in Figure 8 below.

FIGURE 8



Graph to show the Nikkei Position of Account '92000'. Reproduced by permission from the Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings.

(IFCI Risk Institute: 6).

It is clear to see that, when one looks at the dotted line, it appears as if there is a substantial decline in the positions of Barings, which is in line with the instruction from the ALCO meetings held in February 1995 (Fay 1997: 187); in reality, however, the unbroken line shows a substantial increase in the positions that Barings were holding.

6.8 EXTERNAL WARNINGS

6.8.1 THE JOSEPH JETT INCEDENT

As we have seen in the previous chapter, one of the most blatant warnings that should have alerted the management of Barings was the exposure in April of 1994 of a Wall Street trader called Joseph Jett. Mr Jett fabricated a USD 350 million profit through manipulation of his firm's (Kidder Peabody) accounting system (Fay 1997: 131). The Joseph Jett incident did spark an internal review of risk procedures, which identified the fact that the existing procedures were not up to standard. The Board of Barings was apparently informed that a system was under development to allow Barings in London to monitor their overseas activities. The Director Settlements of Barings Investment Bank at this time was aware of the potential hazards associated with the fact that his department was dependent on the relevant traders supplying figures regarding trade prices, as well as volume traded (1997: 133). Risk controllers were, interestingly enough, appointed in London, Tokyo and Hong Kong, but not in Singapore, as Simon Jones viewed it as not necessary (1997: 133).

6.8.2 THE SLK RECEIVABLE

During January of 1995 the external auditors of BFS, Coopers & Lybrand, noted a substantial discrepancy between the BFS general ledger and the SIMEX yen settlement variation account. When Mr Leeson was approached for an explanation, he blamed a computer error for the discrepancy (Singapore Report 1995: 118). He later changed his explanation. As early as

January 30 1995 this USD 86 million receivable from a New York trading firm called Spear Leeds & Kellogg, or SLK, was questioned by the external auditors of Barings Futures Singapore (Reyes 1995: 1-7). The external auditors conveyed their concerns to the Group Finance Director of Barings Investment Bank, Geoffrey Broadhurst, who in turn claimed that he informed Peter Norris, the CEO of Barings Securities Limited. The head of Barings' Futures and Options Settlements office in London claimed that she offered to Broadhurst that she would call SLK on the day of the 30th of January when they first became aware of the USD 86 million receivable; however, he told her not to do it. According to Broadhurst, he was told by Norris not to do anything until it was confirmed that a real problem existed and was further instructed by Mr Norris to advise Coopers and Lybrand that they would prefer to investigate the matter internally. Spear, Leeds & Kellogg from New York was not unfamiliar to Barings, as their SIMEX trades were cleared through the Barings office in Singapore (Fay 1997: 107). Broadhurst himself was, however, not familiar with SLK and he was, on enquiry, advised by the Barings credit department in London that the credit limit of the firm with Barings was only USD 5 million, a lot less than the USD 86 million involved in this transaction (1997: 167).

The matter was apparently never fully investigated and apparently, on the 8th of February 1995, Mr Norris referred to the matter as an “operational error” during a meeting of the Asset and Liability Committee (Reyes 1995: 3-4). This was not out of the ordinary as, on the 2nd of February 1995, Mr Leeson provided the Coopers and Lybrand auditors with a forged letter purportedly signed by the managing director of SLK, Mr Richard Hogan (Fay 1997: 160-170). The letter acknowledged the existence of the receivable in question.

However, this did not totally satisfy Coopers and Lybrand. They also needed confirmation that the trade was authorized by Barings in London and confirmation by SLK that the USD 86 million would be paid to Barings. To achieve that, Mr Leeson went further and forged a fax from Ronald Baker, head of the Financial Products Group at Barings Investment Bank, acknowledging and authorizing the transaction, as well as another fax from Richard Hogan confirming that the premium would be paid. Mr Leeson also provided the auditors with forged documentation “confirming” that the money in question was indeed received by Barings. This satisfied the auditors. It is possible that Coopers and Lybrand conveyed their satisfaction to Mr Norris who, in turn, accepted the view of the auditors and conveyed such at the (ALCO) meeting of the 8th of February 1995.

The forgeries were fairly clumsy and the second fax that supposedly came from Hogan clearly showed that the header on the New York fax was from “Nick and Lisa”. This per se can be explained by the fact that, due to time differences, Mr Leeson could have asked Mr Hogan to send the fax to his home rather than to the office. He may have claimed that he left the fax at home and asked his wife to fax it to him at the office. What is of greater importance is the fact that, in a handwritten memo to Simon Jones, Director Barings Futures Singapore and Finance Director Barings Securities Singapore, dated 1 February 1995 Mr Leeson admitted that he was involved in an unauthorized trade (Fay 1997: 168-169). The Report by the Singapore Inspectors (1995: 118-148) raised a number of questions regarding the handling of the SLK receivable. In the first instance, no less than seven different explanations were provided for the discrepancy.

- When first questioned by the C&L auditors about the discrepancy between the two accounts, Mr Leeson blamed it on a computer error.
- The second explanation he offered was that the shortfall was due to an outstanding refund of a margin deposited with SLK for an OTC Nikkei option that expired on the 30th December 1994.
- At the request of SLK and BNP, an option trade between the two parties had been recorded in the BFS accounting records. BNP sold an option maturing on 30 December 1994 to SLK. Due to a BFS booking error, the BNP leg of the transaction was incorrectly marked for maturity on the 3rd of December 1994. On the third BFS paid the option premium to BNP, causing the shortfall as the payment of the option premium by SLK was only due on the 30th of December. This SLK payment was, however, outstanding and overdue. Mr Leeson admitted in writing that the transaction was unauthorized.
- The fourth version put forward in a letter from Coopers & Lybrand stated that a Barings client, SLK, purchased Nikkei options from BSL and didn't exercise the options or pay over the option premium due to BSL. The outstanding option premium was paid over to BSL on 31 December 1994.
- According to Ms Waltz, she was told by Mr Broadhurst that a booking error of a transaction between SLK and BNP gave rise to the SLK receivable.

- The sixth version of the problem put forward by Mr Broadhurst to C&L in London in February 1995, was that the problem arose because SLK traders wore BFS jackets when they traded on SIMEX. The front and back office function in Singapore has been split and extra staff had been employed to cope with the increase in trades. Mr Leeson's role, and the fact that he admitted to an unauthorized trade, was omitted. The auditors were also asked to omit the incident from the audit management letter, as it could cause problems for Barings at SIMEX. Everything in this account is false.
- On the 9th of February 1995, Mr Leeson told Mr Hawes during a meeting that SLK sold an option to BNP and, on maturity of the option, the amount of 7.778 billion yen in question was payable by SLK to BNP.

The obvious question is why no-one noticed the conflicting stories, why no action was taken against Mr Leeson and why the auditors were misled. There can be very little doubt that this matter was covered up, clearly implicating at least some of the Barings management. Ironically enough, in the three weeks up until the 24th of February 1995, nearly a billion USD was sent to BFS by other Barings entities. It is, therefore, quite conceivable that the collapse of Barings could have been averted if proper care and diligence was exercised by management when they became aware of the shortfall.

6.8.3 THE SIMEX LETTER

On 11 January 1995 Soo Yu Chuan, the Senior Vice President Audit and Compliance SIMEX, in a letter to Simon Dominic Jones, Director Barings Futures Singapore and Finance Director Barings Securities Singapore, questioned an apparent shortfall in margin requirements for account 88888 (Fay 1997: 149-153). He also questioned the ultimate identity of the owner of this account. It appears he was led to believe that account 88888 was a non-proprietary account and, therefore, pointed out that the fact that Barings were funding the margins in this account would be in contravention of SIMEX rule 822 prohibiting SIMEX member firms from financing the margin calls of their clients.

SIMEX officials started to watch Barings traders very closely in the beginning of 1995. It is noteworthy that Tony Hawes had to assure SIMEX officials during a meeting on 8th February 1995 that "...the entire assets of the Barings Group were available to ensure that Barings Futures in Singapore could meet its liabilities to the exchange" (Fay 1997: 180). During this meeting Mr Hawes was corrected by a SIMEX official when he said that Barings was short in Singapore. Mr Hawes knew that Mr Leeson was long in Osaka. The implication of this was an unhedged position, which carries great inherent risk. To his credit, Mr Hawes raised the matter with Mr Leeson, but was told that the Simex official was in error and that the said official conveyed this to him (Mr Leeson) in a telephone conversation (1997: 175).

On 16 February 1995 the company secretary of Barings Bank was telephoned by a senior director from another merchant bank in London called Schroders (Fay 1997: 187). Apparently, a rumor was doing the rounds that a counterparty of Barings was about to default on a large position (20 000 contracts) on the Osaka Exchange. The call and the rumor were discussed by the Barings ALCO and dismissed. As they did three weeks earlier, they once again decided that the Singapore positions should be reduced. Once again, no concrete measures were put in place to monitor whether or not these decisions were in fact implemented. Once again, as with the SLK receivable, any thorough analysis would have exposed Mr Leeson's activities and, even at this very late stage, might have averted the collapse of Barings.

I asked Mr Leeson for his comments regarding the inaction of management and their apparent efforts to conceal the SLK issue. He attributes it to the fact that the event occurred shortly before bonus allocations took place. He credits the possibility that anything untoward may jeopardize the bonuses of management as their motivation to smooth over things.

6.9 INTERNAL WARNINGS

In September of 1993 the head of settlements raised some concerns regarding the controls in Mr Leeson's area, but was apparently rebuffed (Fay 1997: 127). Similarly, the concerns about data integrity raised by Tony Gamby after the investigation following the Joseph Jett exposure didn't lead to any serious risk control measures (Fay 1997: 133). One of the individuals at Barings who expressed his concerns about Mr Leeson was the Group

Treasurer of Barings Investment Bank (BIB), Tony Hawes. He briefed James Baker, who was tasked to carry out the audit of Barings Singapore during the spring 1994 (Fay 1997: 124) about the necessity for Mr Leeson's control of both the front and back offices to be investigated due to the potential for abuse. He further expressed concerns about the amount of margin payments made by Barings Securities Limited London without a clear understanding of why and on whose behalf these payments were being made. As we mentioned before, Mr Leeson claimed these were margin payments made on behalf of his clients. Another voice of concern came from an assistant to Peter Norris, Sajeed Sacranie, who questioned whether or not SIMEX rules allowed the mixing of agency and proprietary trading, as done by Mr Leeson. The motivation for SIMEX to disallow such activity would probably be the potential for front-running of client orders.

During the autumn of 1994 a Tokyo trader working for Barings reported an odd experience he had with Mr Leeson to Mary Walz (Global Head of Equity Financial Products Barings Investment Bank), one of the managers Mr Leeson reported to (Fay 1997: 133-134). According to the Tokyo trader, he detected a discrepancy between what he was led to believe regarding Mr Leeson's trading activity in Japanese Government Bonds on the SIMEX market and what he could see on his own screen. On drawing Mr Leeson's attention to this anomaly, he was advised by Mr Leeson that this was the effect of cross-trading that hadn't been reflected by SIMEX. A short while later, the Tokyo trader's screen reflected trades more in line with what he thought Mr Leeson executed. They both assumed that the SIMEX officials turned a blind eye to his after-hours trading because of the amount of business he conducted. A few months later, in July 1994, Fernando Geuler

(Head of Proprietary Equity Derivatives Trading Barings Securities Japan) complained to Mary Walz about a lack of sufficient information to monitor Mr Leeson's positions (1997: 136). The solution was to give Mr Leeson his own trading book for Nikkei arbitrage. In October the exceptional profits generated by Mr Leeson once again fueled Geuler's suspicions (Fay 1997: 139). There was a lack of activity in the Nikkei 225 index that normally manifests in low volatility, which should translate into fewer money-making opportunities, which is reflected in lower profits. Mr Leeson, however, was making even more profit. The only explanation he (Geuler) could find was that Mr Leeson was, as a matter of course, front-running orders to allow such profits. Geuler once again shared his concerns with Mary Walz and warned of the consequences to Barings. Walz took the issue up with Ron Baker, Head of Financial Products Group Barings Investment Bank who, according to Geuler, contacted him to assure him that the audit conducted by James Baker cleared Leeson. Ron Baker later denied that either Walz or Geuler ever expressed concerns about the way in which Mr Leeson was generating his profits. Fernando Geuler also made Mary Walz aware of an incident during January of 1995 when Mr Leeson, apparently without provocation, started to shout abuse at him in the course of a routine conversation (Fay 1997: 147). It is quite clear that Mr Leeson was under tremendous strain at this point in time.

In an article in the Wall Street Journal, Sydney Finkelstein reported (2003: 1-2) that he was told by clerks at the Singapore Barings office that Mr Leeson's activities were an "open secret". This is confirmed by the fact that he enlisted their assistance in hiding his activities on a regular and consistent basis. During a visit in October 1994, Tony Hawes met one of the

back office staff, called Linda, and was shocked by her lack of understanding of futures and options (Fay 1997: 140). Mr Leeson also used his floor traders to execute large orders 30 seconds before the end of daily sessions. Mr Leeson confirmed to me that his settlement staff were very inexperienced and were very loyal to him. Their lack of experience giving them a point of reference from which to judge his actions, and the relationship he built up by protecting them when they made mistakes, would explain their loyalty. The question that deserves to be asked is why Mr Hawes did not act when he realized that Norhaslinda Haji Hassan (Linda), the settlements officer for Barings Futures Singapore, had a very limited knowledge of futures and options.

The Report to the Board of Banking Supervision Inquiry into the collapse of Barings also identified a number of “indicators” that should have alerted the Barings management (The Risk Institute: 2-4). Some of those highlighted were:

- The identification of the lack of separation of duties between the front and back offices reported in the internal audit report following the July and August 1994 review of the activities of Barings Futures Singapore (BFS).
- The high levels of funding required by Barings Futures Singapore, as well as the fact that no reconciliation took place of funds transferred from Barings in London to Barings Futures Singapore.
- Another red light would have been the extraordinary profits generated by Barings Futures Singapore through a perceived low-risk activity such as arbitrage (low risk, low return and vice versa).

The report pointed out the following other factors that, if viewed collectively, should have raised the alarm: the SLK receivable and the two SIMEX letters, reporting very large Barings positions; market rumors in the beginning of 1995, as discussed previously; and the high levels of inter-exchange arbitrage allowed without the application of gross trading limits.

If any of these warnings were treated with the attention it deserved, a catastrophe could in all probability have been averted. On Thursday the 23rd of February 1995 however, one day before Mr Leeson was to receive his bonus and two days before his 28th birthday, everything became too much. Mr Leeson left his trading desk and with his wife he made his way to Borneo. On Monday morning the 27 February 1995 a newspaper headline confirmed his worst fears, “BRITISH MERCHANT BANK COLLAPSE” (Leeson 2005: 297-299). The massive positions showed in Table 3 were too much for even Barings to bear. Within a few days Mr Leeson was arrested on his arrival at Frankfurt, on his way back to England. From there he was extradited to Singapore, where he was tried and sentenced to six and a half years in prison (Fay 1997: 288). Barings were taken over by the Dutch firm ING for a token 1 GBP (1997: 231).

6.10. WHO IS TO BLAME?

Lynn T. Drennan points out the fact that the huge media interests that accompany events like the Barings collapse and the types of events similar to it are at least in part fueled by a desire to blame either an individual or a group of individuals for what happened (2004: 5). Drennan continues and highlights the apparent obsession with the media to portray individuals as

“demons” or “rogues”. This irrational feeding frenzy often helps to obscure the fact that the circumstances in which the abuse took place are usually created by a whole series of failures that can be attributed to, among other things, management and system inefficiencies. This fact underlines the “culpability” of an organization as a whole. It is, however, very difficult to crucify an entity if the crowds are baying for blood. It is unfortunate for the likes of Rusnak, Iguchi and Leeson that the culpability of these collectives is often only exposed after the media frenzy is over. In the case of Mr Leeson, the Report of the Singapore inspectors highlighted their conviction that Mr Leeson was not solely responsible. Mr Leeson partly contributes the apparent unwillingness of the UK authorities to have him tried in the UK to the possibility that blame would also be apportioned to the powers that be at Barings (Personal Interview 2006).

Drennan summarizes her analysis of the events that led to the collapse of Barings Bank and the Mirror Group of companies of which Robert Maxwell was the CEO, by arguing that to attribute the collapse of these two companies purely to two individuals acting unethically and socially irresponsibly would be a gross oversimplification of the true facts. We should investigate the very important, although very often obscured, role of “...a failure in the corporate culture and management systems of the organization that allowed, if not encouraged, such behaviour” (Drennan 2004: 5) (Drennan & Beck 2004: 7-8). Mr Leeson himself had the following to say when he reflected on what he did: “I tried to remember the pressure I’d been under to perform and produce profits, but then I realized that this was just looking for excuses. These were my crimes, and I had to acknowledge them, plead guilty to them, and then put them behind me and

get on with my life" (Leeson 2005: 335). However, he went further and said: "...I did know that I could never even have begun these crimes in any other bank". This, as we have seen in this thesis, unfortunately turned out not to be true.

During my interviews with Mr Leeson he made it quite clear that he accepts responsibility for his actions. His motivation was twofold: a combination of his need to be successful in order to gain the respect and admiration of his family, his wife, superiors, co-workers and friends. He cites his inability to accept the fact that he was failing as one of the major reasons for trying to trade out of his positions while hiding his losses. This, as we have shown and will further show, was not unique to Mr Leeson. The potential loss of status, standing, respect and maybe your work seems to be a very strong motivator to hide and trade out of your losses rather than admitting to them. Mr Leeson also recounted to me an incident in December of 1994 in which a debt trader in London traded in something he shouldn't have and lost nearly USD 10 million. This loss was covered up by the institution that he worked for. This course of action, Mr Leeson believes, was and still is standard practice in the industry. Mr Leeson is adamant in his conviction that, if he was aware of a rogue trader incident that ended like his did, he would not even have considered going down the road he traveled. He does, however, lay some blame at the doors of his superiors at Barings for creating an environment in which his activities could remain undetected for so long.

6.11 THE ROLE OF SHORT-TERM INCENTIVES

This question is essentially made up of two components; in the first instance, one needs to determine if Mr Leeson's activities were as a whole or in part motivated by his remuneration package. Secondly and potentially more importantly, was the inability of the management at Barings to detect Mr Leeson's activities resultant from their own need to have the company generate profits in order for them to get their very substantial remuneration packages? We will show that the answer to this question, analyzed from both perspectives, undoubtedly has to be yes.

During his holiday in the UK at the end of 1994, Mr Leeson recounts that he told his wife that he wanted to resign his position at Barings. Her response was that he must first go back and collect his bonus which, according to her “will set us up for life!” (2005: 208). One of the most astounding facts about this incident was that, according to his own account (Leeson 2005: 282), Mr Leeson was trying to hang on only until he had received his bonus (2005: 248). He had two options; he could leave or try and trade out of his losses. As he could not leave, his only remaining option was to start doubling up in order to make inroads into his GBP 200 million losses. He would have received his bonus on the 24th of February, the day before his birthday on the 25th of February. According to the Bank of England report, his superiors considered paying him a bonus of more than GBP 700 000. This figure is about double the amount that Mr Leeson recalls was offered to him in November 1994 by Ron Baker, the Head of Barings Financial Products Group (Leeson 2005: 181). By his own account, the bonus Mr Leeson was expecting would have been around GBP 400 000. There is also more than

sufficient evidence to suggest that senior executives at the bank may have been more concerned with their bonuses than the long-term interests of the shareholders of the company. This would provide us with some explanation for the seeming inability to question any of Mr Leeson's activities. A clear example was the audit conducted by James Baker. As we have seen previously, Mr Baker was armed with all the right questions. The failure of his audit to expose Mr Leeson appears to be directly linked to his focus (Fay 1997: 125). Mr Baker was apparently ultimately concerned with threats to the flow of profits to Barings. One of these threats he identified as a drop-off in volatility of the markets and the overall volumes of business available in the market. The second threat he identified was the potential loss of Mr Leeson. It is clear that Mr James Baker appreciated and confirmed the perception in Barings of the direct correlation between the presence of Mr Leeson and the present and future profitability of Barings.

During my interview with Mr Leeson, he confirmed that money undoubtedly played a role as a motivator for, among other things, his actions and the action or inaction of those in Barings who benefited from the "profits" he was generating through the Barings bonus structure (Leeson 2006 Interview). He said that the prestige and the status that went along with being a highly successful trader was probably the principle motivator. He wanted desperately to be the successful trader, son, friend and husband. When I asked him why he started using the 88888 account again after he cleared it in 1994, he said it was the fear of failing that made him use the 88888 account. Mr Leeson was, in other words, dependent on the 88888 account to maintain his status. He could not admit to himself that he was not the superstar trader that he so desperately wanted to be. Mr Leeson also

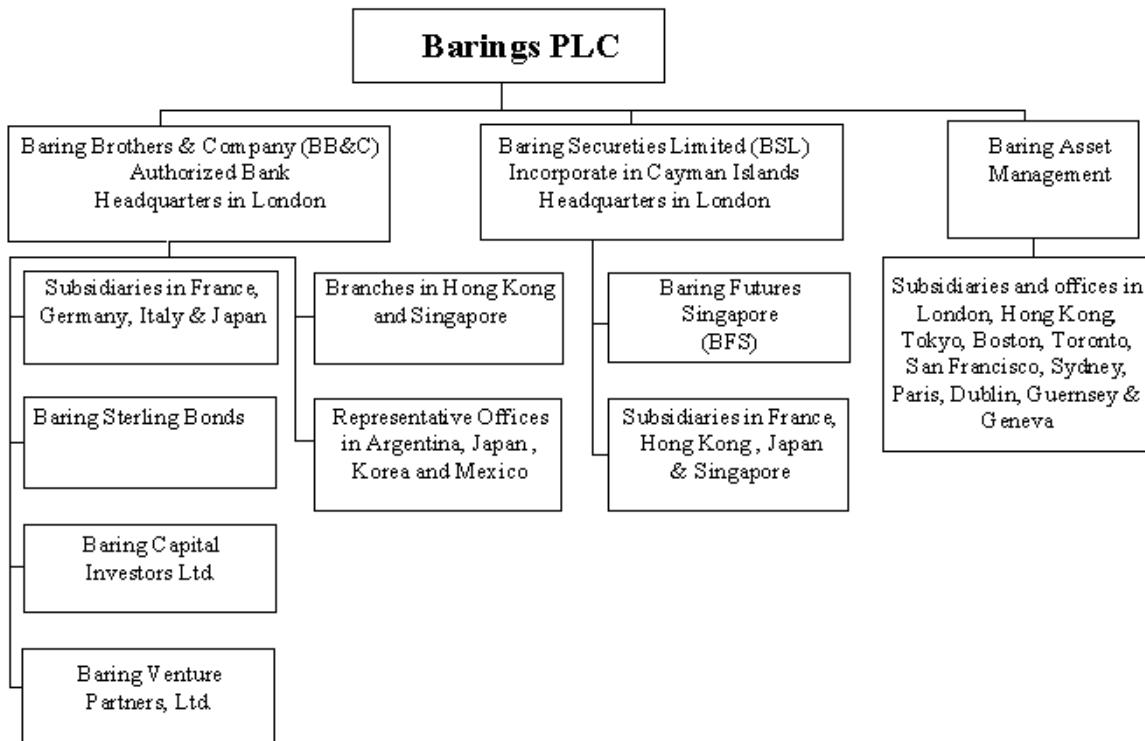
recognizes the fact that he was, by that time, addicted to his 88888 account. The ease with which he could manipulate the books, resultant from being in charge of both the front and back office functions, coupled with the absence of any real oversight by Barings internal risk management systems, allowed him, as he described it, to be “probably the only person in the world to be able to operate on both sides of the balance sheet” (2005: 87). As we have shown and will further show, Mr Leeson was unfortunately not in a unique position and nor was he the only one who showed signs of addictive behavior.

6.12. THE ROLE OF THE BARINGS CORPORATE AND REPORTING STRUCTURES

Barings employed a very fragmented reporting system (Herring: 24-30), which resulted in a situation in which Mr Leeson was reporting to product managers in London who were responsible for the profitability of his transactions. The product manager for proprietary trading was different from the product manager for agency trading. From 1 January 1994 Mr Leeson reported to Mr Ron Baker, director of Barings Bank & Company (BB&CO)/Head of Financial Products Group (FPG) of Barings Investment Bank through Mary Walz, also a Director of Barings Bank & Company (BB&CO)/Global Head of Equity Financial Products, Barings Investment Bank (BIB). He also reported to a local manager at Barings Securities Singapore, who was responsible for operational and administrative matters. He had a further reporting line to the regional operations manager for Southeast Asia. In practice, Mr Leeson reported to both Mr James Bax, Regional Manager South Asia/Director Barings Futures Singapore (BFS)

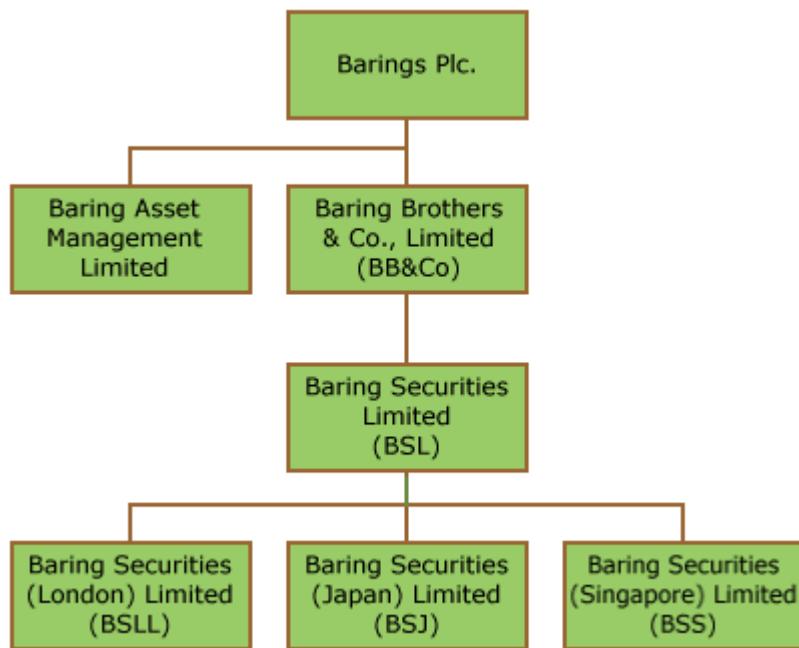
and Mr Simon Jones, Regional Operations Manager South Asia/Director Barings Futures Singapore (BFS)/Chief Operating Officer Barings Securities Singapore (BSS) (The Riskinstitute: 2-4). The argument being made is that it is not uncommon for this so-called matrix system to be employed in financial businesses with global operations. In the case of Barings, the shortcomings of the system were brutally exposed. In practice, an overseas manager would have local reporting lines of an administrative nature, together with a product or operational manager at a regional or head office. In Mr Leeson's case, it appears that everyone wanted him to report to them as he was reporting large profits, while no-one took the time to determine exactly how he was achieving his profits. This view was confirmed by Mr Leeson (Leeson 2006 Interview). Mr Leeson made it clear to me that the reporting structure at Barings was far from ideal. This was further complicated by the fact that the "profit" and loss accounts reflecting the "profits" he was generating most probably served as an incentive to individuals to create the impression that they in some way contributed to this profit and/or were entitled to share in the glory, as he was in one way or another reporting to them. This, together with the constant turf battles in the organization, created the environment in which questions about his profitability were viewed by his immediate superiors as an attack on their turf rather than a genuine effort by someone to solve some of the questions that were raised from time to time. Mr Leeson described his reporting lines as "...hazy and inbred as the Barings family tree itself" (2005: 88). The following diagrams show how an already unwieldy structure before 1993 became even more complicated after the 1993 merger.

FIG. 9



This was the structure of Barings up until 1993. The structure below was the post-1993 structure of Barings Investment Bank (BIB). It was at this time that the “matrix” system of reporting was introduced. Mr Leeson further pointed out to me that, although the group of people who had the responsibility to oversee his actions all had experience in a range of different areas of the financial markets and trading in them, no-one had experience of the whole process from trading through to settlement and reporting. It was this lack of a thorough understanding of the total process, coupled with an already fragmented reporting structure, that became a major contributor to the environment that allowed him to trade unauthorized, hide his losses, inflate his profits and fraudulently receive funding to sustain his activities.

FIG. 10



An abbreviated organization structure for Barings following the 1993 merging of BB&Co. and BSL. In 1994, BB&Co. and BSL became part of the new BIB.

(riskglossary.com)

Mr Leeson emphasized the unwillingness of his superiors to ask questions if they didn't understand something as a key element of failure in the overall oversight structure. Although he holds the view that it is possibly only human nature for people not to ask questions out of fear of looking stupid, it nevertheless allowed him to talk himself out of many tight spots. This phenomenon is unfortunately not restricted to Barings, and played a role in a number of these failures. A striking example of this type of behavior was the claim by Joseph Jett's boss that he didn't understand what Jett was doing, when asked why he didn't detect Jett's activities (Partnoy 2003: 179).

Coming from a man with a PhD in mathematics, how was that possible? Was that precisely the problem, was he was afraid of asking because he was afraid of looking stupid?

6.13 THE ROLE OF THE FORMAL REGULATORY INSTITUTIONS

The question of regulatory failure, in the case of Barings, has two elements to it. In the first instance, the role of British regulator, the Bank of England, needs to be investigated and, secondly, the role of the Singaporean regulator deserves our attention.

6.13.1 THE BANK OF ENGLAND AND THE SFA

There is sufficient evidence to suggest that the Bank of England and the SFA had grave concerns about Barings as far back as the early 1990s. The Bank of England was apparently informed by the banking side of Barings, Barings Brothers, that a distinct possibility existed for the closure of Barings Securities if the losses in this area persisted and grew (Fay1996: 62). In reality, the operating loss for the preceding 12 months up until 30 September at Barings Securities was nearly GBP 40 million, which translated into an after-tax loss on ordinary activities of nearly GBP 12 million. During its June 1992 inspection of Barings, the Securities and Futures Authority (SFA) detected a number of breaches of its rules by Barings. By early 1993 the Bank of England was still very concerned by the state of Barings. During a meeting between a Barings delegation and Christopher Thompson, the Bank of England supervisor responsible for Barings, Mr Thompson apparently advised the Barings delegation that there was a real fear that the earnings

collapse at Barings Securities was threatening the very existence of Barings Brothers & Co. and that this may result in the collapse of the merchant bank that has been around for more than 230 years (Fay 1996: 64).

6.13.2 SIMEX

Mr Leeson himself viewed the role of the officials at SIMEX as a very important contributing factor to the environment in which he was able to conduct his activities and was allowed to build up his massive positions. A SIMEX official apparently asked him to increase his positions only weeks before the collapse of Barings. This is a very critical issue, as SIMEX was the one organization that knew exactly what his positions were (Leeson 2006 Interview). SIMEX not only knew what positions he was holding, they also knew the ultimate ownership of the 88888 account, as they requested Mr Leeson to identify the owner of the account. As the Barings positions on the Osaka and Tokyo exchanges were reflected on Bloomberg on a daily basis, SIMEX was the only role player other than himself that knew exactly what the overall Barings positions were. According to Mr Leeson, a senior SIMEX official asked him to put more business through SIMEX only a few weeks before the collapse of the Bank. Mr Leeson holds the view that SIMEX did not have the expertise to conduct the levels of business they were conducting at the time. He noted to me that the most experienced and best staff was poached by the major banks, leaving SIMEX at a disadvantage. This phenomenon, according to Mr Leeson, is not only confined to SIMEX. In his view, the best people are usually working for the banks, trying to break the rules, and not for the regulatory bodies trying to enforce the rules. Even in the case of Barings, Mr Leeson feels strongly that

there was a lack of emphasis on the importance of proper administrative systems, and experienced staff. A reflection of this is the fact that he was not allowed to pay for experienced back-office staff, a fact that contributed to the eventual collapse of the bank. Because of Barings trying to save costs in all non-profit-generating areas, he was only able to appoint inexperienced staff. This not only led to a lot of mistakes, it also allowed him to conduct his activities without fear that his staff would understand exactly what he was doing.

6.14 SUMMARY

The Daily Telegraph, in reporting on the Bank of England report, expressed astonishment at how Mr Leeson's activities remained undetected for so long. The following line from their report may be truer than we think: "Mr Leeson is neither a victim nor a hero, merely the latest in a long history of young men entrusted with responsibilities for which they proved unfit" (Leeson 2005: 339). The report purportedly continued to question the portrayal of senior Barings management as "sublime incompetents" and the possibility that Mr Leeson would be the only one to be punished with a jail sentence while the board of Barings would come off scot-free.

I asked Mr Leeson to comment on how often traders try to trade themselves out of losses and/or unauthorized positions. He commented that he believed it was human nature to try and trade out of a difficult position rather than just accept it, but added that, although he didn't believe it was rife, it happened more frequently than the financial institutions would like to admit. In his time at Barings he could recall about six or seven occasions when

someone in the debt products department, other than himself, overtraded. When asked how the profitability of a trader affects the diligence of management with respect to enforcing rules, he recalled that during his time at Morgan Stanley there was a successful trader who was sitting in an armchair rather than the normal traders' chairs and was allowed to smoke big fat cigars while everyone else had to smoke outside. He also noted that individuals like that, with bigger-than-life personas, could be very intimidating to junior and/or inexperienced staff and that it would be quite possible for such an individual to dominate such inexperienced staff. It was, therefore, quite obvious that the rules didn't apply equally to everybody in these trading operations. I believe it is very easy for inexperienced staff to not only be dominated, but also to be so impressed with the "status" of such a star trader, that they would find it difficult to question transactions and/or actions of such a revered trader.

Mr Leeson commented that it would be very difficult to remove money as an incentive for extreme opportunism, due to the competitiveness of the industry, unless it was done on an industry-wide basis. If you don't pay the player what he can get elsewhere, he will just move. He noted to me that Deutsche Bank had recently restructured their remunerating structure, a decision he believed would place them at a disadvantage in retaining their best traders and attracting new ones. With regard to the influence of bonuses on the actions of management at Barings, Mr Leeson said that when the auditors (I assume the internal auditors) were conducting their audits of his trading activities, it was quite possible that they didn't scratch as hard as they could have because they were afraid of jeopardizing their bonuses. He did, however, add that he had no hard evidence to support this view, as only

those actually involved would know the true motivation for their actions or inactions. Mr Leeson was asked if it was possible, that the decision by senior management of Barings to spend money on administration and systems, could have been clouded by the fact that the Barings bonus system made it a choice between an improved IT and administration capability and higher bonuses for themselves. Mr Leeson responded that this was possible, as Morgan Stanley had an IT department of around 200 people while Barings had one person when he started there. However, he said this situation did improve during his time at Barings.

I also asked Mr Leeson if he believed that more regulation would prevent unauthorized activities within trading firms. He held the view that more regulation would do very little to prevent such occurrences. Mr Leeson also pointed out to me, in response to another question, that whereas one used to find (in the time that he worked at Morgan Stanley) very large IT departments because of their focus on service and settlements, the emphasis had somewhat shifted, and today one would find very large legal departments, which are needed to bend the regulations. This, he believes, will always be the case and regulators will always be playing catch-up. He believes that the prevention should take place through internal controls within trading firms. He believes measures to prevent these activities need not be complicated or expensive. He also believes complacency plays an important role; as people do the same checks over and over, they tend to lose their vigilance. On the matter of the reliance by firms on the work done by outside audit firms, Mr Leeson pointed out that in the few weeks that even a major audit entails, only a snapshot of the company is taken, at a time when everybody is expecting a snapshot. If you send people without the proper

experience, they have no chance to understand or appreciate the impact some of the complex products could have on a company's balance sheet. To solve this problem, audits should be a continuous process conducted by experienced and seasoned individuals with a thorough understanding of the business they have to audit. Advanced automated audit systems tailor-made to audit investment transactions would also be invaluable to less experienced auditors. The "ELECTRONIC TRUSTEE" (www.electronictrustee.com) system is an example of such a system capable of conducting continuous automated audits of investment transactions. Unauthorized transactions or other anomalies would be detected within hours instead of months or years after the event.

In this chapter we clearly demonstrated that a combination of factors played a role in creating this tragic event. The role of learned behavior cannot be overemphasized; one of the most crucial insights into the soul of Barings was provided to me in an e-mail from Mr Leeson responding to questions I put to him regarding the NAB event in Australia (Annexure A). Mr Leeson acknowledges the fact that most companies engage in questionable market practices and traders may find it difficult to differentiate between what is acceptable and what not. He also commented that "...all of the procedures are wrong, morally and perhaps criminally, some more clearly than others..." and that "if the codes of practice were standard, not 'when suits' as above, perhaps the current ambiguity would be removed" (Leeson 2006: 1-2). The balance between factors facilitating or inhibiting extreme opportunism was non-existent, to put it mildly. Even the most basic systems and staff needed to ensure back office efficiency were too expensive for the Barings management. Auditors were inexperienced and inefficient and were

useless as an inhibitor for opportunism of extreme proportions. The personal interests of senior management outweighed the interests of clients and bond holders of Barings. Money and status were strong motivators in an environment of limited oversight and control.

CHAPTER 7

JOHN RUSNAK AND THE ALLIED IRISH BANKS

7.1 INTRODUCTION

On the 7th of February 2002 the BBC reported that Allied Irish Bank discovered a shortfall of USD 750 million in the accounts of its US subsidiary (BBC: 2002). Reports indicated that evidence pointed to Mr John M. Rusnak as the culprit. Two days later, on the 9th of February 2002, PRAVDA also covered the story and asked a few interesting questions. The article questions the haste with which John Rusnak was declared a swindler by the management of Allied Irish Banks. He has been described as “...a ‘family man’ with two children and a Labrador called Barney...” (McNee: 1-6). Investigators (Ludwig 2002: 32) described him as “unusually clever and devious” – with the benefit of hindsight maybe he was just a good student.

According to his court records, he never “stole” money in the conventional sense of the word (UNITED STATES OF AMERICA v JOHN M. RUSNAK 2002: 1-17). His activities did, however, help him to earn bonuses based on fictitious profits, totaling USD 850 000 between 1997 and 2001 (BBC October 24 2002: 1-2). Other than the bonuses of +/- USD 170 000 per year, there is no evidence that he otherwise enriched himself through committing a fraud totaling nearly USD 700 million. For every USD 1 000 he lost, he earned a one-dollar bonus, a very puzzling “crime” indeed.

In analyzing this event, official and unofficial reports will be used to reconstruct the activities of John Rusnak and the environment in which it took place. Among other things, we will look at the report by Promontory Financial Group LLC and the Wachtell, Lipton, Rosen & Katz legal firm to the AIB and Allfirst Boards of Directors; court records of UNITED STATES OF AMERICA v. JOHN M. RUSNAK IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND; and commentary by Sharon Burke from the Department of Mathematical Sciences at Villanova University, together with work by Colm Kearney, Professor of International Business at Trinity College in Dublin and a Dublin Finance Specialist, Dr Elaine Hutson. This information will be augmented by numerous newspaper reports and records of a debate in the Irish Parliament regarding Allied Irish Banks (AIB). Attention will also be given to an investigation into allegations that senior officials of Allied Irish bank were also involved in irregularities relating to, among other things, “inappropriate dealing transactions” and tax evasion as early as pre-1996 (Dresser 2004: 1-2). Court records detailing the events in 1994 at Chemical Bank will also be used to provide an interesting perspective on the activities of Mr Rusnak.

7.2 A CULTURE OF HONESTY AND BEST PRACTICE?

In 1999 an investigation initiated by the Irish parliament identified Allied Irish Banks (AIB) as being a substantial player in a tax avoidance scheme (Washington Times 30 May 2004). The bank later paid a total of USD 140 million in penalties and unpaid taxes.

Two years after John Rusnak was sentenced to jail for seven and a half years, Allied Irish Bank was in the news once again for all the wrong reasons. May of 2004 was an interesting month for Allied Irish Bank. Early that month the bank admitted that it “...had overcharged many of its foreign-exchange customers since the mid-1990s...” (Dresser 2004: 1-2). Later that year, after initially refusing to testify in public to the Irish parliament’s Finance and Public Services Committee, the Chief Executive and the Chairman of Allied Irish Bank admitted that bank investigators identified more than one million instances of charging “illegal amounts” to 173 000 customers between 1996 and 2004 (Associated Press Newswires 2004: 1). Later, in May, the bank also admitted that it “...had overcharged customers who had invested in trust funds established before 1971” (2004: 1-2). Senior officials at the bank reportedly established offshore accounts for managing clients’ money in a way that was disadvantageous to their clients. We assume the bank was the advantaged party. The extent to which the bank has benefited is not clear; they were, however, ordered by the government-controlled Central Bank to deposit Euro 25 million with it, to cover potential claims against Allied Irish Bank (Associated Press Newswires 2004: 1-2).

This was, however, not the end of it. The bank, reportedly “under pressure from external auditors” (2004: 2) admitted that ten of its current and former directors who invested in some of the bank’s tax-evasive offshore accounts “...may have received unfair investment advantages versus other bank investors”. According to a report published in the Washington Times, the group included three current executives and seven former executives. The Washington Times, quoting the Irish Times, reported that the group included “...Gerry Scanlan, chief executive from 1985 to 1994; Roy Douglas, a

former head of AIB's British division who currently is chairman of another Irish heavyweight, Irish Life & Permanent; David Cronin, former treasurer at AIB's one-time US subsidiary, Allfirst Inc.; Darmuid Moore, AIB's former director of corporate strategy, who retired in 1993; and former deputy chief executive, Paddy Dowling, who is deceased" (The Washington Times 2004: 1-3). These revelations led to the resignation of Tom Mulcahy as chairman of Aer Lingus, the state-owned Irish Airline. Mr Mulcahy was the chief executive of Allied Irish Bank between 1994 and 2001 and was identified as a participant in the scheme. The Irish Deputy Prime Minister reportedly used the words "deeply shocking" in reaction to the actions of the executives and added that "...the Irish public was getting 'fed up' with sloppiness and unethical behavior exposed at the bank" (2004: 2). What is interesting is the level of people involved in the scam, in that they included only the very top echelon at the bank. Mr David Cronin was, therefore, part of the inner circle of executives of the bank and, as a participant, obviously privy to the fact that they were engaging in illegal and immoral activities. The relevance and importance of this fact will become clear as we analyze the report following the investigation by Eugene Ludwig of Promontory Financial Group LLC of Washington DC.

7.3 THE MARKET ENVIRONMENT IN WHICH MR RUSNAK OPERATED

7.3.1 THE NATURE OF THE FOREIGN CURRENCY MARKET

As a currency trader, Mr Rusnak operated in the Foreign Currency Market and the Eurocurrency market (Burke 2003: 1-22). There is no physical

location for the Foreign Currency Market; it exists as a virtual entity in dealing rooms. These dealing rooms are all connected via fax, telephone and computers and can be found in central banks as well as large banks and corporations. Rates of exchange for free-floating currencies are determined by the trading on the Foreign Exchange Market (FOREX). The Reuters agency provides an instantaneous feed of rate quotes to clients, at a cost. An important aspect of the Foreign Exchange Market is the fact that it has “...no regulation, no restrictions or overseeing board” and “...no mechanism to stop trading” (Burke 2003: 2). In the US, a set of guidelines called “best practice” is published by the Federal Reserve Bank of New York. These guidelines are not regulatory or legally binding and a contract between the buyer and seller provides the legal foundation for Foreign Exchange transactions.

7.3.2 THE PRODUCTS HE USED

Mr Rusnak essentially believed that the Japanese yen would strengthen against the USD. Based on this belief, the core of his trading strategy was designed to benefit in the event that this actually happened. According to court records, Mr Rusnak used three types of contracts to execute his transactions, namely “Spot”, “Forward” and “Option” contracts (USA v John M. Rusnak 2002: 1-17).

7.3.2.1 SPOT CONTRACTS

Spot contracts identify two parties (a buyer and a seller), what currency they are buying or selling and what currency is accepted as payment as well as

the ratio at which the transfer will take place. The ratio in this form of contract is the spot rate (the rate at which the currencies trade at the present moment). However, this rate is changing constantly, making it necessary for the two parties to agree on a rate that would probably differ from spot. Once this is done the contract is executed immediately, although funds between the parties normally only flow two days later. In reality, the administration departments of trading operations go through an administrative process that can be electronic or by phone or fax; it normally entails an exchange of the details of the transaction (Burke 2003: 2).

7.3.2.2 THE FORWARD CONTRACT

Mr Rusnak also made extensive use of “forward” contracts. When we look at the anatomy of a forward contract, it is easy to see why it was a “weapon” of choice for him. A forward contract can be defined as “a cash market transaction in which a seller agrees to deliver a specific cash commodity to a buyer at some point in the future. Unlike futures contracts (which occur through a clearing firm), forward contracts are privately negotiated and are not standardized. Further, the two parties must bear each other’s credit risk which is not the case with a futures contract. Also, since the contracts are not exchange traded, there is no marking to market requirement, which allows a buyer to avoid almost all capital outflows initially (though some counterparties might set collateral requirements). Given the lack of standardization in these contracts, there is very little scope for a secondary market in forwards. The price specified in a forward contract, is for a specific commodity. If the value of the underlying commodity however changes, the value of the forward contract becomes positive or negative, depending on the

position held. Forwards are priced in a manner similar to futures. As in the case of a futures contract, the first step in pricing a forward is to add to the spot price the cost of carry (interest forgone, convenience yield, storage costs and interest/dividend on the underlying). Unlike a futures contract, though, the price may also include a premium for counter-party credit risk, and the fact that there is no daily marking to market process to minimize default risk. If there is no allowance for these credit risks, then the forward price will equal the futures price.” (investorwords.com)

Exchange traded forward contracts are called “futures” and are more regulated and more liquid than forward contracts (Partnoy 1999: 32). Forward contracts, on the other hand, are inherently private affairs. Unlike futures, they are not quoted on any exchanges and they are not standardized. These privately negotiated transactions are always Over The Counter (OTC) transactions. The two parties will be exposed to one another’s credit risk. All this suited Mr Rusnak perfectly. Allied Irish Bank, the parent company of Allcorp, was a highly respected bank of substance. It is important to remember that Allied Irish Bank still managed to post a profit despite the nearly USD 700 million loss it suffered as a result of Mr Rusnak’s activities. One of the fundamental differences between a futures contract and a forward contract is the fact that a futures contract makes provision for “margin” payments, commonly referred to as margin calls. Margin calls are defined as “...a call made upon a person with a futures contract ... to deposit more cash with the broker if the market moves against the investor or if the margin requirements change” (Ryan 1998: 71). Furthermore “...when the market turns against the buyer, the broker may call in substantially more margin...” (1998:71). If Mr Rusnak had used this instrument, he would be running the

danger that increasing margin calls, which would be inevitable if the market moved contrary to his view (against him), would undoubtedly force him to exceed his limits. This lack of marking to market allows a counter-party to enter into these transactions without any capital outlay for the term of the contract, other than the cost of the initial collateral requirement, which we know by now is relative to the perceived risk associated with the buyer of the forward. One of the inherent negative characteristics of forward contracts is the fact that there is little or no secondary market for these contracts. If you needed to counter-balance or hedge your position, you would be dependent on other instruments to accomplish that. On the positive side, from Rusnak's perspective, is the fact that he could take very large bets with little capital, allowing him to operate with little up-front cash. This, coupled with the fact that the forward transactions were "Over The Counter" (OTC), non-quoted and non-standard transactions, created a recipe for disaster. These facts made the transactions more difficult than normal to monitor or, as Frank Partnoy ominously put it: "you might never be able to discover certain information about an OTC derivative unless you worked in the derivatives group at an investment bank"(1999: 32). It also implied that, if the market moved in the opposite direction to what Mr Rusnack expected, the sky was the limit to the potential losses sustained by the bank.

7.3.2.3 THE FOREX OPTION

The third instrument used by Mr Rusnack was the Forex (FX) Option. The Forex Option "... involves the buying and selling of an opportunity to enter into an FX spot trade at an agreed-upon exchange rate, known as the 'strike price'." The buyer of an FX option has the ability to exercise the terms of

the agreement to exchange currency at an agreed-upon price at a future date, known as the “expiration date” (USA v John M. Rusnak 2002: 1-3). An option differs from spot and forward transactions in a number of ways. These differences were pointed out in court papers:

- a. “The buyer of an FX option is not required to exercise the option; he may or may not choose to exercise his right to exchange the currencies at the agreed-upon strike price on the expiration date of the option.”
- b. “... an FX option transaction requires the buyer to pay a cash premium to the seller for the rights given in the options contract.”

7.4 WHAT WENT WRONG?

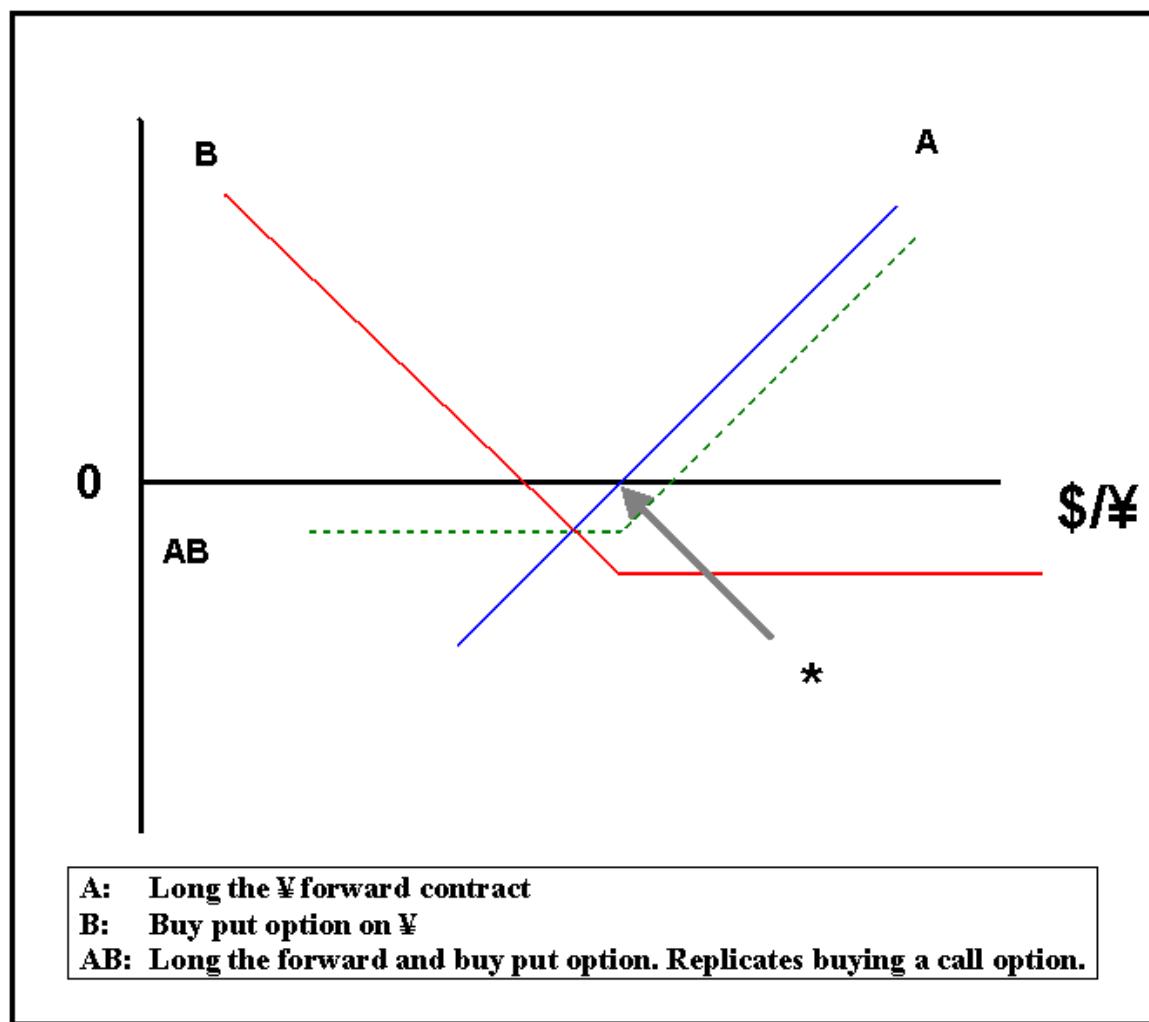
In 2002 Colm Kearney, Professor of International Business at Trinity College Dublin, and Dr Elaine Hutson, a Finance Specialist from Dublin, tried to reconstruct some of the transactions that Mr Rusnak entered or allegedly entered into. One of the important facts about Mr Rusnak’s trading is that he had actual as well as fake positions, the impact of which will be explained using the following graphs (Kearney & Hutson 2002: 1-4).

In the two graphs, Figure 11 and Figure 12, the horizontal axis represents the USD/YEN exchange rate. The spot rate at the time of the transaction is indicated with an asterisk * and an arrow is pointing towards it. The spot rate is the rate of exchange reflecting the price at which the currency can be bought at that point in time (Ryan 1998: 14). Moving to the left from spot on the horizontal axis indicates the Yen weakened against the USD, and moving to the right on the horizontal axis indicates the Yen strengthened

against the USD. The vertical axis indicates the profit or loss position of Mr Rusnak's transactions. Above the zero (0) he was making a profit and below the zero he was making a loss. Mr Rusnak was betting that the USD would weaken against the Japanese YEN. The further to the right from the spot position the currency rate moved, the more money he would be making and the further to the left the currency rate moved, the greater his loss would be.

7.4.1 SCENARIO 1: FAKED POSITIONS

FIG. 11



(Kearney & Hutson 2002: 4)

Figure 11 illustrates the position that Mr Rusnak should have been holding. The blue sloped line A represents the actual position that Mr Rusnak was holding. He believed that the USD would weaken against the Japanese YEN and, buying the appropriate forward at the ruling spot price, he would be able to generate a healthy profit, as the value of these forward contracts would increase as the USD weakened against the Japanese YEN. A skilled trader would, however, know that he could lose a lot of money if his view on the USD/YEN exchange rate was off the mark. In order to be prudent, the appropriate course of action would be to buy a put option on the Japanese YEN. A put option is “an option to sell a security at a specific price and at a specific date” (Ryan 998: 99). This activity is commonly referred to as “hedging”. In this case, the put option would provide the buyer thereof with the right, but not the obligation, to sell his position if the JPY weakened against the USD past a certain point. This point is commonly referred to as the “strike price”. The strike price is “the predetermined price at which the holder of an option may exercise his right to buy or sell securities from, or to, the writer of the option.” (Ryan 1998:116).

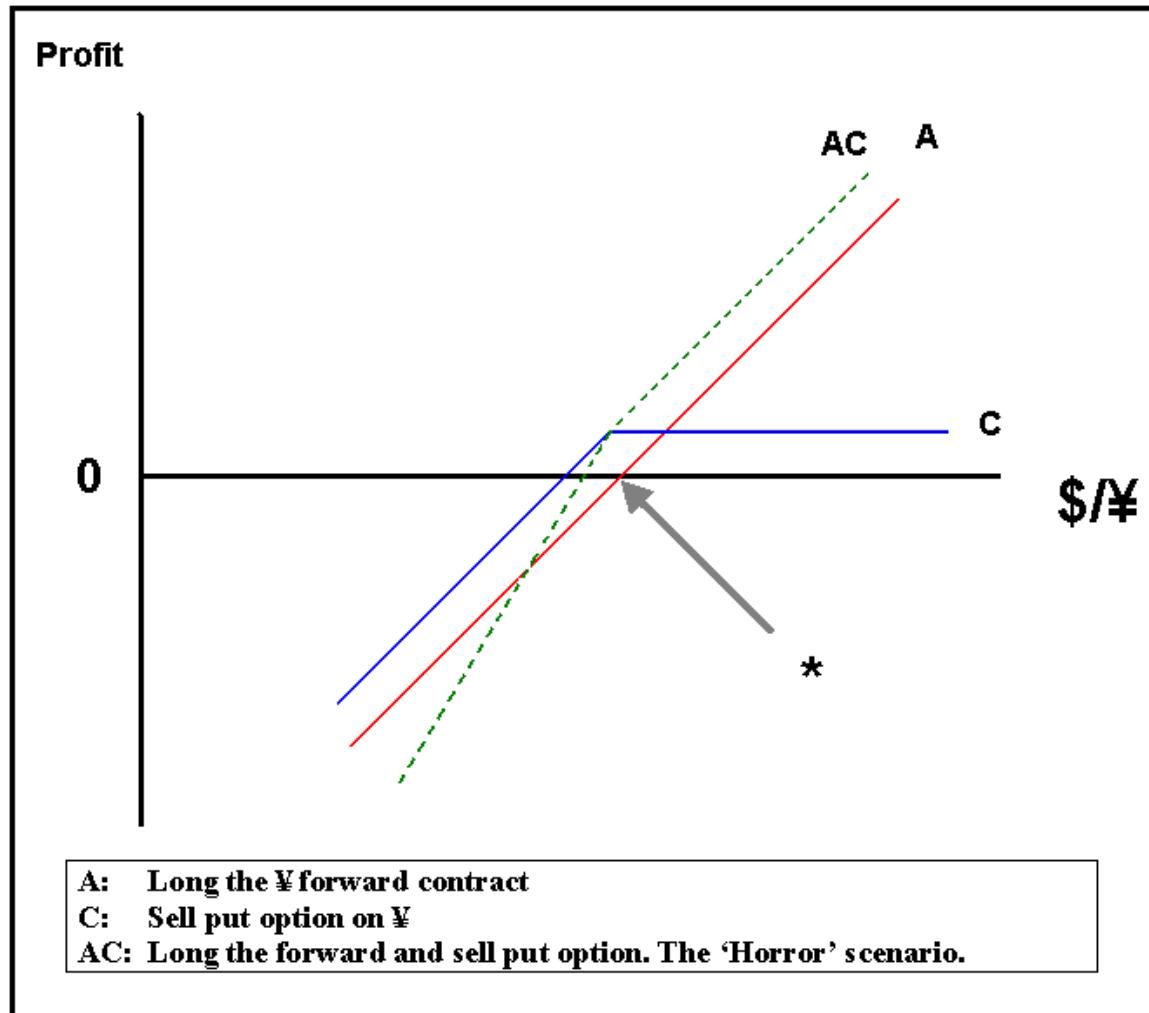
In our Figure 11. the red line marked B represents the effect of the hedge. If the Japanese YEN strengthened against the USD, the option would expire worthless and the loss would be equal to the cost of the option, called the option “premium”. The option premium is “...a term applied to the deposit payable on a traded option in the stock and futures market” (Ryan 1998: 94). In Figure 11 the cost of this option is reflected by the difference between the horizontal axis and the portion of line B that runs parallel with it. The green dotted line marked AB represents the net position of the two transactions. Downside risk (risk of losing money) is eliminated for the cost of the option

and potential upside (profit) is reduced by the cost of the option. However, as it turned out, Mr Rusnak never bought the put option on the Japanese YEN. The reason for this was apparently that he could not afford to buy the appropriate hedge without exceeding his cash limits, because the collateral requirements from his forward counter-parties exceeded his cash limits as the USD/YEN exchange rate moved contrary to his hopes. This in itself may be an indication that his forward counter-parties grew nervous. As explained earlier in this chapter, the size of the collateral required is normally a reflection of the view the seller of the forward contract takes of the credit risk of the buyer. Forward contracts have inherent leverage (Kearney & Hutson 2002: 3). Leverage is: “in speculative terms, the opportunity for a large profit at a small cost. It implies high risk” (Ryan 1998: 65). The first portion is exactly what Mr Rusnak needed. The second portion was a risk he had to take. Large banks that are dealing with one another normally require only a fraction of the value of the full forward contract. This amount, called collateral, could be as low as 5% of the value of the contract. In order to make a USD 100 million bet, Mr Rusnak had to provide collateral to the amount of USD 5 million. However, if the market moves contrary to your expectations, the leverage effect could bite you.

Prof Kearney and Dr Hutson went further and speculated that, in reality, things were slightly different. At the time Mr Rusnak was under tremendous pressure, as his losses were mounting. He also had to make back his losses with very little money, as his daily limits were curtailed. In order to generate the necessary capital, Mr Rusnak went for the proverbial double-or-nothing strategy.

7.4.2 SCENARIO 2: ACTUAL POSITIONS

FIG. 12



(Kearney & Hutson 2002: 4)

The red line A represents one of the actual positions that Mr Rusnak held. He bought a forward contract by putting down, probably, 5% collateral. Then, instead of hedging his position, he went and doubled up his risk position by selling a put option on the Japanese YEN. If the Japanese Yen strengthened against the USD, he would keep the option premium plus his profit. If the inverse happened, he would have double the negative exposure.

However, by selling the put, he would be earning a premium from the buyer of the put. It would have been possible for him to finance (at least in part) his forward with the premium he earned from selling the put. The dotted green line AC indicates the net effect of this strategy. If the USD strengthened against the Japanese Yen or even hold its 2001 levels, he would be in deep trouble. In reality, Mr Rusnak raised (Ludwig 2002: 13) nearly USD 300 million through the sale of deep in the money put options. Over and above the money he raised to finance his trading, he “augmented” his directional long spot and forward positions, all betting on a strengthening of the Japanese YEN against the USD. Kearney and Hutson were dead on the money with their speculation. They clearly demonstrated that it is indeed possible for a trader like Mr Rusnak to enter into extremely large and risky transactions with very little initial outlay, a strategy that was central to most “rogue” trader events.

The USD did not weaken against the Yen to the 73.77 to 96.75 levels needed for the options sold by Mr Rusnak to expire worthless. His firm was severely exposed (see page 210) and suffered massive losses.

7.5 THE INDICTMENT OF JOHN M. RUSNAK

7.5.1 HIS MOTIVATION

The legal proceedings against Rusnak identified three elements to the motivation behind his actions. (1) According to the State (USA v John M. Rusnak) Mr Rusnak’s actions were designed to create a false impression that he was trading profitably for Allied Irish Bank (AIB). (2) He did this in

order to ensure that he would remain employed by the bank, which in turn would entitle him to all the benefits associated with that position. (3) This would include salary, bonuses, position, status and maybe even (Ludwig Report 2002: 9) the lavish entertainment he received from the brokers he traded through.

7.5.2 THE FRAUD

In essence, the fraudulent activity can be divided into three phases or categories. The first phase of activities was designed to hide his losses derived from his actual currency trading. The second phase or group of activities was designed to allow Mr Rusnak to increase his trading volumes undetected. The third phase of activities was to raise capital for Mr Rusnak to continue trading after some of his other activities had been curtailed. According to the papers brought before United States District Court for the District of Maryland, the State argued that Mr Rusnak did the following.

7.4.2.1 PHASES 1 AND 2: HIDING LOSSES AND INCREASED TRADING

In the first phase, Mr Rusnak was accused of entering "...false and fictitious foreign currency trades and trading information into the books and records of the Bank" (2002: 7). It was also claimed that he "...circumvented the confirmation process by creating fictitious telefaxes purportedly sent to the Bank by counter-parties to fictitious foreign currency trades and by causing these fictitious confirmations to be forwarded to personnel in the Bank's back office" and that he "...fraudulently convinced individuals in the Bank's

back office that it was not necessary to confirm certain types of foreign currency trades.”

Adding to this he also, according to court documents “...manipulated the calculation of his P&L (profit & loss) statements by entering false and fictitious trades and trading information into the Bank’s Optics and DEVON systems, thereby concealing his actual trading losses. By manipulating his P&L statements in this manner, Rusnak ensured that he did not exceed his “stop loss” limit and thereby maintained his ability to continue trading on behalf of the Bank despite his large trading losses.”. Mr Rusnak also “...manipulated the calculation of his VaR (value at risk) by providing Bank personnel with a spreadsheet that contained false and fictitious information about ‘holdover’ trades, that is, transactions that the defendant falsely represented that he had entered into after the VaR closing time each day. These ‘holdover’ figures that Rusnak provided, together with the false and fictitious trades and trading information that he entered into the Bank’s Optics and DEVON systems, allowed Rusnak to stay within his VAR limit and to maintain his ability to continue trading on behalf of the Bank despite the large risk inherent in his actual trading positions”(2002: 7-8). The Ludwig Report (see par. 2.6) pointed out that, in a particular three-month period, Mr Rusnak used holdover positions on 52 days out of the 58 that were sampled. In some instances, the same holdover position was left for three straight days without anyone apparently noticing (2002: 15).

In an effort to cut the back office largely out of the loop, Mr Rusnak “...used Prime Brokerage Accounts (hereinafter PBAs) between the Bank and Citibank, Bank of America, and Merrill Lynch to conceal the details of his

daily trading activity and to enter false and fictitious transactions into the books and records of the Bank. PBAs allowed Rusnak, on behalf of the Bank, to enter into foreign exchange transactions throughout a trading day with third parties without entering those transactions into the books and records of the Bank, and without the Bank confirming and settling each transaction; those functions were performed by the relevant prime broker. The Bank and each of the prime brokers typically had one net settlement of all of the PBA transactions on just one date each month. Rusnak entered false and fictitious prime brokerage transactions into the books and records of the Bank and then amended, cancelled or reversed those transactions before the monthly net settlement with a prime broker, thereby allowing Rusnak to conceal his trading losses and maintain his ability to continue trading on behalf of the Bank”(USA v John M. Rusnak 2002: 8).

7.5.2.2 PHASE 3: RAISING CASH AND HIDING IT

After pressure was exerted on Mr Rusnak to reduce his use of the ABI balance sheet, he needed another source of funding. In order to raise money Mr Rusnak “...on behalf of the Bank, sold ‘deep in the money’ Japanese yen/US dollar option contracts, with five different counter-parties. These types of FX option contracts allowed Rusnak to generate large cash payments to the Bank from these counter-parties in exchange for similarly large liabilities to those counter-parties, which would come due a year after the cash payments. After entering into each of these five ‘deep in the money’ transactions, Rusnak entered false and fictitious option transactions into the books and records of the Bank to cancel out and to remove these large outstanding liabilities from the Bank’s books and records, thereby improving

Rusnak's P&L statements and his VaR calculations and concealing his actual trading losses." These five 'deep in the money' transactions are detailed in the following chart:

TABLE 4

Counterparty	Trade Date	Expiration Date	Strike Price	Premium Paid
Citibank	Feb. 20, 2001	Feb. 20, 2002	73.7700	\$125,052,000.00
Bank of America	Mar. 07, 2001	Mar. 07, 2002	75.0000	\$74,878,340.00
Deutsche Bank	Dec. 06, 2001	Dec. 06, 2002	96.7500	\$24,943,750.00
Merrill Lynch	Dec. 12, 2001	Dec. 12, 2002	92.0000	\$25,015,000.00
Bank of New York	Dec. 24, 2001	Dec. 24, 2002	94.1900	\$50,000,000.00

(USA v. John M. Rusnak 2002: 9)

What Mr Rusnak did was to sell the right to these five counter-parties to sell agreed-to quantities of Japanese YEN to Allfirst at a prices ranging from 73.77 – 96.7500 Yen to the USD. The premium that the counter-party would pay to Mr Rusnak would largely be a reflection of the difference between the strike price of the option contract and the ruling price at the time of the transaction. If the Japanese YEN strengthened against the USD, i.e. you would need less Yen to buy one USD, the value of the option would reduce. However, if the value of the Japanese YEN declined against the USD and would you need more Yen to buy one USD, the value of the contract would increase. For this put to expire worthless, the Japanese Yen had to strengthen against the USD to a rates of less than 73.77- 96.75 Yen for every one USD. In actual fact, the USD would have to lose around 30% of its value against the Japanese Yen before these options would become worthless and would

not be exercised (Burke 2002: 11). In reality the yen traded as follows on the expiry dates:

TABLE 5

Expiration Date	Strike Price	Actual price
Feb. 20, 2002	73.7700	133.7600
Mar. 07, 2002	75.0000	127.0700
Dec. 06, 2002	96.7500	123.6900
Dec. 12, 2002	92.0000	122.7500
Dec. 24, 2002	94.1900	120.2700

(Federal Reserve 2006: 1-41)

The options that Mr Rusnak wrote were “European” options and could therefore only be exercised on the expiry date. “American” options can be exercised at any time up to and on the expiry date. Mr Rusnak bought himself some grace for the period of time between the transaction date and the expiry date, usually a year. In order to hide these put options, Mr Rusnak “...entered false and fictitious option transactions into the Bank’s books and records in conjunction with these five ‘deep in the money’ transactions, thereby causing the Bank to have approximately \$380 million in unrecorded but outstanding liabilities as of the end of 2001” (USA v John M. Rusnak 2002: 10). The impact of these transactions is graphically illustrated in par. 7.4.2.

According to court records, Mr Rusnak took a number of steps to conceal some of his transactions; he (2002: 10) “...rented a mailbox ... to receive mail in the name of David Russel, a fictitious name, for the purpose of providing the Bank’s independent auditors with a false confirmation of a fictitious option contract that the defendant had entered into the books and records of the Bank.” He also “...provided to Bank personnel the fictitious name, ‘Mr David Russel’, with a fictitious counter-party, ‘RBCDS FX’, as the person who could confirm directly with the Bank’s independent auditors a fictitious yen/US dollar option contract with a strike price of 84.1000 and an expiration date of January 8 2001.”

The bank duly sent off their request for confirmation and Mr Rusnak in turn “...(a) retrieved from the mailbox he had rented a letter sent by the bank to ‘Mr. David Russel’ ... asking ‘David Russel’ to confirm the fictitious option contract,(b) signed a false confirmation of this fictitious option contract using the fictitious name ‘David Russel’ and the fictitious title ‘VP’, and (c) sent this false confirmation directly to the Bank’s independent auditors, all for the purpose of concealing his fraudulent conduct from the Bank”(2002: 11).

7.6 THE EXTENT AND COMPOSITION OF THE LOSSES

By doing all the above, Mr Rusnak was able to incur and conceal losses totaling USD 691 204 113 up until the beginning of 2002. This amount was made up of (Ludwig 2002: 29) USD 291.6 million in nonexistent assets and USD 397.3 in liabilities that were fictitiously neutralized by nonexistent assets. An amount of USD 2.3 million in “legitimate” trading losses was also

identified. The USD 2.3 million was incurred in 2002. An interesting fact about Mr Rusnak's activities was that he compartmentalized his trading activities. An analysis of his transactions indicated that, of the 71 counter-parties transactions entered into, only 47 were legitimate. However, all the transactions he entered into with 19 Asian counter-parties were fictitious. The options explained in par 7.5.2.2 were entered into with only five counter-parties.

What is also very clear is that the losses incurred by Rusnak snowballed over a period of time. The total losses at 31 December 1999 totaled USD 89.8 million, consisting of real trading losses "neutralized" with fictitious assets. This grew to USD 300.8 million by December 2000, once again made up of real trading losses covered up with fictitious assets. During 2001 the real options used to raise capital were added to the mix and the total losses more than doubled.

7.7 WHY WAS IT NOT DETECTED?

The question that immediately jumps to mind is how did Mr Rusnak manage to avoid detection for so long? It appears to be a fairly complex matter and I am doubtful if there is one factor that can be singled out as the cause of the incident. In my view, the climate at Allfirst was conducive to this event taking place. On the 8th of February 2002 the Board of Directors of Allied Irish Banks plc (AIB) authorized the Promontory Financial Group LLC and the law firm of Wachtell, Lipton, Rosen & Katz to conduct an investigation into the events that led to the losses suffered by Allfirst Financial Inc and Allfirst Bank (Ludwig 2002: 1). The investigation was led by a former

“Comptroller of the Currency” under the Clinton administration, Mr Eugene Ludwig. He purportedly had a strong banking regulation background and also provided a sense of impartiality to the investigation (Burke 2002: 13). The report became known as the “Ludwig Report” shortly after it was tabled on the 12th of March 2002. The findings of the Ludwig report can be grouped into a few categories.

7.7.1 MANAGEMENT FAILURE

In the first instance, the controls at AIB and Allfirst were hopelessly inadequate. The Ludwig Report (2002:31-43) highlighted, among other things, the fact that:

“Senior management in Baltimore and Dublin did not focus sufficient attention on the Allfirst proprietary trading operation.”

“Treasury management weaknesses at Allfirst also contributed to the environment that allowed Mr Rusnak’s fraud to occur.”

“Proprietary currency trading business was inadequately supervised.”

“AIB Group Risk, and Allfirst senior management groups and the respective Boards, assumed that the control and audit structures governing the trading activities that were conducted at Allfirst were sufficiently robust.”

7.7.1.1 INTERNAL ALERTS

There were numerous incidences where red lights should have gone on at both Allied Irish Bank and at Allfirst. Neither the departing trading manager, the treasury funds manager nor the treasurer ever conducted an in-depth analysis of Mr Rusnak's trading (2002:19) or analyzed whether or not he was executing his stated strategy of "running a large option book hedged in the cash markets" (2002: 9). The deep in the money options referred to in par. 7.4.2.1, which expired unexercised, were never questioned, indicating that they were either never noticed or that they were not understood. Similarly, Mr Rusnak's profit-and-loss figures were never compared with the general ledger entries.

The prime brokerage accounts also provide their fair share of red lights. Over and above the fact that the initial motivation for using prime brokerage accounts was suspect, requests from Mr Rusnak in April of 1999 to withhold payments on trades raised alarm at the back office. In a Simultaneous Delivery versus Payment (SDvP) environment, an institution like STRATE, for example, in South Africa will match delivery from both parties before any transfers take place; this practice eliminates principle risk (Bruce 2004: 46). In the absence of an SDvP system, payment can be withheld until the counter-party delivers. This practice is normally reserved for situations in which there is concern about the ability of a counter-party to settle. It does, however, provided time for Mr Rusnak to neutralize a fake transaction with another fake transaction. It is therefore no surprise that during that same period the back office found it difficult to confirm a number of transactions in these prime brokerage accounts (Ludwig 2002: 20). They subsequently

raised concerns with Mr Cronin that intra-day off-market transactions could be executed with counter-parties that would be virtually impossible to confirm. This resulted in a meeting that included Mr Rusnak, his trading supervisor, Mr Ray, the heads of risk control and back office as well as the treasury funds manager. The outcome of the meeting was that Mr Cronin purportedly ordered a brief suspension of Mr Rusnak's use of these accounts, with the proviso that all future transactions entered into should be scrutinized. The aim would be to confirm the existence of an audit trail, as well as evaluating the motive for each transaction. However, all the parties failed to execute this instruction for various reasons, and the treasurer apparently never followed up to ensure his instructions were carried out. At the same time, numerous complaints were reportedly brought to the attention of the treasurer regarding Mr Rusnak's bullying of back office staff. Once again, Mr Cronin did little other than calling a meeting in which treasury staff were asked to respect one another (2002: 21). Difficulty in confirming trades executed by Mr Rusnak continued though 2000 and 2001 and he would often provide confirmations that did not match the transaction that was queried. No evidence exists that the possibility was ever considered that Mr Rusnak was only executing certain deals if confirmation for the existence of such transactions was sought.

7.7.1.2 EXTERNAL ALERTS

One of the most fascinating facts about this whole incident is the extent of external red flags that should have alerted someone in a position of authority at either Allied Irish Banks (AIB) or at Allfirst. Between 2000 and 2002 at least five events took place that should have triggered some form of alert.

7.7.1.2.1 MARCH 2000: CITIBANK ENQUIRY

In March 2000 Citibank enquired from the Group Treasurer at Allied Irish Banks (AIB) if they would be able to cover a gross monthly settlement of more than USD 1 billion due at the beginning of April (Ludwig 2002: 22-23). Mr Ryan, the Group Treasurer, confirmed the ability of Allfirst to meet its commitments. Mr Ryan ordered a discreet enquiry by Allfirst risk-assessment staff. The explanation provided was that the Allfirst's liability was offset by a larger Citibank liability.

The question that immediately jumps to mind is twofold. In the first instance, why was Citibank not aware of its own obligation towards Allfirst? Secondly, why were there such large trading volumes conducted by Allfirst? Evidence provided to the Ludwig investigation revealed conflicting reports regarding this incident. Claims by the Allfirst executive vice president of risk, Mr King, that he discussed this incident with the chairman of Allfirst was denied by the latter. Even if one ignores these discrepancies about who told what to whom, the senior management at Allied Irish Banks (AIB) should have been well aware of the extent to which Allfirst and, in particular, its FX options dealer was trading. Reports to the AIB Group treasurer dating back to 1997 indicated reporting on the fact that, of the USD 1 billion nominal FX options book, Mr Rusnak was responsible for 95% of the activity and of his 95%, 80% was speculative. Similarly, 10 K filings submitted by Allfirst to AIB for 1999 and 2000 clearly spelled out the fact that foreign exchange trading at Allfirst was running into billions of USD per year (Ludwig 2002: 23).

7.7.1.2.2 MAY 2001: THE ANONYMOUS SOURCE

An anonymous source reportedly contacted Allied Irish Banks (AIB) to make them aware of the fact that Allfirst was engaged in “very heavy foreign exchange trading”. Without relaying this enquiry to the Allfirst CEO or other executives, Mr Michael Buckley, the CEO of Allied Irish Banks (AIB), contacted Mr Cronin, the Allfirst Treasurer, directly for an explanation.

Mr Cronin responded in writing as follows:

“To bring closure to our conversation earlier today about foreign exchange turnover, I confirm that we have had no unusual or extra large transactions in the last two weeks with counter-parties locally or in London. Our daily average turnover in this period was \$159M.”

Mr Cronin, in what could be interpreted as a slight reproof, went on to say:

“To the extent that someone who spoke to you has anxieties with respect to our activities, it could be explained by our concentration of turnover with two institutions, i.e. Citi and Bank of America. We transact 90% of our dealings via ‘Prime’ clearing accounts with these banks. This is done to minimize counter-party exposure through a monthly netting arrangement.”
(Ludwig 2002: 23)

This very forceful explanation from someone whom the AIB CEO obviously trusted and respected, understandably put him at ease. There is, however,

evidence to suggest that a little seed of doubt may have been planted with Mr Cronin. Halfway through June 2001, he started to receive daily reports of the extent of foreign exchange trading conducted by Allfirst. These reports clearly indicated that Mr Rusnak was trading hundreds of millions USD per day and, in some cases, his notional turnover reached nearly USD 4 billion. Another matter that deserves attention is that of profitability. It appears, according to the bonus payments to Mr Rusnak discussed hereafter in par. 7.7.2 that, although his “turnover” increased dramatically, his profitability remained more or less the same. Surely this should have raised some eyebrows. The simple answer is that it did. In their efforts to prepare the financial results for 2000, staff at the financial reporting units at both Allied Irish Banks (AIB) and Allfirst detected the fact that Mr Rusnak’s use of the balance sheet was disproportionate with the income that he generated. A meeting was subsequently held between the Allfirst Controller, its Director of Financial and Regulatory Reporting and the Head of Treasury Funds Management. Mr Rusnak’s trading strategy was explained as a low-risk activity. This answer was apparently deemed to be satisfactory and relayed to Dublin, where it was also accepted (Ludwig 2002: 24). This event raises a serious question about how well everyone at AIB and Allfirst understood the transactions that Mr Rusnak entered into. Mr Cronin should, at least, have had a vague idea of what percentage of profit should normally be generated per USD million traded.

7.7.1.2.3 OCTOBER 2001: THE SEC LETTER

As explained in par. 7.3.1, foreign exchange trading per se is a largely unregulated activity. However, financial institutions, especially banks, are

regulated by a number of institutions. One of the topics raised in a comment letter by the Securities and Exchange Commission (SEC), the prime financial markets regulator in the United States of America, to Allfirst was the cash flows related to foreign exchange trading at the firm (2002: 25-25). Although the exact nature of the query is not known, it did at least prompt an internal investigation, which revealed the large “offsetting” foreign exchange positions held by Allfirst. It also raised sufficient concerns to warrant an instruction to the internal audit department to focus on trading in the next treasury audit.

7.7.1.2.4 JANUARY 2002: REPORT TO ALLIED IRISH BANKS (AIB)

In its reporting to the Central Bank of Ireland, Allied Irish Banks (AIB) included reports by Allfirst of its activities. One of these reports, destined for inclusion in its 2001 reporting to the Central Bank, reflected the existence of more than a USD 100 million in open foreign exchange positions held by Allfirst. The subsequent enquiry to the Allfirst treasurer Mr Cronin followed the same route as most others, and was passed on to Mr Rusnak. Mr Rusnak in turn explained the matter away by contending that it was merely a matter of incorrect reporting of prime account positions (Ludwig 2002: 25).

7.7.2 TRADING AND REMUNERATION STRUCTURES

The trading structure in which Mr Rusnak operated facilitated his “Lone Ranger” behavior. It appears that, as a proprietary trader, Mr Rusnak was trying to run something similar to a hedge fund, without the necessary risk management systems (2002: 31). As a lone trader, he was up against very

sophisticated operations that had the competitive advantage over him in all respects. If one just looks at the strategy and tactics used by the derivative desks of major banks (Partnoy 1999: 103), one realizes that Mr Rusnak was playing out of his league. As a lone trader, he also had very little informal restraints to prevent him from engaging in his activities (not that his counterparts at the major investment banks had any either). Mr Rusnak was, however, not working totally alone; there was a second trader who, looked after the external clients of Allfirst. Although they were physically sharing the same dealing desk, data feeds and even a telephone line, the institutional trader on the desk claimed that he was never aware of anything untoward going on (2002: 25). If this was indeed the case, Mr Rusnak was to all intents and purposes a one-man show. The fact that Mr Rusnak was provided with the necessary Bloomberg software to conduct trading from his home is another indicator that he probably didn't rely on his co-worker to execute transactions on his behalf when he was not at the office.

According to the Ludwig Report, the compensation package negotiated with Mr Rusnak was “questionable” from a risk point of view (2002: 39). The report also states that the structure of his remuneration package “...may have had the effect of encouraging greater risk taking on his behalf.” It goes on to point out that such “aggressive” structures are not the best way to “attract” and “compensate” traders (Ludwig 2002: 31). Rusnak’s salary was made up of two components; it had a basic salary component of +/- USD 100 000 (one hundred thousand) per year and a bonus component. His bonus component was calculated as 30% of the amount of net profit he generated after reaching a threshold of five times his basic salary (Ludwig 2002: 8). The remuneration and “profits” generated by Mr. Rusnak were as follows:

TABLE 6

YEAR	SALARY	BONUS	TOTAL	“NET PROFIT”
1997	\$ 102 000	\$ 0	\$ 102 000	< \$ 520 000
1998	\$ 104 000	\$ 128 102	\$ 232 102	\$ 947 006
1999	\$ 104 000	\$ 122 441	\$ 226 441	\$ 928 136
2000	\$ 108 000	\$ 78 000	\$ 186 000	\$ 800 000
2001	\$ 112 000	\$ 220 456	\$ 332 456	\$ 1 294 853

In 1997 Mr. Rusnak made less than five times his annual salary in profits and therefore did not qualify for a bonus. It should also be noted that his 2001 “bonus” was never paid to him, for obvious reasons.

Perhaps the following summarizes Mr Rusnak’s fraud. “Mr Rusnak was unusually clever and devious. He knew the banking system well from his experience at Chemical Bank, so he was able to circumvent their controls. However, given the fact that their controls were weak; this did not take so much cleverness as desperation” (Burke 2002: 15). As we will see later in this chapter, Mr Rusnak may have learned more from Chemical Bank’s traders than we thought. At this point, however, it appears that Mr Rusnak’s competitive advantage lay not in his skill as a currency trader, but rather in his understanding of the risk management and administration systems employed by his firm.

7.8 SIGNS OF ADDICTION?

The aim of this paragraph is purely to determine if there were obvious signs of a possible gambling addiction and is exploratory at best. It is however relevant, as the incidence of gambling by those in certain financial markets is very high. Those in positions of responsibility and oversight should, therefore, at least be aware of this phenomenon. However, in most instances, those in positions of oversight are also gamblers, and participating in gambling is often seen as a necessary prerequisite and trademark for someone to be a good trader. This was clearly reflected in the role that gambling played among the top echelons of LTCM (Lowenstein 2002: 14).

In December of 1990 the “TASK FORCE ON GAMBLING ADDICTION IN MARYLAND” conveyed its findings to the Secretary of the Department of Health and Hygiene. It is ironic that, more than ten years before Mr Rusnak committed his offences, pathological gambling was regarded as a serious problem by the state of Maryland, where he lived. The report provided the following description of a pathological gambler: “The Pathological Gambler can be described as an individual who is above average in intelligence, honest, energetic, competitive, creative, athletic, hard working and motivated to achieve – a citizen with a solid set of values concerning law and order, health, family, job and country” (Lorenz & Politzer 1990: 17). In describing the phases of pathological gambling, three phases are identified. The first phase is called the “winning phase”: while he is winning, the gambler experiences a sense of “status, confidence, control and power”. This phase is, unfortunately, more often than not followed by a losing phase. This phase is characterized by a marked increase in gambling and losses. This robs him of his self-esteem and, to get it back, he starts

betting larger amounts. This losing streak is usually associated with personality changes. The gambler becomes “...restless, irritable, defensive and argumentative” (Lorenz & Politzer 1990: 19-21). The report further states that the gambler can experience physical illness and that, without treatment for his addiction, criminal behavior is often the next step. Fraud and embezzlement are some of the trademark non-violent crimes committed by pathological gamblers.

When reading through this report, the similarities to behavior patterns described in the Ludwig Report are chilling (2002:21). Reports of Mr Rusnak’s “temper and bullying behavior” unfortunately drew little response from his superiors. It must, however, be emphasized that this type of behavior is typical of the trader and salesman behavior on Wall Street, as described by, among others, Michael Lewis in “Liar’s Poker” and by Partnoy in “F.I.A.S.C.O.”. For example, Lewis described the view of the Salomon Brothers Executives of their firm and its place in the market as: (they) “...began to treat it as an instrument of power and glory, a vast playground in which they could be the bullies” (1999:150). If the executives at Allfirst had been alert to signs of addictive behavior, they could have intervened and possibly have averted the disaster.

7.9 WAS THIS LEARNED BEHAVIOR?

In Chapter 1 I emphasized the importance of values, norms and sanctions as key determinants of human behavior. If these social controls do not function optimally, we create the climate for extreme opportunism that may lead to severe personal and financial losses. I have also shown that “deviant” role

models can have an important influence on the behavior of financial market actors.

7.9.1 THE CORPORATE CULTURE

Frank Partnoy, in his book F.I.A.S.C.O., described the corporate culture in the derivatives division of investment bank Morgan Stanley during the 1990s as one in which clients were seen as prey and marketing campaigns were viewed as hunting trips. The firm reportedly urged its derivative traders and salesmen to “rip a client’s face off”, “blow them up” or “blast a client to smithereens” (1999: 1-90). One of the senior managers at the derivative group of Morgan Stanley purportedly held the view that “...investment banking is like war, and derivative salesmen are the special forces” (1999: 108). It was an era in which derivative traders and salesmen were making millions of dollars before reaching their early twenties. Investment banks were making hundreds of millions, if not billions, by selling derivatives. The buyers of these products included insurance companies and municipalities, as well as makers of soap and greeting cards. Why was everyone in the business of buying, selling or trading derivatives? The answer is simple: the lure of easy money. Derivative traders were regarded by many as “rainmakers” and firms depended on them for phenomenal profits. These profits, in turn, funded and justified the payment of phenomenal bonuses. There were, however, those who lost a lot of money. One notable example was Niederhoffer, a very successful and highly respected hedge fund manager who was managing around USD 100 million in June of 1997. In the fifteen years before 1997, he built up a phenomenal track record, averaging returns of 30 % per annum (Partnoy 1999: 259-260). In 1996 he posted a

return of 35%. In June of 1997 Niederhoffer made a wager on the Thai baht and lost nearly half his fund. In what Partnoy describes as a pattern of gambling behavior, Niederhoffer started increasing his bets in order to make his losses back. By October of 1997 Niederhoffer took the view that the Standard & Poor's top 500 shares would maintain their prices or go up. Accordingly, he started selling put options on the S&P 500 index. This put option gave the buyer the right to sell the underlying future at a specific date and price in the future (see par. 7.3.2.1-7.3.2.3). If the price went up, the options would expire worthless and the seller would keep the money he was paid for the options (premiums he received); however, if the price dropped, he would have to buy the futures from those holding the put options at the higher price. The magnitude of his losses would theoretically be the difference between the price he had to buy these futures at and zero, multiplied by the amount of options he had to buy. On Monday 27 October 1997 the USD 100 million hedge fund Niederhoffer was managing was wiped out, after a 7% drop in the US stock market that caused a severe collapse in the value of the S&P index futures that he had to now buy at a higher price. One can only speculate that Niederhoffer may have done this risky trade because he needed the option premiums to either enhance his returns or to make even larger bets. One of his chief investors was apparently the San Diego public employees' pension fund.

7.9.2 THE CHEMICAL BANK INCIDENT

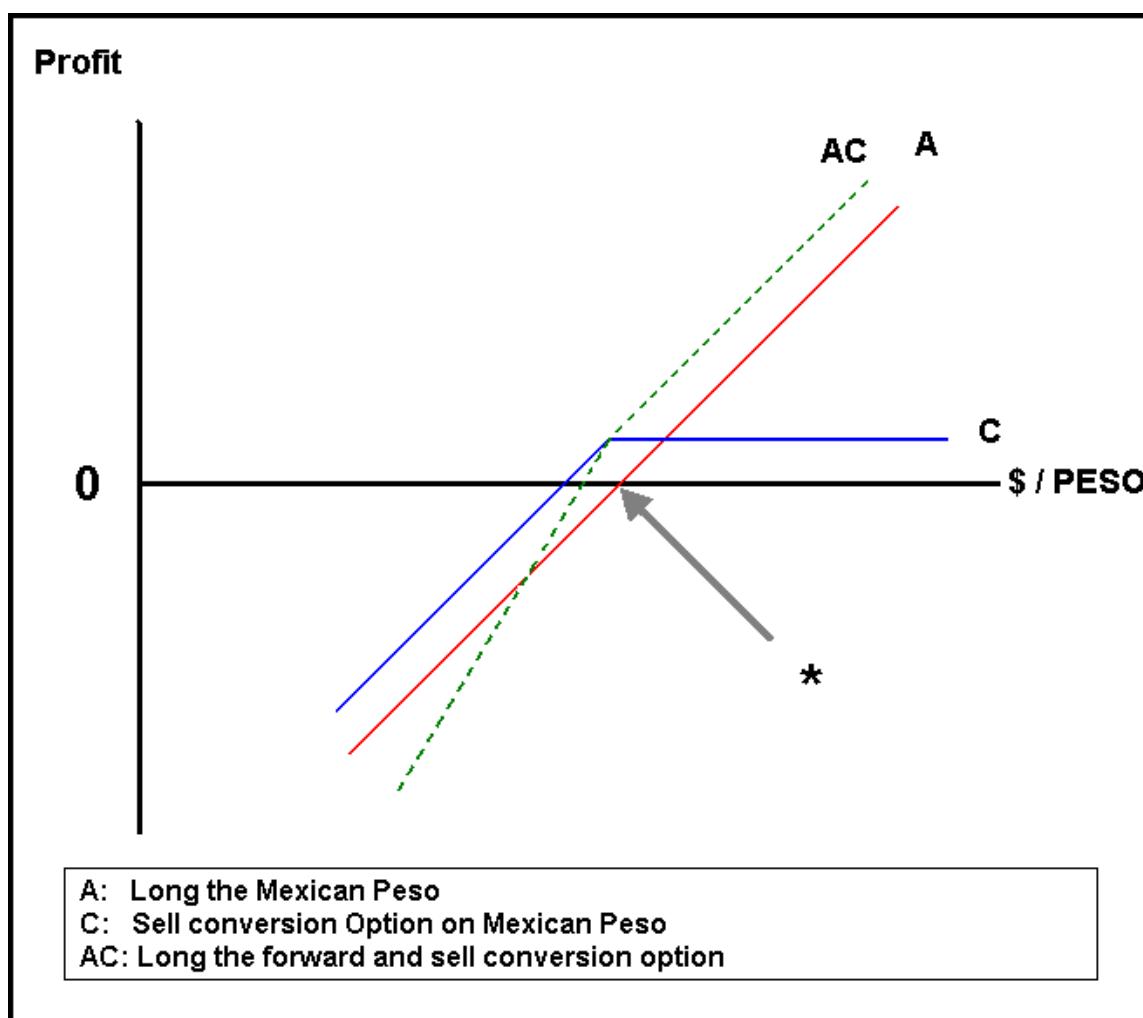
On page 196 of his book, F.I.A.S.C.O., Frank Partnoy mentions the fact that one of the companies that lost a lot of money on currency derivative transactions was a firm called Chemical Bank. An amount of USD 70

million was apparently lost on a Mexican peso transaction. Chemical bank claimed the transaction was unauthorized. Interestingly enough, Mr John Rusnak was previously employed by none other than Chemical Bank. In 1993 Allfirst recruited Mr Rusnak from Chemical Bank, where he had been a currency option trader since 1989 (Ludwig 2002: 7). On the 22nd of March and the 4th of April 1996 the New York Times reported that “a trader” from Chemical Bank has been indicted on charges of “...bank fraud and falsifying bank records”, after it was found that he was hiding large unhedged bets on the Mexican peso from his superiors. He achieved this through the use of fictitious trades that had the appearance of offsetting his peso positions. Does this sound familiar? Court documents from the SECURITIES AND EXCHANGE COMMISSION v VICTOR R.GOMEZ, United District Court for the Southern District of New York, 96 Civ. No. 96-2056 tells us the full story.

Mr Gomez was the Vice President of the foreign exchange trading group at Chemical Bank. Primary responsibility for Mexican peso transactions rested on the shoulders of Mr Gomez. In November of 1994 Mr Gomez used forward contracts to take a position on the movement of the Mexican peso against the USD. Through fictitious entries he then created the impression that he had hedged his position by entering in offsetting positions in USD. The first leg of his trades was identical to the ones that Mr Rusnak entered into a few years later. The only difference was the currency. While Mr Rusnak wagered on the belief that the Japanese Yen would strengthen against the USD, Mr Gomez wagered on the belief that the Mexican peso would increase in value, or at least remain stable, against the USD.

Mr Gomez also failed to record some of his transactions (SEC v. VICTOR R.GOMEZ 1996: 1-2). In particular, Mr Gomez sold a number of convertibility guarantees. These transactions were never recorded and, according to court documents, Mr Gomez kept the transaction papers "...in his desk drawer". Convertibility guarantees are, in essence, the same as the put options sold by Mr Rusnak. In this case, they gave the buyer the right to sell to Chemical Bank a specified amount of Mexican pesos at the market price on specified dates in the future. Mr Gomez, like Mr Rusnak, also received fees for selling these guarantees. In order to disguise these fees, Mr Gomez used false transactions to make the fees generated and interest earned on these transactions look like trading profits.

FIG. 13



In Figure 13 the vertical axis represents the potential profits or losses and the horizontal line represents the exchange rates between the USD and the Mexican Peso. Movement to the right on the horizontal axis indicates the Mexican Peso strengthening against the USD, in other words, you need fewer Pesos to buy one USD. The more to the left you move on the horizontal axis, the weaker the Mexican Peso is against the USD, meaning that you need more Pesos to buy one USD.

The red line represents the long forward position on the Peso. The holder thereof has the obligation to purchase Pesos from the seller at a set exchange rate at a future date. The stronger the Peso is against the USD, the more profit he would make and, inversely, the weaker the Peso against the USD the larger his losses. Similar to Mr Rusnak's put options, the red line C represents the conversion obligations sold by Mr Gomez. If the market in Peso was liquid and the Mexican Central Bank kept on buying Pesos, this obligation would expire worthless and Mr Gomez would have profited the obligation premium. However, if he had to buy Pesos in an illiquid market, he would be exposed to further devaluation in the currency – the difference between what he paid for it and what he can sell it for represents his loss. The green dotted line represents the combined effect of the two transactions.

In Chapter 9 of his book, F.I.A.S.C.O., Frank Partnoy provides us with a vivid account of the speculative abuses that eventually contributed to a severe financial crisis in Mexico. Of interest to us is the fact that Mr Gomez, as mentioned previously, was the “proud” owner of a number of Mexican Peso forward contracts, betting that the Peso would strengthen against the USD and, to make matters worse, for good measure he also was a counter-

party to a number of really happy buyers of his convertibility options, which held a view contrary to his. Mr Gomez, as did many others, (Partnoy 1999: 191) at the time believed that the Mexican Central Bank would protect the Peso at all costs against devaluation against the USD. On Tuesday the 20th of December 1994 things went horribly wrong when the Mexican Central Bank decided to stop supporting the Peso. The result was a 40% devaluation in less than a month. The long forward positions on the Peso, as we explained in par. 7.3.2.2, forced Mr Gomez to buy Mexican Pesos at a price much higher than the market price, and the holders of the convertibility guarantees started to convert their Pesos into USD. The result, as we now know, amounted to a USD 66 million loss to Mr Gomez.

On the 5th of April 1997 it was reported (SFGate.com Business Briefs) that the 36-year-old Mr Victor Gomez, a former bank trader, had been sentenced to three years and one month in prison for concealing a USD 66 million loss while working for Chemical Bank. An interesting element of the judgment was the absence of a financial penalty, as Mr Gomez was apparently broke. The year of 1997 was, incidentally, the last year that Mr Rusnak did not earn a bonus. Of further importance is the fact that, at the very least, the sentencing of his former colleague was reported on Bloomberg, the financial news service monitored by virtually all trading rooms, making it highly unlikely that Mr Rusnak would not have been aware of it.

7.10 OTHER CONTRIBUTING BEHAVIOR

A further important clue in explaining this event is found in the Ludwig Report, commenting on how the back office staff perceived management

priorities (2002: 21). Back office staff perceived management as favoring traders because the traders are making the money and the back office staff, by implication, would be viewed as an expense. Irrespective of whether or not this perception was actually true, it would provide an explanation as to why the back office staff followed the path of least resistance and tried to avoid involvement in the process. The back office “...developed written policies under which it was *not* responsible for confirming the individual prime account trades...” (2002: 20). It is, therefore, no surprise that determined back office action was only taken after Mr Rusnak’s positions were closed down by Mr Cronin mid-January 2002. A purported instruction from the back office supervisor to confirm all Mr Rusnak’s transactions was apparently only executed late in January of 2002, after the news that the closing down of Mr Rusnak’s positions had been ordered (2002: 27). This revealed 12 unconfirmed transactions; when the “counter-parties” were contacted that same evening, they denied any knowledge of the transactions. When Mr Rusnak was informed of the fact that difficulty was being experienced to confirm his trades, he provided the back office with “written” confirmations. Closer inspection, however, revealed that these transactions were fake and were generated by Mr Rusnak on his computer.

The treasurer of Allfirst, Mr Cronin, only requested and received detailed reports on Mr Rusnak’s activities in mid-June of 2001, after Mr Buckley from AIB contacted him about concerns expressed by “a market source” regarding the extent of Forex trading conducted by Allfirst. None of the other executives at Allfirst, not even the CEO, was made aware of this enquiry. Mr Buckley explained this as his normal practice to directly contact the relevant executive. Although this may be true, I do believe the special

relationship that existed between Mr Cronin and the AIB leadership structure is relevant. As I showed in par. 2.2, Mr Cronin was most definitely part of the inner circle at AIB. The Ludwig Report points out that Mr Cronin was initially viewed as an “AIB spy” and he was “...often excluded from senior management meetings and interactions” (2002:4).

7.10 SUMMARY

John M. Rusnak did not steal any money from Allied Irish Banks. He fraudulently and elaborately reported false profits and he fraudulently and elaborately concealed actual losses. There is definitive evidence suggesting that he was displaying signs of addictive behavior. His trading strategy was simple and directional and consistent, and so were his losses. John M. Rusnak was out of his depth and his trading counter-parties made nearly USD 700 million out of him. While the likes of Morgan Stanley were fielding “armies” of “special forces” (Partnoy 1999:108) in what they viewed as “financial warfare” Mr Rusnak, like Mr Leeson, stood alone and we all know how the story about “two against two thousand” ended. It is no wonder that he was wined, dined and entertained. There is also very strong evidence to suggest that Mr Rusnak was either exposed to the type of transactions he conducted while he was employed by Chemical Bank or, at least, that in 1995 he would have seen the method of hiding losses and creating false profits from the activities of Mr Gomez, who was also employed by Chemical Bank.

On a number of occasions the attention of executives at Allfirst and at Allied Irish Banks were drawn to the fact that their positions in the foreign

exchange markets were raising eyebrows. Each and every time, they assured the market that everything was in order and that they were aware of the positions. I do believe one can interpret these enquiries as subtle tests by those who were dealing with Mr Rusnak, to determine if his dealing was authorized. These counter-parties had to know that Mr Rusnak was losing hand over fist, as they were making money at an equivalent rate.

One of the sad possibilities in this case is the fact that Mr Rusnak may “benefit” little from his incarceration. The report of the Task Force on Gambling Addiction in Maryland clearly states that “incarceration will not cure this mental illness, and no professional gambling treatment is available within any state, local or Federal penal institution” (Lorenz & Politzer 1990: 22). Even more disconcerting is the comment made by the US attorney for Maryland after Mr Rusnak was sentenced: “he’ll be in with the bank robbers and drug dealers and other criminals because that is what he is” (O’Donnell & Willing 2003: 1-4). DiBiagio, the US attorney in question, argues that Rusnak’s sentence is fitting because around 650 people lost their jobs, while others lost their bonuses or raises because of what Mr Rusnak did. No mention is made about the bonuses and raises paid in previous years, based on Mr Rusnak’s fictitious profits, and the fact that job losses occurred only after Allfirst was sold. The transaction that led to the job losses was announced in September of 2002 (BBC News 26/09/2002). M&T Corporation, a US bank with Warren Buffet as its largest shareholder, merged with Allfirst. Allied Irish Banks (AIB) received USD 886 million in cash and also received 22.5% of the new company. The transaction pushed the shares of AIB up to 12.96 Euros. After the nearly USD 700 million loss, the AIB share price dropped to around 10.50 Euros (Irish Examiner

26/03/2002). The announcements of overcharging, tax evasion and fraud by executives in May of 2004 had little effect on the share price of AIB and, shortly after an initial dip, the shares were trading at Euro 13.81 (Washington Times 30/05/2004).

There is no doubt that the job losses and loss of income mentioned by Mr DiBiagio is a very serious matter. However, if we locked up all those responsible for job and financial losses, our prisons would be filled with incompetent politicians and corporate executives. One example that immediately jumps to mind is the job losses that followed after the merger of Kidder Peabody with Paine Webber. In Chapter 5 we saw that more than 2 000 Kidder staff lost their jobs as a result of a decision by Kidder and General Electric shareholders to aggressively expand their MBS book. There is compelling evidence to suggest that a complete failure of formal and informal restraints was central to the creation of an environment in which Mr Rusnak could incur and hide his massive losses. The failure of these restraints was, however, a part of the culture at AIB. AIB made money to the detriment of its clients and the Irish State, the extent of which is very difficult to quantify, as is the impact on its clients and their families. Mr Rusnak made money for himself to the detriment of AIB. The lure of the big bonuses, the overseas holidays, lavish treatment by service providers and the obvious status, respect and sense of power that accompany such a lifestyle, were obviously an incentive for extreme opportunism. The competitive edge that Mr Rusnak had was twofold: he convinced his superiors that he could make money for his firm and he had a very good understanding of the bank's risk management and administrative systems. At the micro level this was only possible because his superiors never took the

time to understand fully how Mr Rusnak was “making” money for them. These superiors also created an environment in which there were little incentives for administrative personnel to question Mr Rusnak’s activities. The mere fact that the expenditure of a few thousand dollars for an independent Reuters feed was frowned upon, as well as the relatively small basic salary that Mr Rusnak was paid, is a clear reflection of the AIB culture. A 2004 report by JP Morgan viewed AIB as “...the most profitable major bank in the 25-nation European Union, averaging nearly three times the level of profit per account versus the EU average” (Washington Times 30/05/2004). The powers at AIB attribute this to “extreme efficiency” and the favorable Irish tax regime; consumer groups tended to believe overcharging of customers was a more likely explanation.

Mr John Rusnak liked the status and benefits that came with his position. This, and the money he was paid in bonuses, were in all probability his primary motivators. As in the case of Mr Leeson, one cannot discard the possibility that an addictive personality had an influence. The balance between those factors that facilitated Mr Rusnak’s activities and those that could have inhibited it was, however, severely skewed. Management failure can probably be singled out as one of the prime facilitators. Not only did a number of top AIB officials make themselves guilty of severe abuses, they also did very little to put effective risk management structures in place at Allfirst and to ensure rigorous enforcement thereof. Numerous internal and external warnings were also dismissed without proper assessment of their validity. This environment – conducive to extreme opportunism – coupled with the fact that Mr Rusnak had a role model in the form of Mr Gomez, in all probability, lies at the root of the AIB losses.

CHAPTER 8

THE NATIONAL AUSTRALIA BANK FOUR

8.1 INTRODUCTION

On the 27th of May 2006 it was reported that two former National Australia Bank traders, David Bullen aged 34 and Vince Ficarra aged 27, were unanimously convicted of unauthorized trading by the Victoria County Court (Turnbull 2006: 1-2). The two former traders were respectively found guilty on 17 and 12 charges of “gaining financial advantage for themselves and others” and one count each of “gaining financial advantage by deception”. Both men had pleaded not guilty to all the charges brought against them. On the 4th of July 2006 Judge Geoffrey Chettle handed down sentence in the Victorian County Court. Mr Bullen was sentenced to three years and eight months in jail, of which he must serve a minimum of two and a half years (Bell 2006: 1-2). Mr Vince Ficarra was sentenced to two years and four months in jail, of which he has to serve a minimum of 15 months. During June of 2005 Luke Duffy, who at the time of the unauthorized trading was head of the NAB foreign exchange trading desk, was sentenced to 29 months in prison after pleading guilty to three charges of “dishonestly using his position for personal gain”. The presiding judge in the Bullen and Ficarra trial labeled Duffy as the ringleader of the quartet. In April of 2006 the fourth member of the quartet, Gianni Gray, was sentenced to 16 months in jail, of which he had to serve 8 months before he could be released on good behavior. When sentencing Mr Ficarra, Judge Geoffrey Chettle made two comments that are of the utmost importance to this thesis.

In the first instance, he said “I accept that your crimes took place in a culture where profit and loss distortion had occurred in the past and where risk taking was an inherent part of your occupational duties” and then went further by saying “I also accept that profit was perceived as being the be-all and end-all of business and that you somehow became swept up and carried along by the personality of Mr Duffy. You became enmeshed in the culture that saw you seeing yourself as invincible and somewhat arrogant” (AAP 2006: 1-3). The clear recognition of the influence that the NAB corporate culture had on these individuals, and the fact that the role of learned behavior was at least tacitly recognized by the judge, allows for a much clearer understanding of why such an event could take place. The effect of their behavior was a USD 277 million loss to NAB (AFP 2004: 1). Their demise was purportedly attributed to a single co-worker who reported “suspicious” transactions implicating the NAB Forex team (AAP 2004: 1).

8.2 WHAT INSTRUMENTS DID THEY USE?

The four traders involved in the event were all working on the currency options desk at NAB. Mr Gianni Gray manned the London desk and the other three were all stationed in Australia. They were authorized to conduct proprietary and agency business, transacting in a range of products that involved taking a view on essentially five different currencies (APRA Report 2004: 14). The products used ranged from non-exotic “vanilla” type options that could be exercised during the life of the option (American) or on expiry of the option (European), to more intricate types like the “butterfly spread”, which we will look at in more detail. The sheer number of

transactions executed over an extended period of time, rather than intricacy, provided the multiplying effect, very similar to Mr Iguchi's case.

8.2.1 SPOT FOREIGN EXCHANGE TRANSACTIONS

The spot foreign transaction entails "the purchase or sale of a foreign currency or commodity for immediate delivery. Spot trades are settled 'on the spot', as opposed to at a set date in the future, and are also known as 'cash trades'" (Investopedia). Investopedia also tells us that "Futures transactions that expire in the current month are also known as spot trades because, in the case that goods are actually delivered, delivery time is reasonably expected to take one month."

8.2.2 FORWARD FOREIGN EXCHANGE TRANSACTION

Contrary to the spot foreign exchange transaction, the forward foreign exchange transaction is designed to lock in the price at which a firm like NAB "...can buy or sell a currency on a future date. It is also known as 'outright forward currency transaction', 'forward outright' or 'FX forward' (Investopedia). It is also important to note that "in currency forward contracts, the contract holders are obligated to buy or sell the currency at a specified price, at a specified quantity and on a specified future date. These contracts cannot be transferred" (Investopedia). In other words, if you read the market wrong your risk is real and could be substantial.

8.2.3 NON-DELIVERABLE FORWARD CONTRACT

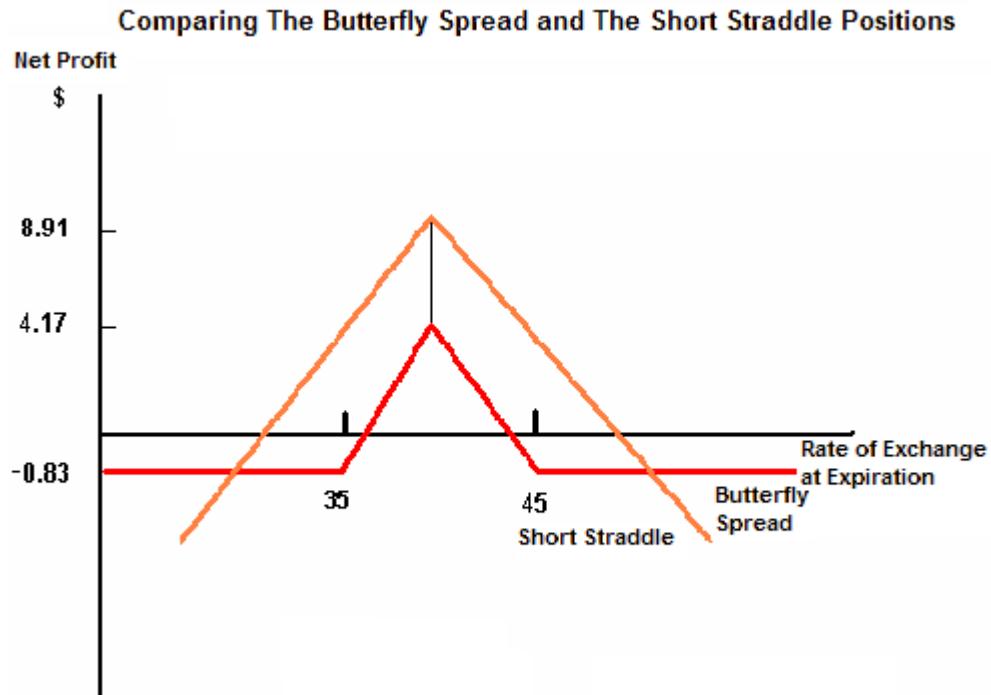
As the name implies, this product allows for profits or losses to be settled with a cash payment and does not, as in the case of the spot foreign exchange or forward foreign exchange contracts, require physical delivery of the underlying currency (Investopedia). It is a “...short-term forward contract on a thinly traded or non-convertible foreign currency, where the profit or loss at the settlement date is calculated by taking the difference between the agreed-upon exchange rate and the spot rate at the time of settlement, for an agreed-upon notional amount of funds”. These instruments are further characterized by a “...fixing date and a settlement date. The fixing date is the date at which the difference between the prevailing market exchange rate and the agreed-upon exchange rate is calculated. The settlement date is the date by which the payment of the difference is due to the party receiving payment. NDFs are commonly quoted for time periods of one month up to one year, and are normally quoted and settled in US dollars. They have become a popular instrument for corporations seeking to hedge exposure to foreign currencies that are not internationally traded” (Investopedia). It is also an ideal instrument for speculation, as all transactions are cash settled and there is no physical settlement of underlying securities involved.

8.2.4 BUTTERFLY SPREAD

The APRA Report (2004: 14) also attributed some of the losses to the selling of “butterfly spreads”. Consistent with the view of the NAB Four that the USD would remain strong against all the major currencies as well as the

AUD and the NZD, they sold a combination of long out of the money volatility options and short at the money volatility options. The effect of these combinations is graphically illustrated in Figure 14 below. The “butterfly spread” is illustrated by the red line. The NAB position is a hedged version of the “short straddle”, illustrated by the orange line in figure 14, sold by Mr Leeson. As explained in par. 6.7.1 the straddle has virtually unlimited downside potential when an exchange rate becomes volatile, while it only has limited upside potential if it remains stable. The “butterfly spread” has the same limited upside potential, but the downside potential is also limited if the exchange rate becomes volatile.

FIG. 14



(Reily & Brown 2000: 1031)

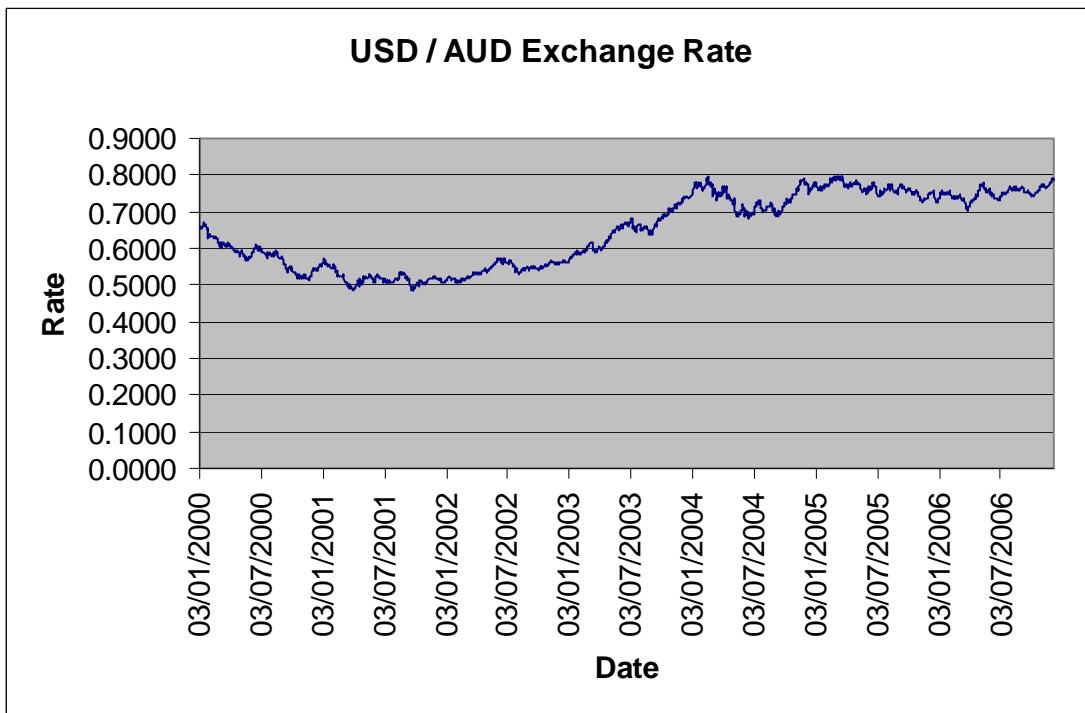
The product used by the NAB traders to generate cash has a lot less inherent risk than the ones used by Mr Leeson; however, their application of the cash they received as option premiums did expose them to further losses. The team entered into a number of spot and option Forex transactions, all betting on the weakening of the US currency. The trading team of a bank like NAB can, for example, sell AUD to a client at a predetermined price at an arranged date in the future, without actually holding the underlying currency, AUD in this case. If the price of the sold AUD rises against their expectations, they have to buy in the AUD necessary to deliver to their client. The difference between what they received as a premium in the event of an option or future, or the price they negotiated in the event of a spot, and the price they have to pay, to secure the underlying currency for delivery, culminates in either a profit or a loss. If you believe a currency will depreciate, you can generate a profit by selling the currency without actually owning it (shorting it). If the currency depreciates in value, below the price you sold it at, you can buy it on the open market at the lower price and deliver to your client. The price difference will be your profit. If the price of the underlying currency actually appreciates, you have to buy the currency you need to deliver at the higher price, thereby incurring a loss. In this case, the losses they incurred on the weakening of the USD against the AUD was further exacerbated by similar transactions that presupposed a weakening of the Japanese Yen (JPY) and the British Pound (GBP) against the US Dollar (USD) (APRA Report: 2004). As we can see from the graph that follows, the USD weakened substantially.

8.3 HOW WAS THE LOSSES INCURED?

Most of the losses occurred in the latter part of 2003 (APRA Report 2004: 14-18). However, it is important to note that the four traders manning and managing the currency options desk for NAB were carrying a loss that they had been rolling with them from as far back as 2001. As we have seen in our other case studies, they were probably also looking for the “Big Hit” to clean the books. An opportunity for the big hit presented itself in the form of a G-7 meeting that was scheduled for the 22nd of September 2003. The NAB traders held the view that the USD would remain strong and that the G-7 would promote a policy of tightly managed exchange rates that would, to an extent, ensure little volatility in especially the AUD and the NZD (two currencies that NAB must have had extensive research on). Over and above their expectation of little volatility in the USD’s exchange rate in relation to major currencies, they also held the view that the USD would remain stable or strengthen in relation to other major currencies. On this they then wagered their futures. As we see clearly in Figure 15, the USD weakened sharply after the announcement and kept on weakening until their story broke and became public knowledge, whereafter it weakened substantially before gaining momentum again in the last quarter of 2004. It is not impossible that there were external party or parties who were aware of the positions of the NAB Four and made substantial profits from their positions. It is interesting to note that the behavior of the market around September 2003 was very similar to the behavior of the market around October 2002, when NAB traders sold deep in the money options in order to raise AUD 322 million. As in the AIB and other cases, these types of transactions alerted outside parties. The management of NAB received a number of enquiries that should

have alerted them, similar to those received by the Barings and AIB management. In par. 8.5.2 I will show that these enquiries were, however, dismissed without due investigation.

FIG. 15



(US Treasury: 2006)

8.3.1 THE ROLE OF VOLATILITY

According to an investment dictionary, "...volatility refers to the amount of uncertainty or risk about the size of changes in a security's value. A higher volatility means that a security's value can potentially be spread out over a larger range of values. Meaning that the price of the security can change

dramatically over a short time period in either direction. Whereas a lower volatility would mean that a security's value does not fluctuate dramatically, but changes in value at a steady pace over a period of time" (Investopedia). Therefore, if you hold the view that the price of a stock, the exchange rate of a currency or the level of an index will not fluctuate a great deal over a certain period of time, you can make money by selling protection against such an event to those who either hold a view opposite to yours or have to hedge their portfolios because of risk management requirements. The buyer of an option for protection would normally only be exposed to the extent of his option premium, except for the case where the option seller cannot meet his obligations. The seller of protection against volatility is the one who potentially can incur substantial losses in the event of unexpected volatility that can often result from unpredictable events like earthquakes (Kobe) or acts of terrorism like 9/11.

"One measure of the relative volatility of a particular stock to the market is its beta. A beta approximates the overall volatility of securities' returns against the market returns. For example, a beta value of 1.1 means that the security will return 110% compared to what the market returns over a specified time period. Conversely, a beta of 0.9 will return 90% of the market's total return" (Investopedia 2006). An unnamed quantitative finance professor is also quoted as saying that "...short volatility trading is a high variance strategy: you win 99% of the time. You lose big 1% of the time." (Wood 2006: 2).

8.3.2 HIDING THE LOSSES

In order for us to understand how it was possible for the traders to hide their losses, it is first and foremost important to understand how the NAB administrative system for currency trading operated. Although currency trading was done from all the major trading rooms of the bank, everything was managed out of Melbourne and London (APRA Report 2004: 14). All transactions were, however, recorded and administered centrally in Melbourne. If any of the trading rooms transacted with a counter-party, the transaction would be “cleared” from their books by the execution of an equal and opposite transaction with the global desk that would, for risk purposes, step into the shoes of the desk that executed the deal in the first place. The administrative system used by the dealers in the front office was called the “Horizon” system. This system was also used to perform daily profit and loss calculations (P&L) (APRA Report 2004: 17). Once these P&L calculations were completed, reconciliation was initiated by the back office between 15 minutes and two hours after “end-of-day”. This reconciliation was done only on those transactions that were still live, in other words, transactions that were not cancelled or neutralized by another trade entered into the system. A secondary system, called the “Kapiti” system, was used for ensuring that all transactions matched, i.e. have an equal and opposite leg. As we will show in more detail in the following paragraphs, this matching process was relying on corrupted data because of fictitious trades that “matched” other fictitious trades, or transactions that were simply cancelled during the “widow period” after the Horizon P&L calculations were completed.

In order to keep their mounting losses from being detected and to buy time to make back their losses, the traders used at least three different strategies. From the latter part of 2001 up until May 2003, spot FX transactions were used to manipulate the profit and loss account of NAB. By entering a spot FX transaction in a pair of currencies in which the traders were sitting with a loss, the opportunity to create a temporary false profit was developed. By entering an incorrect exchange rate, a fictitious profit was created from the transaction with an internal counter-party, similar to what Mr Leeson achieved with his 88888 account. This transaction was entered into the trading system (Horizon) and left until after the system closed for its end of day. The artificial profit negated the existing loss rolled over from the previous day. After the calculation of the daily P&L, the deal was amended with the correct exchange rate, the profit was deleted and the deal, in all probability, settled worthless. However, the spot FX transactions only affected daily P&L figures and a longer-term solution was needed. In order to achieve this, a change to the Horizon system was requested in May 2003 and completed before July of 2003, which allowed traders to amend or cancel their own deals. Who authorized this amendment is not clear, but it was most probably requested by the traders, as this allowed for a new level of manipulation. By the end of September 2003, losses of around AUD 45 million were covered up through the use of fictitious trades that were entered into the horizon system and later amended or removed all together. By entering fictitious unmatched trades between two portfolios on the Horizon system just before close of day , profit could be created for one of the accounts. After the Horizon system had calculated the daily P&L, the fictitious trades were cancelled and, by the time the Kapiti system was matching trades, the two transactions together would have no impact and

would, therefore, not reflect as an exception through being unmatched. These activities, once again, were very similar to the transactions used by Mr Leeson.

As the losses were mounting, the pressure on the four traders obviously mounted and the Head of Currency Options, Mr Luke Duffy, notified the back office that the reconciliation of internal transactions was no longer necessary. By the 10th of October 2003 the back office ceased their reconciliation of internal transactions. This now allowed for unmatched option trades to be entered into the system, which created false profits for the account the traders chose. The benefit of the fictitious option is that it will keep reflecting a profit up until its exercise date. By then it could be cancelled and replaced with another fictitious transaction. This activity is, once again, essentially the same as those used by Mr Leeson and Mr Rusnak. Over and above the fact that the use of fictitious transactions saved the traders a lot of work, it also allowed much larger “profits” to be created. This was essential as, by December 2003, the four traders had to cover up losses of around AUD 150 million. According to Mr Duffy, the decision to stop checking internal trades was the result of a cost-cutting exercise at NAB (Woolrich 2005: 1-2). After that he said that, when the risk section of NAB questioned him about profits or losses being too high or too low “...he’d tell [them]...anything that they would believe.” This is a virtual replay of the SLK receivable incident at Barings. Were it not for the whistleblower at NAB who reported suspicious transactions, the firm could easily have followed the Barings route.

8.4 WHY WAS IT NOT DETECTED?

On the 23rd of March 2004 the Australian Prudential Regulation Authority released its findings regarding the events at NAB. Strikingly in line with our findings in all our other case studies, the report concludes that the cause of the event was undoubtedly the actions of the traders involved. This is unfortunately only half the story, and the report also states that this event can be attributed to the operating environment at NAB. Three key elements of the operating environment are highlighted: “lax and unquestioning oversight by line management; poor adherence to risk management systems and controls; and weaknesses in internal governance procedures” (2004: 5).

A key comment is, however, added to this “...the control failure in this case has more to do with poor implementation than poor design” (APRA Report 2004: 5). The report finds that, although the framework of control was not ideal, proper implementation and enforcement of what was available could, in all likelihood, have reduced the losses substantially and may have averted the event all together.

8.5 WARNING SIGNS

8.5.1 INTERNAL WARNINGS

The APRA Report identified a number of internal and external warning signs that all, if heeded, could have initiated responses that may have reduced or prevented the event. Included were “critical internal audit reports” that were ignored; “prolonged limit excesses” that were allowed

without any effort to either change the existing limits, if they were too low, or to enforce the existing limits, if proven to be appropriate. Added to this was a lack of urgency or the will to deal with “unreconciled reporting issues” (2004: 5). The PWC Report (2004: 43-45) provides us with a detailed analysis of warnings emanating from internal audit reports. As early as May 1999 the Internal Audit department at NAB identified at least two matters serious enough to justify the attention of the Managing Director and the Board Audit Committee. The most important problems regarding the currency operations at NAB were the “...inability to reconcile profit and loss between the front and back offices; no volatility smile included in revaluations; and no independent monitoring of risk concentrations”. These shortcomings were brought to the attention of the Principle Board Audit Committee (PBAC) and, in a June 2000 quarterly audit report to PBAC, it is stated that “...substantial efforts to rectify...” the 1999 problems had been made by management. Although it is not clear what these efforts entailed, it appears that the implementation of the Horizon computer system seemed to be viewed as a solution. An instruction for quarterly updates on identified weaknesses was also issued, but the PWC Report could find no evidence of such updates. A subsequent September 2000 Internal Audit report covering the Horizon system’s influence on the foreign exchange options area claimed that the system would solve some of the problems identified in 1999, but requested a post-implementation review to be conducted. Once again the PWC Report could find no evidence of such a review. A December 2001 Internal Audit review of the options area identified daily limit breaches by the foreign exchange area. In 61 out of 61 days these trading limits were breached and all were approved by the Global Head of Foreign Exchange. No explanation could, however, be found for these breaches and/or the

reason why they were approved. The report also noted that revaluation rates used to revalue positions were only sourced from one broker. In response to this, the Group Internal Audit proposed that reports to the Principle Board Audit Committee should exclude matters of less than AUD 5 million. As we saw in the chapter on Barings where Mr Leeson was also requested not to advise London of all the errors made by Singapore; this led directly to the position where the 88888 account could be abused. In January of 2003 the Internal Audit report on Global Foreign Exchange apparently had no significant problems with the unit. The breaches of limits were, however, still occurring with impunity and the general perception appeared to be that the limits were inappropriate and the whole matter was downgraded as rather unimportant. I believe it is quite understandable that, if you raise a concern over a period of nearly five years and no-one does anything about it, it could get relegated to the back burner. The evidence in this section of the PWC Report proves that claims by Mr Bullen and the other traders that their superiors were aware of their limit breaches were correct.

8.5.2 EXTERNAL WARNING SIGNS

There were also external warning signs that should have alerted management to possible problems. This included weaknesses in the NAB control systems that were identified by APRA during routine inspections and brought to the attention of management. NAB management was alerted to “a lax approach to limit management; a culture of poor adherence to risk management policies; inadequate sourcing of revaluation rates; problems with interfaces to the Infinity risk engine; no formal validation or back-testing for NAB’s approved VaR model; and inadequate stress testing” (APRA Report 2004:

55). The matter for concern is that, according to evidence led during Australian Senate Estimates Committee hearings, this routine inspection took place in August of 2001 (Garnaut & Hughes 2004: 1-2). The matter was that APRS only raised their concerns with the bank in 2003. The time delay is, to this day, unexplained. The management of NAB obviously did not react to these warnings, even though they had ample time to do so. It is clear that the regulator, APRA, should also shoulder some of the blame. One can make the argument that, if they were so concerned with the risk issues at NAB, why did it take them more than a year to take these matters up with the bank? As we have seen in our other case studies, for example Barings, this is a classic replay of events. APRA also admitted that they were aware of the fact that NAB foreign exchange exposure was twice as large as the other three major Australian banks put together. There seemingly was an unwillingness or inability on the part of regulators to act swiftly and decisively against large financial institutions.

One of the most serious warnings that was present in virtually all our case studies was the fact that NAB counter-parties raised concerns about the nature and the extent of NAB foreign exchange positions (Cornell 2004: 4) (ACSI 2004: 4). According to the PWC Report (2004: 25) an unnamed Australian bank expressed concerns about the “size and risk profiles” of some transactions executed by NAB’s currency options traders. These concerns were discussed during a visit to the “other” bank by Mr Dillon and a representative from Market Risk and Prudential Control (MR&PC) at NAB. The NAB response was one of aggression, and the other bank was accused of not “understanding” the NAB strategy. The “other” bank was also threatened by NAB to the extent that NAB would cease doing business

with it and even some of the brokers used by the “other” bank. In October of 2002 the traders needed money, and they followed the tried and tested method used by, among others, Mr Rusnak and Mr Hamanaka – they sold two deep in the money options and raised AUD 322 million. The bank on the other side of the transaction probably read the AIB case study and duly queried the transaction with NAB. At NAB the matter was referred to the EGM Risk Management, but nothing else was done. This was notwithstanding the fact that Operations at NAB also queried one of the option sales and referred it to Market Risk and Prudential Control (MR&PC) who in turn sought an explanation from the traders. The explanation given was that it was more cost-effective to sell options to raise cash rather than to borrow the funds internationally. Those responsible for risk management at NAB were, therefore, not only aware of the transactions, they were also told that the traders entered into these transactions to raise cash. The important question is why no-one bothered to ask why the trading desk needed the money in the first place (PWC Report 2004: 25). It appears that the questionable trading practices such as Mr Leeson’s massive positions were somewhat of an open secret. A former options trader was quoted saying “I can tell you that NAB have been doing dodgy trading stuff for much longer than a few months. The global options market has been waiting for them to blow up for years. No-one is surprised by this at all, except for the fact that it took so long” (Trader 2004: 6).

One of the most damning indictments against the NAB management was their arrogant response to the AIB incident (PWC Report: 47-49). On the 6th and 7th of May 2002 the NAB board concluded that “A report concerning Allied Irish Bank’s FX losses had been reviewed and it was noted that the

Group had appropriate controls in place to identify control breakdowns on a timely basis to ensure that FX losses are minimized.” Their view, it appears, was largely based on the findings of a meeting of the Principle Board Audit Committee, at which a seven-page memorandum that emanated from internal NAB workshops, comments by various NAB employees and two internal NAB documents regarding AIB and its relevance to NAB were tabled. Two of the more noteworthy comments made regarding the AIB incident’s relevance to NAB come from the supervisor of the four traders and Joint Head of Global Foreign Exchange, Gary Dillon, who stated that “...I think the real test of our level of control is in the detail of the specific business structure in place. This is where I believe the NAB currency option business platform (sales/front office/back office/accounting), set up to accommodate the global currency option business, is far superior to others in the market, and most others internally.” In a similar vein Kevin Bakhurst from the Finance division of NAB viewed the use of daily profit and loss analysis as “not an effective tool”, in spite of the fact that the AIB report viewed this report, as well as a thorough understanding of the reasons underlying daily profit and loss movements, as crucial. According to Bakhurst, a monthly analysis and reconciliation to the general ledger is a more appropriate system. One of the reasons provided by Bakhurst for his view is the fact that the use of different systems by front and back offices results in “significant profit and loss differences”. What he is saying is that they do not have an accurate view of determining daily profit and loss movements, a view that on its own should have sounded the alarm bells.

A substantial number of other very crucial issues addressed by the AIB report were not even commented on in the NAB memorandum. These

included the relevance of “the extent of proprietary trading and how to monitor and control it” and the crucial importance of and need for appropriate trading “limits to be in place”. The AIB report also underlined the need for senior management “to understand the intricacies of proprietary trading before it is undertaken.” and the need for the Chairman and the CEO to be actively involved in the “risk infrastructure and regular reporting to them to monitor the trading business”. It also warns against “excessive reliance on VaR” and stresses the danger of “ignoring other risk information available” as well as the need for all transactions “...to be checked for reasonableness of market price and economic rationale”. The need for serious attention to be given to supervisory reports was also stressed by the AIB report. It is quite clear that most of the AIB recommendations that were not addressed by the NAB memorandum were within the reach of the management and staff of NAB and, if these issues had been given the attention they deserved, the NAB FX losses would have been detected or even prevented. It is striking to note that most of the issues in the AIB report relate to senior and top management’s active participation in and thorough understanding of the businesses they are supposed to manage. It appears that passing the buck and non-involvement was part of the culture at NAB.

8.6 THE CULTURE AT NAB

When analyzing the culture at NAB we will, as we did in our other case studies, also use a much wider focus on the general culture of doing business that was prevalent at NAB. Was a lax culture the reason why numerous warning signs were ignored by NAB management and why there appears to

be a lack of attention to detail and hands-on management regarding the FX unit? Was this culture also detectable in other dealings of NAB?

8.6.1 THE HOMESIDE AFFAIR

In October of 1997 NAB announced the purchase of a substantial stake in a US mortgage loan company, called HomeSide, for USD 1.7 billion (Mackenzie 2001: 1-6). The Australian financial media were not all positive about the transaction and at least three commentators expressed serious reservations. One commented on the risk associated with new and untested technology that was still in the process of being implemented by HomeSide, while another underlined the fact that USD 1.1 billion of the USD 1.7 billion purchase price was goodwill. The high goodwill percentage was worrisome, as nearly 50% of HomeSide's clients were tied to the company for only three years. Anna Borzi, a banking analyst, also expressed concern about the fact that mortgage servicing was a new concept to Australian banking. In 2001 NAB announced to their shareholders losses of USD 4 billion at HomeSide. The losses were attributed to, among other things, "data entry errors; input of wrong assumptions; a modeling error discovered by external consultants; and a breakdown of the hedging model under extreme market conditions". A former NAB insider commented on the fact that the HomeSide losses were not detected and addressed earlier, and highlighted the fact that, if the NAB executives had implemented and enforced industry standard internal controls, the causes cited by NAB should never have happened. The NAB comment should also be seen against the backdrop of 1998 APRA guidelines regarding the use of risk models used by banks like NAB. According to these guidelines, users had to ensure that "the processes and models are

conceptually sound; the bank has sufficient staff in the risk control, audit and back office areas who are skilled in the use of sophisticated models; the models have a proven track record; and they are regularly stress tested". A question that also jumps to mind is whether or not the inherent risks associated with Mortgage Service Rights (MSRs) were well known. In a 1998 10-K filing with the US Securities and Exchange Commission, HomeSide clearly states that "there is a substantial interest rate risk in MSRs. They go down in value when interest rates decline and up in value when rates increase. The risk management contracts used by HomeSide to hedge this exposure do the reverse, so hedge profits should be expected during periods of declining rates and hedge losses expected when rates are rising". It is therefore very difficult to comprehend how those involved in the due diligence of HomeSide did not realize the inherent danger posed by MSRs held by the firm it purchased. It is furthermore worrying (but not surprising) that KPMG, the auditors of NAB and HomeSide (since April 1998), never highlighted the inherent risk associated with MSRs. It is also noteworthy that in 2001 NAB employed Christopher Lewis as its "Executive General Manager Group Risk Management". This was the same individual who signed off the 2000 annual report without making any reference to the risks inherent in the MSR portion of NAB's business and the fact that the bank was about to announce a USD 3.6 billion loss. Lewis also headed the due diligence team that recommended the HomeSide transaction (Trader 2004: 4-5). As the auditors to NAB and HomeSide, KPMG should also have been acutely aware of the MSR risk, even if they only read the HomeSide 10-K filings to the US regulators.

8.6.2 THE 2004 EVENT

The APRA Report is very similar to the Singapore Report, as it also highlighted and was equally critical of the culture that existed at NAB at the time. Efforts were made to cultivate a more enlightened (commercial) risk management approach at NAB and the relationship between risk management and operations appeared to be one of a partnership in the pursuit of profit rather than one of effective oversight and risk management. The culture in the Corporate and Institutional Banking division (CIB) of NAB was one of managing the constraints that management laid in their path to profit rather than solid boundaries for their actions. This is similar to a corporate culture wherein regulatory and other penalties are budgeted for as a legitimate and essential business expense rather than a deterrent against extreme opportunism. It should, however, always be remembered that the biggest risk facing any business is not making money. Because of this fact, the pressure on those responsible for managing risks could be immense, as the demise of their firm due to a lack of profits would also seal their own fate. Without strong support in word and deed for effective risk management on all levels including, and especially, board level, the work of risk managers will be an exercise in futility (APRA Report 2004: 5-7). The APRA report summarized the failure of NAB's internal risk management controls as follows: "...NAB's internal control systems failed at every level to detect and shut down the irregular currency options trading activity. NAB's internal governance model, which should have enabled timely identification and effective and quick escalation of serious risk issues on the currency options desk, simply did not function" (2004: 5). In other words,

the main reason for the fact that the failure was complete and at all levels was the prevailing organizational culture.

In virtually every layer of the NAB structure, the APRA Report (2004: 6) identified contributing acts or omissions that created and maintained the culture necessary for an environment conducive to the activities that led to the event in 2004. There is an old saying in the financial world: “shit flows downhill” and from the evidence gathered by the APRA Report it is clear that, although risk was often talked about, there was little or no evidence to suggest that the Principle Board of directors of NAB took a proactive approach to managing the risks that come with the territory their divisions were operating in. The risk management committees that were established on an executive level were equally ineffective. One example highlighted was the fact that when, similar to the “Barings Event”, an internal audit highlighted the existence of control weaknesses, the Risk Management Committee responsible for CIB either dismissed or ignored these warnings, underlining the total lack of importance attached to managing risk. The so-called Middle office that noted the irregularities emanating from the trading desks failed to clear up these anomalies with the trading desk and also failed to solicit adequate managerial response concerning the trading anomalies. The APRA report also probes the inability of the back office to identify the irregular and fictitious trades that were conducted and questions the skills of those employed, the resources allocated to them and the role of a culture that regarded back office activities as overheads that should be kept to a minimum. This lack of adequate resources was also emphasized as a crucial failing at Barings. Similarly, the APRA Report suggests that the back office/administrative function was indeed treated like second class citizens

who were there to serve and not question the traders in their quest to generate profits, a culture we also identified at AIB. The CIB line management and staff had only one motto: “Profit is King” and as long as profits are generated everything must be fine. The equating of profitability with financial and operational wellness was an inherent culture identified in all the case studies we have analyzed up to now. This fundamental error is a partial explanation for the inability of anyone to identify the warning signs that, with hindsight, appear so clearly. Over and above the skewed profit/risk relationship, the APRA Report (2004:72) also identifies the whole issue of “managing” bad news. Good news travels fast, the saying goes. Bad news, on the other hand, as we have seen in other case studies, is very often either repressed all together, or sanitized before it is fed through to boards of directors and even external organizations responsible for oversight. These actions do not absolve these organizations from blame and ultimate responsibility. It is their duty to put the necessary structures in place and to cultivate a culture that encourages openness and transparency. If traders know that they will lose their jobs if they do not reach the ridiculous profits that the board promised to shareholders, you will never get honesty and transparency.

8.7 PRINCIPAL FAILURES

A detailed analysis of the operations function revealed a number of crucial failures or omissions that, individually, could have prevented this incident (APRA 2004: 22).

8.7.1 RECONCILIATION AND VALIDATION FAILURE

The APRA Report cited the reconciliation and validation functionality as one of the functions that was fatally flawed. It cited “failure to check or reconcile internal trades”; “failure to validate surrendered or amended trades” and “failure to extend validation procedures to close-out the processing ‘window’ between front and back office systems” as some of the most important. These failures were attributed to a number of causes. In the first instance, there was a lack of clarity about exactly who was responsible for what. Management delegated without ensuring that everyone fully understood what was expected of everyone and who was responsible to whom and for what. There was a lack of standard operating procedures, communicated clearly and implemented with the necessary training to ensure confident execution of tasks. Staff that is not confident can easily be steamrollered by traders with strong personalities. The operations area was also not consulted in decisions to change procedures that affected their ability to operate efficiently. One example was changes to the reconciliation process for currency options that were effected without consulting the Manager for Structured and Derivative Products. It also appears that the roles attributed to and enforced by role players in the operations department were too narrowly defined, allowing for gaps in oversight to develop (APRA Report 2004: 23). The APRA investigation also found evidence to suggest that some Global markets and operations staff, knowingly or unknowingly, assisted the “quartet” by sharing information regarding the inner workings of the back office, allowing them to circumvent some of the procedures that could have detected their activities.

The operations area responsible for the foreign exchange and options team were primarily tasked with the timely processing of live transactions with external clients. They did however fail, to apply the existing procedures diligently, when it came to internal transactions that were amended or revised. This failure in oversight allowed for non-matching trades to be entered into the system. Similarly, it appears that there were no effective procedures to flag very large or unusual trades. The back office system for foreign exchange had no effective exception report functionality, for off-market rates. The rate variance exception report that did exist was flagging so many exceptions that it was ignored – as the back office in London ignored Mr Leeson's error trade reports because there were so many (Leeson 1996: 53). The system used by the front office did not have the capability to identify off-market rates.

8.7.2 INTERNAL VALUE AT RISK MONITORING

The APRA Report (2004: 37) also identified major deficiencies in the calculation and management of the VaR model utilized at NAB. One of the most startling revelations was the fact that the application of the VaR model on the currency options business at NAB yielded results that were viewed as so inaccurate that, for a period of nearly two years before the event, the VaR excesses functionality was not used for currency options. This led to a situation where VaR was ignored for currency options and excesses were routinely signed off without any attention being paid to them. A further problem was the apparent uncertainty over whether or not the Global Markets division or the Market Risk & Prudential Control section had the ultimate responsibility for enforcing risk reductions. The APRA Report also

criticized the Board of NAB and its senior management for not ensuring that the market risk monitoring functions were reviewed more frequently and that alternatives to the faulty VaR model were not pursued.

8.7.3 LIMIT MONITORING

The monitoring of limits was essentially non-existent at NAB. During one particular month in the last quarter of 2003, the currency option limits were breached a record 750 times. Although this can, in part, be excused because of the unreliable VaR model, other commonly used risk measures like delta, gamma, theta, etc. (called the “Greek” risk measure parameters) were also exceeded with regularity. These excesses were signed off by the management of the front office and were known to the MR&PC. Even though market risk limits were exceeded with such regularity, no effort was made by management to either ensure that it didn’t happen or to amend the set parameters if they were found to be inappropriate (APRA Report 2004: 20). As we have seen with the Barings and AIB events, failure to monitor and enforce limits was, in all the cases, a crucial failure that could have been easily enforced. According to comments made by Mr David Bullen during a television interview (ABC 2004: 1-4), management at NAB at least two levels above him were aware of the fact that they consistently and substantially exceeded their limits. Neither they nor the risk management committee, on which the CEO of NAB sat, did anything to curb this behavior.

8.8 THE ROLE OF INCENTIVES

Before we look at the financial incentives of the four traders, we should put their contribution to the bank's profits into perspective. According to Mr Duffy (Woodrich 2005: 2) "his" group was set a profit target of AUD 37 million for the 2002/03 year. Was it this excessive target that set the scene for a disaster? Was this target reachable with the AUD 3.5 million the traders were allowed to risk on a daily basis? If not, is this the reason why the regular trading outside the limits was allowed? Is the fundamental cause of the "rogue" effect unrealistic profit expectations coupled with insufficient quality staff, systems and other resources? (Cornell 2004: 1-4).

It is highly likely that the remuneration system used by NAB was the principle incentive for these four traders to hide their losses. In the same vein, financial incentives for those who were supposed to oversee and manage them is in all probability also a strong contributing motivator for allowing the four traders to conduct their activities unchecked and unhindered. Where the four currency traders received nearly double their annual salaries in bonuses of between AUD 120 000 and AUD 265 000 for the 2002/03 year (Singh 2004: 1-6), the global head of foreign exchange, Mr Gary Dillon, received a bonus of AUD 500 000 (Kemp 2004: 1-2) at the end of 2003. As we found in the case of Allfirst's treasurer, Mr Cronin, and Mr John Rusnak, we also find that Mr Dillon was a close friend of Mr Duffy.

8.9 WAS THIS A UNIQUE STRATEGY?

As we have seen from the other case studies, this was in no sense an isolated event. What is of extreme concern is the fact that, research conducted by Dr Stephen Brown (professor of finance at the Stern School of Business at New York University) on the trading practices of Australian equity trading firms reveals that what happened at NAB is not unique, as there are traders who “on a regular basis” behave like Nick Leeson (Wood 2006: 1-3). He further says that “...if they are given a sizeable chunk of money to behave with in this way, they are going to look like winners until the ruin event occurs.”

8.10 SUMMARY

By now we have seen that money and status are principle motivators for extreme opportunistic behavior. The NAB event does, however, confirm our suspicions of why these events occur. On page 6 of the APRA report “Line management”, “Operations (back office)”, “Market Risk (middle office)”, “Executive Risk Committees”, and the “Principal Board” are all implicated as facilitators to the NAB event. In its conclusion, the Australian Prudential Regulatory Authority (APRA), identifies “cultural issues” as the heart of the problem. In the world of sophisticated exotic derivative structures, where a PhD in mathematics or an MBA are normally the yardstick for admittance, this was a first. The acknowledgement of the importance of cultural issues is key to a better understanding of opportunistic behavior.

The failures at NAB were complete and on all levels. It is fairly clear that this event was not only detectable but also preventable. Application of the

extreme opportunism probability triangle shows a clear result. All that was necessary was for the most basic risk management principles to be enforced rigorously from the board level downwards. Then why was it not done? The culture at NAB was one in which profit was the ultimate pursuit and everything else was secondary. The risk of not making the desired profit weighed so heavily that every other consideration was cast aside as if they were unnecessary stumbling blocks inhibiting the ability to make profit. The end result was the resignation of both the chairman, Charles Allen, and Frank Cicutto, the CEO of NAB. The new chairman, Mr Graham Kraehe, was a member of both the audit and risk management committees that failed (Kohler 2004: 1-4). It is therefore not surprising that, when asked if NAB would learn from this incident, one of the traders (David Bullen) responded “not a chance”. The whole institution will have to change. They would have to accept what they were doing; managers would have to stop playing political games” (Cornell 2004: 4).

A culture of opportunism was undeniably in existence, not only while the Forex traders were racking up their losses, but well before their time. This fact was so obvious that even the sentencing judge acknowledged it. I do not believe the extreme opportunism displayed by management at NAB is any different from that exhibited by the traders. The losses due to the HomeSide fiasco and the Forex losses were both incurred due to the pursuit of profits through questionable means. There is little difference between management exposing shareholders’ funds to risky investments and traders doing it through risky Forex transactions. In both cases, it was nothing short of gambling. The role of learned behavior is also clear in this case. The court proceedings show that Mr Duffy was setting an example to some of the other

traders. From his perspective, he claimed that he took his cue from senior management, who allowed him to regularly break daily limits in his efforts to achieve the profit targets they set for him and his team. In this case, there is also evidence that the traders were assisted by management and back office staff in their efforts to hide their losses. Like most of the other cases of extreme opportunism, the activities of the traders went on for many years and were clearly visible to outsiders, who even alerted NAB management. The Australian regulators were also implicated in this event. Their very slow response to clear risk management failures at NAB is a reflection of severe shortcomings in the enforcement of regulations. The same applies to the NAB auditors in both the HomeSide affair and the Forex scandal. It is a recurring theme through virtually every incident of extreme opportunism that the auditors made little or no contribution in detecting opportunistic conduct.

Non-existent or poorly enforced formal restraints, a corporate culture of opportunism that acted as a catalyst for individual opportunism rather than a source of informal restraint, coupled with a total absence/failure of basic risk management procedures provided the opportunity for an extremely opportunistic pursuit of money. Evidence of a gambling culture and access to very volatile products and funding methods obviously did little to restrain opportunistic behavior. There is ample evidence to suggest that the group of traders was strongly motivated by the financial incentives offered by NAB. The required balance between facilitators and inhibitors of opportunistic behavior was, however, nearly non-existent. The NAB event is one of the clearest examples of a total absence or breakdown of inhibiting factors, and it is fitting that substantial blame was apportioned to the NAB management

and even the regulatory authority in Australia. In January of 2004 AFP Sydney reported, that the NAB losses had ballooned to USD 277 million, nearly twice the initial expectations (2004: 1).

This was however not the end of NAB's troubles, in July 2005 its chief executive had to admit that they overcharged 200000 of their clients from as far back as 1982. The amount involved is an estimated AUD 80 million (Newman 2005: 1). There is a striking resemblance between this discovery and the activities of AIB described in par. 7.2. It seems the two banks shared more than a "rogue" incident.

CHAPTER 9

MIKE MILKEN AND THE US SAVINGS AND LOANS CRISIS IN PERSPECTIVE

9.1 INTRODUCTION

As we have seen throughout this thesis, extreme opportunism in virtually all the case studies involved the concealment of losses and the creation of fictitious profits. These activities were, however, not limited to individual “rogue traders” or “maverick” executives of large firms. This exact same behavior can be identified during the events that are commonly referred to as the US Savings and Loans crisis. Although blame has often been apportioned to the likes of Mike Milken and his “junk bonds” as the root cause of the disaster, the facts show us that politicians and regulatory institutions often displayed behavior similar to those of the so-called rogue traders. I would also like to emphasize that the analysis of Mr Milken’s case is not aimed at determining his guilt or otherwise. It is aimed at determining the rationality or lack thereof displayed by regulators, the legal system and society at large. Throughout this thesis we have seen the practice of and apparent need to bestow the cause of all evil on “immoral” individuals. This may be our nature, but it is in all probability also our biggest hurdle in determining the true causes of so-called rogue events and/or actions displayed by institutions and individuals alike.

9.2 CAUSES OF THE CRISES

According to Niel Fligstein: “state actors are constantly attending to some form of market crisis or another. This is because markets are always being organized or destabilized, and firms are lobbying for state intervention” (2001: 203). Rules are the embodiment of the interests of dominant groups and transformation of such rules will, in the normal course of events, only be implemented if such a dominant group is in crisis. Fligstein also points out that stable rules are often more important than their content. One trademark of the Savings and Loans industry during 1980 and 1989 was rapid and frequent deregulation followed by rapid and frequent re-regulation. Another interesting point of interest regarding the Savings and Loans industry was that operators could operate under either a Federal charter or a State charter. This allowed for a duality in regulatory controls and guidelines, creating a system in which the rules most advantageous to the operators, and not the depositor, were often the most popular.

At the end of the nineteen seventies and early in the eighties the Federal Reserve Board of the United States raised interest rates in an effort to control inflation. The method employed was to raise the rate that the government, as lender of last resort, charges to the banks of the country. The effect of such a decision was that the rates companies paid on their debt (corporate bonds) exceeded 15% during 81/82 (Stiglitz 2003: 36-40). Within a mere three years the Federal Reserve managed to bring down inflation from 13.5% to 3.2%. This monumental achievement was, however, not without a price. One of the most immediate casualties was the level of unemployment in the United States, which rose to levels reminiscent of the Great Depression. This

was unfortunately only the beginning. With higher interest rates, one of the most vulnerable sectors was the banking sector and, within its ranks, none were more vulnerable than the “thrifts” or Savings and Loans companies that specialized in providing home loan finance to individuals. The basic operational methodology employed by these firms was to collect funds from depositors and lend this money out to those who needed home loan finance. Although this form of banking is perceived by many as low risk, one element of their business model had a hidden risk potential. The interest rates charged on existing mortgages were fixed, while the interest they paid their depositors fluctuated with the ruling market-related rates. The result is simple: if you pay out more than you get paid, you will go under. The reality of what the high interest rate environment did to the viability of the Savings and Loans operators was, however, not clear to everyone involved. This was due to a little creative accounting that was initiated, not by a rogue trader or greedy corporate executive, but by none other than Uncle Sam himself (although the greedy executives probably paid for a lot of lobbying). As we have seen in numerous corporate collapses, for example AT&T and ENRON, future profits came into play. Towards the end of 1982 the Federal Government of the United States of America allowed the ailing Savings and Loans companies to revamp their balance sheets by reflecting expected future earnings as a valuable asset in the form of goodwill, which created a false impression of financial soundness. Although their balance sheets were bulging they were still losing money hand over fist, as they were paying out more than they were getting in. However, this problem was also not insurmountable to the US Federal Reserve. As governments have the power to regulate, they also have the power to deregulate, and it was this arrow that was now pulled out of the proverbial quiver.

The preferred strategy of the Federal Government was to allow the Savings and Loans firms to trade themselves out of the hole they found themselves in (just like any self-respecting rogue trader). This was achieved through deregulation of the industry. This strategy had already been employed from 1967 at state level by Texas, which allowed its Savings and Loans firms to invest up to 50% of their net worth in property development loans. With their newfound freedom, the “thrifts” embarked on a three-pronged strategy commensurate with those followed by our rogues. They started lending out to higher risk borrowers (like real estate developers) at higher interest rates, reflective of the risk. They also started to invest in riskier investments like high yield bonds or, as they were more commonly referred to after the collapse of Drexel Burnham, “junk bonds”. The only other thing they had to do was to hide the risk associated with their investments. This they could easily do, as they were not as closely regulated as normal commercial banks, which had to make provision in accordance with the risk they were taking on board. In fact, the Federal Home Loan Board (FDIC 2002: 3) reduced the net worth requirement for insured Savings And Loans operators from 5% to 4% of total deposits in 1980 and then to 3% in 1982, with the added bonus that they could use the liberal Regulatory Accounting Principles system instead of the more restrictive Generally Accepted Accounting Principles (GAAP). However, in 1986 the US Government came under pressure for the generous tax policy towards real estate investments that it introduced in 1981. When the tax breaks evaporated so did the profits, and the next step for real estate investors and developers was to default on their obligations to the “thrifts” they borrowed money from. The increase in bad debts seriously threatened the solvency of the S&L firms.

Another contributing factor to the whole crisis was reductions in regulatory and supervisory staff, as well as the use of underpaid and inexperienced staff – a problem highlighted by Mr Leeson as a major contributing factor in the Barings Collapse. The average Savings and Loans examiner had only two years' experience and started with a measly USD 14 000 per annum (FDIC 2002: 1-5). In the period between 1982 and 1985, while the Federal Home Loan Board was cutting back on staff, the assets in the overall industry grew by 56%, while some states like California and Texas experienced 100% growth per year. Ironically, in 1987, the state that first started to deregulate in 1967 also led the way when losses in the state of Texas accounted for over 50% of all the Savings and Loans losses in the US. In typical Texas style, 14 of the largest losses also came from Texas. However, in the defense of Texas, it must be added that the state's major source of revenue – oil – took a major dip at the time, causing office rentals demand to decline and adding to the real estate collapse.

Stiglitz sums up the Savings and Loans crisis in the United States by underlining the role of a skewed incentive package which, among other things, promoted creative accounting through the implementation of poorly designed deregulation (2003: 103). When under pressure for their survival, these Savings and Loans companies took large risks, not unlike those undertaken by the so-called rogue traders. The fact that these firms felt that the Federal and state governments were condoning their risky strategies through deregulation and increases in insurance offered to depositors, was a structural factor that created the environment for extreme opportunistic behavior. The question that must be asked is: is there really a difference between the opportunism displayed by politicians and that displayed by

business executives and traders, or is it merely a question of incentives that are large enough and countervailing mechanisms that are too weak or non-existent? Stiglitz also points out that the thin line between ethical and unethical behavior eases the way for moral restraints to be swept aside with relative ease by the business community.

9.3 WAS MIKE MILKEN RESPONSIBLE FOR THE CRISIS?

The cost of the US Savings and Loans collapse was substantial. The cost to the public sector, i.e. the United States taxpayers, is estimated at USD 123.8 billion and to the private sector USD 29.1 billion (Curry & Shibus 2000: 31). It is no wonder that the US Government was looking for scapegoats, and Mike Milken was an easy target. His salary of USD 500 million per annum made even the likes of Rockefeller and Donald Trump envious, and the hostile takeovers funded by his high yield or “junk” bonds made even the most generous of campaign contributing corporate captains nervous. During the sentencing of Mr Milken, the judge made reference to the existence of a perception that he was responsible for the Savings and Loans crisis and the job and financial losses associated with the collapse. However, she did point out that, in order for the state to prosecute Mr Milken for such losses, it had to separate his actions from all the other factors that may or may not have influenced the Savings and Loans industry (Wood 1990: 1). What the judge omitted to say was the fact that the US Government probably was the biggest contributor to the disastrous final years of the Savings and Loans industry.

There are, however, a number of problems with blaming Mr Milken for the Savings and Loans collapse; first is the fact that there were problems that were inherent in the Savings and Loans industry long before Mike Milken ever sold “junk bonds” to them or they were allowed to hold them. Secondly, between March of 1985 and December of 1991, Savings and Loans companies never held more than 1% of their assets in the form of “junk bonds” (Fischel 1995:197-199). The reason why Savings and Loans were allowed to invest in higher yielding and, therefore, riskier investments, were precisely because they were in great financial distress. One of the most important findings regarding the role of “junk bonds” in the Savings and Loans was made in 1989 by the US General Accounting Office (GAO) following an instruction by the US Congress in 1987 (Fischel 1995: 200). The report released in March stated unequivocally that “A review of FHLBB data and discussions with its officials showed only one case in 1985 in which high yield bond investments appeared to have been a factor in a thrift failure. However, in that case, mismanagement of the institution’s high yield bond portfolio was only one part of a broader pattern of unsafe lending and investment practices leading to the institution’s collapse.” It should also be borne in mind that, although Drexel was the largest operator in the high yield bond market, it was most certainly not alone.

9.4 A PERSPECTIVE ON THE CRIMES AND SENTENCING OF MIKE MILKEN

Daniel Fischel analyzed the crimes that Mike Milken pleaded guilty to and came to the conclusion that the “crimes” were “trivial” at best (Fischell 1995: 164-167). The sixth charge Mr Milken pleaded guilty to was related to

assisting David Solomon to reduce his taxable income through a transaction wherein Solomon would purchase illiquid securities from Drexel, which he subsequently sold at a loss that it claimed from his taxable income. The upside to Solomon was an “undertaking” from Mr Milken that he would make up for their loss by finding them profitable transactions in future. (David Solomon was not associated with Salomon Brothers).

Fischell contends that Mr Solomon made a real loss, which he was legally entitled to deduct from his taxable income. The fact that Mr Milken undertook to find him profitable investments in future to offset his losses was an undertaking and nothing more; it could not be regarded as an asset as the prosecution contended. However, it can be argued that the sole purpose of the transaction was to reduce taxable income, an action that most businesses enter into on a daily basis.

The fifth charge also involved Mr David Solomon and related to the adjustment of bid-ask spreads offered by Solomon’s Finsbury Fund in their transactions with Drexel. Drexel charged Mr Milken’s department a 1% fee for promoting and selling the shares of the Finsbury money market fund, which invested in Mr Milken’s high yield bonds in order to get a higher return for their investors. In order to recoup the fee, Solomon agreed to adjust the bid-ask spread in favor of Drexel in securities transactions with it. According to Daniel Fischel, the adjustment was so minor that Drexel always remained competitive and the fact that Drexel promoted the fund and invested in the high yield bonds of Mr Milken could well have made money for investors in the Finsbury Fund, rather than losing them money.

The first four charges that Mr Milken pleaded guilty to all related to the failure by Mr Milken to accurately record the true ownership of securities in their books, records and regulatory public filings. This activity, commonly referred to as “stock parking”, essentially allows the owner of a stock to keep his ownership of a particular security secret. This was and still is a common practice that can be achieved in a number of ways. Large firms would use nominee accounts and a myriad of broker dealers to prevent market participants from detecting their interest in a particular security. As Mr Leeson pointed out, the market would react once participants detected that Barings were buyers of a particular security. Very often the price of the security in question would rise merely because of the fact that a large institution expressed interest in it. This effect could be detrimental to the members of a pension fund, for instance, which would now have to pay more for the securities it is interested in. The question immediately comes to mind: why was this practice such a big issue? The answer lies at the bottom of the whole Milken incident. The largest users of Mr Milken’s services were firms that specialized in doing what is commonly referred to as hostile takeovers. This practice, described vividly in the best-selling book “Barbarians At The Gate”, redesigned the face of corporate America.

In order to put these charges into perspective, one has to look at the environment in which Mr Milken operated. One example is the revelation that Salomon Brothers manipulated the bond market during the late 1980s and early 1990s, and the fact that the firm’s chairman, John Gutfreund, was aware of the false bids made by Paul Mozer at treasury auctions to achieve this manipulation (Partnoy 2003: 107-110). According to Frank Partnoy (2003: 96), Gutfreund’s hands-off management style encouraged his traders

to skirt the rules. One example of such trading involved the buying and selling of bonds at artificial prices to create artificial losses for Salomon in order for the firm to reduce its taxable income. As we now know, this same strategy was also employed by the likes of ENRON and Global Crossing a number of years later, when transactions involving billions of dollars were executed. The use of these transactions was, however, widespread and by no means isolated to the firms mentioned. Tax fraud was also not the only brilliance displayed by Salomon's traders. Around 1990 Paul Mozer hatched a plan to corner the treasury market in the US. At auctions of Government bonds by the US treasury to Prime Brokers, an unspoken rule existed that no one broker was allowed to bid or be allocated more than 35% of a particular issue. During 1989 and 1990 Paul Mozer tried, on a number of occasions, to breach this rule and when cautioned by a treasury official about his conduct, threatened the official that the chairman of Salomon would contact the secretary of the Treasury (Partnoy 2003: 99-102). On the 10th of July 1990, this unwritten rule was formalized by the US Treasury, leading to a public outburst by Mozer against the Treasury. After being forced to apologize by the second-in-command of Salomon and a break to London, Mozer came back with a vengeance. Instead of accepting the rule, Mozer simply designed a strategy to circumvent it. On the 21st of February 1991, Paul Mozer submitted a bid on behalf of Salomon for 35% of the auctioned stock and submitted similar bids on behalf of a Salomon client, Mercury Asset Management, and S. G. Warburg & Co., a subsidiary and a hedge fund managed by George Soros. The clients were blissfully unaware of these bids. After the transaction the bonds were booked over to Salomon through a fictitious transaction, through which Salomon bought the bonds from their clients at below market value. Through this strategy, it was possible for

Mozer to control more than 50% of a particular auction. The problem, however, was that Mercury also entered a small USD 100 million bid of their own, pushing them over the 35% limit. The US Treasury questioned Mercury and also Mozer, who they knew submitted a bid on behalf of Mercury. Mozer called Mercury and told them it was an administrative error and asked them to keep the matter confidential. Mozer also notified John Meriwether, who in turn called Thomas Straus and Salomons's legal council, Donald Feuerstein. A decision was taken to advise Gutfreund, but no action was taken to curtail Mozer's activities. At this time Mozer managed to acquire an additional USD 1 billion worth of notes at the April auction by bidding unauthorized on behalf of another hedge fund, Tudor Investment Corporation. When Gutfreund returned from out of town, he was advised by Meriwether, Straus and Feuerstein of Mozer's actions. Although Feuerstein pointed out to the group that Mozer's actions were illegal, there was no obligation on Salomon to advise the authorities of what occurred. Once again, no decision was taken to curtail Mozer's actions. At the May auction Mozer managed to corner 86% of the market and was in a strong position to manipulate the price of the securities he bought. However, Mozer's trading was not a secret, and other hedge fund managers like Caxton Group, Steinhardt Partners and Tiger Management were actively vying to participate with Salomon in manipulating the market in auctioned securities.

In June 1991 Gutfreund finally decided to rein in Mozer by telling him to stay within the regulations for the June auction while he (Gutfreund) met with Treasury officials, claiming innocence on the side of Salomon. Salomon hired the firm of Wachtell, Lipton, Rosen & Katz on a limited

mandate when regulators started asking for documents. Although their initial brief was only to investigate the May auction, they soon realized the extent of the manipulation and, when they provided their findings to Gutfreund, Straus, Meriwether and Feuerstein, the four were forced to issue a press statement regarding the irregularities. During August of 1991, under pressure from the Chairman of the New York Federal Reserve, E. Gerald Corrigan (a personal friend of Straus), the four Salomon officials resigned.

Paul Mozer, the trader that he was, entered into a process of negotiations with prosecutors, holding as his trump card his in-depth knowledge of the schemes used by Salomon to avoid more than USD 100 million in taxes. He finally pleaded guilty to submitting false bids on behalf of Warburg and Quantum at the February 1991 auction, a crime with a specified maximum sentence of ten years. Judge Leval obviously took Mr Mozer's assistance to the prosecutors into consideration when sentencing him to a fine of USD 30 000 and a four-month jail term in a Florida minimum security prison for a crime the Judge described as "extremely foolish, arrogant" and "insouciant" (Partnoy 2003: 108). The judge also concluded by underlining the importance of deterrence of others as a motivation for his sentence. Gutfreund, Straus and Meriwether were respectively fined USD 100 000, USD 75 000 and USD 50 000 each and Gutfreund was also banned for life from being in charge of an investment bank. Straus and Meriwether were also suspended from the industry for six and three months, respectively. As a going-away present, Meriwether managed to successfully settle with Salomon for USD 18 million, as compensation for his loss of income (2003: 110).

Were the actions of Mozer, at Salomon's, those of an isolated rogue in a reputable firm and can we glibly classify the actions of Mr Milken as a lone rogue within Drexel? Joseph Stiglitz commented on the effects of deregulation in the 1990s that led to, opportunistic conduct by among other Citigroup, Salomon Smith Barney and Merrill Lynch (2003:155-167). Their activities included among other things, systematic stock manipulation (commonly referred to as pump and dump) and the allocation of IPO stock from some clients, at discount prices to other favorite clients, to elicit other business. One of the most infamous proponents of such manipulative activities was Jack B. Grubman, the telecommunication analyst for none other than Salomon Smith Barney. Grubman a close friend of the CEO of WorldCom Bernie Ebbers, recommended WorldCom shares as a buy since 1999 and maintained this recommendation up until April 2002 a mere three months before the firm filed for bankruptcy (Stiglitz 2003: 164-167). According to Stiglitz, "each bank knew that its competitors were engaging in similar practices, and if it didn't compete, it would be left behind; each banking officer knew what that meant: smaller bonuses, perhaps even being fired" (Stiglitz 2003: 143). Grubman's resignation statement contained these chilling words: "I did my work as an analyst within a widely understood framework consistent with industry practice that is now being extensively second guessed." (2003: 167). Would it be preposterous to suggest that, if Mr Milken didn't offer this service to David Solomon, in all probability he would have found it somewhere else? This proposition in itself would suggest that it is quite plausible that what Mr Milken did was not the actions of a rogue but rather a standard service offered by Drexel and its competitors. Was Mr Milken any different from the traders at Salomon who were paid millions of dollars for designing transactions through which legal

rules could be circumvented (Partnoy 2003: 97) or their analysts that recommended failing companies (Stiglitz 2003 167)? I believe a large body of evidence suggests otherwise.

During sentencing of Mike Milken, Judge Kimba Wood outlined her guidelines for determining an appropriate sentence for Mr Milken. According to the judge, the purpose of sentencing a convicted felon is essentially “...individual deterrence, general deterrence, punishment or just deserts, retribution and rehabilitation” (Wood 1990: 1-3). The judge went on to say that the fact that Mr Milken was barred from working in the securities industry for life; his USD 200 million fine and USD 400 million restitution fund (to compensate “victims” of junk bonds), as well as possible further civil law suits, coupled with the emotional stress he and his family endured, served as a more than adequate individual deterrent. In the final analysis, Judge Wood confirmed that Mr Milken had to serve a jail term for the purposes of acting as a “general deterrence” to others who were contemplating similar crimes. In other words, the principle aim was to ensure that other similar actions would be discouraged through sending Mr Milken to jail for an extended period of time. Mr Milken was sentenced to a jail term of ten years and two months, which was subsequently reduced to two years before he was released on parole. The reasons cited for the reduced sentence were his “exemplary” behavior in prison and the assistance he provided to Federal prosecutors in other cases that involved “junk bonds”. The reduction of Mr Milken’s sentence should, however, not detract from the fact that the overall sanction he endured must have had a severe impact on him and his family, as it undoubtedly had on others like Messrs Blank, Leeson, Iguchi, etc., none of whom were hardened criminals or, as far

as we know, had criminal intent. If one justifies the use of jail sentences as a general deterrent, one obviously views the conduct/behavior to be discouraged in a very serious light and one would expect that all such behavior should be treated in the same fashion. It is here, unfortunately, where cracks in the criminalization of Mr Milken and many other rogue trading incidents appear.

Judge Wood summed up the essential motivations for Mr Milken's crimes as actions aimed at increasing his clients' loyalty to him, increasing the likelihood that said clients would in future use and pay for his services (Wood 1990: 2). This Mr Milken achieved through "...skirting the law, stepping just over the wrong side of the law in an apparent effort to get some of the benefits from violating the law without running a substantial risk of being caught" according to Judge Wood. However, if we have to measure the financial services industry, and maybe even business at large across the globe, against this set of immoral actions and motivations, I doubt if many would escape the wrath of Judge Wood. It is also important to determine if the laws that were purportedly being skirted were clearly defined and consistently enforced, otherwise skirting might not be the appropriate term, as it is not possible to skirt an imaginary line. What is of special concern when the two cases are compared is, in the first instance, the apparent "fuzziness" of the charges that Mr Milken pleaded guilty to and the 10-year sentence plus the massive fines the judge deemed appropriate compared to the clear-cut transgressions by Mr Mozer (not even taking into consideration his participation in the tax evasion activities of Salomon) and the relative slap on the wrist he received as a sentence. We can also compare the action taken against the Salomon officials with Mr Milken's punishment. The

Salomon officials were well aware of Mr Mozer's market manipulation transgressions and also intimately involved in efforts to evade more than USD 100 million in taxes. Mr Milken on the other hand was accused of assisting a client to evade tax. When we make this comparison, there appears to be a lack of consistency, even taking into consideration that Mr Milken's term of incarceration was reduced to just over two years, for his cooperation with the state. In an effort to underline the schizophrenic character of those sanctions purportedly employed as a deterrent against conduct of an extreme opportunistic nature, I will make a condensed analysis of events at one of the largest and most prominent global firms, Royal Dutch Shell Petroleum Company, more commonly known as Shell.

9.5 THE SHELL “MISSTATEMENT OF RESERVES”

The misstatement of reserves sound a lot less ominous than having yourself likened to the “head of the Mafia” (Fischel 1995: 167,151) or having the demise of your firm, Drexel, compared with the “fall of Nazi Germany”. The essence of the charges leveled against Mr Milken and most of the so-called rogue traders was the fact that they misled their clients and/or superiors and, in some instances, the receiver of revenues. They misstated the extent of their profits and losses to keep their jobs and/or to receive large bonuses or, in the case of Mr Milken, misled investors in his “junk” bonds. Their actions are not dissimilar to corporate executives who misstate their profits and/or losses to either pay less tax, or to mislead investors by showing fictitious profits, or to ensure that the share price of their company rises, allowing them to exercise their lucrative share options. Are we consistent in our treatment of white collar crime, or are we merely an unruly crowd with

pitchforks baying for the life of a “pacifist” Count in Transylvania because we believe he drinks blood?

In April of 2004 the BBC reported that information had emerged confirming the fact that executives of Shell had been lying about the extent of the firm’s oil and gas reserves since 1991 (BBC News 2004: 1-2). The report stated that the Head of Oil and Gas at Shell, Walter van de Vijver, in an internal memo claimed that he was “sick and tired about lying about the extent of our reserves issues” and the fact that they may not be able to fool their investors forever. It is clear that Mr van de Vijver was aware of the purpose of the lies. Shell was misleading their investors, as it was charged but never proved that Mr Milken was lying to his. It was, however, also reported that Mr van de Vijver instructed staff to destroy an incriminating document he labeled as “dynamite”, an action that also occurred in the ENRON case. The defense raised by Mr van de Vijver was the fact that he viewed the matter as a “business problem” and not a “regulatory and disclosure” problem. In other words, lying is fine as long as you do not breach a regulation.

What Shell did was to lie about their reserves until they could “trade” themselves out of their position and disclose their shortfall at more appropriate levels. The shortfall in 1992 was 4.5 billion barrels lower than declared, while the shortfall in 1993 was a mere 500 million barrels. How does this differ from the actions of Mr Leeson or Mr Iguchi and most of the others we analyzed in this thesis? Their strategy obviously worked perfectly, as the price of Shell overall dipped a mere 0.76% on the London exchange following the disclosure. The result of the deceit was the resignation of the chairman, Sir Philip Watts, Mr van de Vijver and Judy Boyton, the finance

officer who was never accused of any wrongdoing. The rest of the board of Shell was cleared of “material responsibility” notwithstanding the fact that a review found that “many executives had been aware of the problem”. Shell was also investigated by the US Justice Department and the SEC and in August of 2004 a settlement was reached.

9.6 SEC FRAUD CASE AGAINST SHELL

The SEC release no. 116 of 2004 was very blunt about their view of the essence of Shell’s conduct. The document they released announcing the settlement states clearly in its heading that the case settled was one of “Fraud” through the “Massive Overstatement of Proven Hydrocarbon Reserves” (SEC 2004: 1). In the settlement announcement, the SEC also clarifies the reason for these illegal actions by stating that “...the Commission also found and alleges that Shell's overstatement of proved reserves, and its delay in correcting the overstatement, resulted from (i) its desire to create and maintain the appearance of a strong RRR, (ii) the failure of its internal reserves estimation and reporting guidelines to conform to SEC requirements, and (iii) the lack of effective internal controls over the reserves estimation and reporting process. These failures led Shell to record and maintain proved reserves it knew (or was reckless in not knowing) did not satisfy SEC requirements, and to report for certain years a stronger RRR than it actually had achieved” (SEC 2004b: 3). One of the most damning claims made by the SEC is the fact that Shell was undeterred and resolute in its persistence with the fraudulent actions. The SEC report states that “...Shell was warned on several occasions prior to the fall of 2003 that reported proved reserves potentially were overstated and, in such critical

operating areas as Nigeria and Oman, depended upon unrealistic production forecasts. In each case, Shell either rejected the warnings as immaterial or unduly pessimistic, or attempted to ‘manage’ the potential exposure by, for example, delaying de-booking of improperly recorded proved reserves until new, offsetting proved reserves bookings materialized.” There can be absolutely no doubt that Shell was trying to trade themselves out of a hole in an extremely opportunistic fashion that was no different from the actions of many of the so-called rogue traders we have analyzed thus far. Similarly, we find that a generally corrupt environment was also allowed to develop and persist as management failed to implement effective controls and oversight. There can be little doubt that the lack of oversight and control mechanisms and systems were by design and not by accident, as it would have been impossible for the executives of Shell to commit their fraud over such an extensive period in a system with effective checks and balances and a company culture committed to honesty and transparency. One noteworthy example was the fact that the Group Reserves Auditor was not given either the training, resources or the authority to conduct his work with any measure of success (SEC 2004a: 9-10). The Group Reserves Auditor also had to report to the Exploration and Production (EP) Division, exactly the same people he was suppose to audit. It was, therefore, not surprising that, over a five-year period, he never attributed an unsatisfactory rating to any of the units he audited. The frequency of his visits to units he audited was only around every four to five years. There were also clear indications that the Group Reserves Auditor was not objective in his approach, as he allowed questionable proved reserves to remain booked, even if the local management felt they should be de-booked. Furthermore, he also assisted local management to submit plans for development that he knew had little or

no chance of becoming a reality, solely in order to support questionable proved reserves.

9.7 THE CHARGES AGAINST SHELL

The settlement followed a number of charges that were brought against the Royal Dutch Petroleum Company and “Shell” Transport and Trading Company plc earlier. In the Houston Division of the United States District Court for Texas, the SEC allegations provide us with a window on the culture at Shell. In the first instance, the fraud was conducted over a number of years. The following table shows clearly the extent and the impact of the fraud and the level of distortion achieved by it.

TABLE 7.

Year	Proved Reserves Overstatement	% Overstatement	Standardized Measure Overstatement	% Overstatement
1997	3.13 boe	16%	N/A	N/A
1998	3.78 boe	18%	N/A	N/A
1999	4.58 boe	23%	\$7.0 billion	11%
2000	4.84 boe	25%	\$7.2 billion	10%
2001	4.53 boe	24%	\$6.5 billion	13%
2002	4.47 boe	23%	\$6.6 billion	9%

(SEC 2004b:2)

It is quite clear that this is no random act; the executives are consistently overstating their reserves by around 20% and potential future income by around 10%. Furthermore, Shell also overstated their reserves replacement

ratio, commonly referred to as RRR, in order to enhance the perceived longer term viability of the firm. This overstatement would have had a material affect on the potential future earnings of Shell and its ability to maintain its revenue streams in future. These misstatements had no other purpose than to mislead investors in the shares of Shell.

The SEC brought four charges against the firm. The charges related to "... directly or indirectly, falsified or caused to be falsified, their books, records and accounts" (SEC 2004a: 19-21); failure by Shell to "... make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of its assets" and to "...devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances..." on a number of issues, among others to ensure that "...preparation of financial statements..." conform with acceptable standards and to "...maintain accountability for assets...". Shell was also charged with failing to ensure that, at regular intervals, comparisons were made between what assets were reflected in its records and reality, and to ensure that "...appropriate action is taken with respect to differences".

In a similar vein, Shell was also charged with failing to file prescribed reports in line with SEC regulations and ensuring that these reports contained all necessary information to prevent it from being misleading. The primary charge leveled against Shell was that "as a result of the Defendant's knowing or reckless overstatement of their oil and gas reserves in their financial statements, the Defendant's commission filings ... as well as other public statements, contained materially false and misleading statements and disclosures. These filings contained untrue statements of material fact

concerning the company's reported proved reserves and omitted to state facts necessary to make the statements made, in light of the circumstances they were made, not misleading". In the light of these charges and the other evidence available, one has to ask the question: at what point could a case have been made for a charge of conspiracy to commit fraud on an unprecedented scale?

9.8 PENALTIES AND MOTIVATION FOR PENALTIES IMPOSED

There can be no question that the executives of Shell who were forced to resign did endure some level of humiliation and even financial loss. The Administrator of the SEC Fort Worth Office, Harold F. Degenhardt, commented on the penalties imposed on this massive institution by underlining the fact that the fraud was conducted over an extended period. Unfortunately, he omitted to mention the fact that the fraud was committed and maintained with the knowledge and active participation of its most senior executives, notwithstanding the fact that they were warned on several occasions. Degenhardt did, however, conclude that the actions of Shell warranted a "...strong enforcement response, including imposition of significant civil penalties..." (SEC 2004: 1). He further motivated the penalties imposed in much the same way as Judge Kimba Wood did when sentencing Mr Milken, by saying that their aim is to "... deter Shell and others from engaging in similar misconduct". He did, however, mention that the investigation was ongoing and that those responsible for the failures at Shell would come under additional scrutiny.

Without admitting or denying any of the findings of the commission, Shell “...consented to a cease-and-desist order finding violations of the antifraud and other provisions of the federal securities laws, and by paying \$1 million disgorgement and a \$120 million penalty in a related civil action the Commission filed in US District Court.” Shell also agreed to spend USD 5 million internally under guidance of their own legal director to upgrade their compliance. A case of market abuse brought against Shell by the Financial Service Authority in the UK (the FSA) was also settled with a GBP payment of USD 17 million. To put these penalties into perspective, we need to take a look at how these penalties would have affected a company like Shell if weighed up against the benefit that could be derived from committing fraud. When we analyze Shell as an entity, we find that in 2005 it ranked as the third largest corporation in the world when measured by its turnover of USD 306.73 billion and will rank second if ranked by its gross profit of USD 25 billion in the same year (Wikipedia 2006: 1-10). Even if Shell was fined USD 200 million, that would still only represent 0.8% of their annual gross profit and 0.065% of their annual turnover, hardly figures that would strike fear into the hearts of its corporate executives and shareholders.

On the 31st of August 2006 the SEC announced that they would take no action against Sir Philip Watts, the Group Chairman of Shell at the time of the overbooking of oil reserves (Dow Jones/AP 2006: 1). The two other officials who resigned due to the scandal, Judy Boynton and Walter van de Vijver, (FinanzNachrichten.de 2006: 1-2), were also cleared by the SEC notwithstanding the fact that Watts and Van de Vijver, according to evidence led before the SEC hearing, were well aware of the fact that investors and the authorities were being deliberately misled (SEC 2004a: 17). One should

also ask the following question: were Watts and Van de Vijver owners of Shell shares or did they trade in Shell shares during the period of fraudulent reporting, and did they receive any bonuses or share allocations based on the share price of Shell? If the answer to any of these questions was yes, a criminal case appears to be fairly clear-cut. One also has to ask the question: why were any penalties paid in the first place if no-one was guilty of any wrongdoing? If we compare the sentences meted out to ENRON executives, there appears to be a glaring discrepancy. Mr David Delaney, former CEO of ENRON North America, was sentenced to two and a half years in prison and previously paid a USD 8 million penalty to the SEC to settle fraud charges; the founder of ENRON died of a heart attack after being convicted of six counts of conspiracy, securities fraud and wire fraud (Steward & Waldie 2006: 1-3). The CEO of ENRON, Mr Jeffrey Skilling, was convicted of 19 counts of conspiracy, securities fraud and insider trading and was sentenced to a jail term of 24 years in prison and his assets of USD 45 million were to be seized and distributed among former ENRON employees (Pantesco 2006: 1-2). Although evidence existed that ENRON manipulated the energy price of the California electricity market and forced its staff pension fund to invest heavily in ENRON stock (leading to the bankruptcy of many pensioners), the essence of the charges against Mr Skilling, as per the final indictment against him, was that he was "...providing investors with false and misleading financial information from 1999 up until ENRON filed bankruptcy in late 2001" (2006: 1-2, USA v. JEFFREY K. SKILLING, and KENNETH L. LAY 2004: 1-43). The difference between overstating your profits and overstating your proven reserves unfortunately escapes me. Another interesting phenomenon we observe in the Shell incident is the fact that autonomous executive properties are bestowed on companies. It appears

that the reality of what constitutes a company, i.e. groups of individuals and relationships between such individuals and groupings, has escaped the majority of modern observers. If the SEC found that Shell had overstated its proven reserve over an extended period of time and that its senior executives were aware of and participated in such fraud in order to mislead investors, how is it possible that no-one was found to be responsible for the fraud individually or collectively?

This was by no means the first time that Shell was a party to opportunistic behavior that was concealed. In 1993 Showa Shell Sekiyu, 50% owned by Royal Dutch Shell, announced that it suffered a loss of around USD 1 billion due to losses from a USD 6.4 billion foreign exchange position (Ipsen 1993: 1-2). The group managing director of Shell blamed it on "...a gross contravention of established rules and practices, which was deliberately concealed." The result of this incident was the resignation of four top officials of Showa Shell Sekiyu and the dismissal of a fifth (in all probability the trader involved). No evidence could be found of any legal action taken against those involved. What is also of importance to this thesis is the fact that the losses were only announced a few days before Royal Dutch Shell announced an 8% increase in net income for 1992, causing an increase in the share price of Shell despite losing a USD billion. It appears that the investment community is not put off by losses of even a billion, as long as overall profits increase. One must also comment on the timing of the Showa Shell announcement – were the losses made public as soon as they were discovered or were they concealed, like the overstatement of reserves, until the financial climate was appropriate to allow for a low-impact announcement?

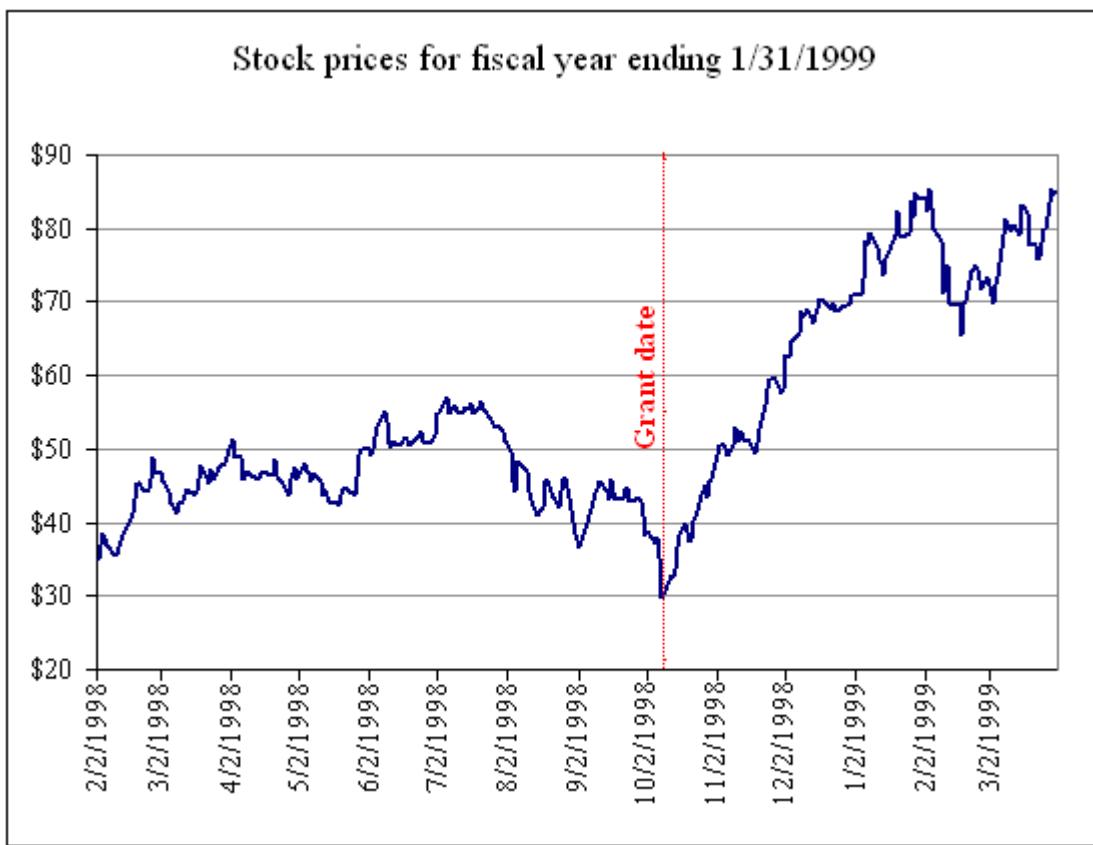
It is of interest to note that Shell Chemical Company also settled charges related to dishonesty and misleading others in 1999 (FTC 1999: 1-3). In essence, Shell was charged with providing "...the means for its trade customers to deceive the public, in violation of the law". The case against Shell related to the fact that Shell provided its trade customers with "...allegedly false or misleading representations about tests it conducted..." relating to some of its chemical products, in this case an oil additive. The moral issue at hand is: what is the difference between lying about the effectiveness of your products, your proven reserves, the profitability of your company or the extent of your losses?

9.9. OPTIONS BACKDATING

In this chapter we have provided clear evidence of discrepancies in the criminalization of opportunistic behavior, as well as the prosecution of extreme opportunists. In spite of all the evidence presented in this thesis, there may be some that argue that opportunistic behavior may be limited to a handful of rogue employees. Any doubt about the extent of opportunistic behavior associated with financial markets was, however, dispelled in 2006 when Erik Lie announced the findings of his research into the possible manipulation of the price levels at which executives of companies are granted stock options. A stock option, in essence, gives the recipient the right to purchase the stock of the company in the future (Lie 2006a: 1-6). Normally such options expire after 10 years. The price at which the executive can exercise his options is called the "exercise" or "strike" price. The strike price of stock options is divided into three categories based on its relation to the ruling price of the underlying share: "out of the money"

(lower than the ruling price), “at the money” (at the ruling price) and “in the money” (higher than the ruling price). These options can be granted any time during the year and the grant date may vary from year to year. For a variety of tax and reporting reasons, most executive option grants are at the money options.

FIG. 16



(Lie 2006 b: 2)

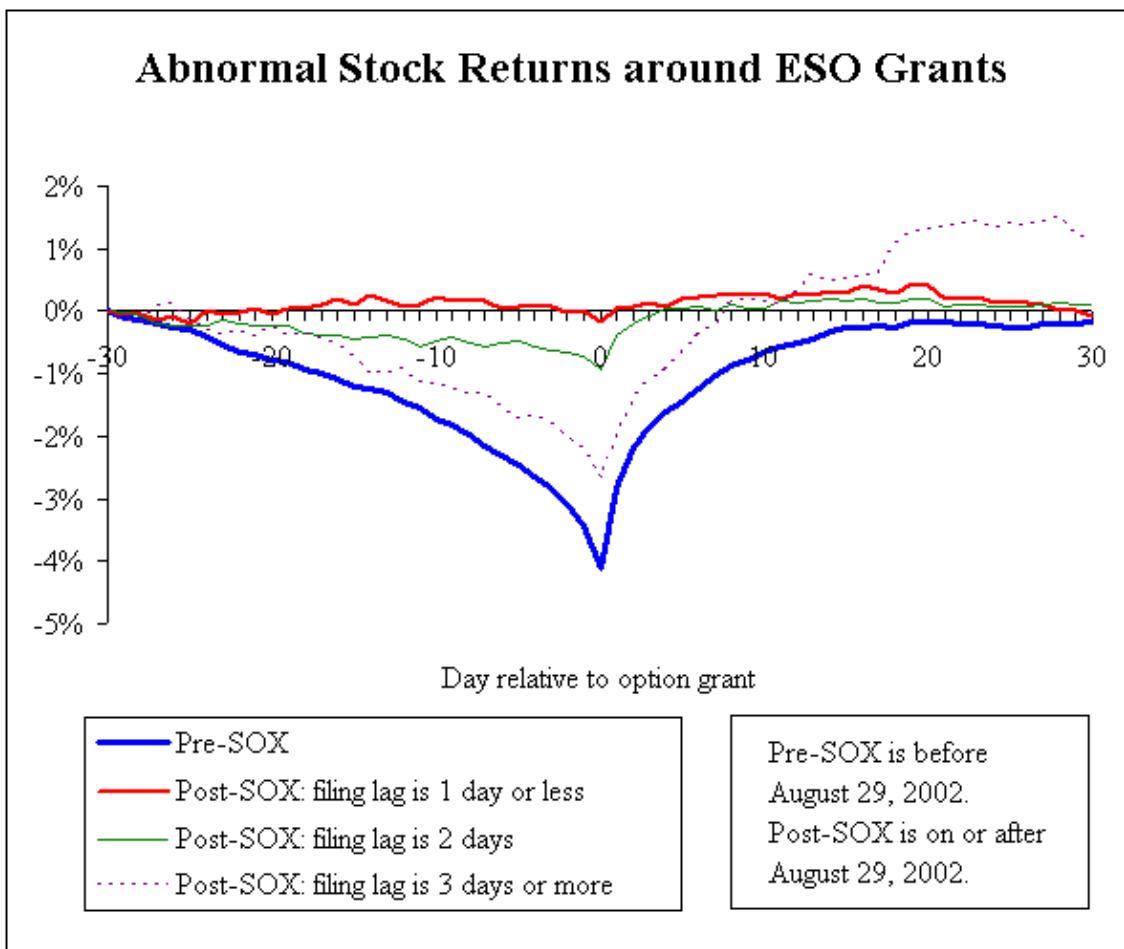
The incentive to grant the stock options at a particular time during the year is therefore clear. If you receive your options on the lowest price during the year, any rise over that price is to the benefit of the option recipient. The

problem is that the executives of companies are not psychic and do not know for certain what the share price of their company will be in the future. However, this is not an insurmountable problem if you are an opportunist. All you need is the benefit of hindsight, i.e. backdate the option, or grant your option before you make an announcement that you know will push up the value of the underlying shares or after an announcement that will adversely affect the share price. The practice of timing option grants to occur before the announcement of good news is referred to as “spring loading” and the timing to fall after bad news is referred to as “bullet dodging”. The typical picture one would find when the granting of options was manipulated is demonstrated in Figure 16 above.

The probability that this official grant date was set retroactively is virtually 100%, “...unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements...” of their company’s future share price. If this was indeed the case, the conduct is tantamount to insider trading. Research conducted by David Yermack and published in 1997, investigated the relationship between company announcements and the issuing of stock options in the US between 1992 and 1994. He concluded that “...grants are timed to occur before anticipated stock price increases” (i.e. spring-loading). A similar study conducted by David Aboody and Ron Kasznik, published in 2000, investigated this relationship between 1992 and 1996 and also concluded that “...information flow around grants is manipulated. (2006a: 3)”. Research conducted by Lie and Randy Heron used a sample of 39 888 grants to executives from 7 774 US firms between 1996 and 2005. Their findings showed that an estimated 29% of the firms investigated, in some form or

other, manipulated options granted to their top executives (2006a: 5). Lie also contends that backdating can be very difficult to identify, as many grants are never filed with the SEC and companies employ a range of strategies to obscure the activity.

FIG. 17



(Lie 2006a: 4)

In 2002, legislation under the Sarbannes Oxley banner was introduced to force executives to report their new option dates within two days, compared to the period of months that was allowed before. The effect of this new legislation is clearly demonstrated in Fig. 17 above. This graph clearly shows that legislation to tighten the reporting regime applicable to the granting of stock options to executives in the United States will at least curb the practice of backdating stock options. Other practices, like timing stock option grants, to occur after bad news was disseminated, or before good news is reported, remains a problem. Similarly, the manipulation of information flow to influence share price movements before or after selected option granting dates still remains a problem.

9.10 SUMMARY

In this chapter we have seen that the US Savings & Loans crisis can largely be attributed to erratic spurts of regulation and deregulation, followed by re-regulation. The reason for this erratic behavior can most probably be found in the interrelationships between politicians and pressure groups. The impact of this erratic behavior was massive and resulted in a cost to taxpayers running into the billions of USD. No action was, however, contemplated against those responsible for the crisis. We do find that a perception was created that Mike Milken was responsible for the crisis, and we find that substantial sanctions were exercised against him for charges that appeared to be trivial. Although one can argue that, during plea bargains, defendants are often allowed to plead guilty to lesser charges, the case against Mr Milken was viewed by legal commentators as shaky at best.

What is important for this thesis is the discrepancy between the way Mr Milken's case was handled by the authorities and the way in which Mr Abel Mozer and other Salomon executives were treated in what appears to be a clear-cut case of deliberate market manipulation and fraud over a period of time. We also saw massive discrepancies in the way ENRON executives were treated for essentially manipulating the company's profits and losses and lying to shareholders, when compared to the treatment meted out to Shell for inherently the same offences. There can be little doubt that such inconsistencies by regulators and enforcement agencies contribute to the development of an environment conducive to extreme opportunism. One partial explanation for some elements of this type of behavior is offered by Ari Adut when he argues that the secrecy of these opportunistic behaviors contributes to the erratic enforcement of the norm (2005. 213-235). According to Adut: "the norm will then be underenforced as long as its transgressions are committed in, or remain private. Once a scandal breaks, however, the externalities that are put in motion by the publicity of the transgression may prod polluted or provoked third parties into showing extraordinary zeal vis-à-vis the offender, to signal rectitude or resolve" (Adut 2005. 216).

In this chapter I presented compelling evidence regarding the extent of opportunistic behavior displayed by company executives in the United States. These same types of executives would have been the clients Mr Milken dealt with and was found guilty of assisting to avoid taxes. One of the uses of executive stock options, according to Lie, is to "cheat on corporate taxes" (2006: 1). Similarly, the abuse of insider information to ensure stock options are always granted at a very favorable price is also

applicable to the manipulation of strategic insider information by Shell executives. In the Shell case, the concealment of strategic negative information would have allowed option holders to exercise their existing options at a price above the issue price, something that would in all probability not have been the case if they did not manipulate their proven reserve figures upwards. The information provided in this chapter also shows that well directed regulation, like that commonly referred to as Sarbannes Oxley, can be effective even if it is unpopular.

CHAPTER 10

CONCLUSION

The magnitude of the global financial markets often exceeds our levels of comprehension. Billions and trillions of USD are made or lost, often at the push of a button. Very often the gross domestic profit (GDP) of countries is dwarfed by the market capitalization of financial services companies. In 2005, the combined market capitalization of the five largest banks in the world exceeded USD 800 billion (Mathewson n.d.). One of the most common misconceptions is the perception that the financial markets do not affect us, unless we directly invest in them. However, extreme opportunism in the financial markets has a direct effect on our daily lives. It may take the form of directors of a bank overcharging their clients, thereby eroding their hard-earned savings over a period of time. It may be a financial analyst recommending an ailing company to potential investors, in order to allow his employer to sell its investment in that same company before it collapses. Virtually everyone that provides for retirement or for future expenses is exposed to the financial markets in one form or another. The compound eroding effect of opportunism and inefficiencies on pension fund returns is clearly illustrated in work done by Logue & Raider (1997: 266 – 275) and provides us with some explanation for the lower-than-market returns posted by many pension funds. Unfortunately, only the most spectacular incidences of extreme opportunism are ever brought to our attention through the popular press. These events are, in most instances, attributed to the actions of a “rogue” individual or group. Managers and regulators are often quick to characterize these events as anomalous aberrations, as unpredictable as

earthquakes, and once the guilty parties are duly punished it is business as usual.

The purpose of this thesis has been to determine if these events are indeed anomalous aberrations. If significant identifiable similarities are consistently present in these events, this may not be the case. If such commonalities do indeed exist, one needs to determine what, if any, influence they had on the manifestation of extreme opportunistic behavior. In order to analyze events of extreme opportunism, a frame of reference is required to facilitate a constructive analysis. The elements of such a framework were found in sociology. Sociologists have been active over at least the last hundred years, finding the factors underlying deviant or criminal behavior in societies. Early in the previous century, sociologists realized that human behavior should always be analyzed in context. Behavior that is viewed by some as normal and praiseworthy is often viewed as reprehensible and deviant by others. Sociologists like Robert Merton and Talcott Parsons focused on factors that had a normative impetus, while later scholars like Mouzelis urged us to have a wider, more inclusive approach, paying equal attention to factors like individual and group interests that may not necessarily have a normative origin. More than fifty years ago, Edwin Sutherland focused on the role of learned behavior and the importance of role models in his investigation of criminal behavior. Knorr Cetina and Breuger confirmed the influence of role models in their analysis of the modern, impersonal and dehumanized financial markets of beyond the year 2000.

Edwin Sutherland, in the 1960s, identified a number of factors that facilitate deviance from the norm. These factors had a distinct influence on how

market actors construct their environments. The construction of markets in general is dependent on political and social conditions according to Niel Fligstein. He emphasizes the importance of governments in defining those social structures that stabilize markets. This construction of financial markets is the focus of Mitchel Abolafia's social construction theory, which views markets as cultures constantly under construction. Abolafia managed to integrate the normative approach with the interests of individuals and groups. He identified the important influence of structural factors on incidences of extreme opportunism. When one analyzes these structural factors from a functional perspective, it becomes apparent that they essentially have one of three functions with regard to levels of opportunism. They act as motivators, facilitators or inhibitors. If these three factors are out of balance, it manifests in extreme opportunism at the one extreme or insufficient opportunism at the other extreme. One must always bear in mind that financial markets, like international sports, are highly competitive and a certain level of opportunism is not only always present, but is probably necessary. Individualism, drive and innovation are necessary traits for those who want to succeed. However, the key word is balance.

My theoretical foundation can therefore be summarized as follows:

- | - Extreme opportunism refers to the extreme pursuit of self-interest by individuals and groups (Abolafia 2001: 4).
- | - Structural conditions refer to those variables most likely to influence the strategies and rules prevalent in a particular sub-culture and determine

the probability of opportunistic action in a culture or sub-culture (2001: 32).

- | - The origin of these structural factors may be normative or interests based, or even a combination of the two.
- | - The roles of these structural factors are principally to act as motivators, facilitators or inhibitors of opportunistic behavior.
- | - An imbalance between these factors should be observable in incidences of extreme opportunism.
- | - Managing levels of opportunism should therefore be possible through the manipulation of one or more of these factors.

By analyzing high profile incidences of extreme opportunism in financial markets, evidence was sought to test the hypothesis that we are not dealing with an unforeseeable or unmanageable aberration or a “rogue” phenomenon. My proposition is that we are largely dealing with behavior that typically manifests itself in situations in which structural deficiencies, for example regulatory and operational shortcomings have created an imbalance between motivating, facilitating and inhibiting factors. These three influences form what I termed a triangle of opportunistic probability, shown in Figure 1.

In my analysis of events surrounding the bulk of the most highly publicized incidences of extreme opportunism in financial markets, a substantial body

of evidence presented itself in support of my view. One example of such supporting evidence is the fact that internal and external, formal and informal regulatory agencies failed, in virtually all the incidents investigated, to play any role in inhibiting or preventing the activities of the “rogue” traders or groups of traders. In cases in which evidence of potentially improper conduct was indeed detected, little or nothing was done to remedy the situation timeously.

Short-term financial reward, one of the structural factors highlighted by Abolafia, was indeed a significant influence in the events analyzed. The matter of financial reward is, however, more complicated than the reckless pursuit of large sums of money by a “rogue” individual or small group of individuals. Failure to generate super-profits has far-reaching consequences for not only the individual and his immediate family, but very often for his colleagues and sometimes even the whole firm. The fear of failure is clearly a powerful motivator and was apparently much stronger than the fear of detection. However, if the possibility of detection is negligible as a result of impotent control and oversight systems, even a moderate fear of failure could result in extreme opportunism. A universal commonality between these cases is the fact that, in virtually every event, the so-called “rogues” were responsible for a very large percentage of the income of the firms they worked for or, at the very least, large sections of the firm. Due to the nature of remuneration structures in most large corporations, the whole management chain would benefit from, and would often be dependent for their own financial rewards and associated status and other benefits, on the “profits” generated by the “rogue”. This fact is also equally applicable to the opportunistic actions of executives who have their management teams and

boards of directors all dependent on the share price of the company for their own rewards. Those responsible for oversight are all, in one form or another, dependent on the profitability of the companies for their own rewards. Similarly, we find that the bankers of large corporations are also dependent on these firms for their profits. As we have clearly seen in the case of Mr Hamanaka, a number of banks very ably and enthusiastically supported Mr Hamanaka because they could extract exorbitant fees from his firm. To exacerbate this situation, one finds that even external institutions (such as auditors), that are responsible for oversight and control; find themselves in a similar position. Audit firms are often dependent on the firms they audit for lucrative consulting contracts that will boost their profitability and the profit shares that will be distributed amongst the partners. As we have seen in the Barings case, SIMEX was one of Mr Leeson's greatest supporters and wanted him to increase his positions right up to the very end. In Japan, we have seen that regulators often turned a blind eye, even accepting bribes. Many of the lax regulatory environments resulted from politicians seeking political favor, from powerful financial markets players, who will in turn ensure their political survival.

One of the most important dissimilarities between events analyzed was the variance in societal, regulatory and judicial responses to these events. What we have found is that, for similar behavior, the responses were vastly different. This leads us to question the rationality of societal, regulatory and even judicial responses to extreme opportunism. Mr Nick Leeson also questioned this fact when he responded to claims by an Australian trader that his superiors were aware and condoned his opportunistic behavior and that of his trading team at NAB, by pointing out that a substantial portion of

corporate behavior is at least morally questionable, and the difference between brilliance and criminality is often opaque. The extent of the opacity is such that some of the world's greatest legal minds differ when a distinction has to be made. However, this is not a new insight, as I pointed out in Chapter 1. Robert K. Merton (1957: 141) identified the fact that the line between right and wrong is often blurred in matters of business and quotes Veblen, who observed that "It is not easy in any given case – indeed it is at times impossible until the courts have spoken – to say whether it is an instance of praiseworthy salesmanship or a penitentiary offense". In his June 2006 e-mail to me, Mr Leeson commented on potential explanations for the NAB incident and said "...all the procedures are wrong, morally and perhaps criminally, some more clearly than others, and 98% of people differentiate correctly, unfortunately a rogue 2% do not" (Annexure 1). I believe sufficient evidence was presented in this thesis to allow us to suggest with a large degree of certainty that the rogue 2% Mr Leeson refers to are in all probability, not the ones who couldn't distinguish between right and wrong, but rather the 2% who were unlucky enough to be caught and prosecuted. If the Kobe earthquake had not occurred, would we have known about Nick Leeson? If the views on the different markets they betted on turned out to be correct, would we have known who Toshihide Iguchi, John Rusnak or any of the others ever were, other than perhaps on the front pages of international finance magazines, being heralded as the rainmakers of their different companies?

It is also quite clear that all the firms or institutions that experienced extreme opportunism being displayed by one or more of its staff also had a history of extreme opportunism as an institution. There is abundant evidence to suggest

that learned behavior played an important role in the formation of extreme opportunistic behavior. None of these firms could ever claim that it was “lily white” and was contaminated by a rogue trader. Greg Blank, Grawie Botha, Joseph Jett, David Bullen and most of the other so-called “rogues” all claimed that what they were doing was commonplace and acceptable practice in the firms they operated in, and in the financial markets in which their firms operated. The employers of Toshihide Iguchi, John Rusnak, Nick Leeson, Yasuo Hamanaka, David Bullen and Joseph Jett all had a history of extreme opportunism in numerous ways, such as exploiting their clients, misleading and even bribing regulators, covering up losses and unauthorized activities, to name but a few. Similarly, the investigation that followed the Salomon Brothers manipulation of the US bond market during the late eighties and early nineties revealed that 98 other banks were involved in manipulating the bond market, leading the SEC chairman to view the manipulation as part of “...the organizational routine...”(Abolafia 2001:1-2). Similarly in 2005, it was revealed that all seven “market specialist” firms operating on the New York Stock Exchange (NYSE) were systematically and deliberately front running their clients. This should probably not have come as a surprise, following the USD 187 million pay packet of the chairman of the NYSE. This pay packet was awarded to him in spite of the fact that he had been made aware of the questionable activities of the “market specialists” on his exchange three years previously, and that he did nothing.

Although the smoothing of performance by traders is as commonplace as chewing gum, there is a hidden danger attached to this practice. The hidden danger is the fact that, if you are able to conceal or hide profits, it is also

possible for you to hide your losses, as the mechanics are very similar. By creating an environment or culture in which traders feel the necessity to hide their profits, one can inadvertently create the environment in which they can also learn how to hide losses. Similarly, corporate executives who massage their figures are setting an example to their employees that such behavior is not only tolerable, but necessary to be successful in business. Shell executives lied about the proven reserves of their firm over an extended period of time, until they could manage themselves out of the hole they were in. Toshihide Iguchi, Nick Leeson and most of the others did exactly the same. None of them ever intended to lose billions or destroy the companies they worked for – they all lied about their profitability in order to gain sufficient time to trade themselves out of trouble. If they had been successful they would have been heroes but, because they failed, we call them criminals.

Emphasizing the danger associated with the practice of massaging the figures is the fact that most of the catastrophic events we analyzed in this thesis resulted from traders trying to win back existing losses that were built up over time. Mr Iguchi, Mr Hamanaka, Mr Leeson, Mr Rusnak and the NAB Four all tried to make back losses. In all cases the initial losses would, if declared immediately, have had a limited influence on the organizations involved. If mechanisms were in place to prevent traders from hiding any losses, or if there were effective incentives and sanctions that discouraged such behavior, the initial trigger would have been disarmed.

In a culture in which successful people are described as “big swinging dicks” one would hardly expect to find their trading to be small in any sense

of the word. One of the most important formal and informal risk management tools available to those responsible for regulating financial market participants is the establishment and enforcement of limits. One of the many golden threads running through this thesis is the sheer size of positions taken and, in most instances, the unusually large volumes of transactions, sometimes real and sometimes fictitious. If trading limits were rigorously enforced, it would not have been possible for traders to build up positions of potentially ruinous proportions. What is especially worrisome is the fact that, in many of the cases analyzed, outsiders were well aware of the size and nature of positions taken and, in many cases, efforts were made to warn, or enquire from, their employers about the soundness of the positions. In not one instance was a serious effort made to investigate these enquiries thoroughly, which leaves us with the question of how their superiors could not have known. According to Mr Iguchi, it was not a case of not being able to see, but rather a case of not wanting to see.

The absence of limit enforcement leads again to the matter of regulatory failure and inconsistencies in enforcement of rules and regulations. If the Bank of England didn't bend the rules for Barings the firm would, in all probability, still be around today. If the SEC inspectors in the US were thorough, Mr Iguchi would have been exposed earlier and, if there were not a culture of hiding losses at Daiwa, Mr Iguchi might have thought twice before he started selling his client's bonds. Daiwa itself would probably have reconsidered exporting and hiding losses if Japanese regulators had a track record of punishing such conduct. If we compare the punishment meted out to the Salomon trader, Mr Abel Mozer, and his superiors compared to what was deemed appropriate for Mr Mike Milken, we find a

glaring discrepancy. One may argue that the judiciary changed over time and became stricter. However, this argument does not hold water if we compare the action taken against Mr Jett, Mr Rusnak and Mr Leeson, or even Mr Blank. Similarly, we find glaring discrepancies between the action taken against ENRON executives and the lack of action taken against Shell executives. Although it is difficult to criticize legal processes due to the very technical nature of legal systems, it is even more difficult to understand why lying to your investors, hiding losses and inflating your profits is different from lying to your investors, hiding losses and inflating your profits. If it is common knowledge that consistency is a prerequisite for conditioning people, and even animals, why do we expect financial market participants and company executives to be any different?

Furthermore, there are definite similarities in the products used by the role players in a number of the case studies analyzed. It is important to note that the products used were in no sense the primary cause for these events of extreme opportunism. However, it does have a multiplying effect, sometimes of massive proportions. One of the most destructive products was, interestingly enough, a product that is very often viewed as benign, and is frequently used by pension plans. This range of products, commonly referred to as “options”, is probably the most widely used derivative and in essence provides the holder of the option the right, but not the obligation, to either buy or sell a particular security or asset. In order to obtain that right, the purchaser of the option pays the seller a premium. One of the reasons for the popularity of options and their benign image is the fact that the potential maximum loss to the buyer of an option would be limited to the value of the option premium. Options essentially come in two forms: a put option would

give the holder the right to sell a product at a future date at a specific price, and a call option would give the holder the right to buy a particular security at a specific price on a future date. As mentioned previously, options also vary as to how exercisable they are: “American” options may be exercised at any time during the life of the option, while “European” options can only be exercised on the exercise date at the end of the life of the option.

The question then is how it was possible for options to be responsible for USD billions in losses. One indication of options possibly having a Jekyll & Hyde personality comes from one of the most successful currency traders of all time, Andy Krieger. One indicator of his prowess was the fact that, during 1987, his CEO at Bankers Trust provided him with USD 700 million of capital to trade with (Partnay 2003: 23). His strategy was not unlike that of Mr Rusnak and the Australian Traders at NAB – to make one-way directional bets on the values of various currencies. However, there was one distinct difference to his strategy. According to Frank Partnay, he “...always bought options, because of what he described as a ‘personal abhorrence to selling options.’” (2003: 14). The reason was most probably that Krieger was aware of the fact that options also have a dark side. All the benign features of options I have mentioned unfortunately only apply to the buyers of options. To the seller of an option, the losses could potentially be disastrous. Losses sustained in at least four of the major events – Sumitomo, AIB, Barings and NAB – can directly be attributed to the sale of options. The answer to this riddle can be found in the “honey pot” that the dark side of the option buries in her bosom. This sweet source of seduction is called an option premium. The seller of an option is in essence selling insurance and, the higher the expectation by the party that buys the insurance that he might

use it, the more money he is prepared to pay in premium. It is one of the easiest ways of generating vast sums of cash if you are perceived to be representing a large financial institution. However, the downside is that potential losses to you, as the option writer, may be limited only by the amount of money you have to lose. It is very important to understand that products are inherently benign, and what makes a product relevant is the way it is used. Selling deep in the money options is undoubtedly one of the easiest and most effective ways in which any trader, who needs money to trade himself out of a hole, can raise large amounts of cash – often undetected and with little difficulty if he is unsupervised and works for a creditworthy firm. Companies that employ traders with access to these “weapons of mass destruction” have an obligation to their clients and shareholders to ensure that no unauthorized use of such products takes place. If they don’t, they are as criminally negligent as any institution using radioactive material that allows such material to be sold to international terrorists. It must, however, be reiterated that in many cases, like those of Grawie Botha, Greg Blank, Toshihide Iguchi and Joseph Jett, the products used were not complicated derivatives.

If one would construct a probability matrix that can be used to populate the triangle of opportunism put forward in chapter 1, it would show a clear concentration of factors that motivate and facilitate opportunistic behavior in all the cases analyzed over a period of 25 years. In this matrix the presence of motivators like financial and status rewards, facilitators like weak and ineffective regulations, oversight and sanctions as well as the presence of inhibitors like effective regulation oversight and sanctions will be indicated.

TABLE 8: Probability Matrix

Case Study:	A	B	C	D	E	F	G	H
Motivators:								
Financial Rewards	*	*	*	*	*	*	*	*
Status Rewards	*	*	*	*	*	*	*	*
Addictive behavior	X	X	X	X	*	*	X	X
Facilitators:								
Ineffective Formal Restraints	*	*	*	*	*	*	*	*
Ineffective Informal Restraints	*	*	*	*	*	*	*	*
Ineffective Oversight Systems	*	*	*	*	*	*	*	*
Opportunity Impact	*	*	*	*	*	*	*	*
Presence of Successful Role Models	*	*	*	*	*	*	*	*
Operated in Culture of Opportunism	*	*	*	*	*	*	*	*
Used Complicated Products	X	*	X	*	*	*	*	*
Inhibitors:								
Effective Formal Restraints	X	X	X	X	X	X	X	X
Effective Informal Restraints	X	X	X	X	X	X	X	X
Effective Oversight Systems	X	X	X	X	X	X	X	X
Limited Opportunity Impact	X	X	X	X	X	X	X	X
Absence of Successful Role Models	X	X	X	X	X	X	X	X
Operated in Culture of Restraint	X	X	X	X	X	X	X	X
Used Basic Products	*	X	*	X	X	X	X	X

*- Positive Response X- Negative response

A- Greg Blank B- Yasuo Hamanaka C- Toshihide Iguchi D- Joseph Jett
 E- Nick Leeson F- John Rusnak G - NAB Four H- Mike Milken

It is clear from the probability matrix in Table 8 that in all these case studies the potential for extreme opportunistic behavior was very high due to the overwhelming presence of strong motivators and facilitators with very little if any inhibiting factors. It is interesting to note that the use of highly geared and complicated products is not a prerequisite for extreme opportunism to take place in financial markets. Indications of gambling addiction were only detected in two of the case studies. I must immediately add that the observation of possible addictive behavior was merely casual and should by no means be viewed as conclusive.

One of the most striking findings of this research is the resemblance between these cases. These cases not only span a period of more than twenty years it also covered events that occurred on five continents across the globe. There is no clear evidence to suggest that the influence of the broader cultural environments in which these events occurred had noticeably different impacts. Extreme opportunism appears to be a global phenomenon that stretches over time and cultural divides.

10.1 Solutions to problems of extreme opportunism.

For the purposes of this thesis, extreme opportunism has been defined as the “extreme pursuit of self-interest by individuals and groups”. Structural conditions refer to those variables most likely to influence the strategies and rules prevalent in a particular sub-culture. The origin of these structural factors may be normative or interests based or even a combination of the two. The roles of these structural factors are principally to act as motivators,

facilitators or inhibitors of opportunistic behavior. An imbalance between these factors was observable in the incidences of extreme opportunism that were analyzed. Managing levels of opportunism should therefore be possible through the manipulation of one or more of these factors. By conceptualizing structural factors underlying incidences of extreme opportunism in financial markets as forces with counterbalancing potential, one is forced to analyze these factors relative to one another and not in isolation. Through a thorough analysis of the role of structural factors underlying incidences of extreme opportunism in financial markets, sufficient evidence was found to support the hypothesis that we are therefore not dealing with an unforeseeable or unmanageable aberration, or a “rogue” phenomenon. Extreme opportunism should much rather be regarded as a very important and potentially very hazardous element of modern business. Clients and shareholders should therefore ensure that it receives as much shareholder, management and regulatory attention as other facets of business, for example making profits. In an environment in which highly geared financial products are used by highly incentivised actors, inexperienced regulatory and oversight actors using outdated and low-budget control systems have little chance of effectively inhibiting extreme opportunism. Proponents of blanket financial market deregulation should also ask themselves if an industry that deeply affects the lives of current and future generations could really be left to its own devices. A former derivatives trader, Satyajit Das, was quoted as saying that “fund managers are performance junkies. Like athletes, there is a significant incentive to cheat” (2006: 83). If you want to manage other people’s money, effective oversight and controls should be a given.

One of the most promising regulatory responses in recent years is the introduction of the Sarbanes Oxley legislation in the United States. Of primary interest to this thesis is the fact that responsibility is focused where it is supposed to be, at the top. Company executives are held directly responsible for, among other things, the accuracy of information disseminated to regulators, shareholders and the investor public at large. The legislation is also very clear with regard to the sanctions attached to breaches of the terms set out in the legislation (Sarbanes-Oxley 2006: 1-2). Some of the measures introduced in the legislation states that “CEO and CFO must review all financial reports”; “financial report does not contain any misrepresentations”; “information in the financial report is ‘fairly presented’”; “CEO and CFO are responsible for the internal accounting controls”; “CEO and CFO must report any deficiencies in internal accounting controls, or any fraud involving the management of the audit committee”; and “CEO and CFO must indicate any material changes in internal accounting controls” (2006: 1). The Act furthermore requires that “All annual financial reports must include an Internal Control Report stating that management is responsible for an ‘adequate’ internal control structure, and an assessment by management of the effectiveness of the control structure. Any shortcomings in these controls must also be reported. In addition, registered external auditors must attest to the accuracy of the company management’s assertion that internal accounting controls are in place, operational and effective.” Section 409 of the Act states “Companies are required to disclose on an almost real-time basis information concerning material changes in its financial condition or operations” (2006: 3). There is no question about where the concerns of the lawmaker are focused – most definitely not on “rogue traders”.

Sarbanes-Oxley has also come under severe criticism, especially due to the costs associated with compliance. A very striking argument made is that shareholders are prepared to live with a certain amount of fraud (Butler & Ribstein 2006: 1-4). It is argued that "...shareholders will find such regulation valuable only if the benefit from reduced fraud is greater than the cost of regulatory compliance. SOX's attempt to create a perfect world with zero fraud goes too far. Moreover, it is well accepted in financial economics literature that the costs and benefits of securities regulation should be evaluated from the perspective of typical shareholders who can avoid some costs of fraud by investing in diversified portfolios of shares. By imposing the costs of eliminating fraud on all firms in investors' portfolios, the SOX mandates are a terrible deal for the ordinary investors it purports to protect."

One of the shortcomings of this argument is the fact that it appears to single out fraud and its cost to shareholders as the only problem. In my view, the costs to shareholders of the culture of extreme opportunism that plagues the financial markets is much greater than the cost of implementing Sarbanes-Oxley. Fraud is but one element of the manifestation of extreme opportunism. It must be duly noted that most cases of spectacular losses or corporate collapses started with apparently insignificant actions. The concealment of a loss or a profit was often the first step. There is no difference between overcharging a client through inflated service charges on his savings account and causing an investor to lose money by front-running him. Was the AIB management's overcharging of their thousands of clients less wrong than the actions of John Rusnak? The argument can be made that the intent to defraud in the AIB overcharging example may have been there

from the start, while in the majority of so-called “rogue” trader cases analyzed, there was no initial intent to defraud. If one would add up the hidden cost of transactions and actions that result in losses but never make the headlines, the billions of USD paid in fines every year by large corporations, and the silent losses suffered by clients when they are being misled by analysts or are traded against by their brokers and portfolio managers, to name but a few, one might find the cost of implementing SOX much more palatable. If Sarbanes-Oxley is viewed as a concerted effort to temper the opportunistic culture prevalent in the financial markets, its benefits over the long term would be immeasurable. If we view fraud as only the visible tip of extreme opportunism we quickly realize that what is viewed by some observers as overkill might in reality be the bare necessity.

An interesting phenomenon highlighted by Abolafia is the fact that clients expect traders to be opportunistic in order to achieve as much profit as possible (2001: 370). The way in which you make money is much less important than the making of money. It is therefore of little surprise that, even after Salomon Brothers admitted that they manipulated the Treasury securities market, their clients kept trading the same securities with them. Extreme opportunism does not deter clients or shareholders and it appears that, as long as the potential profit outweighs the perceived risks, little informal restraint can be expected from these two groups. The culture of opportunism is therefore perpetuated through reinforcement from at least two fronts, shareholders and clients. Other than formal regulation, there appears to be very little to restrain extreme opportunism in financial markets and, as we have shown in this thesis it is in all probability a much more universal and common phenomenon than previously thought. In order to

deal with this phenomenon, the “collective moral hazard” approach used by James Dow (2002: 32-39) has definite merit. A combination of factors like inappropriate incentives for staff and management, encouragement of extreme opportunistic behavior, weak or passive internal control structures, erratic and partisan regulatory and judicial behavior, all contribute to the creation and maintenance of a culture of extreme opportunism. In my view, Sociology provides us with a very practical and robust framework through which a better understanding and insight into the true nature of the phenomenon is possible.

The solution to the problem would, however, require a holistic approach that would require, among other things, changes to the way legal systems operate internationally, the way in which audit firms conduct their business and the mandatory psychological testing of individuals who are employed in positions of trust in the financial service and corporate environments and use potentially hazardous instruments. The limitations of self-regulation and the exclusion of certain products from efficient regulation deserve our attention. In an environment with very strong motivators, like extreme salaries, the balance between motivators and inhibitors should be maintained vigorously. Industry bodies tasked with self-regulation could come under severe pressure from their principals to be as lenient as possible, unless the sanctions they face for not being effective are as extreme as the profits and the rewards at stake. Another problem one faces is situations in which a product or service is less regulated because the users are deemed to be wealthy enough or skilled enough to be able to “handle” the risks associated with the product. This phenomenon is not limited to the financial markets and is quite common in extreme sports. A hedge fund is one such example,

where weak regulation is justified by limiting those who may use it. The problem, as we have seen in the Long Term Capital Management (LTCM) event, is that the actions of hedge funds affect a very large segment of the financial markets and can lead to systemic failure. Furthermore, derivative instruments, collective investment schemes and exotic products like “absolute return” products used by ordinary investors and pension funds, often belie their exposure to hedge fund activity. The mere name “hedge” fund is extremely misleading, as hedge fund managers can follow virtually any investment strategy with virtually limitless gearing levels. There is a real need for hedge fund strategies to be monitored for extreme gearing levels through independent oversight, as it is fast becoming one of the largest asset classes available to investors. According to the FSA, the US hedge fund market in the US exceeded USD 1 trillion in 2005 (FSA 2005). Its lure of high returns for investors and even higher returns for its managers, coupled with little or no regulation and oversight, creates an environment with a high extreme opportunism potential.

One of the most glaring shortcomings still present in financial markets is the lack of effective and objective oversight of financial transactions, through the use of advanced computer systems. The benefits of such systems is their ability to monitor and audit vast amounts of transactions on a near-real-time basis, allowing auditors, executives and regulators alike to detect anomalous transactions in time. These systems would also be capable of tracking and evaluating transactions in most of the world financial markets on a continuous basis and could be programmed to autonomously report anomalous transactions to regulators. One example of such a system is the “ELECTRONIC TRUSTEE” system developed to provide high-speed

transaction monitoring and audit capabilities to those charged with the responsibility of managing investments (www.electronictrustee.com). This system allows for investment transactions to be audited as they are executed and not months or years after the fact. The development and implementation of such systems needs to become a priority. Unfortunately, these systems are often viewed as unnecessary overheads by those in authority. This is a view not dissimilar to those apparently held by the management teams and regulators tasked with overseeing Daiwa, Sumitomo, Barings, AIB, Kidder Peabody and NAB. It is therefore not surprising that the anatomy of the events of extreme opportunism events analyzed over the period of 25 years, are remarkably similar. As long as we have limited oversight and ineffective formal and informal controls in an environment where rewards are massive and instantaneous extreme opportunism will manifest itself.

Another major problem is the ability of regulators to design and implement useful and effective regulation. All too often, regulation takes the form of forcing companies to submit thousands of pages of information, which is stored without anyone actually analyzing it. If this information cannot be converted into useful “intelligence” it means nothing. If anomalies cannot be detected, the scarce resources of regulators cannot be directed efficiently to areas where it is needed. With the ever-present poaching of top quality staff by the private sector, the use of advanced software systems can also play a crucial role in maintaining continuity and standards of oversight. It must, however, be emphasized that there is no substitute for having the “will” to manage extreme opportunism. As Mr Iguchi pointed out, his superiors had no “will” to see his mistakes. Similarly, regulation without a strong and

consistent political “will” to manage opportunism will have little chance of success.

In the final analysis the relative influence that agency and structure exert on human thought and behavior, is still a matter for more research and debate. What is however abundantly clear is that any serious effort to understand or explain extreme opportunistic conduct in financial markets, would be incomplete without taking due cognizance of the very important role played by structural factors.

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LIST OF ABBREVIATIONS

ACI	Association for Collective Investments
ALCO	Asset and Liability Committee (Barings)
APRA	Australian Prudential Regulation Authority
ASX	Australian Stock Exchange
AUD	Australian Dollar
BB&Co	Barings Brothers & Co Limited
BFS	Baring Futures Singapore
BIB	Barings Investment Bank Group
BNP	Banque Nationale de Paris
BNZ	Bank of New Zealand Limited – NAB's banking subsidiary in New Zealand
BoE	Bank of England
BSJ	Baring Securities Japan

BSL	Baring Securities Limited
CEO	Chief Executive Officer
CFTC	Commodities Futures Trading Commission (US)
C & L	Coopers & Lybrand
Deloittes	Deloitte & Touche Auditors
ETB	European Trust and Banking Co.
FCT	First Continental Trading
FDIC	Federal Deposit Insurance Corporation
FPG	Financial Products Group (Barings)
FX	Foreign Exchange
GAAP	Generally Accepted Accounting Principles
GBP	British Pound
G-7	Group of Seven Major Industrial Democracies

IPO	Initial Public Offering
IT	Information Technology
JGB	Japanese Government Bonds
JPY	Japanese Yen
JSE	Johannesburg Stock Exchange
LIFFE	London International Financial Futures and Options Exchange
MANCO	Management Committee (Barings)
MBS	Mortgaged Backed Securities
Nikkei 225	Nikkei 225 Stock Average Index
NYSE	New York Stock Exchange
NZD	New Zealand Dollar
OSE	Osaka Securities Exchange
OTC	over-the counter (transaction)
OUNB	Overseas Union Bank

P & L	profit and loss
Repo	Repurchase Agreement
RRR	Reserves Replacement Ratio
SARB	South African Reserve Bank
SBC	Swiss Bank Corporation
SEC	Securities & Exchange Commission
SFA	Securities and Futures Association (UK)
SFO	Serious Fraud Office
SIB	Securities Investment Board (UK)
SIMEX	Singapore International Monetary Exchange
SLK	Spear, Leeds & Kellogg
TSE	Tokyo Stock Exchange
USD	United States Dollar
VaR	Value at Risk, a quantitative method to calculate possible

losses within a defined interval and time period

YEN Japanese Currency

ZAR South African Rand

GLOSSARY

ARBITRAGE : The exploitation of temporary price differences in the same security on different markets.

BACK OFFICE: The section of a financial services institution tasked with settling transactions.

CALL OPTION: A contract which gives the owner the right but not the obligation to buy from the writer a specified security or securities at a specified price at a specified date , or within a specified time period.

CREDIT RISK: The risk that a counterparty will not settle an obligation fully when due.

FRONT RUNNING: The taking of a position in a security ahead of a buy or sell action, a trader knows will be taken by his firm or one of its clients, that will influence the price of the security he took a position in.

FUTURES CONTRACT: A contract to buy or sell a commodity, currency or security at some future date at a fixed price.

GEARING: The debt equity ratio of a company (or Leverage).

HEDGING: The process through which an investor can offset the risk that the price of one financial instrument will rise or fall, by buying or selling another financial instrument.

LEVERAGE: From a speculative point of view, the opportunity for a large profit at a small cost. It implies high risk.

LONG POSITION: A position taken by a trader in expectation of a price rise in a particular security.

NAKED POSITION: A position in securities not protected from market risk through hedging. One example is where a trader sells an option over a security, without holding a position in the underlying security as protection.

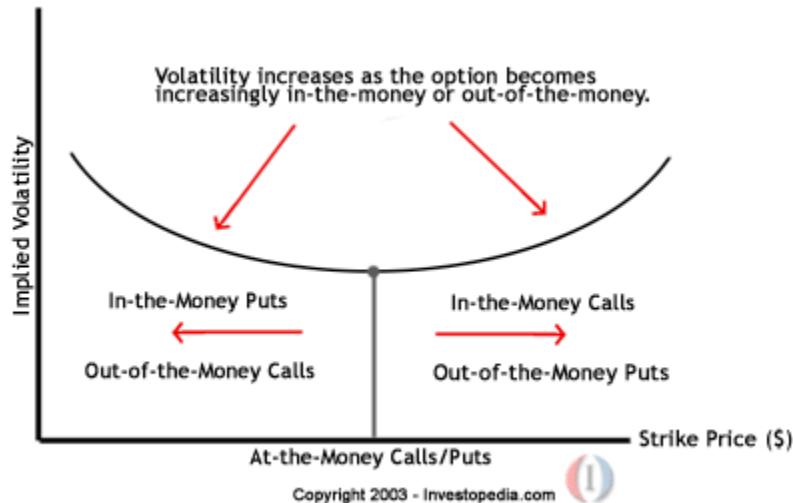
PUT OPTION: A contract that gives the holder the right but not the obligation to sell to the writer of the option specified securities at an agreed to price at an agreed to time.

SETTLEMENT: The process by which balances arising from the buying or selling of securities is paid off.

SHORT POSITION: A position normally established in expectation of a drop in the price of the relevant securities.

STRIKE PRICE: The prearranged price at which the buyer of an option may buy or sell the securities specified in the options contract.

VOLATILITY SMILE: A common graphical shape that results from plotting the strike price and implied volatility of a group of options with the same expiration date.



(Investopedia)

D- Annexure A.txt

From: Nick Leeson Galway United [nick@xxxxxxxxx.ie]
Sent: 13 June 2006 16:26
To: JCBruce
Subject: RE: Emailing: Australian_Financial_Review_Magazine.pdf

JC,

I think Bulleens comments are a weak attempt to justify his own actions and give himself some credibility. He seems to be struggling to accept his wrong doing.

Unfortunately 'window dressing' is part and parcel of the financial markets, bed and breakfast trades, pricing anomalies. Perhaps the confusing part for some traders is where the line is drawn. why is one thing acceptable another not.

I don't have the answers, all of the procedures are wrong, morally and perhaps criminally some more clearly so than others, and 98 % of people differentiate correctly, unfortunately a rogue 2% do not.

If the codes of practice were standard, not 'when suits' as above, perhaps the current ambiguity would be removed.

Hope this makes sense.

-----Original Message-----

From: JCBruce [mailto:jcbruce@mweb.co.za]
Sent: 12 June 2006 12:03
To: nick@galwayunitedfc.ie
Subject: FW: Emailing: Australian_Financial_Review_Magazine.pdf

Dear Mr Leeson

I hope all is well with you and the family.

I am at present working through the NAB event in Australia and would really appreciate your views on some of the comments made in the attached article. (Sorry about the poor quality of the article).

David Bullen one of the traders involved said among other;

"They want the profit, but to get that profit they don't want to accept the risk. It is not that they don't want to take it; they just don't want to see it. So you start out not declaring all your profits, keeping some in store. And then losses (are not declared) as long as it doesn't hit the P&L account it is fine."

"To reach those targets, management would have known the \$3.5 million the traders were allowed to risk were not enough. To achieve the smooth profit targets, the unavoidable, implicit message is "trade outside limits". Everyone had to meet those profits, they talked about risk, about working for clients but they weren't really serious- if they were serious, they would have invested more resources in staff, in systems".

When asked if NAB would learn from the disaster he said "not a chance" the whole institution would have to change. They would have to accept what they were doing; managers would have to stop playing political games."

In terms of the Barings event did you ever feel that your superiors were at least tacitly condoning unauthorized trading?

It is also interesting that NAB had the Rusnak event analyzed but apparently gained little from it. Is this perhaps a reflection of the contention by Krawiec that

D- Annexure A.txt

"... financial institution management has made a conscious decision to foster an institutional culture that encourages at least some rogue trading. . ." and that "... eliminating the conditions that give rise to rogue trading is not in the best interest of traders, managers, or perhaps, of shareholders."

Thank you once again for your assistance.

Best Regards

JC Bruce

--
No virus found in this incoming message.

Checked by AVG Free Edition.

Version: 7.1.394 / Virus Database: 268.8.3/361 - Release Date: 11/06/2006

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No virus found in this outgoing message.

Checked by AVG Free Edition.

Version: 7.1.394 / Virus Database: 268.8.3/362 - Release Date: 12/06/2006

Secret profits can be made in many ways

By Bruce Cameron

Much has been written and said since Personal Finance exposed how Alexander Forbes has made secret profits by the "not lawful" bulking of the bank account assets of the nearly 950 retirement funds it administers. A lot has centred on what is legal and what is not legal about bulking.

Bulking in itself is not illegal. In fact Rosemary Hunter, a top retirement funds lawyer, says that any retirement fund administrator has a fiduciary duty to "bulk" as this will achieve better results for retirement funds. What is illegal, she says, is for a pension administrator to bulk assets of the funds it administers, and not tell the funds that it is bulking their assets and keeping all or part of the profit for itself.

Secret profits can be made by administrators in a number of areas. Bulking of bank accounts is only one area. Hunter says the opportunities for secret profits should be scrutinised by fund trustees to establish whether any service provider is deriving financial advantage from its work for the fund which is not part of the remuneration the fund has agreed the provider should be paid.

She says the law states that it is irrelevant whether the advantage to the provider is at the expense of the fund. The principle of bulking is simple. The money of many investors is bulked together to earn better returns than what individual investors would have received on their own.

There are many avenues open for service providers to retirement funds to earn secret profits. These include:

1 Bank accounts. Retirement funds have to hold significant amounts of money in their bank accounts to meet benefit payments, pay creditors and channel monthly contributions to service providers, such as asset managers.

Benefit payments need to be paid to people leaving a fund when they change employers or retire, or to dependants at the death of a member.

While large retirement funds can demand from banks that they be paid a high rate of interest for the funds in their bank accounts, small funds will not have the same negotiating power.

An administrator can negotiate a higher rate of interest with banks by bulking the accounts (cash) of all the funds it administers.

This preferential rate should be passed on as a better interest rate for each fund. Alexander Forbes negotiated that it was to be paid a fee from each bank instead of ensuring that a higher interest rate was paid to the funds. After all, it was being paid a fee to administer the funds.

The Financial Services Board (FSB) in its investigation into secret profits (sparked by Personal Finance's exposé of Alexander Forbes' practices), also wants to know whether there are other administrators that have failed to negotiate favourable bulking rates for funds.

The FSB is concerned that some life assurance companies which offer administration services and are part owners of a bank, do not negotiate the best interest rates for the retirement funds so the associated bank may make better profits.

2 Delayed payments. Secret profits can be made on money that is coming in or flowing out of a retirement fund bank account. The opportunities include:

- Delayed payments that can be coupled with the "not lawful" bulking of bank accounts by holding money in the bank accounts for longer than necessary to earn additional interest.

For example, payments to asset managers can be delayed, earning extra interest and secret profits.

The consequence can be fund members are "out of the market" and could lose additional investment growth.

- Delaying payments for group life and disability assurance attached to a retirement fund and earning interest on the money.
- Delaying the payment of benefits to fund members to earn additional interest at the expense of members.

3 Holding excess cash. This avenue for secret profits can also be coupled with "not lawful" bulking of bank accounts. Funds need to hold cash in reserve in order to pay out benefits. Money held in reserve is money that could be invested and earning a return.

4 Asset management. This is probably the biggest danger area for secret profits, particularly where a multi-manager is involved.

The areas in asset management where secret profits can be made are:

- Multi-management. An investment consultant decides on the allocation of assets into the various asset classes in which the fund invests. The fund then asks a multi-manager to decide which asset managers to use for each asset class.

In theory, a multi-manager should select the "best of breed" asset managers.

However, what has happened in the unit trust industry (and, as a result, can reasonably be expected to be happening in the retirement industry) is that a complex structure of what the industry calls rebates (but should be called kickbacks) has evolved.

The multi-manager tells the asset manager or unit trust fund that if they want to be included on the offerings of the multi-manager, they must pay a rebate to the multi-manager.

Alternatively, it will negotiate lower fees from the asset managers and not pass on the discount to funds.

To be lawful, any rebate or lower fee should be passed on to the funds.

Trustees need to find out whether their multi-managers are receiving an advantage in any way, under any name - sometimes this includes terms such as "administration fees".

An additional potential problem with the rebate structure is that asset managers who perform well will resist paying any rebate at all because the multi-manager has no choice but to list the exceptional performers. But an average or poor asset manager will need to pay up.

This means that the multi-manager may be tempted to direct funds to an average asset manager because of the rebate that it may receive from the asset manager.

- Scrip lending: This is the practice of lending out scrip (shares) to investors in derivative markets, which are based on buying and selling shares that are not owned. A fee is charged to a lender for borrowing the scrip. Asset managers who hold shares on behalf of retirement funds and other clients are the main source of the scrip. If the asset managers keep the fees without the consent of their clients, they are making unlawful profits.
- Performance fees: There are indications that performance fees are becoming increasingly complex and punishing. Trustees are not being informed of the full effect of the performance fees, as returns are only shown after the deduction of fees.

Performance fees are also increasingly becoming an insidious way of making fee structures so complex, allowing asset managers to camouflage the actual costs to individual and retirement fund investors.

- Money market investments: Asset managers have the ability to bulk all the retirement fund money going into money market instruments.

Trustees need to ensure that any bulking advantage gained is passed on to the funds.

- Life assurance policies. Many retirement funds are managed through a life assurance policy which is provided by a life assurer associated with the fund administrator. The life assurer then invests the retirement fund money through its own associated or pre-selected

asset managers.

This may mean that the "best-of -the-breed" asset managers are not used; or that the asset management fees charged are not the best that could be obtained; or that the life assurer may receive some fee or rebate from the asset manager.

Hunter says trustees need to ensure that consultants, administrators and asset managers declare in writing all direct and indirect financial advantage that they, and associated people and companies, gain from their work with the retirement funds, other than fees directly paid by the funds.

5 Group life and disability. Most retirement funds provide members with group life and disability assurance. In many cases, life assurance companies pay commission to any party that arranges the assurance.

This means that commission can be earned by retirement fund administrators or consultants.

Life assurance companies may also pay ongoing fees to administrators ostensibly for their role as the distributors of the benefits and collectors of the contributions.

Trustees should ensure that these commissions and fees are all properly declared and are for the benefit of fund members.

6 Housing loans. Many administrators make arrangements with banks to provide homeloans to retirement fund members.

The loans are backed by retirement fund guarantees. Many of these administrators insist that only a select bank or banks are used for this purpose.

Trustees should insist on freedom of choice for members and that any fees or rebates which are payable by the banks are declared and used for the benefit of members.

7 Outsourcing of pensions. There is a massive move by the life assurance industry to persuade retirement funds to outsource pensions. The move is mainly driven by the shift from defined benefit funds to defined contribution funds.

With defined benefit funds increasingly having pensioner members only, it is easier for funds to outsource the payment of pensions to life assurance companies and to close down the retirement funds.

In many cases, significant commissions are paid to retirement fund consultants and administrators who advise on the outsourcing.

In a recent arbitration case, two Johannesburg municipal retirement funds were awarded more than R200 million against the retirement fund administrator and consultant, NBC.

Part of the award was for R30 million in undisclosed commissions. The case is on appeal.

Retirement fund trustees should negotiate directly with pension suppliers. They should ensure that commissions are not paid and that the equivalent value is added to the value of the pensions.

Trustees should also take greater care when the recommendation is made to purchase a pension from a life company associated with a consultant or administrator.

The associated company could simply just be making higher profits by offering lower pensions.

8 Switching to umbrella funds. Umbrella retirement funds are sponsored by retirement fund administrators, including life assurance companies.

Their main aim should be to provide cost-effective retirement funds for employers with few employees.

There has been an increasing tendency for administrators to recommend the closure of existing smaller retirement funds and to move employees to an umbrella fund.

There can be enormous advantages in moving to an umbrella fund, including cost savings

to a retirement fund.

However, trustees of employer-sponsored funds need to ensure that they are not placing their members at a disadvantage by transferring to an umbrella fund.

The most important issue for fund trustees to consider is the likely conflict of interest within an umbrella fund. Most umbrella fund trustees are appointed by the umbrella-fund sponsor and may depend on the sponsor (for example, they could be the sponsoring company's employees).

As a result, the umbrella fund trustees may not insist that the fund buy best-value-for-money products and services if this will upset the sponsoring company.

This allows for the sponsoring company to exploit the numerous opportunities for making secret profits from funds.

The trustees of an employer-sponsored retirement fund should conduct a proper due diligence before deciding to close their fund and move their employees to an umbrella fund.

- *Next week: The duties of your pension fund trustees.*

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ANNEXURE C

DATE, DWBNA

1970,	5.95
1971,	4.88
1972,	4.50
1973,	6.45
1974,	7.83
1975,	6.25
1976,	5.50
1977,	5.46
1978,	7.46
1979,	10.29
1980,	11.77
1981,	13.42
1982,	11.01
1983,	8.50
1984,	8.80
1985,	7.69
1986,	6.32
1987,	5.66
1988,	6.20
1989,	6.93
1990,	6.98
1991,	5.45
1992,	3.25
1993,	3.00
1994,	3.60
1995,	5.21

,Instrument,"Discount window borrowing"

,Maturity,"Not applicable"

,Frequency,"Annual"

,Description,"AVERAGE DISCOUNT RATE ON LOANS TO MEMBER BANKS

QUOTED ON

INVESTMENT BASIS FEDERAL RESERVE BANK OF NEW YORK"

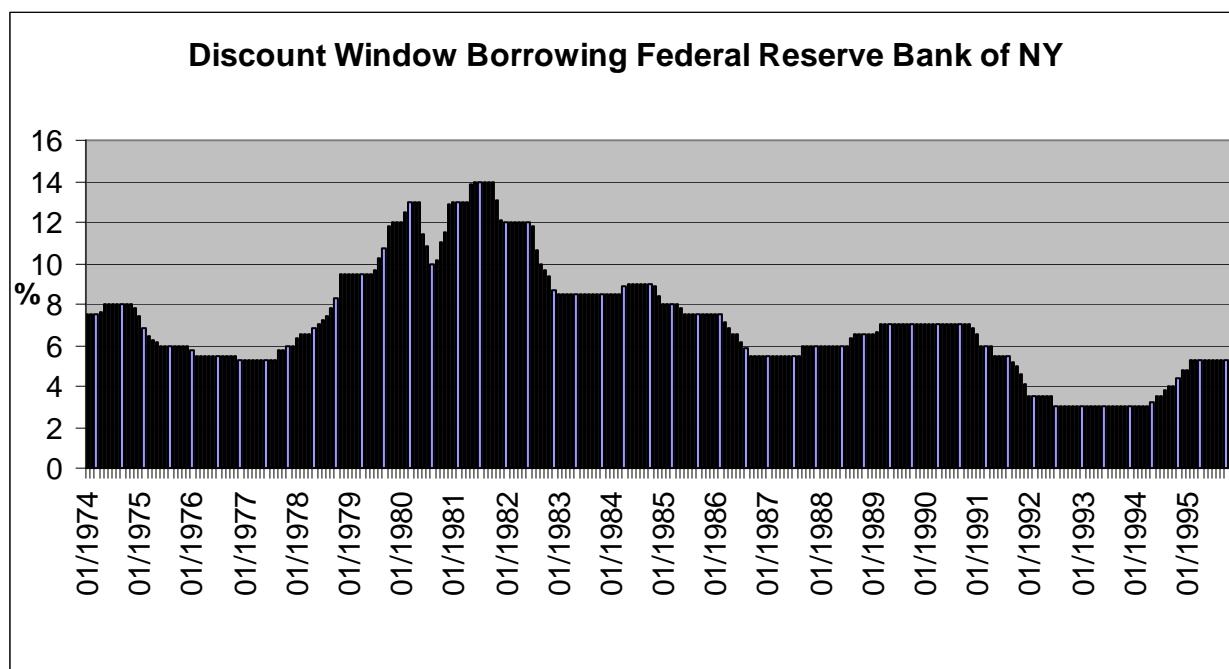
,Status,"Discontinued"

,Note,"Weekly figures are averages of 7 calendar days ending on Wednesday of the current week;

monthly figures include each calendar day in the month."

,Note,"Series ended January 8, 2003. Rate for the Federal Reserve Bank of New York."

http://www.federalreserve.gov/releases/h15/data/Annual/discontinued_DWB_NA.txt)



ANNEXURE D

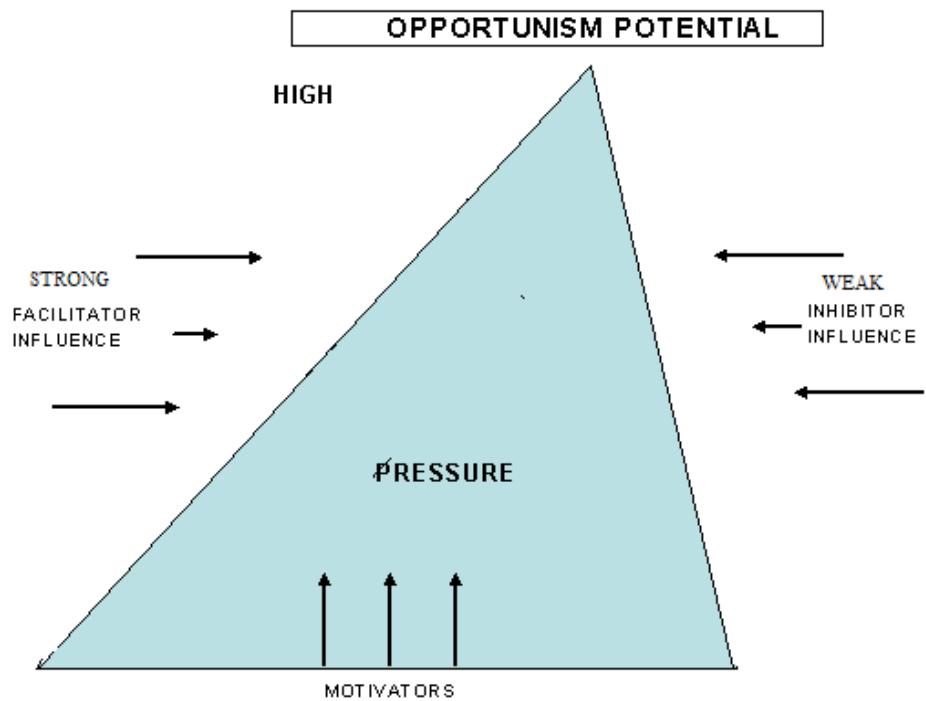


FIG 1. OPPORTUNISM POTENTIAL

