

UNOFFICIAL TRANSLATION

**Report to the Prime Minister on the conclusions to be drawn from recent events at Société Générale**

Prime Minister,

On 25 January, you asked me to submit a report on the events that resulted in a EUR 4.9 billion trading loss at Société Générale and on the initial conclusions to be drawn from this affair.

The following report is organised into four sections:

- the sequence of events;
- handling of the situation by the supervisory authorities;
- performance of the bank's internal control system;
- initial suggestions for strengthening oversight of market transactions.

This report was prepared on the basis of information provided by the Governor of the Banque de France, who chairs the Commission Bancaire, France's banking supervisor, and by the Autorité des Marchés Financiers (AMF), the securities regulator. It also draws on other information that was publicly available at 31 January 2008, particularly the *Explanatory Note about the Exceptional Fraud* published by Société Générale on 27 January 2008, and the hearings of the Governor of the Banque de France and the AMF Chairman before the Senate Finance Committee on 30 January 2008.

Neither this information, nor the resulting analyses and conclusions, have been subjected to a cross-examination. As such, this report cannot be considered to provide an exhaustive view of the events, and its analyses and conclusions are subject to change. This point needs to be stressed because some of the facts mentioned in the report are under official legal investigation by two examining magistrates of the Tribunal de Grande Instance de Paris. Meanwhile, the AMF is investigating trading in Société Générale shares and financial disclosures by the company, while the Commission Bancaire is investigating Société Générale's internal control system. With these investigations underway, the purpose of this ex parte report is not to apportion – still less to prove – blame or responsibility, since all those involved are entitled to be presumed innocent.

**1 Sequence of events**

The transactions that resulted in a loss of some EUR 4.9 billion for Société Générale on its proprietary trading activities are allegedly attributable to a lone trader. At present, there is no known evidence to indicate the contrary. The trader in question worked as an arbitrageur on equity derivatives (including warrants), a job that entails managing two portfolios of similar size and composition, the first being used to hedge the other. The

resultant risk, and also the net proceeds, are supposed to be low relative to the gross exposures arising on the portfolios.

In this case, the trader in question is alleged to have taken unauthorised directional positions on futures contracts on European equity indices, which he hedged using fictitious transactions that concealed the increase in the bank's net position and risk. The trader appears to have repeated the following pattern:

- he entered a trade to hedge the real position;
- he then cancelled the trade before it was picked up by a control or gave rise to a confirmation or a margin call, then entered a new trade.

He seems, therefore, to have managed his portfolios very actively as he attempted to hide his gains and losses.

### **1.1 The fictitious trades allegedly began in 2005**

- The trader began making irregular trades **in 2005**, but only from time to time and for relatively small amounts;
- **in 2006**, his irregular trading still involved small sums;
- **in 2007**, his net positions increased substantially to reach a notional amount of around EUR 30 billion;
- **in November 2007**, Eurex, a clearing house, asked Société Générale about the trader's strategy;
- **in early January 2008**, his real positions had increased to EUR 50 billion in gross terms on three futures indices: the Eurostoxx (EUR 30 billion), Dax (EUR 18 billion) and FTSE (EUR 2 billion).

### **1.2 Once the control department discovered the fictitious trades and informed the bank's senior management, the positions were quickly unwound**

- **Friday 18 January**: a few days earlier, the middle office had discovered an unusually large trade with a broker. This raised sufficient suspicion for the trader's immediate superiors and the bank's senior management to be informed. An internal audit team was formed towards the end of the day.
- **Saturday 19 January**: after questioning the trader and conducting checks with the institution that the trader claimed was his counterparty, senior management apparently obtained proof that many of the trades connected with the trader's portfolio were fictitious
- **Sunday 20 January, early afternoon**: the full extent of the exposure became known, following which:
  - Daniel Bouton, Chairman of Société Générale's Board of Directors, briefed the Audit Committee, which had been convened that day to examine the earnings estimates for 2007; he informed the committee of his intention to unwind the positions as swiftly as

possible and to suspend all communications concerning the situation and the bank's earnings until the position had been completely unwound;

- at the same time, he informed the Governor of the Banque de France, Chairman of the Commission Bancaire, of the situation;

- he informed the AMF General Secretary of the situation shortly before the Board of Directors meeting;

- he then informed the Board of Directors, which met at 6:30 pm to examine the earnings estimates for 2007, that it would not be possible to issue information about the results immediately because heavy losses might have been sustained from trading activities.

• **Monday 21 January to Wednesday 23 January:** the real position is unwound (see point 1.3.). During this period, Société Générale, the Banque de France, the General Secretariat of the Commission Bancaire, and the AMF were in regular contact.

• **Tuesday 22 January:** two representatives from the General Secretariat of the Commission Bancaire met with Société Générale representatives to obtain clarification about the trades in question and the shortcomings that enabled them to take place, to learn how quickly the position was being unwound, and to talk about the bank's proposed rights issue.

• **Wednesday 23 January, 8:00 am:** Daniel Bouton apprised the Minister for the Economy, Finance and Employment. On the same day, once the position had been closed, the Board of Directors was once again convened to be briefed on the situation and its consequences. The Banque de France briefed the US Federal Reserve, the European Central Bank and the supervisors of European countries in which Société Générale has operations.

• **Thursday 24 January, 8:00 am:** after asking for its shares to be suspended from trading, Société Générale publicly announced the trading loss of EUR 4.9 billion. It also provided information on its estimated 2007 earnings and said that it would carry out a EUR 5.5 billion rights issue, underwritten by JP Morgan and Morgan Stanley, that would raise its Tier 1 solvency ratio to 8 % (after recognising the impact of the Rosbank acquisition).

• **Friday 25 January:** a Commission Bancaire team began an inspection at Société Générale.

• **Monday 28 January:** the General Secretary of the AMF opened an investigation (see point 2.1).

### **1.3 Unwinding the position into the markets**

The positions identified on 20 January were unwound on 21, 22 and 23 January, resulting in a loss of EUR 4.9 billion. Société Générale published the following figures concerning the transactions used to unwind the positions. These transactions did not exceed 8.1% of trading volumes on the affected markets on each of the days in question.

% of volumes unwound on futures index markets	Eurostoxx	Dax	FTSE
21 January 2008	8.1%	7.8%	1.7%
22 January 2008	6.8%	5.7%	3.1%
23 January 2008	5.9%	6.1%	0%

Eurex and LIFFE, which operate these markets, informed the AMF that they had no complaints concerning the bank's trading on these three days. Eurex told the AMF that, given their unusual size, the positions were liquidated in a highly professional manner.

The positions were unwound amid particularly difficult conditions. Financial markets were in turmoil owing to uncertainty about future trends in the American economy, huge losses on sub-prime loans reported by major banking groups, and difficulties at one of the main monoline insurers. This caused a period of high market volatility from Friday 18 January 2007. The CAC40 index dropped below 5,100 points, its lowest level for more than a year, while Frankfurt lost 1.34% and Eurostoxx, a pan-European index, fell by 1.74%.

The decline continued and worsened on Asian markets on Monday 21 January before European markets opened. The Tokyo Stock Exchange closed at its lowest level since October 2005, down 3.86%, and the Hong Kong exchange lost 5.5%. The fact that US markets were closed that day, after falling for four consecutive sessions, did nothing to vent the pressures. This situation resulted in a strong reaction from European markets, which were forced to absorb substantial volumes. In Paris, trading volumes attained EUR 16.7 billion, including EUR 8.6 billion on the CAC40.

Markets moved in contrasting directions over the next two days. The Fed cut official rates by 75 basis points on Tuesday 22 January, but this had little effect on markets, which were still highly volatile because of ongoing concerns about the future of the global economy and fears about some monoline insurers. The main European markets continued to head downwards on Wednesday, with Paris and Frankfurt losing more than 4% and London more than 2%.

Any sale of a security on a market will, other things being equal, drive its price downwards. However, in light of the above factors, the transactions used to unwind Société Générale's positions did not cause the negative, volatile trend in financial markets between 21 and 23 January 2008.

## **2 Enforcement of market regulations and handling of the situation by the authorities**

### **2.1 Enforcement of market regulations**

The disclosure rules pertaining to the positions in question at Société Générale were strictly applied in an effort to protect the markets.

Under European rules<sup>1</sup>, which have been transposed into French law, issuers are required to "disclose to the public as soon as possible any privileged information"<sup>2</sup>. However, "the issuer may assume responsibility for deferring disclosure of privileged information" if the following three requirements are satisfied:

- the non-disclosure must be intended to protect the issuer's legitimate interests, and especially "in cases where the issuer's financial viability is in grave and imminent danger"
- the non-disclosure must not mislead the public
- the issuer must be able to ensure the confidentiality of inside information.

The information about Société Générale's open positions can be unquestionably qualified as inside information. At around 5:00 pm on Sunday 20 January, the AMF General Secretary gave his agreement in principle to the proposal to defer disclosure of this information to the market. The AMF Chairman subsequently gave his assent.

The decision to delay disclosure was entirely warranted by the situation in which Société Générale found itself, since it appeared possible both to unwind the positions and thereby eliminate the risk exposure, and to ensure the completion of a capital increase to strengthen the institution's capital. The alternative – immediate disclosure of the bank's actual exposure to equity derivative risk – could well have caused Société Générale's counterparties to lose confidence. This would not have been in the bank's interest and might have threatened the stability of the French and global financial systems.

Absolute secrecy had to be maintained. The AMF, the Governor of the Banque de France and the General Secretariat of the Commission Bancaire obtained assurances on this point from Société Générale, and they themselves took organisational measures to ensure that strict confidentiality was maintained.

Subsequently, on Monday 28 January, the AMF General Secretary decided to open an investigation into trading in Société Générale shares and the financial disclosures provided by the company. The issues addressed by that investigation, which is being conducted by an independent authority and on which government has no say, do not come within the ambit of this report.

## **2.2 Cooperation between authorities; informing the government of the situation**

The sequence of events described in the first section shows that Société Générale and the relevant authorities, namely the Banque de France and the AMF, communicated well. The two authorities engaged immediately in close cooperation.

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<sup>1</sup> Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse).

<sup>2</sup> Particularly Article 223-2 of the AMF General Regulation. Inside / privileged information is defined by Article 621-1 of the same General Regulation, as having three characteristics: it must be precise, confidential, and likely to have an effect on prices if made public.

The question is whether, given the exceptional nature of these events, the government ought to have been informed before the morning of Wednesday 23 January.

The situation definitely came under the supervisory remit and powers of the Banque de France, the Commission Bancaire and the AMF. The independence of these authorities is clearly set down in law. However, this does not preclude regular cooperation and exchanges of information with the government. In France as elsewhere, it is good practice for the government to be fully and swiftly involved in handling situations where the financial situation of a private financial institution is in jeopardy.

In this case, the course of action being considered by Société Générale, namely unwinding open positions and conducting an underwritten capital increase, argued strongly in favour of preserving and even strengthening the bank's solvency. Absolute secrecy was vital to implementing these measures.

Based on these factors and their assessment of the professional secrecy requirements applicable in this instance, the supervisory authorities decided that it was preferable to wait until the morning of 23 January before apprising the government of the situation.

Given the exceptional nature of the situation and its potential consequences for the stability of the financial system, the government should probably have been informed before 23 January 2008. In the future, it will be important to specify more clearly how the supervisory authorities and the government should coordinate in this sort of situation to remove any uncertainty concerning the procedures and deadlines for providing information and the confidentiality rules that apply. These points could be clarified when transposing the crisis management agreements that are currently being drawn up at European level in accordance with principles established at the Ecofin meeting on 9 October 2007.

### **3 Performance of the internal control system**

Subject to the same reservations as those set out in the introduction, this section of the report is intended solely to consider the factors that seemingly enabled the transactions referred to in the first section to go undetected. It does not seek to identify those responsible or to apportion blame, since legal and administrative investigations are under way, and those involved are entitled to be presumed innocent. Accordingly, no conclusions may be drawn in this regard from this ex parte report.

The real unauthorised position was concealed by the following fictitious transactions:

- advance purchases or sales of securities or warrants: this type of transaction is usually finalised a few days before the value date
- futures transactions with a so-called pending counterparty, which are not transmitted to the back-office systems<sup>3</sup>

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<sup>3</sup> Support unit that manages information systems and performs trade accounting, among other things.

- forward contracts with a counterparty inside the group, which do not trigger margin calls
- forward contracts with an external counterparty, a technique used when closing the FY2007 accounts, accompanied by a forged confirmation, in an effort to avoid questions about intragroup accounting discrepancies.

### **3.1 Organisation of internal control and areas of control for positions and transactions**

Société Générale stresses that the trader in question could have been particularly well equipped to carry out the unauthorised trades as he had previously worked in its middle office<sup>4</sup> and was therefore thoroughly familiar with the control procedures.

Speaking at a hearing before the Senate Finance Committee on 30 January 2008, the Governor of the Banque de France said initial information suggested that Société Générale's internal control system had not worked properly, while the controls that had functioned had not always been properly monitored. A Commission Bancaire investigation will identify any shortcomings in Société Générale's internal control arrangements. The investigation will likely focus on the following aspects of internal control that may have played a decisive role, particularly in view of the information provided by the company:

- monitoring of traders' nominal outstanding positions (as opposed to monitoring of net positions, which, by definition, reveals limited market risk);
- monitoring of cash movements (margin calls and payments, initial margins, results);
- more extensive action on requests for information apparently sent to the bank by Eurex in November 2007;
- monitoring of trade cancellations and modifications by a single trader;
- confirmation of trades with all counterparties;
- compliance with the Chinese Wall between front and back offices, and the cross-cutting nature of the middle and back office structure;
- information system security and protection of access codes;
- monitoring of unusual individual behaviour (e.g. no holidays taken).

### **3.2 Earlier controls by the Commission Bancaire**

The Commission Bancaire conducts many inspections every year as part of the process of supervising a group as large as Société Générale. It examines not just the parent company, but also subsidiaries, different business lines, such as retail banking, corporate and investment banking, and specialised financing, and the various types of risk to which

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<sup>4</sup> Unit in charge of monitoring risk and controlling transactions.

the group is exposed (solvency, liquidity, internal control and risk management arrangements, anti-money laundering system).

In his hearing before the Senate Finance Committee on 30 January 2008, the Governor of the Banque de France said that Société Générale had been inspected 17 times in 2006-2007. These inspections focused in particular on the riskiest areas of activity and on the switch to Basel II prudential standards, which took place on 1 January 2008. The inspections resulted in recommendations by the Commission Bancaire, which advised the group to strengthen the teams and resources dedicated to counterparties. In March 2007, a guidance letter and a follow-up letter to this effect were sent to the Chairman and Chief Executive Officer of Société Générale. The follow-up letter dealt specifically with structured equity derivatives, but the recommendations, which were focused on security, were general in nature and covered all financial instruments, including futures.

Société Générale said it had put special control procedures and corrective measures in place as soon as it had discovered the trader's positions. In addition, Société Générale has decided to conduct supplementary controls to strengthen its internal control system.

#### **4 Initial suggestions for strengthening oversight of market transactions**

The events at Société Générale should certainly prompt extensive debate within the financial community at large – authorities and institutions alike – to identify best practices and establish rules to bolster the operational security of market transactions. This process will doubtless lead to changes in internal control regulations. In this regard, it should be emphasised that French legislation in this area has frequently been adjusted in the past to reflect changes in banking business.

Furthermore, to take account of the speed of these changes, some of the best practices that have been identified could be usefully disseminated by the Commission Bancaire without necessarily being incorporated into laws or regulations. In addition, market participants should take measures promptly in response to the events in question without waiting for legislative or regulatory changes.

The following ideas deserve particularly close attention. Aside from systems and procedures, they are intended to capture the importance of human factors when it comes, as in this case, to preventing and detecting abnormal or unusual behaviour that might be a source of operational risk.

##### **4.1 Strengthen the internal control processes of credit institutions**

Institutions need to be more systematic when examining several aspects of control in relation to market transactions. Many of these practices are already in effect, to be sure, but they must be implemented in every case:

- exposure monitoring is currently focused on net positions, which is used to measure market risk; more attention also needs to be paid to gross notional amounts, which reflect the extent of the institution's financial commitment;

- a proper audit trail must be ensured for every trade by every trader;
- trade anomalies, processing errors and trade cancellations should be rigorously identified and analysed;
- trade confirmations should always be verified through reconciliation procedures, both with internal counterparties and with counterparties outside the group;
- the terms and conditions of trades with external counterparties should be carefully documented.

Furthermore, it is crucial that trading room control procedures should be organised to provide an overall view of trading by each trader, making it possible to identify his or her trading profile and so spot unusual behaviour more easily.

In addition, the types of trades that each trader is permitted to perform should always be specified clearly in writing. This would ensure that the nature and amount of financial instruments used are consistent with the prescribed limits and company strategy.

Over-the-counter derivatives trades should be given closer attention, in particular as regards contract terms. For this, efforts should be made to promote the widest possible use of standard agreements drawn up by industry groups.

Information systems need to be properly protected to prevent intrusion. In particular, access modes should be covered by a procedure approved by senior management.

Care must be taken in trading rooms to ensure that the front office and control units are kept strictly separate, without restricting the wide range of possible career paths in this sector of activity.

#### **4.2 Enhance internal control regulations with measures to monitor operational risk**

Under the new Basel II solvency ratio, capital can be assigned to cover operational risk<sup>5</sup>.

Regulation 97-02 of the Banking and Financial Regulations Committee on internal control could be supplemented to address qualitative aspects of operational risk, by requiring all institutions to have a properly documented operational risk management system including operational risk mapping for each entity and/or business line and reporting requirements to the company's governing bodies and the Commission Bancaire.

#### **4.3 Make it clearer that preventing internal fraud is an integral part of internal control**

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<sup>5</sup> Operational risk includes risks that are not related to market or credit risk, but that are connected with external or internal events of a different nature, such as fire, IT failure or fraud, that affect an institution.

Monitoring the risk of internal fraud could be explicitly included under operational risk in the internal control regulations. This could include a requirement to inform the Commission Bancaire of non-compliance with internal rules if this breaches certain thresholds or has certain characteristics, even if no negative effects are apparent.

Furthermore, institutions that exceed a certain size or that have a particular risk profile could be encouraged to create a department dedicated to this task.

#### **4.4 Fully involve management in risk management**

Achieving the tangible improvements to internal control considered in this report will require greater involvement on the part of credit institutions' governance bodies. In this respect, and given the complexity of the transactions being performed, the governing bodies of credit institutions should set up committees that include some independent members in order to supervise risk and internal control. These committees would examine the work done by the different branches of internal control and prepare the discussions by the governing bodies on these issues.

Internal reporting systems also need to be improved, by ensuring that disclosures are consistent with the needs of different management or control levels. These reports should combine quantitative measurement of risk with a qualitative assessment to ensure that the nature of the activities is consistent with the related risks and rewards.

#### **4.5 Modify the penalties applicable to banking and financial institutions**

The maximum fine that the Commission Bancaire can impose on the largest institutions is EUR 5 million. Given what is at stake in this area, as well as the investments needed to build effective internal control systems, this ceiling is too low and should be substantially raised.

#### **4.6 Make proposals at international level**

Because market activities are highly internationally integrated, it would be appropriate for similar discussions to be held at European and international levels so that uniform standards can be applied to all participants.

Also, work could be done on some issues that have been insufficiently addressed at international level. One area is reputational risk, which is inherently difficult to measure. Supervisory authorities that belong to the Basel Committee and the Committee of European Banking Supervisors should clarify the capital requirements to be met by credit institutions with respect to reputational risk.

On the issue of transparency, proposals have been put forward for international work on the consistency of disclosure requirements under Pillar 3 of the new Basel II solvency ratio and under IFRS accounting standards, which at this stage do not require financial instruments disclosures to include information on operational risk.