

Business Associations II, Simulation 2: Shareholders

Simulation 2 will address fiduciary duties, derivative actions and shareholder inspection rights. As the fact pattern for this simulation I chose the Société Générale (SocGen) rogue trading scandal because it both provides detailed, ambiguous facts (as in most real life cases) and an opportunity to learn a little bit about the financial world. SocGen is a French company but for the purpose of applicable law in this simulation please treat it as a Delaware Corporation.

Please read the articles below, which have been edited for the sake of brevity. The first article (from the NY Times) presents an early report on a \$7 Billion loss that SocGen alleged was the result of unauthorized trading by a junior employee, Jérôme Kerviel. The article ends with some experts casting doubt about the bank's presentation of the event.

The next two articles address this issue. The second article (a snippet from the Financial Times) presents Kerviel's claims that contradict the bank's factual portrayal of the events. The third article (from the Economist) points to faults in SocGen's risk management procedures.

In class, your team will split into sections representing the SocGen BoD and unhappy SocGen shareholders. In round one, each section's tasks will be:

- Counsel for BoD: Identify legal risks from SH suits alleging breach of fiduciary duties & recommend what to do to make BoD as unattractive a target for a derivative suit as possible.
- Counsel for SHs: Write a letter to the SocGen BoD on behalf of the SHs, demanding information under SH inspection rights.

In round 2:

- Counsel for BoD: Respond to the SHs letter, trying to find faults in the demand to minimize the amount of information you need to provide and make the information less useful for a potential lawsuit.
- Counsel for SHs: Decide on the content of your derivative suit. Specify the legal basis for your claim and the factual allegations that support your claim. If you decide to make a demand on the board, write this as a demand letter. If you decide not to make a demand on the board, write this as a complaint (that initiates the law suit).

In round 3, the entire team will represent the BoD – Write a memo to the BoD instructing them how to respond to the SocGen complaint, addressing the arguments BoD can make for dismissal of complaint, and instructing on procedures BoD should undertake to improve odds of dismissal.

Please read the articles a first time before we begin teaching the section. As we go through the material, please consider how it affects your analysis of all of the tasks above. Then, just before the class in which we hold the simulation, please re-read the articles (to make sure you remember the details), and write down outline responses to all of the tasks. These will help you be more efficient when working in class.

The New York Times
nytimes.com **French Bank Says Rogue Trader Lost \$7 Billion**

By NICOLA CLARK and DAVID JOLLY

New York Times; January 25, 2008

PARIS — A French bank announced Thursday that it had lost \$7.2 billion, not because of complex subprime loans, but the old-fashioned way — because a 31-year-old rogue trader made bad bets on stocks and then, in trying to cover up those losses, dug himself deeper into a hole.

Société Générale, one of France's largest and most respected banks, said an unassuming midlevel employee who made about 100,000 euros (\$147,000) a year — identified by others as Jérôme Kerviel — managed to evade multiple layers of computer controls and audits for as long as a year, stacking up 4.9 billion euros in losses for the bank.

Unlike many of his high-level trading colleagues, Mr. Kerviel graduated not from one of France's elite universities, but from a business college in Lyon, and worked up the ranks. It was from his perch in the department that deals with auditing the bank's trading that Mr. Kerviel developed what bank officials described as an "intimate and perverse" knowledge that he used to cover up unauthorized trades.

The bank uncovered his scheme last weekend. It was selling off its positions during Monday's market turmoil in Europe that led, in part, to the Federal Reserve's history-making rate cut of three-quarters of a percentage point.

The fraud appeared to be the largest in history by a rogue trader. Mr. Kerviel made no money personally, but apparently hid the trades by making fake orders to balance each of the genuine orders he placed. One unanswered question that authorities will investigate is why it took so long for the bank to uncover the fraud.

The bank maintained Mr. Kerviel acted alone, but experts wonder how that could be possible, given the checks and balances at financial institutions.

Christian Noyer, governor of the Bank of France, the nation's central bank, said that the losses had put Société Générale in "a very dangerous situation," but that the bank's plan to seek 5.5 billion euros (\$8 billion) in fresh capital from shareholders would return it to financial health.

[...]

Mr. Kerviel's whereabouts were unknown, with the bank saying he was missing. But a woman identifying herself as his lawyer told French television Thursday night that "he is not on the run" and that Mr. Kerviel was willing to speak to authorities.

In bankerly understatement, Société Générale's chairman, Daniel Bouton, wrote in a letter to clients Thursday that "Société Générale has been victim of a serious internal fraud committed by an imprudent employee."

The fraud, carried out over the course of a year, harked back to other huge frauds traders managed to inflict on their employers. In 1995, Nick Leeson, a Singapore-based trader, incurred the equivalent of \$1.4 billion in losses over \$27 billion in bad bets on Japanese markets. (Similarly, Mr. Kerviel bet on European stock indexes.)

In the end, Mr. Leeson brought down the venerable British bank Barings. After spending four years in prison and writing a book, he is on the lecture circuit.

Mr. Leeson — who like Mr. Kerviel had detailed understanding of back-office operations — was found to have acted alone. But Barings was criticized for poor controls and oversight.

While Société Générale will survive — in contrast to Barings, which was broken up and sold — the loss is an embarrassment to a venerable French institution. It was founded in 1864 under Napoleon III, and today has 120,000 employees and 22.5 million customers worldwide.

The Kerviel scandal was not the only problem the bank revealed on Thursday. It also said that it would write off 2.05 billion euros (\$3 billion) of United States exposure in the fourth quarter, including 1.1 billion euros related to the housing market and 550 million euros related to United States bond insurance companies. It said it was setting aside an additional 400 million euros in provisions against the risk that losses in those two areas would grow.

Société Générale officials said that Mr. Kerviel confessed and that the bank had begun legal proceedings. They said they did not know his motives, and, in a news conference some French news organizations called "surreal," questioned his sanity, saying he had "family problems." The officials did not offer evidence to support their assertions.

Société Générale said it had no indication that the trader — who joined the company in 2000 and worked for several years in the risk-management office before being moved to the Delta One trading desk in Paris — "had taken massive fraudulent directional positions in 2007 and 2008 far beyond his limited authority."

The bank said that the trader — who Mr. Noyer, the central bank governor, said “breached five levels of controls” and was “a computer genius” — continued the fraud until this past weekend. That is when auditors in the risk-management office detected fictitious trades involving European stock index futures.

When the fraud was unveiled, Mr. Bouton said, it was “imperative that the enormous position that he had built, and hidden, be closed out as rapidly as possible.”

The timing could hardly have been worse. Société Générale was forced to begin unwinding the trades on Monday “under conditions of extreme market volatility,” Mr. Bouton said.

[...]

SocGen, as it is widely known, has been criticized for a reluctance to be more forthcoming about its subprime exposure, but the bank was generally well regarded in the financial world.

This month Risk Magazine, a British publication, named SocGen “equity derivatives house of the year,” praising its ability to manage its risks.

[...]

The bombshell for the bank comes as mounting losses from subprime-related investments have raised questions about risk management at institutions.

Howard W. Lutnick, chief executive of Cantor Fitzgerald, said that such a huge fraud by one trader indicated a bigger weakness in the bank’s systems.

“One person could engineer it — but how could one person finance it?” Mr. Lutnick said on the sidelines of the World Economic Forum. “The question for the risk management department is, How was this kind of fraud financed? Where did that money come from?”

Howard Davies, former chairman of the Financial Services Authority of Britain and now director of the London School of Economics, said the bank’s explanation of events seemed incomplete. “I don’t think we’ve had the full story,” he said, arguing that one person, however well informed on the bank’s control procedures, should not be able to hide a trade of this scale.

“It’s a lot of money,” he said. “Normally you have a compliance mechanism,” which involves trades like these being run by more than one person, to avoid a situation where it is “only one pair of eyes.”

[...]

Société Générale was aware of Jérôme Kerviel's trading actions, according to the transcript of his conversation with financial investigators released yesterday on the website of *Le Monde*, the French daily.

"I cannot believe that my superiors did not know about the amounts I was taking on," he is reported to have told investigators. "It is impossible to generate that much profit with small positions, which leads me to say that so long as I was in profit, the superiors closed their eyes to the way I did it and the amounts I took on.

"From day to day, in the normal course of trading and taking normal-sized positions, no trader can generate that much money. [...] As long as we were earning and it wasn't too visible, it was fine and nobody said anything..."

Finance and economics

The Economist February 2nd 2008 81

Société Générale

No Défense

The humiliated French bank has plenty more explaining to do before putting its rogue-trader scandal behind it

AN OLD line of Hank Paulson's has been dusted off since news broke of a €4.9 billion (\$7.2 billion) trading loss at Société Générale, France's second-largest bank. "We will never eliminate people doing bad things," the former head of Goldman Sachs, now America's treasury secretary, once said. "In a town of 20,000 people, there's a jail." The question now being asked of SocGen is: shouldn't there also be a police force?

In fact, SocGen has plenty of internal cops at its high-security headquarters in the La Défense enclave of Paris. The bank's annual report for 2006 devotes 26 reassuring pages to its risk-management practices; more than 2,000 staff worked in the function that year, and lots more bodies were added in 2007. Yet none of them stopped Jérôme Kerviel, the trader accused of taking enormous unauthorised bets, from building an unhedged €50 billion exposure to European futures markets (Mr Kerviel reportedly alleges that his supervisors were aware of his activities).

On January 28th Mr Kerviel was placed under formal investigation for abuse of trust, breaching computer security and falsifying documents. Two days later Daniel Bouton, SocGen's chairman and co-chief executive, survived a board meeting to consider his handling of the affair. He was lucky. Holes have not only appeared in the bank's accounts; its initial version of events is also looking threadbare.

Mr Bouton's description of Mr Kerviel

as having "an extraordinary talent for dissimulation" certainly looks less convincing as more details emerge. Although Mr Kerviel was properly found out on January 18th, he had tripped alarms inside the bank well before then. "When challenged, he was clever enough to say, for example, that he had made a mistake," says Jean-Pierre Mustier, the head of SocGen's investment-banking arm. Clever, indeed. Rival banks, admittedly fortified by anonymity, say that their traders would not have been able to keep getting away with that kind of explanation. Some people wonder if SocGen would have blown the whistle at all had the bets been profitable. Outsiders raised other suspicions. Eurex, Europe's largest futures exchange, contacted SocGen about oddities in trading patterns in late 2007, which the Paris prosecutor says referred to Mr Kerviel's positions. The bank says that Eurex's questions were rather technical in nature and that it had responded to them.

The sheer size of Mr Kerviel's exposure, the losses on which tripled as SocGen frenetically unwound its positions between January 21st and 23rd, has caused most bafflement among veterans of the futures markets. Two big blind spots saved him from detection. The first was the bank's focus on traders' net exposure, the difference between the portfolios that are being arbitrated. Mr Kerviel did not have a defined gross-exposure limit. By creating a fictitious portfolio of trades that appeared to

balance those he was really making, his net exposure stayed within set ranges and he remained below the radar.

Why didn't the margin calls on Mr Kerviel's real trades (likely to have been of the order of €2.5 billion on a €50 billion position) trigger alarms? This was the second blind spot. According to Mr Mustier, margin data from Eurex showed only consolidated positions. These positions were "not a different order of magnitude" from the volumes expected of a big investment bank. "One lesson of this is that it is important to see what is attributable to each trader," he says. In truth, that should not have been too difficult as well as consolidated figures, Eurex says it does already send data that tie margins to specific traders on a daily basis.

Mr Kerviel's credentials as a supervillain look less impressive in other ways too. His fictitious portfolio did not just comprise over-the-counter transactions with big banks, where agreed credit limits meant he could avoid margin calls. Embarrassingly, it also included trades with other parts of SocGen. Access to risk-control codes did not necessarily require the skills of a seasoned hacker; the bank says he may simply have offered to input details of trades on behalf of middle-office people when there was lots of activity on the trading floor. Some control procedures appear to have been predictable, being timed to take place shortly before the settlement date of futures contracts. Mr Kerviel's limited holidays and late nights should also have raised red flags.