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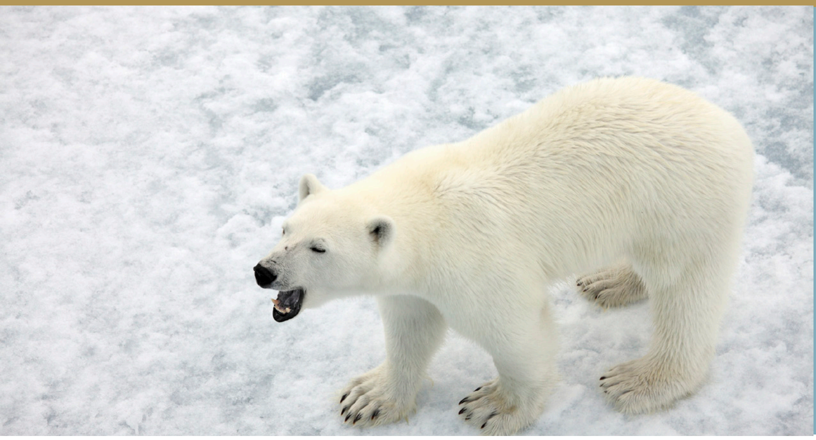
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER



Malfeasance in the Financial Services Industry

Prelude: A Legendary Wall Street Story

Once in the dear dead days beyond recall, an out-of-town visitor was being shown the wonders of the New York financial district. When the party arrived at Battery Park, one of his guides indicated some handsome ships riding at anchor and said: "Look! Those are some of the investment bankers' and stockbrokers' yachts!" Naively, the visitor asked: "Where are the customers' yachts?"

Introduction

Since the onset of the most recent financial crisis, ignited by the Lehman Bros. bankruptcy in 2007, there has been quite a steady parade of wrong doers emerge from the Wall Street shadows to face a variety of malfeasance charges in the U.S. federal courts, mostly focused on fraudulent and insider trading behavior. Interestingly, the majority of those rule breakers stem more from brokerage houses, hedge funds and privately owned investment management firms. The employees of America's major banking institutions have emerged largely unscathed, with regulators only levying sizeable fines on their greedy employers in a corporate sense. While we may be witnessing some evidence that this could soon change, certainly there was no hesitation to charge people in high places with fraud and corruption some 80 years ago during the 1930's, amid the Great Depression.

Fraud, Greed and Corruption since the Onset of the Longwave Winter in 1929

Richard Whitney (Financier)

In 1910, a 22 year-old Richard Whitney followed his brother, George Whitney Jr., to New York City where he established his own bond brokerage firm Richard Whitney & Co. Two years later, using money borrowed from his family, Richard Whitney & Co. purchased a seat on the New York Stock Exchange. His uncle had been a partner in J.P. Morgan & Co. and brother George proved invaluable because of his position at the Morgan Bank which allowed him to direct substantial business to Richard's brokerage. During this decade Whitney became a member of a number of the city's elite social clubs and was appointed treasurer of the New York Yacht Club. In 1919, he was elected to the Board of Governors of the New York Stock Exchange and shortly thereafter was named its Vice President.

Ten years later, Richard Whitney had become President of the New York Stock Exchange and amidst the October 24, 1929 stock market crash, he was asked by a group of major financiers to bolster the market by buying up huge lots of blue chip stocks. While the effort raised share values temporarily, in the end it could not halt the freefall in stock prices. While Richard Whitney was assumed to be a brilliant financier, in point of fact, he had personally been involved with speculative investments in a variety of businesses and had sustained considerable losses. To stay afloat, he began borrowing heavily from his brother George, as well as other wealthy friends and then turned to embezzlement to cover his mounting business losses and maintain his extravagant lifestyle. He stole funds from the New York Stock Exchange Gratuity Fund, the New York Yacht Club and $800,000 (U.S.) worth of bonds from his father-in-law's estate.

Having retired as president of the NYSE in 1935, Whitney remained on the Board of Governors. However, in March 1938, his past began to catch up with him when the comptroller for the NYSE reported to his superiors that he had established absolute proof that Richard Whitney was an embezzler and that his company was insolvent. Within days, Whitney and his company would both declare bankruptcy. Charged with embezzlement by New York County District Attorney Thomas E. Dewey and indicted by a Grand Jury, Richard Whitney was arrested and eventually pleaded guilty to grand larceny. He was sentenced to a term of five to ten years in Sing Sing prison at Ossining, upstate New York. Banned from dealing in securities for life, he was living the quiet life at the time of his death on December 5, 1974.

Ivar Kreuger (The Match King)

The story of Ivar Kreuger is uncannily relevant today. When the dapper 42 year-old Swede sailed aboard a luxury liner into New York in 1922, he could sense the mood of euphoria beginning to grip Wall Street. However, he didn't just take advantage of it like a fly-by-night Charles Ponzi. Actually, he helped define his era accompanied by friends, such as Herbert Hoover. The product on which he built his fortune, the Swedish safety match, kept cigarettes through the jazz age. Author Frank Partnoy, explains in detail how Kreuger used the laissez-faire spirit of the time to persuade cash-strapped European governments to grant him match monopolies, offering them loans financed by American investors in return. He had a genius for financial innovation and an utter disregard for financial niceties, making him a forefather of some of the financial scandals of the 21st. century. Investors didn't care much about the lack of transparency. Kreuger raised $154 million (U.S.) from them in America, enabling him to replace banks such as the House of Morgan as a source of global finance. That caused bitter consternation. When Kreuger made a $70 million (U.S.) loan to the French government, the international media compared him to the Medicis.

In its October 12, 1929 issue, the Saturday Evening Post published an interview with Ivar Kreuger by Isaac Marcosson. This was considered a scoop, for Kreuger had previously been inaccessible to journalists. Marcosson observed: 'Like Hoover, Kreuger is an engineer. He has consistently applied engineering precision to the welding of his far-flung industry. Also, like Hoover, Kreuger rules through pure reason.' In the interview, Kreuger was remarkably candid on one point. He told Mr. Marcosson: 'Whatever success I have enjoyed, may perhaps be attributable to three things: One is silence, the second is more silence, while the third is still more silence.'

This was so. Two and a half years later, Kreuger committed suicide in his Paris apartment and shortly thereafter, it was discovered that his aversion to divulging information, especially if accurate, had kept even his most intimate acquaintances in ignorance of the greatest fraud in history. His American underwriters, the eminently respectable firm of Lee, Higginson and Co. of Boston, had heard nothing and knew nothing. One of the members of the firm, Donald Durant, was a member of the board of directors of Kreuger enterprises. Durant had never attended a directors' meeting and it is certain that he would have been no wiser had he done so. When Kreuger's suicide was reported in 1932 and he was discovered to have forged holdings of Italian bills, his empire collapsed and he was vilified around the world. It virtually knocked the last shred of confidence out of the depression era. Mr. Partnoy makes a point worth remembering as people seek villains to blame for today's financial mayhem. There is always a fine line between sharp business practices and ethical behavior.

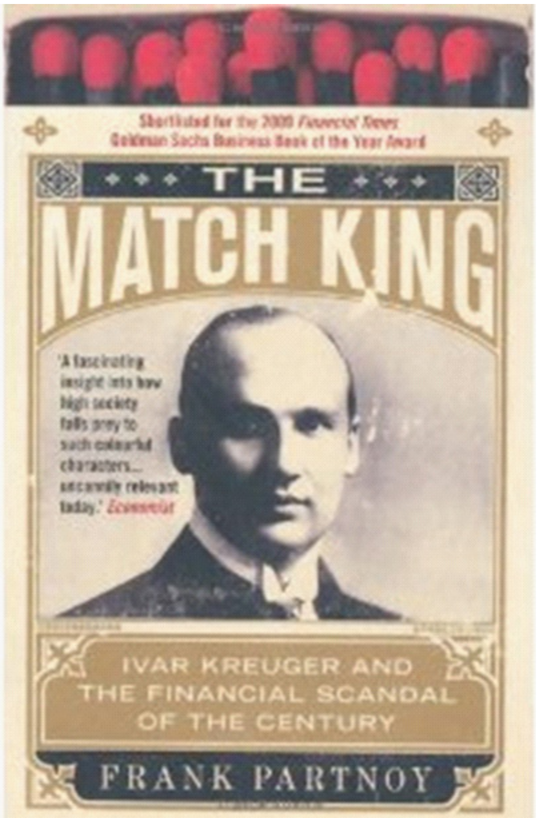


Photo source: Amazon.com

In Goldman, Sachs We Trust

On August 22, 1929, the Goldman Sachs Trading Corporation announced the acquisition of the Pacific American Associates, a West Coast investment trust which, in turn, had recently purchased a number of smaller investment trusts and which owned the American Trust Company, a large commercial bank with numerous branches throughout California. Pacific American had a capital base of about $100 million (U.S.). In preparation for the merger, the Trading Corporation had issued another $71,400,000 in stock which it had exchanged for capital stock of the American Company, the holding company which owned over 99% of the common stock of the American Trust Company. Having issued in excess of $250 million (U.S.) worth of securities in less than a month – an operation that would not then have been unimpressive for the United States Treasury – activity at Goldman, Sachs subsided somewhat. Its members had not been the only busy people during this time.

It was a poor day in August and September in 1929 when no new issue of a trust was announced, or no large new issue of securities was offered by an old one. Thus, on August 1st. the papers announced the formation of Anglo-American Shares Inc., a company which, with a soigne touch not often seen in a Delaware corporation had among its directors the Marquess of Carisbrooke, GCB, GCVO, and Colonel, the Master of Sempill, AFC, otherwise identified as the President of the Royal Aeronautical Society, London. American Insuranstocks Corporation was launched the next day, though boasting no more glamorous a director than William Gibbs McAdoo. On succeeding days came Gude Winmill Trading Corporation, National Republic Investment Trust, Insull Utility Investments, Inc., International Carriers Ltd., Tri-Continental Allied Corporation and Solvay American Investment Corporation. On August 13th. the papers also announced that an Assistant U.S. Attorney had visited the offices of the Cosmopolitan Fiscal Corporation and also an investment service called the Financial Counselor. In both cases the principals were absent. The offices of the Financial Counselor were equipped with a peephole like a speakeasy.

More investment trust securities were issued in September of 1929 – even more than August – since the total exceeded $600 million (U.S.). However, the nearly simultaneous promotion of Shenandoah and Blue Ridge was to stand as the pinnacle of new era finance. It is difficult not to marvel at the imagination which was implicit in this gargantuan insanity. If there must be madness, something may be said for having it on a heroic scale. Years later, on a grey dawn in Washington, the following testimony occurred before a committee of the United States Senate in hearings regarding Stock Exchange Practices during the April – June quarter of 1932.

Senator Couzens: Did Goldman, Sachs and Company organize the Goldman, Sachs Trading Corporation?
Mr. Sachs: Yes, Sir.
Senator Couzens: And it sold its stock to the public?
Mr. Sachs: A portion of it. Originally, the firm invested in 10% of the entire issue for the sum of $10,000,000.
Senator Couzens: And the other 90% was sold to the public?
Mr. Sachs: Yes, Sir.
Senator Couzens: At what price?
Mr. Sachs: At $104 (U.S.). That is the old stock … the stock was split two for one.
Senator Couzens: And what is the price of the stock now?
Mr. Sachs: Approximately, $1.75 (U.S.)

Bernie Madoff (A Former Wall Street King)

Madoff Investment Securities LLC, was among the most successful broker-dealers on Wall Street, specializing in over-the-counter stocks. Madoff Securities was a well-known market maker, meaning he both bought and sold stocks, making his profit by selling for a few cents more per share than his purchase price. Madoff Securities was a pioneer in electronic trading, enabling the company to rapidly move large blocks of over-the-counter stocks. However, what really set Madoff apart was his willingness to pay for order flow. Normally, the difference between what market makers paid for a stock and what they sold it for was about 12.5 cents. That was their profit. However, instead of taking a fee for this service, as was normal practice, Bernie actually paid firms as much as two cents per share for their business. Even though he was earning a penny or two less per share, he more than compensated for that with greatly increased volume. In the early 1990s, Madoff Securities was reputed to be responsible for almost 10% of the daily trading volume of listed securities on the New York Stock Exchange. By the end of the decade the company was the sixth largest market maker on Wall Street. That strategy had made Madoff rich and had enabled him to become one of the most respected men in the financial industry. He marketed himself as a co-founder of the NASDAQ and had served as its chairman; he was a prominent New York philanthropist and a member of numerous industry and private boards and committees. Bernie Madoff was a Wall Street king.

On March 12, 2009, Mr. Madoff pleaded guilty to eleven federal felonies and admitted to turning his wealth management business into a massive Ponzi scheme that defrauded thousands of investors of billions of dollars. While Mr. Madoff revealed he began the Ponzi scheme in the early 1990s, federal investigators believe the fraud began as early as the mid-1980s and may have begun as far back as the 1970s. The amount missing from client accounts, including fabricated gains, totaled almost $65 billion (U.S.). The court-appointed trustee estimated actual losses to investors of $18 billion (U.S.). On June 29, 2009, Mr. Madoff was sentenced to a prison term of 150 years, the maximum allowed under the law.

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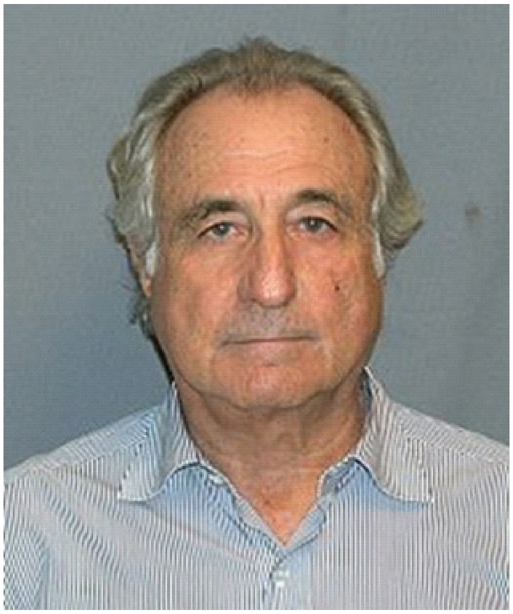
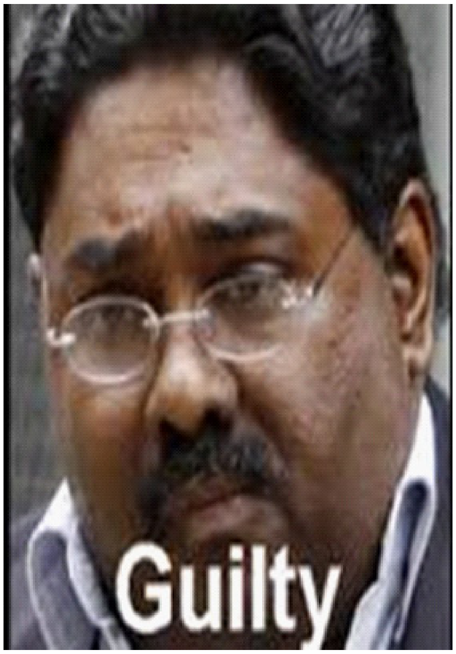


Bernard Madoff. Photo source: U.S. Dept. of Justice

Raj Rajaratnam (Former Hedge Fund Manager)

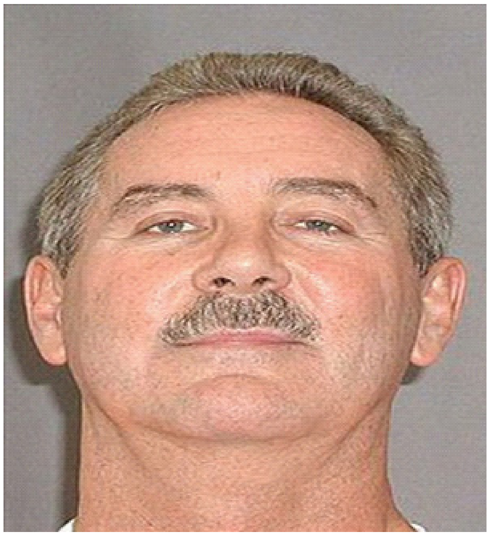
Mr. Rajaratnam is a self-made billionaire hedge fund manager. In 2009, his hedge fund Galleon was valued at $3.7 billion (U.S.), down from a peak level of $7 billion (U.S.) in 2008. On October 16, 2009, Mr. Rajaratnam was arrested by the FBI and accused of conspiring with others to engage in insider trading in the stocks of several publically traded companies. U.S. Attorney Preet Bharara put the total profits in the scheme in excess of $60 million (U.S.), stating that it was the largest hedge fund insider trading case in United States history. After Rajaratnam's arrest, Galleon received requests from investors for the withdrawal of $1.3 billion (U.S.), which caused the fund to close. On May 11, 2011, Rajaratnam was found guilty on all 14 counts of conspiracy and securities fraud. On October 13, 2011, Rajaratnam was sentenced to 11 years in prison, which to date is the longest prison sentence ever imposed for insider trading.



Raj Rajaratnam.   Photo source: ABC News

Allen Stanford (Former Financier and Professional Sports Sponsor)

Early in 2009, Allen Stanford became the subject of several fraud investigations through his now defunct company, the Stanford Financial Group, headquartered in Houston, Texas. In mid-February, 2009 Mr. Stanford was charged by the U.S. Securities and Exchange Commission (SEC) that his company represented a huge Ponzi scheme, alleging massive ongoing investment fraud involving $8 billion (U.S.) in certificates of deposit. Mr. Stanford had claimed his CDs were as safe as, or even safer than U.S. government insured accounts. However, on February 27th. the SEC disclosed that Mr. Stanford's Ponzi scheme has misappropriated billions of dollars of investors' money and falsified the Stanford International Bank's records to hide the fraud. Moreover, the SEC revealed: "Stanford International Bank's financial statements, including its investment income, are fictional." Accordingly, Mr. Stanford's assets, along with those of his companies, were frozen and placed into receivership by a U.S. federal judge. In June, 2009, Mr. Stanford was arrested and taken into custody by FBI agents. Exactly, one year later, Mr. Stanford was convicted of wire and mail fraud, conspiracy, money laundering and obstruction of justice. He was sentenced to 110 years in prison, ordered to pay a forfeiture of $5.9 billion (U.S.) and another $5.9 billion (U.S.) in civil penalties.



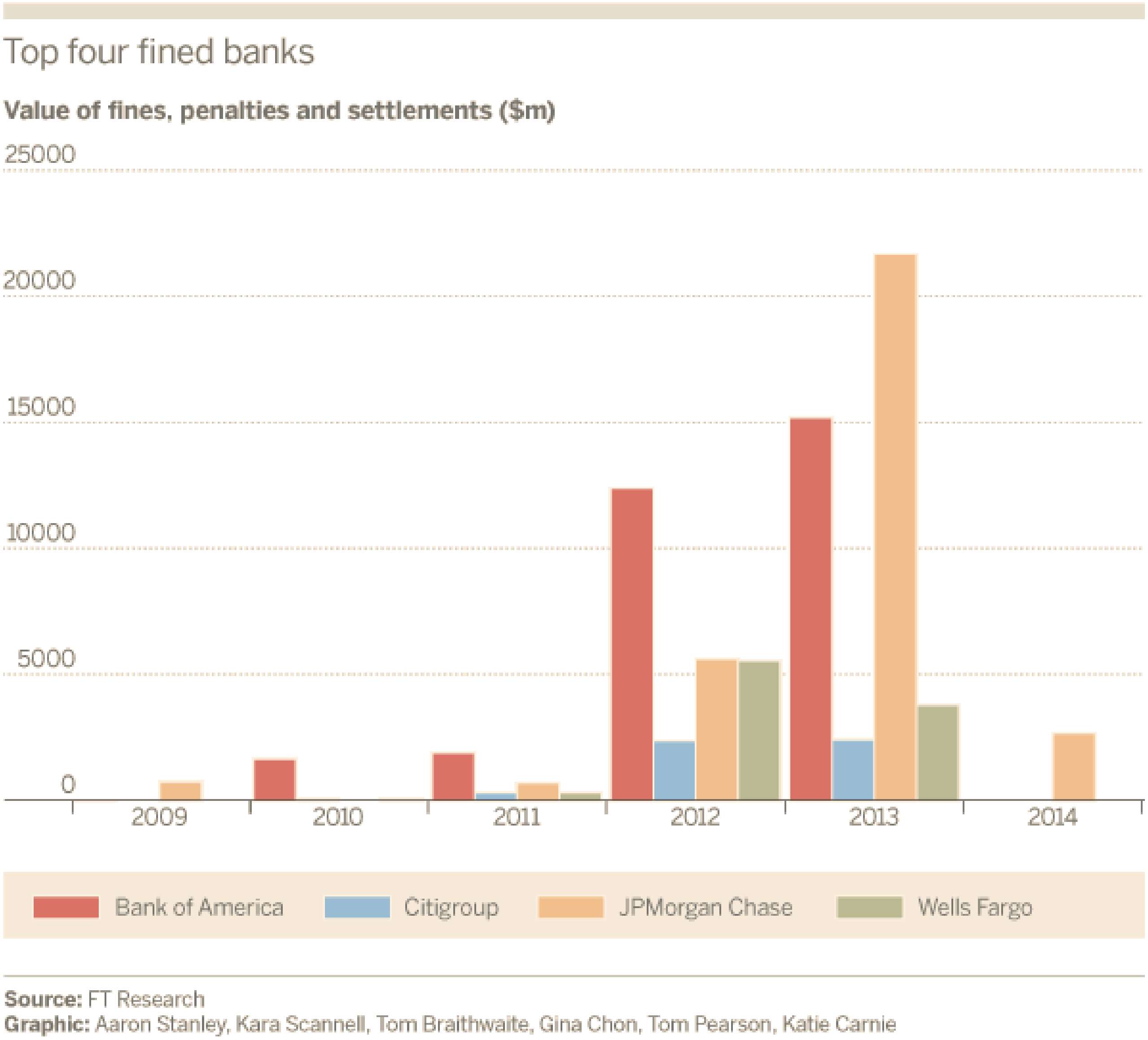
Allen Stanford Source: Federal Detention Center, Houston, TX.

Summation

Just last week it was announced that Citigroup had agreed to pay $7 billion (U.S.) in government fines and investor relief to resolve U.S. Department of Justice claims that the bank misled investors about the quality of mortgage-backed securities issued prior to the 2008 financial crisis. At a Washington press conference, U.S. Attorney General Eric Holder emphasized: "Citigroup's conduct was egregious. The size and scope of this resolution goes beyond what could be considered the mere cost of doing business. Not only did the bank make false statements to investors, but also, in documents filed with the Securities and Exchange Commission (SEC). Ultimately, Citigroup's conduct had devastating effects on economies and financial institutions across the globe. This settlement neither absolves Citigroup, nor any of its employees, from potential criminal charges."

The Oxford English Reference Dictionary defines the word egregious as: 'outstandingly bad / shocking.' At Longwave Analytics, we suspect the U.S. Justice Department chose that word deliberately and is continuing its investigation of Citigroup employees which could well result in the laying of criminal charges at some point. Such an action would send a powerful new message through the U.S. banking system.

The Financial Times has calculated that in excess of $100 billion (U.S.) has been levied in fines and penalties by regulators against many major banks in Europe, as well as the United States over the past six years. As can be readily discerned, from the 1930's to the present day history does repeat itself.



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