Professional Responsibilities – Introductory Comments
Ingo Walter
The market value of firms is a function of *risk-adjusted* expected future net earnings.
Premises

- Risk exposures include -- market risk, credit risk, operations risk and *risks related to misconduct*
  - Adverse civil judgments
  - Regulatory penalties
  - Criminal indictment
  - Loss of reputation
Premises

♦ Problems 1990 - 2000: Failure, near-failure or massive shareholder-value losses attributable to misconduct:
  ♦ 8 of top-10 U.S. securities firms
  ♦ 4 of top-6 U.K merchant banks (pre-acquisition)
  ♦ 3 of top-3 Japanese securities firms
  ♦ Various commercial and universal banking institutions and insurance companies
Premises

- Two related dimensions
  - Individual dimensions
  - Firm misconduct
The Great Ring of Social Control

- Anti-Trust Agencies & Enforcement
- Trade Unions
- Employment & Safety Laws
- Securities Laws
- Tax Laws & Their Application
- Public Interest Lobbies
- Exposure to Litigation
- Protection Laws and Regulation
- Consumerism and Consumer
- Industry-specific regulation (Drugs, Electric Power, Banking, etc.)
- Environmental Laws & Infrastructure
- FIRM
Performances Gaps, Competition and Conflict

- **SOCIETY'S VALUES**
  - Immoral Conduct
- **PEOPLE’S EXPECTATIONS**
  - Irresponsible Conduct
- **LEGISLATION**
  - Illegal Conduct
- **ENFORCEMENT INFRASTRUCTURE**
  - Compliance Failure
- **Conflict Vectors**
- **FIRM CONDUCT**
- **Competition Vectors**
- **MARKET-BASED PERFORMANCE**
The Regulatory Gorilla

He's in charge of market discipline. Nobody understands the market so we're concentrating on the discipline.
Regulatory Tradeoffs, Techniques and Control

- Financial Services Firm
- Delivery System
- Regulatory Techniques
- Goal
- Regulatory Objectives
Regulatory Tradeoffs, Techniques and Control

Goal: Financial system efficiency

Financial Services Firm → Delivery System → Regulatory Techniques → Regulatory Objectives
Regulatory Tradeoffs, Techniques and Control

Goal

Financial Services Firm

Delivery System

Regulatory Techniques

Regulatory Objectives:
- Assure safety & soundness
- Avoid moral hazard & adverse-selection
- Assure market transparency
- Prevent abusive practices
Regulatory Tradeoffs, Techniques and Control

Financial Services Firm

Delivery System

Regulatory Techniques:
- Fitness & properness
- Line-of business limits & firewalls
- Credit-risk exposure limits
- Market-risk exposure limits
- Market-to-market accounting
- Functional separation & Chinese walls
- Conflict of interest controls
- Fiduciary obligation
- Insider dealing rules
- Self-dealing rules
- Disclosure regulation
- Product-level regulation

Goal

Regulatory Objectives
Financial Services Firm

Delivery System:
- Self-control
- Industry self-regulation
- Public supervision with teeth
- Criminal justice system
- Civil justice system

Regulatory Techniques

Goal

Regulatory Objectives
Citigroup Taps Fed Official Small As Anti-Money-Laundering Chief

By PAUL BECKETT
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—Citigroup Inc., the nation’s largest financial-services company, named Richard Small, head of enforcement at the Federal Reserve Board, to the new position of director of global anti-money laundering.

The appointment of Mr. Small, 46 years old, comes after Citigroup, parent of Citibank, has been in the spotlight in recent years over what critics say have been questionable anti-money-laundering controls. Citigroup said the hiring, which will take effect in early July, is part of an effort to become a leading example in combating money laundering.

"Citigroup remains committed to being on the forefront of the global fight against money laundering," Charles Prince, Citigroup’s chief operating officer, said. "I have no doubt that Rick will propel us further as we continue to aspire to be a true industry leader."

Citigroup’s track record on guarding against questionable activity has been spotty, even though the bank, which operates in more than 100 countries, in the past couple of years has been trying to tighten standards.

In November 1999, John Reed, the bank’s then co-chairman, acknowledged in a U.S. Senate hearing that Citibank’s private bank had lapsed in handling accounts of controversial figures. Citibank also acknowledged last year that it opened more than 100 accounts for a Russian businessman through which $725 million in questionable funds moved from 1991 to 2000. And, most recently, Citibank was one of several large U.S. banks, including Bank of America and J.P. Morgan Chase & Co., that were criticized in a U.S. Senate staff report for their handling of accounts maintained for high-risk offshore banks.
Research: Securities Industry Association Preemptive Strike

“Best Practices for Research” Mission Statement

Research should be conducted at all times in a manner consistent with the firm’s business principles and its investing clients’ Objectives. Each firms should have a written statement Reflecting these Best Practices and affirming a commitment to The integrity of research (including ratings, price targets and valuation methodology, and earnings estimates) and should Distribute this statement, at a minimum, to all relevant employees once a year.

June 12, 2001
Start of Congressional hearings on equity research; June 14,2001.
SIA Principles:

- The investing client comes first.
- Objective and independent judgment is required of analysts.
- Research should not report to investment banking or any other unit that compromises its integrity.
- Analyst compensation should not be tied to any source of revenue production.
- Personal trading should be consistent with investment recommendations and personal interests should be disclosed.
- No outside approval of investment recommendations required.
- Investment banking and all other business units should support research integrity.
- Recommendations should be transparent and consistent.
- Disclaimers should be clear and comprehensive.
What Needs to be Optimized

CONDUCT BENCHMARK

MARKET CONDUCT

IMPACT ON COSTS

Operating
Litigation
Compliance
Managerial
Human

POTENTIAL FOR CONFLICT

IMPACT ON RISK

Civil liability & bankruptcy
Earning stability
Reputation
Criminal indictment
Control change

LONG-TERM RISK-ADJUSTED NET RETURNS TO SHAREHOLDERS
<table>
<thead>
<tr>
<th>Firm</th>
<th>Year</th>
<th>Event</th>
<th>Consequence</th>
</tr>
</thead>
<tbody>
<tr>
<td>E.F. Hutton</td>
<td>1986</td>
<td>Check “kiting” scandals</td>
<td>Now defunct (Sold 1987)</td>
</tr>
<tr>
<td>Kidder Peabody</td>
<td>1986</td>
<td>Insider trading scandals</td>
<td>Now defunct (Sold 1994)</td>
</tr>
<tr>
<td></td>
<td>1993</td>
<td>Falsifying government bond trades</td>
<td></td>
</tr>
<tr>
<td>Drexel Burnham Lambert</td>
<td>1987</td>
<td>Insider trading, stock parking</td>
<td>Now defunct.</td>
</tr>
<tr>
<td>Morgan Grenfell</td>
<td>1987</td>
<td>Insider trading, stock manipulation in the “Guinness Affair”</td>
<td>Sold to Deutsche Bank 1989</td>
</tr>
<tr>
<td>County NatWest (sub of NatWest Bank)</td>
<td>1987</td>
<td>Stock Manipulation in the “Blue Arrow affair”</td>
<td>Reorganization</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Major losses at parent Parent management changed CEO changed</td>
</tr>
</tbody>
</table>
## Firms That Have Suffered Serious Damage to Shareholder Value Due to Misconduct, 1986–1996

<table>
<thead>
<tr>
<th>Firm</th>
<th>Year</th>
<th>Event</th>
<th>Consequence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goldman, Sachs &amp; Co</td>
<td>1987</td>
<td>Insider trading (Robt. Freeman)</td>
<td>Large legal expenses</td>
</tr>
<tr>
<td></td>
<td>1994</td>
<td>“Maxwell Affair” pension funds</td>
<td>$250 million in fines</td>
</tr>
<tr>
<td>BCCI</td>
<td>1991</td>
<td>Various frauds, money laundering</td>
<td>Now defunct</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Billions lost to investors and depositors</td>
</tr>
<tr>
<td>Salomon Brothers</td>
<td>1991</td>
<td>US Government bond auction scandal</td>
<td>$500 million in fines, settlements</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$1 billion market cap loss</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Complete management change change</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>CEO changed</td>
</tr>
<tr>
<td>Nomura Securities</td>
<td>1991</td>
<td>Improper payments, market rigging</td>
<td>Large fines, operating losses</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>CEO changed</td>
</tr>
<tr>
<td>Baring Brothers</td>
<td>1995</td>
<td>Fraudulent trading of Nikkei index contracts</td>
<td>Now defunct. $1.4 billion loss</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(Sold to ING 1995)</td>
</tr>
<tr>
<td>Firm</td>
<td>Year</td>
<td>Event</td>
<td>Consequence</td>
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<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Prudential Group</td>
<td>1995</td>
<td>Fraud at Prudential Securities</td>
<td>$1.5 billion in fines and settlements</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Fraud at PRISA</td>
<td>$345 million in further settlements</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Fraud at Prudential Insurance</td>
<td>Up to $1 billion left to settle</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>CEO changed</td>
</tr>
<tr>
<td>Paine Webber</td>
<td>1995</td>
<td>Fraudulent sale of limited partnerships</td>
<td>$300 million in fines and settlements</td>
</tr>
<tr>
<td>Bankers Trust</td>
<td>1995</td>
<td>Misrepresentations in derivatives trading</td>
<td>$300 million in customer losses</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$1 billion market cap loss</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>CEO changed</td>
</tr>
<tr>
<td>Daiwa Bank</td>
<td>1995</td>
<td>Concealed trading losses</td>
<td>Fines, loss of US license</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>CEO changed</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>1996</td>
<td>Orange County loss of $1.2 billion in leveraged</td>
<td>Pending</td>
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<tr>
<td></td>
<td></td>
<td>interest-rate products</td>
<td></td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>1996</td>
<td>West Virginia CIF</td>
<td>Settlement of $20 million</td>
</tr>
</tbody>
</table>