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The Importance of Being Honset - Lessons from an Era of Large-Scale Financial Fraud

Anita Ramasastry
University of Washington School of Law

Thomas C. Baxter

THE IMPORTANCE OF BEING HONEST—LESSONS FROM AN ERA OF LARGE-SCALE FINANCIAL FRAUD

THOMAS C. BAXTER, JR. AND ANITA RAMASASTRY*

I. INTRODUCTION

In recent years, we have seen a series of staggering losses sustained by large multinational banking organizations. The Daiwa Bank ("Daiwa"), Barings Bank ("Barings") and the Bank of Credit and Commerce International ("BCCI") are three prominent examples. Each of these institutions suffered losses in excess of $1 billion through unauthorized, fraudulent or unlawful conduct by management. In each of these institutions, there existed a key bank official who broke through what might be considered a billion dollar barrier. At Daiwa Bank's New York Branch, there was Toshihbe Iguchi, its Senior Vice President and bond trader. Barings Bank had Nick Leeson, a futures and commodities trader. In the case of BCCI, we had Agha Hasan Abedi, the President, and his trusted and capable deputy, Swaleh Naqvi.

The actions of these individuals significantly affected the operation of each of these banks. BCCI was completely shut down and subsequently liquidated. Daiwa was forced to leave the United States. Barings became insolvent, but was eventually rescued in an acquisition by a Dutch bank holding company, "ING." More recently, a Japanese multinational corporation, the Sumitomo Corporation, announced that a single copper trader, Yasuo Hamanaka, had concealed over $2.6 billion dollars in copper trading losses for a period of ten years.[1] The recurrence of these events reveals a significant problem. The re-

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* Thomas Baxter is the General Counsel and Executive Vice President, Federal Reserve Bank of New York. Anita Ramasastry is an Assistant Professor of Law, University of Washington School of Law and former Staff Attorney from the Federal Reserve Bank of New York from 1994-1996. The views expressed in this essay are those of the authors, and do not necessarily reflect those of the Federal Reserve Bank of New York, or any other component of the Federal Reserve System. Professor Ramasastry would like to thank Denise Goodstein and Jacqueline Edwards for their assistance.

1. Sheryl WuDunn, *Sumitomo Increases Size of Copper-Trade Loss to $2.6 Billion*, N.Y. TIMES, Sept. 20, 1996, at D3; *see also* Alex Brummer, *Sumitomo: A Very Modern Scandal*, OBSERVER, June 16, 1996, at 38 ("The way in which Sumitomo has presented its phenomenal losses in the copper market is in the tradition of Barings and Daiwa where the deficit has eventually been put down to desperate activities of a lone trader which are always easier for the authorities to deal with").

currence also suggests that it would be a mistake to regard these events as unique situations attributable only to the frailty of the character who caused them to happen.

The magnitude of the losses involved is most striking. It was also unsettling to learn that neither external bank regulators nor internal managers saw the concealment of the losses until they reached such astronomical proportions. In each case, the fraud was aided by the global structure of these banks.

There are many lessons to be learned from these incidents. One major lesson we would like to impart—the importance of being honest. Financial systems, financial markets and financial institutions are based upon trust and confidence. Bank supervisors need to continually assess the sufficiency of their methods. Banks, in turn, need to focus on greater cooperation and compliance with supervisors. Further, the process of supervision will not function effectively if the process is adversarial. Instead, bank supervisors need to be able to rely—for practical reasons—on the veracity of the banks whom they supervise.

II. WHAT'S IN IT FOR US?

Why should banks cooperate? Cooperation and candor can prevent small-scale fraudulent activity from mushrooming into a catastrophic loss. Cooperation is a cost effective method for banks and supervisors to do business. Information sharing is an efficient and less intrusive way for supervisors to gather information. It is to everyone's advantage that supervisors effectively foster sound internal controls, because these controls are the best method to deter fraud and corruption. To do this, supervisors need to be assured of full disclosure from management rather than partial disclosures, cover ups or concealment.[2]

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2. As other commentators note:

> The Daiwa fiasco comes on the heels of similar other financial institutions around the world, including Barings Bank PLC, BCCI, Kidder Peabody, Prudential Securities, Salomon Brothers, and Drexel Burnham .... Given that breaches of regulatory controls are likely to persist, it is important for management to understand, and embrace the principle that prompt and complete disclosure to, and cooperation with, regulators is the best strategy for controlling the risk and fallout from major regulatory lapses.

Gregory M. Petrick & Sheryl A. Odems, *The Lesson of the Daiwa Bank Scandal*, (Dec. 1995/Jan. 1996), INT'L. COM. LITIG., at 5-7.

Trust and cooperation is also valued in the United Kingdom. As Nicholas Durlacher, Chairman of the U.K.'s Securities and Futures Association ("SFA"), a self-regulatory body that supervises trading firms, notes:

> [Firms] are the front line regulators ... If we can trust the regulatory environment then we can adopt a higher level of supervision that is less intrusive., less likely to get in the way of their aspirations to be inventive and make money appropriately and therefore will be more friendly. The balance for the regulator is to be heavy-handed and intrusive on firms that are not up to scratch and light-handed on firms that have good and appropriate

Poor internal control is a common thread in the fabric of each financial fraud. The so-called "rogue traders"—Leeson or Iguchi—are individuals who were permitted by the control environment to become rogues and engage in fraudulent activity.

III. BCCI AND THE BILLION DOLLAR BARRIER

The BCCI case underscored the importance of honesty in the supervisory process.[3] BCCI not only concealed losses from regulators in many jurisdictions but also misled American supervisors when it secretly acquired Independence Bank in the United States. BCCI was first incorporated in Luxembourg in 1974. By the mid-1980s, BCCI looked to the United States as a new home country for its operations.[4] At this time, BCCI had accumulated, but had not disclosed, losses of more than $1 billion—losses which exceeded BCCI's stated capital.

Rather than disclose these losses, BCCI engaged in a complex series of transactions to cover them up. It embezzled the investment accounts of one of its wealthiest customers, the Ruler of Abu Dhabi. It utilized the proceeds of fictitious loans to conceal the existence of other non-performing ones.

At BCCI, Naqvi tried to keep a sinking bank afloat while searching to replenish the bank's lost capital. He made investments in private corporations through nominee shareholders who "fronted" for BCCI, in a desperate attempt to grow the organization out of insolvency. For example, BCCI invested in an oil company, a grain company and a bank in the United States. To make these nominee investments, BCCI needed cash. It obtained cash by originating loans in the names of its frontmen. The loan proceeds were used to buy securities issued by their targets—the non-banking corporations. In a nutshell,

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systems."

Sarah Marks, *Regulators Justify Reactions to Barings and Daiwa* INT'L. FIN. L. REV. Apr. 1996, at 23, 26.

3. Ernest T. Patrikis, the First Vice President of the Federal Reserve Bank of New York has repeatedly emphasized the importance of honesty: "We expect all institutions to deal with us in an honest manner. This is something we learned from the BCCI . . . case when we were mislead about the bank's ownership." Noel Fung, *Fed Official says Bank Co-operation Crucial on Fraud*, SOUTH CHINA MORNING POST, Nov. 6, 1995, at B1.

4. In 1975, a multinational committee of bank supervisors operating under the auspices of the Bank for International Settlements in Basle, Switzerland, issued a set of banking principles known as the "Concordat" governing the supervision of financial organizations engaged in international banking. The Concordat was revised in 1982. The Concordat divided responsibility for supervision of international banking organizations between a "home" country where the institution was chartered and a "host" country where the institution conducts business. The home country bore responsibility for supervising the worldwide activities of the bank. After the 1982 revision to the Concordat, Luxembourg notified BCCI that it was unwilling to serve as BCCI's home country supervisor. After unsuccessfully trying to obtain a full banking license in the United Kingdom, BCCI turned its sights to the United States.

BCCI sought to "invest" its way out of its losses.

On July 4, 1991, BCCI appeared to have $23 billion in assets and conducted business in seventy-two nations including the United States and the United Kingdom. On the next day, BCCI was shut down through the coordinated efforts of regulators and government entities around the world. Swaleh Naqvi, BCCI's former chief executive officer, was eventually prosecuted and is currently imprisoned in a federal penitentiary in Pennsylvania.

The BCCI case caused supervisors worldwide to reexamine the scope and nature of international bank supervision. It prompted the U.S. Congress to enact the Foreign Bank Supervision Enhancement Act ("FBSEA").[5] Foreign banks who seek authorization to conduct operations in the United States now must wait until the Federal Reserve determines that the foreign bank is subject to a sufficient level of supervision by its home regulator.[6] FBSEA gave the Federal Reserve the authority to terminate foreign bank operations in the United States.[7] The Federal Reserve also hired a greater number of bank examiners to conduct on-site examinations.[8]

IV. FRAUD CREEPS—IT DOES NOT SPRINT

Not a single one of these billion dollar losses resulted from impulsive or cataclysmic conduct committed during the course of a day or even a week. Rather, each scandal resulted from a pattern of fraud occurring over a lengthy period of time. Each case started small and grew gradually over time. The losses reached the billion dollar barrier at a slow and steady pace. Fraud creeps along—it does not sprint.

By 1995, Daiwa Bank had lost approximately $1.1 billion through securities trading in its New York branch. Iguchi incurred his first trading loss of $50,000 in 1983. Rather than report the loss, he tried to trade his way out of it. His losses aggregated over time. In 1995, the losses reached a monumental $1.1 billion. Between 1983 and 1995, Iguchi entered into 30,000 unauthorized trades.

Daiwa management apparently learned of Iguchi's malfeasance on July 24, 1995. The senior management of Daiwa and its New York Branch directed the concealment of these losses from United States bank supervisors. Man-

5. Title II, Subtitle A of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2286-2305 (1991) codified as amended at 12 U.S.C. §§ 3101, 3105, 3109-3111 (1994).

6. This can be found in the act at 12 U.S.C. § 3105(d)(2)(A).

7. 12 U.S.C. § 3105(e)(1) (Supp. 1994). The Board of Governors ("Board") may terminate a foreign bank's authority to operate if the bank is not subject to comprehensive consolidated supervision on a worldwide basis, if the Board has "reasonable cause to believe" that the foreign bank has violated a law or if the foreign bank has engaged in unsafe or unsound banking practices.

8. Marks, *supra* note 2, at 25.

agement further orchestrated the continuation of transactions structured to avoid disclosure of these losses.[9] The losses were concealed through sales of securities held in the branch's custody accounts and falsifications of its custody records. By September 18, 1995, Daiwa had reported a trading loss exceeding $1 billion. Until that time, these losses never appeared in the books and records of the bank, nor in its financial statements.[10] The United States eventually compelled Daiwa leave the country and fined the company $340 million.

Nick Leeson's troubles at Barings began with a simple trading error. In the summer of 1992, a clerk accidentally sold, rather than bought, 20,000 futures contracts on the Singapore International Monetary Exchange ("SIMEX"), generating a loss of £ 20,000. Afraid of losing his new position in Singapore and jeopardizing his annual bonus, Leeson did not report the loss, but instead tried to trade his unit "out" of the loss. Leeson opened an "error" account—Account 88888—where he booked his clerk's loss.

Leeson used this account to trade and take long positions in Nikkei 225 futures. He bought a large number of these in the hope that the Japanese stock market would rise. Typically, a trader will match every purchase with a corresponding sale in order to "hedge" his position and minimize risk. Leeson, however, merely purchased the Nikkei futures and made no corresponding sales.

Leeson repeatedly asked for extensions of credit from London headquarters to supposedly cover certain client positions. He used this money to trade for his own account. By August of 1994, Leeson's loss grew from 20,000 to eighty million pounds. After the Kobe Earthquake in January 1995, Leeson's losses had grown to over 600 million pounds. From January forward, the large size of both the SIMEX and Osaka future positions exchanges produced widespread gossip among the Far East common traders.[11] Leeson told Barings' management that these large positions were held for clients. Eventually, these clients were found to be fictitious.

As Leeson's losses accrued, he requested over fifty million pounds to meet

9. *See* Joint Statement issued by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and New York State Banking Department concerning closing of the Daiwa Bank Trust Company, New York (Nov. 6, 1995), at 1.

10. *Id.* at 2.

11. Richard Thomson, *Rogue Trader, Greedy Bank*, INDEPENDENT, Mar. 5, 1995, Bus., at 1. According to the Barings Report, management had become aware of market rumors concerning the scale of Leeson's losses in January 1995. The report concludes that the "market concerns and rumors do not appear to have caused management undue alarm because management thought that, unbeknown to the rumour mongers, Barings' positions were matched with equal and opposite positions on SIMEX." REPORT OF THE BOARD OF BANKING SUPERVISION INQUIRY INTO THE CIRCUMSTANCES OF THE COLLAPSE OF BARINGS, RETURN TO AN ORDER OF THE HONOURABLE HOUSE OF COMMONS 8 (1995) [hereinafter *Barings Report*].

margin calls in January and February of 1995.[12] The people approving Leeson's funding in London were in position to question the need for funds and the behavior which gave rise to such need. Yet, they did not do so and the funding from the head office continued.

V. AN OUNCE OF PREVENTION, A POUND OF CURE

Management needs to pay closer attention to the seemingly mundane tasks such as back-office settlement and document productions, as well as the internal audit function. Internal controls, rather than external regulations, are the best line of defense against bank fraud. In each of the cases mentioned above, the bank's internal controls were weak. Management failed to either identify the weakness or to remedy the deficiency once notified.

The separation of duties is a fundamental concept. If a bank employee performs more than one duty, there is a greater chance that he or she will be able to conceal fraudulent activity. By contrast, if responsibilities are apportioned among different people, a person committing fraud cannot act alone and is monitored by colleagues working in a complementary position.

If a trader is permitted to both execute trades *and* maintain his or her books or accounts, the opportunity for fraud becomes much higher. Consequently, it is very important to segregate what are known as "back office" duties—i.e., the confirmation and settlement of trades and record keeping—from "front office" duties—i.e., trading. Most trades are still confirmed through an exchange of paper. It takes substantial and tedious work, therefore, for auditors to discover irregular trading patterns or fraudulent or forged confirmations and trade tickets. If that work is not done, rogue traders can go undetected for weeks or months.

At BCCI, Naqvi served as a senior executive officer until Abedi became ill and Naqvi was promoted to CEO. He was able to make loans on behalf of BCCI. He made loans to corporations which he secretly controlled through a power of attorney—thus giving him the ability to route loan proceeds from the borrower to wherever they might be needed. Through this loan structure, he could use the proceeds of new loans to cover older loans, in a "Ponzi"-type scheme. In this manner, Naqvi covered up a major hole in BCCI's balance sheet.

At Barings, Leeson was able to disguise losses because he controlled the back office and also took responsibility for managing and creating customer accounts. Leeson was able to establish the secret Error Account 88888. This account was the repository of substantial unauthorized and unreported positions. Iguchi, at Daiwa, attempted to hide mounting losses by concealing trade

12. Both the SIMEX and Osaka exchanges required everyone showing a loss on their positions to lodge margin payments convening their expected losses at the end of each business day.

confirmations.[13] He was responsible for the New York Branch's Treasury trading operations as well as the bank's custodial department—where Treasury and other securities were held for customers and for Daiwa. Iguchi, therefore, traded Treasury securities for Daiwa *and* simultaneously handled fiduciary matters for Daiwa's customers. To cover his losses, Iguchi sold off customer securities. He also falsified accounting and other branch records to mask the trading losses and misappropriation of securities.

In November 1992 and again in 1993, the Federal Reserve and the New York Superintendent of Banking criticized the poor internal controls at the New York Branch. Daiwa provided written notice to the Federal Reserve of the actions taken by Daiwa to separate custody and trading functions at the New York branch.[14] In reality, Daiwa never rectified the control problems. It would appear that Sumitomo also lacked sound internal controls for its trading operations.[15]

VI. SILENCE IS NOT GOLDEN

Supervisors will always have difficulty seeing fraud if they are blinded by the collusive action of the management and the supervised organizations.[16] Iguchi may have been a "rogue" trader. Daiwa management, however, exacerbated the problem with their failure to disclose Iguchi's renegade behavior in a timely fashion, as well as with their affirmative action to conceal it.[17]

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13. Emilio Terazano, *How the Damage Was Done*, FIN. TIMES, Sept. 27, 1995, at 6.

14. *In re* Daiwa Bank, Ltd., Before the Bd. Of Gov. of the Fed. Res. (No. 95-028-B-FB, No. 95-028-B-FBR), at 3 (hereinafter, "Notice of Charges"). In 1993, Federal Reserve examiners learned of Iguchi's dual capacity as senior vice president in charge of custodial services and securities trading at the New York Branch. The examiners flagged this potential conflict of interest. Senior branch official provided written confirmation to examiners that the supervision of trading and custodial activities had been separated at the branch. *See Chronology of the Daiwa Affair*, FIN. TIMES REG. REP., Dec. 1995.

15. Federal Reserve Board Governor Susan Phillips, testifying before the U.S. House Committee on Banking and Financial Services concerning Sumitomo stated: "Individual traders today have the capacity to inflict tremendous losses on their institutions when they are allowed to operate in an environment lacking adequate operating procedures and control .... Managements must build and maintain adequate systems for controlling risk, whether they operate bank or non-bank institutions ...." *Sumitomo Scandal Underscores Need for Risk Control*, METALS WEEK, Sept. 23, 1996, at 10. Professor John Board of the London School of Economics commented "[w]hat seems to have happened is exactly what happened with Leeson and at Daiwa." *See* Marc Levinson, *The Mighty Copper King*, NEWSWEEK, June 24, 1996, at 48.

16. *See* Keith Bradsher, *U.S. Concedes Lax Response in Daiwa Case*, N.Y. TIMES, Nov. 28, 1995, at D1. "If a bank's internal controls fail, 'it is exceptionally unlikely that we will be able ourselves to pick it up.'" *Id.* (quoting Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System). *See also* Ken Kohn, *Managers of Rogue Traders Share Blame for Huge Losses*, HOUSTON CHRON., June 19, 1996 (stating that managers are loath to examine a trader's activity as long as they are making money for the institution).

17. As two commentators note:

In the United States, the supervisory process is a cooperative dialogue between the bank and its supervisor.[18] In a bank examination, personnel from the regulator will visit a banking institution for a full-scope examination, or alternatively, for a special targeted examination directed toward a specific issue. An effective examiner will engage in an open and honest "question-and-answer" dialogue with the bank. The bank answers the examiner's questions and these answers lead to additional questions. When the examiner is satisfied, he or she will set forth his or her conclusions in an examination report.

Bank supervisors and field examiners rely principally upon the representations of the examined. Why? The process of bank examination is not an adversarial process where the supervisor wants to test the alleged facts as if in combat with the bank. Instead, they rely on the representations made by banks. Specifically, supervisors rely on the bank's management to inform them about problems and managerial challenges. If supervisors were to independently verify each and every fact, the bank examination process would never end.[19] Instead, the process relies on candor. As Chairman Greenspan has observed:

> Trust is a principle of central importance to all effective financial systems. Our system is strong and vibrant, in large part because we demand that financial institutions participating in our markets operate with integrity .... When confidence in the integrity of a financial institution is shaken or its commitment to the honest conduct of business is in doubt, public trust erodes and the entire system is weakened.[20]

> Forcing Daiwa to close its U.S. operations, under all the circumstances, appears to have been an appropriate reaction by the U.S. regulatory authorities. Had the issues at Daiwa been limited to transgressions by a senior trader, the outcome would undoubtedly have been less severe .... This was not, therefore, a case of a rogue trader or a rogue subsidiary. Under these circumstances, which were aggravated by the failure of... the fundamental cooperation and trust that must exist between the regulator and the regulated entity had been destroyed.

Michael Gruson & Jonathan M. Weld, *Daiwa Bank's Ouster from the United States: The Aftermath (So Far)*, BANKING POL'Y REP., Feb. 19, 1996, at 1.

18. Some argue that banking supervision should be left to market forces rather than governmental supervision. The general consensus, however, is that some governmental supervision (preferably through disclosure requirements) is necessary. *See e.g.*, Alfred D. Matthewson, *From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks*, 11 J. CORP. L., 139, 140-41 (1986); Michael P. Malloy, *U.S International Banking Policy: Prospects and Problems in a New Millennium*, 15 ANN. REV. BANKING L. 277 (1996) (demonstrating a commitment to at least a minimum level of supervision).

19. The cost would also be prohibitive. *See* Bradsher, *supra* note 16 (citing Alan Greenspan for the proposition that "[a]ny system that attempted to be fail-safe would impose intolerable costs on the public and the banking industry and almost certainly would stifle legitimate financial innovation").

20. *Investigation and Oversight of Daiwa Bank and Daiwa Trust Company: Heatring before the Senate Committee on Banking, Housing and Urban Affairs*, 104th Cong., 1st Sess. 4

Chairman Greenspan further opined that trust should remain a linchpin of the U.S. regulatory regime:

> An assumption that most bankers are truthful should remain the rule, not the exception. When, however, a bank is shown, through repeated actions, that it cannot be trusted, even at the highest levels of the corporation, supervisors should resort to extraordinary regulatory measures.[21]

In the United States, we require banks to file Suspicious Activity Reports. These Reports are meant to reveal possible legal violations committed not only by a bank's customers but also by a bank's employees. Supervisors rely on bank management as the first line of defense when fighting fraud. Chairman Greenspan has also identified management's essential role in preventing fraud: "[I]n any supervisory regime, the ultimate responsibility for the protection of a privately owned bank must rest with the top management of the bank and its directors . . . . Supervisors must, to some extent, rely on this mutuality of interests in performing their tasks."[22] Despite the emphasis on candor, it is questionable whether banks report all activity by employees that they know is truly suspicious. Perhaps they hope the conduct will never be uncovered by bank examiners or supervisors. Banks seem to view filing Suspicious Activity Reports as an almost "last resort." The egregious activity must rise to the level of a crime—rather than the level of suspicion—before a bank feels obliged to file. Yet, as we have seen, small-scale fraud can mushroom into large-scale disaster.

The Bank of England similarly relies on disclosure by English banking institutions as an essential part of the supervisory process. As one commentator indicates:

> "The BOE's traditional technique of supervision, based as they are on trust, frankness and a willingness to cooperate . . . have served the community well," the report said. But "quite a different supervisory approach" should be

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(1995) (statement of Alan Greenspan, Chairman, Federal Reserve Board). Chairman Greenspan continued his remarks:

> Ideally, the whole process of supervision proceeds upon the basis of trust—whether in terms of the veracity of representations or reports filed by management, or transparency with regard to any material developments affecting the financial condition of the institution. This is not to say that supervision can be based solely on trust. Supervisors must test a bank and its management in its compliance with law and sound business practice. An appropriate balance, however, must be struck. Without reliance on trust, an army of permanent resident examiners would be necessary to assure that the operations of a bank are conducted in a manner that is sage and sound . . . Such an approach to supervision is clearly counterproductive to the desired support of a vibrant, innovative banking system. For a supervisor to become a bank's internal auditor would either stifle the independence of management in the bank or create an *unacceptably adversarial process*.

Id. [emphasis added].

21. *Id.*

22. *Id.*

adopted "where trust and frankness are lacking."[23]

This has not been without pitfalls, however, as seen with both BCCI and Barings.[24] With Barings, the BOE did *not* receive the type of information necessary to detect the magnitude of risk in Singapore. The Board of Banking Supervision, in its 1995 Report to the House of Commons, noted that various key factors should have clued Barings management into its risk exposure in Singapore.[25] These so-called key indicators "together provided Barings in Singapore and London with warnings of the danger to which it was exposed."[26] The BOE, however, remained unaware of these indicators:

> The majority of these indicators were not known to the [BOE] and could not have been known to it (under its existing methods of supervision) unless it had been informed by Barings or another regulator. For instance, the [BOE] was unaware of the identification of lack of segregation of duties in BFS between front and back offices and the failure to act on internal audit recommendations following the review of BFS' operations in August 1994, because the [BOE] does not ordinarily receive internal audits from groups which it supervises and does not normally meet with internal auditors.[27]

In 1994, Barings conducted an internal audit of its Singapore operations. The audit identified "significant general risk" in allowing Leeson to dominate both trading and back office functions. The audit also suggested that another manager should review Leeson's dealing records. Despite these concerns, the report recommended that Leeson nonetheless stay involved in a dual capacity. Barings took no action on the report *and did not disclose* its findings to the

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23. Fred Barbash, *Investing's Naked City? Scandals Prompt a Review of Self-Regulation in London's Financial Hub*, WASH. POST, June 20 1996, at D10.

24. *Id.*

25. These factors included:

(a) the identification of the lack of segregation of duties in BFS between front and back offices which was subsequently reflected in the internal audit report following the review of BFS's operations, which was conducted in July and August 1994;

(b) the high level of funding required to finance BFS's trading activities;

(c) the unreconciled balance of funds (the 'top up') account transferred from Barings in London to BFS for margins;

(d) the apparent high profitability of BFS's trading activities relative to the low level of risk as perceived by Barings' management in London . . . .

(g) issues and questions arising out of Barings' report of large exposures and client money to supervisors and regulators;

(h) the high level of inter-exchange arbitrage or ('switching') positions without any application of gross limits; and

(i) market concerns circulating in January and February 1995. . .

Barings Report, *supra* note 11, at 13.

26. *Id.* at 12.

27. *Id.* at 196.

BOE.[28]

The British Securities and Futures Association ("SFA") took disciplinary actions against several of Barings' senior management.[29] With respect to management, the Barings Report states that "those with direct executive responsibility for establishing effective controls must bear much of the blame . . . others at lower levels of management were also at fault for failing to act effectively in relation to their own responsibilities."[30] Management directly failed with respect to the reports it filed with the BOE: "[T]o a considerable extent, the lack of understanding of BFS's trading activities, the lack of reconciliation to client records of the funding provided by Barings in London to BFS and the lack of verification of (false) information provided by BFS, there were deficiencies and inaccuracies in the large exposure reporting to the [BOE]."[31]

BOE's reliance on Baring's management turned out to be misplaced. As the Barings Report indicates "[t]he [BOE] regarded the controls in Barings as informal but effective. It had confidence in Barings' senior management, many of whom were longstanding Barings' employees. Accordingly, it placed greater reliance on statements made to it by management than it would have done had this degree of confidence not existed."[32] Price Waterhouse was commissioned by Singapore's Ministry of Finance to also investigate Barings' conduct. The Ministry of Finance report more directly implicates senior management.[33]

Barings management received both criticism and penalties for its lack of oversight of Leeson's operations. Peter Norris, the former CEO of Barings

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28. Thomson, *supra* note 11, at 1.

29. *See London Regulator Launches Disciplinary Action Against Barings Managers*, Agence France Presse, Mar 15, 1996, *available in* LEXIS, Nexis Library, Current News File.

30. *Barings Report*, *supra* note 11, at 234.

31. *Id.* at 248.

32. *Id.* at 244.

33. The Singapore report highlights the following issues:

- Leeson's trading losses need not have brought down the Barings Group; "it seems probable that until February 1995 [almost four weeks before the going into administration], the Barings Group could have averted the collapse by timely action";
- The collapse of [BFS] was caused by "institutional incompetence";
- Barings chief executive Peter Norris's "explanation after the collapse, namely that senior management of the Barings group believed that Mr. Leeson's trading activity posed little (or no) threat to the Barings group, but yielded very good returns is implausible and in our view, demonstrates a degree of ignorance of market reality that totally lacks credibility" . . . .
- Referring to a £ 50 million discrepancy uncovered by the auditors, the report said: "Mr. Norris also took steps to conceal this matter from other Baring group directors and to discourage Coopers & Lybrand Singapore and C&L London from including the matter in their audit management letters."

Stephen Timewell, *Too Hard to Hold*, 145 BANKER, Nov. 1995, at 22, 23.

Securities has been prohibited from holding a management position in London's financial sectors for three years.[34] He also was fined 10,000 pounds.[35] Eight other directors were charged with misconduct by the SFA.[36] The SFA has also proposed new guidelines holding senior managers in trading firms more directly responsible for ensuring that proper control structures are implemented.[37]

Management in other banks were also exhorted by the British Board of Banking Supervision to:

(1) fully understand the business they manage;

(2) clearly establish responsibility for each business activity conducted by the institution;

(3) establish relevant internal controls for all business activities; and,

(4) senior management must ensure that significant weaknesses are identified and resolved quickly.[38]

In addition, bank supervisors place great reliance on a bank's internal and external auditors. In the case of Daiwa, Barings and BCCI, the auditors failed to prevent huge fraud losses. In Daiwa's case, the auditor did not detect the fraud because he was not even looking.[39] Daiwa's external auditor never visited the New York branch, notwithstanding the fact that it had assets of $10 billion. In BCCI, there were external audits of Cayman and Luxembourg branches. However, these audits failed to uncover the fraud.

VII. A QUESTION OF SURVIVAL

As regulators and banks strive to learn from BCCI, Barings and Daiwa—it

34. *See* Helen Dunne, *SFA Imposes Three-Year Ban on Former Barings Chief Executive*, DAILY TELEGRAPH (London), May 8, 1996, at 22.

35. *Id.*

36. *Id.*

37. *See British Regulator Wants More Management Accountability*, REUTER EUR. BUS. REP., Sept. 3, 1996, BC Cycle, *available in* LEXIS, Nexis Library, Current News File. The proposed standards provide that:

> [I]n the event of serious damage to a firm, either to its financial position or to its reputation as a regulated entity, and the SFA suspects that management failure has been a cause or a contributing factor, the burden of proof will be on the [senior executive officer] to satisfy us of the adequacy of his management.

Robert Miller, *SFA Puts the Onus on Senior Managers*, TIMES (London), Sept. 4, 1996, *available in* LEXIS, Nexis Library, Current News File.

38. Barings Report, *supra* note 11, at 256.

39. *See* Cal Mankowski, *Daiwa Bank Case Signals 'Buyer Beware,'* REUTERS BUS. REP., Sept. 27, 1995, BC Cycle, *available in* LEXIS, Nexis Library, Current News File. ("A spokesman for Ernst & Young in New York said . . . Ernst & Young . . . conducted no audit of the U.S. branch and to the best of the firm's knowledge there was no separate audit in New York").

seems clear that a new focus on management responsibility and accountability is emerging.[40] It is important that the corners with respect to disclosure to supervisors should be turned at perfect ninety degree angles. The reason for the supervisory premium on square corners is that our process depends on it. Supervisors reserve their most serious penalty—their "death penalty"—for the institution they no longer trust. When they no longer trust an institution, the relationship between the supervisor and the supervisee must end in a divorce. Daiwa was asked to cease operations in the United States not because it was the victim of a rogue, but because it became a perpetrator by failing to disclose the $1.1 billion losses in a timely fashion.[41] In the "Notice of Charges" drawn up by the Board of Governors, the Board alleged that:

Section 211.24(f) of Regulation K of the Board of Governors ... requires foreign banks operating in the United States and their agencies and branches to

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40. As one commentator notes:

> Since Barings, the focus has shifted somewhat from number-crunching exercises and the bugbear of derivatives to a broader view of market and credit risk, management, operational risk and control, standards of business conduct and even the culture of an institution and the character of the people who run it.

David Shirreff, *Regulation, The Agony of the Global Supervisor*, EUROMONEY, July 15, 1996, at 48, 49.

41. Order to Terminate Operations Issued Upon Consent, Pursuant to Banking Law Section 39 at 2, *In re* Daiwa Bank Trust Co., Before the N.Y. State Banking Dep't (No. 95-028-C-FB, No. 95-028-C-FBR). The Order issued by the Superintendent and the Board of Governors of the Federal Reserve System and the New York State Banking Department reads as follows:

> WHEREAS, The Daiwa Bank, Limited, Osaka, Japan ("Daiwa") and its branch located in New York, New York (the "New York Branch") have acknowledged that the New York Branch has suffered a loss of about $1.1 billion as a result of unauthorized trading of U.S. Treasury securities;
>
> WHEREAS, such loss purportedly remained undetected by Daiwa and the New York Branch for a number of years;
>
> WHEREAS, such failure to detect the loss is evidence of an unsafe and unsound condition;
>
> WHEREAS ... such loss resulted from the failure by Daiwa and the New York Branch to implement the controls and supervision necessary to conduct the branch's trading and custodial operations in a safe and sound manner;
>
> WHEREAS, Daiwa and the New York Branch violated Part 300 of the Regulations of the Superintendent of Banks of the State of New York (the "Superintendent") and section 211.24(f) of Regulation K of the Board of Governors (12 C.F.R. 211.24(f)) by not reporting the circumstances surrounding this loss to the appropriate law enforcement and bank regulatory authorities as required by the rules and regulations of the Superintendent and the Board of Governors;
>
> WHEREAS, Daiwa and the New York Branch may have knowingly submitted to the Superintendent and the Federal Reserve Bank of New York (the "Reserve Bank") a misleading and inaccurate report of the branch's condition, as of June 30, 1995; ....

Order Issued Pursuant to the New York State Banking Law and the Federal Deposit Insurance Act, as amended at 1-2, *In re* Daiwa Bank, Ltd., Before the Bd. Of Gov. of the Fed. Res. (No. 95-028-C-FB, No. 95-028-C-FBR).

file with the appropriate law enforcement authorities and the Federal Reserve reports of suspected criminal activity within 30 days of learning of such activity. Notwithstanding this regulatory requirement, neither Daiwa nor the New York Branch filed the appropriate criminal referral form. Instead, affirmative steps were taken to conceal it, thereby delaying informing U.S. law enforcement and bank regulatory authorities about a matter that materially impacts on the safety and soundness of the operations of Daiwa and the New York Branch.[42]

For Daiwa's U.S. operation, the U.S. supervisors pronounced a form of death sentence. In Barings, however, the issue of sentencing never reached a supervisory "jury." Leeson's own actions dealt a fatal blow to the institution and Barings died a "natural" death.

For financial institutions, which depend so heavily on customer confidence, the importance of being honest is a life or death matter. Reporting minor fraud is surely preferable to breaking the billion dollar barrier.

42. Notice of Charges, *supra* note 14, at 6-7.