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LIABILITY AND CONSEQUENCES FOR FAILING TO SUPERVISE EMPLOYEES WHO ENGAGE IN FRAUDULENT TRADING

In May 2008, FINRA published a set of proposals revising existing supervision control rules for member firms. Already this year, two rogue traders have created unwelcome headlines and huge losses at their respective firms. The authors analyze the legal and regulatory framework for supervising brokers and traders, examine recent rogue trading cases, and review the liability issues and consequences surrounding failures to effectively supervise employees engaged in proprietary and retail trading.

By Steven M. Witzel and Eric A. Hirsch *

In light of the two high-profile trading scandals in the first half of 2008 (Société Générale and MF Global), now is a particularly appropriate time to review the changing regulatory scheme related to broker/trader supervision as well as the array of consequences for failing to supervise rogue trading activity. In May 2008, the Financial Industry Regulatory Authority ("FINRA") promulgated new proposed supervisory rules for public comment.[1] FINRA's proposed rules require prompt internal investigations into suspicious trading activities, and (like other existing rules and regulations governing the supervision of trading activity) require that adequate written supervisory procedures be in place and implemented effectively. Unlike existing NASD and NYSE rules, the proposed FINRA rules appear to expand the ambit and responsibilities of supervision to reach a broader group of individuals and business activities at member firms.

This article will first review the statutory and regulatory framework by which the Securities and Exchange Commission, Commodity Futures Trading Commission, and FINRA can (or in the case of FINRA, proposes to) bring actions for the failure to supervise trading activity, and then examine the financial and legal consequences of some of the most recent and infamous incidents of the failure to maintain and enforce adequate supervisory controls.

[1] FINRA Regulatory Notice 08-24, Supervision and Supervisory Controls (May 2008). FINRA was created in July 2007 when the Securities and Exchange Commission ("SEC") gave approval to the consolidation of the member firm regulatory functions of the National Association of Securities Dealers, Inc. ("NASD") and NYSE Regulation, Inc., a subsidiary of the New York Stock Exchange LLC. FINRA, a consolidated self-regulatory organization, operates with SEC oversight, and is responsible for regulating all securities firms doing business with the public, including the regulation (under contract) of the Nasdaq Stock Market, Inc., the American Stock Exchange LLC, the International Securities Exchange, LLC, and the Chicago Climate Exchange. *See* www.finra.org/aboutfinra/corporateinformation/index.htm.

* *STEVEN M. WITZEL is a partner at Fried, Frank, Harris, Shriver & Jacobson LLP in the Government Investigations and Regulatory Counseling practice in the firm's New York office. ERIC A. HIRSCH is an associate in the Litigation Department in the firm's New York office. Their e-mail addresses are, respectively, steven.witzel@friedfrank.com and eric.hirsch@friedfrank.com. Erica L. Markowitz, a summer associate, assisted with the preparation of this article.*

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RELEVANT SUPERVISION REQUIREMENTS

The SEC, CFTC, and FINRA all have the authority – through statute or rule – to bring an enforcement action for the failure to adequately supervise trading activities.

SEC Enforcement

Section 15(b)(4)(E) of the Securities Exchange Act of 1934 permits the SEC to impose sanctions against a broker-dealer if the broker-dealer:

> has failed reasonably to supervise, with a view to preventing violations of [among others, the provisions of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, and the Commodity Exchange Act], . . . another person who commits such a violation, if such other person is subject to his supervision.[2]

To establish a failure to supervise, the SEC must show (i) an underlying violation of the securities laws; (ii) association of the registered representative or other person who committed the violation; (iii) supervisory jurisdiction over that person; and (iv) failure to reasonably supervise the person committing the violation.[3]

The SEC has stated that a broker-dealer may discharge its responsibilities "by having established procedures, and a system for applying such procedures, which would be expected to prevent and detect" securities law violations.[4] Broker-dealers must also "provide effective staffing, sufficient resources, and a system of follow-up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers, and other personnel is being diligently exercised."[5] These principles apply equally in both the rogue trading and rogue broker context.

In a recent fraudulent trading case, the SEC brought a regulatory action against AG Edwards for defrauding over 200 mutual funds by circumventing restrictions that the mutual funds imposed on market timing.[6] As a result of the scheme, during the relevant time period, AG Edwards received approximately $1.93 million in fees from a number of market-timing customers.[7] In a May 2007 decision, an administrative law judge found that AG Edwards violated Sections 17(a) and 10(b) of the Exchange Act, as well as Section 15(b)(4)(E).

According to the Administrative Order, certain AG Edwards brokers (referred to as "financial consultants" by AG Edwards) opened a number of accounts on behalf of customers, including several large hedge funds, through which those customers engaged in market-timing trades. Most of the trades were in mutual funds that prohibited market-timing trades. When AG Edwards received "hundreds of telephone calls, letters, e-mails, and canceled trade notices" from the mutual fund companies as a result of the trades, the financial consultants did not stop, but instead attempted to conceal the market-timing activity through techniques designed to disguise the fact that the same customer was responsible for multiple short-term trades.[8] Specifically, the financial consultants used multiple accounts for the same customer, opened accounts in the names of entities affiliated with the same customer, opened accounts at different branch offices for the same customer, traded using different financial consultant identification numbers, and transferred assets between related accounts.

The SEC found that AG Edwards failed to put reasonable policies and procedures in place to stop the trades. In particular, it found that branch managers allowed financial consultants to obtain more than one identification

[2] 15 U.S.C. § 78o(b)(4)(E).

[3] *In re Dean Witter Reynolds Inc. et al.*, Initial Decision Release No. 179, at 40 (Jan. 22, 2001).

[4] *In re Detwiler, Mitchell, Fenton & Graves, Inc.*, Securities Exchange Act of 1934 Release No. 56363, at 2 (Sept. 6, 2007) (citation and quotation omitted).

[5] *Id.* at 3.

[6] "'Market timing' refers to (a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing." *In re AG Edwards & Sons, Inc.*, Securities Exchange Act of 1934 Release No. 55692, at 2 n.2 (May 2, 2007).

[7] *Id.* at 3.

[8] *Id*.

number that could be used to place trades and approved an unusual number of requests to open new accounts. It further found that AG Edwards did not have sufficient policies and procedures in place to determine whether these requests for new accounts and new identification numbers were being made for legitimate purposes. Although it formed a working group to evaluate the complaints it was receiving from mutual funds about market-timing activity, and although that working group recommended that AG Edwards take steps to prevent such activity, the firm "did not develop or implement any policies or sufficient procedures to address the market-timing activity" for almost one year after the working group had been convened.[9]

AG Edwards settled with the SEC, and was required to pay disgorgement and interest of $2.4 million, as well as a $1.5 million civil penalty. AG Edwards was also required to retain an independent consultant to review its supervisory policies and procedures.

In another recent trading case, the SEC fined Boston-based Detwiler, Mitchell, Fenton & Graves, Inc. ("DMFG") in September 2007 for failing to supervise a rogue broker (Bradford C. Bleidt) who misappropriated over $31 million from customers and falsified account statements.[10] According to the release, DMFG permitted Bleidt to both hire and set the salary of the employee responsible for supervising his trading. The SEC also found that DMFG did not implement existing supervisory procedures, in that, among other things, it failed to investigate how the broker was funding his substantial outside business activities (which, it turns out, were used as a cover to misappropriate client funds), and failed to monitor incoming mail (which would have revealed unusual liquidations of brokerage accounts).[11]

In addition to providing for liability for the failure to supervise, the Exchange Act contains a safe harbor provision whereby a firm can avoid liability if:

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.[12]

Although this safe harbor is based on a reasonableness standard, that "determination must be made in light of the particular violations at issue."[13] Accordingly, if reasonable supervisory procedures are in place that would have detected the primary violation and the persons responsible for enforcing the procedures have effectively implemented them and/or had no reason to believe that they are not being complied with, there is no Section 15 liability.[14]

Perhaps the most notable instance of a firm avoiding liability through use of the safe-harbor is *In re Dean Witter Reynolds, Inc.* There, the SEC alleged that Dean Witter failed to supervise a rogue broker who was "churning" retail customer accounts – the broker engaged in excessive trades in the accounts of elderly and financially unsophisticated customers to generate commissions.

An administrative law judge held that Dean Witter was not liable for failing to supervise the broker. Dean Witter had in place documented supervisory systems and controls around the rogue broker. Those controls called for the appropriate Dean Witter branch manager to conduct a factually intensive investigation when notified of questionable trading activity by the compliance department. Although the branch manager conducted such an investigation, he failed to uncover the broker's fraud. The judge ruled that "Dean Witter's procedures cannot be judged in hindsight or with information learned long after the events in question occurred" and found that Dean Witter was entitled to the Section 15(b)(4)(E) safe harbor protection.[15] Specifically, the judge found that Dean Witter's procedures, which required the compliance department to "identify qualitative factors" that may give rise to questionable trading activity and then notify and rely on the appropriate Dean Witter branch manager to perform

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[9] *Id.* at 4-5.

[10] *In re James X. McCarty*, Securities Exchange Act of 1934 Release No. 56364, Investment Advisers Act of 1940 Release No. 20644 (Sept. 6, 2007). Bleidt pleaded guilty to federal charges of mail fraud and money laundering and was sentenced to 135 months (11 years, three months) in prison. *In re Detwiler*, Exchange Act Release No. 56363, at 2.

[11] *Id.* James McCarty, Bleidt's direct supervisor for over 10 years, "accepted Bleidt's explanation that the source of his money was a 'trust fund,' without any evidence of the existence of the trust fund and the dollar amounts therein." *In re McCarty*, Exchange Act Release No. 56364, at 4. McCarty was fined $50,000 for his supervisory failures under Section 15(b).

[12] 15 U.S.C. § 78o(b)(4)(E)(i) & (ii).

[13] *In re Dean Witter*, Initial Decision Release No. 170, at 44.

[14] *Id.* ("The test is not whether Respondents' supervision of Oberholzer was reasonable generally, but whether it was reasonably designed to detect and prevent Oberholzer's churning and unsuitable trading.").

[15] *In re Dean Witter*, Initial Decision Release No. 170, at 50.

an investigation, were "reasonably designed to prevent and detect [the broker's] churning and unsuitable trading."[16]

CFTC Enforcement

The CFTC employs a similar framework as the SEC in requiring its member firms to monitor and supervise. The CFTC's customer protection regulation, Section 166.3, requires that a registrant:

> must diligently supervise the handling by its partners, officers, employees, and agents . . . of all commodity interest accounts carried, operated, advised, or introduced by the registrant and all other activities of its partners, officers, employees, and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.[17]

Although there is no explicit safe harbor for firms that have adequate supervisory procedures in place, the CFTC has confirmed that there is no violation of Commission Regulation 166.3 unless the Commission demonstrates that "(1) the registrant's supervisory system was generally inadequate; or (2) the registrant failed to perform its supervisory duties diligently."[18]

In a 2008 CFTC enforcement proceeding against Chicago-based and registered futures commission merchant Alaron Trading Corporation, the CFTC elaborated on the supervisory standards that registrants must follow. The CFTC order settling the charges against Alaron describes the deficiencies in Alaron's supervisory systems that permitted unregistered activity and unauthorized trading to go undetected. Although the firm received numerous indications that it was permitting an unregistered commodity trading advisor to manage accounts and allowing an introducing broker to trade customer accounts without authorization, Alaron did not have adequate compliance procedures to discover, deter, and terminate the wrongful conduct. The CFTC Order notes that Regulation 166.3 requires every CFTC registrant to "diligently supervise" the activities and handling of its commodity interest accounts, and imposes affirmative duties to "develop procedures for the detection and deterrence of possible wrongdoing by its agents," and to reasonably investigate alleged incidents of misconduct.[19]

FINRA's Proposed Enforcement Regulations

In May 2008, FINRA released for public comment its proposed consolidated rules governing supervision and supervisory controls of member firms. The proposed rules are based primarily on NASD Rules 3010 and 3012, although they also incorporate concepts from NYSE Rule 342.

Proposed FINRA Rule 3110 requires member firms to "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations," including applicable FINRA and Municipal Securities Rulemaking Board rules.[20] It also mandates member firms to:

> establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and MSRB rules.[21]

Although there is no safe harbor in the proposed rules for firms that demonstrate that they have adequate

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[16] *Id.*

[17] 17 C.F.R. § 166.3 (2007).

[18] *In re Alaron Trading Corp.*, CFTC No. 08-10, 2008 WL 1829519 at *4 (C.F.T.C. Apr. 18, 2008) (finding firm liable for failing to have appropriate procedures in place to detect unauthorized trading in non-discretionary account); *see also Sasse & Sasse v. Kahn et al*., CFTC No. 06-R027, 2008 WL 696361 at *14 (C.F.T.C. Mar. 14, 2008) ("An assessment of an alleged violation of rule 166.3 should focus on the nature of a respondent's system of supervision, the supervisor's role in that system, the evidence that the supervisor did not perform his assigned role in a diligent manner, and the extent to which the supervisory breach played a substantial role in the wrongdoing that proximately caused the damages.").

[19] *In re Alaron Trading Corp.*, 2008 WL 1829519 at *4-5. When the conduct at issue rises beyond individual wrongdoing and a failure to supervise, and implicates trading or manipulative behavior by the firm as an entity, the CFTC can bring a civil action in federal court to enforce the Commodity Exchange Act, 7 U.S.C. § 1 *et seq. See* Complaints, *U.S. Commodity Futures Trading Commission v. Optiver US, LLC et al.*, 08 Civ. 6560 (S.D.N.Y. July 24, 2008) (alleging price manipulation of oil and gasoline futures contracts on the New York Mercantile Exchange ("NYMEX")); *U.S. Commodity Futures Trading Commission v. Amaranth Advisors, L.L.C. et al.,* 07 Civ. 6682 (S.D.N.Y. July 25, 2007) (alleging price manipulation of natural gas futures contracts on the NYMEX); *see also* David Mitchell & David Morris, *CFTC Concludes Largest Manipulation Settlement In Its History*, FUTURES & DERIVATIVES LAW REPORT, March 2008 (describing CFTC settlement with British Petroleum).

[20] FINRA Regulatory Notice 08-24, Supervision and Supervisory Controls (May 2008): Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls, Proposed FINRA Rule 3110(a).

[21] Proposed FINRA Rule 3110(b).

supervisory procedures in place, FINRA has set forth "Sanctions Guidelines" which, like the SEC's Seaboard guidelines, provide some insight into how FINRA will take into account mitigating behavior by member firms under investigation.[22] The FINRA Sanctions Guidelines state that the organization will consider "[w]hether, at the time of the violation, the respondent member firm had developed reasonable supervisory, operational, and/or technical procedures or controls that were properly implemented."[23]

The public comments to the proposed supervision rules are wide and varied, but of particular importance are two changes that appear to broaden the scope of FINRA's regulatory power beyond the existing NASD and NYSE rules. The first is Proposed FINRA Rule 3110(a), requiring each member to maintain a system to supervise all "associated persons."[24] The new language leaves unclear whether the supervision requirement now applies to all employees at a member firm irrespective of whether they are directly engaged in the investment banking or securities business.[25] The term "associated person" may also be overly burdensome in that it could extend the FINRA rules to individuals outside of the United States as well as to individuals subject to other regulatory agencies.[26] The second is Proposed FINRA Rule 3110(a)(2), which would require that firms designate a registered principal to supervise "each type of business" in which the member firm engages, unlike the existing NASD regulation which requires supervision only for those businesses requiring registration as a broker-dealer.[27] The public comments raise the concern that this new requirement could place securities-trained principals in oversight positions over activities unrelated to securities that they are unable to effectively supervise.[28]

RECENT HIGH PROFILE TRADING SCANDALS

In January 2008, Société Générale – one of Europe's largest financial services firms – suffered a $7.2 billion loss while unwinding unauthorized positions taken on by a trader, Jérôme Kerviel, who had exceeded his trading authority. The investigation conduced by Société Générale's General Inspection department, as detailed in a May 2008 report (the "SG Report"), found that Kerviel engaged in unauthorized trading activity between 2005 and January 2008 and falsified entries in Société Générale's trading systems to conceal those unauthorized trades. The SG Report criticized (among other things) the "weakness of the supervision by [Kerviel's] direct manager, without which the fraud would probably have been detected more rapidly," the insensitivity of internal control functions to the possibility of fraud, and the rapid growth of trading operations, which outpaced SG's middle and back offices.[29]

In February 2008, MF Global, Inc. – the world's leading broker of exchange-listed futures and options – incurred a loss of $141.5 million in connection with liquidating positions that were the result of unauthorized trades of between 15,000 to 20,000 wheat futures contracts by a retail trader. The trader, Evan Dooley, made the trades in his personal account through MF Global in the early morning hours of February 27.[30] MF Global had existing automated "buying power controls" that were designed to prevent accounts from taking on large positions with margin requirements that could not be supported by the account. According to MF Global, Dooley circumvented this control by making these trades at a trading terminal that had this feature disabled – MF Global had made the business decision to disable this control on certain internal

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[22] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001).

[23] FINRA Sanctions Guidelines at 6.

[24] Proposed FINRA Rule 3110(a).

[25] *See* Letter from Jill Ostergaard and Christopher Mahon, Chairs of Self-Regulation and Supervisory Practices Comm., Securities Industry and Financial Markets Association, to Marcia E. Asquith, Senior Vice President and Corporate Sec'y, FINRA (June 13, 2008), at 2-3 ("SIFMA Letter"); Letter from James Rabenstine, Vice President of Broker-Dealer Operations, Nationwide Financial Services., Inc., to Marcia E. Asquith, Senior Vice President and Corporate Sec'y, FINRA (June 13, 2008), at 1-2; Letter from Shawn M. Mihal, Chief Compliance Officer, Great American Advisors, Inc. to Marcia E. Asquith, Senior Vice President and Corporate Sec'y, FINRA (June 13, 2008).

[26] *See* SIFMA Letter, *supra* note 25, at 3.

[27] *Compare* Proposed FINRA Rule 3110(a)(2) *with* NASD Rule 3010(a)(2) ("Each member shall establish and maintain a system to supervise the activities of each *registered representative, registered principal, and other* associated person that is reasonably designed to achieve compliance with applicable securities laws . . . .") (italicized language not present in proposed FINRA rule).

[28] *See* Letter from Ronald C. Long, Dir. of Regulatory Affairs, Wachovia Securities, LLC, to Marcia E. Asquith, Senior Vice President and Corporate Sec'y, FINRA (June 13, 2008), at 3; Letter from Bari Havlik, Senior Vice President and Chief Compliance Officer, Charles Schwab & Co., Inc. to Marcia E. Asquith, Senior Vice President and Corporate Sec'y, FINRA (June 13, 2008), at 1-2.

[29] May 20, 2008 SG Report at 7.

[30] Press Release, MF Global, Inc., *MF Global Announces $141.5 Million Bad Debt Provision* (Feb. 28, 2008); MF Global Update Conference Call (Feb. 28, 2008), *available at* http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-calendar.

trading terminals in order to execute large trades more efficiently.[31]

In addition, the collapse of the subprime mortgage market has forced many large investment banks to write down the value of mortgage assets. Reports have begun to surface that some of these mortgage assets may have been fraudulently inflated by employees. For example, in February 2008 Credit Suisse First Boston dismissed a group of employees who purportedly improperly inflated the value of mortgage assets by $2.65 billion during the fourth quarter of 2007.[32]

These are only the latest, however, in a long line of trading scandals. Each of the following illustrates the dire – and potentially institution-ending – consequences of the failure to adequately supervise trading activity.

- **Crédit Agricole (Calyon) (2007)**: $353 million loss in credit derivatives trading. According to Crédit Agricole, this loss at Calyon, its investment banking unit, arose from trades in indices linked to credit default swaps during the last days of August 2007 and in excess of authorized trading limits. The trader responsible for the position, Richard "Chip" Bierbaum, disputes that the trades were made without permission. In addition to Bierbaum, Crédit Agricole dismissed two of Bierbaum's superiors, and three others have "left the firm."[33]

- **Bank of Montreal (2007)**: $618 million commodities trading loss in a portfolio that traded in natural gas options. According to the Bank of Montreal, the portfolio was marked-to-market each day by the traders and the valuations were confirmed by its principal broker. The traders were dismissed and the Bank of Montreal suspended its relationship with the brokerage after a third-party review of the bank's risk measurement, valuation, and control practices.[34] The matter is currently being investigated by a New York State grand jury and the U.S. Attorney's Office, along with the CFTC and the SEC.[35]

- **British Petroleum (2004):** $10 million loss from a failed scheme to manipulate and corner the Texas Eastern Transmission ("TET") propane market in February 2004. Traders at BP purchased substantially all of the available supply of February 2004 TET Propane in the U.S. in an attempt to drive up the price for anyone that needed to purchase propane during that month. Senior BP managers, including BP's Chief Operating Officer and its Compliance Manager, were charged with knowledge of the scheme.[36]

- **National Australia Bank (2004)**: $283 million loss in fraudulent currency options trading. According to an investigative report by PricewaterhouseCoopers, four traders exploited a flaw in the bank's back-office computer systems to enter fake currency options trades in order to smooth profits and conceal trading losses. The report also criticized National Australia for routinely ignoring limit breaches by the trading desk.[37]

- **Allied Irish Bank (Allfirst) (2002)**: $691 million loss in foreign exchange options trading. Baltimore-based trader John Rusnak falsified bank records and documents – as with National Australia, using fake options trades – to conceal trading losses.[38]

- **Deutsche Morgan Grenfell (DMG) (1997)**: $700 million loss in unauthorized equities trading. Peter Young, a UK-based DMG fund manager, made unauthorized, off-market investments in highly speculative stocks, and engaged in a scheme by which Young used transactions with shell companies he

[31] *Firm's Stock Tanks After Trader's $141.5 Mil. Loss; Company is Largest Brokerage at Chicago Exchanges,* CHICAGO SUN-TIMES, Mar. 1, 2008; Christine Birkner, *Trader Clips MF Global for $141.5 Million*, FUTURES CHICAGO, Apr. 1, 2008.

[32] Louise Story, *A Question of Value: What's an Asset Worth? It's Not Always Easy to Tell*, N.Y. TIMES, June 20, 2008.

[33] Pierre Paulden, Jacqueline Simmons, and Hamish Risk, *Calyon Trader Fired for Losses Says He's No Rogue*, BLOOMBERG, Oct. 10, 2007.

[34] Press Release, BMO Financial Group, *BMO Financial Group Issues Update on Commodities Trading Losses* (May 17, 2007).

[35] *See* Tara Perkins, *U.S. Futures Brokerage Probed Over BMO Trades*, THE GLOBE AND MAIL, June 19, 2008.

[36] Mitchell & Morris, *supra* note 19, at 3.

[37] PricewaterhouseCoopers, LLP, *Investigation Into Foreign Exchange Losses at the National Australia Bank* (Mar. 12, 2004) ("National Australia Report").

[38] Promontory Financial Group and Wachtell, Lipton, Rosen & Katz, *Report to the Board of Directors of Allied Irish Banks, P.L.C., Allfirst Financial Inc., and Allfirst Bank Concerning Currency Trading Losses* (Mar. 12, 2002) ("Ludwig Report"). Ironically, two years before their own trading scandal broke (and just before the improper trading activity began in earnest), the National Australia board of directors received a presentation based on the Ludwig Report (which Allied Irish made available to the public). The head of National Australia's currency trading desk (who was terminated in connection with the National Australia trading scandal) concluded at the time that "National has appropriate controls to identify control breakdowns on a timely basis to ensure that any losses are minimized." National Australia Report at 48.

controlled to manipulate the conversion of warrants held by the DMG fund for his personal benefit.[39]

- **Sumitomo Trading Corp. (1996)**: $2.6 billion loss in copper futures trading. Sumitomo is the world's biggest supplier of processed copper. Yasuo Hamanaka, the head of Sumitomo's copper trading desk, used futures contracts to manipulate the price of copper on the commodities markets for "perhaps as long as a decade."[40] Although explicitly making no finding as to whether Hamanaka's activities were in fact unauthorized, the CFTC found that Hamanaka did not enter trades in Sumitomo's normal bookkeeping system and also forged the signatures of his superiors on documentation used to effectuate his trading activity.[41]

- **Barings Bank (1995)**: $1.4 billion loss in unauthorized futures contracts trading. Nick Leeson, a trader based in Singapore, was supposed to be engaged in an arbitrage strategy that took advantage of price differences between the Nikkei Stock Exchange and the Singapore Exchange. Instead, he made significant and highly leveraged directional bets on the market using futures contracts that he purchased primarily on the Singapore Exchange.[42] Leeson took advantage of the fact that he had been given control over Barings' trading and back-office functions in Singapore, and created an error account that he used to conceal his trading losses.

- **Daiwa Bank (1995)**: $1.1 billion loss in unauthorized government bond trading. Over the course of *12 years*, trader Toshihide Iguchi concealed losses due to his unauthorized trades by liquidating securities held in Daiwa's custody accounts and falsifying Daiwa's custody records. Iguchi also admitted embezzling funds from Daiwa "to provide money for his family if Daiwa discovered his crimes."[43] When Iguchi confessed his scheme to Daiwa management, "the senior management of Daiwa and its New York branch directed that those losses be concealed from U.S. bank regulatory and law enforcement authorities for almost two months."[44]

- **Kidder Peabody (1994)**: $350 million loss in Treasury securities trading. Orlando "Joseph" Jett took advantage of a flaw in Kidder Peabody's back-office systems to create the appearance of trading profits. Tasked with making a profit by taking advantage of small price differences between STRIPS (components of treasury bonds) and recons (treasury bonds reconstituted from STRIPS), Jett discovered that Kidder's back-office systems automatically (and erroneously) accrued a profit when settlement dates were set in the future rather than the day of the trade.[45] Because the false profit deteriorated as the settlement date approached, Jett was forced to "enter more and more forward recons, with more and more distant settlement dates" in order to maintain the illusion of profitable trading.[46]

- **Orange County, California (1994)**: $1.6 billion loss in unauthorized trading and investments. Robert L. Citron, Orange County's treasurer, invested in reverse repurchase agreements in order to generate interest income for Orange County. Citron's investments were predicated on the assumption that interest rates would remain low. When interest rates increased, Orange County suffered a substantial loss and was forced to declare bankruptcy. The SEC found that the Orange County Board of Supervisors did not understand Citron's investment strategy, the risks of that strategy, or the potential risk of loss inherent in the strategy.[47]

LIABILITY AND CONSEQUENCES

In addition to the staggering financial losses that directly result from the unauthorized trading activity, firms and their employees can face a broad array of penalties and sanctions as well as significant economic consequences

[39] Press Release, The Serious Fraud Office, *Peter Young -- Hearing of the Facts* (June 13, 2003).

[40] Stephanie Strom, *A Market Ripe for Manipulation; Laxity in London Opened Door for Sumitomo Trader*, N.Y. TIMES, Jul. 12, 1996.

[41] *In re Sumitomo Corp.*, 96 Comm. Fut. L. Rep. (CHH) ¶ 27, 327, 1998 CFTC LEXIS 96, at *6 & n.2 (May 11, 1998).

[42] Richard W. Stevenson, *The Collapse of Barings: The Overview; Young Trader's $29 Billion Bet Brings Down a Venerable Firm*, N.Y. TIMES, Feb. 28, 1995; Richard W. Stevenson, *Breaking the Bank -- A Special Report; Big Gambles, Lost Bets Sank a Venerable Firm*, N.Y. TIMES, Mar. 3, 1995.

[43] Sheryl Wudunn, *Daiwa Bond Trader Puts His Spin on Scandal*, N.Y. TIMES, Jan. 13, 1997.

[44] Press Release, Federal Deposit Insurance Corporation, *Regulators Terminate the U.S. Operations of Daiwa Bank, Ltd. Japan* (Nov. 2, 1995).

[45] This profit "was illusory and there was no legitimate purpose or economic reality behind the entry of forward recons into the computer." *In re Kidder Peabody Secs. Litig.*, 10 F. Supp. 2d 398, 404 (S.D.N.Y. 1998).

[46] *Id.*; *see also In re Orlando Joseph Jett*, Securities Act of 1933 Release No. 8395, Securities Exchange Act of 1934 Release No. 49366 (Mar. 5, 2004).

[47] *Report of Investigation In the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Exchange Act Release No. 36761 (Jan. 24, 1995).

when that activity goes undetected, including criminal convictions, civil fines and liability, the imposition of independent monitors, and even the destruction of the entire firm. The consequences and liabilities for failing to adequately supervise apply equally to unauthorized proprietary trading as well as to more "traditional" frauds involving embezzlement or theft from brokerage customers.

Criminal Charges Against Individuals

Jérôme Kerviel is facing criminal charges in France for his unauthorized trading at Société Générale.[48] In connection with the fraudulent currency options trading at National Australia Bank in 2004, four traders were sentenced in Australia to terms of imprisonment ranging from eight to 44 months.[49] As a result of the scandal at Allied Irish in 2002, John Rusnak was sentenced to federal prison for 7.5 years.[50] Criminal charges were brought against Peter Young in connection with the unauthorized equities trading at DMG, but Mr. Young was declared unfit for trial by a U.K. court.[51] The individual at the center of the Sumitomo trading scandal – Yasuo Hamanaka – served a prison term in Japan of eight years.[52] Nick Leeson, the trader that brought down Barings Bank, was sentenced to 6.5 years in "a gang-ridden Singaporean jail, in conditions that defy belief."[53] Toshihide Iguchi spent four years in a federal prison, and one of his managers – Masahiro Tsuda – served a two-month prison term as a result of his role in Daiwa's attempt to cover-up Iguchi's unauthorized trading after Iguchi disclosed his activities to Daiwa management.[54] Former Orange County treasurer Robert Citron was sentenced to one year in jail for his role in the trading losses that led to the county's bankruptcy.[55] Bradford Bleidt of DMFG is currently serving an 11.25 year sentence for his theft of funds from brokerage customer accounts.[56]

Currently, four former employees of British Petroleum are facing criminal charges of conspiracy to manipulate the propane market in federal court in Houston.[57]

Criminal Charges Against the Firm

British Petroleum entered into a deferred prosecution agreement and paid a criminal penalty of $100 million to the U.S. Treasury to settle U.S. criminal charges including violations of the Commodity Exchange Act, mail fraud, and wire fraud.[58] Daiwa Bank paid $340 million to settle U.S. criminal charges including conspiracy, mail and wire fraud, obstructing an examination of a financial institution, falsification of bank records, and failure to disclose federal crimes.[59] Worse, Daiwa was expelled by the Federal Reserve from operating in the United States because Daiwa "engaged in a pattern of unsafe and unsound banking practices and violation of law over an extended period of time," and actively worked to conceal these crimes from regulators and the public "for almost two months" after Daiwa's management had become aware of them.[60]

Independent Monitors

Société Générale (SG Cowen) has commissioned PricewaterhouseCoopers to monitor, on a quarterly basis, SG Cowen's remediation efforts. PwC will report to SG Cowen's Audit Committee.[61] British Petroleum was forced to submit to an independent monitor to oversee BP's

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[48] Katrin Bennhold, *Société Générale Trader Insists He Wasn't the Only One*, N.Y. TIMES, July 24, 2008. In July 2008, French prosecutors also requested that criminal charges be brought against Kerviel's trading assistant. *Id.*

[49] Press Release, Australian Securities & Investments Commission, *Former NAB Foreign Currency Options Trader Sentenced* (July 4, 2006).

[50] *Ex-Currency Trader Sentenced to Seven and a Half Years*, N.Y. TIMES, Jan. 18, 2003.

[51] Press Release, The Serious Fraud Office, *Peter Young -- Hearing of the Facts* (June 13, 2003).

[52] James Arnold, *Rogue Traders of Our Time*, BBC NEWS, Feb. 6, 2002, *available at* http://news.bbc.co.uk/1/hi/business/1804410.stm.

[53] Nick Leeson – Official Website, http://www.nickleeson.com (last visited July 2008). Leeson's unauthorized trading was conducted in Singapore. Although he fled the country when his fraud was exposed, he was ultimately extradited back to Singapore where he stood trial on fraud charges. Singapore's Commercial Affairs Department also launched a criminal investigation against two of Leeson's supervisors, but the investigation was ultimately dropped for lack of evidence. *See International Briefs; Charges Against 2 Dropped in Singapore*, N.Y. TIMES, June 14, 1996.

[54] Sheryl Wudunn, *Daiwa Bond Trader Puts His Spin on Scandal*, N.Y. TIMES, Jan. 13, 1997.

[55] *Orange County Jail Term Set*, N.Y. TIMES, Nov. 20, 1996.

[56] *In re Detwiler*, Exchange Act Release No. 56363, at 2.

[57] Indictment, *United States v. Radley*, No. 07 Cr. 689 (N.D. Ill. Oct. 25, 2007). The action was transferred to the U.S. District Court for the Southern District of Texas. As of July 2008, that prosecution was still pending.

[58] Deferred Prosecution Agreement, *U.S. v. BP America, Inc.*, No. 07 Cr. 683 (N.D. Ill. Oct. 25, 2007).

[59] *$2 Million Fine Levied; Daiwa Trader Sentenced to 4 Years*, CHICAGO TRIBUNE, Dec. 17, 1996.

[60] Press Release, Federal Deposit Insurance Corporation, *Regulators Terminate the U.S. Operations of Daiwa Bank, Ltd. Japan* (Nov. 2, 1995).

[61] Report of the Board of Directors to the General Shareholders Meeting, May 22, 2008, at 6.

compliance with the consent order entered into in connection with the settlement and review, and monitor the effectiveness of BP's compliance controls. The independent monitor must also file periodic reports with the CFTC with respect to BP's compliance.[62] AG Edwards was also forced to retain an independent monitor to review its supervisory procedures and policies.[63]

Destruction of the Firm

As a direct result of Nick Leeson's $1.4 billion trading losses, Barings Bank was purchased by the Dutch bank ING for £1 (in connection with the acquisition, ING also agreed to assume all of Barings' liabilities).[64] As an indirect result of the negative press coverage following the disclosure of Joseph Jett's fraud, General Electric sold the assets of Kidder Peabody to PaineWebber in 1995, and the Kidder Peabody name was extinguished after a 130-year presence on Wall Street.[65]

Regulatory Fines, Suspensions, and Disgorgements

Not only was British Petroleum required to pay the $100 million criminal penalty described above, but BP also paid a total of $203 million in civil penalties, including a $125 million fine to the CFTC as part of the settlement with prosecutors and the CFTC.[66] In connection with the unauthorized trading at Kidder Peabody, two of Joseph Jett's supervisors – Edward Cerullo and Melvin Mullin – faced SEC charges. Cerullo paid a $50,000 fine and was suspended from the securities industry for a year. Mullin paid a $25,000 fine and was suspended from the securities industry for three months.[67] In addition to suffering $2.6 billion in copper trading losses, the Sumitomo Corporation was fined $150 million by the CFTC in connection with Yasuo Hamanaka's attempt to manipulate the price of copper.[68] The SEC levied fines and disgorgement, and also suspended individuals from practice as a result of the AG Edwards and DMFG incidents, all typical remediations in SEC enforcement actions.[69]

Civil Liability

General Electric paid $19 million to settle a class action lawsuit arising from the Kidder Peabody trading scandal in which GE investors alleged they overpaid for GE stock in 1993 and 1994 because of the phony profits generated by Joseph Jett.[70] Officers and directors of Daiwa Bank were ordered by a Japanese court to pay the equivalent of $774 million in civil damages to shareholders as a result of the Daiwa trading scandal. The ruling was ultimately appealed, however, and the defendants entered into a settlement with Daiwa shareholders for the equivalent of just under $2 million.[71] Allied Irish paid $2.5 million to settle a consolidated class action lawsuit alleging that the firm issued financial statements that contained materially false and misleading information about the financial performance and condition of Allied Irish and its subsidiary Allfirst as a result of John Rusnak's foreign exchange trading losses.[72]

Currently, Société Générale is facing a number of class action lawsuits for allegedly making false or misleading statements and for allegedly ignoring "red flags," which should have led it to uncover Jérôme Kerviel's irregular trading and subsequent losses.[73] The complaints (which have taken full advantage of the public dissemination of SG Cowen's internal investigative reports) allege:[74]

- Société Générale ignored over "75 warning signs" over a two-year period, including letters and e-mails to a Société Générale compliance officer regarding Kerviel's transactions;
- Société Générale ignored repeated numbers of cancelled trades;

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[62] Mitchell & Morris, *supra* note 19, at 7.

[63] *AG Edwards*, Exchange Act Release No. 55692, at 2 n.2.

[64] *See* Suzanne Kapner, *ING Group to Trim Investment Banking Units*, N.Y. TIMES, Nov. 20, 2000.

[65] *See* Robert L. Simons & Antonio Davila, *Kidder, Peabody & Co.: Creating Elusive Profits* (1996) (Harvard Business School; HarvardBusinessOnline).

[66] Consent Order for Permanent Injunction and Other Relief, *U.S. Commodities Trading Commission v. B.P. Products North America, Inc.*, Civil Act. 06-C-3503 (N.D. Ill., Oct. 25, 2007); *see also* Mitchell & Morris, *supra* note 19, at 3.

[67] Saul Hansell, *A Scoundrel or a Scapegoat?* N.Y. TIMES, Apr. 6, 1997.

[68] *In re Sumitomo Corp.*, 96 Comm. Fut. L. Rep. (CHH) ¶ 27, 327, 1998 CFTC LEXIS 96, at *24-25.

[69] *See supra* notes 4, 6, and 11.

[70] *G.E. Settles Shareholders' Suit Over Kidder*, N.Y. TIMES, Mar. 31, 2000.

[71] *49 Former Execs To Pay Daiwa Bank 250 Mil. Yen*, THE YOMIURI SHIMBUN, Dec. 12, 2001.

[72] Allied Irish Banks PLC annual report on Form 20-F, filed with the SEC on May 30, 2007, at 70.

[73] The securities class action plaintiffs have been aided by Société Générale's decision to publish the results of the investigation by its General Inspection department on the internet. That investigation found 39 individual "alerts" "with a direct link to the fraud, further investigation of which could have been liable to identify the fraud", as well as 25 other alerts "having an indirect link with the fraud." May 20, 2008 SG GID Report, Focus No. 14.

[74] *See, e.g.*, Complaint, *Barkett v. Société Générale et al.*, 08 Civ. 2495 (S.D.N.Y. Mar. 12, 2008).

- Société Générale did not change its computer passwords regularly;

- Société Générale was lax in forcing Kerviel to take vacation time to limit his ability to conceal positions;[75]

- Société Générale's back office raised questions about Kerviel's trades, but accepted his explanations (allegedly because the discovered trades were profitable);

- Société Générale encouraged a "culture of risk" by rewarding traders who made risky investments and ignored instances where traders briefly exceeded trading limits. Kerviel had previously been reprimanded for excessive trading, but was not fired or even closely monitored afterwards.

A number of securities class action complaints have also been filed against MF Global, Ltd. The plaintiffs in those actions generally allege that MF Global's public statements concerning the efficacy of its risk management procedures and controls were revealed to be materially false and misleading in light of the disclosures made in connection with Dooley's unauthorized trading in wheat futures.[76]

CONCLUSION AND SOME CONSIDERATIONS

One common theme running through many of these trading scandals is the failure to understand the trades and trading strategies being used by individual traders. The incidents at Société Générale, National Australia Bank, Allied Irish Bank, Barings, and Kidder Peabody all involved false profits from made-up transactions that were not sufficiently scrutinized. Obviously, supervisors should be sufficiently familiar with their traders' strategies that they can explain those strategies to others, and should not accept facile explanations for unexpected profits in books based on small arbitrage strategies. Another common theme is the failure to have or adequately enforce trading limits and other policies. The incidents at MF Global, Calyon, Bank of Montreal, DMG, AG Edwards, DMFG, Alaron, and Orange County all involved circumstances where, if trading limits, trading reviews, and other policies had been strictly enforced or were in place, the unauthorized trading would likely have been detected earlier. A third theme involves the tone at the top, or at certain management levels. The incidents at British Petroleum, Sumitomo, and Daiwa Bank all reflected a weak compliance culture where a rigorous environment would likely have ended the misconduct at an early stage.

The seriousness of the failure to have adequate supervisory controls in place addressing these issues cannot be overemphasized. There is no perfect supervisory framework or set of control protocols that can stop every instance of fraud or rogue trading attempt. However, if policies are reasonable and adequate, frequently updated to reflect changing circumstances and markets, and if documented attempts are made to vigorously implement and enforce those policies, firms can mitigate liability for supervisory violations in actions brought by the SEC, CFTC, or FINRA – and protect themselves from even more serious criminal and civil consequences. ■

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[75] The importance of forcing periodic vacations – which require a different trader to understand and manage the book of the vacationing trader for an extended period of time – was also raised in connection with the Daiwa trading scandal. According to a New York Times report, "When a flood in New Jersey in 1984 kept him from getting to work in Manhattan, Mr. Iguchi, fearing that his losses would be discovered, used his son's rubber boat to reach a pay phone to beg brokers to delay settling his trades rather than have them handled by office colleagues." Sheryl Wudunn, *Daiwa Bond Trader Puts His Spin on Scandal*, N.Y. TIMES, Jan. 13, 1997. In addition, included in the Financial Securities Authority's (UK) list of recommendations to member firms in the aftermath of Société Générale was a "two-week continuous holidays" policy, which the FSA described as a "useful tool in catching a 'rogue trader'." Financial Services Authority, *Market Watch*, Issue No. 25 at 2 (Mar. 2008).

[76] *See, e.g.*, Complaint, *Matassa v. MF Global Ltd. et al.*, 08 Civ. 02895 (S.D.N.Y. Mar. 19, 2008).