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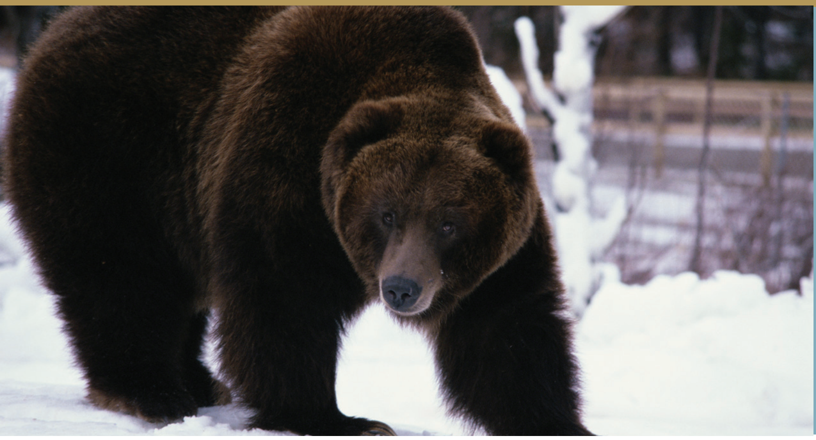
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

# ECONOMIC WINTER



## The Culture of Theft and Greed in the Investment Banking Industry

### Introduction

Five years have elapsed since the financial crisis of 2008 began unleashing its wrath upon national economies on a global basis; not only, wreaking havoc with stock markets, fixed income markets, housing markets, sovereign debt levels and investor portfolios, but also, leaving hundreds of banking and corporate bankruptcies in its wake. In the ensuing period, we note that only American shysters such as Bernie Madoff (client theft and fraud convictions); Enron's Jeff Skilling (fraud conviction); hedge fund manager Raj Rajaratnam (insider trading conviction); Rajat Gupta (conspiracy and securities fraud convictions); Allen Stanford ($7 billion U.S. ponzi scheme conviction) and former Illinois Governor Rod Blagojevich (corruption conviction) are serving sentences in U.S. prisons. To this point in time, while several major U.S. banks have either, agreed to pay sizeable fines for their wrongdoings or, are waging court battles on continuing cases, no senior American banker has yet faced any criminal prosecution charge for any of his bank's illegal activities. However, given the increasingly record level of bank fines being exacted by U.S. Attorney General Eric Holder and other regulators, plus the recent announcement that hedge fund SAC Capital Advisors has become the first large Wall Street firm in a generation to confess to criminal conduct; **we wonder whether serious allegations in the form of criminal prosecution charges against some Wall Street bankers may finally wend their way to the negotiating table.**

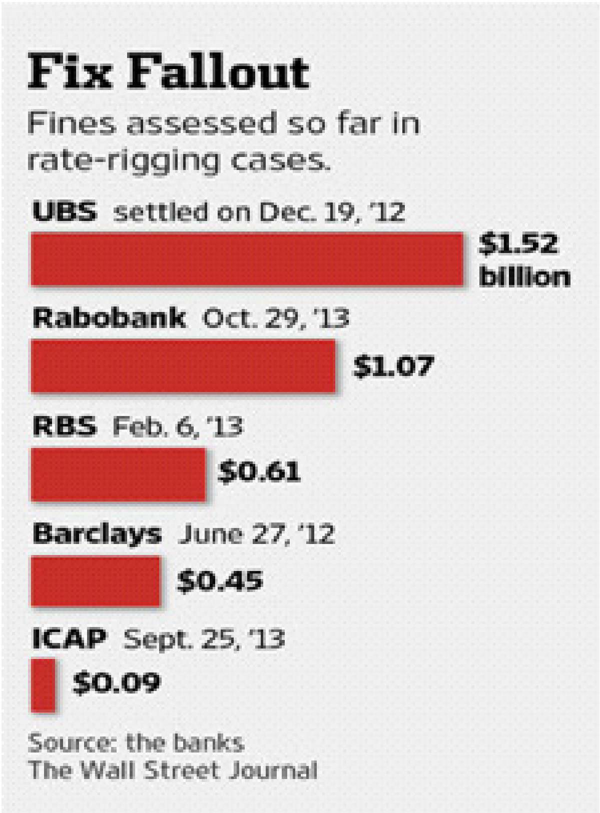
### Does Too Big to Fail Now Mean Too Big to Jail?

In a U.S. commentary recently published in Bullion Bulls Canada, blogger Jeff Neilson wrote: "Prosecutors in the U.S. Department of Justice are refusing to perform their sworn duties and uphold the rule of law in the United States because American banks accused of criminal activity are now considered too big to prosecute. Apart from the pathetically servile attitude which the Justice Department is taking to crimes committed by the Wall Street oligopoly, its argument is totally without merit. Obviously, sending criminals to prison would not cause people to lose confidence in the U.S. financial system. What has already caused much of the world to lose confidence in the American financial system is the refusal to send the criminals to prison ... There is no possible harm which could result from smashing this banking oligopoly into little pieces, which could ever equal the harm of living in an economic system which was subjected to the perpetual coercion, blackmail and endless acts of financial malfeasance of this white collar crime syndicate. How many bankers have gone to jail following the conspiracy among the world's largest banks to fraudulently manipulate the supra $500 trillion (U.S.) LIBOR interest rate? Zero. How many bankers might go to jail, once our corrupt regimes have finished with their token slap-on-the-wrist? Zero … The government's pretense excuse regarding why it refuses to touch the Wall Street criminals is the biggest farce of all."

## EC / ECN Regulators to Levy Large Fines Against Global Banks

According to banking industry officials familiar with the investigations and as reported in the Wall Street Journal, European Union antitrust regulators are poised to levy large fines against a group of global banks, relating to their alleged attempts to manipulate widely used benchmark interest rates. The prospective fines against six banks – expected to be announced within the next month – will bring to a close a two-year antitrust investigation conducted by the European Commission (EC) and the European Competition Network (ECN) into whether banks colluded to manipulate high profile benchmarks, such as the London Interbank Offered Rate (Libor) and its lesser-known cousin the Euro Interbank Offered Rate (Euribor). The office of Joaquin Almunia, the EU competition commissioner and a vice president of the EC, has led the investigation. The penalties are likely to total in the hundreds of millions of euros for individual banks, with fines possibly approaching one billion euros ($1.35 billion U.S.) for large banks which the EC / ECN believe were heavily involved in benchmark rate-rigging. That would likely establish the penalties among the largest ever imposed by EU regulators.

The banks which are expected to be fined include France's Credit Agricole SA and Societe Generale SA; Germany's Deutsche Bank AG; the U.K.'s HSBC Holdings PLC and Royal Bank of Scotland Group; as well as America's J.P. Morgan Chase and Co. Euribor, which is administered by the European Banking Federation – a Brussels-based trade association – has avoided much of the bad publicity surrounding Libor. However, according to U.S. and British regulators, Euribor was subject to frequent attempts at manipulation by bank traders. In their settlements with Barclays, UBS and Rabobank, EU regulators outlined extensive efforts by bank traders to manipulate Euribor in order to benefit their derivative portfolios. EU officials have stated that the interest rate fixing cases are among their highest priority antitrust cases, with Mr. Almunia calling the allegations about banks' behavior "shocking."



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## HSBC Confirms Involvement in Foreign Exchange Probe

As reported widely in the press, London-based HSBC Holdings PLC has confirmed it is cooperating with Britain's Financial Conduct Authority, which is leading an investigation into currency trading manipulation in the $5.3 trillion (U.S.) per day foreign exchange market. Indeed, the investigation has expanded into a global probe, including regulators in Asia, the United States and Switzerland. Currency traders from some of the world's top banks, including Barclays, Citigroup and JP Morgan Chase have either been suspended, or placed on leave. HSBC has vowed to instill a more responsible corporate culture after it was fined a record $1.9 billion (U.S.) in 2012 by the U.S. Department of Justice for lax anti-money laundering compliance involving the transfer of $7 billion (U.S.) of funds through the United States from Mexican drug cartels and on behalf of nations such as Iran which are under international sanctions. By agreeing to a settlement, HSBC – Europe's largest bank by market value – avoided a legal battle which could have further savaged its reputation and undermined confidence in the global banking system. Sabine Bauer, director of financial institutions at Fitch Ratings commented: "These banks are operating in an environment where they can't afford to have uncertainty attached to their name and they are dependent upon confidence from their investors. So, that makes them keen to get past such (embarrassing) events quickly and settle." In return for being spared prosecution, HSBC agreed to continue to strengthen its compliance policies and procedures. The bank's performance will be evaluated by an independent monitor over the 5-year term of the agreement with the Department of Justice, which has used such arrangements in cases involving large corporations, notably in settlements of foreign bribery charges.

HSBC Chief Executive Officer Stuart Gulliver acknowledged: "We have accepted responsibility for our past mistakes. We have said we are profoundly sorry for them and we do so again. The HSBC of today is a fundamentally different organization from the one that made those money laundering mistakes. Over the last two years, under new senior leadership we have been taking concrete steps to put right what went wrong and to participate actively with government authorities in bringing to light and addressing these matters." Among other measures, HSBC has hired a former U.S. Treasury Department undersecretary for terrorism and financial intelligence, as its chief legal officer. According to a report from the Senate Permanent Subcommittee on Investigations (SPSI), HSBC affiliates also skirted U.S. Government bans on financial transactions with Iran and other countries. Moreover, HSBC's American division provided money and banking services to some banks in Saudi Arabia and Bangladesh, thought to have helped fund al-Qaida and other terrorist groups. The SPSI Chairman, Senator Carl Levin (D-Mich.), had cited: "instances in which HSBC had promised to fix deficiencies after being sanctioned by regulators, but failed to comply. The Office of the Comptroller of the Currency had tolerated HSBC's weak controls against money laundering for years, but agency examiners who had raised concerns were overruled by their superiors."

## FHFA Seeks $6 Billion (U.S.) from Bank of America

The Federal Housing Finance Agency is the housing regulator that oversees Fannie Mae and Freddie Mac, the government-backed mortgage companies which came close to failing in 2008 because of the bad mortgage-backed securities they acquired from banks. According to the Financial Times, FHFA regulators are seeking a penalty in excess of $6 billion (U.S.) from B of A, compared with the $4 billion (U.S.) to be paid by JP Morgan. Bank of America has the biggest potential exposure, with a notional value of the securities sold exceeding $57 billion (U.S.) compared with $33 billion (U.S.) at JP Morgan. Bank of America declined to comment on the case, which it is continuing to fight in court. Mike Mayo, an analyst at Hong Kong-based CLSA – an independent brokerage and investment group – commented: "This is an example of the new Big Brother banking. The government is watching the banks and if one makes a wrong step, it's going to pay. While it's not known where the (penalty) boundaries lie in terms of all the respective financial institutions involved, clearly, the range risks that banks may be vaporized."

## Royal Bank of Scotland to Pay $153.7 Million (U.S.) to Settle Mortgage Case

Last week the Royal Bank of Scotland (RBS) agreed to pay $153.7 million (U.S.) to the U.S. Securities and Exchange Commission (SEC) to settle charges that it misled investors into buying a risky mortgage-backed security issue. As documented in the New York Times, the SEC concluded that a bank subsidiary, RBS Securities, had backed the issue with mortgages that a high potential to default. The subsidiary, called Greenwich Capital Markets at the time, purchased the mortgages in 2007 from Option One Mortgage Corporation. Under its agreement with Option One, a subsidiary of H&R Block, RBS had to buy the mortgages by April 30th. of that year. The SEC noted that in its haste to close the deal, RBS did not fully investigate the quality of the underlying mortgages: "RBS hired another company to quickly conduct due diligence on a small sample of the mortgages, which concluded that a large number of them did not meet Option One's own underwriting standards." Despite this turn of events, RBS packaged the mortgages into a $2.2 billion (U.S.) new issue. RBS was paid $4.4 million (U.S.) for its underwriting efforts. In announcing the recent settlement, George Canellos, co-director of the SEC's enforcement division, remarked: "In its haste to meet a deadline set by Option One, RBS cut corners and failed to complete adequate due diligence on these mortgages, with predictable results. Today's action punishes that misconduct and secures in excess of $150 million (U.S.) in relief for those (investors) harmed by this shoddy act of securitization." In a statement, RBS did not admit or deny any wrongdoing: "RBS has fully cooperated with the SEC throughout this investigation." The SEC built its case around the bank's 'misleading' disclosures to investors who purchased the securities. The SEC concluded: "While RBS had stated that the mortgages generally complied with Option One's underwriting guidelines, RBS should have been aware that 30% of the mortgages deviated so much from the bank's own underwriting guidelines that they should have been removed from the new issue entirely." Indeed, just days prior to the new issue closing, one of the RBS bankers cautioned in an internal e-mail that due diligence results on the quality of the mortgages had lately been 'ugly'.

## Virginia Judge Sentences Former Banker to 23 Years for Fraud

As reported in the Virginia Pilot and the Washington Post, Edward J. Woodard Jr., former president and chief executive officer of the Bank of the Commonwealth was sentenced last week to 23 years in federal prison in Norfolk, Va. on charges of conspiring to defraud the bank and related counts. Prior to imposing sentence, U.S. District Judge Raymond Jackson told Woodard: "You behaved arrogantly and indifferently as you exhibited a continuing scheme of criminal conduct and are yet to show any remorse. This court does not believe you understand that you committed crimes. None of us would be in this courtroom today if you had simply done the right thing." Woodard, 70 years of age, had served as the bank's president since 1973. Mr. Woodard; mortgage specialist Brandon Woodard, his son; former vice president Stephen Fields and developer and bank customer Dwight Etheridge were found guilty last May on charges of conspiring to defraud the Bank of the Commonwealth out of $71 million (U.S.) prior to its collapse in 2011. The bank's executives were accused of engaging in illegal banking practices to hide overdue loans from regulators and the bank's board of directors; thereby, masking the bank's financial condition. The bank failed in September 2011amid in excess of $150 million (U.S.) in losses. Brandon Woodard will serve an 8 year prison term; Mr. Fields will serve 17 years and Mr. Etheridge will serve 4 years and 2 months.

## How Jamie Dimon Is Avoiding Criminal Prosecution Charges

While the U.S. Federal Government continues to struggle to prevent a default on the national debt, a basket of historically huge regulatory fines and penalties levied against JP Morgan Chase are no problem for CEO Jamie Dimon. As documented for The Slate by economics correspondent Matthew Yglesias, the bank exited the mortgage-backed securities business early, shored up its balance sheet with government assistance and emerged from the financial crisis with one of the best reputations in the investment banking industry. As recently as last May, BusinessWeek hailed Mr. Dimon on its cover as Wall Street's Indispensable Man – a giant among the titans of Wall Street and he is still treated as such today.

Chase's legal woes includes a total of $3.68 billion (U.S.) for cases already settled for foreclosure irregularities such as: illegal manipulation of electricity markets, overcharging credit card customers and compliance failures at four different regulatory agencies relating to the billions in losses in the London Whale trade. However, those fines are small compared to the $11 billion (U.S.) settlement the bank could be facing related to mortgage-backed securities abuses during the financial crisis years. Then, there's the Libor manipulation investigation, violation of the Foreign Corrupt Practices Act, manipulation of a corporate bond index, an obstruction of justice investigation and even some potential involvement with the Bernie Madoff Ponzi scheme. Today, however, JP Morgan is making a lot of money and Mr. Dimon still holds his dual role of Chief Executive Officer and Chairman of the Board of Directors. Neither is any bank investor suggesting Mr. Dimon should resign from the bank, nor is any investor insisting he should end his dual management role.

Jamie Dimon, CEO of JP Morgan Chase. Source: Associated Press

## Goldman Sachs: Corporate Rap Sheet

Goldman Sachs, once lionized as the premier 'money machine' of Wall Street, has in the past few years become synonymous with greed and duplicity. As documented by the Corporate Research Project, an investment firm that long prided itself on putting the interests of its clients first, was revealed to have repeatedly marketed securities to clients that it fully expected to plunge in value. Rolling Stone reporter Matt Taibbi's depiction of Goldman as a 'giant vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money' and Greg Smith's reference to Goldman as 'toxic and destructive' in a New York Times op-ed, announcing his departure from Goldman are two of the most frequently quoted phrases about the financial crisis. See also, Economic Winters, For the Love of Money – February 15, 2010 and A Rolling Stone Gathers No Moss – March 29, 2010.

Although Goldman was founded in the 1860s and managed its first initial public offering (IPO) in 1906, the firm did not become a top player on Wall Street until the 1980s. It was during that decade when Goldman emerged as a significant force in block trading, risk arbitrage, mergers and underwriting. While other investment houses went public, Goldman remained a private partnership; thanks in part to a $500 million (U.S.) equity investment by Japan's Sumitomo Bank in 1986. The 1980s also saw some minor tarnishing of the company's reputation, which aside from some legal problems related to the Penn Central bankruptcy, was considered sterling. Robert Freeman, the head of Arbitrage at Goldman, was implicated in an insider trading scandal and in 1989 pleaded guilty to one count of fraud. In the early 1990s, Goldman experienced huge trading losses linked to rising interest rates, management missteps and an investigation by the U.K.'s Serious Fraud Office of the firm's links to controversial media magnate Robert Maxwell.

In 1999, Goldman finally went public, further enriching top executives such as CEO Hank Paulson, who saw his personal net worth rise to exceed $300 million (U.S.). Yet Goldman avoided the merger mania to which many of its competitors succumbed. During the first half of the 2000s, a virtual litany of ethical lapses emerged at Goldman:

• In 2002, Goldman was fined $1.65 million (U.S.) by the industry regulatory body NASD (now FINRA) for failing to preserve e-mail communications.

• In 2003, Goldman paid $110 million (U.S.) as its share of a global settlement by ten firms with federal, state and industry regulators concerning alleged conflicts of interest between their research and investment banking activities.

• Also in 2003, Goldman had to pay $9.3 million (U.S.) in fines and disgorgement of profits in connection with federal allegations that it failed to properly oversee a former employee who had been charged with insider trading and perjury.

• In 2004, Goldman was one of four firms each fined $5 million (U.S.) by NASD for rule violations relating to trading in high yield corporate bonds; Goldman also had to make restitution payments of about $344,000 (U.S.).

• In 2005, the U.S. Securities and Exchange Commission (SEC) announced that Goldman would pay a civil penalty of $40 million (U.S) to resolve allegations that it violated rules relating to the allocation of stock to institutional clients in IPOs.

• Also in 2005, Goldman paid a fine of $125,000 (U.S.) to NASD for violating rules relating to the sale of restricted securities during initial public offerings. Shortly thereafter, the firm was fined $140,000 (U.S.) by NASD for late and/or inaccurate reporting of municipal securities transactions.

• In 2006, Goldman was one of 15 financial services companies that were fined a total of $13 million (U.S.) in connection with SEC charges that they violated rules relating to auction-rate securities.

• In 2008, Goldman was fined $22.5 million (U.S.) in another case relating to auction-rate securities brought by the New York State Attorney General.

When the financial crisis erupted in 2008, Goldman and Morgan Stanley relented to pressure from federal regulators to convert themselves into bank holding companies. Goldman also propped itself up by negotiating a deal in which Warren Buffet's Berkshire Hathaway invested $5 billion (U.S.) in the firm in exchange for a 10% ownership stake. Buffet's holding took the form of preferred stock paying a generous 10% dividend. Goldman also received $10 billion (U.S.) from the federal government's Troubled Assets Relief Program (TARP). During this period, Goldman profited from subprime mortgages through its ownership of Litton Loan Servicing, which it sold in 2011 in the wake of numerous abuse allegations. In May 2009, Goldman agreed to provide about $50 million (U.S.) in relief to holders of subprime mortgages in Massachusetts, to remove itself from a state attorney's investigation.

However, Goldman became a symbol of the financial excesses which led up to the financial meltdown. The Taibbi quote was the most colourful of many unflattering depictions of the firm. Lloyd Blankfein, Paulson's successor, initially responded to the criticism by making the far-fetched claim that Goldman was doing 'God's work.' When that didn't go over well, he issued an apology for the firm's mistakes and vowed to spend $500 million (U.S.)to help thousands of small businesses recover from the recession. That did little to rectify the situation. In the 10-K filing it issued in March 2010, Goldman added to the usual risk factors 'adverse publicity,' which it said could 'adversely impact the morale and performance of our employees, which in turn could seriously harm our businesses and results of operations.' The adverse publicity soon escalated.

In April 2010, the SEC accused Goldman of having committed securities fraud when it sold mortgage-related securities to investors without telling them that the investment vehicle, called Abacus, had been designed in consultation with hedge fund manager John Paulson who chose securities he expected to decline in value and had portfolio short positions. Indeed, the Goldman product did decline in value, causing institutional clients to lose more than $1 billion (U.S.) and Mr. Paulson to make a bundle. Paulson was not charged, but the SEC did name Fabrice Tourre, the Goldman vice president who helped create and market the securities. Subsequently, a federal jury found him guilty of deceiving investors. Initially, Goldman defended its actions and claimed that it lost money on Abacus, but a Senate subcommittee later released e-mail messages between Goldman executives, discussing how they expected to make 'serious money' by shorting the housing market. The uproar continued as evidence emerged that Goldman had devised not one, but a series of complex deals to profit from the collapse of the home mortgage values. A group of Goldman officials, including Tourre, were summoned before that Senate subcommittee and questioned for ten hours. A couple of months later, Goldman executives were grilled by the Financial Crisis Inquiry Committee, whose Chairman Phil Angelides suggested that Goldman had helped drive down the prices of mortgage-backed securities, in order to benefit from its short position. In July, 2010, the SEC announced that Goldman would pay $550 million (U.S.) to settle the Abacus charges. That sum included a payment of $300 million (U.S.) to the U.S. Department of the Treasury and a distribution of $250 million (U.S.) to investors who had suffered losses in the new issue. The settlement also required Goldman to 'reform its business practices,' but did not oblige the firm to admit to wrongdoing. The Abacus scandal also led to a 17.5 million pound fine by Britain's Financial Services Authority.

In January 2011, Goldman announced that an internal review of its policies in the wake of the SEC settlement had found that only limited changes were necessary. Apparently, others saw matters differently.

• In November 2010, FINRA fined Goldman $650,000 (U.S.) for failing to disclose that two of its registered representatives, including Fabrice Tourre, had been notified by the SEC that they were under investigation.

• In March 2011, the SEC announced that it was bringing insider trading charges against former Goldman director Rajat Gupta. He was accused of providing illegal tips, including one about Warren Buffet's $5 billion (U.S.) investment in Goldman in 2008, to hedge fund manager Raj Rajaratnam. Mr. Gupta was later convicted and sentenced to two years in prison.

• In September 2011, the Federal Housing Finance Agency (FHFA) sued Goldman and 16 other financial institutions for violations of federal securities law in the sale of mortgage-backed securities to Fannie Mae and Freddie Mac.

• In March 2012, the Commodities Futures Trading Commission (CFTC) announced that Goldman would pay $7 million (U.S.) to settle charges that it failed to diligently supervise trading accounts in the period from May 2007 to December 2009. Later that year, the CFTC fined Goldman $1.5 million (U.S.) for failing to properly supervise a trader who fabricated large positions in an attempt to cover up losses.

• Also in March 2012, Goldman Executive Director Greg Smith published an op-ed in the New York Times, announcing his departure from what he called a 'toxic and destructive' environment at the firm, saying he could 'no longer in good conscience identify with what it stands for.'

• In April 2012, the SEC and FINRA fined Goldman $22 million (U.S.) for failing to prevent its employees from passing illegal stock tips to major clients.

• In July 2012, a federal appeals court rejected an effort by Goldman to overturn a $20.5 million (U.S.) arbitrator's award to investors in the failed hedge fund Bayou Group who had accused Goldman of helping to perpetuate a Ponzi scheme.

• Also in July, Goldman agreed to pay $26.6 million (U.S.) to settle a lawsuit brought by the Public Employees' Retirement System of Mississippi, accusing it of defrauding investors in a 2006 issue of mortgage-backed securities.

• In September 2012, the SEC charged Goldman and one of its former investment bankers with ‘pay-to-play- violations involving undisclosed campaign contributions to Massachusetts state treasurer Timothy Cahill, while he was a candidate for governor. Goldman settled the charges by agreeing to pay $12.1 million (U.S.) in disgorgement and penalties.

• In January 2013, the Federal Reserve announced that Goldman and Morgan Stanley together would pay $557 million (U.S.) to settle allegations of forclosure abuses by their loan servicing operations. Goldman’s portion was $330 million (U.S.).

• In March 2013, the Federal Reserve cited ‘weaknesses’ in Goldman’s capital plan and ordered it to submit a new proposal.

## Summary: Big Banks Undergoing Greater Scrutiny by Government Agencies

A growing number of government authorities have expanded investigations into the multiple business lines at some of America’s largest banks and beyond, as chronicled in the Washington Post; a sign that the legal morass enveloping the banking industry has no clear end in sight. Within the last year, big banks have disclosed a lengthy list of investigations, lawsuits and settlements that continue to grow. Federal prosecutors and regulators have been taking aggressive steps to hold Wall Street accountable for misdeeds of the financial crisis and misconduct which has emerged in the aftermath. One of the latest probes involves the possible manipulation of the global foreign exchange markets (see section above). Crisis era investigations represent only a fraction of the litigation troubles confronting the big banks. A number of institutions have disclosed details about probes into more recent activity in their regulatory filings. For instance, JP Morgan disclosed that the U.S. Attorney’s Office for the Southern District of New York and the Office of the Comptroller of the Currency are reviewing whether the bank ignored red flags about swindler Bernie Madoff in order to earn more in fees and commissions. Both JP Morgan and Barclays disclosed that federal prosecutors in the Southern District of New York are investigating whether the banks engaged in manipulative bidding in the energy markets. The probes stem from investigations initiated by the Federal Energy Regulatory Commission, which accused the banks of charging California and Midwest electricity grids more than prevailing power prices. It remains unclear whether these investigations and others that are expected to follow will quell criticism of the government’s policing of the financial services industry. **The lack of criminal prosecutions of high-ranking bank executives remains a point of contention among industry experts.**

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