CORPORATE GOVERNANCE CASE STUDIES

FINANCIAL SERVICES EDITION

Mak Yuen Teen and Richard Tan

CPA AUSTRALIA

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Editors

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CORPORATE GOVERNANCE CASE STUDIES: FINANCIAL SERVICES EDITION

Authors : Mak Yuen Teen, PhD, FCPA (Aust.) Email: bizmakyt@nus.edu.sg

Richard Tan MBA, FCA (S'pore) Email: biztclr@nus.edu.sg

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Website : cpaaustralia.com.au

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PREFACE

Over the past eight years, CPA Australia has published eight volumes of corporate governance case studies edited by Associate Professor Mak Yuen Teen. A number of these cases involve financial institutions.

In conjunction with the launch of our report “Banking on Governance, Insuring Sustainability” covering how the largest banks and insurance companies in Asia-Pacific are addressing corporate governance, remuneration, risk management and emerging issues, we decided to release this special collection of case studies relating to companies in the financial services industry. These case studies show what can go wrong when financial institutions fail to pay sufficient attention to good practices in board governance, remuneration policies and risk management practices.

This special collection is co-edited by Adjunct Associate Professor Richard Tan, who like Prof Mak, is from the NUS Business School. Prof Tan has extensive working experience in financial institutions and as a partner in one of the Big 4 accounting firms, where he specialised in risk consulting.

This special edition includes 22 cases from Asia-Pacific, Europe and United States. Eighteen of these cases have been published earlier, with some updated for recent developments. There are four new cases on Capital One, CommInsure (the only case involving an insurance company), Goldman Sachs and Swedbank.

We have organised the cases into those dealing with Board Responsibilities and Practices; Misconduct; Unauthorised Trading; Tax Evasion/KYC; Money Laundering; Bribery; and Cybersecurity Breaches. Clearly, some cases span across a number of issues.

Based on these cases and those relating to other organisations, we can observe ethical failures, failures in board governance, and failures in the three lines of defence as common themes. Undoubtedly, poor corporate culture is often the overriding reason for these failures. Complexity in organisations, cross-border challenges, and compensation are also important contributors.

We trust you will find this special collection interesting and useful.

Associate Professor Mak Yuen Teen and Adjunct Associate Professor Richard Tan
NUS Business School
July 2020

ABOUT THE EDITORS

MAK YUEN TEEN

Professor Mak Yuen Teen is Associate Professor of Accounting at the NUS Business School, National University of Singapore and a former Vice Dean of the School, where he founded Singapore's first corporate governance centre in 2003. He holds first class honours and master degrees in accounting and finance and a doctorate degree in accounting, and is a fellow of CPA Australia.

Professor Mak served on committees and councils that developed and revised the Code of Corporate Governance for listed companies in Singapore in 2001, 2005 and 2018. He is a member of the Corporate Governance Advisory Committee set up by the Monetary Authority of Singapore in 2019. He has developed several corporate governance rankings and served on various corporate governance awards committees.

Professor Mak is a regular commentator and speaker on governance issues and conducts professional development programmes for new and experienced directors, including those in financial institutions, and also for regulators and other professionals.

Professor Mak received the Corporate Governance Excellence Award from The Securities Investors Association (Singapore) in 2014, in recognition of his contributions to corporate governance in Singapore. In 2015, he received the Regional Recognition Award for Corporate Governance Contribution from the Minority Shareholders Watchdog Group of Malaysia and was recognised by the Singapore Institute of Directors as a CG Pioneer.

For more information about Professor Mak's work, please visit his website at www.governanceforstakeholders.com.

RICHARD TAN

Professor Richard Tan is an Adjunct Associate Professor with the NUS Business School, National University of Singapore. He has about 40 years of governance, risk and control experience in both the financial services and non-financial services industries, and in risk consulting. He retired from KPMG as a Risk Consulting Partner where he led in the provision of governance, internal audit, and enterprise risk management services. He has advised boards and senior management on corporate governance, risk and control assurance, and enterprise risk management matters. Richard has worked extensively across the Asia Pacific region and has a good knowledge of risks in these markets and in key industry sectors such as banking, real estate, REITS & business trusts, construction, consumer, charitable organisations/IPCs, and education.

Prior to KPMG, Richard worked in the banking industry for 20 years where he held senior management positions either in internal audit or in technology and operational risk management, and was a member of several group-wide operational risk and new products review committees. His latter role also included managing the group-wide business continuity management, and the group-wide technology and operational risk control self assessment.

Richard currently sits on the board of several SGX-listed and foreign-listed entities as an independent director in the capacity of either the chairman or a member of their Audit and Risk Committee. In voluntary services, he serves on the board of several charities/IPCs and on the management committee of two government-aided schools.

Richard is a fellow member of the Institute of Singapore Chartered Accountants, and a Certified Internal Auditor (CIA). He holds the Certification in Risk Management Assurance (CRMA) and the Certification in Control Self Assessment (CCSA) from The Institute of Internal Auditors Inc (USA), and a Master of Business Administration (MBA) degree from Henley Management College/ University of Reading.

BOARD RESPONSIBILITIES AND PRACTICES

GOLDMAN SACHS: HELLO LLOYD, MEET BLANKFEIN

CASE OVERVIEW

The duality of the Chairman and CEO roles is a longstanding controversy in corporate governance. Having been at the helm as Goldman Sachs' Chairman and CEO since 2006, Lloyd Blankfein has drawn much flak from shareholders concerned with the independence of the board. The rise of shareholder activism in recent years has put pressure on Goldman Sachs to review its leadership structure and generous executive compensation. The objective of this case is to enable a discussion of issues such as Chairman-CEO duality; shareholder activism as a corporate governance mechanism; executive remuneration; and the possible measures that can be taken to ensure good corporate governance.

THE GOLDMAN WAY

Founded in 1869 by Marcus Goldman, the bank was named Goldman Sachs & Co. after his son-in-law Samuel Sachs became part of the firm in 1882 and Goldman's son, Henry and another son-in-law Ludwig Dreyfuss, joined in 1885. The firm carved a name for itself as originators of commercial paper within the money markets. Through the years, Goldman Sachs grew from being the firm that completed one of the biggest IPOs (of Sears, Roebuck and Company) in 1906 to becoming a company listed on the New York Stock Exchange in 1999, renaming itself Goldman Sachs Group Inc. That same year, Henry Paulson assumed the role of Chairman and CEO. In 2006, Lloyd Blankfein took over the reins as Chairman and CEO after Paulson left the post to become the U.S. Treasury Secretary.

It was one of the World's Most Admired Companies, ranked 39th by Fortune,[1] and 2nd amongst the megabanks in 2012. The firm has, through its 144-year history,[2] portrayed itself as being superior to its competitors. It paints an image as being more intelligent, more internally symbiotic, and as one of the best at money-making. It has traditionally prided itself on its business model known as "The Goldman Way", which rests fundamentally on hiring the "most talented" and then engaging these talents in Goldman's tough corporate environment where these hires learn to embrace the firm's "14 Principles" - for instance, that "our clients interests always come first".

A series of changes in leadership, mergers and acquisitions, and changes in the financial environment have shaped its structure, with its main divisions of investment banking, securities, investing and lending and investment management, and offices in more than 40 locations across the globe. In 2012, Goldman ranked 80th on Forbes Fortune 100 list, with revenue of US$36.79 billion and profits of US$4.44 billion.[3]

2013: WITHDRAWAL OF SHAREHOLDER PROPOSAL TO SEPARATE THE CHAIRMAN AND CEO ROLES

It was 11 April 2013. CtW Investment Group had just confirmed the withdrawal of its shareholder proposal after Goldman had agreed to widen the authority and responsibilities of James Schiro, its board's lead independent director. Schiro will determine the board's agenda at future meetings and pen his own statements to shareholders within the annual proxy statement to be issued.

Four months earlier, CtW Investment Group had sent a letter to Goldman Sachs asking for the company to separate the roles of Chairman and CEO by appointing an independent Chairman – one who has been neither an executive officer nor has had other relations with the investment bank.[4]

Lloyd Blankfein won the battle to retain both the Chairman and CEO roles - for the third time in a row since he was appointed to both positions in June 2006.[5] The year before, the American Federation of State, County and Municipal Employees (AFSCME), a labor union pension fund, had put up a similar proposal to separate the roles, only to drop its proposal after Goldman compromised, agreeing to reorganise its board structure by introducing a lead director.[6] This year marked yet another victory for Blankfein, but with the rise of shareholder activism over the years, an uphill battle laid ahead.

BOARD OF DIRECTORS

At the end of 2012, Goldman Sachs had 13 directors, of whom 10 were independent.[7] While the average tenure of each director was approximately five years, three had

This is the abridged version of a case prepared by Chan Rui Qi, Baldwin Choy Ching Fai, Nicole Lim Sing Rong, Zhao Pengcheng under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ng Jun Yan under the supervision of Professor Mak Yuen Teen.

held their directorships for more than 10 years. Two of the directors at that time, David Viniar and Stephen Friedman, were also previous employees of Goldman Sachs.

REMUNERATION

The issue of remuneration has undoubtedly been one of the most hotly debated corporate governance issues in financial institutions.[8] Blankfein was compensated with US$13.3 million in restricted shares in 2012, alongside a US$5.7 million cash bonus and a US$2 million salary. This was US$9 million more than the previous year. At its peak in 2007, his total compensation was US$68 million. Blankfein was on a long-term incentive plan, which would pay him shares depending on his performance. The shares were worth approximately US$5 million as of January 2013. Blankfein was known to be the best-paid banker across the globe. His lavish paycheck had earned him the title of "Most Outrageous CEO" in a 2009 Forbes ranking.[9]

RISE OF SHAREHOLDER ACTIVISM

Shareholder activism has been apparent in many U.S. companies in recent years. A point of contention between shareholders and financial institutions is the lack of separation between the Chairman and CEO roles. As at November 2012, only 43% of firms listed on the Standard & Poor's 500 index had split Chairman-CEO roles, and only 18 firms had policies in place necessitating such a split.[10]

Goldman Sachs was a prominent example of companies that had not separated those roles. Shareholders have been proposing to split the Chairman and CEO roles of Lloyd Blankfein since 2010, citing the potential conflict of interests.

2010: BEGINNING OF THE CALL FOR SEPARATION OF THE CHAIRMAN AND CEO ROLES

In 2010, Goldman Sachs was faced with two proposals from shareholders, Christian Brothers Investment Inc. and Needmor Fund, calling on the firm to split the roles of Chairman and CEO.[11,12] This came at a time when the Securities and Exchange Commission (SEC) had filed a civil fraud suit against the firm for bilking investors in the mortgage deal, Abacus 2007-AC1, merely weeks before the shareholder meeting.[13] The deal was one of 25 mortgage-backed securities in Goldman's "Abacus" program. Goldman had structured and marketed synthetic collateralised debt obligations (CDOs) that relied on the performance of subprime mortgage-backed-securities. It had allegedly defrauded investors by not disclosing how the bank had worked with Paulson & Co., a hedge fund, in selecting the portfolio and that the same fund had intended to short the CDO. Goldman received fees of US$15 million from Paulson & Co. for its work.[14]

The proposals were based on the view that it was the duty of the board of directors to act independently when overseeing management, and a conflict of interest existed since Blankfein was essentially chaperoning his own duties as CEO in his capacity as Chairman. It was also argued that separating the two roles would improve Goldman's image following the subprime mortgage crisis.[15]

At the shareholders meeting, few shareholders queried the Goldman board over the SEC suit, and the Board recommended voting against the separation of the roles. Eventually, one of the proposals was removed from the proxy for being a duplication and the other was voted down. Blankfein retained both his roles.

2011: THE SECOND CALL FOR SEPARATION OF ROLES

On 14 September 2011, AFSCME,[16] a labor union with assets of more than US$850 million, which held 7,101 Goldman shares at that time,[17] launched a proxy proposal for Goldman to split the Chairman and CEO roles through the appointment of an independent Chairman.

To back its proposal, the union cited the 2010 SEC suit over the "Abacus deal" which eventually cost Goldman US$550 million in penalties; contingent liabilities of up to US$3.4 billion in law suits according to a March 2011 10-K filing; and the 2011 Levin-Coburn Report on the Subprime Mortgage Crisis, which pointed that conflicts of interest was the driving force behind Goldman putting its own monetary interests in front of its customers'.
The 2011 Levin-Coburn Report noted how during the tenure of Paulson and Blankfein, Goldman's business focus had turned to that of a trading house from its fundamental investment banking role. Under Paulson's tenure, Goldman had canvassed regulators to exempt investment houses from having to keep reserve funds, which would have played the role of limiting the firm's leverage and risks undertaken. AFSCME thought the exposure to risks was potentially detrimental to the bank's stock price, and that the adoption of its proposal could mitigate such risky behavior, serving the long-term interest of investors.[18]

On 28 March 2012, the AFSCME announced that it had withdrawn its proposal the month before, after talks with Goldman's Board Secretary, John Rogers. It was agreed that Goldman would put in place a lead director, allaying concerns over the dual role of Blankfein.[19]

On 3 April 2012, James Schiro was appointed lead director of the Goldman board. Schiro had been on the board since 2009. A Goldman spokesperson told *The Huffington Post* that the independent directors decided to elect Schiro. There was no involvement on the part of management, and that Goldman was confident Schiro would "serve shareholders well".[20]

AFSCME was not satisfied with Goldman's decision to appoint Schiro, and claimed Goldman went against its recommendations regarding the candidates that would be "less desirable" on its board. Schiro was the former CEO of Goldman's auditor, PricewaterhouseCoopers. He also sat on the board of PepsiCo Inc., a firm that has received much flak over the years for its CEO compensation practices. A lead independent director was undoubtedly not as compelling as having an independent chairman. "This is a step in the right direction. But it remains to be seen if it is enough," commented Lisa Lindsley, AFSCME's director of capital strategies on Goldman's appointment of a lead independent director.[21.]

2012: THE THIRD CALL FOR SEPARATION OF ROLES

On 13 December 2012, CtW Investment Group sent a letter to Goldman Sachs with regard to its proposal to separate the roles for inclusion in the year's proxy statement. It recommended putting in place an independent chairman, one with no current or prior executive role or having any other affiliation with Goldman. CtW is an investment firm that advises union pension funds, had US$200 billion in assets and 5.5 million members,[22] and owned 25 Goldman shares.[23] According to CtW:[24]

> *"The chairman should be an independent director to promote the robust oversight and accountability of management, and to provide effective deliberation of corporate strategy, something we believe is difficult to accomplish when the most senior executive also serves as the board's leader. Even with robust responsibilities, we believe the position of a lead independent director is inadequate to this task because competing or conflicting responsibilities for board leadership remain with the chairman/CEO"[25].*

CtW went a step further, defining "independence" as follows:

> *"A chairman cannot have had a financial relationship with Goldman Sachs valued at more than US$100,000 annually in the last three years, been employed by a public company at which a Goldman Sachs executive serves as a director, or be a direct relative of a Goldman Sachs director".[26]*

Following CtW's proposal, Goldman Sach's Associate General Counsel, Beverly O'Toole, sent a letter to the SEC on 16 January 2013 seeking approval for the proposal to be excluded from its proxy statement because the bank thought it was "inherently vague and indefinite" on six counts, including how the term "affiliate" was not clearly defined and could take on more than a single meaning.[27] The firm also questioned the clarity of the fourth independence criterion proposed by CtW. That is, whether a director had a ''business relationship with Goldman Sachs worth at least US$100,000 annually". Goldman Sachs rebutted that it was overarching, blankets all business relationships worth a minimum of US$100,000, and that the type of business relationship and measurement of the US$100,000 was not defined.

On 12 March 2013, the SEC replied, refusing Goldman's request on grounds that it did not concur with Goldman's view that CtW's proposal was "inherently vague or indefinite".[28]

> *"We are unable to conclude that the proposal is so inherently vague or indefinite that neither the shareholders voting on the proposal, nor the company in implementing the proposal, would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires. Accordingly, we do not believe Goldman Sachs may omit the proposal from its proxy materials."*

On 11 April 2013, Goldman Sachs reached an agreement with CtW. The company would widen the authority and responsibilities of James Schiro, its board's lead independent director. Schiro will determine the board's agenda at future meetings and pen his own statements to shareholders within the next issue of the annual proxy statement.[29] The board would also increase the frequency of its independent director annual meetings, from 2 to 4. In return, CtW withdrew its proposal. Blankfein kept his dual roles once again.

Governance experts like independent governance analyst Paul Hodgson and Amy Borrus, deputy director at the Council of Institutional Investors in Washington, believed that the shareholders had achieved significant progress considering the high percentage of Goldman shares owned by its employees.[30] As of 1 February 2013, partners of Goldman Sachs, who were its most senior staff, owned approximately 11.6% of the company's shares.

EPILOGUE

After the SEC had turned down Goldman's request to keep CtW's proposal off as an item to be voted upon, Goldman's lead independent director met with CtW. There, CtW executive director Dieter Waizenegger laid out concerns as to whether Schiro would act as an effective balance of power to Blankfein. The latter appeared attentive toward shareholder interests. German-born Waizenegger shared common ground with Schiro who served as the CEO of Zurich Financial Services from 2002 to 2009. Waizenegger told the Reuters that CtW has a commitment to continue the dialogue and engage with Goldman in the future, including discourse over other environmental and social issues.[31]

With regards to CEO compensation issues, Blankfein's 2013 remuneration saw an overall 11% increase from 2012. The restricted shares held by Blankfein were worth US$14.7 million as of January 2014, and his cash bonus was US$6.3 million.[32] His raise came in a year when many at Goldman Sachs took a pay cut, with an estimated four percent drop in the average worker's salary.[33] In view of the flak Blankfein has received over his pay, this latest increment is set to rile critics and attract objections from corporate governance pundits.

Fast forward to July 2018, the company announced Blankfein's retirement as Chairman and CEO by September that year. Goldman's president and co-chief operating officer, David Solomon took over from Blankfein. Like Blankfein, he will also hold both Chairman and CEO roles.[34]

In the meantime, Goldman has been caught right in the middle of the 1MDB scandal. Critics may wonder – did the fact that it did not separate those roles contribute to this latest and its biggest scandal yet?

DISCUSSION QUESTIONS

1. Shareholder activism has often been argued to be an important corporate governance mechanism. Do you agree?
2. Do you think CEO duality is necessarily bad corporate governance? What are its pros and cons, if any? How different are codes or regulations over the Chairman-CEO role for U.S, UK and Singapore firms?
3. What is your view about CEO duality in the case of Goldman Sachs? What has its impact been for Goldman shareholders? Can CEO duality be justified with Goldman's good financial standing?
4. Amy Borrus, deputy director at the Council of Institutional Investors in Washington had said "It's a significant improvement…Persuading a board to take away the chairmanship from a CEO-Chair is one of the hardest 'asks' in corporate governance". Should AFSCME and CtW have withdrawn their proposals after a compromise with Goldman Sachs rather than allow shareholders to vote on them?
5. What do you think are possible measures that can be taken by stakeholders (e.g., regulators, board of directors and shareholders) or management in curbing the perceived problems of CEO duality, if any?

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HSBC: WHO'S THE BOSS?

CASE OVERVIEW

In September 2010, the business world was shocked by a public boardroom debacle at HSBC. Incumbent Chairman, Stephen Green, had announced his premature departure from HSBC ahead of schedule, putting HSBC's succession plan into the spotlight. An unforeseen and public power struggle ensued, with speculation as to whether incumbent CEO Michael Geoghegan or one of several other possible candidates would get the top job. The chaotic succession process undermined HSBC's stellar reputation for smooth management succession, and damaged the credibility of the board. The objective of this case is to allow a discussion of issues such as the importance of board and senior management succession planning and what it entails; the difference between a Chairman's and CEO's roles; attributes of a good Chairman; and whether former senior executives should become board chairmen.

A MODEL OF SMOOTH SUCCESSION

HSBC has a long history of smooth board and senior management succession underpinned by clear succession plans. Regular review of these plans by independent non-executive directors also serves to strengthen its robustness.

The succession process for the Board Chairman position involves extensive benchmarking against external candidates to ensure its internal candidates are up to standard and not simply chosen by virtue of their insider status. This seeks to ensure that the best candidate is chosen - one who has the capacity for strategic thinking, authority to run the board, and persona standing to represent HSBC externally. Institutional shareholders are consulted with respect to the succession plan, in addition to an independent search process for potential candidates.

HSBC's past successions for the Board Chairman position have been low key, without major disruptions to the business or public outcry. Successions have also been traditionally consensus-driven, with the succession receiving unanimous support from the board of directors.

OVERHAULING HSBC'S MODEL OF SUCCESSION

In May 2006, Michael Geoghegan replaced Stephen Green as CEO of HSBC, while Green was promoted to Chairman. Despite executing another smooth CEO-to-Chairman hand-over,[1] HSBC was criticised for its tradition of promoting its CEO to Chairman, as this was perceived to impair the Chairman from independently and objectively monitoring the company. The handover was thrown into focus in part due to a growing focus on corporate governance.

The roles at HSBC had traditionally been such that the Chairman functioned more as a CEO, while the CEO served as the deputy. Following the handover, Green concurred with governance critics that the operational management and oversight roles should be separate and distinct. He spent the next few years of his term as Chairman taking significant steps to re-define these two roles,[2] transferring the responsibility for strategy development from Chairman to CEO in 2009 and taking on more of a monitoring and ambassadorial role as Chairman. Besides paving the way to a more palatable corporate structure within the bank, these actions emphasised HSBC's renewed commitment to corporate governance.

END OF AN ERA OF SMOOTH SUCCESSION

In late May 2010, news that Green was to step down as Chairman of HSBC within a year leaked out in various media reports. According to these reports, HSBC's board was prepared for the transition and had spent the past three years putting together a succession plan.[3] This involved ceasing the tradition of promoting the CEO to Chairman and naming possibly the bank's first non-executive Chairman successor – John Thornton - a HSBC non-executive director who was also a former Goldman Sachs partner. However, these rumours were refuted by HSBC.

Four months later, on 7 September 2010, an official HSBC announcement confirmed that Green had agreed to become the U.K. Minister of State for Trade and Investment.[4] Following the announcement, the bank revealed that it had always intended "to approve a successor to Mr. Green before the end of the year, and

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that timetable remains on schedule".[5] However, Green had initially announced in May that he would stay on as Chairman until at least the spring of 2011[6] but he had suddenly decided to leave before the year-end,[7] leaving the bank with just three months to appoint a replacement. His premature departure forced HSBC's board to come to a swift decision regarding the succession.

As Green was highly regarded as a modern influence on the 145-year-old bank and had led it admirably through the 2003 U.S. subprime division crisis as well as the 2008 global financial turmoil, it came as no surprise that HSBC's share price plunged when news of Green's leaving first leaked in May 2010 - investors viewed his departure as the loss of a major asset for the bank.

With no official word from HSBC on the candidates to succeed Green, there was widespread speculation in the media.

It was reported that, within HSBC, many wished for the bank to maintain its tradition of promoting the CEO to Chairman. CEO Geoghegan was a hardworking "banker's banker"[8] who had held posts within HSBC all around the world in his 37 years with the bank, a decisive and quick-thinking CEO who had earned the respect of many of his staff. However, certain factors hampered Geoghegan's appointment. First, it seemed that his aggressive management style did not sit well with investors, who did not see his adversarial ways as suited to leading the board[9] and performing the ambassadorial role of a Chairman. Second, and perhaps more significantly, corporate governance guidelines since 2003 had recommended that British companies should not elevate CEOs to Chairmen.[10] HSBC appeared inclined to abandon its tradition of promoting the CEO to Chairman and appoint a non-executive Chairman as a more independent check on the CEO-led business. This would leave Geoghegan out of the race.

Given this turn of events, the board's final decision on chairmanship was very much unpredictable to observers. This was apparent from the extensive list of potential candidates generated through public speculation.

Other frontrunners for the role included John Thornton, a non-executive director who was more well-received by investors[11] because of his independence from bank management, but an unpopular choice internally due to his harsh management style developed from his stint at Goldman Sachs. Another candidate was Douglas Flint, HSBC's Finance Director, who was viewed as a "compromise candidate"[12] to placate both investors and management, although he had perceivably less showmanship and experience at HSBC than Green and Geoghegan[13] and faced the same question on independence. Media reports also mooted the idea of a temporary Chairman,[14] with Simon Robertson (a senior independent director at HSBC) taking the role. However, this was widely viewed as unlikely given Robertson's role as Chair of the Nomination Committee, designated to appoint Green's successor, and his existing duties at Rolls-Royce.

With seemingly no clear successor at the time of Green's announced departure, and a myriad of potential candidates that appeared to leave the public and internal stakeholders divided, the succession looked poised to be the most chaotic that HSBC had seen for a long time.

POWER STRUGGLE IN THE BOARDROOM

To add to HSBC's troubles, news leaked on 21 September 2010 in *The Financial Times* that Geoghegan had threatened to resign after being informed at a meeting that the board did not intend to give him the position of Chairman.[15] HSBC's executives commented that Geoghegan could be unhappy at the possibility of being passed over in favour of Thornton. HSBC eventually followed up with a strongly-worded denial of the incident.[16] However, the damage had been done – the information leakage had given the public an insight into the boardroom power struggle. The picture of a fractured board and rifts over HSBC's succession were thrust into public spotlight.

Even though the official stance of HSBC and its top management suggests that Geoghegan's threat to resign might have been exaggerated and sensationalized,[17] what the public saw at that point in time was an extremely disorganised and poorly conveyed succession plan within HSBC, which is ill-befitting of a large global bank. Naturally, many questions arose. If this leadership transition had indeed been planned for, why did stakeholders and in particular, Geoghegan, not seem aligned to the plan prior to the announcement, leading to internal confusion and the subsequent uproar? It was clear from an external viewpoint that HSBC had not conveyed the plan and managed expectations well, both internally and externally. The pressure was intensified for HSBC to achieve a resolution as swiftly as possible, in order to assuage investors' discontent, prevent divisiveness within the organisation on candidate selection, and restore its public image.

THE DILEMMA

In selecting a new Chairman, the Nomination Committee's dilemma was obvious. Geoghegan was a long-serving HSBC banker with a wealth of intimate knowledge on HSBC's operations. With Green already leaving, the loss of Geoghegan would be a double-whammy. Yet, condoning Geoghegan's appointment and promoting him would undermine shareholders' wishes and impede HSBC's effort to keep up with changes in the governance landscape.

It seemed like no resolution would be able to completely reconcile the interests of shareholders and management. The need and urgency for the board to arrive at a resolution in keeping with the best interests of the company and to quell public speculation on the internal rift was pressing, while external perceptions of an ill-conceived and ill-conveyed succession plan continued to plague HSBC.[18]

THE RESOLUTION

On 24 September 2010, just three days after the reported spat between Geoghegan and the board, HSBC unveiled a new leadership team.[19] After consideration of numerous factors, the board made a unanimous decision to appoint Douglas Flint to succeed Green as Chairman. Stuart Gulliver was appointed Group Chief Executive, while Sir Simon Robertson remained the senior independent non-executive director and assumed the concurrent role of Deputy Chairman. Geoghegan would continue to serve in an advisory capacity until 31 March 2011, after which he would formally retire.

John Thornton stayed on as HSBC's non-executive director. The appointment of Robertson as Deputy Chairman was aimed at countering investors' discontent[20] about the newly-installed, predominantly executive leadership team.

INVESTORS' REACTION

Investors' reaction to the new leadership team was generally positive. On the day the leadership changes were announced, HSBC shares increased by 0.4 percent to 666.4 pence.

General investor sentiment was that despite the infighting, "the right men have ended up in the right jobs".[21] However, many institutional investors remained upset at the poorly executed succession, and their disapproval manifested in numerous calls for HSBC's non-executive directors to be replaced, to take responsibility for the "bloody mess"[22].

DISCUSSION QUESTIONS

1. What is the purpose of a succession plan and what are the components of a comprehensive succession plan?
2. How is succession planning for the board and senior management different for companies with controlling shareholders?
3. Identify the problems that arose as a result of HSBC's Chairman succession. What was lacking in HSBC's succession plan?
4. What is the impact of poor succession planning on HSBC and its stakeholders?
5. What are the roles of the Chairman and the CEO? How are they different? What are the attributes of a good Chairman?
6. What are the pros and cons of having the CEO becoming the Chairman? In your view, has HSBC addressed the concerns of the CEO becoming Chairman by appointing the Finance Director as Chairman?
7. How should a company balance its needs against the expectations of external stakeholders with respect to compliance with good practice?
8. Imagine you are Sir Robertson right after the news broke about the CEO threatening to leave. How would you resolve the situation within and outside HSBC to protect the firm from adverse market reaction?

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THE CO-OPERATIVE BANK: THE WITHERING FLOWERS

CASE OVERVIEW

On 21 November 2013, Paul Flowers (Flowers) was arrested as part of a drug supply investigation. The drug scandal led to Flowers' immediate suspension from his role as a Methodist Church minister and as a member of the Labour Party. Additionally, it sparked a "root and branch" investigation into how the failing Co-operative Bank, where Flowers formerly held the role of Chairman, was run, and how the Co-operative Group ended up with a £1.5 billion shortfall in capital. It was discovered that the directors in the Co-operative Bank were selected based on the candidates' performance in psychometric tests and on interviews by the Committee which focused more on candidates' knowledge of the Co-op Group than their expertise and experience. Additionally, although Flowers was considered as an independent Chairman, he was actively involved with the Co-operative movement and the Labour Party, both of which have strong ties with the Co-operative Bank. The objective of this case is to allow a discussion of issues such as board structure and composition; the role of different parties (i.e., board of directors, nominating committee, regulators and shareholders) in selecting and approving appointments of directors; director selection criteria; director competencies and independence; responsibilities and critical skills and competencies of the Chairman; politically-connected directors; and ethics.

THE CRYSTAL METH-ODIST

Paul Flowers, a Bristol University theology graduate, had been a minister of the Methodist church in Bradford since 1976. He was a long-serving member of the Methodist Conference and was, for a number of years, the Secretary and then the President of the Consultative Conference of European Methodist churches.

Flowers had also been an active member of the Labour Party since he was 16 years old. He served as a Labour councillor in Rochdale from 1988 to 1992, and was elected as Labour councillor in Bradford in 2002. Flowers had also been active in the community, serving on the boards of various community-based organisations, such as the Lifeline Project, which works with substance abuse users. However, on September 2011, Flowers resigned as a Labour councillor after adult content was found on his council laptop.

PLANTING SEEDS IN THE CO-OPERATIVE BANK

Flowers was appointed to the Board of The Co-operative Bank plc (Co-op Bank) in 2009 following its merger with the Britannia Building Society. In April 2010, he was appointed as Chairman of the Co-op Bank and Vice-Chairman of The Co-operative Group Limited (Co-op Group).

The rise of Flowers through the ranks of the Co-op Bank was not due to any banking expertise as he had a mere four years of employment at National Westminster Bank Plc. Rather, it was due to his political connections and the tradition of the Co-op Group of "appointing a democrat from within its own numbers as the chair of that board".[1]

TIES THAT BIND: CO-OPERATIVE AND LABOUR

The Manchester-based Co-op Group is a mutual society which traces its roots to the Rochdale Society of Equitable Pioneers. In 1927, the political wing of the Co-op Group, the Co-operative Party, accepted a junior role within the Labour Party. Since then, the Co-op Group has been closely aligned with the Labour Party, with £1 million spent annually to fund pro-Labour activities, along with a total of £18 million in "soft loans" over the years at interest rates well below that of the market.[2] This support was reciprocated in the form of advice from Labour politicians, which often shaped the Co-op Group's business decisions.

POLITICAL CHEERLEADING

In October 2008, the Co-op Bank planned to merge with the Britannia Building Society. However, this was dependent upon parliamentary support for a bill that would remove legislation prohibiting mergers between mutuals and co-operatives. In support of the merger, Ed Balls, the then-Secretary of State, Children, Schools and Families, and a Labour-Co-operative member of parliament, supported the bill. He also maintained constant contact with Len Wardle (Wardle), the Chairman of Co-op Group at that time and the "darling of the Left-wing establishment",[3] who continually encouraged the merger. The merger between Co-op Bank and Britannia

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Building Society, lauded by Balls as Britain's "first-ever 'super-mutual",[4] was completed in August 2009.

Following this, the board of directors had to approve the merger. Flowers, then a director of the Co-op Bank, approved the merger and allowed it to proceed.[5] Flowers' cooperation eventually led to his promotion to Chairman of the Board of the Co-op Bank.

BOARD STRUCTURE

The Co-op Bank had only one executive director on its 13-member board of directors. Barry Tootell, the Chief Executive Officer and sole executive director of the Co-op Bank, held an executive directorship not only in the Co-op Bank, but also in the Co-operative Banking Group Limited (Co-op Banking Group), CIS Limited and CIS General Insurance Limited, effectively holding four executive directorships within the Co-op Group.

Additionally, the majority of the Co-op Bank's board was not independent as there were only five independent directors present. This was not in line with the U.K. Corporate Governance Code's recommendation that "at least half the board, excluding the Chairman, should comprise non-executive directors determined by the board to be independent".[6] The Co-op Bank explained in its 2012 annual report that it was taking steps to recruit new independent non-executive directors to "improve the Board's independence and ensure compliance with the Code".[7]

Furthermore, only two out of five members on the Co-op Bank's nominating committee were considered independent non-executive directors. In this regard, the Co-op Bank, yet again failed to comply with the Code that states "a majority of the nomination committee should be independent non-executive directors".[8] This could potentially have an adverse impact on the Code's recommendation of "a formal, rigorous and transparent procedure for the appointment of new directors to the board".[9]

CLIMBING THE CO-OPERATIVE LADDER

The Co-op Bank's board of directors was drawn from the regional boards of the Co-op Group, each having different backgrounds, ranging from plasterers to horticulturalists. Many directors were also veterans of the Co-operative movement and had former ties with the Labour Party. As David Stanbury, a member of the Co-operative movement, once commented, "How did Flowers and people like him get into their positions? The answer is that a lot of it stems from their positions within the Labour Party."[10]

In 2010, Bob Burlton stepped down as Chairman of the Co-op Bank. The task of appointing a new Chairman fell to the Remuneration and Appointments Committee, which comprised largely of ex-Labour politicians and Co-operative members. In line with the Co-op Group's tradition,[11] Wardle, Chairman of the Co-op Group, looked at the Group's board for a potential successor for the Co-op Bank.

Flowers had ticked all the right boxes. He was a long-serving member of the Co-operative movement, had been an active member of the Labour Party for years, and was known for his robust style of dealing with people who disagreed with his views.[12] After being shortlisted, Flowers was subjected to various psychometric tests and interviews by the Committee.[13] Interviewees were quizzed extensively on their knowledge of the Co-op Group, which Flowers easily aced, resulting in a unanimous decision to select him as the next Chairman of the Co-op Bank.

LABOUR PARTY TIES

Out of the 13 directors on the Co-op Bank's board, three directors had direct relationships with the Labour Party. Besides Paul Flowers, Duncan Bowdler was a Labour Party and Co-operative member[14] and was involved in several community organisations in Crumpsall, Manchester. It was speculated that his appointment as non-executive director in the Co-op Group, Co-op Banking Group[15] and Co-op Bank was due to his 37 years of active involvement in the Labour and Co-operative movements.[16]

Another director, Wardle, was a former Labour councillor and prominent member of Labour's sister party, the Co-operative Party. Despite the lack of a discernible background in business, he was the Chairman of Co-op Group and a non-executive director of both the Co-op Banking Group and Co-op Bank. He was also the main champion of the merger of Co-op Bank with the Britannia Building Society in 2009, which went through with the help of his allies in the Labour government.

CO-OP GROUP TIES

All the directors of the Co-op Bank were also directors of the Co-op Banking Group. On top of their positions in the Co-op Banking Group, nine directors held additional directorships within other branches of the Co-op Group umbrella.[17] Peter Marks, the Group Chief Executive of Co-op Group, was the "driving force" in pushing for the acquisition of the Lloyds Banking Group branches despite concerns about overstretching in the financial division.[18]

On the push for the acquisition, Andrew Tyrie, the current Chairman of the Treasury Select Committee, criticised the former management of the Co-op Bank, saying that there was "a lack of personal accountability at senior levels, ineffective corporate governance and insufficient experience and expertise among those taking the decisions; this has become a familiar story." [19]

THE FINAL HURDLE

Before Flowers could be officially appointed, he required the approval of the U.K.'s Financial Services Authority (FSA), whose role has since been succeeded by the Financial Conduct Authority from 1 April 2013.

In Flowers' interview with the FSA, the regulators dismissed Flowers' past conviction for gross indecency as irrelevant.[20] The main issue was, instead, his lack of financial experience. Flowers acknowledged this, and proposed appointing two experienced deputy chairmen to assist him. The regulators accepted this proposal and subsequently approved his appointment as Chairman of the Co-op Bank.[21]

Flowers was officially appointed as the bank's non-executive Chairman on 15 April 2010. However, problems soon surfaced. In July 2011, Flowers approved the planned takeover of 632 Lloyds Banking Group branches despite strong opposition from his deputy chairmen, Rodney Baker-Bates and David Davis.[22] The progression of the deal, codenamed Project Verde, by the Flowers-led board led to Baker-Bates' resignation.[23] Despite losing Baker-Bates, Flowers did not appoint a replacement deputy, and the issue was not pursued by the FSA. This resulted in a lack of checks and balances, which came into serious question when Project Verde eventually fell through and the Co-op Bank was found to have a £1.5 billion "black hole" in its finances.[24]

THE END OF FLOWERS

Flowers subsequently stood down from all his roles within the Co-op Group and the Co-op Bank. Following this, The Mail on Sunday published a video footage of Flowers allegedly boasting about his use of cocaine and other illegal drugs.[25] The Methodist Church and the Labour Party then suspended Flowers who was investigated by the police and the Commons Treasury Select Committee.

The "nightmare" at the Co-op Bank led to British Prime Minister David Cameron announcing in the House of Commons that he would initiate an inquiry to determine how Flowers had come to be appointed as Co-op Bank's Chairman.[26] Not only were questions being asked about Flowers' credentials and the motivation behind his appointment, but also the process behind FSA's approval. There was also the issue of how the Co-op Bank spent two years attempting to acquire the 632 Lloyds Banking Group branches, particularly as the FSA would have needed to approve the transaction. One thing is clear – the £1.5 billion black hole was truly a huge price to pay for such a lesson on corporate governance.

DISCUSSION QUESTIONS

1. Evaluate the board composition and structure of the Co-op Bank.
2. What are the typical responsibilities of the Chairman of a Board? What are the most critical skills and competencies of a Chairman? Evaluate the skills, competencies and the independence of Paul Flowers as Chairman of the Co-op Bank.
3. Evaluate the composition of the Nominating Committee of the Co-op Bank. What is the role of the Nominating Committee in screening Board candidates? How far should the Nominating Committee go in performing due diligence on an individual's personal character and ethics?
4. Discuss the importance of political connections in the appointment of board members in the Co-op Bank and the corporate governance issues that arise from such political connections. To what extent do political connections matter for appointments to the boards of listed companies in your country?
5. What role should regulators play in approving the appointments to boards of financial institutions? What are the rules in your country regarding such regulatory approvals?
6. Given the prevalence of banking groups are in the financial sector (i.e., with a financial holding company and subsidiary bank), do you think this particular structure raises any corporate governance issues? Compare this with banking groups in Singapore and Asia.

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FINDING THE WHISTLE AT BARCLAYS

CASE OVERVIEW

In January 2017, a whistleblower contacted Barclays' board of directors, finding fault with the British bank's entire whistleblowing process. According to the whistleblower, Barclays Group Chief Executive (CEO), Jes Staley, had attempted to uncover another whistleblower who had sent in whistleblowing letters concerning Staley himself. Following the whistleblowing incident, more questions surrounding Staley emerged, questioning his suitability to remain as CEO. Barclays' history of scandals and fines was also brought to stakeholders' attention, raising concerns about Barclays' corporate governance. The objective of this case is to facilitate a discussion of issues such as whistleblowing and the effectiveness of whistleblowers; conflict of interests; the role and effectiveness of the board; and the board's influence on corporate culture.

THE WHISTLE IS BLOWN

In June 2016, two anonymous letters were sent from the U.S. to a number of Barclays board members and a senior executive. The letters concerned the recruitment of Tim Main, the Chairman of the bank's global financial institutions group in New York, who was also Staley's friend and former colleague from JP Morgan. The letter contained complaints about Main's behaviour during his time at JP Morgan and touched on Main's personal history while he was working at JP Morgan.[1] They further questioned the appropriateness of his recruitment to Barclays.[2]

Although the letters were reported not to have contained any new information that people did not already know, the bank's compliance team proceeded with investigations on the whistleblowing issue. Sources described the letters as being "very simple, very crude", and "very malicious".[3]

When Staley obtained access to a copy of the letters, he accused the whistleblower of harassment and alleged that his intent was to "maliciously smear" Main.[4] He then made multiple attempts to identify the whistleblower. Staley's first attempt to identify the whistleblower was put to a stop after he and the information security team were informed that their actions were inappropriate due to the protection of whistleblower anonymity and against reprisal in the firm. A month later, Staley took another stab at the matter by instructing the information security team, led by Troels Oerting,[5] a former Europol official, to track down the identity of the writer, after being informed that the whistleblowing probe had been closed. The security specialists at Barclays then requested for assistance from the U.S. Postal Inspection Service through video footages. However, the hunt proved to be fruitless and was eventually called off.[6]

REFORMS IN THE U.K.

In March 2016, a new regime was introduced by the Bank of England and the Financial Conduct Authority of Britain (FCA) for strengthening accountability in banks and the financial sector.[7] The regime sought to reinforce the accountability of managers on an ongoing basis – entities are required to issue an annual certificate to staff, under prescribed functions, to deem them fit and proper to fulfil their professional duties.[8]

The purpose of the Senior Management Arrangements, Systems and Controls was to encourage directors and senior management of companies to take appropriate responsibility for the company's arrangements on matters likely to be of interest to the Financial Services Authority, making them accountable for the control of the company's affairs.[9,10]

Additionally, under Section 60A(1) of the Financial Services and Markets Act, entities are required to be satisfied that the person is a fit and proper person to perform the required function.[11] A wide range of checks are required to prove that a person is fit and proper, and the onus is on the entity to show regulators that the applicant is a fit and proper person to perform his or her required functions.[12]

WHISTLEBLOWER CHAMPION

The attempts made by Staley to uncover the whistleblower came as a slap to Barclays as the bank had just appointed a 'whistleblower champion', Mike Ashley, as the Chairman of its Audit Committee in 2016. As the 'whistleblower champion', he is responsible for "the integrity, independence and effectiveness of the Barclays' policies and procedures on whistleblowing, including the

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procedures for protecting employees who raise concerns from detrimental treatment".[13] Upon his appointment, Ashley sent all employees a video to highlight and raise awareness of Barclays' policies and procedures regarding whistleblowers.[14]

THE SECOND COMING

In January 2017, Barclays' board was contacted by yet another anonymous whistleblower. The whistleblower touched on issues with Barclay's whistleblowing process, highlighting Staley's treatment of the previous whistleblowing letters the year prior. In light of the new complaint on Staley's potential misconduct, Barclays' directors employed the assistance of a London legal firm to investigate. The legal firm issued a findings statement on 10 April, 2017, which stated that Staley had "honestly but mistakenly" sought to uncover the letter writer's identity without fully understanding the implications of his doing so. The explanation was accepted by Barclays' board. In the following month at the annual shareholder meeting, Barclays' Chairman, John McFarlane, defended Staley, despite condemnation from some investors.[15]

In the midst of the intense scrutiny from various stakeholders, Staley fell victim to emails sent by a prankster who pretended to be the bank Chairman. The prankster was later revealed to be a disgruntled customer of Barclays, who emailed Staley using an email address containing the Chairman's name. Staley responded to the joke emails without realising he had been duped. The emails made their way onto the social media and eventually got published in the media.[16,17]

BARKING AT BARCLAYS

Upon the eruption of Staley's whistleblowing scandal, the FCA and the Bank of England's Prudential Regulation Authority (PRA) stepped in to investigate the matter. The Department of Financial Services in New York was also looking into this incident. If Staley is found to be guilty of the claims, the authorities could decide to ban him from working in the financial services in the future and this verdict would cost him his job.[18]

Amidst ongoing investigations, Jonathan Cox, Barclays' global head of whistleblowing when the scandal took place, filed a lawsuit against the bank but subsequently agreed on an out-of-court settlement and was set to leave Barclays. Richard Atterbury, formerly a FCA official, subsequently took over from Cox as global head of whistleblowing at Barclays.[19]

SHAREHOLDERS REACT

While awaiting the decision from regulators on whether Staley should be allowed to remain as CEO, the bank's shareholders expressed dissatisfaction with Staley's investment banking strategy and poor share price performance.[20]

Apart from the whistleblowing incident, Barclays' share price was negatively affected by other problems – the bank faced a potential multibillion-dollar U.S. civil lawsuit over the alleged mis-selling of mortgage securities and a criminal lawsuit in the U.K. over the controversial terms of its emergency fundraising from Qatari investors during the 2008 financial crisis.[21]

POACHING FRIENDS

After Staley became Barclays' CEO, there were several senior defections from JP Morgan, Staley's previous firm, to Barclays. Following the defections, an email was sent by a managing director at Barclays' New York office to colleagues worldwide, including some of Barclays' top managers, in September 2016. The email stated that both parties "have agreed to a 1-year ban on hiring any JPMC employee by Barclays" in key areas like corporate and investment banking. Less than a week after the initial email was sent, a follow-up email was blasted to recipients, informing them to disregard the original email.[22]

Under the U.S. antitrust laws, such 'no poach' agreements are illegal. The claims of non-poaching agreements between Barclays and JP Morgan had prompted the U.S. Department of Justice (DoJ) to scrutinise Barclays' actions to determine whether it had breached antitrust laws. On the other hand, the U.K. authorities did not pursue the affair as 'no poach' agreements are included widely in U.K. contracts for mid-to-senior ranking employees, especially within the finance industry.[23]

CAUGHT IN THE MIDDLE

Shortly after the whistleblowing scandal came to light, Staley was embroiled in a dispute with one of Barclays' important clients in May 2017. The dispute centred around Kohlberg Kravis Roberts & Company (KKR), a private equity giant, and Aceco TI (Aceco), a Brazilian company founded by Staley's father-in-law.

The conflict between KKR and the Nitzan family arose due to a US$700 million investment gone wrong. In 2014, KKR had purchased a majority stake in Aceco from three sellers. Two of the three sellers were Staley's wife – Debora Staley – and Staley's brother-in-law – Jorge Nitzan, who was the CEO of Aceco. However, within two years, KKR had written off the investment and accused Nitzan, who had been dismissed as CEO, of foul play. KKR further alleged accounting fraud and bribery at Aceco after receiving information from an anonymous whistleblower.[24] Nitzan had denied the accusations and blamed Aceco's travails on the crashing Brazilian economy.[25]

Staley then became involved in the row in a personal capacity. A legal dispute between KKR and Nitzan had ensued, and KKR had approached Staley to listen to the discoveries arising from its investigation, believing that he would convince Nitzan to settle. Alexander Navab, KKR's private equity chief for the Americas, also asked Staley why he was aiding Nitzan despite serious allegations of fraud. Staley countered that he was acting not in his capacity as a Barclays representative but was instead acting privately to defend a family member.[26] However, KKR, viewing the situation as a conflict of interests as a client of Barclays,[27] dismissed the notion and accused him of acting against client interests.[28]

Not only did Staley refuse to assist in the settlement of KKR and Nitzan, he even introduced a potential investor, Timothy Collins of New York firm Ripplewood Advisors, to Nitzan. Additionally, KKR later found out that Staley had also discussed the Aceco matter with some KKR's co-investors in the Brazilian company. Staley had vouched for Nitzan, conveying his belief that his brother-in-law would not be involved in fraud.[29]

As a result of Staley's actions, KKR was reported to have barred Barclays from joining potentially lucrative deals until the dispute was resolved, dealing a huge blow to Barclays' already shaky business.[30]

A HISTORY OF SCANDALS AND FINES

Prior to the whistleblowing scandal, the British bank was already said to have "suffered from a perception of a flawed culture",[31] due to its role in the London Interbank Offer Rate (LIBOR) scandal and other regulatory troubles.

On 27 June 2012, Barclays was fined £59.5 million by the FSA[32] and US$200 million by the U.S. Commodity Futures Trading Commission for attempted manipulation of the LIBOR.[33] The then-Chairman Marcus Agius and former Chief Executive Bob Diamonds resigned the following week.[34] Barclays had started to collude with other banks to manipulate the LIBOR for the benefit of its traders during the global economic upturn in 2005. After the 2008 global financial crisis, Barclays artificially lowered the LIBOR to generate an illusion of a lower borrowing rate and hence the perception of a less risky bank.[35]

During the 2008 financial crisis, Barclay's former Chief Executive John Varley and three ex-senior executives allegedly conspired to provide a US$3 billion unlawful loan facility to the Qatari investors in exchange for a £12 billion capital injection to the bank.[36] The raised funds partially offset Barclays' losses and saved it from accepting a government bailout while its strongest competitors in U.K. – Royal Bank of Scotland and Lloyds Banking Group – had to do so. However, the raised funds were not fully disclosed to the market. Upon the uncovering of its actions, Barclays faced three counts of criminal charges by the U.K. Serious Fraud Office, including illegal financial assistance and conspiracy to carry out fraud by false representation.[37]

In 2014, Barclays was fined £26 million by the FCA for failure to manage conflicts of interest with its customers, and systems and control faults with respect to the London Gold Fixing.[38] Between 2004 and 2013, Barclays trader Daniel Plunkett exploited inherent weaknesses in the firm's systems to influence Gold Fixing. As a result, Barclays did not have to pay US$3.9 million to its customer and Plunkett's own trading book was significantly improved. Plunkett was fined £95,600 and banned from carrying out any function related to regulated activities.[39]

STALEY PAY A PRICE

In May 2018, it was reported that Staley was fined a total of £642,430 by the FCA and the PRA, and Barclays had clawed back £500,000 of his bonus over the matter. The bank would also have to report annually to the regulators, detailing how it handles whistleblowing matters after the watchdogs expressed concerns about its existing systems. The regulators said Staley failed to act with due skill, care and diligence. Staley became the first CEO of a major financial institution to be fined by the financial regulators and keep his job.[40]

Staley survived a bruising annual meeting on 10 May 2017, which threatened the loss of his CEO position in the bank. However, fortunately for Staley, with Chairman McFarlane's strong support, 95% of shareholders backed Staley staying in his position.[41]

New York's Department of Financial Services — known for its heavy penalties on banks — is still investigating and has yet to publish its findings.

HAVE THINGS CHANGED?

Against the backdrop of an increasingly competitive banking landscape, will Barclays and its management personnel be able to resist the temptations of gains – be it financial or otherwise – derived from unlawful misconduct and instead establish good corporate governance to be accountable to all its stakeholders?

Perhaps there is a glimmer of hope with Staley seeking repentance and setting the tone at Barclays in his statement: "I have consistently acknowledged that my personal involvement in this matter was inappropriate and I have apologised for mistakes which I made. I accept the conclusions of the board, the FCA and PRA … and the sanctions which they have each applied."[42]

DISCUSSION QUESTIONS

1. What measures can an organisation put in place to ensure that a whistleblowing system is effective? How can whistleblowers be protected and should employees be incentivised to blow the whistle?
2. Identify the different stakeholders involved in the whistleblowing scandal and evaluate their conduct and responses to the incident.
3. Evaluate Staley's conduct relating to the whistleblowing scandal and his involvement in the dispute involving KKR & Co and Aceco TI.
4. Given the number of scandals Barclays had faced, comment on the board's response. Were the directors and Chairman performing their duties? Should the board have fired the CEO? Explain.
5. What is the role of the board in setting the right corporate culture in a company? How should the board go about doing this and ensuring that it is embedded in the company?

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MISCONDUCT

COMMONWEALTH BANK OF AUSTRALIA: ROGUE ONE

CASE OVERVIEW

Commonwealth Financial Planning Limited (CFPL), the financial planning arm of Commonwealth Bank of Australia (CBA), was involved in a huge fraud scheme from 2003 to 2012. Rogue financial planners at CFPL manipulated their clients' files and forged documents to invest their clients' monies in extremely high-risk investments, with the aim of earning higher commissions and bonuses. Such fraudulent financial advice caused hundreds of Australians to lose their life savings, some running into millions. Despite tipoffs by whistleblowers within CFPL, the Australian Securities and Investments Commission (ASIC) was criticised for being inexplicably slow and inadequate in its response. Meanwhile, CFPL's efforts to compensate the victims were also lambasted as covering up for their rogue planners while trying to bully their victims into settling for minimal compensation. The objective of this case is to allow for a discussion of issues such as the impact of "pay for performance" on behaviour; governance in company groups; management's and directors' roles in ensuring compliance; role of regulators and the media in corporate governance; whistleblower protection; and ethics.

DARK UNDERCURRENTS

Commonwealth Bank of Australia (CBA) is the largest of the big four Australian banks, holding 29% of all household deposits in Australia.[1] Commonwealth Financial Planning Limited (CFPL) is a subsidiary that falls under the wealth management division of CBA, and was helmed by the Head of Wealth Management, Grahame Petersen, from 2006 to 2011.[2] In February 2008, as part of a surveillance program by the regulatory body, the Australian Securities and Investment Commission (ASIC), a warning notice was sent to CFPL, indicating that 38 of its planners had been classified as a "critical risk" for non-compliance with appropriate financial planning advice protocols.[3] That was when Jeff Morris, a newly hired financial planner at the Chatswood, New South Wales branch, sensed something amiss in the bank.

THE LEGEND OF DODGY DON

One of the 38 names highlighted in the warning notice, Donald (Don) Nguyen, was hauntingly familiar to Morris. Don was a fellow financial planner who sat just a couple of feet away from Morris at the Chatswood Branch. He was one of the top writers of CFPL, amassing 1,300 clients[4] who had invested their money with him. In 2007, Don was top on CFPL's Financial Planners league table, managing portfolios worth A$39,064,657 for the bank that year alone, grossly exceeding his annual target by more than three-fold.[5]

But Don's ascent to the peak was a tad dubious. Better known by his colleagues as "Dodgy Don",[6] he had a sinister reputation of notching sales through unscrupulous means. After personally witnessing some of Don's dishonest acts, an outraged Morris alerted his team's Financial Planning Manager.[7] To his disbelief, the manager brushed the issue aside. Morris' colleagues later explained that Don held the aegis of management protection due to his status as a top writer in CBA.[8]

YOU GET WHAT YOU PAY FOR

More than half of a CBA financial planner's total annual remuneration depended on short-term incentives such as bonuses. Commissions were pegged to the risk levels of investment assets sold, hence financial planners had an incentive to encourage their clients to opt for as risky an investment portfolio as possible.[9] Furthermore, the tone at the top was unforgiving - meet your sales targets, or surrender your rice bowl.[10] Such was the "boiler-room" culture CBA had nurtured through an aggressive sales-driven and excessively short-term remuneration incentive scheme - one driven by a myopic chase of bonuses with little place for honesty.

FIRST-CLASS COVER UP

Clients soon started to see the value of their investment portfolios plunge to almost nothing within a short span of months and started inundating the bank with complaints. Against the backdrop of a global financial meltdown, it made no financial sense for the clients, especially the retirees, to opt for such aggressive and risky investment portfolios. Sensing something amiss, Morris took the matter to middle management, but once again, the response he got was one of nonchalance and evasiveness.[11]

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However, growing public pressure forced CBA into a formal investigation, and it was discovered that Don had secretly manipulated the risk profiles of his clients into adopting hyper-aggressive investment portfolios for his own benefit of drawing higher commissions.[12] In particular, an extraordinary number of clients' files "requested" a 50% portfolio allocation to Listed Property Trusts,[13] an extremely risky investment asset. Don had deceived and manipulated his clients into thinking their monies were lost because of misfortune. In September 2008, Don was suspended for fraud and compliance failures.

Meanwhile, complaints from clients of other crooked planners in CFPL, most notably Christopher Baker[14] and Rick Gillespie,[15] continued to flood in. To make matters worse, many of Don's frustrated clients who were left without a planner constantly barraged the bank for explanations. CFPL needed someone to douse the flames - someone who could dupe and discourage the clients from pursuing their complaints. Incredulously, on 15 October 2008, not only was Don reinstated, he was also promoted to the position of a Senior Financial Planner.[16]

Morris soon came to the realisation that an internal resolution to the matter would never succeed as the management themselves were covering up for the planners' fraudulent acts. Yet, Morris wanted to keep his cover as he lacked faith in the regulator's whistleblower protection policies and required more time to continue gathering evidence against Don's wrongdoing. On 30 October 2008, together with two other long-serving colleagues, Morris finally spilled the beans on Don. Under the alias of "The Three Ferrets",[17] they faxed a report to ASIC, voicing the need for urgent action.

However, months passed and there was no sign of ASIC taking decisive action to obtain evidence from CFPL, despite the whistleblowers' tip-off that the clients' files were already being sanitised. Instead, ASIC opted for discussions with CFPL in December 2008, which resulted in the joint solution to "closely supervise" Don and subject his advice to "vetting before approval".[18] Exasperated, "The Three Ferrets" then decided to take the issue to Darin Tyson-Chan, a journalist of the trade journal *Investor Daily* in May 2009.[19]

BREAKING DON

A series of articles spelling out details of Don's fraudulent acts was published by *Investor Daily* from May to June 2009. It was brought to light that CBA knew of "at least 14 cases of forgery as early as October 2008",[20] yet did nothing to remedy the problem. CBA attributed the fraud to "a few bad apples", rather than the lack of compliance within the bank, or any conflicts of interest in their financial planning arm. In fact, to prevent certain documents from being accessed in the likely event of a client lawsuit, senior management arranged for these documents to be processed by the legal department so that these would be given protection of legal privilege.[21] CBA also allowed some of the fraudulent financial planners to resign and move on to other companies instead of giving them the boot,[22] so as to avoid "bad press".

The whistleblowers also sent an anonymous email to CBA Group Security and CBA's Senior Management,[23] alleging CFPL management's attempts to cover up for its rogue planners. This time, it succeeded in triggering a massive knee-jerk response within the bank. CBA Group Security launched a thorough investigation within CFPL, where it was found that an alarming number of Don's client files were missing.

On 3 July 2009, Don resigned citing ill health, which allowed him to draw a lifetime A$70,000 payout per annum under CBA's group insurance policy.[24] To make matters worse, the annual bonuses of Chief Risk Officer, Alden Toevs, and Head of Wealth Management Division, Grahame Petersen, increased by approximately A$4.5 million and A$2.1 million respectively from 2008 to 2010.[25] All these came amidst dismal media stories of terminally ill victims who had lost their life savings due to the rogue planners and were struggling to seek any reasonable form of compensation from CBA.

At the same time, Morris felt immense pressure from the top management, which resolved to identify the source of leaks to the media. With their covers blown and yet no action by ASIC in sight, "The Three Ferrets" were left defenceless.

On 24 February 2010, 16 months after the first anonymous fax Morris had sent to ASIC, the whistleblowers finally stormed through the doors of the ASIC office, demanding that client files be seized and decisive action be taken. "They told me I had Whistleblower Protection from that day. He then went on to say, basically, that it wouldn't be worth much," recalled Morris of his conversation with one of the frontline officers in ASIC.[26] Ironically, Australia had just revised her Corporations Act in 2004 to provide stronger protection for whistleblowers. However, Morris was not surprised by this - it was a common view in the finance industry that ASIC was not the most trustworthy of regulators.[27]

DIVIDE AND CONQUER

On 24 March 2010, ASIC issued an order to CFPL, giving them two weeks to hand over client files undergoing investigation, marking the first sign of confrontation between ASIC and CFPL. CBA was also pressured to devise a compensation scheme to pacify the affected clients. In November 2010, CBA finally proposed a voluntary compensation scheme for the victims. The strategy, however, was to divide and conquer - each victim was isolated so they would have limited knowledge of the greater scheme of things,[28] allowing CBA to incur minimal expenses in the compensation.[29]

Janice Lee Braund and her husband Alan were two of Don's most famous victims. In 2002, the couple entrusted A$1 million of their retirement savings to Don, on hearing of his reputation as the "star planner" of CBA. Yet Don only had his eyes fixed on maximising his commissions. Ignoring the couple's clear instructions of preserving capital, Don forged Braund's signature to transfer their capital to high-risk products that were eventually wiped out when the financial crisis struck in 2009.

Under the compensation scheme, Braund was initially offered A$200,000. With good fortune, she had a note that indicated that "the Braunds had a conservative profile and they were extremely concerned and did not wish to use any of their capital in retirement".[30] Using this note as a bargaining chip for negotiation, her compensation quantum was raised to A$215,000 and subsequently A$880,000.[31] Unfortunately, not all victims had such great bargaining power; most received a less than satisfactory amount of compensation.

FAIR FACTS THROUGH FAIRFAX

ASIC's investigation confirmed the frauds of Don and other financial planners in CFPL. On 26 October 2011, CBA entered into an Enforceable Undertaking (EU) with ASIC for two years. The EU was targeted at reviewing CBA's risk management systems, its internal risk profiling, and the monitoring of its financial planners. During this time, three other financial planners were required to "remove themselves from the industry".[32]

At the same time, Braund's patience was running out with the inadequate responses to her complaints at CBA and ASIC. Despite Braund being granted interviews with ASIC to tell her story, she was adamant that not enough was being done to appease the anger and anguish of the victims. Her repeated complaints to CBA and ASIC had generally fallen on deaf ears, and she was disgusted at CBA's ostensible attempts to cover up. She finally decided to take her story to Fairfax Media.[33] The Fairfax reports triggered a Senate Inquiry the following month, on 20 June 2013, centering on two key issues - the misconduct of financial advisers in CFPL and ASIC's general poor performance.

The final report of the Senate Inquiry was released on 26 June 2014. It contained scathing criticisms of both ASIC and CFPL. "There was forgery and dishonest concealment of material facts," as reported in the inquiry.[34] Committee chairman Senator Mark Bishop said CFPL's actions were "facilitated by a reckless, sales-based culture and a negligent management, who ignored or disregarded non-compliance and unlawful activity as long as profits were being made".[35] He also commented that "ASIC appears to miss or ignore clear and persistent early warning signs of corporate wrongdoing, or troubling trends that place the interest of consumers or investors at great risk".[36] Among a whole host of findings with regard to the wrongdoings of ASIC and CFPL, one was to demand for a royal commission into the saga, though it was eventually rejected.

EMERGING FROM HIS SHELL

The negative publicity from the Senate Report that slammed CBA's financial planning arm created ripples around Australia. Seven days later, on 3 July 2014, Ian Narev, CEO of CBA, who had made an effort to stay inconspicuous, was forced to issue a public apology for the first time and propose a new compensation scheme for the victims.[37] The compensation scheme, titled the Open Advice Review Program, which became operational in mid-August 2014, offered an assessment of any received financial advice.[38] After the assessment, a compensation offer would be made by an "independent customer advocate" funded by CBA. If victims still felt that compensation offers were inadequate, they would be able to appeal to an independent panel, chaired by former High Court judge Ian Callinan, whose decision would then be binding.[39]

Yet, questions had been asked about whether the review process was truly independent,[40] as the first stage of this process was still conducted by CBA. Morris even went so far as to dismiss CBA's new scheme as "first-class window-dressing" and disagreed with the "pull" nature of the review process. "The problem with the process is [that] customers have to complain," Morris said, adding, "I suspect very few will".[41]

BUSINESS AS USUAL

Paradoxically, the share price of CBA did not experience any sustained adverse impact during the saga. The only period during which the share price saw a substantial drop was from 20 May 2013 to 10 June 2013, when the price dipped 11.5% from A$73.49 to A$65.02.[42] Since then, the stock has grown from strength to strength to close at A$80.48 as of 31 October 2014. An analyst report by Richard Wiles of Morgan Stanley even showed calculations of both the financial impact of compensation and the potential impact on revenues due to reputational damages with an eventual price target of A$87.20.[43]

ONE STEP BACK, TWO STEPS FORWARD

The reputational damage borne by CBA was coupled with uncertain financial repercussions. Customer satisfaction ratings of CBA have suffered a drastic drop. Under Roy Morgan's "most-favoured institution" satisfaction assessment, CBA slipped from first place at the start of 2014 to third place in September 2014. This would cause management to lose one quarter of their long-term bonuses.[44] The introduction of CBA's new compensation scheme also led to new claims surfacing daily. At present, A$52 million in compensation has already being paid out, with up to A$250 million possibly required eventually.[45]

In light of the CBA Financial Planning scandal, questions have been asked about the integrity of the financial planning sector, with a lack of customer protection being a major concern. The Australian government has quickly responded by putting new measures into place, including a proposal to establish an enhanced, industry-wide public register of financial advisers to increase transparency in the industry. Additionally, in September 2014, a Corporations Amendment Regulation with regard to the Statements of Advice was made to increase clients' accessibility to information and to minimise possible conflicts of interest.

ASIC has also responded quickly to the criticisms of its role in the Senate Report, establishing an Office of Whistleblower to allow quicker response to whistleblowers and commencing an organisation-wide improvement process of its communications and transparency.[46]

DISCUSSION QUESTIONS

1. Describe the actions taken and behaviour displayed by senior management throughout this saga. Discuss if these actions and behaviour were inappropriate and whether they aggravated the situation. If you were in the position of Ian Narev, the CEO, what would you have done differently during the crisis?
2. *"Show me a company's various compensation plans, and I'll show you how its employees behave"* - Jack Welch, Former CEO of General Electric

   Examine the key areas of concern in CBA's remuneration plan. To what extent do you think these influenced the corporate culture and employee behaviour in CBA? What changes, if any, would you make to the remuneration plan?
3. In the Senate Inquiry Final Report, ASIC was described as "*waiting for complaints, investigating a minute proportion of them, and prosecuting even fewer.*" Critically evaluate the actions taken by ASIC throughout the course of the Financial Planning Scandal, while highlighting difficulties ASIC might have faced during its investigations.
4. The media played an important role in exposing the fraud in CFPL. Discuss the role of the media in promoting good governance in your country. Are there factors which limit its effectiveness?
5. Briefly discuss the importance of a good whistleblower protection policy. Do you think the policy sufficiently protected Morris and his fellow whistleblowers? What further improvements can be made to encourage those who are aware of wrongdoings in an organisation to come forward, instead of remaining silent?
6. CBA had an excellent reputation amongst its customers but CFPL severely damaged it. What are the challenges faced by an organisation like CBA in promoting ethical behaviour, compliance and good governance throughout the group?

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WELLS FARGO: FORGONE REPUTATION?

CASE OVERVIEW

On 8 September 2016, Wells Fargo announced that it had agreed to pay fines amounting to US$185 million to the Consumer Financial Protection Bureau, regarding allegations of Wells Fargo's sales practices. Worse was to come as in February 2020, it had to admit wrongdoing and pay US$3 billion to settle criminal and civil investigations by the U.S. Justice Department and the Securities and Exchange Commission Given its outstanding past performance, how did Wells Fargo end up breaking its customers' trust, and how did it respond to the crisis? The objective of the case is to allow a discussion of issues such as corporate culture; the dual roles of Chairman and Chief Executive Officer (CEO); executive remuneration plans; risk management policies; and the role of the board, external regulators and authorities.

THE WELLS REPUTATION

"Our values should guide every conversation, decision, and interaction."

– *The Vision and Values of Wells Fargo*[1]

NYSE-listed Wells Fargo is one of the world's largest financial institutions, serving 70 million customers[2] and boasting total assets amounting to US$1.9 trillion.[3] Its market capitalisation of around US$240 billion in early September 2016 made it one of the most valuable banks in the US.[4] It also received accolades such as 'Best Bank in North America (2016)' by the Global Finance Magazine.[5]

Being a largely conservative and conventional lender allowed Wells Fargo to weather the financial crisis of 2008[6] and outperform its competitors in customer satisfaction surveys.[7] In his 2015 letter to shareholders, then-CEO John Stumpf attributed Wells Fargo's success to the relationships fostered with customers, and stated that the trust placed in the bank would never be taken for granted.[8]

JOHN STUMPF: THE STAGECOACH DRIVER

Stumpf worked his way up the corporate ladder in the loan department of Norwest Corp and joined Wells Fargo when the two firms merged in 1998. He was appointed CEO in 2007 and Chairman in 2010,[9] and was subsequently awarded 'Banker of the Year' by American Banker in 2013 and 'CEO of the Year' by Morningstar in 2015.[10] In 2015, his remuneration amounted to US$19.3 million.[11]

BROKEN TRUST

On 8 September 2016, it was revealed that Wells Fargo's employees had opened about two million unauthorised deposit and credit card accounts since 2011 to satisfy sales goals and earn financial rewards under the bank's incentive-compensation programme.[12] Sales figures were inflated by moving funds from existing accounts into unconsented new ones, and by creating unconsented applications for credit card accounts. This also increased earnings from unwarranted charges such as overdraft fees on original accounts.[13] The fraudulent misconduct was attributed to the obsessive sales-driven culture at Wells Fargo,[14] which previously surfaced in a 2013 report by the Los Angeles Times (LA Times), and may have gone back more than 10 years.[15] Wells Fargo had caught onto the problem internally, with then-CEO and Chairman, John Stumpf, himself unsurprised by the 2013 article.[16]

Fines totalling US$185 million levied by regulators represented a minor setback for a bank bringing in annual profits of over US$20 billion.[17] However, Wells Fargo's stock price plunged to a two-and-a-half year low and its reputation was damaged, as reflected in a survey done by consultancy firm cg42, which showed negative perceptions of the bank rising to 52% from 15% during the period prior to the scandal.[18]

THE "GR-EIGHT INITIATIVE"

After the scandal broke, fingers were pointed at Stumpf for allowing a sales-driven culture to perpetuate in the company.[19] Contrary to the prudent approach to managing risk described in Wells Fargo's annual report,[20] one of Stumpf's mantras was "eight is great";[21] employees were pushed to sell at least eight financial products per household in what was known internally as the "Gr-eight initiative".[22] This cross-selling – pushing different products to the same customer – was a key strategy at Wells Fargo. In 2016, the average retail banking household reportedly used 6.27 Wells Fargo products.[23]

This is the abridged version of a case prepared by Dominic Wong Ngiap Chuang, Yeo Jing Wen and Lee Chang Cheng under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

In a hearing with the Senate Banking Committee, Senator Elizabeth Warren of Massachusetts said that Stumpf touted cross-selling as one of the main reasons for investors to buy Wells Fargo's stock and berated him for squeezing employees to the point that they cheated customers.[24]

CORPORATE CULTURE

Former employees alleged that they were trained to "push customers to open multiple accounts"[25] and were even coached on how to "inflate sales numbers".[26] Branch managers were assigned quotas that were carried forward if targets were not met during the period. The number of new accounts, down to individual employees, were collected by district managers four times a day,[27] with warnings issued for unsatisfactory performance. Furthermore, financial incentives were pegged to cross-selling targets, with personal bankers receiving as much as a 20% bonus.[28] This resulted in a 'pressure-cooker' environment where employees sold products that arguably did not serve the best interests of customers.[29]

However, when rumours of the aggressive sales culture first circulated in 2013, executives like then-Chief Financial Officer (CFO) Tim Sloan denied any form of overbearing sales culture in Wells Fargo, adding that there were "multiple controls in place to prevent abuse" such as an ethics program for employees and a whistleblower hotline to notify senior management of potential violations.[30]

Wells Fargo eventually announced a revamped employee compensation and incentive plan effected in January 2017, which would not include any sales goals, and where performance evaluations would be based on customer service, usage and growth, instead of simply the number of new accounts opened. The new head of community banking, Mary Mack, described this as a milestone for Wells Fargo to restore trust both within and outside the organisation.[31]

DUAL ROLES

The dual roles held by Stumpf since 2010 was another point of contention. CtW Investments suggested that splitting the roles with an independent board Chairman "could help repair the bank's broken compliance systems".[32] Rafferty Capital, a brokerage firm, lambasted Stumpf's lack of leadership as Chairman. Although there was a board meeting and the board could have clawed back the pay of the executives involved, no statement was issued on potential clawbacks. Rafferty Capital's analyst stated that this represented "the strongest argument" for removing Stumpf as Chairman.[33]

After repeated calls, Stumpf resigned as CEO and Chairman of Wells Fargo on 12 October 2016. Tim Sloan, who served as Chief Operating Officer (COO) from November 2015 to October 2016, was promoted to CEO, while lead independent director Stephen Sanger became the non-executive Chairman of the board. In December 2016, Wells Fargo amended its bylaws to require a separate Chairman and CEO,[34] as well as an independent Chairman and Vice-Chairman of the board. These moves were unconventional for banks in the US but were viewed favourably by analysts, such as Gerard Cassidy of RBC Capital Markets, who felt it "should help relieve some of the political pressures the company has felt."[35]

However, there were concerns regarding the promotion of Sloan who, as COO, was in charge of the community bank and consumer lending divisions, the centre of the scandal. Among his critics was House Democrat Maxine Waters, who felt that the COO had the potential ability to stop the misbehaviour.[36] FBR Capital Markets also believed that new blood was required to solve the 'toxic' cultural problem.[37]

EXECUTIVE REMUNERATION AND ACCOUNTABILITY

After the 2008 financial crisis, large banks promised to recover large payouts from top bankers that were obtained through unlawful conduct, underpinned by the Sarbanes-Oxley Act and Dodd-Frank Act. However, Stumpf was walking away with US$133.1 million[38] upon his resignation, including 2.4 million shares he accumulated,[39] despite forfeiting US$41 million worth of unvested options.[40]

Stumpf's bonus scheme was designed to be directly tied to Wells Fargo's account growth. He received US$4 million in awards in 2015 linked to factors such as growing "primary consumer, small business and banking checking customers".[41] Yale's Jeffrey Sonnenfeld believed that Stumpf should be subject to more clawbacks of amounts linked to meeting cross-selling targets, a view strongly shared by Senator Warren, who had accused Stumpf pressuring employees with sales targets to increase the stock value.[42]

Another executive under fire was the head of the community banking division since 2008, Carrie Tolstedt, who led retail operations and cross-selling efforts to customers. Tolstedt had resigned prior to the September revelation, and walked with a US$125 million payout.[43] In 2014, Wells Fargo specifically disclosed cross-selling as a factor behind her multi-million dollar pay[44] Having confirmed that Tolstedt's departure was partially linked to the unauthorised accounts, Stumpf and the board were criticized for allowing the huge payout instead of firing her for the misdeed. Eventually, Wells Fargo recovered US$19 million but Tolstedt still left with US$43 million in stock.[45]

BOARD OF DIRECTORS

Wells Fargo's board faced scrutiny, with proxy advisory firms Institutional Shareholder Services and Glass Lewis calling for shareholders to vote against some or almost all of the incumbent directors.[46] Glass Lewis also advised against the re-election of two directors who they felt were on too many other boards to effectively govern Wells Fargo.[47]

The company's board appeared to be well-equipped; it had a Corporate Responsibility Committee, Risk Committee and Audit Committee.[48] The board composition was also perceived as "admirable", with more than half the board members from minority groups, and its 15 directors boasting diverse backgrounds across industries such as banking, academia and government, including two former banking regulators.[49]

However, the board was seen to be largely inactive. For instance, the Corporate Responsibility Committee met only thrice in 2015, the minimum number set by the board rules.[50] The board also remained mainly passive even when early warnings about the company's business practices surfaced in 2013. It took no action in early September to fire Stumpf or clawback his remuneration. Several reasons were cited for the board's inactivity. For example, directors often nominate themselves for re-election, allowing them to remain on the board without difficulty.[51]

Another issue was the closeness of the board with the CEO, which was accentuated by the fact that the CEO himself was the Chairman of the board.[52] This was partially attributed to the directors' long tenures, with Wells Fargo's directors' average tenure of 9.7 years exceeding those of other S&P 500 companies and banks like J.P. Morgan and Citigroup, leading to an insular board and familiarity concerns.[53]

Various suggestions to improve board effectiveness were made. CtW Investment Group suggested the inclusion of new directors with experience linking employees' remuneration to corporate goals,[54] while shareholders such as New York City's pension funds, who found trouble understanding the responsibilities of board committees, called for fewer directors and greater clarity about their duties.[55]

FAILURE OF THE LINES OF DEFENCE

All three lines of defence adopted as part of the bank's risk management policies had "let Wells Fargo down", according to the University of Maryland's Professor Rossi.[56] Professor Rossi also remarked that it is worrying for a bank "well known for its risk management prowess" to allow "poorly designed business objectives and incentive compensation" to overpower its strong risk culture.[57]

WHISTLEBLOWING BACKFIRED

Stumpf highlighted that the whistleblowing culture at Wells Fargo allowed every employee, regardless of their position in the hierarchy, to "raise their hands" and speak out on issues,[58] and the bank mentioned confidential ethics lines as a platform for employees to submit constructive feedback.[59] However, reports showed otherwise. Ex-employee Bill Bado claimed to have used the hotline and sent an email to human resources (HR) to flag unethical sales activities but had his contract terminated eight days later due to "tardiness".[60] At least five Wells Fargo employees had also sued the bank or filed complaints with regulators regarding similar treatment.[61] An Occupational Safety and Health Administration investigation also revealed that a former bank manager's whistleblowing activity contributed to his termination in 2010. The bank was ordered to rehire and pay US$5.4 million in compensation to the whistleblower.[62]

One former Wells Fargo HR official was also quoted saying that the bank "had a method in place to retaliate against tipsters" and found ways to fire these employees "in retaliation for shining light" on unethical sales practices.[63] In a letter to Sloan, senators reprimanded the bank for filing "defamatory statements to retaliate against employees who questioned the bank's aggressive cross-selling practices".[64]

REGULATORS AND AUDITORS: THE FOURTH LINE OF DEFENCE

Much blame had been laid on the shoulders of Wells Fargo's officers. However, according to the Financial Stability Institute of the Bank of International Settlement, regulatory supervisors and external auditors serve as a fourth line of defence for banks.[65]

The auditor's role

Senator Warren questioned the quality of KPMG's audit for its failure to detect the fraudulent practices at Wells Fargo.[66] She took particular issue with the internal controls over financial reporting audit, referencing KPMG's conclusion that Wells Fargo had "maintained ... effective internal control over financial reporting." while the illegal behaviour was ongoing.[67]

Several points were offered in KPMG's defence. As Forbes noted, auditors are not expected to actively seek out fraud if there is no material effect on the financial statements, which the bank contended were immaterial in this case. In addition, stricter tests on internal controls would unlikely have revealed a fraud either, unless there was a resulting material impact on figures.[68] Former Acting Chairman of the Public Company Accounting Oversight Board Dan Goelzer described such immaterial effects on the financial statements as outside the scope of the auditors' work.[69]

Regulators asleep at the switch

On 8 September 2016, the Consumer Financial Protection Bureau (CFPB) announced that it had imposed a US$100 million fine on Wells Fargo for its illegal actions, along with a US$35 million fine by the Office of the Comptroller of the Currency (OCC) and another US$50 million fine by the City and County of Los Angeles. The CFPB also required Wells Fargo to make full refunds to affected customers, and to hire an independent consultant to review and ensure proper sales procedures were in place. CFPB director Richard Cordray asserted that "because of the severity of these violations, Wells Fargo is paying the largest penalty the CFPB has ever imposed".[70] The OCC also imposed new restrictions on the bank, such as the banning of 'golden parachutes' and allowing the government to disapprove the hiring of certain executives.[71]

However, questions were raised as to why the agencies had not stepped in earlier. Referring to the 2013 LA Times report, Republican Jeb Hensarling, Chairman of the House Financial Services Committee, criticised the agencies for failing to uncover the improper sales tactics at Wells Fargo in a timely manner, suggesting that the OCC and the CFPB were "asleep at the switch".[72] On the other hand, Representative Democrat Carolyn Maloney defended the CFPB, indicating that they had maintained data, as well as acted and investigated customer complaints accordingly.[73]

The Securities and Exchange Commission (SEC)

In late September, three senators of the banking committee called for the SEC to launch an investigation into whether Wells Fargo had violated internal control provisions of the Sarbanes-Oxley Act, securities law, as well as whistleblower protection laws during the scandal.[74] On 3 November 2016, Wells Fargo disclosed that it was facing a probe by the SEC, but left out details on what the SEC was investigating aside from its "sales practices".[75]

Other agencies involved in the investigation of Wells Fargo included the US Department of Justice[76] and the California Attorney General Office,[77] which could result in potential criminal charges for the bank.[78]

Shareholders

Activist shareholders like Gerald Armstrong were also critical about the matter, calling for clawbacks of large payments to top executives, or for an independent Chairman, at the time of the scandal.[79] Institutional investors, such as the California State Teachers' Retirement System, also mentioned that they encountered difficulties understanding the responsibilities of board committees, and felt Wells Fargo's board was slow to tackle the problem and disclose information.[80]

Warren Buffet of Berkshire Hathaway, Wells Fargo's largest shareholder, initially kept mum about the scandal, but broke his silence in November 2016. He revealed that he had not lowered his stake in the bank, calling it "a great bank that made a terrible mistake". Buffett was also supportive of Sloan's promotion, in direct contrast to critics' preference for an outsider.[81]

MOVING FORWARD: WILL ALL BE WELL?

Half a year on from the revelation on 8 September 2016, Wells Fargo had instituted various changes, ranging from new executives to improved company policies. These have placated some observers, but others remain sceptical of the bank's inherent profit-seeking nature. Looking ahead, the bank can be comforted by the fact that other equally sizeable companies have recovered from similar incidents. Yet, trust is something easily broken but not easily earned.

In February 2020, Wells Fargo agreed to pay US$3 billion and admit wrongdoing to settle criminal and civil investigations with the Justice Department and the Securities and Exchange Commission.[82]

How Wells Fargo will do in the years to come remains to be seen.

DISCUSSION QUESTIONS

1. How might John Stumpf's dual role as Chairman and CEO have affected Wells Fargo leading up to the scandal? Why do you think he held both roles despite the potential corporate governance issues? What measures are necessary to mitigate the potential risks of combining the two roles and to what extent were those measures in place at Wells Fargo?
2. What is the role of the board of directors in ensuring the right corporate culture? To what extent do you think Wells Fargo's corporate culture contributed to the cross-selling scandal? What could the bank have done differently to avoid this problem?
3. What are the duties of a board of directors in light of this incident? Given the apparently admirable and competent board of directors at Wells Fargo, why did they not address the issue internally before it escalated to the public?
4. Examine the remuneration policies in Wells Fargo for both senior executives and employees. Did they contribute to the cross-selling scandal? What could have been done better?
5. It was said that the three lines of defence had failed at Wells Fargo. Explain the three lines of defence and what factors contributed to their failure. Did the federal regulators and external auditors act appropriately and quickly enough in response to the scandal?

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COMMINSURE: NO ONE'S COVERED

CASE OVERVIEW

In March 2016, Commonwealth Bank of Australia (CBA), Australia's biggest bank, was caught in a second major scandal involving its insurance arm, CommInsure, just as it was recovering from the fallout from the previous financial planning scandal. CommInsure is one of Australia's largest life insurance companies, with about 4 million policyholders.[1] The CommInsure exposé created a huge uproar after it was accused of denying legitimate claims of sick Australians in their greatest time of need.[2] The scandal went beyond CBA and highlighted issues in Australia's life insurance industry. The objective of this case is to facilitate discussion of issues such as corporate culture; the role of the media; whistleblowing policy; shareholder-stakeholder conflict; and regulation of the insurance industry.

(FOUR) CORNERED

"How can someone go to bed at night with a clear conscience, knowing that somewhere in Australia there's someone that's dying in their darkest hour, and your organization throws up difficulties, hide behind technicalities, bully their way with their medical and legal experts... against a helpless and defenceless claimant. How can that be right?"

- Dr Benjamin Koh, Former Chief Medical Officer of CommInsure[3]

On 7 March 2016, *Four Corners*, Australia's leading investigative journalism program, aired a 50-minute documentary following six months' worth of investigations accusing CommInsure of unscrupulous practices in denying the legitimate claims of sick and dying policyholders. CommInsure was alleged to have manipulated client data, used outdated medical definitions, pressured doctors to modify opinions, and used delaying tactics in order to deny customers their claims.[4]

The documentary rocked the life insurance industry as the government scrambled to order an urgent Senate inquiry[5] into the scandal, even as the Australian Securities and Investments Commission (ASIC) was investigating CBA's financial advice scandal.

At the centre of the scandal was James Kessel, who had suffered a severe heart attack in September 2014. Kessel had been paying his life insurance premiums since his 20s, and never thought he would ever need it. When his claim was received by CommInsure's HQ in November, it set off a series of events eventually leading to CommInsure's exposé.

CommInsure's outdated heart attack definition relied on the measurement of a protein called troponin, which is present in one's body when heart tissue is damaged. Kessel's troponin concentration in his blood fell below CommInsure's stipulated troponin level that entitles a heart attack victim to a payout. On this basis, CommInsure rejected Kessel's claim.[6]

Unbeknown to Kessel, there was an internal dispute on his case as an email had circulated in CommInsure, warning that rejecting Kessel's claims based on troponin levels alone was not in line with current medical practices. The email recommended claims to be paid to Kessel as acting in "utmost good faith" is a legal requirement for insurers in assessing claims.[7] However, this advice was allegedly swept under the mat.

Kessel's claims then happened to be reviewed by Dr Benjamin Koh, the then chief medical officer (CMO) of CommInsure. Koh had realised that part of Kessel's file was missing, and alerted the IT department to investigate, suspecting that a technical glitch may be deleting files.[8] After his request was declined, Koh uncovered several more files which have been modified or deleted. It was allegedly common for claims assessors in CommInsure to pressure the medical team to omit or modify opinions which "ran counter to a claim strategy", and Koh found the disappearance of the crucial files to seem too convenient.[9] He raised his concerns to his manager, Helen Troup, and subsequently to the board under CommInsure's whistleblower protection guidelines. Less than a year later, Koh was dismissed.

Koh later spoke to journalists of *Four Corners*, alleging that CBA had avoided paying the claims of policyholders by using outdated medical definitions, changing or deleting customer records, and pressuring doctors to provide opinions that were not in favour of customers.[10]

The First Seizure

Despite executives' knowledge of the bank's usage of outdated definitions of heart attacks since 2012,[11] CommInsure chose not to update its policies. The CMO before Koh had advised the executives to update

This case written by Eng Lik Hng Jethro, Gay Ling Ling, Gong Jie Hui, Lee Li Xin and Rowena Teo Yu Qi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This case was edited by Professor Mak Yuen Teen and Professor Richard Tan.

CommInsure's existing heart attack definition, which required troponin levels in the blood to be 20 times higher than those required by the current universal definition.[12] However, this advice fell on deaf ears. Two years later, the executives were warned again that CBA's definitions would discriminate against policyholders, this time by Koh. His advice too was ignored.

On 12 September 2018, Troup, the Managing Director of CommInsure, admitted that the company's failure in keeping medical definitions updated was due to its profit-making objectives.[13]

"STAR" TREATMENT FOR STAR EMPLOYEES

CommInsure had a talented medical team of professionals responsible for independent medical underwriting, claims and product advice. This was unlike the industry norm where companies entrusted those roles to non-medically trained persons.[14] Koh instilled a motto of "Evidenced, Reasoned and Utmost Good Faith" in his medical team when he first joined the company,[15] but he would soon find out that the company did not seem to place any regard at all to their moral obligations.

Incriminating documents of complaints that doctors were pressured to modify opinions to avoid payouts, and heated emails telling doctors to "stick to the brief" were leaked.[16] Testimonies from Koh also added to the serious allegations that CommInsure bullied doctors to rectify their medical opinions in order for claims to be denied.

CommInsure was also said to have not spared even its best employees in its treatment of policyholders. One of the harrowing stories featured in the documentary was that of Matthew Attwater. He had been one of CBA's star employees before suffering major depression and post-traumatic stress disorder in March 2013. After informing his superiors about his condition, Attwater was permanently medically retired from CBA and the workforce in general.[17] Attwater had purchased his insurance with CommInsure, but his claim for total and permanent disability[18] was rejected on the basis that he was capable of returning to work, even though he was declared unfit for work due to his "severe mental symptoms".

It was reported that in the two-and-a-half years it took for CommInsure to assess his claim, Attwater was forced to sleep in his car. It was only after his interview with Four Corners that his case was finally settled.

Misleading Advertisements

Misleading and deceptive advertisements were also allegedly made on CommInsure's websites[19] from mid-2013 to March 2016, where policyholders were led to believe that if they were to suffer a heart attack, they would be entitled to a lump sum payment, when in fact only heart attacks meeting outdated and restrictive medical criteria defined in the policy were covered.

Aftermath

ASIC concluded its investigations into CommInsure after almost two years. It was unable to find evidence supporting allegations that CommInsure claims managers had applied undue pressure on doctors to alter their medical opinions, or that medical records of customers had been deleted or modified in any inappropriate way.[20]

ASIC also announced that CommInsure's use of severely outdated medical definitions in its trauma policies did not breach any laws, even though it was unethical as consumers cannot be expected to know if a medical definition is outdated.[21] However, it prompted ASIC deputy chairman Peter Kell to call for law reforms, including no longer exempting insurance claims handling from several laws, harsher penalties for breaches of good faith, and subjecting insurance to bans on unfair contract terms.[22] On top of this, ASIC said it is pressuring companies to treat clients better, through better and faster interaction and increased preparation and support from claims executives.

In response to ASIC's request that CommInsure conduct an independent investigation to provide reassurance, CommInsure appointed Deloitte as an independent expert to assess the bank's alleged misconduct and law firm DLA Piper to review ethical concerns.[23] However, Deloitte expressed that it "did not identify any systemic issues relating to historically declined claims and did not identify any evidence that the current and planned improvements to the claims handling processes are designed in a way that could systematically deliver poor customer outcomes".[24] Criticisms were raised as Deloitte relied only on the files provided by CommInsure, and did not interview the customers or their families. Reports by DLA Piper remain confidential.[25]

CommInsure also formally acknowledged that it published misleading advertisements for its Total Care Plan and Simple Life Insurance and was ordered to make an A$300,000[26] community benefit payment instead of an A$8 million fine.

CommInsure also updated key definitions in trauma insurance relating to heart attacks and arthritis. The updated definition of heart attack was applied retrospectively to May 2014, resulting in an additional A$2.5 million paid to 17 people.[27]

A heart attack victim, having seen the media reports, attempted to file again for a claim previously rejected by CommInsure in January 2014, but was rejected again. However, he had the backing of the Financial Ombudsman Service (FOS) this time, which demanded that CommInsure provides medical reports supporting its decision. After repeatedly challenging the FOS' authority, the bank finally provided the evidence behind its rejection – but the document was redacted to omit medical opinions in favour of the claim.[28] FOS brought up the matter to ASIC, accusing CommInsure of "serious misconduct" after CommInsure refused to explain the redaction. CommInsure was given a warning from ASIC to not mislead FOS again, and CommInsure later took the definition further back to 2012.[29]

In addition, CBA announced the creation of a Claims Review Panel, to "provide an additional layer of assurance for complex claim assessment and decision-making processes" in CommInsure. Where CommInsure's claims committee recommends a complex life insurance claim be declined, it will be referred to the Panel. The Panel will consist of at least two independent panel members, along with Troup, and aims to provide an independent review and assessment of each claim to provide confidence that the outcomes are fair and consistent. A sub-committee of the CommInsure Board, comprising independent non-executive directors, will monitor the outcomes of the panel.[30]

At a parliamentary hearing, Ian Narev, CBA's then-CEO and Managing Director, confirmed that no one at CBA had been sacked for poor dealings with respect to individual customer insurance cases.[31]

CORPORATE CULTURE

"Profit before anything else". This quote from Koh have been cited in many headlines surrounding the incident as the underlying theme of the entire scandal. Critics such as Koh perceive CommInsure's corporate culture as one where the company was not just bent on earning maximum profits, but forgone whatever ethics they had in order to achieve them[32] while trampling over the rights of both employees and policyholders.[33]

There were several practices in CommInsure which fueled the firm's culture of valuing profits above the interests of its stakeholders, starting from the claims department.

Remuneration of claims managers were tied to key performance indicators (KPIs) such as the ratio of paid claims to premiums earned. Claims staff were able to affect the amount paid for claims. Despite possessing very limited medical knowledge, claim assessors in CommInsure could determine how long it takes to assess a claim, the way a customer is treated while the claim is being assessed, and more importantly, have the final say on whether a claim will be paid.[34] The assessors also allegedly paid scant regard to the professional opinions and ethical obligations of CommInsure's doctors, bullying them to change opinions not fitting the "claims strategy".

"They were quite blatant about it… 'can you please change it or delete it so that we can go to someone else to provide another opinion that's more favourable'."[35]

– Dr Benjamin Koh

This culture was exacerbated when Troup joined CommInsure as its top executive in April 2014. Within the medical team, there were already fears that the restructuring led by Troup would give more power to claims managers and underwriters, at the expense of the medical team, who were meant to independently judge the condition of customers.[36]

A feedback presentation on Koh and his medical team showed the lack of check-and-balance medical officers were able to provide on claim managers. Koh and his team were told to "stop providing opinions where not required/requested" and "start allowing case managers to pick the doctor they want to refer to" amongst many other criticisms.[37] Despite having the title of CMO, Koh's and his predecessor's advice to change the then-existing definition for heart attack in May 2014 and 2012 were disregarded on both occasions, causing heart attack claims to continuously be denied. This was not an isolated incident but rather, one that reflected the culture of CommInsure - where claim assessors and managers wield considerable power.

THE APPLE DOESN'T FALL FAR FROM THE TREE

In this case, the apple, in the form of CommInsure, does keep the doctor away by denying policyholders their claims. However, it seems that CommInsure's aggressive profit-driven culture matches that of its parent's, CBA.[38]

A short year before the CommInsure's scandal, CBA's misconduct in its wealth management arm was exposed. The aggressive sales-driven culture had pressured financial advisors to place their clients' money into high-risk investments without permission. The public brushed the incident away, thinking that it was a one-off incident. However, that was just the start of the damage to CBA's reputation.

Board of Directors

Details of CommInsure's board are not available in CBA's Annual Report. CBA's 2015 and 2016 Annual Reports showed that CBA's board had 11 and 12 directors respectively (excluding directors who retired during the year). According to a report by The Korn/Ferry Institute in 2013,[39] Australia's average board size was 8.4.

Directors' Remuneration

In CBA's 2015 Annual Report, the CEO and Group Executives' pay comprised three elements: fixed remuneration, short-term incentive (STI) at risk and long-term incentive (LTI) at risk. They are rewarded up to 150% of their STI target, depending on performance. The LTI is measured against relative Total Shareholder Return (TSR) and customer satisfaction, with weighting of 75% and 25% respectively. The vesting period was four years. Non-financial performance criteria included the alignment to the key business priorities of customer focus and long-term shareholder value creation.

In the 2016 annual general meeting (AGM), there were objections to the executive remuneration report by nearly 49% of the shareholders, well above the 25% mark which constitutes a 'strike'. With a second strike in the next AGM, the board would be required to disclose certain information for the board. The Australian Shareholders' Association said that the variable remuneration goals had become subjective and discretionary rather than being measurable.[40] For its STI, the CEO's remuneration had a 40% weightage based on financial outcomes, executives managing business units had 45%, and those managing support units had 25%, according to its annual report.

Following the Royal Banking Commission's investigations on CBA, it was revealed that while scandal after scandal was being unearthed within CBA, executives continued receiving multi-million-dollar short-term incentive payments of up to 150% of their base pay. In fact, while CBA was embroiled in its insurance arm scandal, then-CEO Narev recommended all executives receive at least 100% of their short-term incentives, in part because they had met their risk-management objectives in 2016.[41] The then-chairman Turner recommended Narev receive 108% of his target bonus, on top of his fixed pay.[42] Only one executive - CBA's then-head of wealth, Annabel Spring, had her bonus reduced to 95% over CommInsure's scandal.

Catherine Livingstone, CBA's Chairman during the investigations, admitted that the board's "10-minutes discussion" of the CEO's remuneration recommendations was inadequate, and the board ought to have challenged it.[43] Livingstone confirmed that from 2011, CBA had never reduced an executive's short-term remuneration as a result of a risk-related incident that had not yet been made public. Livingstone added that the board was sending a message that "there will only be consequences if there is a public event, a media event".[44]

In light of the scandals faced, the bank said that it would change the composition of long-term incentives of its top executives, from the original 75% linkage to shareholder returns and 25% linkage to customer satisfaction, to a new 25% focus on "people and community", 50% on shareholder returns, and 25% on customer satisfaction.[45]

Beauty, or Rather Ethics, is Skin Deep

CBA often made great play of their corporate governance strategies, with CBA's executives and directors constantly parroting that CBA upholds high ethical standards. Back in 2015, David Turner, CBA's Chairman, said that "(CBA) will be the ethical bank, the bank others look up to for honesty, transparency, decency, good management, openness"[46] in response to its financial planning scandal. Subsequent scandals prove that CBA's promises and policies were all for show.

One of the corporate governance failings was in CBA's whistleblowing policy "SpeakUp", which promised protection to whistleblowers and assured that proper action will be taken to address concerns.[47] Koh reported his concerns under this very policy on numerous occasions, to Troup, key independent directors of the CommInsure board, and also an intermediary the board had put in place. The board promised an audit but refused to disclose details about the investigation or outcome.[48] Shortly after, he was fired on 11 August 2015.

CommInsure gave Koh an option to resign and take a payout, as long as he signed a gag order. Koh walked away.[49] This is not the first time CBA's whistleblowing policy had apparently failed and the whistleblower fired. The previous scandal in CBA's financial planning department saw whistleblower Jeff Morris allegedly fired and subjected to a witch hunt by the bank.[50] The bank also allegedly failed to protect another whistleblower, Tim Cradock back in 2013.[51]

CBA's head of compliance department made a scathing remark about how the compliance department's concerns were never taken seriously, and that compliance was seen as a "rubber stamp" exercise in CBA.[52]

AUSTRALIA'S INSURANCE INDUSTRY

While CommInsure's corporate culture has been attributed to CBA's own culture, such a culture was said to be pervasive in the Australian insurance industry.

Insufficient Insurance

"They are paying commissions to financial advisers to sell product and, at the same time, they're obviously seeking to contain costs, obviously seeking to maximize profitability,"

- David Whiteley, Industry Super Australia CEO[53]

The life insurance industry has an inherent conflict of interest. By promising more benefits to policyholders, an insurance company can reap more revenues,[54] but fulfilling those promises through claim payouts will undermine their profit margins. There is an in-built propensity for insurance providers to make a lot of promises yet fulfil as few of them as possible.

Under CBA's pay structure, employees received commissions that were pegged to the risk levels of investment assets sold, which incentivised financial planners to encourage their clients to opt for riskier products.[55] This was made worse by CBA's "boiler-room" culture, where high-pressure sales tactics and strategy to sell financial products thrived.[56]

In Australia, ASIC and Australian Prudential Regulatory Authority (APRA) watch over the insurance industry. ASIC has the responsibility to take action to enforce and give effect to the law that governs the industry, to minimise misconduct and promote confident and informed participation by investors and consumers.[57] This is enforced through two External Dispute Resolution schemes (EDRs) - the Financial Ombudsman Service (FOS) and Credit and Investment Ombudsman (CIO), funded by members including banks, financial advisors and other financial service providers. This results in a significant private and self-regulatory element in Australia's regulatory framework.[58]

When the largest Australian banks made the decision to move into wealth management, the string of financial scandals that followed suggests that this may not have served Australian consumers well. CommInsure and CBA were not the only ones who have been accused of unscrupulous behavior - other big banks like Westpac and National Australia Bank faced similar accusations.[59] The pervasive allegations of misconduct highlight real issues in Australia's financial services sector as a whole - that regulators may have contributed to misconduct with their lack of oversight and slow actions.[60]

"It's an industry that is in catch-up mode, where some of the practices and products have not kept pace with consumer expectations, and the very blunt message is that has to change."[61]

- Peter Kell, ASIC deputy chairman

After the exposé by Four Corners, Parliament was pushed to consider a bill to tighten regulations of the industry since ASIC's review found that 37% of life insurance advice failed to comply with the law.[62] The Government also ordered that ASIC conduct an urgent review into whether the questionable practices raised were systemic in the whole industry, rather than just isolated to CommInsure.

The Watchdog Nobody Fears

ASIC's findings in the investigation of CommInsure following the scandal disappointed many.[63] Due to deficiencies and loopholes in the law, CommInsure managed to get away with their harmful products and behaviour, and simple advice from ASIC to "treat their customers better." This was only one case amongst many where ASIC failed to come down hard on companies that have committed misconduct.

ASIC had often come under fire for its lenient methods of enforcement, as the regulator often imposes administrative or negotiated sanctions, likened to regulatory parking fines, rather than taking tougher action.[64] ASIC has also been called a "spectator" rather than the "tough cop on the beat"[65] the Minister for Financial Services had claimed it was, as it had always been other parties, such as *Four Corners*, who sniffed out misconduct in the sector.[66]

James Shipton, head of ASIC, admitted that ASIC may be too lenient and appear "too friendly" with Australia's major banks.[67] Commissioner Kenneth Hayne also frowned upon ASIC's familial and social approach towards dealing with banks, questioning why ASIC officials often held informal meetings with the heads of Australia's banks, and did not take notes during those meetings.[68]

Back in 2014, the previous ASIC Chairman, Greg Medcraft, had admitted that the regulatory environment in Australia did not have harsh enough civil penalties, remarking that "*(Australia) is a bit of a paradise, ... for white collar (criminals)* ".[69] However, Medcraft also claimed that it did not receive enough funding and resources, which curtailed its ability to crack down on errant companies.[70]

Salvaging the Industry

Following the financial planning scandal, Labour Senator Mark Bishop chaired a Senate committee inquiry, which recommended a Royal Commission into CBA and ASIC.[71]

Under political pressure and following the spate of scandals, Prime Minister Malcolm Turnbull announced the formation of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, otherwise known as the Banking Royal Commission, on 14 December 2017, in order to restore public faith in the sector.[72] The Royal Commission uncovered the glaring issues behind the CommInsure scandal that many have known for a long time.[73]

The Commission's report contained 76 recommendations, with a key focus on closing legal loopholes, increasing protection for consumers and the banning of particularly egregious sales practices in the pension and insurance markets.[74] A new oversight authority, Australian Financial Complaints Authority (AFCA), started operations on 1 December 2018 for dispute resolution in the banks and financial services sector.[75]

Following the CommInsure scandal, regulatory pressure has been put on the whole industry. APRA wrote to the boards of all active life insurers seeking information about the effectiveness of their governance and oversight mechanisms for claims handling, benefit definitions, rejected claims and customer complaints.[76] The importance of consumer protection relating to updating of out-of-date medical definitions for life insurance policies created a "legacy products" issue in the life insurance industry, and the government is currently considering this industry-wide issue further in response to recommendations from the Financial System Inquiry.[77]

FORGOTTEN VOICES

CBA has a relatively dispersed shareholding structure, with no dominant majority shareholder.[78] From 2014 to 2017, no single shareholder held more than 20% of the shares, while management owned less than 0.1% of shares collectively.[79] Dispersed shareholders are likely to be more concerned with short-term profits like dividends and the company's earnings, due to a lack of incentive in monitoring the management of the company.

While CBA's profits and dividends declared to shareholders increased, the Prudential Inquiry Final Report on CBA released by APRA on 1 May 2018,[80] found that two other critical voices became harder to hear: that of the customer, and talk of non-financial risks.[81] APRA said that CBA's continued financial success had "dulled the institution's senses to signals that might have otherwise alerted … to a deterioration in CBA's risk profile", and this was particularly apparent in the non-financial risks identified.[82] Some of the key issues identified included a lack of accountability and ownership of risks, framework of processes that "worked better on paper than in practice" and a remuneration framework that had "little sting" for the senior management when issues with stakeholders occurred.[83]

APRA identified a widespread sense of complacency and overconfidence from top down due to the bank's strong financial performance. The reactive culture and complacency lulled CBA into a false sense of security. In addition, the collegial and collaborative working environment lessened constructive criticisms, and with a lack of reflection on past incidents, CBA became insular, limiting its ability to accurately identify risks.[84]

While CBA's shareholders enjoyed their share of dividends, this was at the expense of CBA's customers. However, they are now bearing the bulk of the costs as current CEO Matt Comyn confirms that the customer compensation amount would be borne by the bank's shareholders.[85]

Besides shareholders, other key stakeholders include customers, the community, CBA staff and regulatory bodies. The Group's engagement with other stakeholders is less than acceptable considering the scandals that have occurred from 2003 to 2018. The lack of customer protection and victimisation of whistleblowers who reported misconduct issues are major areas of concern. Only with the government's intervention and the threat of a royal commission were the matters then set right. ASIC's slow response on investigation and indecisive action with regards to whistleblowing did not help the situation.

Findings in the Deloitte report[86] commissioned by CommInsure regarding accusations of their misconduct revealed no wrongdoing on their part. Notwithstanding that, the alleged misconduct had already undermined the trust and confidence of the policy holders and community. The review also found CommInsure's heart attack definitions were consistent with some but not the majority of players in the industry in May 2014. Executives were aware of the outdated medical definitions since 2012 but chose not to update its policies since it "ran counter to a claim strategy". This reflects the shareholder's wealth maximization corporate objective which is widely accepted barring a few exceptions.

CBA Group has since been placing more focus on stakeholders under its Corporate Governance Framework. In its 2019 Corporate Governance Statement, stakeholder engagement is set out as: "… providing better outcomes for customers, earning the trust of the communities we serve, ensuring our people are energized and accountable, and delivering sustainable, long-term returns for our shareholders."

GOVERNANCE FROM ABOVE

ASX Corporate Governance Council's 4th edition of Corporate Governance Principles and Recommendations published in February 2019 describes corporate governance as "the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account."[87]

CBA's corporate governance from 2014 to 2016 was described in a separate report (Corporate Governance Statement), with brief comments on these issues in the Chairman's Statement of their Annual Reports (AR).[88] With the appointment of Livingstone as Chairman on 1 January 2017, the 2017 AR was revamped and a comprehensive section on Corporate Governance was included.

Since 2017, CBA has been strengthening corporate governance practices for the group to meet the higher standards expected of them in light of the APRA Prudential Inquiry and the Final Report released by the Royal Commission. A section for "Whistleblower protection" was added in CBA's 2017 Corporate Governance Statement[89]. This section was not included in their 2015 Statement. The 2019 Corporate Governance Statement[90] was further expanded and describes the key governance arrangements and practices of the Group which met all the requirements of the fourth edition of the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations. The Board now regularly reviews and refines its corporate governance arrangements and practices in light of new laws and regulations, evolving stakeholder expectations and the dynamic environment in which the Group operates.

To monitor the bank's culture and effectiveness of its cultural change initiatives, CBA gathers information from employee surveys, audit and compliance reports, whistleblower reports and other sources. The Group's Code of Conduct sets the standards of behaviour expected of employees when engaging with and balancing the interests of stakeholders.[91] Material breaches must be reported to the Audit Committee.

The Group Whistleblower Policy outlines the protection extended to a whistleblower from any form of retaliation or victimisation, including termination of employment, harassment and discrimination.[92] The Risk Management Framework allows the Group to manage risks within a Board-approved risk appetite and is regularly reviewed in light of emerging risks arising from changing business environments, better practice approaches and regulatory and community expectations.[93] The board's approach to its composition and renewal emphasises the need for: (i) an appropriate mix of relevant skills, expertise and experience, and (ii) independence by adopting Independence Standards for assessment.

LESSON LEARNT, OR NOT

For wholly-owned subsidiary CommInsure, the corporate culture in its parent company, CBA, played a significant part in influencing the corporate culture of CommInsure. Thus, when CBA's other business units came under fire in scandals from money laundering to hawking less than a year after its insurance arm scandal, it was not a surprise.

The Final Straw

On 3 August 2017, Federal financial intelligence agency, AUSTRAC, accused the bank of serious and systemic failures to report suspicious deposits, transfers and accounts, which resulted in millions of dollars flowing through to drug syndicates. CBA admitted to the late filing of 53,305 reports of transactions of A$10,000 or more through its intelligent deposit machines (IDMs), preventing AUSTRAC's effective monitoring of money flow.[94] The biggest fine to date in Australian corporate history of A$700 million was paid by CBA for breaches of anti-money laundering and counter-terrorism financing laws.

A Change of Faces

After CommInsure, it took one more scandal to prompt CBA to take more drastic action. On 8 August 2017, one day after AUSTRAC's was reported in the news, CBA's Chairman Livingstone released a statement announcing that the board had decided to cut its short-term variable bonuses for Narev and senior executives for the financial year ended 30 June 2017, as well as cut its non-executive directors fees by 20% in the 2018 financial year.[95] Livingstone also said that in addition to hiring more than 50 financial crime experts and spending more on technology, CBA will be revamping its board. This included the retirement of Laura Inman and Harrison Young in November, Andrew Mohl who would seek re-election for one more year, and the recruitment of former Westpac banker Rob Whitfield.[96]

In January 2018, CBA announced that Comyn would replace Narev as CBA CEO,[97] claiming that Narev's retirement had nothing to do with the scandals.

Once Bitten, Never Shy. The Attacks Continue

A year later, on 13 March 2018, CBA once again made headline news. It had breached its insurance license conditions by mis-selling credit card insurance to customers who were ineligible for the product. The Hayne Royal Commission heard that CBA should not have sold its Creditcard Plus insurance to 64,000 customers,[98] who were unemployed when they purchased the credit card insurance, despite that being a requirement under the eligibility criteria.

Comyn personally admitted under the commission's grilling that CBA's culture had problems - short-term bonuses for staff often carried an inherent risk that they would encourage staff to put their own interests ahead of a customer's. However, despite the identification of such risks, Comyn ultimately decided against ending bonuses, stating that it was necessary to motivate and incentivise staff.[99]

Other flawed practices revealed during the Royal Commission included the charging of "ongoing service" fees to 31,500 customers between July 2007 and June 2015 by the CBA financial planning business, despite the lack of evidence to show that it actually provided any services to those customers, as well as CBA's lack of actions taken under the 2017 Sedgwick review to changing its volume-based commissions paid to mortgage brokers, which encouraged them to write larger-than-necessary loans, in turn putting customers at risk.[100]

On 4 October 2019, CBA made what was becoming an annual appearance in the news, when CommInsure was charged with breaching an anti-hawking law 87 times.[101] CommInsure illegally sold "Simple Life", a life insurance policy using unsolicited phone calls, through Aegon Insights Australia, its agent telemarketing firm. Hawking is an unethical and aggressive sales strategy that has pressured Australians into buying products they don't need.[102]

Will CBA Ever Learn?

Although CBA is in the process of selling CommInsure to global group AIA as part of a plan by Comyn to strip the company of its scandal-prone financial advice and insurance arms to return to the core business of taking deposits and making loans, the sales process has been delayed and is not expected to be completed until 2020.[103] Would the simplification of CBA's portfolio of businesses through severing the insurance arm mean "excellent customer outcomes" as promised by Comyn?[104]

As CBA and its revamped board of directors attempt to start afresh in the changing and ever more competitive banking landscape, the public waits in anticipation for its next move. While CBA has accurately pinpointed the company's culture to be the root problem, whether it is able to overcome it remains to be seen.

DISCUSSION QUESTIONS

1. Commonwealth Bank of Australia (CBA) group had put a whistleblower protection policy in place following the Commonwealth Financial Planning Limited (CFPL) scandal from 2003 to 2012. Provide reasons as to why CommInsure was still unable to avert the scandal in its insurance arm? Comment on CommInsure's actions taken in response to its insurance arm scandal.
2. The exposé on CommInsure was a combined effort between Fairfax Media, and the investigative journalism programme *Four Corners*. Discuss the role of the media in monitoring the insurance industry's corporate governance. Compare this with your country.
3. Should the parent, CBA, be responsible for the CommInsure's corporate governance and risk management? Discuss this in the context of board risk governance and the Enterprise Risk Management (ERM) framework. In what ways have weaknesses in CBA's business and remuneration policies led to the failures in CommInsure?
4. The financial impact on CBA's share price arising from the scandals of CFPL and CommInsure appears to be short term and only during the period of the media reports. Discuss the significance of these scandals to CBA's reputation and explain the damage, if any, to the CBA brand.
5. ASIC's investigation report on CommInsure mentioned that "CommInsure had trauma policies with medical definitions that were out of date with prevailing medical practice, … However, this was not against the law…". As this is a "legacy product" issue in the life insurance industry, is it fair to say that CommInsure is only partly responsible for the scandal? Discuss how a company's business strategy may prevent it from upholding high ethical standards and integrity. Comment on whether the regulators' "light-touch" approach has failed to correct the industry's culture.
6. APRA's Final Report dated 1 May 2018 of the Prudential Inquiry into CBA stated that "CBA's continued financial success dulled the senses of the institution" resulting in a deterioration in CBA's risk profile, in particular its operational, compliance and conduct risks. Discuss the importance of risk management and its connection to corporate governance.

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UNAUTHORISED TRADING

ANOTHER DAY, ANOTHER TRADING SCANDAL: THE CASE OF NATIONAL AUSTRALIA BANK

CASE OVERVIEW

In January 2004, an employee within the National Australia Bank (NAB) revealed that there were cases of unauthorised foreign currency derivatives trading that resulted in total losses of A$360 million. The NAB trading scandal was one of the largest rogue trading scandals that shook the Australian market. The traders had concealed losses by entering into fictitious one-sided currency transactions. The Australian Prudential Regulation Authority (APRA), the regulatory body for banks, condemned the bank for its lax management, as it had ignored the warning signs of irregular currency options trading practices. The objective of this case is to allow a discussion of issues such as the important elements for good corporate governance; board oversight; different lines of defence; risk management; remuneration policies; and regulatory oversight.

BACKGROUND

Headquartered in Victoria, Australia, NAB provides personal and business financial services, including credit cards and loans. It has expanded globally and established its presence in New Zealand, Asia, the United Kingdom and United States with over 12 million customers and 50,000 employees.[1]

THE CORPORATE AND INVESTMENT BANKING DIVISION

The Corporate and Investment Banking Division (CIB) was set up to handle large corporate clients, banks, financial institutions and other government bodies. CIB services and products include debt financing, financial risk management products and investor services and products.[2]

Within the CIB, the Market Division provides clients with various traded financial products and risk management solutions, covering foreign exchange, money market, commodities and financial derivative products. The foreign currency trading department operation was split into two main trading desks, the spot foreign exchange desk and the currency options desk, where the scandal and foreign exchange loss arose.

The currency options desk at that time operated on a 24-hour basis from two places, Melbourne and London. Trading activities occurred mainly within the interbank market; nonetheless, it also had several non-bank clients. The customer business originated from the Bank's branches and subsidiary banks from around the world and was passed to the currency options desk.

RISK MANAGEMENT AND INTERNAL AUDIT FUNCTIONS

The organisational structure of NAB dictated that the risk management responsibility such as the trading, profit and risk responsibility, had to be delegated to the traders with varying layers of supervision, monitoring and reporting procedures to be followed. This risk management philosophy was consistent with the approach widely used by other major financial institutions at that time.

Within the CIB division, the risk management function was disaggregated into smaller units that served the business units. Operations were split into different desks, which reported to CIB management and Group Risk Management separately. The Market Risk and Prudential Control Department (MR&PC) in CIB was responsible for ensuring the compliance of risk strategy.

It was the responsibility of the internal audit function to ensure effective operation and compliance with the bank's policies and procedures. The head of internal audit reported relevant information, problems and recommendations mainly to four parties, namely the Principal Board Audit Committee (PBAC), Central and Regional Risk Management Committees, the CEO and the Group Risk Management.

This is the abridged version of a case prepared by Kit Jia Min, Low Siao Chi, Ng Voon Siew Janice, Adalyn Yeap Hui Lin, Eric Yong Jun Kang and Zhang Jiaxin under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lau Lee Min under the supervision of Professor Mak Yuen Teen.

THE METHODS OF CONCEALMENT

Three principal methods of concealment were used. Initially, smoothing of earnings was done through entering incorrect dealing rates into the system. This allowed profits and losses to be shifted from one day or one period to another. Thereafter, two more methods were employed: processing false spot foreign exchange and false option transactions.

The traders discovered that there was a one-hour window between the bank's close-of-day and the review time. The bank's end-of-day close was at 8 a.m. and the Operations division (back office) would start reviewing the transactions at 9 a.m. This one-hour period allowed them to manipulate the profits recorded.

The modus operandi was to enter genuine spot foreign exchange transactions with incorrect transaction rates. During the one-hour period, this incorrect information would be amended to the actual rates. The profits or losses recorded in the general ledger would be incorrect because they were recorded according to end-of-day valuations. Since the general ledger did not get re-stated after these amendments, these concealments would go unnoticed.[3]

A second method of concealing losses was the use of one-sided transactions. In September 2003, the traders lost heavily on the bet that the Australian and New Zealand dollars would fall against the US dollar. The traders then entered one-sided transactions to disguise their true loss position. The one-sided transactions with other divisions within NAB worked by first entering a false transaction at only their end of the position, with no offsetting position created in other divisions. These one-sided transactions were subsequently 'surrendered' during the one-hour window before the bank office checks took place.[4]

By 'surrendering' these transactions, the back office checks would not reveal any discrepancies. These figures would still be posted to the general ledger and used for management reports as well as the preparation of financial statements. The accounting entries for transactions that were 'surrendered' were reversed; however, the transactions recorded remained in place. Using this method, the traders were able to record false profits and losses on the same day. When the transactions were surrendered the following day, the false profit was reversed. By creating and surrendering these transactions on a daily basis, the false profits or losses were rolled forward and the real position could be concealed.

Other methods of concealment included the revaluation of the portfolio using incorrect rates and entering false option transactions.[5]

FAILURE OF RISK MANAGEMENT AND INTERNAL CONTROL

Risk management controls were overridden. NAB required proper approval from Market Risk & Prudential Control (MR&PC) before traders could engage in transactions that involved new products. However, the rogue traders did not seek approval from MR&PC. Despite this concern being raised by MR&PC to their supervisor, no action against the traders was taken. In fact, MR&PC was pressured to approve the options transaction. Although MR&PC eventually did not approve these transactions, they were overridden when the head of global markets gave his approval.

It was also found that the supervisors, such as the General Manager of the Markets Division, had failed to follow through the entire review procedure. Monitoring was simply limited to headline profit and loss statements, suggesting that there was a lack of understanding with regard to the underlying risks undertaken by the traders. In fact, the management simply attributed smooth profit to the successful implementation of the department investment strategy.

Furthermore, the reliability of Value-at-Risk (VaR) was being questioned because there was a conflict of opinion between MR&PC and the currency options desk. This resulted in the VaR currency trading limit breaches being removed from the front page of daily risk reports. At the same time, many VaR limit breaches were committed by the traders and these breaches were simply approved by the trading and global products head. This matter was exacerbated by the little urgency and attention given for the resolution of these differences in opinion. It was only in October 2003 that the issue was included on the agenda of the CIB Risk Management Executive Committee, which was then further postponed to January 2004. This enabled the traders to get away with these limit breaches as the mechanisms in place to monitor risks fell apart. In hindsight, all false one-sided transactions were actually captured by the VaR algorithm, but disregarded.

Finally, in October 2003, MR&PC identified an unusual sale with another bank for a premium of A$322 million. The traders clarified that this transaction was required to finance some other positions and the issue was not pursued further. The lack of supervision had enabled the traders to exploit the systems in place further.

In its May 1999 report, Internal Audit rated currency options as 'unsatisfactory', and highlighted several 3-star issues, which were defined as "Serious matters for the attention of the Managing Director and reportable to the Board Audit Committee".[6] The weaknesses identified included the inability to reconcile profit and loss between the front and back offices, the exclusion of volatility smile (observed pattern of options) in revaluations and the lack of independent monitoring of risk concentrations. The report further stated that review processes were unsatisfactory, as many of these issues surfaced due to "an inadequate control framework in currency options".

In its June 2000 quarterly audit report to the PBAC, Internal Audit stated that the weaknesses in May 1999 had been rectified by management. Following this, in the December 2001 audit report, Internal Audit gave an overall rating of 'adequate' for the foreign exchange business, including currency options. Two 3-star issues in relation to currency options were identified - limit breaches occurred daily (for 61 out of 61 days), and incorrect VaR numbers produced. The daily limit breaches were not explained, and the incorrect VaR was attributed to the non-usage of volatility smile. At the same time, the Head of Internal Audit introduced a new rating system i.e. a 'three star plus' for all issues in the range of A$5 to A$30 million in place of the current A$1 million to A$30 million." As a result of the new rating criteria, the number of issues for PBAC consideration was reduced from 70 to 21, and the two remaining 3-star currency options issues were not reported to PBAC.

In the January 2003 audit report, no significant matters on currency options were highlighted. However, the report raised a new issue "Currency options desk operating limits need to be reviewed", rated as 1-star (thus reported only to business unit management). It was evident from the report that the limits were still being breached. NAB held the view that the limit breaches were due to inappropriate design of the limits and not due to a disregard for the limits. NAB also felt that the breaches would be eliminated with better-designed limits.

Due to the low ratings assigned by Internal Audit to the currency options issues (1-star instead of 3-star), PBAC was not alerted to the limit breaches even though it continued to occur in 2001 and up until 2003.

PROFIT-DRIVEN MANAGEMENT

Breaches of higher limits occasionally reached a higher level of management. These transactions would then be approved by the head of global markets, as mentioned previously. Management seemed to have informally consented to these limit breaches by the traders since nothing was done to stop their actions. This cultivated a culture where the traders could flout the standards of the bank and felt free to engage in risky behaviour because there were seemingly no consequences.

Management seemed to focus heavily on the profits and ignore the potential problems. They were keen to protect their bottom line and disregarded the risks and possible slipups in their internal management.

The culture of poor adherence to rules, responsibility shirking and suppression of bad results was partly a consequence of the profit-oriented culture. As such, the risk committee chairman, Graham Kraehe, acknowledged that the board should bear full responsibility for the culture at the bank.

WHERE WAS THE BOARD?

Management simply kept the directors in the dark. Additionally, the directors trusted the management deeply and relied only on information and reports supplied by management.

Collectively, the inaction of both parties allowed the scandal to go unnoticed for a long time. The directors were so trusting that they even failed to ask for the annual management letter from the external auditor when the management did not provide it. The board would have been alerted to the concerns KPMG had with regards to the foreign trading desks, as early as 2001 when it was first noted in the management letter, if they had insisted on reviewing the annual management letter.

The two principal board committees – risk and audit –also failed to probe further and provide sufficient oversight for the audit and risk management activities in the firm. During the Principal Board Risk Committee (PBRC) meeting in November 2003, management assured the committee that the VaR was safely within the limits for the Markets Divisions as a whole. The committee was unaware of the currency option desk's risk limit breaches. Had the audit and risk committees actively sought information and provided oversight over their areas of responsibilities, they probably would have discovered the warnings from internal audit and the risk management department.

When other Australian banks and the Australian Prudential Regulation Authority (APRA) raised their concerns about the large and unusual currency transactions of NAB in 2002 and 2003, NAB sat on these concerns and no further investigations were conducted by management in response. Moreover, the head of global risk management dismissed APRA's request to enforce compliance with risk management policies and credit limits. In addition, a letter was sent in to

APRA containing misleading information to conceal limit breaches committed in December 2003. All these decisions were made without seeking the advice of the board. NAB's management downplayed both the market's and APRA's warnings, along with other internal warnings from the internal audit and risk management departments.

The feedback from APRA was directed to Chairman Allen. Some key issues that were highlighted included lax approach to limit management, non-adherence to risk management policies, absence of formal model validation, insufficient back-testing for the approved VaR model, and valuation of NAB's portfolio using front office's information. Without consulting the Board or the risk committee, the responsibility for preparing a response to APRA was delegated to the head of global risk management. Although most of APRA's feedback given was within the Board's area of responsibility, they were not notified. Furthermore, the risk manager's reply to APRA suggested that most of the issues were either insignificant or had been addressed, when in fact, neither the Board nor the Management had done anything.

AFTERMATH

In January 2004, the bank announced that it had uncovered losses of up to A$185 million. The majority of the fictitious trades had occurred between October 2003 and mid-January 2004. A revaluation of the options portfolio raised the options losses to A$360 million.

According to NAB Chief Executive Frank Cicutto, weak internal controls enabled the traders to carry out the fraud. The losses had stemmed from a punt on the value of Australian and New Zealand dollars, and the four traders – Bullen, Duffy, Ficarra and Gray - had sought to cover the losses with unauthorised trades on NAB's account.

EPILOGUE

The four traders who were involved in the scandal were prosecuted in court and received jail terms of between 16 to 44 months[7]. NAB was also required to comply with 81 special APRA remedial requirements.[8] A new executive committee was put together[9] as the firm looked towards rebuilding its culture.[10]

DISCUSSION QUESTIONS

1. Evaluate the effectiveness of the board of directors at NAB.
2. Were there other aspects of corporate governance at NAB that were problematic?
3. In 2003, the currency option control issues were not reported to the Principal Board Audit Committee (PBAC) despite it being a "3-star" problem. The Internal Audit function believed that the monetary value of this issue to be less than A$5 million threshold. Was the reliance of the PBAC on Internal Audit to screen the firm's control issues reasonable? Should PBAC only have reviewed issues with a "3-star" and above rating? Discuss the impact of using such a screening mechanism on NAB between 1999 and 2004.
4. In your opinion, what has to be done to improve the corporate governance at NAB?
5. Prior to the NAB trading scandal, rogue trader Nick Leeson's unauthorised trading led to the collapse of Barings Bank. More recently, Societe-Generale, UBS and JP Morgan also reported massive losses from unauthorised trading. Why do such trading scandals continue to happen in banks? Are banks too complex to govern and manage well?

ENDNOTES:

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5 NAB- FX Options, Apr 2009, *PRMIA*, <http://prmia.org/pdf/Case_Studies/National_Australia_Bank_Short_Version_April_2009.pdf> accessed 20 Dec 2012

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JP MORGAN AND THE LONDON WHALE

CASE OVERVIEW

In 2012, media released the story of the "London Whale". Two traders had used an atypical trading strategy which greatly increased the size and risk of the portfolio they were handling. This trading strategy was later described by the group's CEO as flawed, complex, poorly reviewed, poorly executed, and poorly monitored. More than US$2 billion of mark-to-market losses for these trades were reported.

But who was to blame? The risk committee which was responsible for monitoring the entire company's transactions, the regulator – the Office of the Comptroller of the Currency, or the management of JP Morgan? A Task Force was set up to investigate these losses. The objective of this case is to allow for a discussion of issues such as internal control; risk management; competencies of the board of directors and those responsible for the different lines of defence; and how the various stakeholders could have played a part in preventing the massive loss.

ABOUT JP MORGAN

JP Morgan Chase & Co. (NYSE: JPM) is a leading global financial services firm and one of the largest banking institutions in the United States. It began as JP Morgan & Co, a commercial bank founded in New York in 1871. A series of mergers and acquisitions subsequently led to the formation of JP Morgan Chase today.[1]

JP Morgan Chase's businesses are organised into six major segments – Investment Banking; Retail Financial Services; Card Services & Auto; Commercial Banking; Treasury & Securities Services and Asset Management; as well as a Corporate/Private Equity segment which comprises Private Equity, Treasury, the Chief Investment Office (CIO), and corporate staff units and expense functions that is centrally managed.[2]

The CIO was spun off as a separate unit within the bank in 2005. The primary responsibility of the CIO is to invest the bank's excess deposits and to hedge trading risk in other parts of the bank. Ina Drew served as the bank's Chief Investment Officer from 2005 to May 2012. In 2007, CIO launched the Synthetic Credit Portfolio (SCP), which sought to provide protection against credit risk and adverse credit default events in the market.[3]

HOW THE SCANDAL UNRAVELLED

The head of credit trading of CIO, Javier Martin-Artajo, and the credit derivatives trader Bruno Iksil, generated billions in profits on a portfolio that featured bets on certain corporate credit indices from 2007 to 2011.[4] They were instructed by executives to reduce Risk Weighted Assets (RWA) in late 2011. Rather than dispose of the high risk assets in the SCP, which is the typical action taken by CIO, they purchased additional long credit derivatives to offset its short derivative positions in January 2012. This trading strategy eventually increased the portfolio's size, risk and RWA, as well as eliminated the hedging protections.[5]

Despite the fact that the SCP's derivative holdings were increased, the portfolio was losing value. Hedge fund insider, Boaz Weinstein of Saba Capital Management, found that the market in credit default swaps was probably being affected by aggressive activities in February 2012.[6] Ina Drew suspended trading in the portfolio on 23 March 2012.[7]

In early April, the media broke the story of the "London Whale" and unmasked JP Morgan Chase's CIO as the entity behind the large positions in the market. The market for the credit derivatives in the SCP was small and had limited players; thus CIO's large positions and trades became very visible.

According to CIO's analyses, the SCP was generally "balanced", the market was dislocated, and mark-to-market losses were temporary and manageable. JP Morgan Chase's Group Chief Executive Officer (CEO), Jamie Dimon, who is also the Chairman, agreed that the publicity surrounding the SCP was a "tempest in a teapot" and the Chief Financial Officer (CFO), Douglas Braunstein, stated that the firm was "very comfortable" with its positions in a 13 April analyst call.[8]

This is the abridged version of a case prepared by Benjamin Chua Kok Lee, Lian Jiahui, Lim Meei Shin, Vanessa Poh Yun Han and Jason Tan Jia Shen under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Trina Ling Tzi Chi under the supervision of Professor Mak Yuen Teen.

When losses continued to increase after the analyst call, non-CIO personnel were directed to review and take control of the SCP in late April. It was then revealed that the portfolio's exposure was much greater than previously reported by the CIO and the market's knowledge of the CIO's positions would make it even more difficult to reduce losses and close out their positions. A review of the valuation of positions in the SCP concluded in consultation with PwC that the SCP complied with U.S. Generally Accepted Accounting Principles (GAAP).[9]

On 10 May 2012, Dimon disclosed that the trading strategy for the SCP was flawed, complex, poorly reviewed, poorly executed, and poorly monitored. More than US$2 billion of mark-to-market losses in relation to these trades were reported. A Task Force was formed shortly after 10 May to investigate these losses.[10]

JP Morgan Chase stated that it was no longer confident that the 31 March valuations reflected good-faith estimates of the fair value of all the instruments in the SCP after consulting with PwC for the second time. Cumulative losses of US$5.8 billion and a restatement of first quarter net income (a downward adjustment of US$459 million) were announced on 13 July.[11]

MISMARKING OF DERIVATIVE VALUATIONS (INTERNAL CONTROL)

Corporations that own derivatives, such as those held in JP Morgan's SCP, are required to determine their fair values at the end of each day in accordance with U.S. GAAP. However, GAAP allows some subjective judgement in determining what prices are most representative of fair values.[12] While most entities use the midpoint price of the daily range (bid-ask spread) as their valuations, or "marks", CIO began to deviate from this policy in the later part of the first quarter of 2012 to hide fair value losses on the credit derivatives in its SCP.[13]

The traders managing the SCP were themselves in charge of providing the daily accounting valuations, based on the "marks" they had chosen to use. Julien Grout, a junior trader on the SCP team, would then send out a daily communication to key CIO personnel on the profit-and-loss performance of the portfolio as per bank practice. In order to show a more favourable picture by hiding some of the unrealised losses, the traders began using marks that differed from the midpoint.[14]

For five days in the middle of March, Grout began recording on an internal spreadsheet the difference between the values they were reporting to the bank and the midpoint valuations. On 16 March, this difference representing unreported losses reached US$300 million, and Grout later stated that it could grow to US$1 billion by the end of the month.[15] These differences would only begin to significantly reverse toward the end of the first quarter, as the traders decided to report larger and larger losses by reporting valuations closer to the midpoint, gaining significant attention from senior management.

Under U.S. regulations, banks were required to have an internal process to verify the accuracy of asset values reported. In JP Morgan, the CIO's Valuation Control Group (VCG), which reported directly to the CFO of CIO, fulfilled this requirement by conducting a review at the end of each month, which included a check on the derivative valuations in the SCP by using data from independent pricing services, actual transactions and market quotes. In the month-end reviews during the first quarter of 2012, VCG approved CIO's valuations for the SCP as the bank's policy allowed some degree of subjective judgement, and also because the marks used were still within the bid-ask spread and the range set by the oversight group.[16] Thus, no requests were made for the SCP traders to cease using their own favourable estimates or to revert to the midpoint valuations from these reviews. The CIO would only do so when ordered to in May, arising from the discovery in March that the Investment Bank, a separate line of business in JP Morgan, was assigning different values for the very same credit derivatives also held by CIO.

BREACHES OF RISK LIMITS (RISK MANAGEMENT)

In relation to its trades, the CIO used five different risk metrics to monitor its risk exposure – the Value-at-Risk (VaR) limit, Credit Spread Widening 01 (CS01) limit, Credit Spread Widening 10% (CSW10%) limit, stress loss limits, and stop loss advisories.[17] From January to April 2012, all of these limits were breached more than 330 times in total.[18]

Under the firm's policy, breaches of these limits had to be reported to their respective signatories, as well as the CIO Risk Committee, and the Market Risk Committee or Business Control Committee. When a breach occurs, "the business unit must take immediate steps to reduce its exposure so as to be within the limit, unless a one-off approval is granted".[19] The one-off approval represents a temporary allowable increase of the relevant limit. The Value-at-Risk (VaR) of the SCP was an estimate of the maximum daily mark-to-market loss. As early as January 2012, the VaR had already begun to exceed its limits.[20] In response, Jamie Dimon and John Hogan, the CEO and Chief Risk Officer (CRO) of JP Morgan respectively, approved exactly such a one-off increase from US$125 million to US$140 million until the end of January.[21]

At that time, CIO then implemented a new VaR model which instantly reduced the VaR by close to half the previous amount, thus allowing it to end the limit breach via new calculation methodology. Subsequently on 10 May, the bank reverted back to the old model, with CEO Jamie Dimon announcing that the new model it had adopted was inadequate in portraying risk.[22]

The Company later admitted during the Senate inquiry that the new model was rushed through internal approval – the Model Review Group (MRG) of the bank had found problems with the new model and requested action plans to resolve the issues. However, these were never completed.[23]

The continuing increase in the size of the portfolio also led to breaches in the other metrics, as the large position taken by CIO meant that small variations could translate to larger losses in the SCP.[24] These breaches were apparently ignored by management or handled by having their limits raised.

CIO RISK COMMITTEE[25]

Prior to the first quarter of 2012, the CIO risk committee was subjected to less scrutiny than other critical lines of business and this resulted in weak risk controls and pervasive infrastructures that performed ineffectively within CIO. In addition, the committee itself was understaffed. This was made worse when the risk function of the firm did not place any emphasis on hiring more risk personnel for CIO. Even if the risk personnel were hired, they were seemingly more accountable to the CIO management, instead of the firm's risk function. As such, some of the risk managers did not feel independent enough from the business operations of CIO to criticise the trading strategies used. In essence, no meaningful checks could be done on the activities of CIO.

Other than the fact that the Committee only met three times in 2011, the composition of the attendees was poor, as it mainly involved only key members of CIO. As such, along with its passiveness, the committee could not update the risk structure and risk limits for CIO in time. As the SCP increased in size and complexity, these inherent weaknesses in CIO's risk management became more critical. The threats posed by these weaknesses, such as permitting the pursuance of risky trading strategies, grew in significance with the size and complexity of the SCP.

Even though a new CRO was hired for the CIO in January 2012 to build risk controls and to improve practices, it was all too late to develop structures that may curtail the losses in CIO. Furthermore, he lacked sufficient experience in risk management.

BOARD RISK COMMITTEE[26]

Unlike the other largest U.S. lenders, the board risk committee of JP Morgan lacked directors with the relevant banking and financial risk management experience. The only one with the requisite experience had not been employed in the industry for more than 25 years. Despite the severe lack of relevant financial risk management experience, the composition of the risk committee had not changed since 2008. The committee that was headed by James Crown, with members Ellen Futter and David Cote, was also relatively small. It met seven times in 2011.

The severe lack of Wall Street experience made it almost impossible for the committee to pose critical questions to the CIO CRO to eliminate any potential risks in the trading strategy. The committee simply gave the bank's risk-appetite policy the green light.

OTHER CONTROLS AND OVERSIGHT[27]

As with the case of the CIO risk committee, the CIO VCG faced operational shortcomings in its reviews that were accentuated as the SCP grew in size and complexity. At the time, they were also under criticism from JP Morgan's internal audit group relating to issues of inadequate price and valuation testing. Within the firm, there was no practice of circulating daily trading activity reports, which would have allowed for easier detection of issues. In particular, the CFO should have noted the significant financial risks that resulted from the firm's lack of control over traders.

Furthermore, the process of approving and implementing the new VaR model was haphazard. The CEO, Jamie Dimon, appeared to have provided an approval in writing without much thought, as he would later testify that he could barely recall giving the approval.[28] Consumed by the idea that the operational and risk infrastructures were robust, reviews carried out by the Model Review Group that uncovered operational and mathematical problems with the new model were largely ignored, with no corrective actions taken before implementing the model.

OFFICE OF THE COMPTROLLER OF THE CURRENCY

A key regulator for JP Morgan Chase is the Office of the Comptroller of the Currency (OCC), whose primary mission is to charter, regulate, and supervise all national banks and federal savings associations.[29] Prior to the media reports of the "London Whale" trades in April 2012, almost no information regarding the SCP was disclosed to OCC. The lack of disclosure provided by JP Morgan precluded effective OCC oversight and hence, no reviews were conducted on the SCP prior to 2012.[30] However, there were red flags which signalled the increasing risk taken up by the CIO.

In 2011, the bank had filed risk reports with OCC, which disclosed that the CIO had repeatedly breached its stress limits in the first half of 2011. This should have warranted attention and follow-up from the OCC. However, the OCC did not take further action. Furthermore in 2012, the CIO took up a US$1 billion high risk derivative bet, which resulted in a US$400 million gain to the CIO. The OCC was aware of the US$400 million gain, but had failed to enquire on the reason and the extent of the trade going on at the CIO.

The role of SCP was further downplayed in January 2012. The CIO misinformed the OCC claiming that it will decrease the notional size of the SCP. However, the notional size of the SCP was tripled over the course of the quarter instead.[31] Furthermore, in the following months, JP Morgan began to omit key CIO performance data from its reports to the OCC. The OCC did not notice the missing reports and did not request for a new CIO management report from JP Morgan.

In addition, various VaR breaches were disclosed in JP Morgan's risk reports to the OCC. However, the OCC did not review the reports or question the trading activities which resulted in the breaches. Following the media reports on the "London Whale" trades, the OCC subsequently conducted a review on its own missteps. In October 2012, the OCC released an internal report that concluded that they had failed to monitor and investigate multiple risk limit breaches by the CIO and improperly allowed JP Morgan to submit aggregated portfolio performance data that concealed the CIO's involvement in high-risk trading activities.[32]

IMPLICATIONS OF THE VOLCKER RULE

The Volcker Rule, introduced as part of Dodd-Frank Wall Street Reform and Consumer Protection Act, "is intended to reduce bank risk by prohibiting high risk proprietary trading activities by federally insured banks, their affiliates, and subsidiaries".[33] However, the Volcker Rule allows hedging activities to continue.

On 13 April 2012, CEO Jamie Dimon dismissed the media reports about the SCP as "a tempest in a teapot". In addition, JP Morgan Chase Chief Financial Officer Douglas Braunstein reassured investors, analysts, and the public that the SCP's trading activities were made on a long-term basis, transparent to regulators, had been approved by the bank's risk managers, and served a hedging function that lowered risk and would ultimately be permitted under the Volcker Rule whose regulations were still being developed.

However, on the day prior to the earnings call, Ina Drew wrote to Mr Braunstein, stating that "the language in Volcker is unclear," a statement that presumably refers to the fact that the implementing regulation was then still under development.[34] In addition, the bank had earlier written to regulators expressing concern that the SCP's derivatives trading would be "prohibited" by the Volcker Rule.

Misstatements and omissions about the SCP's transparency to regulators, the long-term nature of its decision-making, its VaR totals, its role as a risk-mitigating hedge, and its supposed consistency with the Volcker Rule, misinformed investors, regulators and the public about the nature, activities, and riskiness of the CIO's credit derivatives during the first quarter of 2012.

IMPACT ON JP MORGAN'S STOCK PRICE

The announcement of the trading losses on 11 May 2012 sent the stock price down by more than 9% (US$40.74 to US$36.96).[35] It also prompted a law firm, Finkelstein Thompson LLP,[36] to investigate claims on behalf of JP Morgan's shareholders with regards to the losses. By 4 June 2012, JP Morgan's share price had dropped by 33% from its high of US$46.27 set on 28 March 2012 to US$31.00.[37] The following day, on 5 June 2012, it was reported that the U.S. regulators would be reviewing the possibility of clawbacks from the staff involved in the trading losses.[38]

Investors were largely supportive of this as they took the view that it would help cover a portion of the losses, sending the stock up slightly over 3%. On 13 July 2012, at the same time second quarter earnings were reported, JP Morgan restated its 2012 first quarter earnings and announced to the public that the problems reported in the media had been fixed.[39] Investors, upon receiving the information, were happy that measures had been taken to avoid further losses and this brought about a 6% increase in its share price during its day trade.[40] Following the announcement of the results for the second quarter, the stock price rose back to the pre-11 May level by mid-September and back to its 28 March-high in early January of 2013.

AFTERMATH AND FURTHER DEVELOPMENTS

Since the trading scandal was exposed, changes have been seen in the management at CIO. Ina Drew, the Chief Investment Officer, stepped down and retired from her position and also voluntarily returned two years of her compensation to the company.[41] Several other CIO personnel, including Martin-Artajo, Iksil and Grout, saw their employment terminated as well.[42]

Following the announcement of the trading losses in May 2012, several official inquiries have been set in motion to examine the factors that led to such events. JP Morgan set up a task force to examine the errors and proposed measures to prevent a repeat of the events.[43] The U.S. Senate also publicly investigated the issue, subpoenaing internal evidence and key personnel from the bank, and subsequently issued a comprehensive report on the matter.[44]

DISCUSSION QUESTIONS

1. What were the key corporate governance issues with JP Morgan? What can be done to improve the risk management and internal control in JP Morgan? Contrast this with another financial institution in the United States.
2. Evaluate how JP Morgan communicated with stakeholders following the trading scandal.
3. What should be the role of government in regulating financial institutions? Compare this with your country.
4. Should the non-executive and independent directors be held accountable for the trading losses at JP Morgan? On hindsight, if you were one of the directors on the board, what would you have done before the scandal was made public in May 2012?
5. "The tone at the top significantly influences a company's corporate governance." To what extent was this related to the trading losses suffered by JP Morgan? Explain.
6. The breach in the regulations could have potentially been avoided. If you were the trader, what would you have done? How do you think a whistleblowing policy may help prevent this?

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UBS: ALL BETS ARE ON

CASE OVERVIEW

Swiss banking giant UBS shocked the world when it was revealed that, Kweku Adoboli, a member of its Global Synthetic Equities (GSE) Trading team in London, had engaged in unauthorised trading that resulted in an estimated loss of US$2 billion. For committing one of the largest frauds in UK's history, Adoboli was jailed for 7 years.[1] The scandal revealed persistent weaknesses in UBS' internal controls and highlighted the excessive risk-taking culture for which UBS received heavy criticism from regulatory bodies. This incident also shook investors' confidence in the capital market and has raised public concerns about corporate governance in UBS and other financial institutions. The objective of this case is to facilitate a discussion of issues such as board and management accountability; risk management and internal control; and corporate governance of financial institutions.

THE STORY OF THE SWISS BANKING GIANT

As the largest Swiss bank and a leading financial service provider, UBS has a global presence in more than 50 countries with approximately 60,000 employees providing investment banking, asset management and wealth management services.[2]

Since 1998, UBS has been the world's largest manager of private wealth assets.[3] Following its formation, the bank quickly proceeded to pursue its ambition of becoming a global power in investment banking by expanding rapidly into the U.S. market. By 2003, UBS had become the fourth largest investment bank in the world, and was among the top fee-generating investment banks globally.[4]

By the end of 2007, UBS was purportedly the most-leveraged major bank worldwide, with its assets far exceeding its total equity.[5] In mid-March 2007, the bank's channeling of more than US$100 billion into asset-backed securities led to massive losses during the subprime mortgage crisis. UBS then received a substantial financial bailout from the Swiss government and one of the bank's largest shareholders, Government of Singapore Investment Corporation (GIC), further injected US$9.7 billion into the bank.[6] On 6 March 2009, the share price of UBS hit a record low of US$7.72.

OSWALD GRÜBEL, THE CEO

On 26 February 2009, Oswald Grübel was named Group CEO and was tasked with leading UBS out of its crisis.[7] The move was well received by traders on the Zurich exchange as UBS' share price rose 14.85% to open at 11.60 Swiss francs (US$9.99) for the day.

Grübel's performance, to a large extent, met expectations. In his first year at UBS, he managed to stave off huge losses and in 2010, Grübel led UBS to even greater recovery as he returned UBS into profitability.[8] The organizational culture of UBS also changed under the leadership of Grübel, who said in a statement, "I'd actually like to see us put more risk on the table".[9]

THE SCANDAL: FURTHER EROSION OF CONFIDENCE

UBS suffered an enormous dip in investors' confidence in 2008 after the subprime mortgage crisis and the multi-million-dollar tax evasion controversy in the U.S. However, the worst had yet to come.

On 15 September 2011, UBS became aware of a massive loss, estimated at US$2.3 billion, arising from unauthorised trading allegedly conducted by Kweku Adoboli, an employee in UBS' GSE Division. Adoboli was a director on UBS' GSE Trading team in London on the Exchange-Traded Funds (ETF) Desk and had been responsible for a portfolio of companies with assets totaling US$50 billion. To maintain his 'star' status in the bank, he started increasing his risk exposure for greater profit, which resulted in greater losses when his bets failed. Using the knowledge and skills he had obtained from his time as an analyst in the "back office", Adoboli began to engage in unauthorised trading, entering false information into the computer systems to conceal the risks he took. The increasingly risky trading resulted in volatile earnings and losses that he concealed using a range of prohibited mechanisms. These included one-sided internal futures positions, the delayed booking of transactions, fictitious deals with deferred settlement dates, and a concealment mechanism he termed the "umbrella". Eventually, losses snowballed to hit US$2.3 billion[10] before anyone was any wiser.

This is the abridged version of a case prepared by Ma Yan, Ng Wai Hong, Nie Yile and Su Liwen under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Chloe Chua under the supervision of Professor Mak Yuen Teen.

When the scandal became public, UBS' stock price fell from US$12.68 to US$11.41, a 10% fall in value in one day.[11] The scale of the losses led to renewed calls for the global separation of commercial banking from investment banking while media commentators suggested that UBS should consider downsizing its investment bank.

THE GATEKEEPER: BOARD OF DIRECTORS

Swiss law requires UBS to operate under a strict dual board structure comprising the Board of Directors (BOD) and the Group Executive Board (GEB), with clear separation of duties and responsibilities. The BOD is responsible for overseeing the Group's direction and monitoring and supervising the business. The GEB is responsible for the executive management and is accountable to the BOD for the overall financial results of UBS.[12]

As at 31 December 2011, the BOD comprised 11 directors with diverse backgrounds, 10 of whom were independent. The exception, Chairman Kaspar Villiger,[13] was the former Swiss Minister of Military and Finance. He had come out of retirement to guide UBS back on track[14] despite public concerns of whether his capabilities could be extended to places outside of the ministries, particularly in a bank like UBS.

Under the BOD, there were five board committees covering audit, corporate responsibility, governance and nominating, human resource and compensation, and risk. The Risk Committee ("RC") was responsible for reviewing the bank's risk management and control framework. The Group chief risk officers and CEOs of the different banking divisions were to be present at meetings with the committee to ensure they were kept updated on the execution of risk management and controls. The RC had the duty to make reasonable enquiries into the possible deficiencies detected in the bank's control and monitoring mechanisms, and to raise these concerns during these meetings.[15]

A RISKIER CULTURE

"If a bank doesn't take any risk, it is incredibly hard to make money, and that is our job. Grübel thought there was room for more market risk, which in general was a view I agreed with."

- Phil Allison, UBS AG's Head of Global Cash Equities.[16]

Under Grübel's charge, the bank undertook riskier business activities in order to increase profits, including proprietary trading which seeks opportunities with higher leverage using the bank's own resources. In the Investment Banking Division, risk limits were increased, and punishment for excessive risk taking was overlooked in favour of generating profit. In particular, UBS was accused of rewarding traders who had breached compliance rules relating to personal account dealing and spread betting with increased remuneration and bonuses, as well as enrolment into higher-level management programmes.[17] This sent the signal that excessive risk taking and non-compliance with rules were acceptable for profit, thus incentivising such risk-seeking behaviour.

There were also signs that senior management neglected the importance of controlling and monitoring functions in the bank organisation as evidenced by the lack of control infrastructure realignment during the transfer of ETF desk from the Cash Equities (CE) Division to the GSE Division.[18] Responsibilities over Product Control continued to be held by the CE team despite the transfer. On many occasions, senior management sacrificed the effectiveness of controls for efficiency of processes.

RISK MANAGEMENT AND INTERNAL CONTROLS

Where were the Controls and Monitoring?

The ETF trading desk was controlled and monitored by three separate back office functions – Operations, Product Control (PC) and Market Risk (MR), and the line managers who supervised traders. The key responsibility of the Operations unit was to ensure that trades at the Desk were accurately recorded and properly processed. The PC unit was tasked with performing checks and ensuring correct reporting of profit and loss (P&L) of each trader. The MR department was responsible for daily market risk reporting and analysis. The line managers ensured that the risk limits were adhered to and reported any breach to the management.

However, over time, breaches of compliance instructions remained unchallenged and warnings went uninvestigated. The Operations unit did not raise any doubts even though there were unresolved reconciliation errors followed by suspicious and unsatisfactory explanations. PC personnel simply accepted the traders' explanations for anomalies without sufficient analysis. It went completely unnoticed that the PC unit had not generated an important control report for a few months.[19]

Furthermore, UBS did not impose an approval threshold or require evidence for adjustments of P&L, thus providing traders with the opportunity to conceal their losses. The market risk system for the ETF Desk also did not automatically monitor trading positions in relation to pre-set risk limits. Line managers were uncertain of what their functions and responsibilities were in monitoring the ETF desk. Following a re-organisation, no specific arrangements were made for transferring responsibility for monitoring. System alerts failed to reach the new direct line manager in New York, and ended up instead with the previous manager who acknowledged them, despite it no longer being his responsibility.

Too Much Trust?

The relationships between traders and supervisors were characterised by a high degree of trust. Supervisors often did not question traders sufficiently regarding unusual increases in proprietary trading revenue as per guidelines. On numerous occasions where risk limits were breached and brought to the attention of the Desk's line manager, no further investigation was made. Explanations were usually accepted without further verification.[20]

The operational risk department also placed a high degree of trust on the front office and their self-assessment of risks. Based on their internal framework of risk assessment, the operational risk department did not impose requirements for evidence or substantive testing to be done in order to validate self-assessment results. In addition, self-assessment was only done on an annual basis, hence presenting the possibility of control deficiencies going undetected for a long period of time.

Question of Competencies

Personnel in the control functions were allegedly incompetent and had a poor understanding of ETF-related trading activities. They saw their role as a support function rather than as a control mechanism. Moreover, the poor definition of certain roles and responsibilities and a lack of proper training essential to navigating the complexities of the ETF trading desks exacerbated the supervisors' confusion, and compromised the supervisors' ability to effectively carry out their duties.

Growth of Synthetic ETFs: The Need for Regulation

By European bank conventions, no confirmation of positions from the bank's finance, risk-control and audit functions is required before proceeding with the trade.[21] Investigators found that Adoboli had exploited this loophole in the regulations of ETFs to distort the true magnitude of risk exposure arising from the trade. This then allowed him to conceal his violation of stipulated risk limits and thus advance his fictitious trades.

This incident has prompted global banking and securities regulators to increase scrutiny on ETF regulations.[22] Regulators are contemplating strict new rules dictating the amount and quality of collateral ETF providers need, and could impose requirements for fund managers to disclose a greater degree of detail in relation to their counterparties.[23]

CLEANING UP THE MESS

In the aftermath, CEO Oswald Grübel and the co-heads of Global Equities at UBS, Francois Gouws and Yassine Bouhara, resigned to assume responsibility for the trading scandal. Sergio Ermotti was appointed as the Group CEO on an interim basis.

Investigations took place over an eight-month period to pinpoint the causes of the incident. Significant changes were made to the infrastructure and controls, including changes to processes and monitoring capabilities. Changes to their internal control system, such as the escalation process for daily adjustments over defined thresholds and a supervisory signoff process, were implemented. Monitoring became more robust in the equities business, and there was better information flow to supervisors and risk managers.

UBS also aimed to reinforce accountability by the clarification of supervisory roles, reiteration of trading mandates and how employees' performance reviews were done. A new supervision structure was implemented to ensure that supervisors are suitably experienced, while management information was improved with clearer prioritisation of information.

On 20 October 2012, UBS announced its intention to transform the firm by restructuring business activities. In particular, UBS wanted to sharpen its focus in investment banking, and to exit fixed income business lines, proprietary trading and other lines and products that were overly complex and which did not deliver stable and attractive risk-adjusted returns under new regulatory rules.

A POST-MORTEM: PROBLEM RESOLVED?

In late 2012, however, UBS was involved in yet another trading scandal.[24] UBS traders Tom Hayes and Roger Darin were charged for taking part in a multi-year scheme to manipulate LIBOR and other benchmark interest rates. UBS was fined US$1.5 billion – the second largest fine ever imposed on a bank– by regulators in United States, UK and Switzerland. Along with UBS, many other banks, such as Barclays and RBS, were also fined for their involvement.

The persistent occurrence of banking scandals in financial institutions reflects a significant failure to address the core issues facing the whole financial sector. Despite the repeated revamp of internal control systems and changes in company leadership in individual banks, banks continue to hog headlines with shocking reports concerning new schemes involving fraud and manipulation. This points toward one overarching question: Can such issues in financial sectors ever be truly avoided?

DISCUSSION QUESTIONS

1. What were the key controls and monitoring mechanisms in UBS before the scandal took place? Comment on the effectiveness of these controls and mechanisms and how their inadequacies provided opportunity for the trading scandal to happen.
2. Discuss how the risk-taking culture in UBS could have given an incentive to the traders to circumvent the controls.
3. Should the board of directors have been held responsible along with the CEO? What should the Risk Committee have done before the scandal fully developed? What are some possible challenges faced by the committee in pre-empting such scandals?
4. Were the measures implemented by UBS to remedy the problems sufficient? How else could UBS improve corporate governance and internal controls?
5. What were the regulatory loopholes that contributed to the unauthorised trading? Could regulators play a bigger role in the governing of financial institutions with heavy trading activities?

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TAX EVASION AND KYC

MIZUHO FINANCIAL GROUP: DOING BUSINESS WITH THE YAKUZA

CASE OVERVIEW

Mizuho Financial Group (Mizuho), the second largest financial services group in Japan, was embroiled in a case of illicit loan financing to the Japanese mafia through its affiliate, Orient Corporation (Orient Corp). Early warnings by Japan's regulatory authority, the Financial Services Agency (FSA), about such business dealings were initially labelled as an isolated event, but the dealings were later exposed to be done with the knowledge of the Mizuho Bank's President and CEO. The slow response of the board and Mizuho's failure to fulfil its promise to tighten internal control resulted in persistent tolerance of lax screening and allowed illicit loan financing to go undetected in Orient Corp. Gaps in management oversight and the lack of streamlined control following Mizuho's birth from a merger of three banks allegedly contributed to the failure to enforce compliance. The scandal left Mizuho with a tarnished reputation and led to an urgent call to revamp its board structure to institute greater independence and transparency of board processes. The objective of this case is to allow a discussion of issues such as board independence; board effectiveness; directors' oversight role in ensuring compliance; corporate governance and management challenges resulting from a merger; governance of entities such as affiliates in a complex group; and the Japanese system of corporate governance.

LOOKING BACK AND FORWARD

As Yasuhiro Sato, President and CEO of Mizuho Financial Group (Mizuho), made his customary Japanese bow to apologise and acknowledge his mistakes, the recovery of the Group was only at its beginning. The decisions and penalties were announced one by one – suspension of parts of Mizuho's operations, issuance of a business improvement order, management changes, and pay cuts. For the second time in three months,[1] Mizuho was penalised for loans to organised crime groups.

Why did the issues persist for so long? How did Mizuho end up in this predicament? What more could be done to improve the situation? The curtain may have fallen for the time being, but Mizuho's problems were far from settled.

THE FIRST SIGN OF TROUBLE

On 1 October 2011, the *Boryokudan Haijojorei*[2] was formally written into Japanese law, signifying the country's renewed effort to keep the Japanese mafia, more commonly known as Yakuza, out of Japanese society. Under the organised crime exclusion law, any forms of financing or payment to Yakuza are criminalised. Regrettably, not all within Mizuho heeded the message.

The fiasco began with a routine inspection between December 2012 and March 2013 by the FSA, which oversees banking, securities and exchange, and insurance in Japan.[3] The inspection uncovered 230 loan transactions with Yakuza-linked entities or individuals with loan amounts exceeding ¥200 million (approximately US$2 million) over more than two years.[4] Although it was established that most of the loans were auto loans taken out via its consumer-finance affiliate, Orient Corp, Mizuho was the ultimate entity financing these loans.[5]

THE YAKUZA: AN ENTRENCHED SOCIAL ELEMENT

The history of the Yakuza dates back to the 17th century, when they controlled construction and dockside labour in addition to other unsavoury businesses such as prostitution, gambling and liquor distribution.[6] From the 1980s, the Yakuza expanded their reach beyond the underworld to infiltrate the Japanese corporate world and financial system, in areas of real estate development and stock market manipulation.[7]

In 2012, a new revision was made to the Boryokudan Haijojorei to allow "police to designate organised crime groups as "extremely dangerous" and arrest any member of that group, without issuing a cease and desist order, if he (or she), makes unreasonable or illegal demands towards ordinary citizens". [8]

Despite these measures, the Yakuza is still pervasive in many areas and echelons of Japanese society, with 63,000 known members in Japan currently.[9] They are known to cover their tracks well through the use of front companies and other disguises, making prosecution difficult due to the lack of evidence. The banking sector has suffered

This is the abridged version of a case prepared by Tan Ze Shan, Chan Yu Wei, Lee Xian En Paul and Wu Jiaying, Louisa under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Toh Jia Yun under the supervision of Professor Mak Yuen Teen.

from the Yakuza's penetration and influence as well. For instance, Citibank Japan lost its private banking license in 2004 due to high-ranking Yakuza members holding numerous accounts with the bank.[10]

A FINANCIAL POWERHOUSE

Mizuho is a bank holding company headquartered in the Ōtemachi district of Chiyoda in Tokyo, with a primary listing on the Tokyo Stock Exchange (TSE).[11] It is one of the largest financial institutions in the world, offering a wide range of financial services, including banking, trust and securities, and asset management services.[12] Mizuho Holdings, Inc. was established in September 2000 through the merger of three banks – Dai-Ichi Kangyo Bank (DKB), Fuji Bank (Fuji) and the Industrial Bank of Japan (IBJ). Mizuho Financial Group was then established in January 2003 as the parent company of Mizuho Holdings, Inc, and became its sole shareholder.[13]

In Japanese, "mizuho" means "a fresh harvest of rice". This expresses Mizuho's commitment to "offer highly fruitful financial products and services to all customers, both in Japan and abroad".[14] Mizuho's brand slogan, "One Mizuho: Building the future with you", indicates their commitment to become "The most trusted financial services group with a global presence and a broad customer base, contributing to the prosperity of the world, Asia, and Japan".[15]

BIG BANK, BIG TROUBLE

On 27 September 2013, Mizuho received a Business Improvement Order from the FSA regarding its illicit transactions with "anti-social elements", a euphemism for organised crime groups such as the Yakuza.[16] It was a warning for Mizuho to tighten its processes and procedures in accordance with the law, which prohibits transactions with organised crime. In response, Mizuho vowed to "implement its improvement plan in relation to this problem and also work with utmost effort towards further improvement and reinforcement of its internal control systems".[17]

Initially, Mizuho claimed that the loans were traced to a rogue compliance executive; that it was not pervasive through the ranks.[18] However, this stand was reversed three days later when Mizuho admitted that top management, including Mizuho Bank President and CEO Yasuhiro Sato, had been kept in the loop long before the scandal unfolded.[19]

In response, the FSA called for an additional detailed report to be submitted, including the names of all executives who knew about the loan. Shortly after, on 25 October, Mizuho announced that it would punish 54 executives in connection with the illicit loans.[20] In addition, Sato would forfeit six months of salary.[21] Takashi Tsukamoto, the Chairman of Mizuho Group and Mizuho Bank, would step down as Chairman of Mizuho Bank. However, at that time, he was allowed to remain as the Group Chairman.[22]

On 5 November 2013, the FSA began to conduct additional probes, resulting in a more punitive administrative order being meted out to Mizuho on 26 December, involving suspension of its loan business with consumer-credit affiliate firms for a month and a requirement to submit a mandatory business improvement plan by 17 January 2014.[23]

Furthermore, on the same day, Tsukamoto announced that he would be stepping down as Group Chairman in March 2014 to take responsibility for the Yakuza loans scandal. In addition, Sato would extend his no-pay period from six months to one year.[24]

Following Mizuho's loan scandal, FSA began inspections of Japan's two other largest banks, Mitsubishi UFJ Financial Group (MTU) and Sumitomo Mitsui Financial Group (SMFG), to ensure compliance with regulations regarding transactions with organised crime.[25]

FAILING FROM WITHIN

"Executives from the former bank defended their own fiefdoms … even from the outside, we can see they are not well-informed, from the top to the bottom."

- Kanji Tanimoto, Professor in Corporate and Social Responsibility at Waseda University[26]

The formation of Mizuho through the merger of the three banks did not result in any dominant party, and thus created a lack of coordination and synergy within the Group and created gaps in its governance structures. For instance, on Mizuho's first day of business on 1 April 2002, it experienced "the biggest banking system failure in history" due to the many transaction errors relating to its Automated Teller Machine (ATM) system.[27] This was mainly because the three banks could not come to a unanimous decision on the adoption of a single computer system. Eventually, instead of deciding whose computer system to use, the three banks decided to bridge the existing systems of each bank. However, this also did not work out as Mizuho ATMs had to be shut down in March 2011 due to a system overload, delaying the processing of more than one million money transfer orders.[28]

LACK OF OVERARCHING OVERSIGHT ON CAPTIVE LOANS

More significantly, some loans made through Orient Corp, Mizuho's consumer-finance affiliate and the entity predominantly funding Yakuza-linked entities, were carried out without stringent due diligence and background checks.[29] In such a "captive" lending situation, Orient Corp extends and guarantees a loan while Mizuho finances it. However, the customer screening process responsibility was outsourced to Orient Corp, instead of applying the more stringent screening conducted by Mizuho for conventional loans. Orient Corp's lax screening system allowed Yakuza-linked loans to be approved with minimal identification checks.[30] Despite calls from the FSA to enhance internal controls in order to curb loans tied to Yakuza as early as 2003, Mizuho did not perform its own customer background checks for affiliate-linked customers until seven years later.[31] Mizuho's management did not provide oversight on the corporate governance and internal controls of its affiliated companies,[32] and the scandal showed that the conduct of its affiliates would have as great an impact on Mizuho as if it were making the loan itself.

FAILURE TO TAKE ACTION AND ADDRESS ANTI-SOCIAL LOANS

Perhaps what was more damaging was that the former banking unit President, Satoru Nishibori, did not take action although he was made aware in July 2010 of the loans made to the Yakuza. After stepping down a year later, he did not inform his successor, Tsukamoto, of the illicit loans, and also did not inform Sato, CEO and President of Mizuho, of the issue. Sato claimed that he only knew of the issue in March 2013, after a regular FSA inspection raised red flags.[33] Due to the lack of coordination and communication within Mizuho, the issue was only dealt with in 2013 although the former President, Nishibori, already had knowledge of this issue in 2010.[34]

Mizuho's failure to address the issue for nearly two years after uncovering the transactions highlighted the ineffectiveness of the board in ensuring compliance with legislation and ethical standards. At Mizuho, the legal compliance department was in charge of overseeing financial transactions with Yakuza members and other questionable dealings.[35] At that time, Masakane Koike was the executive director acting as the head of both the risk management and compliance departments. While the departments failed to take appropriate measures to address the issue, the board as a whole failed to oversee and ensure that Koike carried out his duties properly and diligently.

BOARD INDEPENDENCE

Before the scandal, Mizuho's Board comprised 12 members, consisting of Chairman Tsukamoto, eight executive directors and three 'outside' directors who did not engage in day-to-day management.[36] Under Tokyo Stock Exchange listing rules, companies should have at least one independent director.[37] A lack of independence on the Mizuho Board still persists today, with the majority being executive directors. This issue is common and prevalent in Japan, where most board members are company insiders.[38]

REPUTATION MATTERS

In absolute terms, the controversial loans amounting to US$2 million would not have any material impact on Mizuho's earnings and financial performance. Furthermore, the FSA merely ordered Mizuho to strengthen its internal control and compliance without imposing any monetary penalties. The month-long suspension of business with its affiliates should not have material financial consequences as well. However, the business improvement order was seen as a public spanking and placed Mizuho in a bad light, thus adversely affecting the Group's reputation.

Unsurprisingly, Mizuho's investors and shareholders reacted negatively to the news. On the first trading day after the FSA released its findings on 27 September 2013, Mizuho's shares fell 4.1%, the most in three months, while the benchmark index retreated one percent.[39] Over the next few weeks, Mizuho shares declined to a low of ¥203 on 10 October from a high of ¥222 on 27 September. Correspondingly, Mizuho's market capitalisation fell from ¥5.37 trillion to ¥4.91 trillion, a decline of over ¥400 billion that far exceeded the direct economic consequences of the scandal. However, Mizuho share price recovered to its previous level within two months and continued with an upward trend till early 2014.

Similarly, Orient Corp's share price fell from ¥283 on 27 September to ¥238 on 7 October. However, Orient Corp's share price did not recover to its previous level as of early 2014.

MIZUHO'S RESPONSE

In response to its compliance failure, Deputy President Toshitsugu Okabe replaced Koike as head of compliance on 30 September 2013.[40] With the aim of strengthening the holding company's power to oversee subsidiaries and affiliates and to achieve greater transparency, Mizuho announced that audit, nominating and compensation committees will be formed as advisory bodies of the board, and Mizuho will pick an outsider to lead its board after the departure of the Group Chairman, Tsukamoto. With this, Mizuho will be the first among Japan's three biggest banking groups to have its management supervised by three committees consisting largely of outside directors[41], allowing for a clearer separation between management oversight and business operations, improving Group-wide governance[42]. This plan was approved at a general shareholders' meeting in June 2014.[43]

REPAIRING A TARNISHED REPUTATION

While rivals Mitsubishi UFJ Financial Group and Sumitomo Mitsui Financial Group continue to aggressively expand overseas, Mizuho's primary concern for now will be its problems with corporate governance and company culture.[44]

Mizuho has undergone management shake-ups in the wake of the scandal, which seem to have been met with shareholder approval, based on its rapid share price recovery. The latest shake-up was announced on 14 March 2014, consisting of changes in executive positions across the Group. On 1 April 2014, Nobuhide Hayashi, a 56-year-old deputy president of Mizuho, replaced Sato as CEO of Mizuho Bank. Sato remains as President of Mizuho, focusing on revamping the corporate culture of the Group.[45]

EPILOGUE

Since the saga, Mizuho has led the way in governance overhaul in Japan with the transformation to a more U.S.-style board. In a recent report released on 25 June 2015 endorsed by President Sato, it was stated that "the Board of Directors has started off well" in its first year after the transformation. Six out of thirteen directors in total are outside directors and five out of these six directors are independent.[46] The Chairman is also an outside director.[47] This represents a significant improvement in the overall independence of the board. Mizuho's share price has also been on the rise in the aftermath of the reform, marking a positive turnaround for the troubled bank.

DISCUSSION QUESTIONS

1. Why do you think that the Mizuho board, after being made aware of the illicit business dealings, chose not to take any action against the illicit loans?
2. Evaluate Mizuho's board composition before the fallout from the loans scandal.
3. Discuss whether the penalties meted out by the FSA were sufficient.
4. Has Mizuho taken appropriate steps to improve its internal control and governance structure?
5. With reference to Mizuho and other examples, what are the corporate governance and management challenges that may arise from a merger?
6. What are the unique challenges relating to governance of group entities, such as Orient Corp in Mizuho's case?
7. Evaluate the Japanese corporate governance system in terms of the existing legislation and codes (or lack thereof). Are there certain cultural or business norms which may have contributed to these issues?

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THE taX-FILES: HSBC GROUP

CASE OVERVIEW

In early 2015, HSBC was accused of knowingly helping its clients evade taxes. When faced with the allegations, HSBC admitted to control and compliance failings, but insisted that they were due to poor integration of its subsidiaries, and had not been intentional. The objective of this case is to allow a discussion of issues such as the ethics; whistleblowing; corporate governance in company groups; and tax risk governance.

GOING "GLOCAL"

HSBC, "The World's Local Bank", began operations in 1865. Today, it has operations in over 80 countries and a total asset value of approximately US$2.67 trillion.[1]

HSBC's first foray into the Swiss private banking market was in 1999 after its acquisition of Republic New York Corporation and Safra Republic Holdings.[2] HSBC Private Bank (Suisse) S.A. was then incorporated to take over the clients of the acquired firms. It offers clients private banking, investment and wealth management services.[3]

HSBC has had its fair share of controversies. Within the past four years, it has been involved in the 2012 LIBOR[4] and EURIBOR[5] fixing scandal, and the 2014 money laundering scandal. As a battered HSBC crawled out from the wreckage of its scandals, it was slapped with accusations that its Swiss private banking arm had actively abetted tax evasion for its clients.

FALCIANI TAKES A LEAK

"I worked with a group called 'change the bank' but this was against another group called 'run the bank' which wanted to do things without being monitored."

– Hervé Falciani[6]

Between 2006 and 2008, Hervé Falciani, a French national and a computer security specialist tasked with the migration of client data between HSBC Suisse systems, allegedly pilfered a significant amount of the data.[7] After a tip off about Falciani's illicit activities, the Geneva police picked him up on 22 December 2008 for questioning before releasing him on bail.[8] Falciani jumped bail and absconded to France with the two most important things in his life – his family and the stolen data.[9]

In France, Falciani proceeded to hand the data over to French authorities. Despite repeated attempts by Switzerland to extradite Falciani and recover the stolen data, France resisted on the grounds that the information was against France's national interest,[10] and that Falciani, being a French citizen, was not subject to extradition agreements.[11]

The stolen information was shared with other governments' tax bodies by the then French Finance Minister, Christine Lagarde.[12] This led to the tax authorities of various countries commencing tax recovery efforts amounting to hundreds of millions of unpaid taxes against offenders on the list.[13]

FALSE-CIANI?

"They will pay me for what I have done, which is worth a lot." – Hervé Falciani[14]

It soon emerged that Falciani may have had other intentions for swiping the data. Guillaume Brachet, a fiscal consultant Falciani engaged to help monetise the data, indicated that while Falciani claimed that the data was obtained via the "expert mining of open, public sources", Falciani appeared nervous and evasive when probed further.[15] Geogina Mikhael, a HSBC contract employee at the time, was responsible for tipping-off the authorities about Falciani. The pair had set up a virtual company, Palorva, which served as a front for selling the data. In February of 2008, the pair flew to Beirut, Lebanon, to try to sell the data.[16]

In Lebanon, Mikhael and Falciani attempted to sell the data to various banks, but Falciani's evasive nature when questioned on the data's origins scuppered any possibility of a deal with the banks. One of the banks informed the Swiss Bankers' Association about Falciani's offer, alerting the office of the Attorney General in Switzerland which commenced an investigation.[17]

With the banks pulling out, Mikhael alleged that Falciani turned his attention to selling the data to the authorities.[18] Falciani and Mikhael sent emails to

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European Tax authorities and intelligence agencies offering "the client list of one of the world's largest wealth management banks". Signed by a "Ruben Al Chidiack", the email was titled "Tax evasion: Client list available".[19]

ROBIN HERVÉ?

"I am not Robin Hood. I'm not a mercenary. I acted like a citizen."

– Hervé Falciani[20]

Falciani publicly denounced Mikhael's claims and stated his only intention was to expose the tax-evasion that HSBC was abetting. He claimed that he flew to Lebanon and attempted the sale only because he was instructed to do so from men claiming to be agents of Mossad.[21]

Falciani also maintained that he had handed the data to French authorities instead of the Swiss because the Swiss refused to protect his anonymity when he tried to whistle-blow on HSBC.[22]

SWISS SECRECY LAWS

"Imprisonment of up to three years and/or a fine of up to 250,000 SFr will be awarded to persons who deliberately discloses a secret that is entrusted to him in his capacity as employee… of a bank... or attempts to induce such an infraction of professional secrecy."

– Article 47, Swiss Banking Act

In Switzerland, there is a federal act that enshrines banking secrecy. The Swiss Federal Banking Act criminalises transgressions against banking secrecy by slapping imposing a prison term and a large fine on offenders. Under the law, it is illegal for anybody to deliberately disclose, or attempt to disclose, any bank related confidential information made privy to him/her. This restriction on divulgation extends to certain information by subsidiaries operating in Switzerland given to parent companies. HSBC therefore faced severe restrictions on the amount and type of information they were allowed to be made privy to with regards to HSBC Suisse.[23]

SWISS VIEW: TAX AVOIDANCE VS TAX EVASION VS TAX FRAUD

Swiss Law distinguishes between tax avoidance, tax evasion and tax fraud.. Tax avoidance is the reduction of one's tax exposure via legal exploitation of loopholes in the system. Tax evasion constitutes the failure of the taxpayer to declare certain income or assets to tax authorities. Swiss law views tax evasion as a misdemeanour, but not a crime. Authorities are prohibited from lifting banking secrecy to obtain information regarding taxpayers' assets.[24]

Tax fraud is defined as the submission of falsified or forged financial documents with the intention to avoid payment of tax. As tax fraud is subject to Swiss penal prosecution, and a judge has the right to lift banking secrecy and subpoena client information directly from the bank.[25]

SWISS APPEASE

Due to EU pressure over its banking secrecy, Switzerland signed an agreement in 2005 known as the Swiss-EU Savings Tax Agreement. Under this agreement, Switzerland would charge a final 15% withholding tax on capital and savings income of EU citizens. This was increased to 20% since 2008, and 35% since 2011. 75% of the retention tax collected would go back to the EU and its member states while Switzerland would keep the remaining 25%.[26]

Under this scheme, Switzerland got to keep its banking secrecy while earning 25% of the withholding tax. Clients could protect their wealth information by paying a fixed rate, and the EU could collect some taxes that were previously uncollectible. This seemed like a win-win-win situation for everyone involved. What could possibly go wrong?

ASSET RICH, ETHICS POOR

"I think they were a tax avoidance and tax evasion service. I think that's what they were offering. They knew full well that people come to them to dodge their tax liabilities."

–Richard Brooks, former HMRC tax inspector[27]

Clever manipulation of Swiss banking laws can set the stage for tax evasion. However, it takes two to tango, and HSBC Suisse's questionable practices had to share the stage. HSBC Suisse exploited the freedom accorded by the Swiss laws and took advantage of a loophole within the Swiss-EU Savings Tax Agreement to initiate and aggressively market a "device" to its clients.[28]

The withholding tax agreed on only applied to individual savings and not corporate funds.[29] Armed with this knowledge, HSBC Suisse allegedly began offering "Tax, Trust and Real Estate Planning" services to its clients. Clients were advised to circumvent the withholding tax by depositing their funds into shell companies. HSBC would provide the necessary paperwork and incorporate the companies for an annual fee.[30] A complementary service which allowed clients to withdraw huge amounts of foreign currencies in Switzerland came packaged with the deal.[31]

HUFF AND PUFF AND BLOW YOUR HOUSE DOWN

"Most Swiss banks do have a whistle-blower program, but they use it to punish those who avail themselves of it"

– Hervé Falciani[32]

HSBC's Employee handbook outlines the company's definition of wrongdoing at work, and the avenues that employees can avail themselves to make a "protected disclosure".[33] HSBC Chairman, Douglas Flint, asserted that firms should "encourage the calling out of bad behaviour" and reward and praise "those who escalate their concerns even if they are sometimes wrong".[34]

The recent cases of Everett Stern[35] and Nicholas Wilson[36], however, offer a different viewpoint. Both raised concerns over suspicious transactions and illegal practices only to see them fall on deaf ears, despite reporting to HSBC via proper channels.

Being ignored is rarely the only repercussion whistle-blowers face, particularly in Switzerland which is in the midst of tightening its law on whistle-blowing.[37] In Falciani's case, Swiss authorities are in the midst of indicting him for qualified industrial espionage, unauthorised obtainment of data, and violation of banking secrecy.[38]

THE APPLE DOESN'T FALL FAR FROM THE TREE

"We deeply regret and apologise for the conduct and compliance failures highlighted which were in contravention of our own policies as well as expectations of us."

– Douglas Flint, CEO HSBC Holdings PLC[39]

While HSBC apologised and accepted responsibility for its failures within its Swiss subsidiaries, it took due care to stress that its Swiss arm had not been fully integrated into HSBC after its purchase and was therefore run in a more "federated way" with decisions "frequently taken at a country level".[40] This allowed "significantly lower" standards of compliance and due diligence to persist.[41] A quick peek into HSBC annual report, however, showed that "the integration of the former Republic and Safra businesses went smoothly during 2000".[42]

It is worth noting that this was not the first time HSBC had claimed poor integration. Douglas Flint, Chairman of HSBC Group, made a similar claim when HSBC's Mexican subsidiary was exposed for money laundering back in 2012. Flint claimed that it was "impossible for board members to know how the bank's different businesses were operating" unless issues were raised.[43] Stern and Wilson, however, harshly rebuked this claim by alleging that their reports of compliance failures fell on deaf ears.

GULLIVER'S TROUBLES: STUART'S LITTLE PROBLEM

"Being in Switzerland protects me from the Hong Kong staff. Being in Panama protects me from the Swiss staff"

– Stuart Gulliver, CEO, HSBC[44]

It soon emerged that HSBC's CEO Stuart Gulliver had private Swiss and Panamanian bank accounts. Apart from that, Gulliver was found to be registered as a non-domiciled citizen of the UK.[45] Additionally, Gulliver's role as CEO of HSBC Holdings PLC was merely a secondment from the Dutch-headquartered HSBC Asia Holdings.[46] All these conferred tax advantages which allowed Gulliver to limit his tax exposure in the UK.[47]

Gulliver issued statements maintaining that he had "never paid less than the marginal UK tax rate".[48] He further emphasised that he had declared his Swiss account to UK tax authorities over the years. These claims were supported by Flint who openly backed Gulliver by stating that "there is absolutely no story here. There is nothing Stuart has done that is not absolutely transparent, legal and appropriate".[49]

FAIR WEATHER AHEAD?

"I can assure you that we had no evidence of tax evasion"

– Rona Fairhead[50]

Rona Fairhead, Independent Non-Executive Director of HSBC Holdings PLC, joined Gulliver at the centre of the furore when she insisted that no evidence of tax avoidance had surfaced during her tenure.[51] She blamed HSBC Suisse's relationship and domestic managers for the failings.[52] However, her status as "independent" non-executive director was called into question due to concerns over her remuneration of £847,000 in 2014.[53] Her plea of reliance on internal auditors, FINMA, and on strict internal controls were refuted as she was criticised for her passive regulation of the bank and gross incompetence which led the court to call for her resignation.[54]

HIDE AND SEEK NO MORE

The practices that HSBC was decried for is by no means exclusive to the bank itself. Other players in the private banking industry, such as UBS, Julius Baer, RBS[55] and BSI[56] have been either convicted or are under investigation for the same transgressions.[57] In the wake of these incidents, private bank managements are scrambling to inspect and eradicate tax evaders from their client lists.[58]

Following a growing global outcry regarding corporate tax compliance, a framework for the crackdown on global tax avoidance has been released by the Organisation for Economic Co-operation and Development (OECD) and supported by more than 60 governments.[59] The framework aims at creating global guidelines for tax reform and reporting, as well as exercising pressure on specific countries to address and correct commonly exploited tax loopholes.[60]

As part of the OECD's efforts, Switzerland has budged slightly on the international front and committed to the automatic exchange of information about individual accounts, taxes, assets and income, subject to reviews and rules of confidentiality.[61] The proposed timeline for full implementation by 2017 or 2018 and has been hailed as the final nail in the coffin for banking secrecy.[62]

A FRANC DISCLOSURE

"I would say that a number of us, myself included, think that the practices at the Swiss private bank in the past are a source of shame and reputational damage to HSBC."
– Stuart Gulliver[63]

As of February 2015, HSBC has neither confessed nor denied any of the tax evasion allegations. Instead, in a statement released by HSBC on 8 February 2015, they maintained that individuals themselves exploited Swiss banking secrecy laws to circumvent tax obligations and that such problems were prevalent throughout the entire industry.[64]

When quizzed about a recurrence of the scandal, Gulliver asserted that HSBC had put in place controls, systems and compliance functions to reduce the risk of recurrence to an "absolute minimum", and to uphold the "highest or most effective standards across the group to combat financial crime".[65] However, he carefully noted that he could not "absolutely guarantee that it (would) not happen again".

In a bid to win back investor confidence, a new management team was established to lead HSBC Suisse and implement a host of new reforms, such as reviewing clientele and refusing service to those who did not manage to pass, or enforcing a new tax transparency policy.[66] This is in line with a major restructuring of HSBC's control and management, with MWM Consulting appointed to facilitate the sourcing and engagement of non-executive directors for the board. Analysts have described this as the most sensational change in the management of Britain's largest bank. In addition, prior to the exposure of the tax scandal in its Swiss arm, HSBC announced that it would do away with its age old tradition of nominating the next chairman from its internal pool of talent.[67]

The repercussions for HSBC have been financially and reputationally damaging. In light of the recent scandals, almost a third of its shareholders refused to back the proposed remuneration for top management at the 2015 Annual General Meeting and called for the resignation of key management figures who were heavily involved in the tax scandal.[68]

AU REVOIR

"Can I know what every one of 257,000 people is doing? Clearly I can't" – Stuart Gulliver[69]

Following allegations that the company had become "too big to manage", HSBC has been scaling down its international operations by divesting businesses in less profitable countries.[70] In doing so, HSBC, the world's local bank, may be laying an epitaph on the slogan that it worked so hard to be synonymous with.

DISCUSSION QUESTIONS

1. Comment on the effectiveness of HSBC's whistleblowing policy.
2. Based on your answer in Question 1, evaluate the implications of having a poor internal whistleblowing environment. When whistleblowers have to resort to exposing their organisation to external parties, what impact does it have on the organisation?
3. Falciani's whistleblowing differed from most other cases due to his questionable motives. Discuss whether the eventual result of whistleblowing necessarily justifies the means, in this instance theft and an intention to monetise the stolen data.
4. HSBC stressed that its failure to integrate its Swiss arm was the underlying reason for its low ethical standards. How should acquiring companies integrate their subsidiaries and what are the implications for corporate governance?
5. The HSBC parent bore the brunt of the public scrutiny and criticism for the subsidiary's misdeeds. To what extent should the parent board of a multinational company be held responsible for the actions of its subsidiary?
6. The HSBC case brought up an increasingly pertinent issue of tax governance. How should companies integrate the tax function within their corporate governance framework?
7. Directors have a fiduciary duty to act in the best interest of the company and have an obligation to maximise shareholder value. To what extent does this justify using legally permitted structures to shift profits to low tax jurisdictions in order to minimise tax? Or do directors have a broader ethical obligation to society to ensure that the company pay its fair share of taxes?

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MONEY LAUNDERING

HSBC: THE WORLD'S LOCAL (LAUNDRY) BANK

CASE OVERVIEW

In December 2012, banking giant HSBC was fined US$1.92 billion by the U.S. authorities over allegations of money laundering and involvement in illegal financing activities. This followed the release of a detailed investigation report in July 2012 by the U.S. Senate Permanent Subcommittee on significant lapses in HSBC's counter-terrorism financing systems and anti-money laundering program. Despite having been issued several warnings to reinforce its anti-money laundering programs over the past seven years, HSBC failed to make the proper adjustments. The US$1.92 billion penalty was at that time the largest fine ever in a case involving a bank and also brought significant reputational damage to the company. The objective of this case is to facilitate the discussion of issues such as the effectiveness of whistle blowing policies and ethical codes in preventing fraudulent behaviour amongst employees; internal control and risk management; money laundering and terrorism financing risks; corporate governance of complex company groups; and corporate governance of banks.

THE MAKING OF A FALL

"The HSBC settlement sends a powerful wake-up call to multinational banks about the consequences of disregarding their anti-money-laundering obligations"[1].

–Senator Carl Levin[2]

HSBC has over 7,200 offices in more than 80 countries and reported US$20.6 billion of profits before tax in 2012.[3] It was ranked as the world's third largest bank in terms of market capitalisation in 2013.[4]

Although HSBC had a code of conduct and a whistle blowing policy that served as a guide for doing business, there were numerous accusations of money-laundering violations over the years.

In the 340-page report produced by the U.S. Senate Permanent Subcommittee on Investigations, it revealed that at the root of HSBC's money-laundering practices was a confluence of factors – structural inadequacies of HSBC's Anti-Money Laundering (AML) Program, as well as the Office of Comptroller Currency's (OCC) failure to enforce regulations to prevent HSBC's wrongdoings.[5] The investigation report also illustrated the means through which HSBC's money-laundering practices were carried out - through its dealings in Mexico, bypassing the U.S. Treasury Office of Foreign Assets Control's (OFAC) filters, as well as its persistence in trading with terrorist-affiliated counter-parties.[6]

THE RISKY MEXICO AFFILIATE

"It was a financial institution with inadequate AML resources, inadequate AML systems and controls; and AML leadership"

– U.S. Senate Committee Report

HSBC USA (HBUS) has correspondent accounts with hundreds of affiliates located in over 80 countries. These accounts can be used for cashing in US$ instruments such as travelers cheques, and account for "63% of all US$ payments processed by HBUS".[7] One such affiliate is HSBC Mexico (HBMX), which handles almost US$2 billion in assets and over 8 million clients.[8]

Prior to HSBC's acquisition of the Mexican affiliate, the U.S. State Department had already alerted HBUS to the fact that Mexico was a place with "high incidents of drug trafficking" as international money launderers used it as a vehicle to introduce their drug proceeds into the "global financial system".[9] Despite this warning, HBUS still classified HBMX as a "low-risk" affiliate through its country-specific risk assessment process.[10]

Other than operating in a high-risk location, HBMX also had a history of severe AML deficiencies. Its problems included a pervasive lack of Know Your Customer (KYC) information in client files; database of high profile clientele connected to drug trafficking allegations; and a huge backlog of accounts earmarked for closure due to suspicious activities.[11]

FROM LOCAL BANK TO LAUNDRY BANK

"These traffickers didn't have to try very hard...They would sometimes deposit hundreds of thousands of dollars in cash, in a single day, into a single account, using boxes designed to fit the precise dimensions of the teller windows in HSBC Mexico's branches".[12]

– U.S. Assistant Attorney General Lanny Breuer[13]

This is the abridged version of a case prepared by Amanda Aw Yong Zhi Xin, Eunice Tan, Yoke Si, Kang Zheng Yang, Kenneth Ling, Puah Yee Kai under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Ng Jun Yan under the supervision of Professor Mak Yuen Teen.

Since HBUS previously categorised HBMX as a low-risk affiliate,[14] the AML monitoring system failed to detect US$881 million of suspicious dealings.[15]

During the five-year period from 2005 to 2010, the OCC (Office of Comptroller Currency) – whose job is to supervise and regulate national banks[16] - conducted over four dozen AML examinations and highlighted at least "83 AML matters requiring attention".[17] Despite this, the OCC took no formal or informal enforcement actions, thus allowing HSBC's AML deficiencies to fester. Further findings of the investigation also revealed that HBMX were fully cognisant of these money-laundering activities.

CIRCUMVENTING OFAC FILTERS[18]

In 2001, HSBC European Union (HBEU) proposed to use its correspondent account with HBUS to clear U-turn transactions involving Iran's Bank Melli,[19] and was approved upon review.[20] HBEU then requested all U-turn transactions to be done via bank-to-bank transfer, and structured to hide the origins of transactions, so that information about the origins would not trigger the OFAC filter.[21] Even though HBUS' Compliance Head rejected this request,[22] HBEU instructed Bank Melli to make "cover payments",[23] which effectively concealed Bank Melli's role in laundering money through HBEU into the U.S. financial system.

"HSBC knew what was going on, but allowed the deceptive conduct to continue"

– Senator Levin

Although HBUS' compliance executives consistently reminded HBUS to require full disclosures of Iranian transactions,[24] HBEU and HSBC Middle East (HBME) repeatedly sent U-turn transactions through U.S. dollar accounts at HBUS without disclosing the Iranian links.[25] Some HBUS officials even pretended that they knew nothing about processing these deceptive U-turn transactions.[26]

DISREGARDING LINKS TO TERRORISM – AL RAJHI BANK (ARB)

ARB has US$59 billion of assets and is the largest private bank in Saudi Arabia.[27] For more than 25 years, HSBC provided ARB with a large variety of banking services, including providing US dollars through a Banknote account. In 2002, U.S. agents revealed that Sulaiman Al-Rajhi, one of the Bank's founders, provided finances to Osama bin Laden's "Golden Chain"[28] terrorist activities.

Because of ARB's alleged terrorism links, the U.S. placed the bank under inspection and included it in the OFAC filter list.[29] Upon subsequent recommendations by HSBC Group's Compliance Chief, HBUS decided to sever ties with ARB in 2005.[30]

Just four months after the declaration to terminate business relationships with ARB, HSBC Group Compliance made another announcement that HSBC affiliates were allowed to resume business with ARB.[31] Meanwhile, ARB threatened to stop dealing with HSBC entirely if their Banknote account was not reinstated.[32] Hence, HBUS Compliance approved the recommencement of business between HBUS with ARB in December 2006.

HSBC only decided to exit the business of selling U.S. banknotes[33] after the OCC's criticism[34] in 2010, thus ending its contentious relationship with ARB.

AFTERMATH – CHANGES IN HBUS

"We accept responsibility for our past mistakes. We have said we are profoundly sorry for them, and we do so again."[35]

– HSBC Group Chief Executive Stuart Gulliver

To future reduce money-laundering risks, HBUS embarked on a variety of measures to strengthen its internal controls. These include the implementation of stricter KYC standards,[36] and the subjecting of non-U.S. group affiliates to similar due diligence as non-affiliates. In addition, to further reduce its exposure to high-risk transactions, HBUS terminated 109 correspondent relationships. New monitoring systems for wire transactions and improved customer risk rating methodology have also been developed.[37]

As a means of internal disciplining, HBUS clawed back bonuses from their AML and Compliance Officers. It also increased spending on AML controls by nine times to address the inadequate staffing and also to reorganise its AML department.[38]

TOO BIG TO JAIL

It's a dark day for the rule of law.

– New York Times Editorial, 11 December 2012

Upon the conclusion of the investigation by the U.S. federal and state authorities, it was decided that no charges would be pressed against any of the HSBC officials.[39] Despite the gravity of the matter, HSBC would only have to pay a US$1.92 billion settlement,[40] which is insignificant relative to the US$20.6 billion profit before tax HSBC earned in 2012.[41]

The decision not to prosecute HSBC was allegedly driven by the fact that HSBC employs nearly 16,500 workers in the U.S. Should the bank faces criminal charges, it would necessarily lose its license and cost thousands of Americans their livelihood.[42] Therefore, it was purportedly for society's good that the bank was not prosecuted.[43]

Although Columbian drug traffickers who took advantage of HSBC's lax regulations were charged and ended in prison, the HSBC employees who allowed for such poor regulations escaped unscathed.[44] Even with the fine of an unprecedented amount of US$1.92 billion, the passing of a no-jail sentence begs the important question – are global banks really too big to jail? Nobody, not even Senator Carl Levin, has an answer to that, at least not for now.

DISCUSSION QUESTIONS

1. What were the ethical dilemmas in the case? Evaluate based on the three scenarios provided in the case.
2. HSBC had a code of conduct, code of ethics and whistle blowing policy, but did not implement them effectively. Why do you think this was so? What can the board do to ensure that they are effective?
3. How can the board of a bank set the right corporate culture and ensure that it is applied consistently throughout the group? What can a board do to understand the culture of the company?
4. How can the board of a complex banking group like HSBC ensure good corporate governance in all its subsidiaries and operations around the world?
5. Comment on the regulatory actions and behaviour with respect to HSBC's wrongdoings. Were there red flags that should have been raised with the regulator?
6. What were some of the key lapses in internal controls within HSBC's anti-money laundering program? Do you think the new internal control and AML policies implemented by HSBC will help to mitigate these issues?
7. What are the consequences of such money-laundering cases for banking companies? Was the Department of Justice's decision not to press criminal charges the right thing to do – from an ethical point of view?

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MEGA BANK, MEGA FAILURE?

CASE OVERVIEW

Taiwan's third largest bank, Mega International Commercial Bank Co., Ltd. (Mega Bank), was fined US$180 million by US regulators on 19 August 2016. The New York branch of the bank was penalised for its compliance failure and for violating the US anti-money laundering regulations. This was not the first time that the bank was involved in money laundering scandals. The bank's branches in Australia were previously involved in similar cases as well. The objective of this case is to allow a discussion of issues such as board structure; the impact of strong government influence on corporate institutions; internal control and risk management; and money laundering in the banking industry.

HISTORY OF MEGA BANK

Mega Bank was formed on 21 August 2006 from the merger of The International Commercial Bank of China Co., Ltd. (ICBC) and Chiao Tung Bank Co., Ltd. (CTB), both of which were privatised in the 1900s. In 2014, it had 107 domestic branches, and a total of 39 overseas outposts.[1] It was the third largest bank in Taiwan in terms of size of assets in 2016.[2]

BOARD STRUCTURE

Mega Financial Holding Company (MFHC), formed in 2002, is the holding company of Mega Bank.[3] The board of MFHC consisted of 15 directors, of which three were independent directors.[4] The independent directors sat on both the Audit Committee and Remuneration Committee. The holding company did not have a separate Nomination Committee.[5]

Mega Bank did not have separate Audit, Remuneration or Nomination Committees. Instead, MFHC's Remuneration Committee approved Mega Bank's remuneration policies, and its Audit Committee assigned supervisors onto Mega Bank's board. Of the five supervisors sitting on the board, three held executive positions in MFHC.[6]

There was a total of 15 directors on the board of Mega Bank in early 2016. The Chairman of the board, Tsai Yeou-Tsair, was also the Chairman of MFHC. Wu Hann-Ching was the president and managing director of both Mega Bank and MFHC. In addition, there were two managing directors, eight other non-independent directors, two independent directors, and an independent managing director on the board. Three of the 10 non-independent directors also held executive positions in MFHC.[7]

In September 2016, both Mega Bank and MFHC reshuffled their boards, re-appointing the majority of the board members.[8] Tsai resigned from his post as Chairman of MFHC and Mega Bank, while Shiu Kuang-si was appointed as his replacement by Taiwan Premier Lin Chuan.[9] Tsai had reportedly offered to resign over 10 times since May 2015, but was repeatedly rejected by Minister of Finance Chang Sheng-ford on the grounds that the January 2016 presidential election was approaching.[10] Mega Bank also carried out an organisational restructuring, which included separating the Risk Management Committee from the Asset Liability and Risk Management Committee as a standalone independent committee, and establishing new departments such as the Anti-Money Laundering Centre.[11]

PRIVATISATION OR A FACADE?

"Some of the largest state-owned enterprises are becoming almost like private corporations… They are traded in stock exchanges and have boards of directors, maybe even with external managers. We haven't always understood these changes."

– Associate Professor Aldo Musacchio, Harvard Business School[12]

To improve the performance of Taiwan's banking industry, the Taiwan government focused on privatising many state-owned banks in the 1990s.[13] Although Mega Bank became a privatised bank, it still maintained some inextricable links to the Taiwan government.[14] As of September 2016, the Ministry of Finance was the largest single investor of Mega Bank, with an 8.4% share ownership, and was able to appoint seven directors on the MFHC board to represent its interests.[15]

The track records of the two ex-Chairmen of MFHC were indicative of their connections with the government. Tsai, who served as Chairman of MFHC from 1 July 2010 to

This is the abridged version of a case prepared by Cindy Amelia, Cheryl Tan, Eric Wong, Eugene Soh and Tan Yan Shan under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Mok Xiao Chou under the supervision of Professor Mak Yuen Teen.

1 April 2016, had also served in various governmental organisations.[16] In fact, he was appointed to the board by former Taiwan President Ma Ying-jeou.[17] Shiu, who succeeded Tsai as Chairman of MFHC on 16 August 2016, had served as the Chairman of partially state-owned Hua Nan Financial Holdings and held high-level positions at state-owned banks. Shiu also served as the president of MFHC and Mega Bank previously.[18] Amid criticism over possible conflicts of interests in the Mega Bank scandal, Shiu resigned from his position as Chairman within two weeks of his appointment, on 31 August 2016.[19]

THE BEGINNING OF A MEGA FAILURE

In June 2009, Mega Bank admitted to breaches of the Australian Financial Transaction Reports Act and the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF). Following this, Mega Bank agreed to enter into an enforceable undertaking with the Australian Transaction Reports and Analysis Centre (AUSTRAC), and its processes and procedures would be reviewed by the Australian Prudential and Regulatory Authority (APRA).[20] An enforceable undertaking was an alternative to criminal or civil enforcement action in ensuring compliance with the AML/CTF Act.[21]

Two months later, Mega Bank entered into another enforceable undertaking with APRA for suspicious transactions identified within the bank. APRA had concerns that Mega Bank's risk management system and internal audit were ineffective. In addition, some of the bank's staff had structured transactions to bypass the anti-money laundering laws. Some staff also knew about the non-compliant practices but did not act upon them.[22]

Despite prior warnings, concerns regarding Mega Bank's compliance with financial services laws were raised for the third time in August 2010, this time by the Australian Securities and Investments Commission. No penalties were imposed, but the bank had to undergo an independent review by PricewaterhouseCoopers.[23]

THE MEGA FINE

"DFS will not tolerate the flagrant disregard of anti-money laundering laws and will take decisive and tough action against any institution that fails to have compliance programs in place to prevent illicit transactions."

– Maria T. Vullo, Financial Services Superintendent[24]

On 19 August 2016, The New York State Department of Financial Services (DFS) announced that Mega Bank's New York branch (Mega-New York) was fined US$180 million for money laundering activities. During the investigation, DFS discovered "numerous deficiencies in Mega-New York's compliance function". These deficiencies were of great concern as Mega Bank also operated branches in Panama, a country often associated with money laundering scandals.[25] A significant number of the bank's "customer entities" were found to be shell companies formed by Mossack Fonseca, the law firm involved in the Panama Papers scandal.[26]

FAILED RISK MANAGEMENT AND INTERNAL CONTROLS

DFS highlighted several internal control problems present in Mega-New York. Firstly, there was a lack of proper segregation of duties between the compliance and business functions, due to conflicting responsibilities of certain compliance personnel. For instance, Mega-New York's BSA/AML officer was also operations manager of the Business Division.[27]

DFS further found fault in Mega-New York's transaction monitoring systems and policies. Compliance staff failed to regularly review "surveillance monitoring filter criteria designed to detect suspicious transactions".[28] Various documents were also not translated from Chinese to English, impeding effective checks and investigations by regulators.[29]

In addition to these structural deficiencies, the staff at Mega-New York lacked proper knowledge and training with regards to US regulatory requirements. These included executive staff such as the BSA/AML Officer and the Chief Compliance Officer.[30]

SUSPICIOUS ACTIVITY

The compliance failure identified at Mega-New York further raised concern over suspicious activity involving the Panama branches. Due to the high risk of money laundering in Panama, the bank was supposed to deal with transactions between Mega-New York and the Panama branches with high-level surveillance and diligence. However, the compliance failures in the bank's New York branch raised doubt on whether checks had been carried out properly. This was aggravated by the large sums of financial transactions between the two locations. On top of this, Mega-New York failed to give adequate explanations regarding suspicious "payment reversals" received from its Panama branches.[31]

NEGOTIATING THE FINE

DFS reportedly intended to impose a larger penalty on Mega-New York, but the penalty amount was negotiated down by Perng Fai-nan, the governor of the Central Bank of the Republic of China. Perng was the brother-in-law of Shiu, the Chairman of MFHC at that time.[32]

Huang Kuo-chang, the New Power Party Executive Chairman, expressed his concerns about "the administrative negligence and the question of who will foot the bill for the US$180 million fine". He also raised concerns about the inappropriateness of having Shiu participate in the administrative investigation conducted by the Financial Supervisory Commission (FSC), and the inaction of the Ministry of Finance against former MFHC Chairman Tsai. By not holding the bank's officers responsible, Huang believed that it was unfair to the shareholders and taxpayers who might end up bearing the burden for the fine.[33]

MFHC DENIAL

After his meeting with US regulators, Shiu, then-Chairman of MFHC, claimed that his US trip was not meant to investigate misconduct at the bank, but to meet with US regulators and clear up any misunderstandings.[34] Moreover, the vice president of MFHC also denied that the bank had any involvement in money laundering activities, claiming that the fine was due to the bank's failure in adapting to the new and more stringent anti-money laundering regulations in the US.[35]

GOVERNMENT INVOLVEMENT IN MEGA BANK

As the money laundering saga continued to snowball, Taiwan lawmakers alleged former President Ma Ying-jeou's involvement in the illegal transactions. Ma was also the Chairman of Kuomintang (KMT), the second largest political party in Taiwan and the ruling party at that time, which was alleged to have used Mega Bank to conduct money laundering activities.[36] In its defence, KMT released the results of an investigation by the Legislative Yuan, showing that none of the 174 suspicious transactions flagged by DFS had passed through Taiwan.[37] However, political activists still found it difficult to ignore the possibility that Mega Bank had assisted KMT in cleaning up illicitly gained assets. Democratic Progressive Party (DPP) legislator Luo Chih-cheng alleged that Mega Bank had been used to empty out KMT's assets, while Mega-New York was used to launder them.[38] Another DPP legislator, Su Chen-ching, also highlighted the fact that the bank had increased its loan to KMT-backed businesses, from NT$3.68 billion in 2010 to NT$11.19 billion in 2015.[39]

CLEANING UP THE MESS

"The amended law shows our country's resolve to fight economic crimes and money laundering."

– Premier Lin Chuan[40]

The entire Mega Bank scandal had cast doubt on the integrity of the anti-money laundering protocols in Taiwan.[41] Given the severity of the situation, the Taiwan government undertook several corrective actions. In one notable move, the government passed a bill to amend the country's anti-money laundering law, which included, inter alia, increasing the ceiling for the amount of fine from NT$1 million to NT$5 million.[42]

The Ministry of Finance also planned to make several improvements by strengthening mechanisms, requiring government-controlled banks to report serious incidents, assessing the qualifications of board members who represent government-controlled shares, reviewing the responsibilities of the board of the banks, as well as enhancing on-the-job training for staff assigned to overseas branches.[43]

CONFLICTS OF INTEREST: SELF-INVESTIGATION IS NO INVESTIGATION

The Executive Yuan was first informed of the fine on 1 August 2016. Before breaking the news of the Mega-New York scandal to the public on 19 August 2016, the Executive Yuan appointed Shiu as the new Chairman of MFHC on 11 August,2016.[44] Premier Lin justified the appointment by asserting that Shiu bore little responsibility in the scandal, and that he had prior experience from dealing with a similar crisis.[45]

Thereafter, in response to the money laundering scandal, the Taiwanese government appointed the FSC to lead an administrative investigation on 21 August 2016.[46] Tsai, who held office as MFHC's Chairman when the lapses in compliance occurred, was summoned to the FSC headquarters for questioning on 28 August 2016. FSC officials claimed to have obtained greater insight into the case after the questioning, but refused to release any details.[47]

As investigations continued, Huang expressed his concern over the fact that the FSC was "an agency that is likely to be found guilty of administrative negligence over past violations". Furthermore, the fact that Shiu was involved in the investigations was questionable given his alleged involvement in the scandal.[48] Some political activists also pointed out the potential conflict of interests embroiling the FSC-appointed task force since they were reporting to the Ministry of Finance, which had substantial shareholdings in Mega Bank.[49] Furthermore, the Deputy Minister of Finance also stated that there were no plans to level any charges against Tsai.[50]

THE INVESTIGATOR BECOMES THE INVESTIGATED

Amid mounting pressure and criticism on the Executive Yuan, Premier Lin appointed a new cabinet task force, which consisted of legal and finance experts, on 30 August 2016 to investigate Mega-New York and oversee the ongoing efforts under the FSC and the Ministry of Justice.[51]

On 18 September 2016, Premier Lin issued a directive to investigate possible negligence of FSC officials in detecting compliance issues in Mega Bank. The political responsibility of FSC and the Ministry of Finance would be reviewed as well. FSC's claim of ignorance of Mega Bank's non-compliance could not be overlooked, given its responsibility in overseeing financial institutions. This sent a message to the top financial watchdog that it would be held accountable if it failed to detect serious breaches of regulations made by banks.[52] Indeed, as pointed out by Huang, in addition to the misconduct within the bank itself, the Mega Bank incident had also revealed the shortcomings of Taiwan's regulatory bodies.[53]

DISCUSSION QUESTIONS

1. Critically evaluate the board structure and composition of Mega Bank and its holding company and identify any corporate governance concerns.
2. Despite being privatised, Mega Bank still maintained close ties with the Taiwanese government. Discuss the impact of strong government influence on the quality of corporate governance of Mega Bank and companies in general. Could strong government ties be one of the factors that led to the money laundering scandals in Mega Bank? How can banks strive to mitigate this problem?
3. Given the strong governmental influence on Taiwanese banks, evaluate the effectiveness of the regulators as the fourth line of defence in the financial industry.
4. What were some of the deficiencies in internal controls and risk management within Mega-New York's anti-money laundering system? Suggest possible improvements.
5. Do you think that the US$180 million fine was appropriate in deterring potential future compliance failures? What are the implications of such a hefty fine on different stakeholders of Mega Bank? Are there alternative measures that regulators can adopt to ensure effective compliance in the banking industry?
6. In light of recent money laundering cases involving several global banks such as HSBC and Deutsche Bank, discuss the effectiveness of regulators in detecting and reacting to the scandals, drawing comparisons to Mega Bank. What were the underlying factors that perpetuate such a phenomenon?

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DEUTSCHE BANK: A RUSSIAN AFFAIR

CASE OVERVIEW

In 2015, Deutsche Bank (DB) started investigations after the bank received reports of suspected "mirror trades" in DB Moscow. The internal investigation, known as "Project Square", revealed that Tim Wiswell, the head of equities for DB Moscow, helped Russians divert an approximate US$10 billion out of the country, through a series of mirror trades between 2011 and 2015. This scheme was facilitated by long-standing inadequate compliance procedures in DB. The objective of this case is to allow a discussion of issues such as anti-money laundering controls; know-your-customer policies; internal controls; dual board structure; compliance culture in banks; and risk management issues.

THE AMERICAN DREAM

Tim Wiswell grew up in Old Saybrook, Connecticut. As a child, he occupied his time with sports and sailing. Wiswell and his sister often travelled to Russia to live with their father. He went on to study for a year at the Anglo-American School of Moscow, where he picked up Russian. He then continued his studies in Colby College in Maine, United States (U.S.).[1]

Upon graduation, Wiswell found a job at United Financial Group in Russia, which was bought over by DB in the mid-2000s.[2] In 2008, Wiswell was promoted to head of equities in Russia[3] at the age of 29.[4] He was "loyal and reliable", working well with the London equities management team and acting as a "straightforward Western presence" to "bridge the cultural gap" between Moscow and London. Meanwhile, economic conditions in Russia worsened. The previous years of spectacular growth backed by a global commodities boom came to an end with the onset of the financial crisis, and Russian clients grew "desperate to get money out of the country".[5]

THE RISE OF DEUTSCHE BANK

In 1870, DB was incorporated as a German global banking and financial services company in Berlin.[6,7] As of 31 March 2018, DB has a total of 2,407 branches, including branches in emerging markets such as the Asia Pacific, Central and Eastern Europe, and Latin America.[8]

BOARD STRUCTURE

DB has maintained a dual board structure since its inception,[9] as mandated by German law which came into force in 1870.[10] In 2014, DB's supervisory board consisted of approximately 20 members, headed by Chairman Dr Paul Achleitner and Alfred Herling, who was the deputy Chairman then.[11] The supervisory board had established seven standing committees, with Dr Achleitner being involved in all committees.[12] Meanwhile, the management board had seven members.[13] DB had two CEOs, Jürgen Fitschen and Anshuman Jain.[14] Up till October 2015, DB also had a Group Executive Committee that comprised of the members of the management board and senior representatives appointed by management board. However, this committee was dissolved to reduce the organisational complexity of DB.[15]

On 7 June 2015, the supervisory board of DB appointed John Cryan to the position of co-CEO. The co-Chairmen of the management board and co-CEOs, Jain and Fitschen, stepped down from their positions on 30 June 2015 and 19 May 2016 respectively,[16,17] following news releases on DB's mirror trades scandal.[18]

PROLIFERATION OF SCANDALS

Since 2008, DB has paid fines and settlements amounting to more than US$9 billion, as a result of improprieties such as its involvement in the conspiracy to manipulate the price of gold and silver, and the violation of U.S. sanctions by trading in Iran, Syria, Myanmar, Libya and Sudan. In April 2015, the U.S. and United Kingdom (U.K.) regulators fined DB US$2.5 billion over alleged benchmark interest rate rigging.[19]

A TALE OF TWO CITIES - MIRROR TRADES

The "mirror trades" in DB went by largely undetected and unchecked until the beginning of 2015, when DB organised an internal investigation. The checks revealed that DB had ignored signs of dubious transactions and more than two thousand transactions did not comply with internal AML control procedures. Although DB Moscow passed the audit in 2014, it received warnings

This is the abridged version of a case prepared by Ong Shu Hui, Elizabeth, Lee Xin Yi, Rachel Pan Yu and Yeoh Wei Huan under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Yeo Hui Yin Venetia under the supervision of Professor Mak Yuen Teen.

from its independent auditors that there were "serious shortcomings" in its system of vetting its clients.[20]

Between 2011 and 2015, a Russian broker, Igor Volkov, called a sales trader of the equities desk of DB's Moscow headquarters, Dina Maksutova, nearly every weekday and instructed her to place two trades simultaneously. He would buy a Russian blue-chip stock with Russian rubles on behalf of a Russian company, where the order was usually approximately US$10 million worth of the stock. Meanwhile, Volkov, who was acting on behalf of a different company typically registered in an offshore territory such as the British Virgin Islands, would sell the same amount of that Russian blue-chip stock in London, receiving U.S. dollars, euros or British pounds in exchange.[21]

Initially, the trades seemed trite and pointless, as the transactions yielded little to no profit. However, these transactions had a deeper underlying purpose: to turn rubles in Russia into dollars abroad. The counterparties actually had the same owner, so DB was essentially helping Volkov to buy and sell stocks to himself.[22] At least 12 entities were involved[23] and three members of the Russian equities desk were suspended afterwards for their involvement in the mirror trades.[24] Overall, around US$10 billion was squirrelled out of Russia through these trades from 2011 to 2015.[25]

The New York Department of Financial Services (DFS) discovered that DB and its senior managers missed numerous opportunities to detect, investigate and intercept the mirror trading scheme due to serious compliance failures.[26]

According to a former manager at DB, the mirror trades' clients were willing to repeatedly lose small amounts of money, which was the difference between the Moscow and London stock prices, in addition to paying DB a commission for each transaction. These obvious signs of a recurring pattern should have been a red flag for DB and should have warranted a rigorous "client review" process. However, all the clients were deemed satisfactory by DB's compliance team.[27]

Both the DFS and the U.K. Financial Conduct Authority (FCA) expressed the view that DB should have suspected improprieties in mirror trading as early as 2011, when the license of one of the counterparties, Westminster Capital Management, was suspended and subsequently revoked by Russian regulators.[28]

More red flags appeared in early 2014, when a Cypriot bank sent a query to a senior AML manager at London's DB, regarding "suspicious high-volume transactions" through a particular U.K.-registered company's account. However, no follow-up action was taken by the manager and the inquiry was eventually handled by the equities trading desk in Moscow, which replied to the Cypriot bank that the trades were in compliance with the rules.[29]

THE REVELATION

Following the revelation of DB's shocking five-year scheme, three DB employees

– Wiswell, Maksutova, and Georgiy Buznik – were suspended.[30]

The suspension of Wiswell, the then-head of the equities desk at the Moscow branch, came as no surprise. In 2011, the year which the mirror trades started, revenues on Wiswell's desk had been declining drastically and it was suggested that the mirror trading started as a consequence of the pressure on Wiswell to boost the performance of his desk.[31] An internal investigation, known as "Project Square", confirmed that Wiswell's desk had indeed helped to expatriate billions of Russian rubles out of the country through mirror trades.[32] Despite the role Wiswell played in the scheme, he filed a lawsuit against DB over his dismissal soon after he was fired.[33]

While Wiswell stood to benefit from the mirror trades through bonuses or even bribes,[34] there was no clear financial benefit for the sales traders on the Russian equities desk conducting the mirror trades.[35] Interestingly, neither of Wiswell's supervisors nor DB's compliance managers had faced similar disciplinary action.[36]

As part of the consent order entered with DFS following the massive scandal, DB had to engage an independent monitor approved by DFS and submit an engagement letter that provides for the independent monitor to review and report on the following: the areas in DB's corporate governance that might have led to or fuelled the improper conduct; revamps to corporate governance that DB had made since the improper conduct and the impact they have on DB's AML compliance; and the coverage of the bank's current global AML compliance programs. The submission of a written action plan to enhance DB's existing global AML compliance programs was also required.[37]

The DFS and FCA also imposed nearly US$630 million of fines on DB for various money laundering offences in Russia.[38]

MIRROR MIRROR ON THE WALL: A TIME FOR REFLECTION

"We will do what is right – not just what is allowed."
– Deutsche Bank[39]

Mirror trading is not always illegal.[40] If DB had remained firm with its values and beliefs, what might then explain how it got itself into one of the largest scandals for funnelling Russian rubles offshore? Was the scandal a result of a few rogue sales traders, or did DB play a role as well?

Several reasons had been cited for the motivation behind the bank's misconduct. First, the New York authorities suggested that DB's sales traders were driven by "greed and corruption", having experienced sluggish business following the slump in oil and gas prices and the global financial crisis. A trader admitted to being "focused on commission" during the time of "slow markets" and hence continued these trades despite doubts. The earning of commissions was seemingly also the reason why the traders had refrained from questioning suspicious trades.[41]

Although the DB head office in Germany had not been directly involved in the mirror trades, its lack of participation did not absolve it from being accountable for the scandal – in fact, DB Moscow could conduct mirror trades undetected for such a considerable period because of extensive inadequacies in the AML control framework, as revealed in investigation findings by both the FCA and DFS.[42,43]

Deficiencies in know-your-customer policies and procedures

DB adopted the risk-based approach to know-your customer (KYC) procedures,[44] which was in line with the application of Regulation 7 of the Money Laundering Regulations 2007.[45] However, the due diligence for onboarding customers was not appropriately performed. In particular, there was inadequate documentation by DB Moscow's securities desk for its onboarding files and there were many lapses in DB's KYC procedures.[46] Investigations revealed that many customers were only asked to provide cursory or informal documentation on the source of funds.[47] Additionally, there were insufficient resources and infrastructure to facilitate the KYC process.[48] DB's onboarding staff also faced threats when they did not expedite processes to facilitate the mirror trade transactions. Although the senior management were aware of the deficiencies for years, DB did not take steps to implement any proper reforms until 2016, after the scandal had been uncovered.[49]

Flaws in AML risk rating system

DB's AML risk rating system was not precise in providing risk ratings for the relevant countries and customers. DB also did not have a global policy with benchmarked risk appetites, which led to significant inconsistencies and the absence of a methodology for updating the ratings. DB was also not on the same page as peer banks, which classified Russia as a high-risk country, before DB did so in late 2014.[50]

Inadequate compliance and internal audit resources

DB's anti-financial crime, anti-money laundering and compliance units were ineffective and understaffed. A single personnel had to handle multiple roles simultaneously, and employees in leadership positions of the units were inexperienced in their respective roles and lacked necessary training.[51] They also had no real authority to challenge suspicious actions or clients that they discovered.[52]

Furthermore, the bank's third line of defence – its group audit – was unable to fulfil its key role of ensuring compliance and effectiveness of controls.[53]

Inadequate KYC and AML IT structure

DB did not have a shared repository for KYC information, and thus a reconciliation between trading and the customer onboarding system was not possible. Moreover, DB did not have an automated system to monitor securities transactions, which further increased the risk of using the remote booking model.[54]

Flaws in corporate structure and organisation

DB's decentralised, non-global AML framework resulted in inconsistencies in the formulation and application of policies and procedures across the bank. This created the potential for a lack of compliance with international or other countries' regulatory requirements.[55]

The dual reporting structure and lack of clear delegation of roles and responsibilities also led to excessive reliance on the supervisor for the management of trading activities at DB Moscow's securities desk. The London supervisor of Wiswell had effectively failed in his supervisory role. When they praised Wiswell for promoting global products among Russian clients, an adverse culture was created that gave rise to the mirror trades and enabled the proliferation and continuation of the improper trading over a five-year period. There were also indications that DB had a corporate culture which permitted "short-term profiteering through improper conduct", at the expense of strict compliance, which could incur higher costs in the long term.[56]

AN END TO A CHAPTER?

"Where we encounter...business lines that are not controlled to the standards we demand, we will exit them, even if this means closing them down."

– John Cryan, CEO of Deutsche Bank [57]

DB's latest strategic plan, "Strategy 2020", was released in October 2015, focusing on strengthening individual accountability and discipline within the bank by reducing the complexity of DB's management structure.[58]

In 2015, DB enhanced its "Three Lines of Defence" model, with the overall goal of decreasing the risks associated with its people, systems and conduct-related failures.[59] DB has also agreed with the Federal Reserve to engage an outside monitor to review transactions with international banks in the second half of 2016 and to review DB's compliance with anti-money laundering laws.[60]

Although the regulatory authorities have concluded that there was no evidence that any of the senior management or employees of DB in London had been aware of or involved in the suspicious trading,[61] the shareholder advisory group, Institutional Shareholder Services, called for an independent audit into the conduct of DB's management in handling this issue and previous scandals.[62]

A GAME OF RUSSIAN ROULETTE

Can DB escape this difficult game of Russian Roulette unscathed? Unfortunately, it appears not to be the case, as the mirror trades have been linked to other major global money laundering schemes.

As further investigations into the mirror trades continue, it has been revealed that DB might not be the only international lender found to have conducted such mirror trades in Russia.[63] This might just be the start of something much bigger.

Aside from the mirror trade scandal, DB was also involved in other scandals, such as the mis-selling of toxic bonds, as well as using insolvent shell companies to hide significant tax liabilities in recent years.[64]

In light of all these problems, is DB really too big to govern?

DISCUSSION QUESTIONS

1. Discuss the implications of a dual board structure and the advantages and disadvantages. In addition, consider the effectiveness of the board structure in Deutsche Bank and discuss any board structure issues.
2. Evaluate Deutsche Bank's risk management framework and discuss the effectiveness of the "Three Lines of Defence" model adopted by Deutsche Bank. What are the possible reasons that led to the failure of the third line of defence?
3. Deutsche Bank has a whistleblower policy. Why were there no whistleblowers in the case of mirror trades, despite suspicions over the trades that were booked at the Moscow securities desk? How can financial institutions like Deutsche Bank strengthen their compliance culture?
4. Discuss how financial institutions can strengthen their anti-money laundering policies and know-your-customer procedures. Is the risk-based approach truly effective?
5. Do you think the shareholder advisory group's action to call for a special audit on management's conduct is justified? Should the blame solely be on Wiswell and two of his team members? Explain.

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COMMONWEALTH BANK OF AUSTRALIA: THE UNWITTING MULE

CASE OVERVIEW

Australian banking giant Commonwealth Bank of Australia (CBA) received international scrutiny in 2017 when it emerged that international criminal syndicates had been using the bank's Intelligent Deposit Machines (IDMs) for years to launder money and finance terrorism. The bank was accused of having a poor regulatory compliance and governance environment, which was exploited by the money laundering syndicates. An Australian Transaction Reports and Analysis Centre's (AUSTRAC) investigation highlighted many instances where CBA was forewarned of illicit activity but took inadequate actions – public observers voiced their opinions that the bank's key management and directors were all asleep at the wheel. With CBA's large influence in the international financial market, news of the money laundering scandal not only shocked and impacted the domestic market, but also stakeholders worldwide. The objective of this case is to facilitate a discussion of issues such as money laundering; board leadership and oversight; risk assessment and management; and accountability to various stakeholders.

ABOUT CBA

CBA is a multinational financial group that provides integrated financial services such as retail banking, business and private banking, institutional banking and markets, and wealth management to its customers.[1] Founded in Australia in 1911,[2] the bank has established its longstanding position as one of the pillars of the Australian financial industry. In 2015, CBA was ranked at the top of the Australian Securities Exchange (ASX) market capitalisation report.[3] The group has grown its operations both locally and globally through a wide network of branches, subsidiaries and associates such as Bankwest, Colonial First State Investments, ASB Bank, and Commonwealth Securities.[4]

THE LANDMARK CASE

On 3 August 2017, AUSTRAC initiated civil proceedings against CBA in the Australian federal courts for severe breaches of the Australian Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (the AML/CTF Act) between November 2012 and September 2015.[5] This was a landmark case that caused a ripple of shock for observers as each instance of breach in the Act carried a maximum penalty of A$18 million. The maximum fine of nearly A$1 trillion dwarfed the entire bank's market value.[6] After news of the legal proceedings emerged, CBA's share value fell by 3.9% the following day.[7]

Four syndicates, of which three were linked to drug dealing and distribution, were discovered to have carried out money-laundering activities using the bank's fleet of IDMs – smart ATMs that could process cheques and cash deposits instantly – making the funds immediately available for transfer. The drug syndicates made deposits into several separate accounts under fake names, ensuring that each deposit was under A$10,000 – a limit that legally required CBA to report the transaction to AUSTRAC. The syndicates transferred the money out to overseas accounts thereafter.[8] CBA had allowed such transfers exceeding A$75 million to remain undetected for over two years.

ATTACKS FROM ALL SIDES

After the first civil proceeding were initiated by AUSTRAC, more parties started to hop on the bandwagon, adding to the bank's headache. AUSTRAC's allegations sparked off a series of subsequent proceedings against CBA from their various stakeholders. Other regulators such as the Australian Securities and Investment Commission (ASIC) also began to announce that they were starting their own investigations into CBA.[9] Members of the Australian Senate also called for a royal commission in parliament to investigate the breaches.[10]

The Australian Prudential Regulation Authority (APRA) then announced that it would initiate an independent public inquiry against CBA, focusing on whether the bank deliberately overrode its controls and safeguards in pursuit of higher potential profits.[11] Such an action was unprecedented as APRA had normally operated 'behind the scenes', and the overt action was interpreted as a symbolic move that government regulators were adamant in making changes to the bank's leadership.[12]

This is the abridged version of a case prepared by Khoo Dingyan, Le Quang Quan, Tng Shiqi and Wecom Huang under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Clarisse Tan under the supervision of Professor Mak Yuen Teen.

THE INTELLIGENT LAUNDROMATS

Problems started back in 2012 when CBA introduced its IDMs into the market. The IDMs provided its customers with another integrated financial service. The introduction of IDMs saw an increase in transactions and savings.[13] Competition in both domestic and global markets remained stiff with other competitors launching new innovative products and services. Therefore, to place itself ahead of its competition and to prepare for potential stagnant economic growth, CBA offered consumers an option of using IDMs in the hope that this would bring the bank to the forefront of financial technological advancement.[14]

What made the IDM seem like a superior service was that individuals, regardless of whether they were personally CBA customers, could deposit either cheques or cash into CBA accounts without a limit on the number of transactions.[15] This strategy helped attract more customers to CBA, especially small and medium enterprises, which were heavily reliant on cash.[16] These small and medium enterprises could also now bypass certain stringent restrictions in place when making large transactions. Furthermore, the technologically advanced and fast IDMs would ameliorate the large salary expenses that CBA incurred for bank tellers and front desk personnel, significantly reducing the bank's operating expenses.[17]

Without a limit on the number of transactions per day, large transactions could take place daily without any restrictions imposed by the IDMs. However, due to control oversight, the IDMs failed to capture unusually large transactions. This violated the compliance regulations imposed by the Australian authorities. The AML/CTF Act prescribed that any transactions exceeding the threshold value of A$10,000 had to be reported in Threshold Transaction Reports (TTRs) to AUSTRAC within 10 business days.[18] In addition, as the machine could be used by anyone – including non-CBA customers – anonymous deposits were permitted.[19]

In fact, the IDM platform was not a unique technological innovation exclusive to CBA. Westpac Banking Corporation (Westpac), another Australian bank, had also conducted a trial using IDMs. However, Westpac concluded in its trials that the risk of such machines being utilised by criminal gangs for money laundering purposes were too high, and ultimately chose to not proceed with the roll out of IDMs for public use.[20] However, CBA decided to install more than 805 IDMs country-wide by May 2017.[21]

FOONG'S GOLD

The launch of CBA's IDMs with weak controls came as pleasant news to two members of a methamphetamine manufacturing and trafficking ring based in Sydney, Australia – Yuen Hong Fung and Kha Weng Foong. Fung and Foong began laundering more than A$650,000 a day through CBA's IDMs from late 2014 to August 2015. An estimated total of A$20.6 million was deposited through IDMs into CBA accounts, and all of it was transferred offshore.[22]

This was not the first time that Foong had used his expertise in fabricating false identification cards. In 2009, he was involved in producing fake credit cards that enabled him to misappropriate almost A$7 million from retailers in Australia. Foong's expertise was just what Fung, who wanted to launder money made from methamphetamine sales to Hong Kong, needed. In 2014, Foong helped Fung to create false CBA accounts using fake driving licenses. Foong went by many names, such as Ronald Brown, Luke Shaw, and Richard Whippy. However, had CBA's staff looked closer, they would have noticed that all the fabricated licenses used the same picture of Foong.[23]

Fung used a number of IDMs throughout Sydney and ensured that the amounts deposited were under A$10,000 for each transaction. CBA had identified consistent, suspicious patterns of cash deposits in 16 of these accounts by April 2015. Despite this, the bank did not follow up on its findings, and allowed an estimated A$9.1 million to be transferred to Hong Kong between April and July 2015.[24]

THE LONE HERO

On the morning of 28 May 2015, the manager at CBA's Leichhardt branch received an error message from one of the branch's IDMs, indicating that the machine was full. As this was an unusual occurrence, he was prompted to investigate further. He found that multiple deposits of about A$50,000 each were made to two accounts that morning. Upon further investigation, it was discovered that over the past month, both accounts had received deposits of at least A$1 million each which were then almost immediately transferred offshore. Fung had deposited A$457,980 that day as he went around using IDMs located in different locations. The problem at Leichhardt meant he had to go to Ashfield to deposit the remaining amount.[25]

A month later, on 30 June 2015, the Leichhardt branch manager approached Fung while he was doing his usual deposit run, which disrupted his actions. Fung simply moved to another location to carry on his business. That same night, CBA blocked 19 of Foong's accounts at the request of the Australian Federal Police (AFP). By this time, the bank had identified that the false accounts were opened by foreign nationals on holiday visas. The money laundering was therefore put to a stop for five days. However, it resumed later with 11 new accounts. These accounts utilised the same modus operandi previously identified by CBA. They fell through the cracks as there was a lack of subsequent follow-up monitoring for money laundering and terrorism financing risks.[26]

Foong and Fung were eventually arrested on the morning of 24 August 2015 at CBA's Eastgardens Branch for dealing with the proceeds of crime and structuring offences. Meanwhile, AUSTRAC alleged that CBA had failed to report 60 TTRs related to transactions by Fung and suspicious activities relating to Fung on 92 separate occasions.[27]

A LACK OF FOLLOW UP

Foong and Fung were not the only criminals making use of CBA's IDMs to launder money. Between June 2014 and May 2016, three other money laundering syndicates making use of CBA accounts were identified. These three syndicates adopted similar practices of executing financial transactions in a specific pattern. Large amounts of cash were deposited into multiple CBA accounts through IDMs. Almost immediately after each deposit was made, the money would be transferred to either other domestic accounts or offshore bank accounts. These deposits were the proceeds made from drug manufacturing and trafficking carried out by the syndicates.[28]

In all three situations, CBA was aware of the unusual patterns of these transactions and identified the suspicious accounts, a few months after the money laundering activities started. For one of the syndicates, CBA had even identified evidence of structuring, and concluded that some of the accounts belonged to suspicious money remitters that were potentially part of a money laundering syndicate. However, CBA did not continue to monitor these customers and accounts and continued to allow these highly suspicious individuals to deposit cash and make transactions for their accounts. Despite the large and structured cash deposits made, several transactions for these accounts did not trigger transaction monitoring alerts for structuring. Although alerts were raised in the remainder of these instances, CBA failed to review them in a timely manner and did not submit timely Suspicious Matter Reports (SMRs), as required legally by the AML/CTF Act.[29]

In late 2015, the AFP advised CBA that several of the accounts related to one of these syndicates were involved in an investigation into serious criminal offences including drug importation and unlawful processing of money. However, even after the warnings were issued, CBA did not close several of these accounts and allowed more transactions to occur.[30]

REGULATORS GIVEN THE RUN-AROUND

It was clear as day that CBA had failed to manage its regulatory compliance obligations adequately. Within the three-year period from November 2012 to September 2015, CBA did not submit 53,506 TTRs on time, totalling A$624.7 million.[31] Even when the amounts transacted were less than A$10,000, CBA had a legal obligation to file SMRs to AUSTRAC when it identified suspicious patterns of activity. Such patterns might include customers who deposit amounts just under the threshold transaction limit to avoid detection. However, CBA adopted an internal policy where SMRs would not be submitted if suspicious matter of the same nature had already been reported in the previous three months. Between August 2012 and June 2017, there were 69 cases identified where CBA failed to submit SMRs related to possible money laundering crimes on a timely basis, even after receiving requests from law enforcement for account details to assist in their criminal investigations.[32]

In many other cases, SMRs were not submitted due to a lack of transaction monitoring alerts raised or reviewed. For the incidents where alerts were raised and reviewed, CBA's submissions were usually incomplete.[33]

RISK ASSESSMENT FALLS SHORT

Before the introduction of IDMs into the mass market, CBA did not perform risk assessments for anti-money laundering and counter-terrorism financing risks. Such risk assessments were required under the AML/CTF Act in Australia. As a result, there was a lack of adequate risk-based systems and controls to manage these risks. [34]

After the IDM launch, CBA did not carry out the necessary risk assessments from 2012 to mid-2015 even when there was an exponential increase in the amount of cash deposited during this period. An estimated A$8.9 billion in cash was deposited through CBA's IDMs before it performed the risk assessment required. CBA had also failed to comply with its transaction monitoring program for 778,370 accounts from the launch date to September 2016.[35]

Around July 2015, CBA's intelligence analysis had obtained evidence that criminal syndicates were laundering several millions of dollars through its IDMs. Following that, CBA contacted the serious organised crime units of the AFP, New South Wales (NSW) police, and Western Australian police regarding the said money laundering activity. However, once again, CBA failed to follow its own anti-money laundering procedures and no new risk controls were introduced to tackle the problems that surfaced.[36]

One year later in July 2016, CBA evaluated that the IDMs had a high inherent money laundering risk but once again, it concluded that the residual risk was low. Hence, no action was taken to address the high inherent risk.[37]

MISMANAGEMENT OF OPERATIONAL RISKS

CBA had the legal obligation to continually monitor its customers so that the risk of money-laundering and terrorism financing could be managed and reduced. Once suspicious transactions have been identified, CBA must carry out enhanced customer due diligence (ECDD), as required by the AML/CTF Act. This may include ascertaining the source of the customer's wealth or terminating their accounts.

However, when dealing with suspicious customers, CBA was slow to decide on whether to cease doing business with these customers. They gave the criminal syndicates 30 days' notice before suspending their accounts and in 20 of these cases, AUSTRAC noted that the money laundering offences continued during the notice period given. CBA did not put in place any additional checks on these transactions and was unable to address the problem properly.[38]

LEGAL TUSSLES

By December 2017, CBA had filed its response to the legal suit by AUSTRAC. The bank only admitted to 91 allegations, challenging the remaining hundred or so claims made by AUSTRAC.[39] The agency responded by increasing the scope of its claims and charged the bank with 100 additional new claims of breaches of the AML/CTF Act.[40] CBA responded by denying a further 89 of these claims. A deadlock between CBA and AUSTRAC ensued, with both parties increasing their accusations and claims over the scandal. On 22 March 2018, the courts ordered mediation between the two parties.[41]

MISSING FROM THE EQUATION: ACCOUNTABILITY

The bank identified 'accountability' as one of its five core values in its 2014 Shareholder Review.[42] However, accountability was clearly lacking in CBA's corporate culture.

APRA released the CBA prudential inquiry final report on 30 April 2018.[43] The report noted that CBA's culture had a lack of clear accountability, and hence it was difficult to identify who was accountable when problems arise. A lack of collective accountability by senior leadership was one of the main factors identified by the regulator that led to CBA's ineffective management of its regulatory compliance obligations, leading to the money laundering scandal.[44]

APRA had also assessed the internal practices of CBA through interviews and focus group discussions with employees from various levels. The company's culture was characterised as lax, complacent and reactive based on the findings. The report highlighted that CBA employees tended to adopt a sense of helplessness because of the large size of the company and the complexity of issues. The employees of the bank attributed the problems faced by the bank to external factors such as the highly volatile nature of the financial markets, rather than internal failures. Employees were found to have a "check-box" mentality whereby they would just carry out the processes assigned to them and nothing more due to their lack of understanding of the rationale behind decisions made.[45]

WHO IS TO BLAME?

CBA's first response to the AUSTRAC accusations was to downplay the severity of its error. It claimed that due to technicalities of the law, the 53,700 breaches alleged by AUSTRAC may only be considered as just one breach as all the breaches were caused by a software update error.[46] The software update error had caused the IDMs to malfunction and stopped the generation of TTRs required for all transactions above A$10,000. CBA's Chief Executive Officer (CEO) Ian Narev claimed CBA only discovered the error three years later in 2015 and had taken steps to notify AUSTRAC and provided a fix for the machines within a month.[47]

Critics, however, pointed out the fact that suspicions related to illegal activities had already been raised within the bank since July 2014. These red flags should have prompted the company to file a report regarding their IDMs being used for illegal activities to AUSTRAC within three business days under the AML/CTF Act.[48] However, CBA did not do so.

According to a report by AUSTRAC, "Had [CBA] introduced daily limits earlier it would have disrupted money laundering activity through IDMs by syndicates involved in the importation and distribution of drugs including methamphetamine."[49]

SIGNS OF REPENTANCE

Under immense public pressure, the board of CBA announced in August 2017 that it would cut all short-term incentive bonuses for its top management, as well as reduce the director fees of its board members by 20% for the year.[50] In addition, CBA announced that its CEO would be leaving the bank by the end of the 2018 financial year.[51]

Following the additional pressure from legal actions being taken against the bank, as well as the fall in its share price, Catherine Livingstone, the Chairman of the board, announced a board restructuring plan, with three directors being replaced. She also announced that the bank intends to establish a director subcommittee to oversee the investigations and responses relating to the scandal.[52]

Analysts estimated that the increase in operating costs arising from legal fees to defend itself against lawsuits would amount to A$200 million over the following two years.[53] In addition, it was estimated that CBA would have to incur a A$2.5 billion fine as a result of its breaches.[54]

Subsequently, CBA announced that Narev would not be eligible to cash in his long-term bonus shares for the year. In an investor conference, Narev apologised for the scandal and took responsibility for it. Livingstone also apologised for the scandal during the shareholders meeting. In addition, it was announced that two more board directors would leave by the end of 2018.[55]

DIRECTORS ASLEEP AT THE WHEEL?

CBA's board of directors also came under the spotlight when consumer advocates claimed that the "long-serving Commonwealth Bank board members had been asleep at the wheel", leading to the bank's long string of scandals since 2009 that included the bribery of CBA's executives in relation to the award of business contracts, provision of shoddy financial planning advice, and the "fees for no service" scandal.[56]

The board was originally made up of 10 directors, out of which eight were independent non-executive directors.[57] The Chairman of the Risk Committee, Shirish Apte, did not reside in Australia, where the CBA headquarters are located. Instead, he lived in Singapore, where he was employed.[58]

APRA's final report on CBA's prudential inquiry had found that there was a culture of complacency, dismissiveness toward government regulations, and a general lack of accountability and oversight of the risks by CBA's key management and senior executives. The regulator found that the board had placed high trust and confidence in the bank's management due to their continual financial success. The board also believed that CBA, being one of the four largest banks in Australia, was conservative and had a culture of prioritising their customers' interest. This led the board to let its guard down.[59]

APRA noted that these factors resulted in the board being complacent and less attentive to signals that may have alerted it to the risks introduced by the IDMs and the money laundering scandal. The report also said that the board and its committees were often slow in dealing with non-financial risks, which may have communicated a tone of inaction to the rest of organisation. The inquiry found that the board was not sufficiently rigorous in ensuring that management mitigated high risk areas.[60]

THE BEGINNING OF THE END

In early April 2018, Narev stepped down as CEO of CBA with A$12 million worth of shares as a parting gift. He was replaced by Matt Comyn, the head of CBA's retail bank since 2012.[61] Two months later, CBA and AUSTRAC reached a settlement agreement. As part of the settlement, CBA would pay a record A$700 million fine to settle the claims of money laundering and terrorism financing breaches. The bank admitted to failure in the late or non-filing of more than 53,700 reports to AUSTRAC for cash deposits over A$10,000 and 149 suspicious matter reports. CBA claimed that it had improved its internal controls and systems since then.[62]

EPILOGUE: HAYNE'S CALL FOR CHANGE

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was tasked with investigating if Australia's banks have engaged in misconduct, and whether adequate controls were put in place. The one thousand-page report by Commissioner Hayne, which was released in February 2019, contained 76 recommendations. Among the recommendations, financial regulators are to impose criminal charges against entities associated with the "fees for no service" scandal. The royal commission also recommended the retention of the "twin peaks model" for financial regulation, but with a clearer segregation of roles. APRA continued to retain its role in regulation, and ASIC would oversee conduct and disclosure. ASIC was also urged to commence legal proceedings when dealing with large corporations in the event of law breaches, instead of merely issuing infringement notices, which should only be used for administrative matters. In addition, APRA and ASIC should also be more stringently monitored by an independently chaired regulator-oversight body, to ensure the accountability of regulators by conducting regular reviews.[63]

Following the royal commission's calls for further investigations by the regulators into CBA's failings, CEO Comyn addressed past lapses and pledged to improve its compliance and risk functions.[64]

Commissioner Hayne highlighted that the Australia's financial institutions must change their culture and conduct.[65] The CBA scandal involving money laundering and terror financing breaches was arguably one of the largest scandals in recent years. However, other misconduct such as deceased customers being charged fees and unqualified customers being sold insurance, was also uncovered. It remains to be seen if the Hayne report will act as a wakeup call to the financial industry.

DISCUSSION QUESTIONS

1. Describe the deficiencies in oversight and accountability within CBA that contributed to the failure. Should the CEO, Ian Narev, be held responsible for a technical operational error? Suggest potential improvements.
2. Discuss how the culture at CBA contributed to the lapses in risk management. Suggest improvements to be made.
3. Comment on the actions taken by CBA following the discovery of the vulnerabilities. Was there more that the company could have done?
4. Evaluate if the penalty imposed by the courts was fair to CBA's stakeholders. Should the board of directors have been held responsible for the breaches?
5. In light of the recent wave of technological integration within the banking and finance industry, discuss its impact and how the risks can be managed.
6. What are the regulatory bodies and regulations in place in your country in relation to money laundering and terrorism financing? In your opinon, would the CBA case have been prevented if it were to happen in your country?

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DANSKE BANK: HUNG OUT TO DRY

CASE OVERVIEW

In 2017, it was revealed that Danske Bank – Denmark's largest bank – was involved in one of the world's largest money laundering scandals. Between 2007 and 2015, 9.5 million suspicious payments from Russia and other ex-Soviet states, amounting to an aggregate of 200 billion, were made through the Estonian branch of Danske Bank. The scandal rocked the financial sector and significantly dampened the credibility of Denmark's financial markets and negatively impacted Danske Bank's reputation as a stable and efficient bank. The objective of this case is to facilitate a discussion of issues such as risk management in financial institutions; whistleblower policies; group structure and integration; anti-money laundering (AML) regulations and policies; and the role of financial supervisory authorities.

THE SOURCE OF IT ALL

In November 2006, Danske Bank expanded into Finland through the acquisition of Sampo Bank, the third-largest bank in Finland. This acquisition also included Sampo Bank's Estonia subsidiary and its non-resident portfolio, which comprised of customers from the Russian Federation and the larger Commonwealth of Independent States, including Azerbaijan and Ukraine.[1]

From 2011 to 2013, there was a significant increase in the proportion of the Estonian branch's profits that were derived from foreign money. By the end of 2013, the non-resident portfolio held 44% of total deposits from non-resident customers in Estonian banks – an increase from 27% in 2007 – and 76% of the share of profits before tax of Danske Bank's Estonian branch was derived from customers in the non-resident portfolio.[2]

THE BEGINNING OF A HUGE DISCOVERY

In 2007, months after acquiring Sampo Bank together with its Estonia branch, Danske Bank received a warning from the Russian Central Bank[3] that its Estonia branch was being used for tax evasion and money laundering[4] of billions of Russian roubles every month.[5] Additionally, the Estonian Financial Supervisory Authority (FSA) issued a critical inspection report, which highlighted possible "tax and custom payments evasion" and "criminal activity in its pure form, including money laundering", estimated at "billions of roubles monthly", at the Estonian branch.[6] In 2009, the Estonian FSA performed further follow-up investigations. The investigations concluded with a less critical report than the financial regulator's initial inquiry in 2007.[7]

In 2010, Danske Bank's executive board got wind of the high level of suspicious activities occurring in the Estonian branch. However, the issue was brushed off as the bank's managers felt that they were "comfortable" with "substantial Russian deposits".[8]

THE LAUNDROMATS

Laundromats are criminal financial vehicles which used shell companies to perform money laundering activities across the globe through fraud, manipulation of state contracts, and evasion of tax. It was found that the Russian and Azerbaijani Laundromats were central to the Danske Bank money laundering scandal.[9]

Between 2011 and 2014, 21 shell companies were created in the U.K., New Zealand, and Cyprus to launder US$20.8 billion from 19 Russian banks. These funds eventually ended up in 5,140 companies in 96 countries.[10] Several accounts in Danske Bank had been used by a member of Russian President Vladimir Putin's family and the Federal Security Service of the Russian Federation, to launder significant amounts of suspicious money.[11]

The Azerbaijan Laundromat – which existed between 2012 and 2014 – was a secret fund utilised by the Azerbaijan government to court favours amongst international peers. Similar to the Russian Laundromat, it utilised Danske Bank's Estonian branch to process 'dirty' funds, before the funds were channelled to four U.K.-registered shell companies and used to pay off politicians and purchase luxury goods.[12,13] The Estonian branch of Danske Bank managed the accounts of all four Azerbaijani Laundromat companies and it enabled billions to move without scrutinising their propriety.[14]

This is the abridged version of a case prepared by Chua Tuan Xin, Goh Kwee Yong, Katty Teo Kai Heng, Jerome Lim Zi En, Jessica Goh Kai Ling and Nicholas Lee Jian Wei under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Mirabel Clarissa Reynaldo and Isabella Ow under the supervision of Professor Mak Yuen Teen.

WHAT'S HAPPENING AT THE ESTONIAN BRANCH?

Danske Bank's branch in Estonia functioned as if it was a stand-alone entity which had its own systems and procedures relating to its anti-money laundering methods.[15] As such, any reporting to the Group was dependent on reporting from local management in Estonia.[16]

The Estonian branch had its own IT platform. As a result, the branch was not using the same customer, risk and transaction monitoring systems as the rest of the Group. The idea of integrating the Baltic banking activities onto the Group's IT platform were abandoned in 2008 due to the high costs involved. Hence, it did not subscribe to the Group's AML procedures.[17]

Further, as numerous documents were prepared in Estonian or Russian, Danske Bank had faced a language barrier and thus a lack of insight into the Estonian branch's activities. Danske Bank simply assumed that the branch was using appropriate AML procedures. However, the Group's faith in the branch was misplaced. The Estonian branch's AML procedures were found to be insufficient to monitor and mitigate the risk of fraudulent financial activities, leading to many breaches of legal obligations by the branch.[18] This also resulted in missed opportunities to detect and investigate any fraudulent activities at the Estonian branch, allowing fraudulent transactions to carry on undetected for a significant period of time.[19]

Forty-two staff and eight ex-staff of the Estonian branch had also been deemed to be involved in colluding with criminals to carry out money laundering activities. Amongst other misdeeds, these staff actively evaded the bank's compliance procedures,[20] performed dubious transactions, deposited large amounts of cash, and were involved in suspicious transactions with other staff.[21] They were also found to have failed to carry out basic background checks on non-resident customers.[22] Moreover, the Estonian branch's employees actively conducted and covered up the violations to the bank's senior management in Denmark as well as to the Estonian FSA.[23]

PROBLEMS WITH INTERNAL CONTROLS

"All three lines of defence collapsing in this case: it's a matter of internal collusion; it's an underestimation from management of the impact of this case; it's basically looking at this case as risk minimising and not as crime. That might be the biggest mistake. We have a cultural thing we need to work on."

– Jesper Nielsen, Danske Bank's interim CEO[24]

The first line of defence, the business operations, paid insufficient attention on high risk clients in the branch's portfolio. Meanwhile, the Group's business banking team that the Estonian branch reported to relied on continual assurances that all regulations were followed by the branch.[25]

The second line of defence omitted the details of AML risk residing in the Baltic branches in reports to the top management.[26] The bank deferred the decision to terminate part of the high risk non-resident portfolio that related to clients with no personal or business-related links to the Baltic nations until January 2015, which was not completed until January 2016.[27]

The third line of defence in the form of the branch's internal audit function was not fully integrated into Danske's Group Internal Audit department.[28] At the beginning of 2014, Danske Bank failed to inform the Danish FSA of the problems related to the AML issues, even though it was evident to some executive board members that previous reports provided by the bank to the Danish FSA and the Estonian FSA were inaccurate.[29]

CORPORATE CULTURE

The culture cultivated in the Danske Bank discouraged employees from speaking up. When faced with problems, employees were encouraged to work out the issues at a lower level instead of alerting top management. This "mean and lean" culture could have contributed to the sudden explosion of Danske Bank's Estonian money laundering scandal.[30]

RUN-IN WITH THE FINANCIAL REGULATORS

In 2007, the Russian Central Bank alerted the Danish FSA regarding the money laundering risks. Subsequently, the Danish FSA requested a report from Danske Bank and discussed the matter with the head of its legal department and the bank's Chief Audit Executive. The response stated that no money laundering risks were found in the Estonian branch. The Estonian FSA discovered lack of care related to the management of money laundering risks by the Estonian branch. Thus, the Estonian FSA ordered the branch to enhance its background checks on non-resident clients and its internal controls to prevent money laundering.[31]

Between 2007 and 2014, the Estonian FSA conducted a total of four AML inspections.[32] In 2012, the Estonian FSA became concerned about the number of non-resident clients in Danske Bank's Estonian branch and communicated these concerns to the Danish FSA. The Danish FSA then ordered Danske Bank to resolve the issues raised by the Estonian FSA. Following the bank's submission of a comprehensive illustration of the Estonian branch's management of money laundering risks and a review of its business procedures, the Danish FSA decided that even though the concentration of clients from high risk countries could be "problematic", the bank's procedures and controls were adequate.[33]

The Estonian FSA contacted the Danish FSA in 2013 once again on the risks of money laundering in the Estonian branch following a warning given by the Russian Central Bank, which covered a record of dubious clients from Russia and its own analysis of the customer mix of the branch. The Danish FSA ordered Danske Bank to solve this issue. In response, the bank said that it had already established a special arrangement in the Estonian branch in light of the increased money laundering risk. The Estonian FSA subsequently requested documentation from the Estonian branch on the suspicious Russian customers but did not find any significant breaches of internal procedures or legal requirements, and therefore saw no basis for swift regulatory action.[34]

Thereafter, two AML inspections were carried out by the Estonian FSA in 2014. However, the Estonian FSA did not invite the Danish FSA to participate in these inspections. It was later revealed that there were serious deficiencies in Danske Bank's AML system, which prompted an overhaul of the branch's local management. Eventually, the Estonia FSA issued a critical report to Danske Bank,[35] putting pressure on the bank to exit the non-resident business.[36]

The Danish FSA was of the view that as the host country supervisor, the Estonian FSA was responsible for the AML supervision of Danske Bank's Estonian branch, which is in line with the AML directives and the division of responsibilities prescribed by European Union (EU) legislation.[37]

The Estonian FSA, on the other hand, was of the opposite view that supervision over branches operating in Estonia should be exercised by the supervision authority of the country of origin. It therefore relied on the Danish FSA as the lead for AML supervision of Danske Bank.[38]

As a result, a war of words erupted in late January 2019 between the two regulators when the Danish FSA released a report placing responsibility on the Estonian regulator.[39]

DID THEY KNOW?

The Russian Central Bank's warning in 2007 was Danske Bank's first real opportunity to investigate the suspicious transactions at its Estonian branch. However, this opportunity was missed by the bank's management and board. Five years later, in 2013, J.P. Morgan, a correspondent bank of Danske Bank, brought the correspondent banking relationship with the Estonian branch to an end as it was concerned that it was being used as a conduit for illicit funds. Although this event prompted the Group to initiate a review of the non-resident portfolio, the review was not properly completed.[40,41]

Reporting from the Estonian branch to the Group's executive board and board of directors was almost completely reliant on reporting from local country management. This resulted in censored information that did not paint the full picture of the Estonian branch's activities and performance. For example, between 2011 and 2013, the board of directors was given incomplete reports regarding the Estonian branch, including a presentation on 5 May 2011 which provided no detailed analysis and no mention about the non-resident portfolio.[42]

For years, the Group believed that the high risk represented by non-residents in the Estonian branch was mitigated by appropriate AML procedures. However, in late 2013, a report from a whistleblower emerged. Together with audit letters from the Group Internal Audit in early 2014, the fog surrounding the circumstances at the Estonian branch dissipated and it became clear that the branch's AML procedures were vastly inadequate.[43]

THE WHISTLEBLOWER

In 2013 and 2014, Howard Wilkinson, who led the trading unit of Danske Markets in the Baltics since 2007, alerted the executive board of Danske Bank about the occurrence of suspicious activities at the Estonian branch.[44] He made four reports to the executive board regarding suspicious clients in the Estonian branch's non-resident portfolio[45] in the hope that investigations would be promptly initiated.[46]

Wilkinson's suspicions were first aroused when he came across the documents of Lantana Trade LLP (Lantana). The U.K. company did not have any net assets and yet it moved US$480 million through the Estonian branch of Danske Bank in five months. This prompted Wilkinson to check if the business records filed by Lantana with the authorities were aligned with the deposits with Danske Bank. Based on its filings to the U.K. authorities, Lantana's bank accounts had US$20,500 as at 31 May 2012. However, bank records revealed that it had deposits amounting to nearly US$1 million with Danske Bank. Wilkinson then emailed the bank's headquarters about the matter in December 2013.[47]

After several more reports made by Wilkinson drawing management's attention to several suspect transactions and an investigation by the bank's internal audit team – which produced a damning draft report stating that the Estonian branch acted in violation of AML legislative requirements, there was still no action taken to address the matter. Wilkinson then realised that Danske Bank's top management did not seem to want to fix the problem. He observed that "there was a curious lack of interest at senior management level".[48]

In April 2014, Wilkinson resigned from his position.[49] On 8 April 2014, he informed Danske Bank's Chief Risk Officer that he would report the false accounts to the Estonian authorities if no action was taken by the bank.[50] Soon after, the Group presented Wilkinson with a non-disclosure agreement (NDA) to sign before he left the bank.[51]

In Europe, whistleblowers generally lack special legal status to protect them from retaliation by their employer.[52] As such, they may risk retaliatory action if they expose wrongdoing.[53]

WHAT HAPPENED NEXT?

Over the period from 2015 to 2016, Danske Bank closed its non-resident business in its Estonian branch. This withdrawal occurred following orders issued by the Estonian FSA in 2015 for Danske Bank to exit the non-resident business.[54,55]

On 19 September 2018, Danske Bank announced that its board of directors and executive board "[did] not wish to benefit financially" from the suspicious transactions in its Estonia branch. It decided to donate the gross income derived from the non-resident portfolio between 2007 and 2015 – estimated to be kr. 1.5 billion – to an independent foundation established to support initiatives directed at tackling international financial crime and money laundering.[56]

Wilkinson was invited to address both the Danish and European Parliaments in late November 2018. Prior to his testimony, on 24 October 2018, the European Union placed pressure on Danske Bank to drop its NDA with Wilkinson to ensure crucial whistleblower testimony from Wilkinson would not be blocked. On 29 October 2018, Danske Bank informed that it had "released the person in question of all contractual duties of confidentiality in relation to Danske Bank."[57,58]

IMPROVEMENTS

Following the eruption of the money laundering scandal, enhancements were made to Danske Bank's AML and compliance frameworks. Initiatives to address the specific issues relating to the Estonian branch were also implemented.

Firstly, Danske Bank made the decision to only enter into engagement arrangements with subsidiaries of Danske Bank's Nordic clients and global clients with a solid Nordic footprint. The bank's non-resident portfolio in Estonia was shut down in 2015. Danske Bank also strengthened its governance and oversight of its branches in the Baltics with the establishment of a new pan-Baltic management team, and boosted independence of control functions in the region to uphold the same degree of risk management and control as the rest of the Group. There was also an IT migration exercise to integrate the Baltics operations' IT systems with the rest of the Group, thus allowing greater transparency and oversight.[59]

Danske Bank also started a comprehensive AML programme, including better organisational structures, improved routines and procedures, and the implementation of new, upgraded IT systems. Additionally, Danske Bank promised to continuously improve the organisation-wide compliance knowledge and culture through extensive compulsory training and a robust management focus. Furthermore, risk management and compliance in performance agreements were put in place for all members of the executive board and senior managers.[60]

This was further reinforced by the appointment of Philippe Vollot as the bank's new Chief Compliance Officer on 18 July 2018. He was formerly the Global Head of Anti-Financial Crime & Group Anti-Money Laundering Officer in Deutsche Bank, and has extensive experience in tackling financial crime and money laundering activities.[61]

Danske Bank's whistleblower setup was also upgraded and a better governance setup was implemented to manage reports. The bank's employees were also actively informed about the whistleblower system through mandatory training sessions. On this matter, Danske Bank made a commitment to ensure that whistleblower reports and correspondences with supervisory authorities form part of reporting to the board of directors.[62]

As part of a new governance model for interactions with financial authorities, Danske Bank planned to establish a central unit at the Group level, which role is to "coordinate and register all significant interaction" with the financial authorities. The Group would hold this unit to the highest standards of "quality, transparency and completeness".[63]

BORGEN OUT

On 19 September 2018, Borgen announced his plans to step down from his position as CEO after a long-term successor was found. However, he was officially dismissed by Danske Bank on 1 October 2018, after the board of directors selected Jesper Nielsen – who formerly headed Danske Bank's Danish banking activities – as interim CEO.[64,65] Observers were of the view that the appointment of Nielsen as interim CEO demonstrated the board's sense of "urgency" to remove Borgen. The decision came after the bank's shareholders, including the Danish Shareholders' Association – Denmark's largest investor group - demanded his immediate exit and expressed anger and frustration at the board's initial decision not to dismiss Borgen.[66]

In December 2018, Estonia arrested 10 former employees of the Estonian branch of Danske Bank on suspicion of knowingly enabling money laundering. This came as a part of an investigation into the bank's money laundering activities.[67]

EXITING THE BALTICS AND RUSSIA

In February 2019, Estonian FSA demanded that Danske Bank exit the country and quit all operations in Estonia. The head of Estonian FSA, Kilvar Kesser, said that scandal had greatly harmed the Estonian financial market reputation and called for Danske Bank's departure due to "serious and large-scale violations of the local rules". In response, Danske Bank said that it would not only cease its operations in Estonia, but in Russia, Latvia and Lithuania as well.[68]

FINANCIAL REGULATORS NOT SPARED

European Banking Authority's investigation

During the money laundering saga, fingers were also pointed at the Estonia and Denmark FSAs over their supervisory failings. On 19 February 2019, the European Banking Authority (EBA) launched a formal investigation into both financial regulators.[69,70]

However, two months later, on 16 April 2019, EBA decided to shelve the investigation after it voted to reject an internal draft report into the supervisory failings of the Danish and Estonian supervisory authorities. The draft report identified breaches of union law, such as "significant shortcomings" in cooperation between the two supervisory authorities, insufficient and ineffective monitoring of whether due-diligence procedures were carried out by Danske Bank, as well as inadequate reviews of Danske Bank's governance arrangements.[71]

This move drew severe criticism from senior EU policymakers who wanted tougher legislation for the financial services industry. One member of the European Parliament, Sven Giegold, commented that it was "scandalous" that the EBA had rejected the report. He further urged the EU commission to open "infringement procedures" against Denmark and Estonia for failure to apply EU law.[72]

Other inquiries

The U.S. Justice Department also started criminal investigations into Danske Bank in January 2019. The investigation was regarding whether as a correspondent bank, Deutsche Bank, had sufficiently monitored billions of dollars in suspicious transactions from Danske Bank when it assisted its Estonian branch to convert foreign currency into US dollars for its customers.[73]

On 20 February 2019, Estonia's state prosecutors expanded their investigations to include Swedbank AB – a Nordic-Baltic banking group based in Sweden, in view of allegations of suspicious transactions in Estonia with Danske Bank. It was alleged that from 2007 to 2015, US$4.3 billion were transferred between Swedbank and Danske Bank.[74] Meanwhile, Denmark's authorities also expanded investigations to target accounting firms, including Ernst & Young for its audit of Danske Bank's accounts in 2014.[75]

EPILOGUE

Danske Bank's money laundering scandal has stunned the world's banking sector, the general public, as well as Denmark's political establishment. As a result, Danske Bank's reputation has been severely tarnished and its shares had plunged about 50% during 2018, reducing its market value by over US$18 billion.[76]

All in all, one of history's largest money laundering scandals highlighted the importance of implementing robust internal control policies and proper enforcement of such policies. It also highlighted that countries' financial supervisory authorities have a part to play in ensuring that money laundering is not pervasive. As money laundering methods evolve to become more sophisticated and complex, countries and companies alike need to stay vigilant and constantly update national and organisational policies to be several steps ahead in the game.

DISCUSSION QUESTIONS

1. Evaluate Danske Bank's internal control framework using the Three Lines of Defence Model and/or other relevant concepts.
2. If you were Howard Wilkinson, would you have blown the whistle? Compare and contrast the whistleblowing policies implemented in Europe and in the U.S.
3. Who were the key players in the money laundering scandal, and how did their roles and actions further contribute to Danske Bank's money laundering scandal becoming one of the largest money laundering scandals in history?
4. Discuss the effectiveness of the Danish and Estonian FSAs in carrying out their duties as regulators. What more could they have done to prevent money laundering activities?
5. Comment on Danske Bank's improvements in response to the money laundering scandal and what other financial institutions could learn from the scandal.

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A SWEDBANK AFFAIR

CASE OVERVIEW

On the morning of 28 March 2019, an hour before Swedbank's AGM was due to start, CEO Birgitte Bonnesen was dismissed following various money laundering allegations afflicting the company over its Baltic operations. In an investigative news report, Swedish broadcaster SVT claimed that at least US$4.3 billion had been funnelled through Swedbank accounts, thrusting the company into public scrutiny. To make matters worse, Swedbank was simultaneously caught in an insider trading scandal. The objectives of this case study are to facilitate the discussion of issues such as money laundering; cross-border governance and regulatory oversight of subsidiaries; risk management in financial institutions; board composition; and corporate culture.

ABOUT SWEDBANK AND BIRGITTE BONNESEN

Swedbank AB, Sweden's oldest bank, was founded in the early 19th century. As a company rooted in tradition, it was the go-to bank for its people to deposit their savings, and the bank expanded rapidly to become one of Sweden's largest banks. In 2005, Swedbank acquired Hansabank, one of the largest banks in Estonia with operations spanning all three Baltic states.[1]

Born in Denmark, Birgitte Bonnesen relocated to Sweden in 1987 and worked at Swedbank from the late 80s. She rose through the ranks and supervised the bank's anti-money laundering policy between 2009 and 2011.[2] From 2011 to 2014, she took over as head of Swedbank's Baltic operation. Following this in 2015, she headed Swedbank's Swedish operations for a year. In 2017, Bonnesen took over as CEO of Swedbank before she was named second in the list of the top 125 most powerful women in the Swedish business sector by VA just a year later.[3]

COVERING NEW GROUND: BOON OR BANE?

When the Baltic states gained independence in the 1990s, it created an opportunity for Nordic banks to cater to the underbanked populations across the Baltic Sea. Regional expansion into the Baltics opened new markets and was seen as a lucrative business for banks willing to accept money laundering risks.[4]

While the opportunity seemed promising, the truth was the Baltics offered limited upside potential while significantly adding to money laundering risks for Swedbank. The combined population in the Baltics was only 6.2 million, not much higher than that of Denmark or Norway.[5] Additionally, as at FY2018, the combined Baltic banking sectors' assets stood at €75 billion (US$82.49 billion), a much smaller figure in comparison to the Nordic countries with figures amounting to €2.6 trillion (US$2.86 trillion).[6]

CROSSING BORDERS: SWEDBANK'S BALTIC EXPANSION

In 1998, Swedbank group acquired 50% of Hansabank which consequently led to their expansion into the Baltics.[7] In 2005, Hansabank became wholly owned by Swedbank and by the autumn of 2008, Hansabank was renamed to Swedbank in the Baltics region.[8] Nevertheless, a name change does not signify a change to the underlying risk management and compliance culture. In fact, Swedbank professes that the local roots are and will continue to be ingrained in the principles.[9] However, as the largest bank in Estonia[10], coupled with the close proximity of the Baltics with Russia, it has undoubtedly increased Swedbank's risk of getting embroiled in illegal financing flows.[11] There exists a recurring pattern where Nordic banks with operations in the Baltic area get caught up in money laundering scandals of their Russian counterparts, which puts into question the probity of Nordic banks.[12]

TROUBLED TIMES IN THE BALTICS

Things did not always go as planned. Earlier in 2007, some US$230 million was stolen from American financier Bill Browder's investment fund Hermitage Capital Management in Russia.[13] Sergei Magnitsky, a tax accountant initially tasked to investigate the fraud, was arrested and imprisoned following his unveiling of the US$230 million fraud. It was later revealed that the Magnitsky affair was the largest tax fraud in Russian history.[14]

SVT alleges that a total of US$26 million from the tax fraud was transferred to about 50 accounts in Swedbank, through companies suspected of money laundering identified from the Danske Bank scandal.[15] Howard

This case written by Blondell Kong, Seah Yong Xian Donovan, Shaun Phang, Rong Jun and Tang Wei Hao under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This case was edited by Professor Mak Yuen Teen.

Wilkinson, the whistle-blower of dirty Russian money laundering at Danske Bank recalled the time when he was employed at Danske's branch in Tallinn, Estonia.[16] He noted that Russian customers would call in daily to exchange rubles for dollars, and on the very next day, transfer the money out to other places. By 2015, Danske Bank subsequently shut down its Estonian non-resident portfolio after risks of money laundering surfaced.[17]

Further problems arose in 2008 when Swedbank was accused of reckless lending in the Baltics.[18] This forced Swedbank to stomach huge credit losses when the global financial crisis hit. In 2009, swelling loan losses in the Baltics led to a net loss amounting to US$1.14 billion and a negative return on equity of 12.5%.[19]

On 19 September 2018, investigations into Danske Bank's Estonia branch concluded that "major deficiencies in controls and governance made it possible to use Danske Bank's branch in Estonia for criminal activities such as money laundering."[20] Until 2016, Danske Bank's Estonia branch had a non-resident portfolio of thousands of customers who did not reside in Estonia, including customers from the Russian Federation and the larger Commonwealth of Independent States ("CIS").[21]

Fourteen years after the expansion into the Baltics, Swedbank was now embroiled in a dirty money scandal.[22] This was thought to be the result of the company's weak policies and inadequate Anti-Money Laundering (AML) and Know Your Customer (KYC) procedures.[23] News of the alleged money laundering scandal arose when SVT claimed that at least US$4.3 billion was funnelled between high risk accounts between the period of 2007 to 2015.[24] This came after Danske Bank was investigated for allowing US$230 billion worth of non-resident money from Russia and other former Soviet states to pass through its Estonia branch.[25] SVT obtained an internal document of Swedbank which showed that Swedbank did not know "who the real owners of the accounts were, or where the money was coming from" and that many of the bank's "high risk customers should never have been approved."[26]

THE STRAW THAT BROKE THE SWED'S BACK

"Swedbank have zero tolerance on money laundering and when we see signs, we act,"

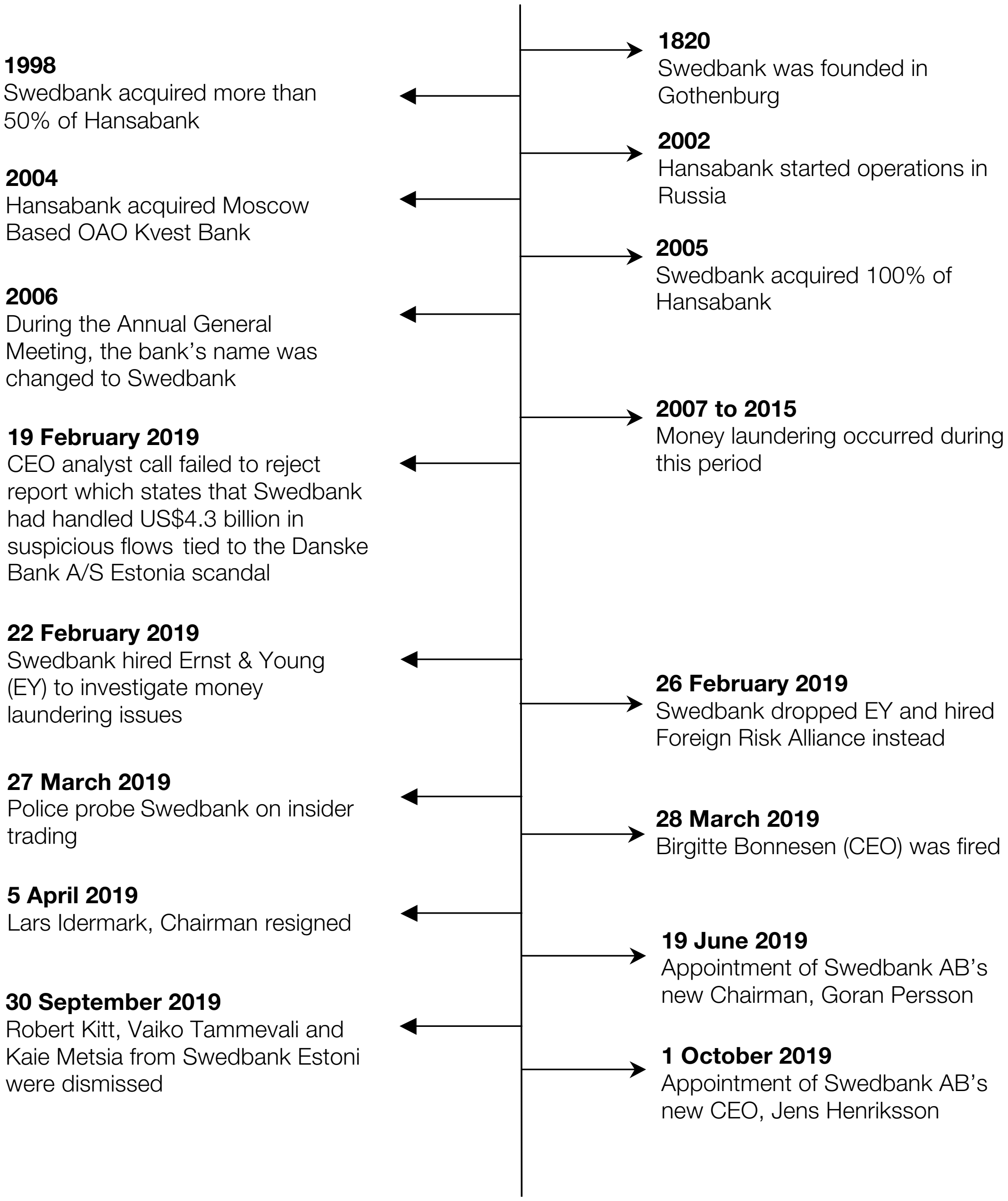
Gabriel Rodau, Head of Group Communication[27]

In February 2019, Swedbank came under the spotlight after reports from Swedish television SVT revealed dubious transactions totalling US$4.3 billion possibly occurring between Swedbank and Danske Bank's Baltic accounts.[28] SVT had obtained scores of classified documents corroborating the numerous transactions between the two banks' clients between 2007 to 2015. Following the allegations, Swedish and Baltics regulators initiated a joint investigation into Swedbank.[29] Figure 1 summarises the key milestones in Swedbank's history and key events relating to the scandal.

On 21 February 2019, Swedbank announced the appointment of Ernst & Young (EY) Global Ltd. to investigate allegations of fraud and money laundering.[30] However, on 26 February 2019, just five days after the appointment, Swedbank discharged EY and hired Forensic Risk Alliance instead.[31]

Swedbank's decision was due to reports of the Danish government probing into EY's ties to the Danske scandal. A Swedbank spokesman said in an email that they were aware of the reports in the media and to avert any future misunderstandings, Swedbank resolved to change the firm.[32]

Figure 1: Swedbank's History and Key Events Surrounding the Scadal



Subsequent probes unveiled that 50 of Swedbank's clients with high risk indicators of money laundering had possibly channelled US$5.8 billion through Swedbank.[33] These client companies had neither operations nor legitimate owners.[34] Evidently, warning signs were insufficient to flag out the problem of money laundering that was occurring right under the noses of Swedbank's management. Ever since allegations of money laundering surfaced, Bonnesen had repeatedly emphasised her faith in the company's anti-money laundering (AML) and know-your-customer (KYC) procedures. However, when then acting CEO Anders Karlsson took the helm in March 2019, he admitted that previous internal investigations revealed shortcomings in Swedbank's AML and KYC procedures. Karlsson disclosed cases in which risky customers connected to previous money-laundering cases were not flagged out, and cases where reports on suspicious transactions should have been made to authorities but were not done.[35]

To further exacerbate matters, these transactions were purportedly linked to the Russian tax fraud totalling over US$230 million.[36] In addition, Sweden's Economic Crime Authority (SECA) commented that its search of Swedbank's head office on 27 March 2019 was part of its independent inquiry into whether the bank contravened insider trading regulations by notifying major shareholders about SVT's initial report before the information was disclosed.[37]

In an interview with Sveriges Television (SVT), Bonnesen mentioned that the Baltic business was "the most successful business at Swedbank under her reign." When Swedbank was alleged to be involved in money laundering, she attempted to convince shareholders and customers that everything was under control, asserting that the business model and processes were sound and that the bank had operated in the Baltics with the highest customer satisfaction rates of all banks. However, all was not as it seems.

It appeared that Bonnesen had misled the public regarding the gravity of the money laundering case.[38]

WRAPPING FIRE WITH PAPER

"If the information is correct, there are two alternatives: they have known about it but let it continue or they haven't checked and the transactions haven't triggered any alarm, I don't know what's worse."

- Joakim Bornold, savings adviser at Soderberg & Partners[39]

The culture in Swedbank encouraged keeping information under wraps. In April 2016, New York State Department of Financial Services, DFS, approached Swedbank seeking its cooperation in providing information of all dealings tied to Mossack Fonseca, a Panamanian law firm sinking in its own scandal.[40] In response, Swedbank said that the only dealings associated with Mossack Fonseca were outside of the Baltics, in Norway and Sweden. However, incriminating evidence provided by SVT pointed to Swedbank suppressing crucial transactional information between over 100 companies and Mossack Fonseca within the Baltics.[41] In order to withhold details from the DFS, Swedbank had allegedly spun a colossal lie.

Perhaps the more pressing issue was the extent that Swedbank's top management would go to in order to evade accountability. At the helm of Swedbank was former CEO Bonnesen who responded to SVT's inquiry saying "It sounds incredibly strange that we would have had any intention of covering things up," and went further stating "That is not at all consistent with the way we work, or how we've done things throughout the years."[42] Subsequently, in an email response, Swedbank even cited banking secrecy as the reason why full disclosure was not given.[43] Despite damning evidence laid out by SVT pertaining to money laundering taking place in Swedbank, top management refused to cooperate and instead chose to sidestep the issues at hand.

OVERLOOKING RED FLAGS: DELIBERATE OR NEGLIGENT?

Records obtained by SVT had unravelled events alluding to Swedbank's failure to uncover serious money laundering issues. The documents portrayed recurring dealings amounting to US$5.8 billion between Swedbank and Danske Bank.[44] Another red flag was raised when SVT alleged that up to US$22 billion in annual gross transactions from risky Russian clients were funnelled through Swedbank's Estonian bank between 2010 to 2016.[45]

Swedbank had failed to identify the illicit money laundering taking place over the years. The Swedish Shareholders' Association claimed that Swedbank had fostered a tendency to treat lightly the regulations and laws it should have followed.[46] However, Swedbank top management held a different view.

Gabriel Rodau, the Head of Group Communication, pointed out that "Swedbank have zero tolerance on money laundering and when we see signs, we act."[47] He later went on to reassure SVT of the bank's robust transaction monitoring and reporting systems.[48] In a telephone interview, Bonnesen also stated that she was satisfied with the safeguard systems of Swedbank and was confident that any discoveries had been looked into.[49] However, she later conceded that the bank might have been unable to catch everything.[50]

THE FALL FROM GRACE

"It's a massive scandal. From what we've learned from SVT's information, Swedbank's accommodation of suspicious transactions comprised a significant part of the money laundering operations, in parity with Danske Bank…"

– Louise Brown, corruption expert and chair of Transparency International's Swedish chapter[51]

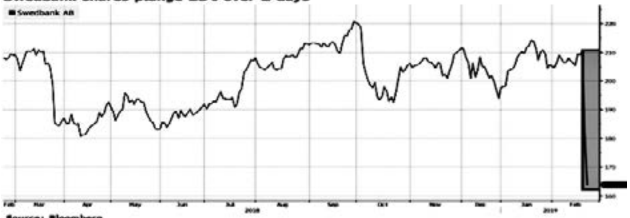
On 20 February 2019, Swedbank saw their market value plummet by 14% (Figure 2). Bonnesen attempted to re-establish calm by getting in touch with analysts. However, the effect was far from what she had hoped to achieve.[52] In a conference call, Bonnesen found herself unable to refute a Swedish media report alleging that Swedbank had handled US$4.3 billion in dubious transactions tied to the Danske Bank Estonia scandal.[53] In a desperate bid to allay concerns, she announced that Bill Browder, an investor known for clamping down hard on money launderers, had informed Swedbank that he would not be filing a criminal complaint against them. This announcement was short-lived, as Swedbank subsequently retracted the statement after Browder disconfirmed Bonnesen's words.[54]

Philip Richards, an analyst at Bloomberg Intelligence in London, said that Swedbank's management was either unable or unwilling to deny or confirm virtually anything. In particular, whether the management knows the "full extent of what links they may or may not have had with suspicious transactions or customers."[55] Due to the sensitive nature of the subject, another analyst chose to be anonymous and he said "the call left him with more questions than answers."[56]

At Morgan Stanley, the opinion was that there was little chance for the shares to recover after the conference call with Bonnesen.[57] They said that there was insufficient assurance to fuel a prompt recovery in Swedbank's shares.[58]

Responding to the spate of bad news, investors proceeded to dump the stock and Swedbank traded down about 10%. Over the span of two days, alarmed investors caused Swedbank's market value to fall by US$5.3 billion.[59]

Figure 2: Impact of the Scandal



After two days of precipitous losses, Swedbank's shares regained some ground. However, Joakim Bornold, a savings adviser at Soderberg & Partners, said that "the danger is far from over."[60]

Meanwhile, it emerged that several senior management personnel at Swedbank have been buying thousands of Swedbank's shares and these included board members Ulrika Francke, Bo Johansson and Anna Mossberg. Moreover, Ola Laurin, head of large corporates and institutions, and Anders Ekedahl, head of group IT, had also been buying the bank's shares. Just two days after their purchases, Swedbank shares rose by almost five percent.[61]

After the public was made aware of the scandal, Lars Idermark, Chairman of Swedbank, attempted to salvage the situation through the promise of increased transparency.[62] However, his actions were contradictory to what he had promised. During a press conference following the AGM, he reportedly evaded an important question concerning a leaked report alleging billions in suspicious flows funnelled through the non-resident unit in Swedbank Estonia.[63] His actions raised new suspicions, after he provided frivolous excuses such as not having known about the report beforehand. When probed further about the supposedly leaked report, he declined to give a reply.[64] He was further discredited when SVT made claims of Swedbank having knowledge of transactions relating to Viktor Yanukovych which is suspected bribery wrapped as a book deal since 2017.[65]

Swedbank's anti-money laundering policy was overseen by Bonnesen between 2009 and 2011, when she was the Chief Audit Executive.[66] SVT asserted that Bonnesen had herself to blame for Swedbank's inability to identify the spate of money laundering activities that occurred.[67] Swedbank has since confessed to potential shortcomings in its internal system for detecting money laundering risks during an internal probe.[68] However, Bonnesen's retraction of her initial denial regarding Swedbank's connection with the Danske Bank scandal led to a fall in investor's confidence.[69]

Less than a week before the AGM was held, Bonnesen still had the full backing of the board. However, increasing allegations of money laundering and indications of the US investigating Swedbank riled investors. To make matters worse, Swedbank was now being investigated for other criminal activities, including suspected fraud and a breach of insider trading rules.[70] Some of Swedbank's major shareholders expressed their disapproval and intimated at an extraordinary general meeting to potentially elect a new board.[71] This sentiment was also shared by Nordnet, an online broker, and the Swedish Shareholders' Association.[72]

The Swedish Shareholders' Association was of the view that Swedbank's new leadership should come from outside the company, as the company's mindset was to 'take lightly' current laws and regulations.[73] Bonnesen was subsequently fired on 28 March 2019 on grounds of failing to detect and prevent the illicit money laundering activities as CEO and Head of Baltic operations.[74] According to the terms stipulated in her contract, she was entitled to a compensation of US$2.3 million.[75] Iderman also left.

On 5 April 2019, Browder lodged a criminal complaint against Swedbank to Latvian authorities, accusing them of their involvement in the Russian money laundering scandal.[76] On 28 October 2019, new allegations were directed at Swedbank indicating that it might have contravened European Union laws and on the morning of 29 October 2019, Swedbank's shares fell by more than four percent and its market value plunged more than 30% for the year.[77] The bank is currently being investigated by several U.S. agencies as well as the European Central Bank, and investors are bracing for large fines and higher compliance costs.[78]

DIVIDEND WOES

"The lender's dividend, cut to a 50% payout, may need to change again if fines approach $1 billion."

– Philip Richards, Senior Bank Analyst at Bloomberg Intelligence[79]

On 17 July 2019, Swedbank revealed to the Stockholm Exchange it will no longer be able to accomplish its goal of maintaining the "highest dividend ratio within the Nordic finance industry."[80] The ongoing money laundering scandal culminated in Swedbank finishing last in terms of stock performance in 2019. Up till now, Swedbank had aimed to pay out 75% of its profits to shareholders. However, in light of the ongoing investigations, it was forced to adjust its pay-out downwards to just 50% of profits.[81]

Philip Richards and Georgi Gunchev, bank analysts of Bloomberg Intelligence, commented that the reduction of dividend pay-out to 50% is a practical and needed move as Swedbank strives to strengthen "its capital buffer of just over US$1 billion compared to the 14.6% CET1 requirement."[82]

On 28 October 2019, new allegations were directed at Swedbank, accusing it of contravening European Union (EU) sanctions. Barely a day later, Sweden's financial watchdog, the Financial Supervisory Authority (FSA), announced that its findings up till then suggested that sanctions could be imposed on Swedbank. Under Swedish law, fines of "up to 10% of a bank's total annual income" could be imposed.[83]

Bloomberg Intelligence also weighed in, commenting that Swedbank is vulnerable to money-laundering fines due to a new Swedish FSA sanction case and Swedbank's tight capital buffer which is "US$800 million over the regulatory minimum."[84]

POTENTIAL FINES

Anders Karlsson, the acting CEO, remarked that Swedbank's new dividend policy reflected the circumstances of the bank being "in a very special situation" which required it to have a "safety buffer."[85] Furthermore, he stated that it was too early to say how the bank should prepare for the possibility of a money laundering fine.[86]

In an interview with Bloomberg Television, Karlsson was quoted as saying "If there is a fine, when there is a fine, we will pay that fine, and exactly how that will pan out, it is still too early to say," and "I think it is important to build a safety buffer, in the environment we are in."[87]

STEPPING ON TOES: UNITED STATES

Swedbank admitted to Swedish and Estonian regulators that it still has "shortcomings" in its anti-money laundering work and facing multiple inquiries by US regulators.[88]

Any action by the US authorities, such as the Department of Justice or the Securities and Exchange Commission, is a major concern for investors because the magnitude of potential US sanctions could dwarf those from Swedish watchdogs and even compromise Swedbank's ability to transact in the US dollar.[89]

The cornerstone US criminal money laundering statutes are 18 USC sections 1956-1957, along with other federal criminal statutes. 18 USC section 1956 outlaws international money laundering (1956(a)(2)): "moving money into or outside of the US with the intent to promote an SUA, or with the intent to conceal a money laundering offence or avoid reporting requirements knowing that the funds are proceeds of an SUA."[90]

GUARDIANS OF THE SWEDES: CORPORATE GOVERNANCE IN SWEDEN AND SWEDBANK

Corporate governance in Sweden has been a model for other countries to emulate, with the first official Swedish Code of Corporate Governance issued in 2005. It is widely known for its practice of giving investors a large say in the oversight of companies through its novel nominating committee, which has been praised for promoting stability and a focus on the long-term.[91] According to an annual survey by the Reputation Institute in 2018, Sweden emerged top as the most reputable and trustworthy country.[92] The survey results further showed that Sweden has a "high standard of living" and "a strong sense of business."[93]

Despite being ranked as the fourth most transparent country in the world by U.S. News,[94] a string of corporate scandals has rocked the financial markets and undermined Sweden's credibility as an ethical and virtuous country. Companies such as Swedish pulp and paper manufacturer Svenska Cellulosa AB (SCA) have been decimated in the wake of such scandals, raising questions regarding the effectiveness of the Swedish system of corporate governance. In the case of Swedbank, several top executives of the company, including CEO Bonnesen and Estonia Chief Executive Robert Kitt were fired as a result of the money laundering scandal.[95] This scandal sent shockwaves across the Swedish community.[96]

Under Sweden's unique nominating committee system, investors decide on the composition of the board through electing members into the nominating committee during the Annual General Meeting.[97] Shareholders 'sit' in the nominating committee and have the right to choose its directors and auditor each year.[98] In Swedbank's case, the nominating committee comprised of at most six members including the Chair of the Board and representatives of the five largest shareholders.[99] This is in contrast to the system of nomination in other countries such as the US and UK, where nominations are made by the directors themselves. In these countries, shareholders have limited ability to influence these nominations.[100]

Shareholders in Sweden play an active role in the strategic decisions of companies, helping to shake up the board structure when necessary. The participation of the five largest shareholders in the nominating committee limits the issues of over-concentration of power and lowers the risks of short-termism. Apart from the scrutiny of shareholders, the Board is also heavily subjected to media scrutiny.[101] Sweden has done well out of having robust media scrutiny, which has helped to shine the light on corporate scandals and abuses. Armed with ample information and the ability to act, shareholders have spared executives no mercy.[102]

GUARDIANS OF SWEDBANK AB

Swedbank has a corporate governance framework which laid the foundation of the company structure. It serves as a guideline for the board to follow when deciding the direction of the company.[103] The three key principles when determining the company structure comprise of board oversight, group level executive management oversight and business level executive management monitoring and oversight.[104]

Swedbank AB elects its board of directors annually through an annual general meeting (AGM), where each director is re-elected every year.[105] The Board is tasked with the responsibility of running Swedbank's affairs in the interests of the company and shareholders. In addition, the board places emphasis on the interests of its customers and sound risk-taking to guarantee the bank's continued survival and instil stakeholder confidence.[106] The roles of the Board include the establishment of financial goals and strategies; the appointment, dismissal and evaluation of the CEO; providing the assurance that competent systems are in place to monitor and control operations; ensuring compliance with the laws and regulations; and ensuring the accuracy and transparency of the information released.[107]

GUARDIANS OF SWEDBANK ESTONIA

Swedbank Estonia has a Supervisory Board which is separate from its Board of Directors It consists of between five to 12 members appointed by Swedbank AB,[108] and do not receive remuneration from the company. The primary purpose of the Supervisory Board is to provide oversight and assist in the company direction, through decision making and evaluation relating to operations, as well as to delegate and monitor the Board of Directors.[109] Strategic issues also require the approval of the Supervisory Board.[110]

The Supervisory Board works hand in hand with the Board of Directors, by helping ensure that the consolidated financial statements are accurate before they are provided to shareholders.[111] Swedbank Estonia adopted the Enterprise Risk Management (ERM) policy which aids in the bank's risk management efforts, detailing the framework, process and duties.[112] The proposal and approval of a remuneration policy is also based on an analysis of potential risks that could occur in the bank.[113]

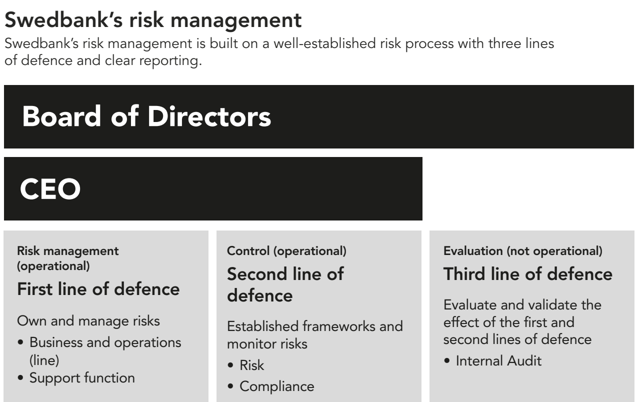
The Board of Directors comprises of six to 12 members, and the members are elected by the Supervisory Board for a term of three years.[114] The Board of Directors focuses on operations and ensures compliance to rules and regulations.[115] The directors' remuneration is based on variable pay following the "Performance and Share based Remuneration Program."[116]

WHAT WERE THE SIRENS IN PLACE?

Swedbank's risk management framework is built upon a three lines of defence model as shown in Figure 3 below.

Its first line of defence focuses on risk management by business operations whereby individual business units are expected to manage their own risks. The second line of defence relates to its risk and compliance-related functions.[117] Swedbank has its own separate compliance function led by the Chief Compliance Officer who is directly accountable to the Chief Executive Officer. Under its third line of defence, the Internal Audit function evaluates the risk management, governance and internal controls of the company. The Internal Audit function reports directly to the Board.[118]

Figure 3: Swedbank's Three Lines of Defence Model[119]



However, doubt was cast on the robustness of Swedbank's three lines of defence and risk management policies. In the midst of the money laundering scandal, Swedbank admitted to the inadequacy of its risk assessment practices in both Sweden and Estonia.[120] It also admitted to the blurring of responsibilities within the bank which resulted in the occasional non-compliance with its internal policies.[121] These admissions came after SVT released incriminating evidence that over US$135 billion in risky money moved through Swedbank's Estonian branch for over a decade undetected.[122]

UNITED THEY FELL: DISMISSAL OF ESTONIA EXECUTIVES

On 30 September 2019, amidst the ongoing probe into the money laundering scandal, three top executives at the Estonian branch of Swedbank were simultaneously fired. They were Robert Kitt, Chief Executive Officer; Vaiko Tammevali, Chief Financial Officer; and Kaie Metsla, head of Swedbank Estonia Private Customer Division. According to Bjoern Elfstrand, council chair of Swedbank Estonia, the resolution to remove these executives was based on "information concerning historical shortcomings connected to anti-money laundering work."[123]

Following the dismissal of these executives, Swedbank Estonia appointed Olavi Lepp to lead the Estonian business and Anna Kouts as the new Chief Financial Officer, alongside Tarmo Ulla as the new head of the Private Customer Division.[124]

The money laundering scandal greatly impacted Swedbank. The company also had to deal with the fall in share price, reduction in dividend pay-out, potential fines and contravention of US money laundering law.

SILVER LINING OR THE START OF A PERFECT STORM?

"The investigation is like a cloud hanging over Swedbank, so the sooner the FSA reaches a decision, the better."

– Joakim Bornold, a savings adviser at Soderberg & Partners in Stockholm[125]

On 23 October 2019, Jens Henriksson made the decision that his top priority would be to ameliorate the "dark cloud" of money laundering allegations. Furthermore, he repudiated claims that investigations by US and European authorities were an "existential threat" for Swedbank.[126]

With the aid of law firm Clifford Chance and forensic accountants, Swedbank proceeded to commence 132 initiatives to bolster its ability to combat financial crime and aimed to complete about 70 of them by the end of 2019.[127] Swedbank's internal investigation would be expected to set it back by approximately €93 million (US$102.3 million). The findings are expected in early 2020.[128]

Barely a week later, on 30 October 2019, Swedbank ran into a heightened risk of fines following allegations of having handled more than US$100 billion in possibly dubious funds. "Sweden's financial watchdog gave its strongest indication yet that there is evidence of serious wrongdoing" in Swedbank.[129]

The Swedish FSA aimed to announce its findings in the beginning of 2020. A fine would be issued if investigations concluded Swedbank contravened the law with respect to money laundering prevention.[130] Will this once prestigious bank will be able to successfully make a comeback and once again become Sweden's most reliable bank?

Only time will tell.

DISCUSSION QUESTIONS

1. With reference to the case, discuss the importance of corporate culture and the tone at the top. Comment on Swedbank's actions in response to the money laundering scandal and provide recommendations moving forward.
2. Birgitte Bonnesen was highly regarded as the second most powerful woman in the Swedish business sector. Evaluate the conflict that a company might face between a CEO's competency and her integrity.
3. Given the high transaction volume that banks handle daily, how may they mitigate the risks associated with money laundering using the different lines of defence? Suggest potential improvements for Swedbank.
4. Under the Swedish system of corporate governance, the five largest shareholders have the option of electing a representative each to sit on the nominating committee, along with the head. Evaluate the pros and cons of such an arrangement in improving corporate governance and how it can protect the interests of shareholders.
5. With reference to Swedbank, what are some of the risks when companies venture abroad? Explain your answer and discuss the other aspects that companies have to consider in risk assessment.
6. Who were the key players in the money laundering scandal at Swedbank? Evaluate the role of the media and shareholders in promoting good corporate governance and whether measures implemented by Swedbank are sufficient.

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BRIBERY

JP MORGAN: PRINCE UN-CHARMING

CASE OVERVIEW

JP Morgan China was not getting the deals as it would have liked. It believed that other banks were able to secure deals because they were hiring their potential clients' children. JP Morgan therefore allegedly followed suit by hiring several sons and daughters of officials in Chinese state-owned companies, commonly referred to as princelings. The connections from the princelings apparently started to help JP Morgan gain deals just like its competitors.

However, the good times did not last. JP Morgan was investigated by the United States Securities and Exchange Commission (SEC) under the Foreign Corrupt Practices Act (FCPA). As a result, it dropped out of two billion-dollar Initial Public Offering (IPO) deals. The objective of this case is to explore issues such as ethics and tone at the top; role of the board in ensuring the appropriate culture in a company; effectiveness of codes of conduct and whistleblowing policies; and the fine line between bribery and "guanxi" in China.

COURTING ROYALTY

"You all know I have always been a big believer of the Sons and Daughters programme – it almost has a linear relationship with winning jobs to advise Chinese companies."

– Fang Fang, former Chief of investment banking, JP Morgan China[1]

It was the loss of a key deal to Deutsche Bank (DB) in 2009 that started it all. When Wall Street suffered during the global financial crisis, JP Morgan China was urged to push up earnings. "We lost a deal to DB today because they got chairman's daughter work for them this summer," [2] a fellow executive from investment banking had remarked via email. The replies followed: "I am supportive to have our own hiring strategy"; "We do way, way, way too little of this type of hiring and I have been pounding on it with China team for a year"; "Confidential, just added son of #2 at SinoTruk to my team".[3] Even though none of the executives themselves have been implicated or accused of any wrongdoing yet, the carefully detailed spreadsheets specifying appointments of these sons and daughters of prominent people and their resulting effects had been found.[4]

Investigations were ongoing, and it was going to be tough.

In November 2013, JP Morgan withdrew as an underwriter for a share sale by China Everbright Bank. The IPO eventually launched in December amounted to US$3 billion. In January 2014, it also withdrew from a US$1 billion IPO for Tianhe Chemicals. In March, amidst investigations, Fang Fang, the Chief Executive for investment banking in JP Morgan China, retired. Two months later, he was arrested.[5]

ABOUT JP MORGAN

JP Morgan Chase and Co, headquartered in New York City, traces its roots back to 1799. In 2000, JP Morgan merged with The Chase Manhattan Corporation and was renamed JP Morgan Chase and Co[6]. The key areas of business include investment banking, markets and investor services, treasury services, investment management, private banking, wealth management and brokerage, as well as commercial banking.[7]

The company serves clients in 100 locations, including the Americas, Asia Pacific, Europe, Middle East and Africa. In 2011, the firm celebrated the 90th anniversary of its presence in China,[8] where it has offices in Beijing, Shanghai, Tianjin, Guangzhou, Chengdu, Harbin, Suzhou, Shenzhen and Zhongshan, which serves corporations, financial institutions and government agencies.[9]

KINGDOM RULES

JP Morgan's Code of Conduct is given to all new employees and has a section addressing anti-bribery and anti-corruption. Employees are not allowed to "give, offer or promise (directly or through others) anything of value to anyone, including government officials, clients, suppliers or other business partners, if it is intended or appears intended to obtain some improper business advantage." [10]

Employees are also required to report any known or suspected violations of the Code and this was specified as the responsibility of all employees. Each employee would be assigned a Code Specialist from the Compliance or Legal Department, to answer questions on the Code.[11]

This is the abridged version of a case prepared by Chua Zi Hui Grace, See Xiaowei, Sng Jing Kai and Trina Ling Tzi Chi under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lim Hui Ying under the supervision of Professor Mak Yuen Teen.

THE CHOSEN ONES

The Sons and Daughters Programme was started in 2006 to weed out nepotism and avoid bribery charges in the United States[12]. The two-tiered process was originally meant to prevent the controversial hiring of the sons and daughters of senior officials in the Chinese Communist Party and executives in state-owned enterprises, so-called "princelings".[13] This was done by separating them in the recruitment process. However, the programme ended up fostering the very results it was intended to prevent, with these candidates allegedly facing fewer interviews and sub-par standards.[14]

YOU SCRATCH MY BACK, I'LL SCRATCH YOURS

Such hiring practices were triggered[15] by the loss of the deal to DB, when JP Morgan apparently realised[16] that others in China secured deals through the hiring of princelings.[17]

The concept of exchanging favours is deeply etched in China's culture. Big banks often hire sons and daughters of senior Chinese government officials in the hope of creating opportunities and securing deals.[18] Relationships or networking, also known as "guanxi", is a fundamental concept to grasp if one wishes to operate effectively in the Chinese economy.[19] With the right "guanxi", businesses are able to overcome obstacles and gain new opportunities. Often, it is the power of networking that will determine a company's long run competitiveness in China.

One of the banks which demonstrated the concept of "guanxi" in the hiring of employees was Morgan Stanley. The bank hired Zhang Nan, the son of Zhang Dongsheng, an official of China's powerful economic planning agency National Development and Reform Commission. A list of other princelings allegedly hired by Morgan Stanley was also circulated in the Chinese social media. Some of those included in the list are the son of Xiao Tian, deputy head of China's sports bureau, and the son of Xie Xuren, China's former finance minister and current chairman of the National Council for Social Security Fund.[20]

ERA OF THE PRINCELINGS

The loss of the deal to DB dealt JP Morgan a huge blow. In order to prevent history from repeating itself, JP Morgan allegedly followed suit and stepped up its hiring[21] of the sons and daughters of the elites. This ironically achieved what its initial Sons and Daughters Programme had in fact hoped to prevent. JP Morgan executives in Hong Kong studied the hiring movement of established banks in China and decided to hire Tang Xiaoning, the son of the chairman of China Everbright Group. As such, JP Morgan successfully secured deals which had not previously been possible since 2010.[22]

The company continued the streak by engaging Fullmark Consultants, which was owned by the well-connected Lily Chang, the daughter of Wen Jiabao, who was China's Premier at that time. The engagement helped JP Morgan to clinch deals with state-owned Chinese companies during Wen Jiabao's premiership.[23] JP Morgan also hired Zhang Xixi, the daughter of an official of China Railway Group who was later arrested on charges of bribery. She was hired around the time when China Railway Group's IPO was facilitated by JP Morgan.[24]

Tang Xiaoning and Zhang Xixi have since left JP Morgan.[25]

CLAMPING DOWN ON THE GIANTS

It is uncommon for the American authorities to scrutinise hiring practices of banks and such practices have been left relatively unchecked until recently.[26] In August 2013, SEC began its investigations into JP Morgan's hiring practices in China. JP Morgan was suspected to be involved in the bribery of foreign officials. In exchange for hiring their children, JP Morgan allegedly gained lucrative businesses which were influenced by the officials. The FCPA prohibits U.S. companies from giving "anything of value" to a foreign official to win "an improper advantage" in retaining or attracting business[27] and such hiring practices would be a clear breach of the Act.

Despite the relatively low monetary value of the salaries paid, the princelings value jobs in banks as it improves and adds credibility to their resumes.[28]

WALKING A FINE LINE

What made the SEC suspicious was the fact that the hiring of princelings was usually accompanied by large deals from princelings-related companies which the bank never had much dealing with.[29] For instance, the emergence of China Everbright as one of JP Morgan's prized Asian clients coincided with the time that Tang Xiaoning was hired by JP Morgan. Similarly for Zhang Xixi, JP Morgan clinched the IPO for China Railway Group around the period she was hired.

SEC questioned JP Morgan about their hiring of personnel related to these two companies. In May 2013, SEC's anti-bribery unit asked JP Morgan for documents related to Tang Xiaoning. They also requested for "documents sufficient to identify all persons involved"[30] in the decision to hire Zhang Xixi. Aside from these two persons of interest, SEC also inquired about "all JP Morgan employees who performed work for or on behalf of the Ministry of Railways" over the previous six years, which hinted that the investigations were targeted at the broad hiring strategies of JP Morgan's China office.[31]

In addition to the investigation, JP Morgan's Sons and Daughters Programme was hit by whistleblowers as it was not popular among some of the employees. In December 2011, a junior banker from JP Morgan in Hong Kong resigned with an email commenting, "I do not think my family is in a position to help you to the extent as others did; bring their family business to the firm."[32] Furthermore, at least two whistleblowers reported to the Hong Kong stock exchange and the U.S. authorities with regards to JP Morgan's hiring practices.[33]

CROSSING THE LINE

The investigations uncovered a series of emails and confidential documents which seemed to link JP Morgan's business opportunities directly to the hiring of these well-connected employees. The documents showed how JP Morgan referred to the hiring practices of other banks in China.[34] Spreadsheets listing JP Morgan's history of converting hires into business deals were submitted to the authorities. The spreadsheets also revealed how the Sons and Daughters Programme, which was originally meant to be a preventive measure against unethical hiring, eventually became a means of doing businesses with state-owned companies in China through the hiring of princelings.[35]

JP Morgan executives in New York were alerted by a bank official in Asia with regards to anonymous accusations about the bank hiring for the purpose of winning investment banking assignments. Email discussions showed that the executives dismissed those accusations and continued to propose revisions to the region's hiring practices which were in favour of the hiring of princelings.[36]

DOMINO EFFECT

Following JP Morgan, SEC ramped up the scale of the investigations and issued letters of inquiry regarding hiring in China to several other major banks, including Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs and Morgan Stanley.[37] The scope of the investigation expanded to non-U.S.-headquartered firms and the hiring practices in the rest of Asia.

FIFTY SHADES OF GREY

However, SEC has yet to accuse any banks, including JP Morgan, or executives of any wrongdoing. Legal analysts commented that such unethical practices have flourished in the banking industry partly due to the difficulty in pinpointing wrongdoings. Banking is a relationship business, and being well-connected is a big advantage to an individual vying for a position in the top banks. Furthermore, many of the princelings who are employed by the major banks are highly educated and hold degrees and MBAs from top universities around the world.[38] It is therefore seen to be reasonable for the banks to hire these individuals who, on top of their academic capabilities, can build on their existing relationships to bring in big contracts.

TAINTED AND BRUISED

JP Morgan would face substantial legal costs if SEC decides to take enforcement actions against them. Together with other charges and investigations such as the Madoff Ponzi fraud and the 'London Whale' case, the princelings investigation may further tarnish JP Morgan's reputation.[39]

JP Morgan's stock price fell by 2.7% when the investigation on JP Morgan was publicly announced on 17 August 2013. When the company withdrew from China Everbright Bank's IPO in November 2013, its stock price fell by 0.08%. There was another fall of 5.3% when the IPO with Tianhe Chemicals was dropped. The stock price fell by a further 1.9% when Fang Fang retired in March 2014.[40]

However, as the timing of this investigation coincides with the prosecution of Madoff Ponzi fraud and 'London Whale' cases, the impact on the stock price that was directly related to the princelings issue was unclear.

TOO BIG TO REGULATE?

Some economists have commented that banks like JP Morgan are too large to be regulated.[41] The frequency of significant legal cases involving JP Morgan raises questions about JP Morgan's ethical culture. Although the authorities have had some success in acting against unethical or illegal activities and taking enforcement actions against banks, financial analysts have questioned the effectiveness of the legal enforcements on large banks. This is because while the effectiveness of fines is questionable,[42] restrictions on businesses might upset the financial markets to a large extent[43].

END OF THE MONARCHY

On 29 May 2015, JP Morgan was subpoenaed by SEC for all of the company's communications related to 35 Chinese government officials.[44] Together with the departure of the Vice Chairmen Todd Marin and Catherine Leung, JP Morgan announced a wider reshuffle of senior roles.[45] Even if JP Morgan was found innocent of hiring princelings to secure contracts, the damage done to its reputation would remain. Such hiring practices remains prevalent in other American and European investment banks, such as Bank of America, Citigroup, Credit Suisse, Goldman Sachs and Macquarie. All of these banks have hired relatives of high-ranking Chinese officials over the years to secure deals in China. A thorough investigation would inevitably affect more companies both within and outside the financial sector.[46]

In 2016, JP Morgan agreed to pay US$264 million to settle the charges relating to the "princelings" bribery scheme.[47]

In recent years, the authorities in China seem to have stepped up on their stand against corruption and bribery.[48] The tide may have turned for doing business as the world moves towards a more transparent and fair society.

DISCUSSION QUESTIONS

1. To what extent should the Board of Directors be responsible for the corporate culture of a company?
2. What do you think is the "tone at the top" for JP Morgan? How did this affect the decision to hire princelings?
3. What do you think JP Morgan (New York headquarters) could have done to prevent the abuse of the "Sons and Daughters" programme?
4. JP Morgan's main defence is that 'every other bank is doing it' and that the princelings are well qualified as well. Do you think this justifies the hiring practices adopted? Explain this using both a legal and ethical perspective.
5. Some economists are of the view that the Wall Street banks are getting "too big to regulate". Discuss whether or not you support this view, taking into account the role and powers of the SEC and other regulators.
6. JP Morgan's Code of Conduct specifically prohibits bribery and corruption. How effective is it in preventing such acts? Whistleblowing arrangements are increasingly seen to be an important component of the corporate governance framework of an organisation. To what extent does having a whistleblowing policy help to mitigate such acts?

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GOLDMAN SACHS: HUNGRY LIKE A WOLF

CASE OVERVIEW

In July 2015, news broke regarding the embezzlement of money from Malaysia's sovereign wealth fund, 1Malaysia Development Berhad (1MDB) with the then Prime Minister, Najib Razak, accused of siphoning off up to US$700 million into his personal bank accounts. Since then, many countries have launched investigations into 1MDB-related fund flows across borders. These led to Goldman Sachs, a United States-based multinational investment bank and financial services firm, being thrust into the spotlight for its bond dealings with 1MDB. As the appointed bank for 1MDB's three bond offerings, Goldman Sachs helped raise a total of US$6.5 billion for the state-owned sovereign wealth fund. Further probes revealed that US$600 million was paid as fees to Goldman Sachs.

On 1 November 2018, the United States Department of Justice (DoJ) announced charges against three key players in the fraud - Tim Leissner, Roger Ng and Jho Low. Authorities from other countries such as Malaysia and Singapore also took action. The objective of this case is to facilitate discussion of issues such as corporate culture, risk management, internal controls, director duties, remuneration, and the role of regulators and banks in cross-border deals.

THE GOLD(MAN) STRATEGY

Founded in 1869, Goldman Sachs (Goldman) is one of the leading global investment banking, securities and investment management firms and provides a wide variety of financial services to individuals, companies, financial institutions and governments.[1] Headquartered in New York, it has a global presence in more than 30 countries with offices in all the major financial centres.

Goldman's business strategy, said the former Chief Executive Officer (CEO) Lloyd Blankfein, is "chasing GDP around the world."[2] It was his commitment to this that led him to a meeting with Malaysia's then prime minister, Najib Razak, in late 2009.[3] The meeting, held in a New York hotel, was arranged and attended by Goldman's former employee, Tim Leissner, and Malaysian businessman Jho Low. This gathering marked the start of Goldman's expansion into Malaysia. The Securities Commission in Malaysia announced the approval of Goldman's fund management and corporate finance license advisory operations in the country shortly after, in December 2009.[4]

A few years later, Goldman proceeded to raise a total of US$6.5 billion for the state's sovereign wealth fund, 1Malaysia Development Berhad (1MDB).[5] However, misdeeds underlying these transactions were subsequently unveiled, embroiling the firm in a mess of regulatory investigations.

BOARD AND COMMITTEES

As at 26 March 2013, the Board of Directors (BOD) comprised 13 directors, with 10 independent directors and three executive directors, namely Blankfein (CEO), Gary D. Cohn (President & Chief Operating Officer (COO)) and David A.Viniar (Chief Financial Officer (CFO)).[6] The board was chaired by Blankfein and had a lead independent director, James J. Schiro.

The board comprised directors from diverse backgrounds, with directors from different countries, including United States, Europe and Africa. One of the directors, Adebayo O. Ogunlesi, was a Nigerian lawyer and investment banker with experience in international business. He was the chair and managing partner of Global Infrastructure Partners and was 60 years old.[7]

Another director, 50-year-old Debora L. Spar completed her education at Harvard University, and later became the President of Barnard College (Barnard) in Columbia University. Blankfein's wife, Laura, is a Barnard College alumna and is listed as a member of the board of trustees at Barnard. The Lloyd & Laura Blankfein Foundation donated US$50,000 and US$25,000 to Barnard for fiscal years ended 31 January, 2010 and 2009 respectively. In response to queries, Gregory Brown, Barnard's Chief Operating Officer, claimed that Barnard does not receive any direct funding from Goldman but it does receive contributions from its employees.[8]

Stephen Friedman (Friedman), the Chairman of Stone Point Capital, was the oldest director on the board, at 76 years old. He was also a Class C director at the New York Federal Reserve Board (Fed). Being among those who were assigned to represent the public interest in the Fed, he played more of a supervisory role over Goldman.[9] In 2009, he began boosting his holdings of the Goldman

This case written by Cheok Sin Ping, Chua Jia Yi, Loh Zhi Yan and Than Jia Hui under the supervision of Professor Mak Yuen Teen and Professor Richard Tan. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This case was edited by Vidhi Killa under the supervision of Professor Mak Yuen Teen.

stock without checking with the Fed. He bought 37,300 shares on December 17, 2008 and a further 15,300 shares on January 22, 2009, raising a total of around five million dollars in volume. The Federal Reserve Act bars directors representing the public interest from owning bank stocks or being bank directors or officers.[10] These rules created a controversy involving the ethicality of Friedman's actions. While Friedman was lambasted by the Fed and other colleagues, Blankfein believed that "there was nothing in the slightest way wrong or untoward about his actions". [11]

The board also included Indian businessman, Lakshmi N. Mittal (Mittal), aged 63. Based in the United Kingdom, he became Chairman and CEO of the world's largest steelmaking company, ArcelorMittal S.A. However, his appointment was questioned given his non-financial background. Blankfein defended the decision to place an industrialist on the board, saying that Mittal had "reshaped a global industry" and "sparked remarkable growth" in the economy. He added that Mittal's "experience, judgment and independent thinking" were important to Goldman's board, and would be of "tremendous value" to all their shareholders and their clients.[12]

Other directors included:

– 65 year-old Claes Dahlbäck, a Swedish businessman, senior adviser to Investor AB and Foundation Asset Management, and a graduate of the Stockholm School of Economics;

– James A. Johnson, 70, a United States Democratic Party figure, who was the former CEO of Fannie Mae and the Former Vice Chairman of Perseus, L.L.C.;

– M. Michele Burns, 56, who was the CEO of the Retirement Policy Center and Mercer;

– 71-year-old William W. George, Professor of Management Practice at Harvard Business School; and

– Mark E. Tucker, 57, Executive Director, Group Chief Executive Officer and President of AIA Group Limited.[13]

There were four board committees covering audit, risk, compensation and corporate governance/nominating, all comprising solely of independent directors. The Audit Committee (AC) which comprised of professionals with an extensive range of audit and industry experience, was responsible for independently assessing and validating key controls within the risk management framework.[14]

The Corporate Governance and Nominating Committee (Governance Committee) at Goldman was responsible for talent development, recruitment and board succession planning. It recommended individuals for nomination and appointment to the board and its committees as it deemed fit. It reviewed the succession plans of the senior managers and directors of the company. The committee was also responsible for board evaluation, upholding governance and ethical standards, and reviewing board compensation, among other things. [15] It was also to ensure diverse demographics on the company board by considering race, ethnicity, nationality, gender, culture and other factors, to inculcate healthy and diverse viewpoints within the board.

The Risk Committee (RC) was responsible for the board's oversight and review of the company's risk management process and control framework.[16] It conducted regular reviews and held discussions with management regarding the aggregate risk exposures relating to areas such as market risk, credit risk and operational risk. During the review of risk, there will be frequent interactions between the RC, the CFO, the General Counsel, the Chief Risk Officer (CRO) and other key risk management executives. The CRO was tasked to advise the RC of relevant risk metrics and material exposures which will be communicated to the board as part of the firmwide risk.[17]

The overlap in membership between the Compensation Committee (CC) and RC allows the CC to recognise the significance of having compensation programs that are consistent with the safety and soundness of the firm. Firmwide compensation policies were frequently reviewed, taking into consideration the firm's risk appetite to ensure that it does not impact the firm adversely and materially.[18]

RISK MANAGEMENT

The risk management process was governed by a comprehensive framework revolving around three core components: governance, processes and people. The framework was applied to monitor, evaluate and manage the risks assumed by Goldman in conducting the activities which included market, credit, liquidity, operational, legal, regulatory and reputational risks.[19]

The risk management process involved various functions such as the revenue-producing units, independent control and support functions, risk-related committees and senior management. In order to foster a strong oversight structure with appropriate segregation of duties, the company adopted a comprehensive framework involving multi-layered supervision and dedicated extensive resources to independent control and support functions.[20]

With the numerous risk committees in place, the Management Committee (MC) was responsible for overseeing the global activities of the firm as well as all the independent control and support functions. Directly under the MC, the Firmwide Client and Business Standards Committee (FCBSC) and Firmwide Risk Committee (FRC) were established with two and four subcommittees respectively. The FCBSC was responsible for assessing and making determinations regarding business standards and practices, reputational risk management, client relationships and client service. The FRC handled the monitoring and control of firm's financial risks through approving risk limits and reviewing results of stress tests and scenario analysis. Under the FCBSC and FRC, the Firmwide Capital Committee (FCC) was established with the aim to safeguard business and reputational standards for underwritings and capital commitments on a global basis. The FCC's main responsibilities were in providing approval and oversight of debt-related transactions as well as principal commitments of the firm's capital.[21]

Under the independent control and support functions of the risk management framework, 11 subcommittees were established: Compliance, Controllers, Credit Risk Management, Human Capital Management, Legal, Market Risk Management, Operations, Operational Risk Management, Tax, Technology and Treasury.

COMPLIANCE AND LEGAL FUNCTIONS

The Compliance and Legal functions, which were part of the independent control and support function, played an important role in the 1MDB scandal. The key responsibilities of the compliance function were managing and overseeing the compliance policies and internal accounting controls of Goldman, while the legal function was responsible for conducting due diligence and analysing the impact of potential clients' reputational risk on Goldman. The legal function was also in charge of conducting investigations and probing inquiries related to fraud, corruption, sanctions and money laundering.

For the implementation of projects, lawyers and internal and external auditors were engaged to conduct due diligence on investment banking, through reviewing public records and performing additional screening. Potential or actual risks identified were raised to senior management and various committees to mitigate the same. These reviews and the approval process by the compliance and legal functions ensured that business, suitability and reputational standards were maintained as required and transactions were executed in accordance with management's authorisation.[22]

OPERATIONAL RISK MANAGEMENT

The Operational Risk Management (ORM) function was mainly responsible for developing and implementing policies, methodologies and a formalised framework for operational risk management so as to minimise Goldman's exposure to operational risk. A combination of top-down and bottom-up approach was implemented to manage and measure operational risks on a day-to-day basis. For example, senior management was required to assess the operational risk profile while the revenue-producing units, independent control and support functions were responsible for identifying, mitigating and escalating operational risks to the appropriate personnel. The operational risk framework, subjected to annual review by the internal audit function, comprised of three main practices: risk identification and reporting, risk measurements and risk monitoring.[23]

Under risk identification and reporting of operational risk events, a comprehensive data collection process with firmwide policies and procedures was adopted. Established policies were present which required risk events to be documented, analysed and escalated so as to determine if changes were necessary in the firm's systems or processes to prevent any recurrence. Additionally, Goldman implemented firmwide systems that allowed management to capture internal operational risk event data, key metrics and statistical information. The data was used to evaluate operational risk exposures and identify businesses, activities and products with higher operational risks.[24]

Under risk measurement, Goldman adopted statistical modelling and scenario analysis to measure the firm's operational risk exposure over a 12 months' time horizon. Both qualitative and quantitative factors were incorporated into the assessment such as internal and external operational risk event data, evaluation of the complexity of the firm's business activities and the legal and regulatory environment. Results from the analysis were utilized to monitor changes in operational risks as well as identify business lines that may have heightened exposure to operational risk. Ultimately, the results were used to determine the appropriate level of operational risk capital to hold.[25]

Under risk monitoring, changes in operational risk profile of the firm and its businesses, which included changes in business mix or jurisdictions that the firm operates in, were evaluated by the ORM function at the firmwide level. Both, detective and preventive internal controls, were in place to reduce the frequency and severity of operational risk losses as well as the probability of operational risk events.[26]

THE GENESIS OF 1MDB

"We cannot have an egalitarian society - it's impossible to have an egalitarian society," "But certainly we can achieve a more equitable society."[27]

-Najib Razak, Former Prime Minister of Malaysia

1MDB is a state investment fund which Najib Razak (Najib) launched in July 2009 shortly after becoming Malaysia's Prime Minister. The aim of the fund was to resuscitate Malaysia's economy through investing in green energy and tourism via issuance of various debt securities. However, it was discovered that multiple key figures including public officials and associates allegedly formed a conspiracy in fraudulently siphoning off billions of dollars from 1MDB from 2009 to 2015. The funds were transferred illegally through banks and foreign wire communications. The funds were then used for personal purposes, by co-conspirators, their relatives and associates, including the purchase of artwork worth more than US$200 million, luxury real estate in the U.S. and other countries, lavish gifts for family and friends, and even funding the production of major Hollywood films.[28]

GOLDMAN STEPS IN

"That's a bit too cozy, a bit too overly generous. Goldman was one of the few firms, in fact the only firm, that could provide the solution that was required."[29]

-Arul Kanda, Former 1MDB President

In 2012, Goldman provided services for the acquisition of Tanjong Energy Holdings from Malaysian billionaire Ananda Krishnan, and domestic power plants from Genting Berhad (Genting). These acquisitions were financed by two separate bond offerings in 2012 worth US$3.5 billion.[30]

The bonds were guaranteed by 1MDB and the International Petroleum Investment Company (IPIC), an investment fund wholly-owned by the government of Abu Dhabi. In 2013, 1MDB issued an additional US$3 billion in debt underwritten by Goldman to raise capital for new strategic economic initiatives with Abu Dhabi. These initiatives comprised of a financial centre built on 70 acres of prime Kuala Lumpur real estate. Goldman received US$600 million in fees for all the underwriting and arranging services. The bank's fees amounted to 7.7% of the face value of the securities, as compared to prevailing market rate of 1.32% in 2013 for comparable deals.[31]

THE GOLD DIGGERS

Tim Leissner, a German national, had worked for Goldman since 1998. He was the Southeast Asia Chairman under Goldman's Investment Banking Division.[32]

Low Taek Jho, also known as Jho Low, was a Malaysian national who acted as an adviser on the establishment of the Terengganu Investment Authority (TIA), which was later named as 1MDB. He worked as an intermediary for 1MDB and other foreign government officials on projects that involved Goldman but he did not hold any formal position in 1MDB.[33]

Ng Chong Hwa, also known as Roger Ng, another Malaysian national, was a former Goldman partner and the head of its Southeast Asia sales and trading department.[34]

Leissner, Ng and Low worked together to obtain business for Goldman. In January 2009, they discussed the engagement of Goldman in raising funds for Project Tiara, the predecessor of 1MDB. At that point in time, Low was the person-in-charge of Project Tiara and served as an adviser for the project. They used Low's connections with high-ranking officials to build the network. A meeting involving the Executive Director of 1MDB, Low and the two bankers for a potential partnership was set up by email in January 2009.[35]

In February 2009, the Malaysian municipality of Terengganu officially launched TIA for the purpose of investing and managing the municipality's public funds, with the support of Goldman. TIA issued Islamic medium-term notes valued at US$1,425,680,000 with Low and Leissner involved in these transactions. They kept their relationship confidential despite knowing that they were obligated to disclose it to Goldman. The Ministry of Finance (MOF) took over control of TIA for national expansion in July 2009 and it was renamed to 1MDB.[36]

In November 2009, there was speculation regarding Low's source of money, when he splurged in New York City Clubs. He was seen going to the city's most lavish night clubs in a fleet of black Cadillac SUVs. Despite the red flags, the two bankers still continued to work with him.[37]

Between May 2012 and March 2013, Goldman was appointed as the lead bank for three 1MDB bond offerings. Leissner was the lead banker on the deal teams and Ng was involved for the two bond offerings in 2012. Jasmine Loo Ai Swan, 1MDB's General Counsel and Executive Director of Group Strategy, was the main point of contact between 1MDB and Goldman for the bond offerings.[38]

PROJECT MAGNOLIA

1MDB approached Goldman for advice regarding the acquisition of a Malaysian energy company, Tanjong Energy Holdings Sdn Bhd (Tanjong Energy) in February 2012 and appointed Goldman as the sole bank to handle the US$1.75 billion debt financing. Within Goldman, the bond deal was named Project Magnolia. During the engagement on Project Magnolia, Leissner and Ng contacted each other via email and met up on at least two occasions during March 2012 to discuss the transactions. Low also arranged meetings for Leissner with high-ranking officials. Low allegedly mentioned that they needed to pay bribes to government officials in Malaysia and Abu Dhabi, including Najib, to gain their approval for part of the transactions.[39]

The deal team structured Project Magnolia as bond deals instead of other financing alternatives which could be cheaper for 1MDB. This is because bond deals could generate much higher commissions for Goldman and boost Goldman's reputation worldwide. They could also provide Leissner and Ng with additional remuneration and professional prestige.[40]

The offering circular for the bond, dated 18 May 2012 indicates that 1MDB Energy issued US$1.75 billion in privately-placed notes at an interest rate of 5.99% per annum, redeemable in 2022. The net proceeds were estimated to be approximately US$1.553 billion after the deduction of Goldman's fees and commissions. The offering circular also stated that US$810 million of the net proceeds from the bond issue were to be used to fund the acquisition of Tanjong Energy. The remaining of US$744 million was designated for "general corporate purposes", such as future acquisitions. On 21 May 2012, the bond deal was closed.[41]

In exchange for Goldman's services as the arranger and underwriter of the notes, Goldman received an arranger fee of one percent of the principal amount of the notes which was US$17.5 million as well as a commission of US$192.5 million. The total fees added up to around 11% of the principal amount of the bond and was directly deducted from the subscription proceeds of the bond. This resulted in lucrative year-end bonuses paid to Leissner and Ng as well as the other members in the deal team who were involved in obtaining and structuring the bond deal.[42]

PROJECT MAXIMUS

On 31 May 2012, Leissner informed Goldman about 1MDB's plan to purchase power assets from Genting and its intention to issue a second bond amounting to US$1.75 billion. This private placement bond transaction was named Project Maximus. 1MDB entered into an agreement with Genting for the acquisition of power assets on 13 August 2012. 1MDB had established a wholly-owned subsidiary known as 1MDB Energy (Langat) Limited (1MDB Energy Langat) to take possession of the power assets and issue debt securities to fund the acquisition.[43]

The offering circular for Project Maximus, dated 17 October 2012, stated that 1MDB issued US$1.75 billion in privately-placed notes, at an interest rate of 5.75% per annum, redeemable in 2022. The net proceeds of the bond sale were estimated at US$1.636 billion after taking into account Goldman's fees and commissions. It also disclosed that the net proceeds of the bond were to be used for 1MDB Energy Langat to fulfill its obligations under its contract with Genting, in relation to the acquisition of power assets. A total of US$692 million of the bond proceeds were meant for Genting acquisition and the balance were for general corporate purposes including future acquisitions. Both, Project Magnolia and Project Maximus, were guaranteed by 1MDB and IPIC in order to increase the credit rating and negotiate for better interest rates on the bonds.[44]

PROJECT CATALYZE

In November 2012, almost right after the closing of Project Maximus, Leissner and Low started to work on the next 1MDB bond deal. The latest bond transaction was called Project Catalyze within Goldman. On 13 March 2013, 1MDB entered into the joint venture with Abu Dhabi Malaysia Investment Company (ADMIC), with each holding 50%. The creation of ADMIC was meant for the strategic initiatives to be undertaken jointly by both, the Government of the Emirates of Abu Dhabi and the Government of Malaysia, for the growth of both countries. Both parties were to pump in a capital of US$3 billion each. Hence, 1MDB Global Investment Limited (1MDB Global), a wholly owned subsidiary of 1MDB, issued US$3 billion in bonds, dated 16 March 2013, at an interest rate of 4.4% per annum, redeemable in 2023. The net proceeds after deduction of Goldman's service and commission fees were US$2.716 billion. On 23 April 2013, 1MDB announced that the full amount of capital raised will be deployed for investments in strategic projects such as energy and real estate, which can significantly contribute to the long-term economic growth of both parties.[45]

Unfortunately, the truth is that the funds for all the projects were not used for legitimate business purposes and were diverted into different accounts in other countries.

STUMBLING BLOCKS

Between September 2009 and March 2011, Leissner and Ng made several attempts to make Low a formal client of Goldman, but were unsuccessful.

In September 2009, Leissner attempted to open a Private Wealth Management (PWM) account for Low with 1MDB's Swiss office. Compliance personnel, part of the independent control and support function in the risk management framework, reviewed his finances and raised doubts regarding his source of wealth highlighted by his lavish spending.[46]

During the period from January to March 2011, Leissner again suggested a transaction with Project Gold, a private equity firm controlled by Low. The legal team of Goldman expressed concern and a senior employee also opposed the transaction. In March 2011, Leissner referred Low for another PWM account with the Singapore office. After a background check was conducted by Europe, Middle East and Africa (EMEA) counterparts and the legal team, he was again rejected due to unfavourable information stemming from the suspicious source of his wealth. A compliance employee stated that they have zero appetite for a relationship with Low.[47]

Knowing that the Compliance and Legal departments have strong objections towards dealings with Low, the two bankers decided to conspire with Low without disclosure to certain personnel who would jeopardize their deals, as they believed that Low's connections with the government officials in Malaysia could bring about lucrative business deals to Goldman.[48]

GOING THROUGH THE BACKDOOR

"The due diligence functions at Goldman Sachs fell apart. If you're going to raise $6 billion for someone you better know everything there is to know about that someone."[49]

-Richard Bove, Analyst at Odeon Capital

Across the three bond offerings, Goldman conducted compliance reviews for all projects and it mostly involved the Compliance team questioning Leissner and the deal team regarding the involvement of Low in the transactions. Compliance personnel repeatedly enquired whether Low was involved and Leissner affirmed that he was not aware of his presence for the transactions. Firmwide Capital and Suitability Committees then approved the projects based on the information given to them.[50]

The revelation of the bribery and kickback scheme in late 2018 brought several internal control loopholes to the surface as authorities questioned the robustness of the firm's system in reviewing the approval for those illicit deals. In November 2018, Goldman's quarterly filings revealed that Leissner and Ng circumvented the firm's internal accounting controls, which are based on Foreign Corrupt Practices Act (FCPA)'s anti-bribery and internal accounting control provisions.[51]

The duo managed this feat by providing misleading information about Low's involvement to the control personnel and the internal committees reviewing the deal. In addition, it was alleged that at least one high-ranking executive in Goldman's Asian operations knew of the bribery, but the deal was able to successfully evade the bank's detection system.[52]

The findings from DoJ showed that the compliance and legal divisions of Goldman were willing to rely on the word of Leissner to dismiss the concerns they had in dealing with such an inexplicably affluent and politically connected individual, Low.[53] They failed to take any further actions to substantiate Leissner's words. In addition, the fact that they had repeated success in closing bond deals with 1MDB is partly attributed to the willingness of other colleagues to assist them to cover up Low's participation in the deals.

LACK OF BOARD APPROVAL

It was further discovered that Goldman proceeded with the issuance of at least one bond without gaining approval from the BOD of the bond guarantor, IPIC. Typically, board resolutions should be obtained for corporate actions involving any material transaction that entails considerable risks. In the case of US$1.75 billion raised in 2012, the funding was only approved by a senior IPIC official, Khadem Al Qubaisi. Goldman also relied on the close relationships between senior IPIC executives and a few key Malaysian government officials to evade scrutiny from the compliance teams. It simply relied on documents presented by IPIC executives and legal opinions of external counsel as proof of IPIC's consent to be the chief guarantor.[54]

HUFF AND PUFF, WHERE DID THE MONEY GO?

1MDB had no interest in the assets that were being acquired with the funds and envisaged no return on those investments. During the course of their detour and misappropriation, the funds were transferred to several shell companies across numerous countries. These countries included Switzerland and Singapore, before they finally reached the hands of those involved in the scheme. Some of these funds flowed through the United States, in particular, the Eastern District of New York. Low, together with the other accomplices, continued to make payments to the 1MDB officials, including those officials who had the power and authority to grant business to Goldman. Some of the funds that were used to bribe the foreign officials were derived from the proceeds of the bonds issued by 1MDB in 2012 and 2013, with the aid of Goldman.[55]

PROJECT MAGNOLIA

Based on the review of the financial records that were gathered during the investigation, Goldman had sent the proceeds of the Magnolia bond offering to 1MDB Energy Labuan, outside the U.S., amounting to nearly US$577 million. This sum was equivalent to more than one-third of the net proceeds of the bond offering, and was being transferred to the bank account of the Aabar-British Virgin Islands (Aabar BVI).

The name of the account was intentionally created to give the impression of a link to Aabar Investments PJS (Aabar), a subsidiary of IPIC. In reality, there was no affiliation between the companies, and the Swiss bank account was just a conduit for transferring the funds from the bond proceeds, before being subsequently used for the benefit of officials at 1MDB, IPIC, and Aabar, including Qubaisi (IPIC's Chairman), and Husseiny (Aabar's CEO). These transfers were not disclosed in the offering circular.[56]

Sometime in May 2012, approximately US$295 million was wire transferred from the Aabar-BVI account to a Singapore bank account in the name of a real estate company, Tanore Finance Corporation (Tanore). However, this company was believed to have no relation to a widely known real estate investment firm which was similarly named. The registered beneficial owner of Tanore, Eric Tan Kim Loong, is a Malaysian national and associate of Low. Low had used Tan as a proxy for financial transactions and further instructed him to transfer funds. Low had control over Tanore as well.[57]

About two weeks after the bonds were issued, approximately US$35 million was transferred from Tanore to a Hong Kong bank account. This company was a BVI-incorporated entity controlled by Leissner and owned by his close relative. Financial records found during the investigations revealed that the company's bank account also received a transfer of approximately US$16.9 million from Tanore Finance Corporation. The other bond funds were distributed to officials of a foreign agency, foreign investment firm and 1MDB, including "foreign officials" under the FCPA, Low and his accomplices.[58]

PROJECT MAXIMUS

Two days after Project Maximus was closed, about US$790 million of the proceeds from this bond was diverted to Aabar-BVI account on the same day that 1MDB Energy received the proceeds. The US$790 million was transferred into and then out of the United States. Some of the proceeds were transferred to another shell company account. Financial records showed that funds amounting to approximately US$209 million were transferred between these two shell companies' accounts. Like Project Magnolia, the unauthorised proceeds that were being diverted from Project Maximus were transferred to Tanore and distributed to various accomplices.

Between late October and early November 2012, approximately US$200 million was transferred from Tanore, through several intermediaries, to an account that was beneficially owned by Low. Amongst other things, he used these funds to purchase jewelry, and pay off credit card bills and expenses related to a private jet. Funds were also transferred to other accounts that were beneficially owned by Low or immediate family members.[59]

About US$472 million was transferred from Tanore to a Luxembourg account. This account, which was under the control of an accomplice, was used to purchase luxury properties in New York and Beverly Hills, amongst other things. Another US$238 million was transferred to a Singapore bank account belonging to an entity owned by Low's friend. This person was also a relative of Najib.

Leissner also facilitated the transfer of approximately US$2.7 million from the holding company account to the account of a company beneficially owned by several 1MDB officials. By 22 February 2013, Tanore's account balance had fallen to zero.

PROJECT CATALYZE

Leissner began to transfer millions of dollars to accounts that were beneficially owned by 1MDB officials, several days after Goldman was awarded Project Catalyze. On 17 January 2013, he transferred about US$2 million to these accounts. The illegal proceeds, which amounted to US$3 billion, raised by the Catalyze bond issuance were transferred to Leissner, Low and the others.

About US$65 million which could be tracked to the Project Catalyze bond issue, was transferred in and out of U.S. from an account of a purported private equity firm controlled by Low.[60] Around US$681 million was transferred from an account in Switzerland in the name of an implied financial corporation to an account in Malaysia belonging to Najib, which had an individual and a 1MDB official as signatories.

US$620 million was wired from a separate account, controlled by Najib, to another shell account. A share of these funds then passed through several additional accounts and was ultimately used to purchase a 22-carat pink diamond pendant and necklace for Rosmah.

On 4 June 2013, about US$58 million was transferred from that shell account to an account maintained in New York by an auction house. The funds were used to purchase five pieces of valuable artwork for Low and another individual. Additional transfers of about US$7.9 million and US$71 million were used to purchase additional artworks for them as well.

MORE GOLD!

After the closing of the bond offerings, Leissner and Ng were still actively seeking more 1MDB business. In order to persuade government officials to provide a role for Goldman in any 1MDB dealings, they used more bribes and kickbacks. The DoJ's charge documents alleged that Low and Leissner discussed the need to get on the good side of a 1MDB official and to send "cakes" to Rosmah in 2014. A few months later, Leissner's bank account was used to transfer approximately US$4.1 million to pay for gold jewelry for Rosmah.[61]

Low and Leissner continued to make corrupt payments to 1MDB officials and Low also persisted in his promise to pay the 1MDB officials. For instance, one of the 1MDB official had emailed himself a saved chat with Low, in which they discussed the 1MDB business. This included ways to cover up the diversion of the funds from the 2012 to 2013 bonds into shell company accounts from auditors and bondholders. In the same chat, Low promised him "one American burger should be delivered next week" when they were discussing the payment of bribes.[62]

THE HUNT BEGINS

In July 2015, The Wall Street Journal released a report alleging that US$681 million of deposits have flowed into Najib's personal bank accounts.[63] A special task force was formed to investigate these accounts, which concluded that the amount deposited into his accounts were donations from the Saudi royal family, not from 1MDB.

As a result of the US$681 million transfer, various authorities, including Swiss prosecutors, the Monetary Authority of Singapore (MAS) and the DoJ, were involved in an international probe to trace the flow of cash allegedly siphoned out of the state fund.[64]

On 1 November, 2018, the DoJ unveiled charges on the three key parties involved in the 1MDB scandal - Leissner, Ng and Low.[65] The court filings outlined their collusion in the 1MDB money laundering scheme as well as their violation of the FCPA for circumvention of internal controls and bribery to several government officials. The embezzled 1MDB money had been moved around the globe before being used to buy luxury real estate in the US, precious artwork and custom-made jewellery.[66]

That same day, Leissner pleaded guilty to his two-count indictment and agreed to pay US$43.7 million.[67] Ng was detained in Kuala Lumpur, shortly after the announcement of charges by the U.S DoJ.[68] Low, however, has denied any wrongdoing. He is wanted by several countries and is the subject of a global manhunt.[69]

HUNTERS ARE COMING

Malaysia has filed charges against three of the bank's units (Goldman Sachs International (UK), Goldman Sachs (Singapore) and Goldman Sachs (Asia) LLC).[70] It also filed charges against former employees, Leissner and Ng, for alleged false statements involving US$6.5 billion of 1MDB bond sales that the bank arranged.[71] The Malaysian authorities allege that Goldman misled investors, when the bank knew that proceeds from 1MDB bond sales it arranged would be misappropriated. The government is seeking fines in excess of both the US$2.7 billion of allegedly misused funds and the US$600 million in fees received by Goldman on the deals.[72]

Less than a week after Malaysia filed charges, it was reported that Singapore has expanded a criminal investigation with regards to fund flows linked to 1MDB to include Goldman.[73] In the country's first criminal investigation of a company relating to the 1MDB scandal, the authorities are trying to determine if the US$600 million fees earned from the bond issuance had flowed to Goldman Sachs' Singapore unit.[74]

Various regulatory and law enforcement agencies around the world are working closely together to unravel the complex network of transactions which involved various offshore shell companies and conspirators operating in numerous jurisdictions.[75]

On 1 November 2018, the DoJ announced the profiles of the Goldman bankers who were involved in the 1MDB fraud and indicated that there is a high possibility that the firm will face significant fines. The announcement caused Goldman's shares to dive to an all-time low since 2011.[76]

On 17 December 2018, Goldman was officially charged for the first time for its alleged violations of Malaysia's securities laws. Malaysia has also filed related charges against Leissner and Ng, as well as the former 1MDB employee, Loo and fugitive financier, Low. Goldman's stock fell 30% from US$226.97 in November 2018 to US$167.05 as on 31 December, 2018.[77]

As of 1 April 2019, Goldman's shares had not completely recovered from the 1MDB fraud, closing at US$202.23.[78]

"WOLF CULTURE"

Under the leadership of the former CEO, Blankfein, who had been in the role since 2006, Goldman faced many allegations of prioritising profits to the detriment of its clients.[79]

Blankfein was compensated with US$13.3 million in restricted shares in 2012, together with a US$5.7 million cash bonus and US$2 million in salary. This was US$9 million more than the previous year. Since Blankfein was on a long-term incentive plan, he also received shares depending on his performance. Blankfein was known to be the best-paid banker across the globe and his lavish paycheck also earned him the title of "Most Outrageous CEO" in a 2009 Forbes ranking.[80]

"They have embarked on a very aggressive course of having their cake and eating it too"[81]

- A private equity executive from Goldman

During the investigation of the scandal, when fingers were pointed at Goldman, the company simply claimed that such misconduct was just the behaviour of a "rogue" employee who did not truly reflect the corporate culture of Goldman. While on the sidelines of the DealBook conference, Blankfein attempted to brush the case aside.[82]

"These are guys who evaded our safeguards, and lie. Stuff like that's going to happen."[83]

- Blankfein, Former CEO of Goldman Sachs

Ironically, Blankfein was reportedly present at the meeting with Low and Najib for discussions regarding 1MDB.[84] It was alleged in the indictment that the culture in Southeast Asia "prioritized consummation of deals" over complying with the law. Greg Smith, who was the executive director and head of the firm's U.S. equity derivatives business, highlighted that Goldman's culture was depraved to the state where clients are seen as "muppets" and were being manipulated to produce as much revenue as possible for the company. Inexperienced trainees at the firm were encouraged to coerce clients to invest, even if those investments were not in their best interest.[85]

Additionally, Leissner justified his action of pocketing US$200 million of the proceeds from the bond offerings and concealing facts from the compliance and legal side as being very much in line in the Goldman culture.[86]

THE NEW PACK LEADER

On 1 October, 2018, David Solomon succeeded Blankfein as the new CEO of Goldman and also took over as Chairman when Blankfein assumed the role of "senior chairman" at the end of that year.[87] Solomon's background in banking contrasts with Blankfein's background in trading, indicating the direction Goldman is likely to take under him. This signaled that the company is likely to move away from high risk trading towards less volatile businesses, including mergers and acquisitions (M&A), securities underwriting and consumer banking.

Today, a majority of Goldman's employees are millennials.[88] Goldman now competes for talent not only with other investment banks such as J.P. Morgan and Morgan Stanley but also with technology companies such as Amazon, Facebook and Apple.[89]

It has publicly indicated that it needs to become more transparent and open so that it can be a friendlier place to work in. It has already started offering opportunities through social media channels, allowing employees to share information and interact like at major technological firms. Solomon also laid down new guidelines to allow the firm to successfully shift towards being a more diverse firm. Solomon believes that such a shift would help it to serve its current diverse client base better.[90] He believes that the quality of his employees and his belief in them can serve as the cornerstone to the success of Goldman.[91]

The top management at Goldman claim to be committed to "driving diversity" in their work with clients and in their core commercial activities. In fact, diversity is a shared priority among many of Goldman's clients and stakeholders. The current board at Goldman believes that wider diversity in terms of experience, gender identity, race, ethnicity, and sexual orientation on boards reduces the risk of groupthink and unlocks creative and impactful solutions for the company.[92]

A NEW BREED?

The current board at Goldman has 58-year-old David M Solomon as its Executive Chairman. He has been Goldman's CEO and director since 2018.

Drew G. Faust, aged 72, an American, serves as an independent director on the board. She has been a professor, dean and president at Harvard University. She joined Goldman's board in July 2018. Peter Oppenheimer, 57, joined Goldman in 2014 as an independent director, chairing the AC. He has a strong background in finance, and has been a CFO for over 20 years. Mark A. Flaherty, 53, an independent director, has been at Goldman since 2014.

Ellen J. Kullman, another American who is 64, joined the board as an independent director in 2016. She chairs the Public Responsibilities Committee and is a member of the Compensation and the Governance Committees as well. Another American, Jan E. Tighe, 57, had served as an independent director in Goldman since 2018. She has been highly involved in the company's strategic and technological planning.

Mark O. Winkelman, aged 72, is an independent director and a trustee at Goldman since 2014. He chairs the Risk committee. He is currently a private investor and has previously been an investment officer as well.

M. Michele Burns, Lakshmi N. Mittal and David A. Viniar remain on the board and Adebayo O. Ogunlesi is the lead independent director.[93]

Solomon announced that from February 2020, the bank would only underwrite IPOs of private companies in the U.S. and Europe that have at least one diverse board member. The CEO said that he had benefitted a great deal from the counsel of his Lead Director who is "a black man from Nigeria" and from the board with four out of 11 directors who are females.[94]

In 2013, the board renamed its existing Corporate Governance and Nominating Committee as the Corporate Governance, Nominating and Public Responsibilities Committee.[95] However, in 2015, the Public Responsibilities subcommittee was restructured to form an independent board committee called the Public Responsibilities Committee.[96] According to Goldman's policy, its lead independent director is an ex-officio member of all the committees.[97]

THE HUNT CONTINUES

The spectre of 1MDB remains as authorities in various countries continue to pursue their investigations. In June 2019, representatives from all three Goldman units in London, Hong Kong and Singapore were expected to appear in a Malaysia court hearing.[98] It has been estimated that US$2 billion in penalties[99] will be imposed on the Wall Street firm. This court hearing was subsequently pushed to 30 September, 2019, when the Prosecution appealed to transfer this case to the Malaysian High Court.[100]

This court case in Kuala Lumpur involved three of Goldman's subsidiaries, Goldman Sachs International Ltd, Goldman Sachs (Asia) LLC and Goldman Sachs (Singapore). In December 2019, the case against all the three business units had been moved from the Magistrate Court to Malaysia's High Court.[101]

Ng will face trial in the U.S. in May, 2020. Low, who is currently reportedly in China, also finds himself facing charges in the US and Malaysia.[102] Leissner has already pleaded guilty to conspiring to perpetrate bribery, money laundering and violating Foreign Corrupt Practices. He was fined US$1.42 million by the Fed.[103] A lifetime ban from the securities industry has been issued against both Leissner and Ng. While Ng has only been banned in the U.S., Leissner has been barred in the U.S., Hong Kong and Singapore.[104]

Another permanent ban from the banking industry was issued by the Fed against another Goldman executive, Andrea Vella, for his role in Malaysia's 1MDB scandal. Despite being the former co-head of Asia investment banking, he failed to flag Low's involvement in the 2012 and 2013 bond offerings. He was aware that Low was "a person of known concern" with regard to this scandal. His role in the firm was to provide complete and accurate information to the board committees reviewing the complex financing transactions and appropriately supervising financing personnel working on those transactions. Moreover, he was accountable for both, Ng and Leissner. Vella had already left Goldman.[105]

In the second week in January 2020, Goldman's problems were underscored by the second consecutive miss of its target quarterly earnings, with a 24.8% drop in the fourth quarter profit.[106] Litigation provisions related to the 1MDB scandal knocked off more than US$1 billion from the bank's bottom line.

Goldman has been negotiating a settlement. This case once again shows that large banks like Goldman may be too big to regulate.[107] Goldman's business in Malaysia, relative to the size of the group, is extremely small such that any fines or restrictions on the bank's operations in the country are unlikely to have a large impact on the Group's bottom line.[108]

In addition to the large fine that Goldman will likely have to pay, the DoJ is also seeking a guilty plea for the company itself. Given that Goldman has never previously pleaded guilty to any criminal wrongdoing in its 150-year history, it is far from clear that this will happen.[109] The bank and U.S. officials have discussed a deal in which a Goldman subsidiary in Asia would plead guilty to violating US bribery laws and pay up to two billion U.S. dollars as fine. This settlement involves agreement between three regulators- the DoJ, the SEC and the Fed- and is not yet finalized.[110]

DISCUSSION QUESTIONS

1. How might Lloyd C. Blankfein's dual role as Chairman and CEO have affected Goldman Sachs leading up to the scandal? Why do you think he held both roles despite the potential corporate governance issues which may arise? What measures are necessary to mitigate the potential risks of combining the two roles and to what extent were those measures in place at Goldman Sachs?
2. Discuss whether the former Chairman and CEO, Lloyd Blankfein, should be held responsible for the behaviour of its employees in the 1MDB scandal. Identify and propose other measures in which the new CEO could take to rebuild Goldman Sachs' reputation as a leading global investment bank.
3. Evaluate Goldman's corporate culture and how it could have encouraged or incentivised employees to circumvent internal controls. How can the board of directors set and oversee corporate culture?
4. Critically evaluate the composition of the board and board committees as of 2013 and after the scandal. To what extent should the board of directors of Goldman be held accountable for Goldman's role in the 1MDB scandal?
5. Goldman has a separate Audit Committee and Risk Committee. Discuss the advantages and disadvantages of having separate committees, and how may the Board ensures that the governance and oversight of risk, control and compliance matters do not fall through the crack of the two committees.
6. Critically evaluate the failure in the different lines of defence at Goldman in relation to the 1MDB scandal.
7. Examine whether the Risk Committee took adequate steps in assessing the bond transactions. What were the weaknesses in internal control of Goldman Sachs leading to the fraud being undiscovered for years? Suggest how those weaknesses should have been addressed.
8. To what extent did remuneration policies contribute to Goldman's role in the 1MDB scandal? Explain.
9. Do you think the changes introduced by Goldman following the scandal will help prevent a recurrence of similar scandals? Explain.
10. Discuss the effectiveness and efficiency of regulators in detecting and taking action against cross-border money laundering. To what extent should the various banks be held accountable for failing to detect suspicious money laundering activities? What could both parties have done to better address money laundering risks?
11. To what extent does the anti-corruption legislation in your country hold the company, board and management accountable in a situation such as Goldman's role in the 1MDB scandal? Explain.

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CYBERSECURITY BREACH

CENTRAL BANK OF BANGLADESH: THE BIGGEST CYBER HEIST IN ASIA

CASE OVERVIEW

On 4 February 2016, the Central Bank of Bangladesh (CBB), fell victim to the largest financial cybercrime in Asian history. Hackers attempted to move a total of US$951 million into fake accounts using the Society for Worldwide Interbank Financial Telecommunication (SWIFT) messaging system. Although the heist was discovered before all the money transfers could be completed, CBB suffered a total loss of US$81 million. The heist was not limited to the breach of the security system of CBB, but also included the subsequent lapses that occurred along the communication channel for SWIFT financial messages. The increasing sophistication of cyberattacks is a growing concern to the global payment network. The objective of this case is to allow a discussion of issues such as board and committee expertise; cybersecurity risk management; the roles of stakeholders; and crisis management.

CENTRAL BANK OF BANGLADESH

CBB was established under the Bangladesh Bank Order, 1972 (P.O. No. 127 of 1972) on 16 December, 1971. CBB holds the official foreign reserves of Bangladesh and is responsible for the regulation and supervision of banks and financial institutions in Bangladesh.[1]

During the financial year 2015, CBB had nine members on its board of directors. The board was led by Governor, Dr. Atiur Rahman and Deputy Governor, Md. Abul Quasem.

CROUCHING TIGER

In May 2015, four accounts were opened with the Rizal Commercial Banking Corporation (RCBC) Jupiter branch in Manila, using fake driving licences as identification documents. A fifth account under the name of a Philippines businessman, William So Go, was created on 1 February, 2016. These accounts were dormant until the illegitimate transfer of Bangladeshi funds from the Federal Reserve Bank of New York (FRBNY) in February 2016.[2]

A malware, evtdiag.exe[3], was alleged to have been propagated through Universal Serial Bus (USB) by an insider or technician working with the bank.[4] Other sources speculated that it was done through the use of email spear phishing. According to BAE Systems security researchers, evtdiag.exe was custom-made for this heist and is likely part of a broader attack toolkit. A BAE Systems report stated that "the malware registers itself as a service and operates within an environment running SWIFT's Alliance software suite, powered by an Oracle Database".[5] The malware was able to function in the system and allowed the hackers to carry out sabotage actions. According to CBB's officials, the malware likely resided in the system as far back as January 2016, giving the hackers time to study CBB's system while they remained unnoticed.[6]

The hackers stole local administrative credentials and were able to navigate their way and obtain access to the SWIFT-connected systems, on which a monitoring software was installed. They managed to capture SWIFT-issued digital certificates, enabling them to execute the heist by submitting financial messages over the SWIFT network.[7]

THE FATEFUL DAY OF THE HACK

On 4 February 2016, when CBB closed for the day, the hackers logged onto the SWIFT messaging system and attempted to withdraw funds amounting to US$951 million from CBB's account at the FRBNY.[8] This was performed by issuing 35 separate transfers via SWIFT.[9] The first five transfer requests, which amounted to US$101 million, were approved and sent to the FRBNY and its correspondent banks.[10]

Out of the five transfer requests sent to FRBNY, four requests amounting to US$81 million were routed to the four accounts set up in RCBC Jupiter branch in the Philippines.[11] The funds were deposited and consolidated in the account under Go's name.[12]

The fifth request was intended to send US$20 million to a non-governmental organisation in Sri Lanka. The money had initially reached Pan Asia Banking Corporation

This is the abridged version of a case prepared by Desmond Teng, Serene Lee, Tan Ai Ling and Ye Keyu under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Raffles Ng under the supervision of Professor Mak Yuen Teen.

(PABC). However, it was later diverted back to routing bank, Deutsche Bank, for further verification due to the unusually large payment size.[13] This later led to the cancellation of the payment and recovery of the money.[14]

The subsequent 30 requested transactions were rejected after suspicions were raised when the name "Jupiter" formed part of the address of the targeted RCBC bank. It was a coincidence that a US-sanctioned Iran oil tanker and shipping company was named "Jupiter". The sanction listing prompted the FRBNY to scrutinise the fake transactions before releasing the funds. FRBNY then sent multiple queries to CBB but did not get a response as it was closed for the day.[15]

A day later, on 5 February 2016, the malware installed on CBB's servers bought time for the money to be collected and laundered. Incoming confirmation messages that may have alerted the bank about the fraudulent transfers were automatically removed from the SWIFT messaging system.[16]

An apparently broken printer was not an unusual sight. Jubair Bin-Huda, former joint director of CBB, requested for it to be fixed. However, it was a Friday in Bangladesh, which had a Muslim majority, and all the bank officials had left by 12.30pm for their mid-day prayers. The officials thus did not see FRBNY's queries and remained oblivious to the cyber-heist.[17]

It was only over the weekend did the officials at CBB recognised the scale of the problem. They tried to contact the FRBNY but there was no response. SWIFT then fixed the messaging system remotely.[18]

On 8 February 2016, CBB issued stop orders to the relevant banks. It requested for RCBC to freeze the money in the four accounts. Unfortunately, it was a special non-working day in the Philippines and the messages were not read.[19]

AFTERMATH OF THE HACK

According to RCBC, the cancellation requests were sent via SWIFT messaging system in the wrong format and not flagged as urgent. As such, priority was not given for their review.[20]

From 5 February to 13 February 2016, the US$81 million from Go's account was routed to PhilRem Services Corporation, a money transfer company, and funnelled into the Philippines casino industry.[21] The Philippines casino industry is exempt from many of the anti-money laundering laws in the country. The country also practises some of the world's toughest bank secrecy laws.[22] Under the Philippines Banking Laws, stolen funds cannot be frozen unless a criminal case has been lodged.[23]

According to Julia Bacay Abad of the Anti-Money Laundering Council (AMLC), the money was traced to three different accounts namely: Solaire (US$29 million), Eastern Hawaii Leisure Company (US$21.2 million) and Weikang Xu (US$31.6 million).[24] The trail for the US$81 million has gone cold as the money disappeared into the Philippine casino industry.

With regards to the incident, Sergio R. Osmeña III, a senator from the Philippines, who heads a committee on banks and financial institutions, said that "They picked [the Philippines] to launder this money because [the Philippines] system is full of loopholes."[25]

RCBC: A LITTLE TOO LATE

Since 2013, RCBC has been recognised for its good corporate governance practices and was awarded numerous awards. Under the board of directors, RCBC has eight board committees, two of which are the Audit Committee and the Risk Oversight Committee. By virtue of Bangko Sentral ng Pilipinas (BSP) Circular No. 145[26], RCBC also has a compliance office, which is tasked to supervise the implementation of the compliance program.

Lorenzo Tan, president and Chief Executive Officer of RCBC, and Ana Luisa Lim, head of the internal audit group, certified that RCBC's internal control system for year ended 2015 complied with PSE Corporate Governance Guidelines for Listed Companies.

Besides conducting regular training, RCBC also regularly revises its policies to comply with the latest Anti-Money Laundering Act. The Money Laundering and Terrorist Financing Prevention Program is approved by the board of directors before being implemented throughout the bank. It aims to prevent RCBC from "being used, intentionally or unintentionally, for money laundering and terrorist financing activities".[27]

In July 2014, RCBC adopted the Base60 AML Monitoring System (Base60) to facilitate the detection of money laundering or terrorist financing activities by using its rule-based scenarios that include the application of pattern analysis and monetary thresholds. The system's enterprise-wide approach also helps to prevent money-laundering schemes by studying the client's profile and transactions.[28]

LAPSE AT RCBC?

Bank officials of RCBC reproached Maia-Santos-Deguito, former manager of the Jupiter branch, and Angela Torres, senior customer relations officer, for delaying the submission of a suspicious transaction report (STR). RCBC's head office requested for the STR on 5 February 2016, in the hope of freezing the accounts that held the stolen US$81 million. Both Deguito and Torres were dismissed from their positions for the contravention of bank protocols, falsification of commercial documents and assisting in the transfer of illicit money. Deguito was said to have facilitated the opening of the five bank accounts that stored the heist funds and helped in the withdrawal of the funds.[29]

On 15 March 2016, the AMLC filed a complaint against Deguito for the breach of BSP Circular No. 706.[30] According to the AMLC, Deguito approved the opening of accounts based on fictitious documents. She violated the Know-Your-Customer rule by failing to verify the identities of the account holders and allowed them to withdraw funds even after knowledge of the stop payment request.[31] Claiming to be a scapegoat, Deguito said she only acted in accordance with Tan's instructions.

Tan and Raul Victor, former RCBC treasurer, resigned from their positions after the incident.[32] Deguito came under the investigation of the prosecutors from the Philippines government for money laundering. If found guilty, she may face the maximum jail sentence of 14 years.[33] On 24 April 2017, it was reported that the Department of Justice "has resolved to indict" Deguito and a few other individuals linked to the money laundering; they would be charged for violating the Anti-Money Laundering Act. Kam Sim Won, one of the casino junket operators, surrendered a sum of US$4.63 million and Php488.28 million to the BSP, the Monetary Board of the Philippines, which subsequently returned the monies to the Bangladesh government.[34]

THE FINE

In relation to the cyber-heist, RCBC's non-compliance with the New Central Bank Act resulted in a record-high fine of one billion pesos imposed by BSP. RCBC also faced a supervisory enforcement action, whereby it was subjected to increased obligations in transparency and documentation.[35]

A week after the announcement of the hefty fine, CBB insisted that it would initiate a lawsuit against RCBC if efforts to recover the funds were not successful.[36]

THE BLAME GAME

The FRBNY did not have a real-time system to identify unusual transactions immediately. Most transactions are executed automatically, unless a problem is identified and highlighted. The flagged transaction and review usually occurs only one day after the request, which may be after payments have already been made. In the review, the staff would verify SWIFT formatting and authentication, and determine if the US economic sanctions or anti-money laundering laws have been violated.[37]

On 4 February 2016, the first 35 messages sent by the hackers were rejected by the system due to incorrect formatting. The hackers simply corrected this and resent the messages, of which five were cleared automatically and payments were made. The other 12 payment requests made by CBB were seen as potentially suspicious by the staff and flagged for review. However, a complete manual review only began on the following day.[38]

The Bangladesh government claimed that the Federal Reserve did not perform sufficient due diligence, resulting in the funds being stolen. However, FRBNY denied responsibility, stating that it was not their systems that the hackers had compromised.[39]

No firewall and US$10 switches, CBB?

Investigations revealed that CBB had no firewall and used second-hand US$10 switches for network computers connected to the SWIFT global payment network. Cyber consultants such as Jeff Wichman criticised CBB harshly, finding it ironic that CBB was "an organization that has access to billions of dollars and they are not taking even the most basic security precautions."[40]

Officials at CBB, however, claimed that it was only after the attack that SWIFT advised about the upgrade of its switches.[41]

Why were installations not thorough?

CBB claimed that its vulnerability to the hackers increased as 13 security measures were not implemented by SWIFT when installing the Real Time Gross Settlement system. SWIFT also made mistakes when setting up a local network.[42]

However, SWIFT rejected all allegations as it was certain that the security of its financial messaging system had not been breached. It emphasised that member banks should be responsible for their own system interfaces.[43]

PERPETRATORS RUN FREE, MONEY GONE FOR GOOD?

Subsequent to the heist, the relevant parties involved took measures to prevent a similar attack from repeating in the future. The heist attracted worldwide attention as it targeted the SWIFT messaging system, the pillar of today's international finance operations. Concerns over the integrity of the SWIFT reporting system were also raised, which sent shock waves throughout the global banking community.[44]

In March 2017, it was reported by a US official that the CBB's heist was "state-sponsored".[45] The US federal prosecutors believed that North Korea was behind this heist.[46] It was also reported that CBB managed to recover some funds that were stolen from the heist, "from a casino in the Philippines".[47] However, the pieces of the puzzle have yet to be put together. To date, no one can say with certainty who pulled off this massive cyber-heist that has created chaos in the global financial sector and some funds have yet to be recovered.

DISCUSSION QUESTIONS

1. Explain if you would consider the cyber-heist at CBB to be a Black Swan event. In your evaluation, assess the cyber risk management at CBB. With reference to publications made by Bank of International Settlements (BIS), what do you think CBB should do to prevent a similar attack in the future?
2. Explain the significance of a cyberattack on a Central Bank. Discuss some of the cybersecurity measures taken by the Central Bank in your country to protect the country's banking sector.
3. With regards to the cyber-heist at CBB, explain the importance of different stakeholders' roles in an organization's risk management. Provide suggestions on how SWIFT and its member banks can prevent similar future cyberattacks.
4. Identify and explain the roles of the committee(s) and department(s) responsible for RCBC's risk management and anti-money laundering compliance. Discuss the risk management and compliance controls, policies and procedures that were in place before RCBC was implicated in the cyber-heist saga. Explain why you think they had failed in this incident.
5. Who do you think is ultimately to blame for the losses from the cyber-attack? Do you think that the RCBC's board of directors and senior management should be punished for the lapses at the bank?

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CAPITAL ONE: A BREACH IN THE CLOUD

CASE OVERVIEW

On 19 July 2019, Capital One released an announcement stating that an outside individual, Paige Thompson, had gained unauthorised access to the bank's cloud databases and obtained confidential customer data, including approximately 100 million credit card applications. Further investigation revealed that Thompson, a 33-year-old former Amazon Web Services software engineer, had managed to exploit a 'configuration vulnerability' in a misconfigured firewall, which allowed her to transfer critical data to her own personal server from as early as March 2019. Before Capital One was informed of the breach by an anonymous tipster, Thompson had posted about her access to the Capital One data on social media, and also uploaded information relating to the Capital One data breach on GitHub, a popular code-sharing platform.[1] The data breach highlighted glaring vulnerabilities in Capital One's cybersecurity systems and raised questions about the adequacy of the bank's corporate governance and risk management processes. The objective of this case is to facilitate discussion on issues such as the effectiveness of Capital One's risk management framework and measures; the remuneration policy for the board and management; the adequacy of crisis management; as well as the influence of these factors on the cybersecurity breach and its aftermath.

TECHNOLOGY - BOON OR BANE?

Technological advances have had a major impact on many companies across various industries, and the banking sector is no exception. From contactless payments to biometric security authentication to the storage of critical data on the cloud, banks are starting to leverage on technology to provide enhanced services at more competitive prices.[2]

However, the increased reliance on technology is accompanied by a growing threat of cybercrime, perpetrated through lapses in cyber-security frameworks and systems.[3] This growing threat is exemplified in the recent cybersecurity data breach suffered by Capital One, which affected over 100 million individuals in the United States and approximately six million in Canada.[4]

BANK AT THE FOREFRONT OF TECHNOLOGY

Capital One, the eighth-largest bank in the United States, offers commercial lending as well as consumer lending products and services to retail consumers, small businesses and commercial clients.[5] The bank is renowned amongst its peers for its unrelenting focus on technology, placing it at the heart of its business.[6] Through years of steady investment in information technology, the bank has managed to secure a captive cardholder base, as clients were attracted by its technology-oriented banking services, which boasted capabilities such as cloud-based data management.[7]

THE BIG LEAP TO THE CLOUD

"We are entirely focused on moving to the public cloud."[8]

- Rob Alexander, Capital One's Chief Information Office

Single-minded in its path towards cloud-based data management, Capital One announced in 2015 that it would slowly migrate its system to cloud computing and wind down the existing data centres 'from eight in 2014 to zero planned by the end of 2020',[9] making Capital One one of the first large financial institutions to adopt such a practice. To manage its massive stash of critical data through the cloud, Capital One engaged Amazon Web Services (AWS), one of the largest cloud-computing third party service providers in the world, to develop and manage its digital infrastructure for cloud computing solutions.[10]

SAFEGUARDS AGAINST A STORM

Facing the need to secure customer data in the cloud platform properly, Capital One engaged both employees across the bank and AWS to construct a risk management framework for the cloud system. According to George Brady, the Chief Technology Officer of Capital One, the framework was updated and refined quarterly as they moved their applications into the cloud.[11]

To mitigate the risks of third-party cloud platforms, Capital One spearheaded the development of Cloud Custodian, a programme specifically targeting the enforcement of compliance and security of the cloud infrastructure.[12] The Cloud Custodian can detect and

This case written by Chen Yufang, Elizabeth Ho, Nicolas Lye, Yong Hui Ting and Zheng Tang Wei Hao under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This case was edited by Professor Mak Yuen Teen and Professor Richard Tan.

correct any policy violations automatically, thus allowing Capital One to 'keep the teams in guardrails'. The bank also bought a software company called Endgame around late 2017 to enhance its ability to detect hacks and data breaches. However, even after more than a year following the software was purchased, Capital One had still not completed the installation of the software. A reporting portal was further established to monitor and ensure compliance in the entire system.[13] However, despite the gamut of measures put in place, it took just one individual to breach the seemingly impenetrable walls of Capital One's cybersecurity systems.

ONE WOMAN ARMY: PAIGE THOMPSON

The individual in question, Paige Thompson, was a 33-year-old software engineer residing in Seattle. Her resume lists eight different employers over a 12-year period from 2005 to 2016, with almost all the jobs lasting less than 18 months.[14] Her most recent job was a stint at Amazon S3 (Simple Storage Service) from May 2015 to September 2016. An AWS spokesperson confirmed a former employee had been arrested in conjunction with the investigation, but said that AWS "was not compromised in any way and functioned as designed."[15] According to the Justice Department, Thompson had commenced her hacking attempts into corporate databases as early as 12 March 2019. Thompson's former employers attested that she was a 'very talented white hat ethical hacker' who excelled at testing clients' security systems to uncover lapses.[16] Her excellent hacking skills, together with her prior knowledge of AWS's cloud security systems, allowed her to bypass a faulty firewall which granted her access to Capital One's customer information.[17] This was the moment where all hell broke loose.

BURNING BREACHES - WHAT THE HACK HAPPENED

Thompson, who also goes by the online handle "erratic," allegedly created a program in late March 2019 to search for cloud customers for a specific web application firewall misconfiguration.[18] She managed to exploit a 'configuration vulnerability' in a misconfigured open-source Web Application Firewall (WAF) that Capital One was using as part of its operations hosted in the cloud with AWS, granting her access to the cloud databases. This misconfiguration allowed Thompson to 'trick' the firewall into relaying requests to a key backend resource, called the 'metadata' service, to issue temporary information to the targeted cloud server, i.e. Capital One's cloud server. This included credentials sent from a security service to access any cloud resource that the server has access to.[19] Using this well-known method called a 'Server Side Request Forgery (SSRF)' attack, Thompson was able to manipulate the credentials of various employee accounts, giving her access to critical data, including 140,000 social security numbers of credit card customers, 80,000 linked bank account numbers of secure credit card customers, and a whopping 1,000,000 social insurance numbers from Canadian customers.[20] Thompson managed to remain undetected during her initial hacking attempt, having used several methods to mask her identity and location, including a virtual private network service and the anonymous TOR browser.[21] Thus, like a thief in the night, Thompson continued her hacking spree, hiding under the veil of anonymity, with all the critical data at her fingertips.

HACK AND SLACK

After gaining access to victims' cloud infrastructure using the stolen credentials, Thompson then allegedly accessed and exfiltrated data over the following weeks. From April to June 2019, Thompson posted the data to her GitHub account, which included her full name and resume, and openly described her hacking techniques on Twitter.[22] It is unclear whether anyone downloaded the data after she allegedly posted it, but they very well may have given that Thompson allegedly talked openly about stealing the data, even on Slack.[23] Immediately after Thompson posted the contents of the data dump under the handle "Erratic", a friend replied "sketchy ****, don't go to jail plz".[24] Thompson, seemingly aware of the potential implications of her actions, posted a direct message on her Twitter account admitting she believed her actions were likely to be discovered, tweeting that she 'basically strapped (herself) with a bomb vest…' and that she aimed to 'distribute those buckets'.[25] However, while her concerns proved to be spot-on, it was already too late; words of Thompson's actions had spread like wildfire across cyberspace, and eventually someone decided to spoil her party.

BLOWING THE WHISTLE

One measure that differentiates Capital One from most other banks is their Responsible Disclosure Program.[26] The Responsible Disclosure Program maintains security by enabling customers or any other parties to report any potential holes or vulnerabilities in Capital One's systems. These reports will then be promptly acted upon to secure Capital One's systems and data.[27] This disclosure program worked in Capital One's favour during the breach, as the leak was anonymously reported to Capital One through the program.[28]

On 17 July 2019, an unidentified tipster informed Capital One of its existence by emailing the bank's responsible disclosure address with a brief warning about the data and a link to it on GitHub, with the message 'there appeared to be some leaked S3 data of yours' (S3 data refers to a type of file that is normally stored on Amazon's cloud network).[29] The online Slack room which held the links to the data was subsequently taken down. The bank swiftly alerted law enforcement to the data theft and immediately fixed the configuration vulnerability discovered. The FBI connected the incident to Thompson quickly, as it was relatively easy to link the Github page where she posted information about the stolen data to her handle and real identity. Thompson was subsequently arrested by the authorities in less than two weeks at her residence and has been under police custody ever since.[30] While it might have been convenient to close the case there and then, given that the perpetrator had been caught, the ease in which the cloud servers had been breached called for a more comprehensive investigation.

UNCOVERING THE TRUTH

As part of their investigation, Capital One examined the material on the GitHub page, which contained three commands and a list of 700 folders.[31] The bank determined that 'a firewall misconfiguration permitted commands to reach and be executed by that server, which enabled access to folders or buckets of data in Capital One's storage space at the cloud computing company'.[32] Apparently, Thompson had utilised a combination of four main software commands to access the cloud folders. The first command allowed Thompson to obtain security credentials to access the folders; another two commands listed the available buckets, and the final command allowed Thompson to copy or sync the data over to her own personal server.[33] Most of the data that was copied was related to credit card applications.[34] With the details of the investigation finalised and confirmed, Capital One then moved on to addressing the repercussions of the breach.

CLEANING UP THE MESS

"This is a defining moment for us to put our values on display and to be swift, open, and profoundly empathetic"[35]

- Richard Fairbank's internal address to employees

The bank subsequently made an official apology and announced that those affected would be notified by mail to the breach by Capital One and offered free identity theft and credit monitoring protection.[36] The bank further clarified that it would not be calling, texting, or emailing customers regarding their account information or Social Security numbers. The bank also set up an FAQ, as well as a dedicated hotline, for people looking for more details.[37]

Richard Fairbank, Capital One's CEO and chairman, was quick to call the bank out. "While I am grateful that the perpetrator has been caught, I am deeply sorry for what has happened," he said in a statement. "I sincerely apologize for the understandable worry this incident must be causing those affected and I am committed to making it right."[38] In its official statement published post breach, the bank reaffirmed its commitment to safeguard critical information and promised to incorporate learnings from this incident to further strengthen its cyber-defenses.[39] Whether or not it lives up to this promise, only time will tell.

LEFT IN THE LURCH

During a briefing on 31 July 2019, Capital One specifically promised to the United States Senate Committee on Banking, Housing and Household Affairs (Committee) that it would provide free credit monitoring and identity protection to all Capital One's customers who request it, regardless of whether they are part of the affected consumers.[40] However, subsequent checks by the Committee led some to believe that Capital One has not taken sufficient steps to make good on its commitment to protect consumers from further harm.

On 22 August 2019 and 4 September 2019, the Committee called the 1-800-227-4825 customer service number listed on the Capital One webpage that provides information regarding the data breach.[41] However, the telephone number linked back to Capital One's general customer service line, and not the dedicated line for consumers to call about the data breach or to request free credit monitoring and identity protection.[42] Furthermore, there was no dedicated numerical option for inquiries about the data breach or to request free credit monitoring.[43]

Eventually, staff were able to reach a Capital One's customer service representative by pressing '0'.[44] Based on the Committee's discussion with the Capital One's customer service representative, the Committee concluded that Capital One did not adequately inform consumers of their eligibility for free credit monitoring and identity protection services, nor does it appear that those services were yet available for consumers when they call in to request them. According to the Committee, these deficiencies suggest that consumers may not know whether their personal information has been breached and that Capital One may have limited the number of consumers who are eligible for free credit monitoring and identity protection services.[45] As of 23 September 2019, Capital One announced that they had finished sending notifications to Canadians by mail or email, and not by phone or text message. Furthermore, according to the Capital One website, it has completed notifying all the affected customers.[46]

CUSTOMERS' DATA COMPROMISED

In the aftermath of the breach, the subsequent adverse impacts on various stakeholders were both significant and extensive. Considering the scale of the data breach, it is worth noting that only 140,000 US Social Security Numbers (SSN), 1,000,000 Canadian SSN, and 80,000 linked bank account numbers were compromised out of the 106 million individual sets of critical data leaked.[47] Capital One was quick to point this out to assuage concerns, *"Importantly, no credit card account number or log-in credentials were compromised and over 99 percent of Social Security numbers were not compromised,"*[48] it said in a statement regarding the data breach.

However, as Adam Garber of US Public Interest Research Group (PIRG) highlighted, "Fraud doesn't necessarily occur immediately after breaches. But that doesn't mean consumers can breathe easily".[49] A majority of the stolen critical data belonged to consumers and small businesses, who are more vulnerable to fraud as they do not possess the necessary internal controls and security measures compared to larger institutional clients.[50] Stolen Social Security Numbers could potentially be used to access existing credit accounts or authorise the creation of new ones.[51] Furthermore, as Social Security Numbers cannot be changed, there will always be a risk that these numbers will be misused for fraud in the future.[52] This risk is noted by Garber, "Sometimes people hold onto it for years before they take action. So you might not see something tomorrow, but you could see something years from now".[53]

BURNING A BIG HOLE IN THE POCKET

Even though Capital One claimed that most customers did not suffer any material financial loss, the same could not be said for the bank itself. Capital One's share price before the announcement of the data breach on 26 July 2019 was US$98.08. After the news broke on 29 July 2019, its share price plunged to US$91.21 on 30 July 2019, and subsequently dropped to a low of US$83.11 over the next two weeks. It has languished below its pre-breach peak since.[54]

Share price decline aside, Capital One estimated that the total expense attributable to the remedy of the data breach (including customer notification, credit monitoring, technology support, and legal advisory costs) could range anywhere from US$100 million to US$150 million.[55] However, some experts believe the actual figure to be significantly higher as current estimates exclude related expenses from lawsuits filed against the bank, the loss of customer confidence and lower business revenues. Evercore ISI analyst John Pancari wrote to clients, "We are skeptical of management's implication that an issue of this magnitude will not impact go-forward earnings and efficiency expectations".[56]

Betsy Graseck, an analyst from Morgan Stanley, estimated that Capital One could pay between US$100 million to US$500 million in regulatory fines and state settlements as a result of the breach.[57] The possibility of higher fines is not unimaginable; in Equifax's 2017 data breach, where nearly 150 million personal data were exposed, the company paid a total of US$800 million in settlements.[58]

The incident also exposed the bank to several class-action lawsuits and potential regulatory fines,[59] which are expected to cost well above the bank's estimated 2019 outlays.[60] Many affected customers have filed a Class Action under the law firm, Morgan & Morgan, which has been appointed to represent them to obtain a class-wide relief against Capital One for its purported negligence in the data breach.[61]

According to the US Class Action system, affected customers are not required to pay the law firm prior to the lawsuit with the contingency fee agreement. If the law firm wins the case, the client will pay a percentage of the damages awarded by the court. However, if the case is lost, the clients are not required to pay any fee at all.[62]

The lawsuit seeking class-action status was first filed in the federal court in Washington, D.C. by Kevin Zosiak, a Capital One's credit card customer whose personal information was compromised.[63] It is likely to herald many similar lawsuits over the breach. As of 2 October 2019, the federal judicial panel has consolidated more than 40 lawsuits against Capital One over its alleged negligence in data security.[64]

Amidst the onslaught of potential litigation, one of the bank's contingencies is its cyber-risk insurance policy with a US$10 million deductible for a US$400 million cyber insurance coverage. However, it is still uncertain if Capital One's cyber insurer is obligated to cover the full costs associated with Capital One data breach.[65] Cyber insurance normally covers customer support, credit monitoring and some legal costs of the data breach.[66] They may not be liable to insure the full amount if it can be proven that Capital One lacked adequate internal security controls to prevent such a data breach. In Capital One's Quarter Three earnings release, the bank reported US$22 million of net Cybersecurity Incident expenses.[67] The total Cybersecurity Incident expense incurred by Capital One is expected to be US$49 million, in which US$27 million is accounted as probable insurance recoveries.[68]

BOARD INQUISITION

While the breach had mostly highlighted the bank's lapses in cybersecurity, the incident also thrust Richard Fairbank, the bank's low profile CEO and Chairman, into the spotlight. Being one of the founders of Capital One, he has been recognised as a CEO who is knowledgeable about credit card laws and bank technology, and a 'visionary' who speaks about dreams and revolutions.[69] As reported by the Wall Street Journal, his mantra is to be "strategically bold but risk averse".[70] The recent boom of the financial-technology industry has put immense pressure on him to keep Capital One ahead in the technology arm-race with the rival start-ups and attract customers through different avenues.

Fairbank was not the only one to face the scrutiny of the media and observers; the rest of the board was also placed on the hot seat, and the competencies and experience of each of the members were called into question. To put themselves ahead of their competition, especially in areas like cyber risk, financial performance, and business strategy, Capital One claimed to have cultivated a board that encompasses an optimal mix of diverse backgrounds, experiences, skills, expertise, and qualifications to 'cover all vectors or effective challenge of management'.[71] According to its website, out of the 11 directors, 10 (excluding the CEO) have skills and prior experience in Digital, Technology, and Cybersecurity. Furthermore, five of the directors also possessed executive-level experience with direct oversight and expertise in technology, digital platforms and cyber risk. All the 10 directors (excluding the CEO) are deemed to be independent directors. Three are female directors. Two of the independent directors serve on 1 other public board, another two serve on three other public boards, while the other six do not serve on any other public boards.

Capital One's Risk Committee consisted of seven directors, with Peter E. Raskind serving as the chairperson.[72] Raskind was the former Chairman, President and Chief Executive Officer of National City Corporation. He has more than 30 years of banking experience, including in corporate banking, retail banking, wealth management/trust, mortgage, operations, technology, strategy, product management, asset/liability management, risk management and acquisition integration. He does not serve on any other public board.

Among the six other members of the risk committee, Mr Peter Thomas Killalea, Owner and President of AOINLE LLC and Former Vice President of Technology at Amazon, previously led Amazon's Infrastructure and Distributed Systems team, which later became a key part of the AWS Platform. Killalea serves on three other public boards.[73]

KEEPING BOTH EYES OPEN

Given that Capital One relies heavily on technology in the processing and management of highly confidential information, the board is actively engaged in the oversight of the bank's cyber risk profile, enterprise cyber program, and key enterprise cyber initiatives.[74] In particular, the Risk Committee receives regular quarterly reports from the Chief Information Security Officer (CISO) on the above matters and meets with the CISO at least twice annually.[75] It is also stated that the Risk Committee meets periodically with third-party experts to evaluate the bank's enterprise cyber program, and reviews annually and recommends the bank's information security policy and information security program to the board for approval.[76] In addition, in the event of a significant cyber incident impacting the bank, the Chief Information Officer (CIO) and the CISO are required to submit a report to the Risk Committee, which includes management's assessment of the root cause and the relevant areas of improvement gathered from the incident.[77]

CARROT AND THE STICK

The remuneration policies and structure implemented by a company for its board and management are critical in ensuring good corporate governance as it aligns the incentives and interests of the key officers with other stakeholders.[78]

The compensation program for directors consists of an annual cash retainer of US$90,000 for their services, as well as annual cash retainers for committee services. The Chair of the Risk Committee received US$60,000, while a member of the Risk Committee received US$30,000. In addition, each non-management director serving on 2 May 2018 received an award of 1,907 restricted stock units of Capital One common stock (RSUs) under the 2004 Stock Incentive Plan with a grant date fair value of US$170,066 valued at US$89.18 per share. The RSUs can vest one year from the date of grant, but the delivery of the underlying shares is deferred until the director's service with the board terminates.[79]

Starting from 2019, the Compensation Committee and the Independent Directors increased the alignment of CEO compensation with the bank's performance and shareholders' interest by increasing the percentage of the CEO's total target compensation tied to a year-end evaluation of CEO and company performance from 40% to 90%.[80] Under the current performance management process, Capital One includes an individual assessment specifically designed to evaluate the degree to which the executive balanced risks inherent to the role. This report is compiled by the Chief Risk Officer, and is separately reviewed by the Chief Auditor before the assessments are submitted to the Compensation Committee in making their determinations regarding individual performance and compensation levels.[81]

The CEO does not receive a cash salary and 100% of his compensation is at risk based on his and the company's performance. In 2018, 76% of his pay is equity-based compensation, with all his compensation deferred for three years. A majority of the Named Executive Officers (NEOs) are provided with long-term equity or equity-based compensation.[82] In deciding the CEO's compensation, the compensation committee considered both quantitative and qualitative performance of the bank, which include (1) Financial and Operating Performance; (2) Governance and Risk Management; (3) Strategic Performance; and (4) Winning with our Customers and Associates.[83]

However, in the 2018 Performance for Governance and Risk Management, the bank did not disclose much information about its performance in cyber-security measures, and simply provided a cookie-cutter statement relating to risk management and operational risk capabilities across all three lines of defence.[84] The bank simply stated that it had accelerated its focus on cloud capabilities, modern software, engineering and delivery, and enhanced cybersecurity capabilities, without elaborating much on what these 'enhancements' were.[85] For the CEO's compensation program, while Performance Shares and the Year-End Incentive Opportunity are the only two compensation determinants, performance and recovery provisions for these elements only include clawbacks for misconduct and financial restatement, with no clawbacks for breaches of regulations or cyber-security lapses.[86]

For NEOs, starting from the 2018 performance year, the compensation program has been simplified, with three of the six compensation elements having been eliminated, increasing the proportion of NEOs' total target compensation that is performance-based from 65% to 80%.[87] The compensation program now comprises of a 20% base salary, 25% cash incentive, and 55% long-term incentive opportunity.[88]

TECH-CENTRIC CULTURE

Before the data breach, there was a popular perception among industry players that Capital One was ahead of the game in terms of technology, and the bank stood out as the dream workplace for top technology talents. Technology employees were 'often given leeway to operate as they saw fit'.[89] However, according to people associated with the technology teams, the broader tech-centric culture of the bank had complicated security; technology employees were given free rein to write in many coding languages, making it harder for the cybersecurity unit to detect problems within the code.[90]

KNOWING THY ENEMY

Prior to the data breach, Capital One had made visible efforts to understand the nature of its technology risks and its characteristics by considering the uncertainties, likelihood, and severity of the impact of its risks, which were listed under the Operation Risk Assessment section of its 2018 annual report.[91]

The bank acknowledged that given a large part of its business is involved in the management of sensitive information, cyber-attacks designed to obtain confidential information or sabotage systems may be derived from human error or fraud from insiders or external parties. In addition, due to the proliferation of new technologies and the increased sophistication of hacking methods, Capital One has recognised that the cyber and information security risks for large financial institutions, such as itself, have increased significantly in recent years.[92] Moreover, with more customers opting to access the bank's products and services via mobile devices such as smartphones and tablets which are beyond the bank's security control systems, the risks are amplified as well.[93]

In addition, virtually all of Capital One's core information technology systems and customer-facing applications are migrated to third-party cloud infrastructure platforms, principally AWS. The bank thus recognised that if its service providers experienced system disruptions arising from the vulnerability of patches from key vendors and cyber-attacks (including Distributed Denial Service DDOS attacks), it could result in a material adverse effect on the bank's business and reputation. However, it continued to engage AWS, even though it was aware that larger third-party service providers often are unable to offer dedicated servers, which meant that the servers could not be comprehensively customised and monitored regularly to safeguard against potential cyber-attacks.[94]

Capital One also recognised that it may not be able to anticipate or identify certain attack methods in order to implement effective preventative measures despite having a 'robust suite of authentication and layered information security controls (cyber-threat analytics, data encryption, tokenization technologies, anti-malware defenses) as these controls may not have been updated to recognise and deal with newer hacking methods. Thus, in the event of a breach, the bank highlighted several costs, from operational costs such as those associated with replacing compromised cards and remediating fraudulent transaction activity, to broader implications such as a general loss of customer confidence and poor market perception of the effectiveness of security measures, both which could lead to reduced use of the bank's products and services.[95]

RED FLAGS IGNORED

Capital One was aware of the fact that it was an attractive target for cyber threats due to its strong online presence. Hence, it uses a 'Three Lines of Defence' risk management model to structure the roles, responsibilities and accountabilities in the organisation for taking and managing risk.[96]

The 'First Line of Defence' consists of the various business units that take on risk throughout their daily operations. On a business-wide scale, the CEO and the other business heads are accountable for managing risks and own their respective risk decisions.[97] Within the more granular day-to-day operations, Capital One deploys "post-compromise protections," such as the tokenization of Social Security and bank account numbers, to mitigate the risks of unauthorised access, given that the bank may not be able to watch every piece of data that sits in its cloud.[98] Furthermore, managing and keeping all identity and access management rules secure remains a key challenge for cybersecurity departments. As Capital One had integrated many critical information management processes into the cloud, the list of rules that dictate who got access swelled, snowballing into an issue that system administrators found hard to manage.[99] As mentioned by a senior cloud security engineer from a reputable cybersecurity firm, "Sometimes, the rules for these things span into six, eight pages of dense JSON text. You can't just point to a folder and say 'Administrators can read this, analysts can read that,' It doesn't work like that. It's all these weird inherited side effects. It's not that obvious at all".[100]

The 'Second Line of Defence', which oversees the first line, comprises of the risk management committee.[101] Key officers in the risk management committee are Robert M. Alexander, the Chief Information Officer; and Sheldon "Trip" Hall, the Chief Risk Officer.

Alexander has served as the Chief Information Officer since May 200, and is responsible for overseeing all technology activities for Capital One. Prior to taking up this role, he worked under Capital One's lending businesses, including the U.S. consumer credit card and instalment loan businesses.[102] Hall stepped up as Chief Risk Officer in August 2018, and has since been responsible for all aspects of Capital One's risk management, which includes oversight of risk management activities in areas such as credit risk, operational risk, compliance, and information security risk. Hall has been with Capital One since June 1997, working in various departments, and taking up executive positions since November 2012.[103]

The 'Third Line of Defence', comprising Capital One's Internal Audit and Credit Review functions, provides assurance to management and the board of directors regarding the risk management capabilities of their internal controls and processes.[104] Celia Karam, has been Capital One's Chief Auditor Officer since June 2018, leading a team of 300 for Capital One's internal audit function.[105] Furthermore, as Capital One is a highly data-driven bank, it also has a Tech audit team run by Chris Kyriakakis. In order to improve the audit process and resolve issues quickly, the internal audit team has involved management earlier in the audit process.

Celia Karam's vision for Capital One's internal audit is to "provide high value, independent and proactive insights, innovating with technology and being a destination for top talent". Additionally, Capital One has an internal group, "red team" that helps to supplement the firm's cybersecurity systems through identifying vulnerabilities.[106] However, although vulnerabilities had been identified months before the breach, there was no follow up. For example, in the months prior to the breach, employees were concerned when the bank saw high turnover in its cybersecurity unit as well as a failure to promptly install some software to help spot and defend against hacks.[107] In light of these situations, employees raised their concerns to internal audit, but their concerns were not acted upon.[108]

DIVIDED WE FALL

In 2017, Michael Johnson was appointed as the Chief Information Security Officer. Prior to his appointment, Johnson served the US Department of Energy as their Chief Information Officer. Johnson's experience, however, did not translate well into the private sector, especially for the employees.[109] He reprimanded employees and prioritised forming what he called his own "front office" that comprised of 'administrators and employees who helped with internal public relations'.[110]

With the change in management, employees clashed with the new style of work and some doubted his knowledge of security issues. Senior cybersecurity employees, being unhappy working under Johnson, left for better jobs. Most of Johnson's initial direct reports and some of their replacements left.[111] In 2018, Capital One lost one-third of its employees in the cybersecurity unit, which was responsible for ensuring Capital One's firewalls were properly configured and scanning the internet for evidence of data breaches.[112]

Adding to the problems of the cybersecurity department, the unit also faced difficulties working within their budget. Additionally, the security operations centre, which experienced burnout and attrition due to alert overload, long hours, and incomplete visibility into systems and threats, contributed to an increasing shortage of cybersecurity skills within Capital One.[113]

While Capital One's spokeswoman emphasised how Capital One constantly scans for configuration lapses and "address them where they're found", the misconfiguration of firewalls was not addressed fast enough.[114] Since the disclosure of the breach, 'at least a dozen experienced cybersecurity employees' have departed as many of them were frustrated at reporting security issues to Johnson and other executives that they believed had not been fully resolved.[115]

HOARDING THE PAST

The personal data breached covered 100 million and were dated back up to 2005. Credit card application data included names, addresses and credit histories of applicants.[116] It is also estimated that 600,000 of the people who had suffered a loss of personal information were former customers of Capital One.[117] Although there is no specified time limit for retaining information as set out by the law, Halifax privacy lawyer David Fraser, stated that Capital One could have followed the industry practice of moving the information kept for longer than seven years to a secured offline archive. In storing data that are no longer relevant, it raises questions as to why Capital One would choose to retain such information.[118]

LOST IN THE AMAZON

While both Capital One and Amazon claimed that its cloud services were not compromised during the data breach and the breach was not a result of any flaws in AWS, many have questioned the role played by Amazon in the events leading up to the breach.[119] The partnership between Amazon and Capital One has been cited by Amazon as one of the exemplars on how its AWS service is empowering the business and transforming the industry. While AWS is renowned for being one of the largest cloud service providers, there was a disadvantage to its size; unlike smaller companies, larger third-party service providers often are unable to offer dedicated servers, which meant that the servers could not be comprehensively customised and monitored regularly to safeguard against potential cyber-attacks.[120] It was precisely because the servers were not updated regularly, that a former employee could gain access to Capital One's cloud database.[121]

THE DEVIL IS IN THE DETAILS

It appeared that Thompson possessed sensitive information relating to Amazon's cloud systems because of her previous employment with the tech giant, allowing her to leverage on her prior knowledge to exploit the misconfiguration.[122] She was vocal about the hack and even posted on Twitter about a few companies whose data she believed was prone to exposure as a result of the faulty Amazon cloud technology.[123] According to Grinius, who is the CEO of a company providing dedicated server solutions, the obvious security flaws simply 'went under the radar' of Amazon probably because it is just impractical for a company of Amazon's size to notice these seemingly minute details.[124] However, other security experts asserted that AWS should put in more effort to 'implement mitigations to help prevent SSRF attacks on its platform', especially since its competitors- Microsoft and Google- have ramped up measures against SSRF attacks.[125]

REGULATORY AND LEGAL CHALLENGES

On 24 October 2019, Democratic presidential candidate Sen. Elizabeth Warren and Senator Ron Wyden penned an open letter to the Federal Trade Commission to investigate Amazon's role in Capital One's data breach.[126] However, it was met with criticism from an Amazon spokesperson for "conflating the client and host".[127] The spokesperson brushed aside the letter as merely "a publicity attempt from opportunistic politicians" and restated "the SSRF technique used in this incident was just one of many subsequent steps the perpetrator followed after gaining access to the bank's systems and could have been substituted for a number of other methods given the level of access already gained" in the email.[128]

The data breach at Capital One highlighted the vulnerabilities of the cloud system and renewed concerns among regulators. According to a U.S. Treasury report last year, bank regulations had not 'sufficiently modernised to accommodate cloud and other innovative technologies'.[129] It may be important to note that around the time of the Capital One data breach, the Federal Reserve orchestrated an official investigation of an Amazon facility in Virginia. The Fed focused on Amazon's resiliency and backup systems, people familiar with the matter said, describing the visit as the first of what is expected to be a period of ongoing oversight on the tech giant and other cloud providers.[130]

INDUSTRY-WIDE WAKE UP CALL

Lapses in data security, which was exaggerated by the improper maintenance of historical data, are not unique to Capital One's case and have become a prominent issue in banks, with the increasing application of Information Technology in bank's day-to-day operations, such as electronic transfer and online transactions. According to a 2018 study done by Accenture on 30 major banking applications, all 30 applications were found with vulnerabilities, including insecure data storage, insecure authentication, and tempering of code.[131] In a similar study conducted in 2018, researchers at security firm Positive Technologies found that 85% of the web bank applications had flaws that allowed attackers to steal information from users using phishing attack and stealing users' cookies.[132]

With the incidence of cyber threats on the rise, the SEC has warned companies of the cybersecurity risks that they face, whilst emphasising the need for timely and transparent disclosures and internal accounting controls.[133] The SEC subsequently issued a new guidance on cybersecurity disclosure, focusing on cybersecurity policies and procedures, specifically those regarding disclosure controls and procedures, insider trading as well as disclosure prohibitions.[134] This addressed the necessity for companies to improve their response plans, ensuring that their cybersecurity risks and incidents are promptly recorded and reported where required. With the new guidance on disclosures, companies would have to review and adjust their disclosure procedures to ensure that any cybersecurity considerations are disclosed.[135]

As the cybersecurity landscape continues to change and evolve, the SEC has signalled its intention to continue observing and evaluating developments in the field and provide further guidance and rules where needed. Furthermore, the SEC has been looking to improve cybersecurity through a deeper understanding of cloud computing and other technologies. To improve on their enterprise security controls, the SEC is researching on ways to reduce the potential for cyberattacks.[136]

CALL FOR STRICTER REGULATIONS - A PANACEA?

The SEC was not the only regulator to voice out its concerns; there have been several other calls to enforce stricter rules and regulations against a data breach. CUNA (Credit Union National Association) tweeted "There is an urgent need for Congress to act to set federal #data #privacy standards. We've urged Congress to treat data privacy as a national security issue, fix the weak links in the system, and set strong federal standards. #StopTheDataBreaches".[137] Even before this incident, CUNA has already made similar requests to Congress to treat data security as a national issue.

In a letter to the Senate Banking Committee, CUNA wrote "Congress should not expect any data privacy law it may enact to succeed in providing the desired level of privacy if such legislation does not also require all businesses and organizations that collect, use and house personally identifiable information (PII) to protect that data consistent with strong, federal security requirements".[138]

However, there is another school of thought that stricter regulations are not a panacea to a potential data breach. Steve Soukup, Chief Revenue Officer for cybersecurity firm DefenseStorm draws attention to the bigger issue behind the scenes, "Meeting the bar of regulatory requirements is not enough and should not be the standard. It's the lowest bar for measuring preparedness. For those that are doing the minimum to pass their exams, more regulation will help on the margins. But it won't address what needs addressing."[139] Going forward, it still remains a question whether the U.S. law authorities will enforce stricter regulations against a data breach.

DETENTION OF PAIGE THOMPSON

Paige Thompson had been held despite her protests in the men's wing of the Federal Detention Center in SeaTac. According to Prosecutors, the 33-year-old woman was a flight risk and a possible danger to the public. Thompson's attorneys disputed all of those allegations. U.S. District Judge Robert Lasnik, continuing a detention hearing that began in August 2019, imposed stringent rules on Thompson's release, including that she be moved to a federal halfway house and be subjected to GPS monitoring at all times. Paige Thompson will be banned from accessing the internet and using computers, handphones or other electronic devices without explicit permission from the court or federal Pretrial Services.[140]

PENDING CLASS ACTION

In the United States (US), a Securities Class Action was filed against Capital One by Faruqi & Faruqi, LLP due to the data breach. Faruqi & Faruqi encouraged investors who suffered losses exceeding US$100,000 to join in the class action and the deadline of joining was 2 December 2019.[141] A Consumer Class Action was also filed in the US by Morgan & Morgan, which has been appointed to represent consumers to obtain a class-wide relief against Capital One for its purported negligence in the data breach.[142] Vancouver, in Canada, is filing a class action against Capital One on behalf of six million Canadians whose personal data are compromised.[143]

CHANGE IN CYBERSECURITY LEADERSHIP

On 7 November 2019, four months after the data breach, Capital One replaced the cybersecurity chief, Michael Johnson. "Michael Johnson is moving from his role as chief information security officer to serve as senior vice president and special advisor dedicated to cybersecurity,"[144] said the spokesperson of Capital One. Mike Eason, who served as the chief information officer for the bank's commercial banking division, will be replacing him, while the bank searches for a permanent replacement.[145]

LESSONS LEARNED?

Capital One's data breach serves as a poignant reminder that technology is a double-edged sword; while it has its merits in improving operational efficiency and enhancing customer experience, it also exposes banks to a plethora of technology risks, such as cybersecurity breaches. Capital One had the misfortune of experiencing this duality first-hand; the bank's unprecedented progress in technology ironically became an instrument of its own undoing. While the bank has promised to learn from this setback and make improvements for the future, it remains to be seen if the bank can make good on its commitment. With the SEC's newly issued guidance on cybersecurity disclosure focusing on the cybersecurity policies and procedures, the ball is in the hands of the banks to ensure that their corporate governance and risk management frameworks are appropriate and adequate in the context of a more tech-oriented banking landscape. As articulated by writer and philosopher George Santayana: 'Those who do not learn history are doomed to repeat it'.

DISCUSSION QUESTIONS

1. Discuss the extent to which the composition of the Board, especially the Board Risk Committee, and the competencies of its members are effective in ensuring sound cyber risk management within Capital One.
2. How effective is class action in protecting the rights of various stakeholders such as customers and shareholders of Capital One? Assess the effectiveness or applicability of class action in both the US and your country.
3. Evaluate the extent to which existing remuneration policies and structures affect the behaviour and decision-making of directors and management in the context of the data breach. Discuss the potential corporate governance pitfalls associated with improper remuneration packages.

4. Evaluate the effectiveness of Capital One's risk management frameworks and processes in the context of the data breach. Identify some of the potential lapses in its cyber-security systems that could have led to the breach. Assess the extent to which Capital One's risk assessment process is adequate.
5. Evaluate the effectiveness of Capital One's response to the data breach and provide suggestions on how it could have better managed the crisis. Provide suggestions on how Capital One can develop and improve its crisis risk management framework and policies to minimise the impact of disruptions.
6. Examine Amazon's role in Capital One's cyber-security systems and analyse the extent to which lapses in Amazon's corporate governance and risk management frameworks may have led to the data breach. Discuss how banks can better manage the risks involved with outsourcing services to third-party vendors.

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SINGAPORE

1 Raffles Place
#31-01 One Raffles Place
Singapore 048616

P: +65 6671 6500
E: sg@cpaaustralia.com.au

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