

Case Study

Trading Scandal at Société Générale

In January 2008, Société Générale (SocGen), France's second largest banking establishment, was a victim of internal fraud carried out by an employee, Jérôme Kerviel. SocGen bank lost €4.9 billion (euros) as an immediate result of the fraud. (At the time of this incident, the euro was worth approximately \$1.45 dollars.)

In 2007, SocGen was rated the best equity derivatives operation in the world by *Risk* magazine. Its internal control system of checks and balances was world renown. For example, its trading room has five levels of hierarchy. Each of those levels has a clear set of trading limits and controls, which are checked daily by a small army of compliance officers.²⁷ In addition, "the bank also has a shock team of internal auditors who descend on a corner of the bank without warning and pull apart its operations to ensure they conform to bank rules."²⁸

During the summer of 2000, Kerviel began employment in the bank, ironically, in its compliance department. Five years later, he was promoted to a junior trader in the arbitrage desk, which deals in program trading, exchange traded funds, swaps, stock index futures trading, and quantitative trading. Kerviel was responsible for generating profits for the bank and its customers by betting on the market's future performance. His first major win came in 2005 when he shorted stock of German insurer Allianz and earned the bank €55,000.

Thanks to his years of experience in the compliance department, Kerviel was an expert in the proprietary information system SocGen used to book trades. He knew that while the risk-control department monitored the bank's overall positions very closely, it did not verify the data that individual traders entered into the system. Kerviel also knew the timing of the nightly reconciliation of the day's trades, so that he was able to delete and then re-enter unauthorized transactions without getting caught.

On November 7, 2007, SocGen received an e-mail alert from a surveillance officer at Eurex (one of Europe's largest exchanges). The message stated that Kerviel had engaged in several transactions that had set off alarms at the exchange over the past seven months. A SocGen risk-control expert responded two weeks later that there was nothing irregular about the transactions. A week later, Eurex sent a second e-mail alert stating that they were not satisfied with SocGen's explanation and demanding more details. Following another two-week delay, SocGen provided further details, and both Eurex and SocGen let the matter drop. The compliance officer who made both replies to Eurex used accounts provided by Kerviel and his supervisor as well as a compliance officer at a SocGen subsidiary. Kerviel's supervisor stated that there was no anomaly whatsoever.

Following the Eurex warnings, Kerviel took additional steps to cover his tracks by manipulating portions of the internal risk-control system with which he was unfamiliar. This ultimately led to the discovery of his alleged fraud.²⁹ On January 18, 2008 Kerviel executed trades, which set off another alarm. This time, upon a more thorough investigation, a major problem became apparent. As SocGen risk-control experts reviewed Kerviel's latest transactions carefully, they were shocked to discover that they had resulted in a position of €50 billion (obviously far beyond Kerviel's trading limit) which, when finally cleared, resulted in a loss of more than €4.9 billion!

As of this writing, Kerviel is still under investigation and involved in litigation charging him of using his insider knowledge to falsify records and commit computer fraud. Prosecutors suspect

his motivation was to boost his income by making successful trades far beyond his trading limits, thus earning large bonuses (his total salary and bonus for 2007 was a relatively modest €94,000). Kerviel spent five weeks in jail but is currently free on bond. He was hired in February 2008 as a computer consultant by the French firm Lemaire Consultants & Associates, however, he is said to be “traumatized” by his new-found infamy.

Kerviel admits he took trading positions beyond his authorized limit to make transactions involving European index futures. Kerviel told prosecutors “the techniques I used aren’t at all sophisticated and any control that’s properly carried out should have caught it.”³⁰ He insists he did no wrong and that the bank was fully aware of his transactions. Kerviel has said he refuses to be made a scapegoat for the bank’s lapses in oversight. He argues that his superiors tacitly approved his activities—as long as they were generating a profit. Kerviel had earned a profit for the bank of nearly €1.5 billion in 2007 by exceeding his trade limit and executing similar, but successful, trades. The bank meanwhile said the fraud was based on simple transactions, but concealed by “sophisticated and varied techniques.”³¹ If convicted, Kerviel faces up to five years in jail and fines for as much as €300,000.³²

The sterling reputation of SocGen was tarnished badly and the market value of the firm dropped 50 percent over the course of just a few months. The bank’s highly respected CEO and Chairman of the board, Daniel Bouton, was put under enormous pressure to step down; this included requests for his resignation from French President Nicholas Sarkozy. Bouton eventually resigned as CEO in May 2008, but he remains chairman of the board.³³ In December 2008, European hedge fund GLG Partners entered into an agreement to acquire the bank in the second half of 2009.³⁴

Several internal and external investigations of the bank’s operating procedures and internal controls have been completed. The French banking regulator stated there were “grave deficiencies” in the bank’s internal controls and fined it €4 million. The Banking Commission said SocGen did not focus sufficiently on fraud weaknesses and there were “significant weaknesses” in the bank’s IT security systems. Another report pointed out that Kerviel’s direct supervisor was inexperienced and received insufficient support to do his job properly. It also stated that Kerviel’s fraudulent transactions were entered by an unnamed assistant trader thus raising the issue of collusion and indicating even more widespread weaknesses in internal controls.

Pascal Decque, a financial analyst who covers SocGen for Natixis (a leading player in corporate and investment banking) commented, “SocGen was brilliant in their achievement, they were the world leader in derivatives. Maybe when you are that good, you think you will never fail.”³⁵

Discussion Questions

1. Peter Gumble, European editor for *Fortune* magazine comments: “Kerviel is a stunning example of a trader breaking the rules, but he is by no means alone. One of the dirty little secrets of trading floors around the world is that every so often, somebody is caught concealing a position and is quickly—and quietly—dismissed. Traders do this not infrequently, and the question is how quickly compliance systems pick it up.” [This] “might be shocking for people unfamiliar with the high-risk, high-reward culture of most trading floors, but consider this: the only way banks can tell who will turn into a good trader and who won’t is by giving every youngster it hires a chance to show his mettle. This means allowing even the most junior traders to take aggressive positions. The leeway is supposed to be matched

by careful controls, but clearly they aren't foolproof."³⁶ What is your reaction to this statement by Mr. Gumble?

2. What explanations can there be for the failure of SocGen's internal control system to detect Kerveil's transactions while Eurtex detected many suspicious transactions?
3. Should banks and investment firms permit members of their compliance departments to become traders?
4. Do research on the Web to find out if Kerveil was found guilty and punished. What other outcomes resulted from this incident?

Endnotes

- ¹ "About Hannaford," Hannaford Web site at <http://hannaford.com>, accessed November 21, 2008.
- ² "Hannaford Bros Supermarkets Hit By Big Data Breach," <http://wbztv.com>, March 17, 2008.
- ³ Bill Brenner, "Hannaford Breach Details Indicate Inside Job," http://searchsecurity.techtarget.com/news/article/0,289142,sid14_gci1307486,00.html, March 28, 2008.
- ⁴ Ed Dickson, "Hannaford Brothers Data Breach Might Reveal Current Security Standards Are Outdated," Blogger News Network, www.bloggernews.net/114589, March 19, 2008.
- ⁵ "Hannaford Bros.Faces Class Action Over Data Breach," ConsumerAffairs.com, www.consumeraffairs.com/news04/2008/03/hannaford_data2.html, March 21, 2008.
- ⁶ "What is an Ethics Officer?" Web site of Ethics Officer Association, www.eoa.org, accessed November 22, 2008.
- ⁷ Patricia Harned, "A Word from the President: Ethics Offices and Officers," *Ethics Today Online*, www.ethics.org, Volume 3, Issue 2, October 2004.
- ⁸ Robert Mullins, "HP Hires Ethics and Compliance Officer," *Computerworld*, October 17, 2006.
- ⁹ K.C. Jones, "Calif. Attorney General Attempting Deal Between HP, Pretext Victims," *Computerworld*, December 8, 2006.
- ¹⁰ "Chief Privacy Officers: Forces or Figureheads?" *Computerworld*, March 24, 2001.
- ¹¹ David Herron, Scott H. Dunham, Linda Kwak, and Shannon Gibson, "Ninth Circuit Court Addresses Privacy Rights for Employer-Provided Text-Messaging Capabilities," *O'Melveny & Myers LLP Employment Law Newsletter*, October 3, 2008.
- ¹² "CSI Survey 2007," GoCSI.com, accessed June 27, 2008.
- ¹³ Keith Regan, "Web Crime Spikes in 2007, Losses Near \$240 M," *Electronic Commerce Times*, April 4, 2008.
- ¹⁴ Ross Kerber, "Cost of Data Breach at TJX Soars to Over \$256 M," *Boston Globe*, August 15, 2007.
- ¹⁵ "Botnet," *SearchSecurity.com*, accessed December 8, 2008.
- ¹⁶ Robert McMillan, "Internet has A Trash Problem, Researcher Says," *Network World*, April 1, 2008.
- ¹⁷ Carolyn Duffy Marsan, "How Close is World War 3.0," *Network World*, August 22, 2007.
- ¹⁸ Marc Gartenberg, "How to Develop an Enterprise Security Policy," *Computerworld*, www.computerworld.com, January 13, 2005.
- ¹⁹ Robert Richardson, "2008 CSI Computer Crime & Security Survey," accessed at www.gocsi.com/forms/csi_survey.jhtml, January 12, 2009.