

COUNTDOWN TO THE GLOBAL FINANCIAL CRISIS

A STORY OF POWER AND GREED

Paul Mazzola

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By

Paul Mazzola

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This book is dedicated to my father, Rosario, from whom I drew much encouragement and inspiration and who always provided well-timed and sage advice.

There are never wanting some persons of violent and undertaking natures, who, for they may have power and business, will take it at any cost.

(Francis Bacon)

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FOREWORD

BY CHRIS WHITEHEAD

CHARTERED BANKER F FIN, CEO & MANAGING DIRECTOR - FINSIA

Unfortunately, history is littered with instances of financial crises, so often driven by greed and, of course, the strong connection that exists between wealth and power. In every instance, it seems that the foundations of sound banking are forgotten, and we rush headlong and lemming-like into the creation of large financial investment schemes based on intangible or obscure assets. We forget the usual disciplines of real security and diversification.

What made the Global Financial Crisis (GFC) different was that the impact of the collapse was not contained to a narrowly defined market—geographically or asset class. It was an unravelling worldwide of trust across financial institutions that very quickly impacted the real economies of nations, regardless of their participation in the underlying causes.

This book provides a fascinating and compelling background to the GFC. It tells the story from a human perspective and the motivating forces behind behaviours, as well as explaining the market dynamics and economic effects. In taking us back to the American War of Independence and following the story up to the collapse of Lehman Brothers, we can see how the seeds of crises are sown.

Ultimately, almost no-one was untouched as the impacts moved into government guarantees for deposits, while property prices collapsed along with securities market impacts. However, some were impacted more than others.

Like the author and many of the readers of this book, I am very conscious of my own personal story. I write this Foreword from the perspective of my current role as Chief Executive of a professional body in financial services. The GFC was the direct driver behind my taking on this role. I had

a 'front-row seat' to the GFC. As a leader responsible for over 150 branches of a major UK retail bank network I saw first-hand the impacts on customers and staff and felt them personally, alongside all the other bank shareholders. These impacts were personally disastrous; for example, when retiring staff had all their retirement savings as shares in the bank. Insult was added to injury, as bank staff were abused in the media and in the street as government rescues were mounted.

My keenest observation of the crisis from within the banking industry was that we had lost sight not just of prudent management of risk, but of the very purpose for our existence. Above all, I noted that many of the leaders within financial services had no qualifications and little relevant experience in financial services. When some years later, I was offered the opportunity to lead this professional body, a key personal driver was the belief that skills, knowledge and a culture of professionalism were the best defence from re-occurrence of such crises in future.

Hence, I believe that the greatest value in telling the story of the GFC is to maintain awareness of the underlying causes and the corrupting effect that a desire for power and wealth has on financial markets. Our challenge is to contain these forces, to recognise the warning signs and to contain the fallout of future collapses in value of the assets that sit behind financial instruments.

The author has supported the power of these historical observations and the evolution to the GFC with two valuable theories. The explanation of the underlying cause and impact of influences of powers external to industry is of value to all stakeholders, including government and regulators. The explanation of the influence of power brings the element of the individual into focus. This goes directly to culture, and I believe professionalism. Ideally, in a professional environment, self-actualisation could help guard against the adverse impacts of the quest for power on behaviours and risk management. This cannot be relied upon and there is a need for peers to establish a culture that supports sound banking practice and holds individuals to account for their behaviours. Professionalism directly connects behaviours to purpose. It is only through constant clarity of purpose and the vigilance of stakeholders that we can avoid re-occurrence.

I commend this book to readers as a fascinating and enjoyable read, a story, but also a diagnostic that brings clarity to the confusion of an event like the GFC.

ACKNOWLEDGEMENT

I would like to acknowledge and offer my deepest gratitude to Dr Celeste Rossetto for her rigorous editing assistance, support, inspiration and guidance throughout the preparation of this book. Her insightful suggestions have added to the legibility of an otherwise technical topic. I am greatly indebted to her.

CHAPTER 1

INTRODUCTION

Power throughout the ages has been used to drive self-interest by those who hold the reins. This story exposes those who possessed and wielded it to drive the course of history. We are destined to have financial crises and repeat the mistakes of the past whilst greed continues to motivate human behaviour. The USA, a powerhouse of capitalism, has endured a litany of financial crises since the American War of Independence. It is no coincidence then that a pattern of similar influences causing the crises has emerged. Is it possible for the US to ever avoid repeating the same mistakes? As the famous American philosopher, George Santayana, quoted in 1905, “those who cannot remember the past are condemned to repeat it”.

The Global Financial Crisis (GFC), which was the most devastating financial calamity to date, surpassing the Great Depression, originated in the US and peaked during 2008. It significantly impacted the global financial system with dire consequences for the world economy that continues more than a decade later. The resulting social effects touched many individuals, corporations, and political bodies. It also triggered the failure of several large financial institutions including systemically important banks and large investment banks. The most prized scalp claimed by the GFC was also one of the most notorious dealers in the market—Lehman Brothers—whose history is traced in this book and who achieved the dubious title of ‘the largest bankruptcy in history to date’.

Numerous books and articles have been written about the failure of Lehman Brothers, however, what is more interesting is the backstory that begins with the American War of Independence where the US financial system had its antecedents. It is these beginnings that provided a template for the subsequent behaviours within the industry and set the benchmark for posterity.

There are various contributing factors that led to the GFC which are either technical or qualitative in nature. This book analyses certain qualitative factors and explains an often-ignored cause of the GFC which relates to the cultural and behavioural characteristics of individuals and corporations – often described as displaying characteristics of psychopathy – which played a profound role in the years leading to its manifestation.

Looking at historical figures from Haym Salomon (1740-1785), a pioneering financial privateer to the infamous Richard Fuld (1946-), the last CEO and Chairman of Lehman Brothers, it is possible to trace how particular practices and behaviours were tolerated, condoned and persisted across the US financial landscape. An understanding of the evolving culture and practice of the investment banking industry is assisted by the historical context. Profiles and behavioural characteristics of a sample of historical personalities are provided to describe practices within the investment banking industry which are found to persist up to the pre-GFC period. These personalities are placed alongside certain historical events such as economic crises and trends. The following chapter begins with the American War of Independence and finishes at the War of 1812 between the British and the US. Subsequent chapters trace the investment banking crises through the nineteenth, twentieth and twenty-first centuries up to the GFC. Ultimately, the historical influences help explain the industry's modern-day *modus operandi*.

The story we tell in this book is told from a particular viewpoint that is underpinned by two theories that will now be briefly explained and for the purpose of this book, simplified. The first, New Institutional Theory, is concerned with the application of external institutional forces on the industry (DiMaggio and Powell 1983). The second is the Theory of Power (Clegg 1989) that helps to clarify why individuals throughout the history of the investment banking industry behaved in specific ways. Those risk-taking personalities seized opportunities that shaped organisations and decision-making processes and made themselves wealthy and often respected in the process.

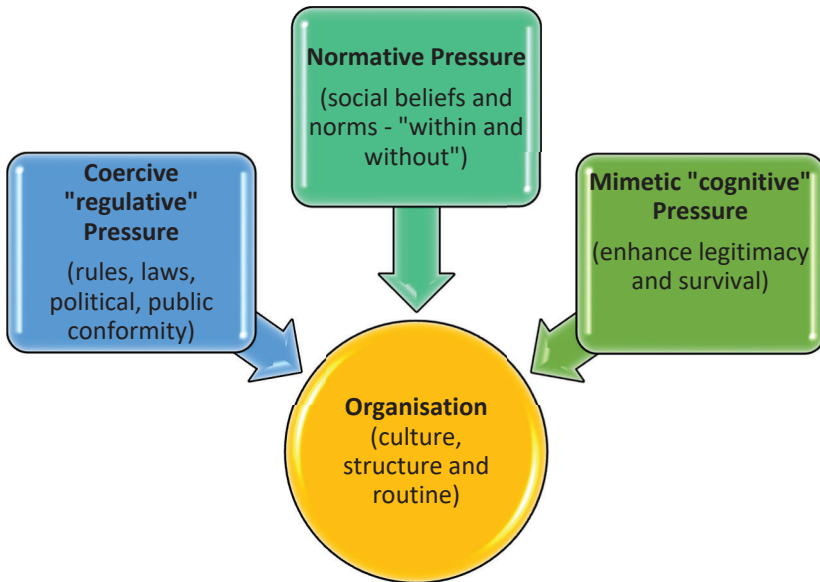
To offer a bit of detail about these theories will increase the enjoyment of the story. New Institutional Theory argues that institutions are social structures that are highly resilient, are understood within a culture, are normative in nature (they tell us what we should do), and are regulated, that is, they are enforced. These social structures are communicated in the

field through symbols, relationships, routines and artefacts. They provide stability for organisations, and operate at both the global and organisational levels.

This theory helps us understand how the social structures of the investment banking industry at the global level and at the organisational level, as in the case of Lehman Brothers, are created, adopted, adapted and in time, fail or change. The investment banking culture had developed a commonality. This culture established a structure of internal morality for behaviours and practices that were evident prior to the GFC as the next chapter will illustrate. These behaviours and practices were socially justified in view of their common usage within the industry and in the shared motivations of individuals which was dominated by the maximisation of profits and bonuses.

The universe of organisations is heavily influenced by ‘institutionalised isomorphism’, that is, organisations incorporate operational structures, policies and practices which are similar within a particular field. This type of conformity appeals to the perception that ‘normal’ practice is risk averse and accrues legitimacy in the eyes of stakeholders, however, perception may differ from reality. New Institutional Theory comprises three classifications; coercive, mimetic and normative institutional forces to explain key drivers that affect decision-making at the firm, industry and regulatory levels of investment banking. **Coercive factors** involve any coercion by an institution, often in the form of governmental power and political influence to generate outcomes consistent with the will of the state and political pressure groups. **Normative factors** emanate from the influence of the profession to conform to the best practice for its field and through the education system used to train the professionals. **Mimetic forces** act on agents when they succumb to the safety of long-accepted practices and choose to mimic others when dealing with decisions in times of uncertainty. The following diagram offers a simple image that clearly illustrates the application of the three institutional forces.

Figure 1.1: New Institutional Theory Framework



A well-known theorist, Stewart Clegg, explains power as emanating from and progressing through three circuits: the episodic, dispositional and facilitative. The **episodic circuit** is where power is exercised on a daily basis through communications, feelings and conflict and enabled by resources such as time, wealth, position, commodities, or knowledge. Within this circuit, social relations are shaped by the interaction where power is exercised or contested.

The **dispositional circuit** is primarily concerned with the formation and continuation of a member's standing and power within the organisation and the relevant rules to which they are subjected. Meaning is therefore provided to an organisation through these rules and policies which can undergo a process of constant change thereby potentially altering the balance of power within social relations. Various communication channels are essential for these rules to be established and changed when necessary.

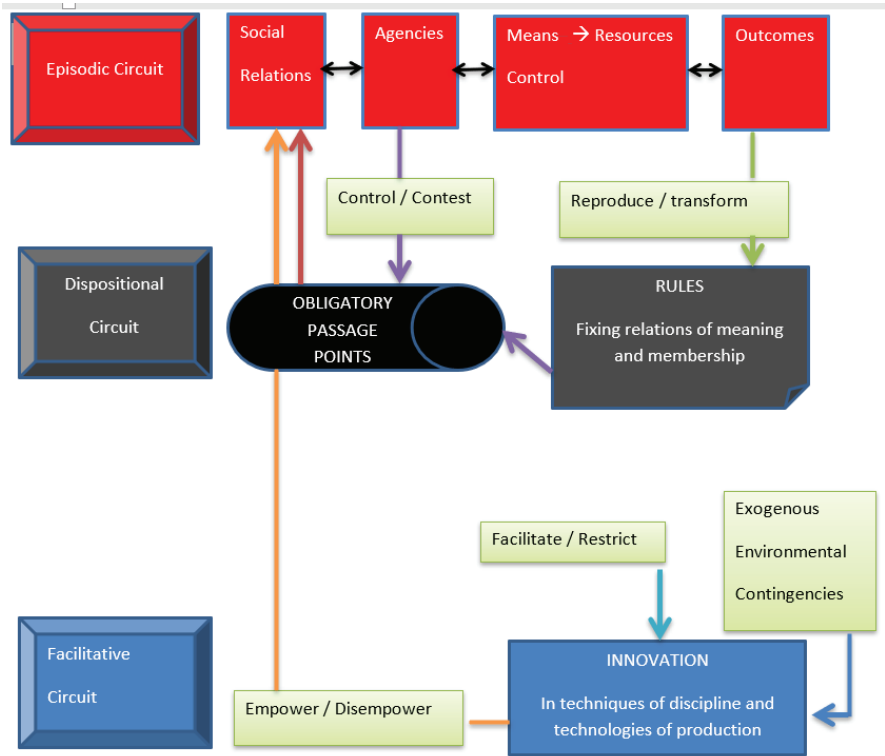
The final circuit, the **facilitative circuit**, deals with technology, environmental contingencies, job design and networks. (Clegg 1989, 233). An example to describe how technological innovation can affect power could be the automation of certain manufacturing processes which were previously carried out by skilled workers. The obviated skills disempower those affected employees whilst the employees responsible for the ongoing maintenance of the automated systems become empowered. The use of job design and networks are useful in applying power both at the regulatory level and through internal relationships within the investment bank. This level of power has the potential to reconstrue organisational morality and transform previously deemed unacceptable behaviour into acceptable behaviour.

The flow of power through Clegg's (1989) three circuits operates through channels known as "obligatory passage points" that are likened to conduits which allow the conveyance of empowerment or disempowerment. These flows are represented in the following diagrams.

An example of how the circuits of power model operates is located in a study conducted by Crozier (1964). He analysed a tobacco factory which relied on machines maintained by maintenance workers. These machines were controlled by production staff whose bonuses were dependent on the success of the maintenance workers keeping the machines operational. Without the co-operation of the maintenance workers, the ability of the production staff to succeed in their roles and hence generate bonuses was limited. The highly bureaucratic state-owned tobacco factory's operations were centred on the production staff whose formal standing in the organisational hierarchy was much higher than the maintenance workers. However, the power of the maintenance workers over other staff was superior in view of their control over the production outcomes on which the production staff performance was measured. Management, including the production staff, attempted to resist this power by instituting a program of preventative maintenance. In response, maintenance workers destroyed work manuals and machines were occasionally decommissioned by them regardless of their operational functioning. This example shows how technical knowledge and skill empowered workers who were otherwise low in the formal structural hierarchy of an organisation. Their knowledge of the production process empowered the maintenance workers to overcome the formal power held by others in the organisation (Clegg 1989, 236). The maintenance workers

effectively possessed a degree of power by way of technical knowledge and skill depicted as the “technology of production” located in the facilitative

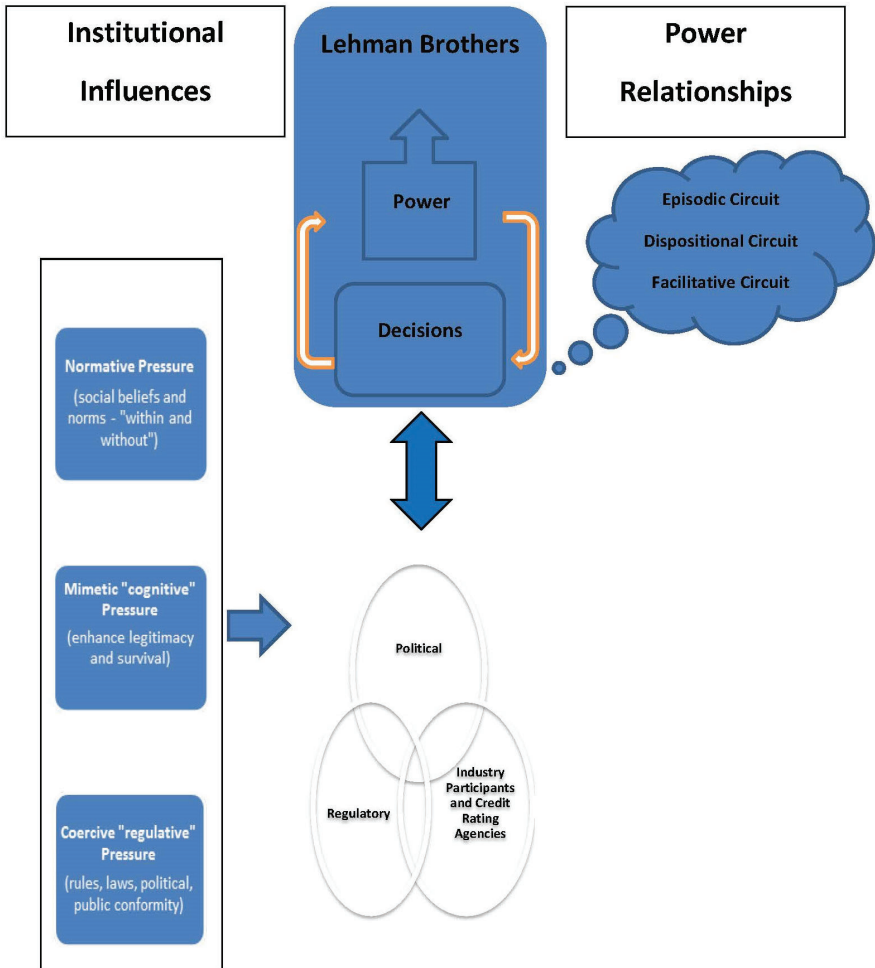
Figure 1.2: Diagram of Clegg's Circuits of Power



Circuit of Clegg’s (1989) model. The resultant power was transmitted through an obligatory passage point—the process being represented by the destruction of the operational manuals which were instruments vital in management’s attempts at diffusing the relative control of the maintenance workers. The resultant effect in the dispositional circuit was to change the significance and meaning of maintenance work. The workers’ power in the episodic circuit was also enhanced as their everyday actions involved more control over production resources, pay rates and bonuses. Conversely, changes in “technology of production” can render certain skills redundant, thus disempowering the affected individuals.

Neither DiMaggio and Powell's New Institutional Theory or Clegg's Theory of Power on their own can fully explain the machinations within the investment banking industry. However, when one is augmented with the other, all the dysfunctional outcomes can be explained.

Figure 1.3: An Institutional View of Lehman Brothers Impacted by Three Circuits of Power and Institutional Influences



The application of a theoretical lens over historical events, documents and characters is aimed at generating a rich understanding of the cultural and behavioural aspects that led to Lehman Brothers' failure rather than a mere technical analysis which has permeated the literature relating to the GFC. This method explains rather than predicts events, behaviours and actions of actors to offer insights within the historical and social contexts.

This book assumes a non-realist ontological stance, that is, the culture of investment banking is socially constructed and socially constructing (Chua 1986; Hopwood 1987; Hines 1988). It is argued that regulations covering financial institutions, such as accounting standards and the reliance on credit rating agencies are a socially constructed phenomenon, dependent on people for their existence and use, interpretation and perpetuation. Additionally, investment banks that operate within their regulatory framework are reliant on individuals' decision-making occurring within a business model that is bound by a set of internal rules and policies which are shaped by an organisational hierarchy and influenced by the regulatory environment and individuals' capacities. This book emphasises the importance of recognising the social, political and economic contexts to explain the how, why and who of the event (Burrell and Morgan 1979; Chua 1986; Hopwood 1987; Gioia and Pitre 1990; Hassard 1991). An awareness of the contextual nature of the inquiry is fundamental to this approach (Dillard 1991; Hassard 1991) and will extract the presences, as well as the silences, and absences of power, its uses, and institutional influences in and between the various organisations. It also identifies who were the power holders, those subjected to power and how power was exerted.

Whilst this book is divided into four distinct parts, there are three major themes that provide a leitmotif throughout the book. These are the reliance on key relationships with government authorities and officials; influence through formal, personal and commercial networks; and the impact of personal characteristics and organisational culture.

Part 1 outlines the birth and development of the US investment banking industry from its antecedents during the American War of Independence up until the GFC. It covers the essential role of bankers the quasi-Treasury to the government during war-time; rapid growth during the railroad expansion; and the opportunities and challenges during the early part of the twentieth century which covered financial crises and regulatory

impositions. The British colonials rose up against Great Britain to assert their political freedom to govern themselves. The banking system had close ties with Europe, especially France and it was through the connections of certain entrepreneurial individuals that the war was financed. In order to fund the next war against the British in 1812 the government relied on firms, such as S & M Allen & Co., that had an enviable distribution. However, further financing was required so individuals, such as Albert Gallatin, Secretary to the Treasury, issued bonds to raise additional capital.

As the century rolled on, the introduction of the railroads to move people and goods more swiftly and efficiently, saw entrepreneurs turn to Europe for funding. Individuals who had education, backgrounds in the military, government or banking with connections in Europe proved valuable when trying to access funds for these large infrastructure projects. Whilst the country benefited from an expanding, efficient transportation system, so did the entrepreneurs who invested in this risky business. It is at this time when the “revolving door” between the government and the investment banking industry becomes more overt – a behaviour that became embedded within the industry.

It behoves investment bankers to exploit business opportunities, especially when profit beckons. The pattern of bankers profiteering from war continued. The Civil War was costly to both the North and the South but the agrarian South was unable to raise the necessary funds through taxes and exports, leading to its inevitable defeat. The North, whilst challenged, fared better due in no small part to the expertise of its bankers such as Salmon Chase and Jay Cooke.

In the nineteenth century, the investment banking industry had two competing groups of bankers known as “Our Crowd”, that comprised Jewish firms and the “Yankee Houses” that were non-Jewish. As the use of lending syndicates to fund major transactions became more important, so did these alliances. Members within each group supported each other to prosper and as their wealth accrued so did their power. However, it was not plain sailing for bankers as the turn of the century ushered in the Panic of 1907 and public pressure was brought to bear on these powerful investment banking giants through regulations. The abundance of funds in the 1920s created asset bubbles that led to the famous Wall Street Crash of 1929, so once again, the legislators stepped in. A raft of regulations was

subsequently introduced that changed the balance of power. As the investment banks morphed from a partnership to a corporate structure in the years following WWII, the investment banking industry relied less on the tacit skill and reputation of individuals and their firms. The benefits of limited liability afforded to a corporate legal structure combined with an increased level of merger and acquisition activity amongst the investment banks created larger organisations with greater access to capital. Investment banks were therefore prepared to take on the high costs of litigation allowing the regulatory pendulum to swing in the banks' favour. This enabled a powerbase to increase enough to successfully drag the US Government through the courts. The result ensured that the industry was not overly hindered by hard-line financial regulation.

Part II of this book outlines a chronological history of Lehman Brothers, highlighting events and personalities that have contributed to the development of the firm. It explores the individual and institutional machinations, influences, power relationships and pressures which helped shape Lehman Brothers and led to its final demise. The book divides Lehman's history into two eras. The first covers its foundation by the three Bavarian brothers who emigrated from Germany and concludes with the anointment of Richard Fuld as CEO and chairman. The second era of Lehman's history represents the period when the firm was under Fuld's dysfunctional leadership, which ultimately led to its bankruptcy. Part II further examines Lehman Brothers' business model and financial structure and draws similarities with its peers hinting at systemically ingrained deficiencies. It also investigates the role that hubris played in its dying days.

Part III revolves around connections and influence between the investment banking industry and the financial network. This network encompasses the US government, the various financial industry regulators, lobby groups, credit rating agencies and other financial institutions. They make for good bedfellows at times of convenience. The book provides relevant information that offers solid evidence of how lobbying, political pressure, knowledge asymmetry and the influence exerted over the Financial Accounting Standards Board (FASB) coalesced. This influence is highlighted in the book by a discussion of the influence exerted over the FASB in changing their draft accounting standard for repurchase agreements. Lehman Brothers seized on this opportunity to apply a loose interpretation of the standard to window dress its financial statements. For Lehman Brothers, concealment became the order of the day which contributed to

its collapse and the Global Financial Crisis (GFC). The seeds of exploiting useful relationships and the exertion of undue influence that were planted at the beginning of the nation's formation are now seen as growing vigorously.

Part IV interrogates how the "Fall of the House of Lehman Brothers" (apologies to Edgar Allen Poe) during the GFC was able to happen. It delves into its governance through the board and why this board seemed incapable of reining in its chairman, who was also the CEO. In addition, it looks at the behaviour of the CEO and his employees and uses theory to explain why he was able to proceed unchecked in spite of maintaining a corporate governance policy that rated itself as having impeccable ethical standards.

The book concludes with a call to governments, regulators and the investment banking industry itself to consider the impact of the abuse of power, dysfunctional behavioural traits and organisational cultures that foster unethical practices. A world without ethics is bound to foster bad behaviour and malpractice to the detriment of the public good.

PART ONE:

HISTORY OF US INVESTMENT BANKING

CHAPTER 2

WAR TO WAR (1776-1815)

This chapter focuses on the analysis of the key events from the latter part of the eighteenth century to the end of the War of 1812-1815 in the US which affected the US investment banking industry and enables an understanding of evolving societal contexts. The critical events and those pioneering colourful personalities who influenced the industry and the wider financial community are presented because they reveal how the important themes were established throughout the history of the industry in relation to behavioural characteristics of the players and the organisational culture. The main themes of power and influence dates back to the American War of Independence and continues to influence the industry today. In the beginning of the industry, whilst there were formally structured business entities that resembled the modern investment bank, it also included the commercial undertakings of individuals who routinely undertook commercial fund raising or advisory services.

The US investment banking industry had humble beginnings and emerged parallel with the formation of the US, following the American War of Independence (1775-1783). Most commercial funding up until this point was carried out by small private banks or merchants, primarily for funding trade and other commerce. Many of these private banks developed into investment banks in the period following the Revolution (Bass and Moulton 1921). The metamorphosis of these smaller entities into investment banks progressed along two major paths. One involved the transformation of currency broking firms such as Prime, Ward & King, and John E. Thayer & Brother, which carried out private banking as well as some investment banking activities. The other route involved merchants expanding their business to incorporate lending activities, followed by trading in commodities, such as cotton. These firms included Lehman Brothers, Thomas Biddle & Co. and Alexander Brothers (Werner and Smith 1991).

Currency exchange dealers were necessary in the colonies as there were numerous currencies in circulation. By the late 1700s, there existed over fifty currencies in the US. These included offshore currency imported from Britain, Spain, France, and Portugal as well as notes issued by a variety of entities such as state and municipal governments, and private businesses. Valuation of these currencies was carried out by the various brokers and since communication was inefficient, exchange rates varied widely between brokers and regions. The publication in newspapers and wider media of exchange rates in the 1790s improved the consistency of currency quotations and minimised unfair transactions (Weiss 1970). This money was used by merchants in their domestic and international trade and for settling other deals between citizens and government authorities. The exchange value for each currency was a difficult task to ascertain given the different values ascribed to a currency by different states and therefore the expertise offered by the exchange dealers was important (Weiss 1970).

The expansion of the financial sector in the 1800s provided opportunities for entrepreneurs to raise the necessary finance to undertake projects which accompanied the substantial US industrial expansion of the period. The early private and commercial bankers often relied on their personal relationships with established entrepreneurs to facilitate their credit assessment process. Consequently, their inside information on projects enabled the industry to maintain relatively low levels of problem loans and the period was characterised by very few bank failures (Bass and Moulton 1921). The exploitation of personal relationships as a means to improve an understanding of credit risk and expand business activities became a consistent theme within the industry throughout its history. This *modus operandi* can be explained through normative and mimetic pressures. The normative pressure established the practice as an acceptable way for a banker to behave and therefore created a social norm amongst the investment banking community. After all, the practice indirectly led to protecting the firms against loss by providing deeper insights into the credit risk of borrowers. Risk mitigation and revenue generation was also managed by sharing amongst a peer group known as a syndicate. Additionally, bankers succumbed to mimetic pressure by imitating successful strategies adopted by other industry participants to maximise profits. Otherwise, they feared suffering a competitive disadvantage by losing market share.

Mercantile firms largely dealt with international trading transactions, facilitating payments for goods by providing short term credit to shippers. US mercantile firms often undertook their activities by using agents in the overseas country where the trade had been carried out. This contrasted to the British practice of using a network of branches. Not only was the mercantile firm a precursor to the US investment bank but it was from these firms that many British merchant banks emerged (Cameron and Bovykin 1991).

Timeline of Events Shaping the Investment Banking Industry

The timeline below (Figure 2.1) characterises a series of major events which prompted changes and highlighted features of the US investment banking industry. Periods not covered by the timeline are generally characterised by stable economic growth following the birth of the Industrial Revolution circa 1780.

Figure 2.1: US Banking Crises: Historical Summary

Year	Brief Summary
1814	Johnson Matthey Bankers failure.
1817-1819	46 banks rendered insolvent due to demands for specie by Second Bank of the United States.
1825	Preceded England's crisis; Bank of the United States and all other banks brought US Banking Crises: Historical Summary to the verge of suspension.
1837-1838	Three banks failed (March 1837); Bank of England gave generous advances to other banks to prevent panic; failures began in New Orleans and New York City and spread to other cities' banks.
1841	Second Bank of the United States liquidated; lenders repaid but stockholders lost all interests. Twenty-six banks failed.
1857	Discovery of Australian and Californian gold fields led to massive speculation on various commodities and property and then collapse; paralysed finances throughout the world (spread from US to Europe, South America and Far East). Many banks suspended; The Bank of England the only source of discount/financing.

1861	Government suspended specie payments – lasted until 1879; drove up price of gold (peaked in 1864) and all other retail items.
1864	US panic due to Civil War.
1873	Philadelphian banking firm, Jay Cooke & Co. failed, triggering a recession that lasted until 1877.
1884	Weak commodity prices and a series of brokerage firm failures led to bank runs and suspended payments, mostly in the New York region. The output effects were mild.
1893	Monetary uncertainty and stock market crash led to bank runs. Political action to ameliorate the crisis; severe decline in output but the economy recovered quickly.
1907	Global credit restrictions and domestic financial excesses, increasing number of state banks, and a rising ratio of deposits to cash reserves set the stage for a crisis. Real estate and stock market speculation burst; crisis spread from New York nationwide. Growth rate fell by 9% per annum. JP Morgan, the Bank of Montreal and the Treasury of New York replenished liquidity.
1914	New York Stock Exchange closed on 31 July until December in response to World War 1; however, a banking crisis was avoided by flooding the country with emergency currency to prevent hasty withdrawals.
1929-1923	Great Depression: thousands of banks closed; Bank of USA failed in December 1930; between August 1931 and January 1932, 1,860 banks failed.
1984-1991	1,400 savings and loans institutions and 1,300 banks failed.

Source: Reinhart and Rogoff 2013, 17-8.

Figure 2.2 below offers a chronology of events that shaped the US financial system. This chapter traces some of the key players and their financial activities around the first four highlighted contexts.

Figure 2.2: Evolution of the US Investment Banking Industry (1775-1815)

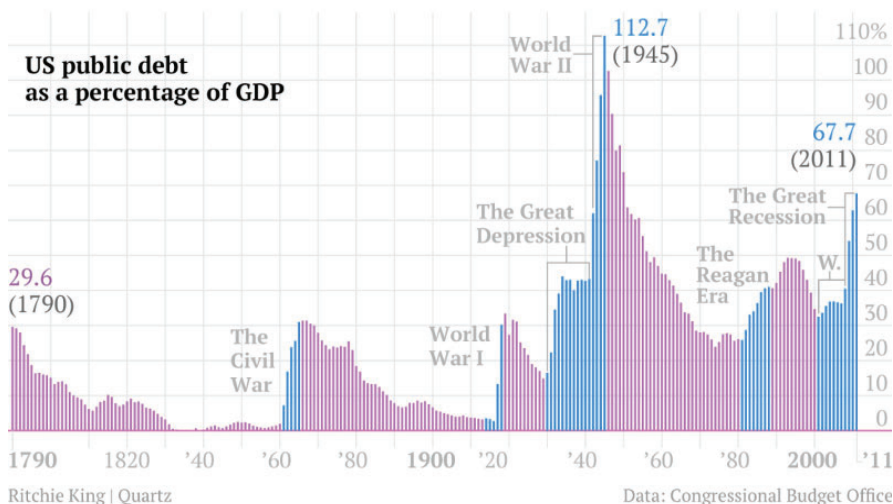


The evolution of the investment banking industry was punctuated by the US banking crises during the nineteenth and twentieth centuries. As an emerging economy, the US was susceptible to volatile economic cycles and financial market disruptions. A disproportionately high number of financial crises occurred in the 1800s during which the US experienced eight major panics whilst from 1900 to 2008, the US experienced three further major crises. Financial crises can be identified in the table below. Financial crises most often precede a systemic failure of banks.

Most banking crises naturally coincide with the troughs of economic cycles. The GFC was similar to many of the previous crises that were preceded by speculative bubbles in certain asset classes. These culminated in a crash, often involving the stock market and ultimately, resulting in a recession. As most investment banks are traditionally active in both the debt and equity capital markets, stock market crashes inevitably negatively affect their operations. Inadequate regulation is a customary contributor to a financial crisis. When the US was not in crisis, economic growth and industrialisation kept investment banking firms occupied and profitable, thereby removing incentive for regulatory reform. As a result, successful practices and behaviours, which prevailed in the late 1700s, has continued through to the modern day. Apart from financial crises and periodic regulatory reform, the evolutionary timeline was punctuated in the post WWII era by the search for capital, which carried far reaching implications for the investment banking business model and financial structure.

The following graph of public debt as a percentage of GDP from 1790 to 2010 sourced from data from the Congressional Budget Office shows debt to GDP for the US.

Figure 2.3: US Public Debt as % of GDP: 1790 to 2010



Source: Phillips 2012.

American War of Independence (1775-1783)

The American War of Independence, also known as 'the American Revolution' or 'the Revolution', is used as a starting point to trace the beginnings of the US investment banking industry. Firstly, it symbolises the birth of a modern nation which was to become the United States of America; and secondly, it symbolises a struggle for independence from Great Britain, both politically and economically. This war resulted in funding needs which gave rise to a class of financier that would eventually morph into the modern investment bank.

The Revolution began when thirteen British colonies in North America governed by the Continental Congress sought independence from Great Britain. It concluded with the Treaty of Paris, which recognised the sovereignty of the US. The Americans entered the war with many disadvantages compared to the British. They had no national government; no national army or navy; no financial system; no domestic banks; no established credit; and no functioning government departments such as a

treasury department. It is against this background that the seeds of the modern investment banking industry were laid.

The Revolution was costly on several fronts for the Americans. Not only did it cost the lives of over 25,000 people, but it had cost the new nation at that time USD 37 million (USD 1,107,789,000 in 2021) federally plus USD 114 million (USD 3,413,160,000 in 2021) by the states (Jensen 2004). This cost was mostly covered by loans from France and the Netherlands, who participated in the war in support of the Americans. Also, they, together with Spain, provided supplies such as guns, ammunition, clothes and blankets. Much of the funding for this equipment was sourced domestically within the US by loans from the American public and through the issuance of paper money known as 'specie' including both continental and state currency (Baack 2001).



Figure 2.4: Haym Salomon
Source: Historic.us 2015

The British attempted to sabotage the economy of the American colonies and thus weaken the Continental Congress by counterfeiting the Continental Dollar and flooding the local market with the currency. The resultant increase in money supply impacted the inflation rate, and a depreciation of the currency leading to an increase in costs for everyday goods including supplies for the continental army. This event gave rise to the saying of 'not worth a Continental'. By the end of 1777, inflation had depreciated the value of the Continental Dollar by over 70%. This rapid devaluation posed significant financing issues for

the Continental Congress, since up to 1777, currency emissions accounted for almost 90% of Congress revenue which had by then declined to 19% (Baack 2001, 643). It was clear that to continue to fight the war, the Continental Congress needed to secure alternative sources of finance

other than printing currency. This provided some entrepreneurial individuals with the opportunity to enter into relationships with the Continental Congress and its officials to support the required financing effort. An assessment of the role played by financier, Haym Salomon (1740-1785), provides an example of how key relationships were used for financial gain. This is a recurrent theme throughout the history of the US investment banking system. He was one of the earliest individuals whose activities typically resembled that of an investment banker given his role in assisting the financing of the Revolution. Salomon, born into a Jewish family in 1740, emigrated from Poland to New York City in 1772. Through his travels around Europe, he learned several languages including German and operated as a merchant, foreign securities dealer and a financial broker in New York City. After becoming friends with Alexander MacDougall, leader of the New York Sons of Liberty, he was attracted to the colonial cause for independence. His patriot activities became known to the British and in 1776 he was arrested as a spy. The British released him on the basis that he co-operated as an interpreter assisting the British with their German allies (Feldberg 2001). Salomon's loyalty remained with the patriots and he continued to offer support by assisting patriot prisoners to escape British imprisonment and German soldiers to desert. He was again arrested in 1778, however, escaped and finally settled in Philadelphia, where he resumed his investment banking activities. He continued to assist the patriots by serving their French allies as paymaster and as a financial consultant to the French consul (Blythe 2008).

Whilst Salomon was in Philadelphia, the Continental Congress had been relatively unsuccessful in raising the necessary funds to finance the war effort. Most funding was met by the issuing of currency with small amounts coming from the states that were similarly struggling. Without a formal federation in place, the Continental Congress did not have a mandate to raise funds from taxation. One of the principal roles of Salomon as the official broker to the Continental Congress was to exchange the foreign currencies arriving from Europe, representing the proceeds from the French and Dutch loans, into Continental Dollars. The most common type of currency conversion emanated from the remittance of bills from the French Government in French currency.

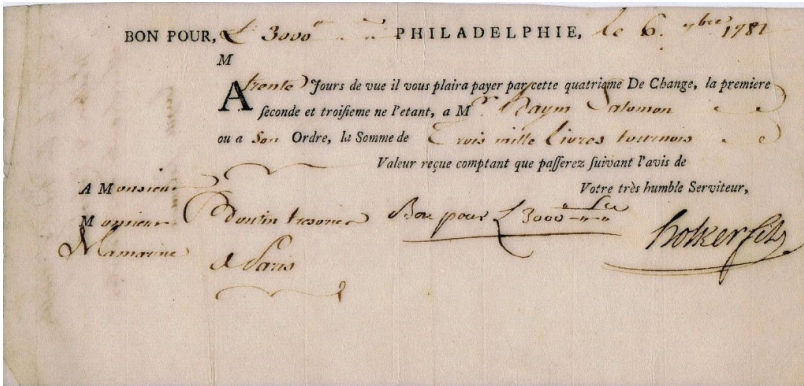


Figure 2.5: Bill drawn by French Government in 1781 to Bearer or Haym Salomon

Source: Salomon 1781

By 1781, Congress was struggling to manage its financial commitments and assigned Robert Morris, a member of the Second Congress, to the position of Superintendent of Finances (Blythe 2008). Morris established the First Bank of North America, also known as the Bank of North America, and provided much needed finance for the patriots' war effort. Salomon continued to support the war effort by acting as a broker for bills of exchange, which were instruments drawn to raise funds for Congress. Salomon would sell the bills to the public, usually wealthy merchants, in exchange for Continental Dollars and he passed on the currency proceeds to the Continental Congress to be used for the war effort. Upon maturity, the bills were redeemed by the bearers (the public) who would be reimbursed for their original investment directly by Salomon as the representative of the French and Dutch Governments. The proceeds used by Salomon to reimburse investors would be simultaneously paid to Salomon by the Continental Congress as a repayment of their original loan. To attract investors in the bills, Salomon advertised his service as a broker through newspapers. In return for the sales of bills, mostly to merchants, Salomon received a commission of 0.25% on the bills' face value (Peters 1911, 16). The delegation of power from government to Salomon for his intensely detailed involvement in the fundraising process is testament to the willingness of the government to trust private individuals with whom they had an intimate relationship.

Salomon earned the trust of the Continental Congress which was the ultimate debtor in these bill transactions and he was also trusted by the French and Dutch Governments, the signatories upon which the bills were drawn and which were shipped to Salomon in the US as the broker of the bills. Figure 8 above shows an example of a typical bill remitted by the French Government and payable to the bearer, Haym Salomon. It reads that the amount of 3000 livre is to be paid to Haym Salomon or to his order, within 30 days of presentation of the bill. The fact that the bill included Salomon as a payee reflected his high degree of integrity.

Salomon also provided personal loans to members of Congress, on an interest-free basis. One of the recipients of these favourably termed loans included James Madison, who later became the fourth president of the US (Blythe 2008). This is one of the earliest examples of a private financier providing assistance to members of government whilst also providing assistance to the government itself.

The advertisement below (Figure 2.6) describes Haym Salomon as a well-connected broker and financier. Apart from espousing his role as broker to eminent offices in the US and France, the advertisement assures customers that they “may depend on having their business transacted with as much fidelity and expedition as if they were themselves present” (*The Pennsylvania Journal and Weekly Advertiser* 1783). Further, his advertisement noted that “he flatters himself his assiduity, punctuality, and extensive connections in his business, as a Broker, is well established in various parts of Europe and in the US in particular” (*The Pennsylvania Journal and Weekly Advertiser* 1783). This self-promotion of the individual combined with a self-confidence intended to assure potential customers is characteristic of similar investment banking advertisements appearing in newspapers and magazines in the twentieth and twenty-first centuries. Salomon further emphasised the attribute of his “connections” as one which is beneficial to customers and his business; the business of investment banking. It could therefore be argued that the important feature of being well-connected has been a common attribute necessary to succeed in investment banking from as early as the 1780s. Salomon’s view of himself was also shared by Alexander Hamilton, a former Secretary of the Treasury:

Haym Salomon brought not only all his wealth to the aid of his adopted country, but a financial insight which, for clearness and depth, was not surpassed by Alexander Hamilton nor equalled by Robert Morris. America

found in Haym Salomon a champion equalled by few, his fertility in resource and soundness of financial views made him, through Robert Morris, Superintendent of Finance, the real financier of the Revolution and judged by Alexander Hamilton's standard of patriotism, surpassed by none... (Peters 1911, 16).

Enquire as above,
Philadelphia, December 3, 1782.

Haym Salomons,

BROKER to the Office of Finance, to the *Contul General* of France, and to the *Treasurer* of the French army, at his Office in Front-street, between Market and Arch streets boys and sells on commission

BANK Stock, Bills of Exchange on France, Spain, Holland, and other parts of Europe, the West Indies, and inland bills, at the usual commissions.—He buys and sells

Loan Office certificates, Continental and State Money, of this or any other State, Pay-Master and Quarter-Master Generals notes; these and every other kind of paper transactions (bills of exchange excepted) he will charge his employers no more than

ONE HALF PER CENT on his Commission.

He procures Money on Loan for a short time, and gets notes and bills discounted. Gentlemen and other, residing in this State, or any of the United States, by sending their orders to this office may depend on having their business transacted with as much fidelity and expedition as if they were themselves present.

He receives, Tobacco, Sugars, Tea, and every other sort of goods, to sell on commission, for which purpose he has provided proper stores.

He flatters himself his assiduity, punctuality, and extensive connections in his business, as a Broker, is well established in various parts of Europe, and in the United States in particular.

All persons who shall please to favour him with their business, may depend upon his utmost exertion for their interest, and

Part of the Money advanced, if required.

Figure 2.6: Advertisement in *The Pennsylvania Journal and Weekly Advertiser* 1782

What was expected in return for Salomon's generous assistance to the Continental Congress and selected congressmen is subject to conjecture. However, it is not unreasonable to assume that the generally accommodating nature of the relationships with those in positions of

power and authority could have been intentionally developed to secure commercial favour. In any event, Salomon exercised a power sourced from both facilitative and dispositional circuits. His relatively unique knowledge of finance, as attested by Alexander Hamilton, and possession of an advantageous distribution network for the sale of bills of exchange, gave Salomon a competitive advantage over other financiers. The unique “technology of production”, that is, an ability to use his skills and knowhow to broker bills of exchange, rendered Salomon almost indispensable for the war funding effort. Without the prevailing exogenous environment of the Revolution, Salomon’s position of influence may not have materialised. An exogenous environment provides the context and stimulus for the empowerment in a facilitative circuit (Clegg 1989). The finances of the Continental Congress were in chaos in 1781, and innovative and urgent solutions were required. Salomon was able to fulfil this requirement. The resultant social relationships developed by Salomon with Morris and other congressmen enabled his appointment as the official financier of the government which led to two outcomes: firstly, a financial solution for Congress and secondly, further business transactions which were commercially favourable to Salomon.

Given the industry’s technical sophistication, many outside groups such as politicians, other professionals and the public at large were relatively unfamiliar with the prevailing *modus operandi* of the industry. Therefore, due to this widespread unfamiliarity with investment banking skills, the practices and behaviours of individual investment bankers remained unchallenged and were considered to be acceptable within a social context.

One of the key practices emulated by others was the tactic of soliciting relationships with politicians in exchange for favours. These favours would inevitably include privileged treatment in selection for government fundraising. Often these financings would be transacted on favourable terms to the investment banker. Salomon’s other business activities and practices were also emulated by other firms as they represented profitable enterprise and were accepted by the general commercial, political and public communities. This replication of business practice is a form of mimetic isomorphism. Other investment bankers soon entered the business of broking financial instruments, such as bills of exchange and foreign exchange trading, until these lines of business became commonplace. The business of broking contributed significant profits to

many investment banks as it does in the modern era. Moreover, the practice of developing special relationships with parties that could offer commercial benefit became accepted, even if it involved personal favours for government officials. This public acquiescence to the behaviour of the investment banking industry was to last until the early twentieth century when the investigations of the Pujo Committee commenced. The mimetic influence established a practice which was to be adopted by the industry in future years as a formula for continuing success in business.

The War of 1812

Similar to the Revolution, the War of 1812 presented opportunities for some firms and individuals to support the American cause by assisting in the war funding effort. In 1812, the US Government declared war on Britain due to a number of factors relating to oppressive behaviour by Britain over the US. Britain had forcefully recruited US citizens into its navy to help in the war against France. The French war had also caused a restriction on trade with the US that had detrimental effects on the US economy. These factors, in addition to the British support for American Indigenous tribes in their resistance against the American territorial encroachment, had brought the US to the point of war (Hickey 1989).

Following the conclusion of the British-French war, Britain resumed trade with the US and ceased its forceful recruitment of US sailors (Black 2002). This development had appeased the US Government, resulting in the end of the war of 1812, with the signing of the Treaty of Ghent on December 24, 1814. An unintended consequence of the war was a new nationalistic pride in the North American continent where there was a peaceful and productive US-British relationship.

Estimates of the cost to Britain of the War of 1812 are unavailable however British Government debts had increased by GBP 25 million during the war (Hickey 1989). In the US, the cost of the war totalled "USD 158 million (USD 309,680,000 in 2021) which included USD 93 million in army and navy expenditures, USD 16 million in interest on war loans, and USD 49 million in war veterans' benefits" (Hickey 1989, 306). This resulted in the national debt increasing from USD 45 million in 1812 to USD 127 million by the end of 1815, implying a net borrowing of USD 82 million by the end of the war (Hickey 1989, 233).

Sources of income for the government were scarce. The government had not yet instituted an income tax regime, and other taxes were inadequate. Apart from selling bonds, the government resorted to raising funds through lotteries. A number of private organisations and institutions participated in the selling of lottery tickets including S & M Allen & Co. which was established in 1808 to sell the new lottery tickets (Geisst 2001, 11). S & M Allen & Co. was typical of businesses that developed skills tangential to those required for an investment bank. Selling lottery tickets from their network of twenty offices generated only meagre profits however. The firm quickly realised that greater profits could be earned from selling securities through the same network. There was little difference between the two activities and by 1820, the firm switched from selling lottery tickets to selling securities exclusively. Unfortunately, after twenty-eight years of successful operations, S & M Allen & Co. was forced to close its doors in 1836, not from a failure of their business model but due to a series of losses following the collapse of the Second Bank of the United States, which contributed to the financial crisis of 1837 (Geisst 2001, 12).

The key asset of S & M Allen & Co. was the vital twenty-strong office distribution network along the east coast of the US that connected the firm to its ultimate customer base and enabled settlement of transactions. To this day, distribution power is considered one of the most important attributes of a successful modern day investment bank. The benefits of a large and effective distribution network in selling financial instruments, whether lottery tickets or other forms of securities accrue through the ability to reach a higher number of ultimate investors and thereby, increase sales and profits. As other firms realised these benefits, they too organised themselves with similar distribution networks and an effective business model dealing with selling securities was given new impetus and remains a strong business segment for investment banks even to the present day. The imitation of this business model is an example of mimetic pressure where firms copy other firms which they consider successful. The overriding driver for mimicry lay in the desire by other firms to sell higher volumes of securities. To achieve this, they needed a wider spread of customers as local markets ultimately became saturated. The natural limitation of a local geographical market restricted a firm's ability to reach a broad client constituency. Therefore, after observing the improvement

in sales by S & M Allen & Co., other firms decided to imitate their successful geographical distribution strategy.

Albert Gallatin (1761-1849), the Secretary of the Treasury, had to deal with the funding shortfalls of the government during the war of 1812. A sequence of events led him to seek the assistance of a group of investment bankers who together developed an innovative technique to provide certainty of funds for the government. This was generically to be known as an underwritten securities issue which is still used today.

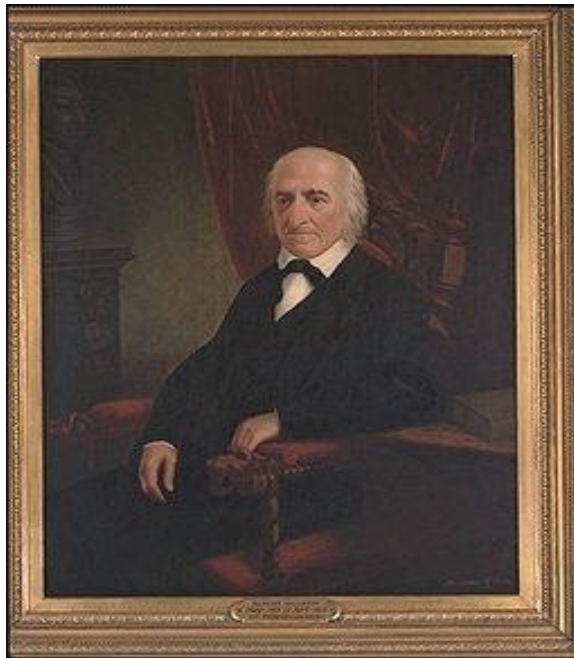


Figure 2.7: Portrait of Albert Gallatin

Source: Wikimedia Commons

Gallatin encountered difficulties in attempting to source the necessary funding for the War of 1812 from the private sector. Three years earlier, Gallatin had warned Congress of the dangers of not renewing the charter of the First Bank of the United States as the bank was a possible source of finance for the Treasury in the event of an emergency. At that time, the federal government had been generally free of routine bank debt for

approximately 10 years but Congress was not swayed by Gallatin's precautionary warnings (Heidler and Heidler 2004).

Following a realisation that the sale of lottery tickets was not going to raise sufficient funds for an impending war, Congress ultimately authorised the issuance of USD 11 million in new bonds at 6% interest in March 1812, three months before it declared war. Congress considered the amount and relatively low interest rate proposed for the new issue, was within the appetite of the private sector given the perception that the US represented a solid risk. At that time, the US had a sound international reputation with over 50% of its bonds held by foreign investors and was one of the few nations that had followed a consistent policy of paying down substantial amounts of its national debt for over a decade; less debt reduced the interest drain on budgets and lowered the risk of default. However, uncertainties surrounding the war altered the investment climate (Heidler and Heidler 2004).

The Treasury Department had become accustomed to managing its bond sale programmes without assistance of private underwriters. It began accepting subscriptions in May 1812, but only USD 6.2 million of the initial offering was taken up – USD 4.2 million by banks for their long-term loan portfolios and USD 2 million by individuals (Heidler and Heidler 2004, 182). Meanwhile, requests for military expenditure were accumulating. Gallatin might have considered offering the bonds at a discount price or increasing the interest coupon above 6% to attract more investors but these options were rejected by the then president, James Madison, and his closest advisors. When it became clear that the terms offered to investors were insufficiently remunerative to raise the entire USD 11 million, Madison instructed Gallatin to seek permission from Congress to pursue an alternative strategy. This had last been used in 1780 during the American War of Independence: the issuance of fiat paper money. Gallatin was aware of the inflationary problems related to the emissions of the Continental Dollar during the American War of Independence. He considered, as an alternative to fiat money, the issuance of short-term debt instruments similar to the one and two-year treasury notes issued by the colony of Massachusetts in 1751. The plan involved the issuance of negotiable treasury bills that were legal tender in public dealings but not in private transactions. These bills would have maturities of one year or less and carry an interest rate of 5.4%, slightly below the yields on the longer-term US bonds (Heidler and Heidler 2004).

In June 1812, Congress authorised USD 5 million in treasury bills to cover the shortfall from the earlier bond sale. Over the course of the war, the Treasury issued a total of USD 36.7 million in treasury bills, although no more than USD 17.6 million were outstanding at any given time. Most treasury bills were issued in denominations of USD 20, USD 100 and USD 1,000 which ensured they catered to most wealthy classes of investors. In 1815, the Treasury issued approximately USD 2.75 million in bills in even smaller denominations of USD 3, USD 5 and USD 10 that bore no interest. These small bills, tantamount to fiat money similar to the Continental Dollar of the 1770s, immediately entered the money supply with the risk of fuelling inflation. These small bills constituted less than 4% of the Treasury's total indebtedness and their overall impact was fairly modest (Heidler and Heidler 2004, 183). Unlike the Continental Dollar, the purchasing power of these small bills remained relatively stable since holders had the option of converting the bills at face value into long-term government bonds paying 7% interest thereby creating a secondary demand for the bonds.

Meanwhile Gallatin tried to float another issue of long-term bonds in early 1813. Congress authorised an issue of USD 16 million and given the shortfall experienced in the 1812 issue, military indecisiveness, and the opposition of many wealthy New England investors to the war, Treasury was allowed to pay a commission of 0.25% to private agents who solicited bond sales (Heidler and Heidler 2004, 183). This is another of the earliest examples of the acknowledgement that the Treasury could not fulfil the government's fundraising on its own and that it could turn to the investment banks for the much-needed assistance. Whilst the Treasury was solely responsible for the routine government debt offerings, it was lacking the aggressive marketing expertise that these investment bankers could provide.

In response to its appeal for funds—the traditionally passive system of merely announcing a subscription date—the Treasury had received applications for only about one third of the sum required up to March 1813, which left approximately USD 10 million of bonds unsold. Gallatin was now prepared to consider any debt structures including higher interest rates, discounts on purchase prices, call rights and other features (Heidler and Heidler 2004, 183).

During the first week of April 1813, Gallatin engaged in negotiations with representatives of a syndicate of underwriters and investors. The three principals who could be considered as sophisticated investment bankers were Stephen Girard of Philadelphia, John Jacob Astor of New York and David Parish, the agent of an international banking house who had resided in Philadelphia since 1806. Parish, who was the lead arranger of the syndicate, was the son of the senior partner of Parish & Co., a firm headquartered in Hamburg, Germany. He was familiar with the techniques of forming syndicates and underwriting large issues of government securities and he transferred those skills to the US capital markets. The syndicate agreed to underwrite the remaining USD 10.1 million of 6% bonds at a discount price of 88% of par which produced a current yield to investors of 6.8%. Between them, Girard, Astor and Parish took up a total of approximately USD 7.7 million on terms which they considered acceptable and earned USD 11,510 (USD 18.7 million in 2020) in commissions after costs for their services. The remaining underwriting amount was filled by independent firms in New York and Philadelphia that acted as junior members of the syndicate. These new syndicate members sold an additional amount of USD 2.4 million in bonds to various investors. The underwriting process provided the Treasury with the assurance that the funds were committed. It was then the responsibility of the syndicate members to place those bonds which they had underwritten to other investors otherwise the underwriters would be left holding any unplaced bonds in their own proprietary portfolios. With the cooperation of the private syndicate of investment bankers, Gallatin was able to avoid the embarrassment of a second unsuccessful or unduly prolonged fundraising campaign. Moreover, with total commissions representing a fraction of 1% of the total face value of the amount underwritten, the government was well-satisfied (Heidler and Heidler 2004).

This underwriting process has remained unchanged ever since and is the cornerstone of the global debt and equity markets providing assurance to borrowers and users of capital that funding in whichever form would be provided by the underwriters of any particular issue. This precedent - setting fund raising exercise in April 1813 is considered the first official US Government involvement with financiers performing essentially investment banking functions. The association between government and underwriters was a singular event in the financing of the War of 1812. Despite the

success of the public offering, the participation of underwriters was not repeated during the war (Heidler and Heidler 2004).

Gallatin resigned from the position of Treasury Secretary in May 1813, soon after the conclusion of negotiations with the syndicate. He was succeeded first by Secretary of the Navy, William Jones, later president of the Second Bank of the United States, who served as acting Treasury Secretary until February 1814. William Jones managed to sell USD 8.5 million of 6% bonds at a discount of USD 88 in August 1813, on the same terms established for the successful bond issue by the syndicate three months earlier. Thereafter, treasury secretaries had difficulty raising sufficient funds in the capital markets to cover military expenditures on equally favourable terms. They resorted to a mix of short-term treasury notes plus occasional sales of long-term bonds to keep the government afloat (Heidler and Heidler 2004).



Figure 2.8: David Parish
Source: Hough 1853

Another important personality was David Parish (1778-1826). He was a financier, property investor and trader from a British family who had important and influential connections throughout Europe. Parish spent time in Hamburg and began his fortune when he founded a commercial house in Antwerp. Apart from playing a major role in financing the US military effort in the War of 1812, he chartered the Second Bank of the United States (Walters and Walters 1944, 149-50).

Following his move to the US in 1806, Parish commenced his property investment activities by purchasing vast tracts of land in Philadelphia, to on-sell to new American settlers (Walters and Walters 1944, 157). Sympathetic to the anti-war Federalist Party, he nevertheless was instrumental in arranging the USD 10.1 million underwriting syndicate for the US Treasury in 1813 to continue the war. For that support, Parish gained enough political leverage to insist on neutrality for the St. Lawrence Valley on the border between the State of New York and Quebec and on peace

negotiations with the British in view of his business interests in the region (Taylor 2010).

Parish's efforts for peace contributed to a continuing commercial relationship between the US and Britain within a peaceful environment. He was able to use his social networks to become one of the most influential players in the international financial community (Taylor 2010). Apart from his business and finance skills, his successful career was attributable to his personal charm, courage, and luck that allowed him to confront and overcome many challenges. Parish's fortunes changed due to commercial failures following the banking crisis of 1826. His excessive pride and self-confidence affected his personal decision-making. When hubris is combined with a banking crisis, a significant financial loss is likely. This combination established the template for subsequent crises in the US.

Stephen Girard (1750-1831) was born in France; the son of a sea captain and merchant. In his youth, Girard trained as a seaman undertaking voyages between France, the US and the West Indies. His sailing skills proved useful when in 1776, he immigrated to the US where he established his own shipping business in Philadelphia. Like many financiers of his era, Girard started his commercial career in a traditional ordinary shipping business and used social networks and innovative practices to expand and exploit opportunities. An example of Girard's innovative operating style is

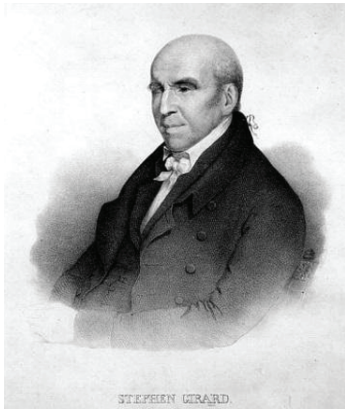


Figure 2.9: Stephen Girard
Source: Brown 1832

that he would warehouse goods imported from overseas until market prices reached optimal levels. This trading skill and market awareness may be viewed as a hallmark skill of any modern-day investment banker where prior to the GFC, investment banks warehoused mortgage securities for on-selling once market conditions became favourable.

Girard's shipping business expanded into trade routes encompassing China, Europe, the Caribbean and South America (Klem 2016). As Girard's wealth increased, he diversified into the financial services sector by becoming a

majority investor in the First Bank of the United States immediately following the expiration of its charter. His investment also involved the purchase of the bank's headquarters on Philadelphia's South Third Street (Schroeder 2011). The bank was instrumental in assisting the US Government in its financing of the War of 1812, therefore, making the US Government its major customer. This further cemented Girard's relationship with government since his involvement with Astor and Parish in the USD 10.1 million syndicated government fundraising. Simultaneously, he negotiated that in return the US Government sold him the majority of its shares in the First Bank of the United States (Cowen 2010). At the time of his death in 1831, Stephen Girard was the richest man in the United States (Schroeder 2011).

Girard is most famously recognised in the US as a generous philanthropist. He supported a wide variety of civic associations in his adopted hometown of Philadelphia. He contributed to a number of charities and social institutions such as to "the Pennsylvania Hospital, the Society for Relief of Distressed Masters of Ships and Their Widows, the *Société de Bienfaisance Francaise*, the Public-School Fund of Philadelphia, the Pennsylvania Institution for the Deaf and Dumb, the Fuel Saving Society, and the Orphan Society, among many other groups" (Klem 2016). Although Girard is well-known for his philanthropic activities throughout his life, he was also prepared to undertake devious business practices. "Girard was a smuggler himself and a deviser of ways that are dark and tricks that in one notable instance... were vain". Examples of Girard's dishonest activities included "lying, official declarations which were quite different of the cargo carried by his ships, gratifications for the customs inspectors, counterfeit passports and camouflaged ship ownership and consignees" (Henry 1918, 284).

This acknowledgement that a successful merchant like Girard was prepared to behave in such a manner is an indication of the times. This normalisation of antisocial and dishonest behaviour laid the foundation for the continuing behavioural trait that reached its apogee in the GFC. There is no record of Girard ever being convicted of any criminal or civil indiscretion which supports how these practices were accepted. At worst, legal authorities cast a blind eye, which is tantamount to "what is commonly approved – that is, what is socially sanctioned" (Zanna 1991, 202).

The normative influences existing during this era regularised certain dishonest practices as a means of doing business. A common feature of these practices within the field of finance and trading is the complexity of transactions. Large merchant businesses dealing with more complex international trade transactions encountered many obstacles and challenges in concluding the deals. Therefore, given their complexity and relative remoteness from the purview of the legal and regulatory authorities, the indiscretions were successfully concealed, or at worst, ignored by the same authorities.

CHAPTER 3

BANKING ON RAIL

American Railroad Expansion (1830-1850)

In the nineteenth century, railroads were seen internationally as an efficient and economical way of transporting people and goods between established cities and towns. The US economic and social development during the period from 1830 to 1850 was accelerated by railroad expansion, which coincided with a period characterised by a scarcity of long-term capital in the US. This drove entrepreneurs, investors and promoters of transport infrastructure to seek funding through the bond and equity markets in Europe. The funding of railroads underwent cycles of success and failure. Initially, funding was easily accessible, however, once the economic impact from direct and indirect competitors to the railroads became apparent, funding for new railroads dissipated. Competitors in the transportation market that had a meaningful adverse influence on new funding included stagecoach companies, canal operators, and turnpike companies (Kansas Historical Society 2011).

One of the earliest railroad projects in the US was the Baltimore and Ohio Railroad, which was constructed in 1827. The success of any railroad depends on having a sufficient customer base driven by a region's population and businesses and given the population of Baltimore, the economic feasibility for this railroad, connecting Baltimore with other towns, was justified. In assessing the risks of the project, investors needed to consider competitors, for example, the Erie Canal, which also accommodated New York passengers. However, the railroad continued, through a number of extensions, until it reached Parkersburg, West Virginia, thereby providing an expanded service (Kansas Historical Society 2011). Railroads were able to differentiate as a mode of transportation through offering a more efficient and broader network.

Other railroads soon followed such as those based in Charlestown, South Carolina, and Albany, New York. As settlements across the US expanded, the federal government wanted to develop a trans-continental railroad connecting New York and San Francisco. This railroad was constructed between 1863 and 1869 and became known as the Pacific Railroad (Linda Hall Library 2012). As the project economics of the trans-continental railroad were not apparent, the federal government granted public land to railroad companies via the Pacific Railroad Act as an incentive to construct sections of track in selected areas. The government anticipated that the land grants would increase in value as the new settlements along the track expanded and demand for adjacent land increased. This would contribute to the profits or net worth of the railroad companies and therefore improve the project economics. Moreover, as railroads usually operated as monopolies between destinations, an ultimate profit was expected by the railroad companies. The Pacific Railway Act also committed government financing by way of issuance of government bonds, which contributed USD 32,000 per mile of track laid to the two sponsoring companies, the Central Pacific Railroad and the Union Pacific Railroad. The balance of the financing was sourced from private investors (Linda Hall Library 2012). From 1840 to 1890, with the help of government, US railroad mileage had increased almost sixty-fold. An indication of the expansion rate of railroads between 1830 and 1890 is given by the following table:

Figure 3.1: US Railroad active mileage by region between 1830 and 1890

Region	1830	1840	1850	1860	1870	1880	1890
New England	30	513	2,596	3,644	43,273	5,888	6,718
East		1,484	3,740	11,927	18,292	28,155	40,826
South	10	737	2,082	7,908	10,610	14,458	27,833
Midwest			46	4,951	11,031	22,213	35,580
South Central		21	107	250	331	1,621	5,154
West				239	4,578	15,466	47,451
Total USA	40	2,755	8,571	28,919	88,115	87,801	163,562

Source: (Porter 1892).

The support provided by the government in the form of land grants combined with the monopolistic nature of the railroad business in the early period of the industry made financing this modern infrastructure an attractive and relatively low risk proposition for investment bankers. As this was a capital-intensive industry, which required large amounts of debt and equity from a country with a short supply, it was fertile territory for strong growth of the investment banking industry. The following section outlines some of the pioneers who initiated the required railroad financing.



Figure 3.2: Portrait of Nicholas Biddle
Source: Longacre c.1830

Nicholas Biddle was born in Philadelphia in 1786. He was the son of Charles Biddle, who was a strong supporter of American Independence and ultimately served as Vice President of the Supreme Executive Council of Pennsylvania under President Benjamin Franklin. Nicholas' uncle was regarded as a hero and died in the American War of Independence, whilst another uncle was a member of the first Continental Congress of 1774. This ancestry provided Nicholas Biddle with an unusually valuable network of political and business connections (Hammond 1957, 287-8).

Biddle graduated with a degree at Princeton University at the age of 15. He followed his degree with further studies in law. Following his studies, he began writing for a prestigious journal, Joseph Dennies' *Port-Folio* and in 1804 became secretary to General John Armstrong, the American Minister in Paris. This job enabled Biddle to tour Europe and in 1806, he served the future US President, James Monroe, who was at that time the Minister to the Court of St James in England (Hammond 1947). During this period, Biddle established many connections which would become useful in his later finance career, especially in the distribution of bonds to European investors. Hammond (1957, 287) describes Biddle as having "a superfluity of social and economic advantages". His network permeated both the US and Europe.

In 1807, Biddle returned to the US and began writing journal articles and books. In 1810, he was elected to the Pennsylvania House of Representatives whilst his father was a member of the State Senate. Later, he also became a Senator of Pennsylvania and during this time, sought a new charter for the Second Bank of the United States following the expiration and non-renewal of the federal charter of the First Bank of the United States in 1811. The Second Bank of the United States was chartered in 1816 with the same responsibilities and powers as the First Bank. Biddle was initially appointed as a federal government director by President Monroe and in 1823 succeeded Langdon Cheves as the bank's president. Under Biddle's leadership, the bank assumed the role of a central bank and his interest in the welfare of the US economy inspired him to implement monetary policy to aid the government's attempts to expand economic activity. Biddle remained in this role until the bank's charter expired (Hammond 1947).

Biddle was a major contributor in elevating Philadelphia to its primary role in railroad financing during the 1830s. He helped market the securities of the Reading, the Virginia, and some of the local Pennsylvania railroads. The Second Bank of the United States acted as the fiscal agent for the Reading and other coal railroads and was of prime importance in financing the Philadelphia, Wilmington and Baltimore railroads. His involvement with railroad financing earned Biddle the informal title of America's pioneer investment banker (Chandler 1954). He also used the Second Bank of the United States, "to funnel American securities into the London market directly and efficiently through its agent, Mr. Jaudon, planted in London for this express purpose" (Chandler 1954, 253).

In April 1836, the national charter granted to the bank by the federal government expired, however, Biddle was instrumental in ensuring the bank continued operating under a state charter to guarantee its status. In 1839, Biddle resigned as the bank's president, and in 1841, following the impact of the bank panic of 1837, the bank failed. Biddle was subsequently arrested on fraud charges but was later acquitted and died soon after (Hammond 1947). When the Second Bank of the United States failed, it had large holdings in nearly all the important privately financed railroads south of New York.

Biddle's networks enabled his progression through political positions in government which in turn led to the influential position as the head of the Second Bank of the United States with the ongoing support of President

Monroe. His influence and capacity to organise finance for the burgeoning railroad infrastructure in the US was vital for the development of the US economy. It is not surprising therefore that his knowhow, network, and credibility attracted favour from key individuals in the government executive and other prominent businessmen. In the process, he ingratiated himself to the country's elite leaders which in turn, served to increase Biddle's commercial success and influence even further.

The Role of Bonds in Funding Railroads

Investment banks became an important conduit for the issuance of bonds for the financing of railroads. In the 1830s, US railroad companies either chose local investment banks such as Clark Dodge & Co. and Thomas Biddle, or London-based investment banks to undertake the role of underwriter and distributor of bonds. The importance of the size and quality of social and commercial networks in the distribution of bonds is well demonstrated in the period between 1840 and 1850. During this period, the US investment banking industry was converging on New York, which as the new major financial centre, was the destination for most railroad and canal companies in their fundraising efforts.

The New York-based investment banks had the capability to distribute bonds in the Eastern regions of the US as well as to Europe. These vast regions relied on strong commercial and social networks to reach the ultimate investor. However, given the geographical remoteness from the investor base, particularly Europe, it was difficult for the New York investment banks to distribute equity. There are two main types of capital; debt and equity capital. Equity capital is the shares issued by a corporation and represents the riskier form of capital. Debt capital is usually in the form of bonds issued to investors typically for periods of greater than one year and in the event of the winding up of a company, have preferential treatment over equity in the repayment to the investor. Consequently, risk averse investors preferred to invest in the less risky bond instrument. Since the equity issued by railroad corporations was generally considered a riskier form of investment, the performance, operations and risks associated with the railroad project generally required a greater level of monitoring. Alternatively, bonds paying a fixed amount of interest, a condition preferred by European investors, represented a less risky form of investment and therefore required a lower level of risk monitoring.

However, in contrast with European investors, New England investors expressed a greater preference for equity as opposed to debt instruments. The social and commercial networks in New England were considered more closely knit than elsewhere in the US. The manufacturing and mercantile community of New England and specifically Boston, where most wealthy investors resided, represented one of the country's primary investment markets. Given the strength of relationships throughout this community, railroad promoters had enhanced access to the ultimate investor which often obviated the need for an investment bank as a conduit for bond issues. Railroad companies could often issue directly to the investor and given the relational closeness and physical proximity between the parties, the risk monitoring by the investor was less problematic. This led investors in the region to be more amenable to equity issues in preference to bond issues. The preference for equity capital soon changed by the 1850s, as the amounts required for railroad expansion exceeded the available equity capital in the region (Chandler 1954).

By the beginning of the 1840s, various states were acknowledging the economic benefits of railroads. However, in this early phase of railroad expansion, non-government private capital willing to invest in railroads was relatively scarce. The states stepped in by arranging large state-guaranteed public bond issues. These included issues by the states of Massachusetts, Pennsylvania, Virginia, South Carolina, Georgia and several of the new states of the West. Given the scale and cost of the railroad projects, combined with the risk related to the uncertain prospects of a sustainable profitable business, willing private investors during this period were relatively difficult to find. Consequently, public issues became the norm (Chandler 1954, 249).

The personal and business networks of the investment bankers in the Eastern States were critical to arranging much needed financing. This aspect of investment banking is similar to the traditional role of the investment banker in raising capital for specific projects or companies from sources usually well known to the firm. Toward the end of the 1840s, the firms of John E. Thayer & Brother and Henshaw & Ward began creating a dynamic market for railroad securities and fostered relationships within their personal networks to enable investors to buy and sell their securities freely. The importance of personal networks in raising finance is exemplified by the capital raising for Michigan Central, Boston's largest single railroad venture in the West. In this fundraising, John E. Thayer &

Brother and John Murray Forbes sold securities for the project to stockholders such as “Perkins, Cushing, Quincy, Weld, Neal, Brown from a Who's Who of the closely knit, family related inner circle of mercantile and manufacturing capitalists who dominated New England's economy” (Chandler 1954, 259).



Figure 3.3: Portrait of Nathaniel Thayer

Source: Ellis 1885

In his obituary, Nathaniel Thayer was reported as receiving large profits from the financing of the railroad expansion. The *New York Times* (1883) attributed his success with the railroads to his “far-sightedness, courage and ability”, a trait which is common amongst some investment bankers to this day.

By the end of 1847, the railroad industry realised that traditional vanilla bond issues could no longer meet the full financing requirement of the large Western railroads. The 1847 depression resulted in a reduction of available capital and

forced investment bankers to complement traditional funding sources with alternative and innovative ways to raise the necessary railroad finance. Consequently, the Michigan Central railroad issued USD 1 million of 8% convertible mortgage bonds which were successfully sold to the public. The convertible mortgage bond became the preferred instrument of financing for railroad projects. The mortgage was typically over the assets of the railroad including land to provide security to the investor. The convertible nature of the bond however was an option to convert the bond into a dividend-paying equity instrument. It was intended to reward the investor once the railroad was generating considerable income and provided for capital growth. This style of financial product is often used by investment bankers today for various financing opportunities and represents the creative and innovative skills developed by US investment bankers during the formative years of the industry.



Figure 3.4: Portrait of James Gore King

Source: Mott 1899, p. 32

Born in 1791 in New York City, James Gore King was another individual who led a successful career as a politician and investment banker. King was well-educated, having studied law at Harvard University and graduated in 1810. Whilst in Paris, he also studied languages. In 1812, King married Sarah Rogers Gracie, whose father was a prominent businessman, Archibald Gracie Snr. This connection helped King to serve as Assistant Adjutant General of the New York Militia in the War of 1812. His commercial career began as a mercantile agent in New York City in 1815 (King 1854). His commercial experience led King to Liverpool, England in 1818, where he

established a banking firm known as King & Gracie, with his brother-in-law, Archibald Gracie Jr (Weygant, 2016). It was at this time that he met John Jacob Astor who offered King a lucrative position in the American Fur Company that he declined. He returned to New York City in 1824 and engaged in banking as a partner in the firm of Prime & Ward (later known as Prime, Ward & King) before leaving this firm to form James G. King & Son. King had an estate in Weehawken, New Jersey named Highwood and became known as “the ‘Merchant Prince’ and the ‘Almighty of Wall Street’” (Litchfield Historical Society 2010). In 1835, King accepted another prominent position as the President of the New York and Erie Railroad (Markham 2002). According to his obituary, King was involved in “one of the wealthiest banking firms in the country” (*Times* 1853). His political career as a member of the US House of Representatives over the period 1849 to 1851 was short-lived in view of his preference for commercial pursuits (Weygant 2016).

King had the ability to combine leadership roles in politics and industry and this combined with his domestic and European networks facilitated his business of securities dealing. These networks assisted in providing much

of the necessary funding for the US railroad expansion. Again, the associations with both government and the elite in business circles proved useful in generating substantial wealth.

Needy Americans

In the 1850s as the railroad expansion escalated, and the demand for capital from other non-railroad corporations increased, the ability of New York to absorb numerous bond issues became increasingly difficult. As railroads accounted for the major share of bonds outstanding in the 1850s, investors became overexposed to this industry, which had the effect of raising concentration risk levels within investment portfolios. Fortunately, the funding gap was met by European investors who were able to access investment opportunities through New York which was the centre for international merchant transactions with Europe. Most of these connections originated from US individuals who either travelled through or were born in Europe and had immigrated to the US. Merchants with trading relationships in Europe also participated in the distribution of US bonds to European investors (Chandler 1954, 263).

Baring Brothers, a British merchant bank, which was heavily involved in the securities used to finance the War of 1812, became the agent for many American businesses in London. It also used Prime, Ward & King as its agent in New York. The interest in US securities increased from 1822 when the British "Navy Five Percents" were being refinanced with 4% bonds. London investors became disaffected with the lower return and thus appetite grew for alternative higher yielding bonds. The timing was ripe for the US issuer market as it constituted a high-volume source for higher yielding bonds and securities. Brokers began to capitalise on this growing appetite and established marketing agents in London. Charles Deveaux was one such broker who established a capability to sell American securities in London and bonds were even sold on consignment through English brokers or correspondents. During this time, the business of Baring Brothers & Co. continued to grow. Barings had two partners in the US before the Civil War, Joshua Bates and Russel Sturgess and a special agent in Boston, Thomas Wren Ward (Markham 2002, 166). During the 1850s, investments in railroads totalled approximately USD 1 billion (Markham 2002, 165). The mortgage bond became the issue of choice for New York-based investment banks who raised the bulk of the financing for the

railroad expansion from the 1860s onwards, supplanting the role of Boston during the 1840s and Philadelphia in the 1830s (Markham 2002).

Baring Brothers had noted the expanding need for capital in the US and attempted to use its US political contacts cleverly, in particular, with the then US Secretary of State, Daniel Webster, to position itself as a key player in the bond distribution process. Webster was appointed as a consultant to Barings and thus was able to profit also from this relationship. This is an early example of the “revolving door” concept whereby politicians and government bureaucrats are offered lucrative roles within industry, often as a reward for favours granted whilst in government. Barings’ involvement with the US Government extended to encouraging a former head of Barings to assist Webster negotiate a treaty (known as the Webster-Ashburton Treaty) which ended the Aroostook War between the US and British North American colonies and settled disagreements over border claims in the Maine/New Brunswick area. Barings’ involvement in the negotiations was a precondition to it marketing further US bonds in Europe (Wilson 2007, 149). This was not surprising given the close relationship Barings had with the US Secretary of State as a paid consultant, which involved a conflict of interest on both sides. Firstly, concerning Daniel Webster, who whilst being on Barings’ payroll, encouraged the appointment of Barings in the marketing role for US bonds. Secondly, on the part of Barings, since it was an advantage for them to help settle disputes over the Maine-Canada border as this allowed the credit markets to flourish. This was essential for trade within the region, including that in which Barings had an interest.

Barings was never able to fully capitalise on its privileged position with the US Government in view of the US Government’s financial difficulties following the financial panic of 1837 (Sexton 2003, 26). The panic resulted in the default of eight US states and given that British banks held large quantities of US debt, they used their influence to encourage the US states to prioritise repayments to British creditors. According to Sexton (2003, 27-8), “London bankers responded, by mounting behind-the-scenes public-relations campaigns in the US. By distributing campaign contributions and commissioning an anti-repudiation magazine and newspaper articles, the London bankers helped to convince several states to resume payments on their debt”.

This example of the exertion of power directly benefited British bankers as interest and principal payments continued. The influence exerted by British bankers was only made possible by their considerable resources and the leverage they had as one of the few providers of capital open to the US states at the time. In the late 1840s and 1850s, British bankers continued to support US relations, in the hope that the support would translate to continuing business and as a mechanism to encourage reciprocal support in times of US difficulties (Sexton 2003). The influence exerted by a regional cohort such as the British bankers, is likened to a cohort brought together by ethnicity and religion such as the Jewish connections known as “Our Crowd” who played a significant role in the development of the US investment banking industry. This pattern of government and banker–mutually beneficial interactions, laid the foundation for the conflicts of interest evident in the lead up to the GFC.

CHAPTER 4

BANKERS AND THE CIVIL WAR

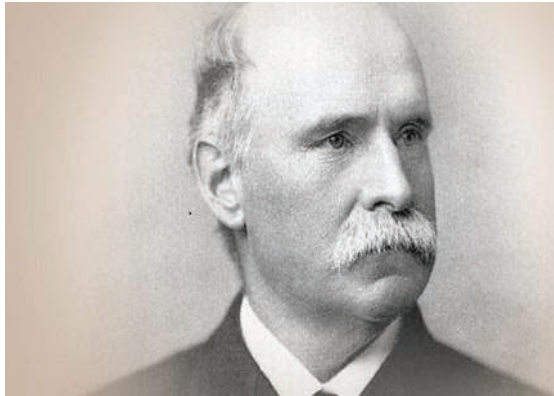


Figure 4.1: Portrait of Anthony Joseph Drexel (CC)
Source: Drexel University c. 1880

Another prominent investment banker of the era was Anthony Drexel born in 1826. He began his career in his father's firm of Drexel & Co., which was based in Philadelphia. Anthony Drexel was appointed a full partner in the firm in 1847 alongside his brother, Frank. Under his father, Francis Drexel, the firm gained an early reputation as a broker of currencies, an activity which the firm established in 1838, which was the year after the financial panic. Once the Second Bank of the United States passed the role of distributing currency to the state-chartered banks, many of which were unprepared to undertake this function, Drexel's business began to flourish. The lack of liquidity in bank notes and the recovering US economy allowed Drexel to expand into railroad financing and convert his brokerage into a private bank. Under the guidance of their father, Anthony and his brother gained much experience in business affairs (Rottenberg 2001).

Within a decade, Anthony assumed the leadership role of the firm. Drexel concentrated on government bonds and railroad issues. As the demand for railroad financing increased, Drexel and Co. established an office in Chicago and New York. In 1871, the firm merged with the London-based firm of George Peabody forming Drexel, Morgan & Co. (later J.P. Morgan & Co.). Drexel admitted John Pierpont Morgan as a junior partner at the urging of JP Morgan's father, Junius Morgan, whose own career had centred on bonds and stocks (Schweikart and Doti 1999, 102). The partnership with JP Morgan, which was based in New York, operated initially as an agent for European investors, gaining a large share of the transatlantic trade in railroad securities. The firm is also acknowledged as influential in developing a national market for the securities issues of industrial companies, other than railroad and canal companies (Rottenberg 2001). Drexel Morgan & Co. also assisted the US Government through underwriting the wages of the US Army when the US Government was unable to meet its obligations in 1877; again, rescuing the US Government during the Panic of 1895; and rescuing the New York Stock Exchange during the Panic of 1907 (Rottenberg 2001). These actions empowered Drexel to produce an enviable reputation in the business community and amongst fellow investment bankers.

Drexel's power originated from his superior skill in arranging difficult financings, especially for government, which created an image of Drexel as the "go-to man" in times of crisis. The assistance to the government in difficult circumstances also created a sense of obligation amongst the government executive. Drexel's sense of self-importance and his routine exercise of power is exemplified by an incident with President Ulysses S. Grant:

In a telling incident ... President Ulysses S. Grant once called on Drexel—and because Grant was five minutes late, Drexel made the President wait an entire hour before seeing him. President Grant, needing Drexel's bond selling expertise, was not insulted by the delay (Wooster 2002, 1).

Drexel's technical skills differentiated him from many of his compatriots. These skills enabled him to foster a bond market in the emerging corporate sector. In the process, given the substantial size of the issues, Drexel had to accurately assess the credit risk of the industrial corporate borrowers, whose profiles were different from those of the railroads and canals. These differences required an astute judgement of risk for a diverse portfolio of

customers insofar as the variety and non-monopolistic nature of the industries were considered. Additionally, the type of credit analysis required focused on financial statements which reflected operational businesses relying on manufacturing and marketing to generate profits differing significantly to those of a transport concession. Drexel was also able to create a national bond market for industrial companies which required a network of like-minded investment banks and brokers capable of selling corporate bonds issued by a riskier class of borrower.

The knowledge Drexel developed led to the innovative solutions required to bailout the government from its numerous predicaments. His unique ability empowered Drexel in his social relations with key leaders in government and industry alike. These favourable key relations translated to a repeat of these successful transactions and therefore contribute to his success. Drexel used his fortune and influence to establish the Drexel University in 1891 and was the first President of the Fairmount Park Art Association (now the Association for Public Art), the country's first private association dedicated to integrating public art and urban planning (Rottenberg 2001).

Apart from the influence Drexel acquired, he was also an innovator of practices which are routinely used today. "These include, trading of national currencies, guaranteeing credit for travellers abroad, rewarding workers based on individual initiative, and offering sweat equity to deserving employees who could not ordinarily buy shares" (Wooster 2002, 1). Two years after Drexel's death in 1893, Drexel Morgan & Co. was renamed J.P. Morgan & Co.

Enoch Clark, born in 1802, was another eminent financier instrumental in supporting the financing of the US railroad system. Clark established his name as a prominent financier whilst a partner in the merchant bank S. & M. Allen and Co. which eventually failed following the panic of 1837. S. & M. Allen and Co. was a founding member of the New York Stock Exchange and during his time in the firm, Clark gained a reputation as a stock trader and speculator (Geisst 2001).



Eno Clark

Figure 4.2: Portrait of Enoch Clark
(founding partner of Clark Dodge)
Source: Scharf & Wescott 1884

Clark subsequently began his own firm with his brother-in-law, Edward Dodge as partner. The firm was known as Clark Dodge and Co. and specialised in trading banknotes and gold bullion. Clark Dodge & Co. soon established a sound reputation by guaranteeing the firm's notes with their own stock of gold and silver. The firm's reputation grew when it participated as a co-underwriter alongside merchant bank, Corcoran & Riggs, in a bond issue for the federal government to assist in the financing of the Mexican War which began in 1846 (Geisst 2001).

As the firm expanded, it introduced new partners, including Jay Cooke, who was admitted in 1849. Prior to the Civil War, the firm participated in the underwriting of a number of bond issues on behalf of some of

the earlier railroads such as The Pennsylvania Railroad (founded in 1846), Rocks Island Line (founded in 1854), Northern Central (founded in 1858) and the Philadelphia and Erie (founded in 1861). These successful transactions generated notable esteem and earned the participating firm's generous fees (Chandler 1954; Geisst 2001).

Clark died in 1856, a year before the panic of 1857. As with all panics, the viability of merchant banks is strained. Clark Dodge closed its operations temporarily following the panic and by the time it recommenced operations, Jay Cooke, one of the most successful partners in the merchant bank, departed to open his own firm. Clark Dodge continued operating until 24 June, 1974, when it was acquired by Kidder Peabody (Geisst 2006). Like many other investment banks, Clark Dodge had been incurring losses in the early 1970s, and Kidder Peabody, recognising the valuable distribution capability of the firm was able to justify the acquisition (*New York Times* 1974).

Clark Dodge & Co. was typical of the various investment banks of its era which often relied on effective distribution networks for the sale of bonds. The ability to reach investors with appetite for bond investments is considered a crucial skill of any firm. The wider the distribution network, the larger the potential volume of bonds that can be underwritten. It therefore follows that the higher the value of bonds underwritten the greater the potential profits for the firm.

This distribution capability was equally important for the financing of the US railroad expansion as it is today for any corporate bond issue. A cornerstone of the development of valuable distribution capability is a network of social relations amongst other investment banks and wealthy investors. The power of individuals within a firm is facilitated by the possession of superior knowhow and technology. This knowhow incorporates the complexities of developing effective distribution networks. In creating these networks, a reputation for reliable delivery of credit information on bond issuers and structuring and pricing of suitable capital market transactions are essential in order to generate sufficient investor appetite for a successful issue. Therefore, the knowhow required to arrange securities issues and ensure their effective distribution is an important factor for an investment banking firm intent on participating in this sector of the market.

John Pierpont Morgan (JP Morgan) was born in 1837 in Hartford, Connecticut, where he spent his formative years. He became one of the most influential investment bankers of his time and arguably in the history of US investment banking (Witzel 2003). He dominated corporate finance and industrial consolidation during the period 1871 until 1913 following the end of the Pujo Committee hearings.

His father, Junius Morgan worked as a partner in J. M. Beebe, Morgan & Co., a Boston, Massachusetts dry goods wholesaler, and in that role transferred to London as the company's representative. Junius Morgan encountered George Peabody in 1854 soon after arriving in London. Peabody also started his career as a dry goods merchant in Massachusetts and later became a financier. Peabody originally moved to London to develop his investment firm, George Peabody & Co., to support the funding of a railroad company he had previously incorporated in 1836, known as

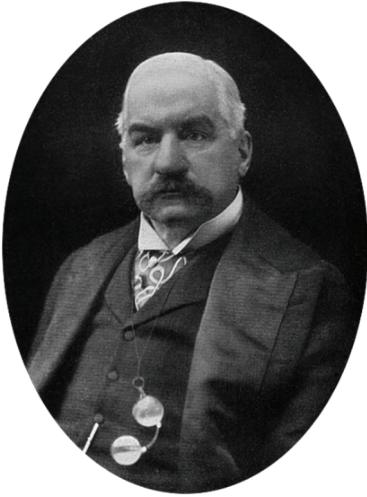


Figure 4.3: Picture of John Pierpont Morgan
Source: Images of American Political History; CC

the Eastern Railroad, and to trade in bonds. Following his meeting with Peabody, Junius Morgan joined George Peabody & Co as a partner and the name of the firm was changed to Peabody, Morgan & Co., ten years later in 1864. Upon the retirement of George Peabody, Junius Morgan succeeded Peabody as the head of the London operation and changed its name to J.S. Morgan & Co. (Schweikart and Doti 1999). The principal activities of the firm were the distribution of bonds, and during the Civil War, the firm increasingly focused on the sale of US war bonds (Chernow 1990).

In 1857, Junius employed his son, J.P. Morgan as a secretary in the count house and as the operator of the telegraph system. Later J.P. would send out telegraphs to US War Bond investors of the outcomes of battles of the Civil War before it became general knowledge in England. Knowing the outcome of the battles before the investors, Junius was able to profit by trading the bonds whose value would fluctuate according to this important information—contemporarily known as ‘insider trading’ (Schweikart and Doti 1999). In 1858, J.P. Morgan returned to New York to join Duncan, Sherman & Co., which was the US representative firm of the British merchant bank, George Peabody & Co.

From 1864 to 1871, J.P. Morgan worked in the firm of Dabney, Morgan, and Company alongside the Drexel brothers and went on to establish the firm of Drexel, Morgan & Company in 1871, following the merger with George Peabody. Apart from the important influence of his father, J.P. Morgan was also mentored by Anthony J. Drexel at the request of his father. This mentorship equipped Morgan with valuable skills relating to corporate restructuring which augured well for his corporate mergers and acquisition activities in the latter part of the nineteenth century (Rottenberg 2001).

Two years after the death of Anthony Drexel, in 1895 Drexel, Morgan & Company was renamed J.P. Morgan & Co. Morgan realised that in order to sustain business it was crucial to maintain and develop important relationships. He therefore continued to associate his firm with a sister firm, Drexel & Company of Philadelphia; and Morgan, Harjes & Company of Paris; and J.S. Morgan & Company (which in 1910 became known as Morgan, Grenfell & Company) of London. By the end of the nineteenth century, J.P. Morgan & Co. was considered one of the most influential investment banks globally, with a focus on mergers and acquisitions, corporate restructuring and large financings (Chernow 1990). J.P. Morgan & Co. also became an employer of choice within the investment banking industry and was therefore able to draw many influential partners to the firm (Morris 2015).

J.P. Morgan's power and influence was recognised by contemporary commentators. Examples of perceptions of Morgan can be found in the newspaper articles of the time. Mallios (2013, 1) recounts the words of a contemporary journalist who describes J.P. Morgan as "[t]he most powerful private citizen in the world to-day, so far as financial affairs are concerned ..." (*New York Tribune* 1910). J.P. Morgan was also described as "the personification of a banking system: the most powerful private banking system in the US" (*New York Tribune* 1910). The Pujo Committee, which was mandated by the government to investigate the behaviour of the investment banks during the 1907 crisis, found that a small number of financial leaders, including J.P. Morgan, exercised considerable control over many industries (Brandeis 1932).

An example of J.P. Morgan's power occurred in 1895 when the US Federal Treasury had almost exhausted its gold reserves following the Panic of 1893. Morgan had recommended that the federal government supplement its gold reserves through purchases from various banks in Europe as well as from his own firm, J.P. Morgan & Co. The federal government declined the plan and preferred instead to raise the necessary government funding to survive the crisis from a direct sale of bonds. Believing that the federal government was on the cusp of default, Morgan sought a meeting with US President, Grover Cleveland, to express his concerns. J.P. Morgan came up with a plan to use an old Civil War statute that permitted the US Secretary of the Treasury to issue bonds without congressional approval, for the purchase of gold coins from J.P. Morgan & Co. and the Rothschild family (JP Morgan Chase 2016). President Cleveland

sought a guarantee from J.P. Morgan that the gold would remain in the US and not to be diverted to Europe. Morgan agreed to the request and immediately arranged for a US government bond issue to be sold to his connections, the proceeds of which were used to purchase the gold and thereby restore liquidity to the US Treasury. "The firm offered the bonds for sale at \$112.25 and sold out the entire issue in New York within 22 minutes" (JP Morgan Chase 2016). The US Treasury's dire need for gold reserves created an exogenous environment which required a solution – otherwise known as a 'technology of production' which is a source of power. This need for a technical solution empowered J.P. Morgan, as he was one of very few investment bankers with the resources and knowledge to provide an appropriate solution.

His knowledge of market appetite for bonds reflected an unrivalled stranglehold over relationships with other banks and investors. This power was gained through experience and an intimate knowledge arising from those close relations. The relationships also permitted J.P. Morgan to ascertain the pricing level at which the bond appetite would become attractive to investors. The government funding strategy was very profitable for Morgan as it encompassed two tranches to the transaction. It ensured Morgan could earn commissions firstly, from the bond sale process and secondly, from profit margins on the gold purchase brokered for the government. Again, the exogenous environment of the government funding dilemma gave it little choice given the lack of alternative remedies. J.P. Morgan achieved his desired outcome of selling gold to the US Treasury as his social relations through his professional network allowed him to appeal to the ultimate decision maker in the country – US President, Grover Cleveland; the agency of his own firm and the Rothschild family. Funding the Civil War effort offered impetus to the investment banking industry in general and apart from allowing bankers to further develop government funding techniques, it presented them with opportunities to exploit important government relationships.

American Civil War (1861 – 1865)

The origins of the Civil War emanated from the aversion to slavery by the US northern states of America (Union) which was adopted as a formal policy by the Republicans in 1860 upon the election of Abraham Lincoln as the US President. The southern states relied heavily on large scale agriculture and specifically cotton plantations, which utilised large numbers of slaves as manual labour. The southern states' objection to the moral attitudes of the northern states led to South Carolina seceding from the Union and this led other southern states to follow and form their own government, which, under the leadership of Jefferson Davis is referred to as the Confederate States of America (CSA) (Foote 2006; Killick 2006). The ensuing war was costly for both sides. In all, the war resulted in 650,000 deaths and casualties of over a million (Foote 2006).

Major differences existed between the Union and the CSA at the commencement of the Civil War. Apart from military capacity, these included the industrial and economic stage of the respective regions' development and the level of financial support. The Union's institutional financial support consisted of a multi-tiered taxation stream of income and an established government treasury which was able to manage a range of debt issues and print currency. In contrast, the CSA relied mostly on donations, meagre taxation revenue, printing of currency and a more modest level of debt issues. Although there were similarities in the types of revenue sources, the warring factions differed with regards to funding strategy and execution which led to varying effects and successes. It was the raising of new debt where investment bankers and their special networks were most helpful to both sides especially when these networks extended overseas to Britain and continental Europe.

As indicated in Figure 20, the cost of the various wars in which the US participated varied widely. The cost of the Civil War far exceeded the cost of any other war in which the US had participated during that era.

Figure 4.4: Military Costs of Major US Wars 1775 – 1900 (current and constant dollar values)

War in which The US Participated	Years of War Spending Total Military Cost of War (USD)
American War of Independence	1775-1783
Current Year USD	101 million
Constant FY2021USD	3,588,530,000
War of 1812	1812-1815
Current Year USD	90 million
Constant FY2021USD	1,856,233,083
Mexican War	1846-1849
Current Year USD	71 million
Constant FY2021USD	2,529,351,948
Civil War: Union	1861-1865
Current Year USD	3,183 million
Constant FY2021USD	99,219,173,864
Civil War: Confederacy	1861-1865
Current Year USD	1,000 million
Constant FY2021USD	31,171,590,909
Spanish American War	1898-1899
Current Year USD	283 million
Constant FY2021USD	8,821,560,227

Source: Daggett 2010, 1

The dollar amounts included in the above table represent estimates which are expressed in USD at the time of each conflict (Current Year) and in constant USD that reflect values as at 2011 (Daggett 2010).

This data shows that whilst the Union had spent over USD 59 billion in 2011 equivalent dollars, the Confederation had spent a much lower USD 20 billion in 2011 equivalent dollars. In other words, “the Union expenditure represented about 65 per cent of 1861 gross domestic product (GDP)” (Giroux 2012, 83). The combined expenditure of almost USD 80 billion in 2011 equivalent dollars is by far the highest amount expended by Americans in any conflict during either the eighteenth or nineteenth centuries (Daggett 2010).

In the early years of the Civil War, funding was difficult for both sides. The Union Secretary of the Treasury, Salmon Chase, was conscious of earlier history such as the public fear and mistrust of taxing authorities and therefore was initially opposed to additional tax measures. The public fear of new tax measures emanated from the past experience of paying excessive taxes imposed by the British prior to the Revolution. Resentment against British taxes are often cited as a contributing cause to the Revolution. Additionally, the public was wary of taxes generally given the resentment from certain quarters associated with the levying of excise taxes on spirits by the first federal government causing the Whiskey Rebellion. A protracted war would require additional resources and revenues. This became a problem for Chase at the time as the major source of federal government revenue came from customs duties which provided USD 40 million in 1861 and represented a meagre fraction of the total revenue required (Giroux 2012, 83).

Given the burden of the financing requirement, Congress passed the Revenue Act (1862) which enabled the introduction of new taxes. Not only did the new stable source of tax revenue assist in funding the war, it established an improved credit profile for the Union which was to become helpful in future borrowings, especially from overseas sources. As stated by Brownlee (1996, 23):

It was the nation's first modern war in the sense of creating enormous requirements for capital. Union war costs drove up government spending from less than 2 percent of the gross national (product) to an average 15 percent ... The capital requirements evoked a program of emergency taxation that was unprecedented in scale and scope.

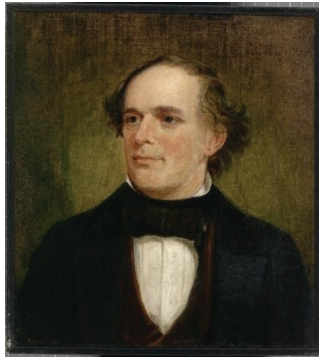


Figure 4.5: Portrait of Salmon Chase, Secretary of the Treasury between 1861 & 1864

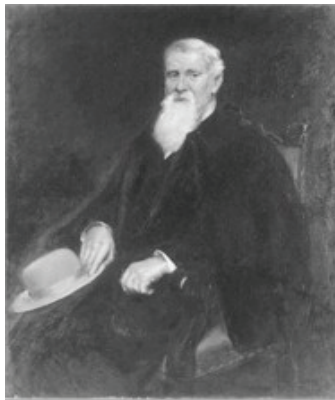


Figure 4.6: Portrait of Jay Cooke, Financier to the Union.
Source: Tax Analysts 2014

Chase was inexperienced in undertaking a large-scale financing as required by the war effort. He realised that external assistance was necessary and sought assistance from Jay Cooke, a well-known investment banker, to advise him on external borrowings and administer the sale of war bonds. This method became the principal means of financing the war effort.

Jay Cooke was born in 1821 and was another investment banker who mixed politics with banking. He was a member of Congress between 1831

and 1833 and worked for the firm E.W. Clarke & Co. before establishing his own firm in Philadelphia of Jay Cooke & Company (Ellis and Vertin 2003). Jay Cooke & Company had an enviable reputation as an influential investment bank, and was to prove invaluable to Chase as its “reputation among investors around the world enabled the bank to sell...bonds when other brokerages could not” (Snowden et al. 1909, 107).

The funding requirement in 1861 amounted to an historically high level for the federal government. According to reports from Chase to Congress in July 1861, the required financing amounted to “USD 320 million, with USD 80 million needed from taxes and the remainder from loans” (Thorndike 2001). Chase borrowed USD 150 million in 1861 from a consortium of New York banks. This loan was offered in gold and caused a drain on the gold reserves of many New York banks which consequently led them to reject the gold standard in December 1861 (Thorndike 2001). The new debt was deemed insufficient and the federal government proceeded to issue USD 150 million of paper currency (known as Greenbacks), pursuant to The Legal Tender Act of 1862. The currency was to serve two purposes: firstly, it was a source of income needed by the government to service its debts; secondly, it was an attempt to introduce liquidity to the economy to enable the investing public to purchase government bonds (Giroux 2002). The amount was subsequently increased to USD 450 million (Giroux 2002, 613). Features including identification numbers and signatures were designed to limit counterfeiting, a major weakness of similar bills, called Continentals, issued during the Revolution. A unique and important difference of the currency issued by the federal government to that issued by the CSA, was that it represented legal tender (Giroux 2002). This meant that the face value of currency notes was at all times available to extinguish personal debt to the government, such as taxes payable.

A cornerstone of the success of the Civil War financing by the Union was this level of innovation which was the result of collaboration between Chase and his investment banker associate, Cooke. The principal intention was to make the bonds attractive to investors. Having interest paid in gold created a windfall for investors as the value of gold had historically increased during times of war and given that the Union was planning to print additional currency it was expected the value of the Greenback would depreciate. Given the relatively short supply of gold, and that paper notes were not redeemable in gold, the public established a strong preference for gold as a means of exchange and the price of gold escalated whilst

confidence in the currency notes declined during the period 1861 to 1879 (Giroux 2002).



Figure 4.7: Civil War Five-dollar Greenback issued in March 1863

Source: Tax Analysts 2014

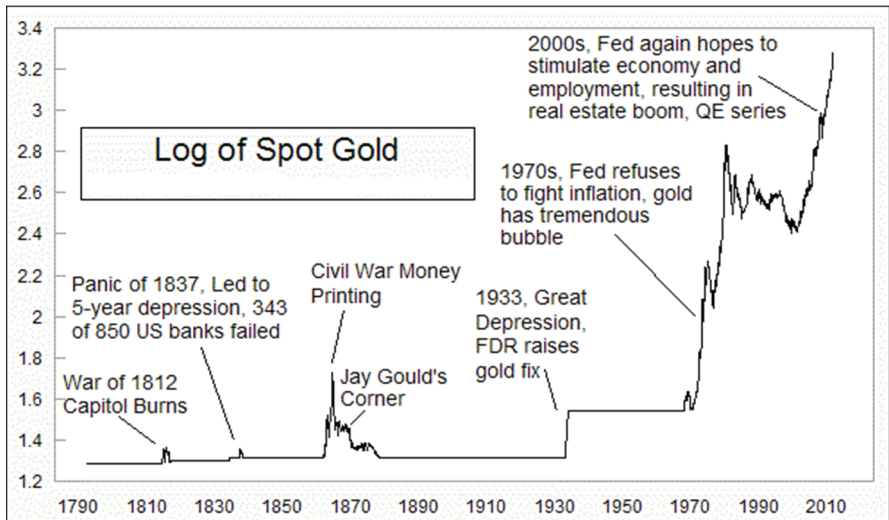


Figure 4.8: Log Price of Gold between 1790 and 2010

Source: McClellan Financial Publications 2015

Innovations were not limited to the structure of the bond issues, however, also extended to their settlement. Cooke & Co's innovative use of the telegraph to confirm sales allowed selling throughout the country to be coordinated centrally in Philadelphia (Geisst 2001, 37). Chase therefore proceeded to sell USD 500 million in government war bonds (known as 5/20s) to pay for the war effort. The term 5/20s was an abbreviation for bonds that paid six percent interest (in gold) and matured in 20 years, but were callable in five years. Chase worked with Jay Cooke & Co. to successfully manage the issue in 1862 (Geisst 1999, 54).



Figure 4.9: A One Thousand-dollar 5/20 Bond featuring the face of Salmon Chase

Source: Museum of American Finance 2014

The cost of the war escalated, and by 1862, reached approximately USD 500 million. The war attracted many unscrupulous contractors and corrupt government officials. Fraud was not uncommon. As stated by robber baron Jim Fisk: "You can sell anything to the government at almost any price you've got the guts to ask" (McCullough 1981, 60). War expenditure rose to USD 1 billion in 1865. Chase and Cooke varied the debt instruments in order to attract the appetite of the broadest range of investors. These included individual bonds, serial bonds, which attracted different interest rates, Treasury notes, and certificates of deposits (Giroux 2012).

It is not generally known how large a proportion of the securities of the United States are held by people of moderate means for the investment of their savings. We have not at hand the precise figures of the denominations in which the several series of Five-twenties were issued, but the following statement shows the number of notes of each denomination embraced in the issue of the Seven-thirty Treasury notes, which are now being converted by the Treasury into Five-twenty bonds. In these conversions the Treasury has never been able to supply enough small bonds to adequately meet the demand:

962,680	50s.....	\$48,129,000
1,474,940	100s.....	147,494,000
436,792	500s.....	219,896,000
370,376	1,000s.....	370,376,000
8,821	5,000s.....	44,106,000
<hr/>		
3,256,509	\$830,000,000

These figures will give an approximate idea of the amount in which all of the 5-20 bonds of the Government are held.

They show that *one-half of the loan* in amount was taken in 50s, 100s and 500s, and further, that as 2,877,813 pieces of these three denominations were issued against 371,197 pieces of the large denominations, the capitalists are in very small minority, and any legislation repudiating, in whole or in part, the obligation of the bonds of the Government would fall most severely upon widows, orphans and people of small capital, who invested their money in those securities in perfect reliance upon the representations made to them by the Treasury Department, directly and through its agents at the time of their issue.

More than once during the war, resolutions were offered in Congress looking to the payment of the 5-20s in currency, but in every case were promptly voted down. Yours, respectfully,

JAY COOKE & CO.

Figure 4.10: Article by Jay Cooke & Co. regarding distribution of the 5/20 Bonds

Source: Cooke 1868

The above *New York Times* article in Figure 26 conveys Cooke's argument that the 5/20 bonds were subscribed by many types of retail investors such as 'widows, orphans and people of small capital' as much as the wealthy capitalists. His argument is based on the records that show that half of the amount raised were in relatively small denominations. This record goes to support the argument that Cooke's distribution strategy was indeed successful at reaching a very broad investor base that proves the power of a well-executed and designed distribution strategy which is still considered an important hallmark of any capital market issue in modern times.

The success of any bond distribution naturally relies on the effectiveness of reaching the investor. Many investment banking firms have therefore developed assertive sales' cultures required to accommodate the necessity to sell bonds. The pressure of selling bonds is even more acute when the investment bank has itself underwritten them. Otherwise, the unexpected residual risk of holding the remaining unsold bonds may be unacceptable and, in some cases, could place the firm in financial difficulty, either by imposing liquidity restrictions or leveraging the firm to unacceptable levels. The market risk associated with holding excessive levels of bonds are also problematic, particularly if the bonds decline in value. Given the risk of holding bonds with depreciating values, investment banks underwriting issues would apply a relatively deep discount to their price during the competitive bidding process. They would subsequently offload the bonds to the public and other financial institutions at a higher price thereby generating a significant profit.

It was important for the government to support its own bond issues given its reliance on this form of financing. In an innovative move, the government introduced legislation, in the form of the National Banking Acts requiring "a third of a national bank's capital to be invested in federal bonds, since the new currency notes were to be backed by federal bonds" (Gordon 1999, 94). The federal government noted that the state banks which were subject to their respective state charters, were not bound by this federal regulation, and attempted to proportionally increase the number of national banks to state banks thereby creating a greater demand for federal government issued bonds (Comptroller of the Currency Administrator of National Banks 2003). To encourage the state banks to convert to national banks, the federal government imposed on the state banks a tax of 10% on the value of federal currency notes issued by state banks. By the end of the war, this new tax had the desired effect by

quadrupling the number of US bond purchases and tripling the number of federal banks (Tax Analysts 2014). The imposition of this new legislation had two additional impacts for the banking community and government. It secured the value of the Union currency being partly backed by government bonds, and induced demand for the same bonds which were critical to funding the war effort.

The large government bond issues required a new and innovative plan to reach new potential investors. Cooke devised a marketing campaign involving patriotic newspaper advertisements and a distribution network of 2,500 agents to sell the bonds. This campaign managed to sell USD 3 billion of government bonds to approximately twenty-five percent of the population (Brands 2010; Tax Analysts 2014). Cooke's "bond distribution" techniques have been copied by investment banks up to the present day.

Apart from his thorough and effective distribution strategy, Cooke's greatest assistance was in the role of underwriting the bonds thereby guaranteeing part, or all, of the financing requirement under a particular issue. Although Cooke earned a relatively modest underwriting commission of 0.5%, his earnings were boosted by the high transaction volumes and from the deep discount mechanism upon the sale to the public. The volumes were made possible by his innovative technique of using the telegraph to streamline settlement of the sales which resulted in sales of over USD 1 billion in Treasury bonds (Brands 2010, 80). Government bond issues were focused on the domestic market as there was little appetite from European investors. The federal government was represented in Britain by agents such as Joshua Bates and August Belmont, however, only managed to sell approximately 10% of bonds to the European market, predominantly to German and Dutch investors (Sexton 2003). Following the war in 1866, the federal government ran budget surpluses for almost 30 years (Giroux 2012, 95).

Financing the war was not only a challenge for the North. It proved to be an even bigger one for the Confederate States which, not being regarded internationally as an established nation, found it difficult to obtain funding from overseas sources or even by way of taxes. The Union blockade prevented the export of most of the South's cotton and other staple crops and stymied attempts to import specie (gold and silver coins) or other goods from abroad. Specie was therefore in short supply and tariff revenues were almost non-existent. The CSA, ostensibly founded on the

principle of states' rights, found it politically unacceptable to raise, let alone collect, direct taxes. Tax revenues therefore accounted for less than 10% of the CSA's total receipts (Giroux 2012, 94).

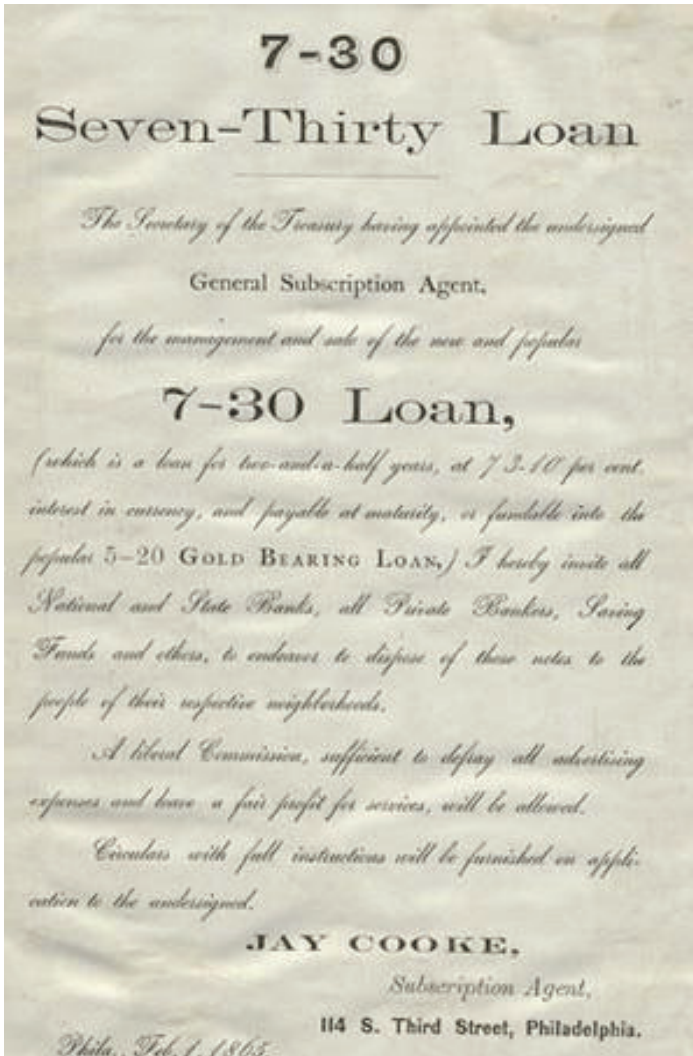


Figure 4.11: An announcement advertising 7-30 Bonds
Source: Museum of American Finance 2015

Loans therefore accounted for only about a third of CSA's wartime expenditures and much of its borrowing occurred early in the war, when a quick victory appeared possible. Individual states supported the Confederacy by paying for war expenses out of their own treasuries. In addition, churches, corporations, and private individuals donated money, food and clothing for the army. These donations continued throughout the war and increased especially during the final months of the conflict (Museum of American Financial History 1994, 16). On February 28, 1861, the Provisional Congress of the CSA authorized the first Confederate loan which became known as the "Fifteen Million Loan". Under its terms, CSA Treasury Secretary, Memminger, was authorised to issue 15 million dollars-worth of bonds bearing eight percent interest, payable in 10 years and redeemable in five years at the option of the government by giving three months public notice (Museum of American Financial History 1994, 16).



Figure 4.12: USD 1,000 Confederate Bond

Source: Museum of American Financial History 1994, 16

Similar to the Union, the CSA was also unsuccessful in raising loans in London where the default on several loans by some of the Southern states following the 1837 financial crisis tainted their credit risk profile with European financiers. However, the CSA was able to arrange a relatively

small loan in Europe in 1863. The CSA Treasury attempted to use the cotton crop as collateral for securing this loan which was in the form of a bond issue. In 1862, John Slidell, the Confederate Commissioner to France, negotiated an agreement with Emile Erlanger and Co., a Parisian banking house, to manage the sale of a £3 million (2021–USD 14,550,000) Confederate bond issue secured by cotton. This agreement became known as the Erlanger Loan. According to the terms of the loan, the twenty-year, seven percent bonds were to be converted into cotton below market prices. The Confederate government hoped that the chance of lucrative profits would lure European investors and restore the South's credit rating abroad. Erlanger proposed to pay £77 for every £100 bond the Confederacy offered, and then to offer the bonds to the public at £90, providing an immediate profit of £13 which is considered abnormally high given comparable bonds issued concurrently by the Union were often issued at par or with only minor discounts.

Although this money helped the South to acquire materials, it was not enough. The bonds became worthless when the South finally collapsed, but by that time Erlanger held no bonds (Lester 1974, 130). Given the deep discount on the bonds, the CSA paid a high price and appears to have been taken advantage of given the much-reduced discounts paid by the Union bond issues. The key differences were that the CSA did not possess the same sound credit risk profile or the same level of collaboration or close-knit relationship with its foreign investment banking firm as did the Union with its domestic firm, Jay Cooke.

The CSA implemented a flawed strategy in late 1861 by instituting an informal cotton embargo, hoping that this would increase the value of cotton. Instead, the CSA should have considered shipping as much cotton as possible to European warehouses, where it could have been used as collateral for larger loans. Constrained by its limitations in the debt markets and tax revenue potential, the CSA resorted to printing currency to meet most of its financial resources. Similar to the Continental forces during the Revolution, state governments issued bills of credit which were used as currency while the CSA issued so-called “Graybacks” analogous to Continentals.



Figure 4.13: 10-dollar Confederate Currency
Source: Museum of American Finance 2014

Although similar in form and function to the North's Greenbacks, CSA currency was issued in sums far greater in proportion to the Southern economy than the Union's currency which was partly backed by Union bonds and considered "legal tender". Given the CSA's less sophisticated printing techniques, it suffered much more from counterfeit Graybacks than the north with its Greenbacks. The result of the rapidly expanding money supply was rampant inflation, second in American history only to the hyperinflation of the Revolution (Museum of American Finance 2014, 19). By 1863, it took ten CSA dollars to purchase a gold dollar and by 1864, it took thirty. By early 1865 the price of a gold dollar was fifty or more CSA dollars. By contrast, it never took more than three Greenbacks to buy a gold dollar (Museum of American Finance 2014, 29).

The US investment banking industry clearly benefited from the fundraising activities of the North during the Civil War conflict and much of this credit goes to Jay Cooke. He collaborated effectively with the Union Treasury Secretary, Salmon Chase, to fund a majority of the Union war effort through the issuance of innovatively structured and well-distributed bond issues. The clever use of taxation by the North also established a platform for its creditworthiness and no doubt, engendered the confidence necessary amongst investors for any large-scale bond issue.

On the other hand, given the relatively smaller amount of debt raised by the South and the lack of evidence of close collaboration with the

investment banking industry, the CSA were ultimately reliant on printing money which eventually caused severe economic and financial difficulties. The fact that the North was better able to fund its war efforts is often mentioned as a major contribution to its eventual victory. In addition, Chase's willingness to engage closely with the expertise of one of the best investment bankers in the country, in Jay Cooke, ultimately made a major difference to the outcome of the war.

The Civil War proved a challenge to the respective sides in finding new and innovative ways of seeking the necessary war financing. The newly united country was now left to focus on economic development. Following the Civil War, the manufacturing industry began to grow rapidly. For example, sewing machines began being manufactured and the shoe industry became mechanised. Horse drawn reapers became widely introduced, significantly increasing the productivity of farming. The use of steam engines in manufacturing increased and steam power exceeded water power after the Civil War, while coal replaced wood as the major fuel. The combination of railroads, the telegraph, machinery and factories began to create an industrial economy (North 1982). This growth in the economy, which dovetailed with an increase in exports of agricultural products to Europe, represented a peaking of the economic cycle and created a large demand in domestic currency. The resultant increase in interest rates, which is the price for money, is a typical precursor to a downward economic spiral. Consequently, an environment conducive to a financial crisis was produced.

Formal and Real Power

This and preceding chapters introduced individuals who were distinguished through the combination of unique skills and knowhow, superior ability to distribute financial instruments and special relations developed with key individuals within commercial and government circles. These attributes and practices, and the accompanying power would set the bankers apart in their industry, and commerce generally, offering them a privileged position in conducting further profitable business. An interesting distinction in the power relationships between the selected investment bankers is what was perceived as "formal" power which rested with government and official institutions, and the "real" power that was exercised by investment bankers.

The power in the hands of government is typically created in Clegg's (1989) dispositional circuit where it is responsible for the establishment of regulation and laws. The ability to establish the rules and discipline associated with the laws and regulation is the source of this formal power. The power that is primarily generated in the dispositional circuit relates to the similar fixing and refixing of rules to which an organisation is subjected. A breach of these laws and rules in the ordinary course of daily events would result in punishment either through jail sentences, official sanctions or penalties, which are the means by which formal power can be enforced. There were numerous instances where individuals escaped this punishment. Moreover, through special relationships, they prospered economically by pursuing their objectives regardless of the formal legal and regulatory frameworks. The evasion of punishment and ability to direct economic and legal outcomes by the investment bankers reflect a real power which overcame the formal power held by government and other authorities.

Although the formal power held by officials passed through the dispositional circuit whereby rule-makers can fix and refix rules and their meanings, the real power that rested with the investment bankers was created in a more subtle and even obscure way. As a covert instrument, the investment bank's power proved more potent as it was less obvious to recognise, and therefore mitigate or challenge. Often this power arose out of a need precipitated by crisis, war or technological knowhow. The exogenous environment, in which these sources existed, represented the fertile ground which instigated the process of empowerment. According to Clegg (1989), the facilitative nature of these sources transmitted the investment banker's power to the episodic circuit where their selfish actions provided for positive outcomes, usually in the form of wealth creation.

In some instances, the investment banker virtually assumed the unofficial role of the government treasury officials. For example, Haym Salomon advised Robert Morris in raising the required financing for the Continental Congress' war effort during the American War of Independence. Further, Albert Gallatin, the Secretary of the Treasury sought the direct assistance of the syndicate of well-known investment bankers, Girard, Astor and Parish in structuring and delivering the much-needed bond issue to finance the War of 1812, without which the government would have been unable to prosecute the war. Finally, J.P. Morgan was able to persuade the US

Government to accept a gold financing transaction to alleviate financial pressure following the panic of 1893. In the process, he generated even higher profits by utilising an innovative technique.

Once the success of an investment bank's activities was observed by other industry participants, an isomorphic process ensued, such as the replication of effective distribution networks, the use of advertising for bond issues, creation of useful relationships with government, development of innovative securities transaction structures and networking with influential individuals, corporations and other firms. In most cases, these influences were either mimetic or normative in nature. The security and legitimacy generated by the isomorphic process encouraged a cultural consistency within the industry. The public cultural and moral standards of the early years of the investment banking industry sanctioned actions of key individuals. The consequent behaviour continued into the twenty-first century.

This chapter also highlights certain events in the history of investment banking that can be interpreted as milestones as they presented opportunities and posed threats to participants which would impact the development of the industry in general. These events also set the context within which the key individuals operated.

CHAPTER 5

THE PENDULUM SWINGS

This chapter describes the shift in power and influence from the well-connected and the historically empowered investment bankers to government authorities, underpinned by a tighter regulatory framework. This enhanced framework came about from a groundswell of public pressure which intensified throughout a series of crises, starting with the Panic of 1907 and the resultant Pujo Committee that investigated the industry. The period of prosperity between the World Wars typified by asset price bubbles and lax regulation culminated in the 1929 stock market crash and the Great Depression. This turned the tide where the investment banking industry no longer occupied poll position in the power stakes and government regulation restrained their activities. A background to how investment banks and individuals built relationships that garnered power needs to be explained in order to track how it was manipulated and why it was constrained.

“Our Crowd” and the “Yankee Houses”

An understanding of the history of investment bank partnerships also allows an appreciation of the history of the influence some participants carried in corporate and government circles. Many firms in the US were Jewish by origin, for example: J & W Seligman, Goldman Sachs, August Belmont & Co., Kuhn Loeb & Co., Lazard Freres, Salomon Brothers and Dillon Read (Geisst 2001, 4). This Jewish group was known as ‘Our Crowd’. Although many conspiracy theories evolved over the years ranging from the clandestine control of the Federal Reserve to being the invisible power behind many a political power base, there is no evidence that their influence was any greater than that of their non-Jewish counterparts, the “Yankee Houses,” such as Brown Brothers, J.P. Morgan & Co., Kidder Peabody and Clarke Dodge & Co. (Geisst 2001, 4).

US firms lacked connections to generate sufficient volumes of business in Europe where banking was considered more sophisticated and where demands for credit up until the nineteenth century were greater (Geisst 2001). This drove a degree of insularity amongst the industry in the US and a need to establish informal communities domestically in order to share ideas, experiences and opportunities. For example, the second generation of the Lehman Brothers family formed strategic friendships with their counterparts at other Jewish-American firms. Philip Lehman, in particular, was closely associated with Henry Goldman, the son of Goldman Sachs' founder. Goldman and Lehman Brothers participated together in many investment banking transactions. The two firms agreed not to compete with each other for new business and this agreement and alliance was a critical reason for Lehman Brothers' achievements in the late nineteenth and early twentieth centuries (Geisst 2001).

The use of syndicates to underwrite new securities issues had become a popular technique in the early 1900s and as transactions grew in size it became difficult for an investment bank to underwrite any single issue solely, primarily given the firms' own capital constraints. The desire to share underwriting risks, so that a firm's capital would not be overly exposed to an unsuccessful securities issue, was as important as to share opportunities to participate in one another's transactions. The very nature of syndication requires firms to cooperate, preferably within a friendly "community" (whether in the "Our Crowd" or "Yankee Houses" community), as repeated sharing of opportunities promoted continued survival (Geisst 2001). This necessitated firms with similar outlooks on risk and market conditions working together. The normative practice of syndication has survived until the modern era and is accepted as a safe and legitimate way to process securities transactions.

The repetitive behaviour of sharing through syndications allowed investment banks to offer competitively priced loans for large and prestigious borrowers. This *modus operandi* spread throughout the industry from a common desire to survive and grow. The strategy of pursuing relationships with larger organisations and especially government was mimicked within the investment banking industry for two reasons. Firstly, it was hoped such clients would provide a continued stream of large and lucrative transactions. Secondly, these relationships with influential organisations would foster an expansion of their networks and create an impression to the market that the firm was a preferred

option, given the importance of its clientele and track record. Networks were useful for future business and as an instrument in pushing a point of view with government and regulators.

Since the beginning of the Industrial Revolution, the US Government had relied on the investment banking industry. This led to relationships which can be described on a continuum from institutional in nature to personal. For example, the Seligmans had a close relationship with Ulysses S. Grant, who was a leader of the Union army during the Civil War and the 18th President of the US between 1869 and 1877. Jay Cooke of Clarke Dodge & Co., and later founder of Jay Cooke & Co., had a personal relationship with the US Senator and Governor Salmon Chase as US Treasury Secretary under President Abraham Lincoln and as the sixth Chief Justice of the US Supreme Court. It was as Treasury Secretary during the Civil War that Salmon Chase enabled Jay Cooke to win the mandate for selling the very large bond issues needed to finance the Union's war effort during the Civil War. Bankers from Kuhn Loeb & Co. and Lehman Brothers were instrumental in advising the government on the establishment of the Federal Reserve between 1908 and 1912. The perceptions of influence with government which disenchanted the public in the early part of twentieth century largely instigated the Pujo Hearings of 1912 and the Pecora Commission of 1932. The behaviour of exerting influence is a hallmark of the investment banking industry throughout its history.

The Panic of 1907

An analysis of the background to the Panic of 1907 is useful in understanding the context in which the investment banking community developed its influence over regulatory institutions and relationships with external parties. During the period of 1863 to 1913, the monetary system in New York experienced significant volatility affecting both interest rates and liquidity of financial instruments. This market dynamic was caused by severe fluctuations in the volume of currency in the financial system caused by the seasonal export of cotton crops to Europe. As traders increased their trade finance facilities with banks, which were used to pay for production costs, the supply of cash available in the local economy was depleted causing a seasonal spike in interest rates. New York financial markets were squeezed by even less liquidity than usual.

The climax of the crisis of 1907 materialised in October when F. Augustus Heinze attempted to take a majority stake in a mid-sized listed US corporation, United Copper Company. Heinze's plan to raise the share price backfired and the share price instead declined. Heinze had an extensive list of Board directorships including banks. He entered the banking business, forming a close alliance with Charles W. Morse with whom he served on at least six national banks, ten state banks, five trust companies and four insurance companies. As Heinze's involvement in banking became apparent, the failure of Heinze's scheme triggered a loss of confidence in the share market which was operating under the adverse conditions of a slowing economy, and a stretched money market. Depositors' fears of insolvency precipitated a series of runs on the banks where the two men held prominent positions including in the popular Mercantile National Bank. Consequently, a credit crisis characterised by a freeze on lending markets triggered a panic amongst banks which became known as the Panic of 1907.



Figure 5.1: Portrait of Fritz Augustus Heinze
Source: King 2012 -PD

The New York Clearinghouse Association reviewed the Mercantile National Bank balance sheet and concluded that the bank was solvent. The clearinghouse stated that it would support Mercantile on the condition that Heinze and his board of directors resign. Both Morse and E.R. Thomas, another of Heinze's cohorts, were persuaded by the clearinghouse to sell their investments in banks in return for the clearinghouse support of the affected bank (Gordon 1999).

Almost simultaneously, the National Bank of Commerce stopped accepting the cheques of the Knickerbocker Trust Company. The Knickerbocker Trust Company was a bank owned by Frederick G. Eldridge, an associate of J.P. Morgan. The main activities of the Knickerbocker Trust Company involved acting for individuals, corporations and estates (Wexler 1908). In 1907, its funds were being used by the bank's president Charles T. Barney

in his plan to corner the market for copper and increase its price. This venture collapsed due to the dumping of millions of dollars in copper onto the market to prevent the above-mentioned takeover of the United Copper Company (Gordon 1999). On October 22, 1907, Knickerbocker underwent a run and was finally suspended later that day. Following the publication on the next day of an article in the *New York Times* that Barney sat on the Board of Trust Company of America, the depositors' run spread to that bank (Tallman and Moen 1990, 7).

J.P. Morgan was seen as a potential saviour to the financial community in the absence of a relevant regulatory authority. This position of informal responsibility was well documented in the press at the time (*New York Times* 1907; *The Kingston Daily Freeman* 1907). Even though Morgan and his cohorts refused to bailout the Knickerbocker Trust, *The New York Times* was still optimistic about the situation given the perception that J.P. Morgan was in charge. Although this optimism in a rescue proved to be unwarranted, it nonetheless signalled to the general public the confidence in J.P. Morgan's power and means to resolve problems in the business community.

The Panic of 1907 involved several types of financial intermediaries, each distinct, playing unique roles in the capital markets and operating under different sets of regulations. This regulatory framework created conditions that made a panic more likely than if regulation had allowed uniform access to all investment opportunities. The New York City trust companies, a group of financial intermediaries that had grown rapidly in prominence at the turn of the century, had experienced the most severe depositor run during the Panic of 1907 (Moen and Tallman 1992, 611). The run on the New York trust companies was preceded by a period of significant growth. Between 1897 and 1907, their assets had grown by 244% as compared to national bank assets which grew by 97% and state bank assets by 82% (Moen and Tallman 1992, 612). Trust company growth can be attributed largely to freer investment opportunities that resulted from being subject to less regulation than national or state banks. The trust companies were profitable because they specialised in collateralised loans at higher interest rates to riskier firms that could not typically obtain credit through national or state banks. This situation added to the severity of the panic (Chen et al. 2010).

KNICKERBOCKER WILL NOT OPEN

Conference of Bankers Deems It
Unwise to Aid the Trust Com-
pany Further To-day.

EIGHT MILLIONS WITHDRAWN

Attorney General Jackson,
Though, Will Take No Step
to Close the Institution.

STILL HOPES FOR THE BEST

Results of Conferences After a Sus-
pension, a Brokers' Failure, and
Panicky Day in Wall Street.

What J. P. Morgan Said.

The closing of the bank, which some Directors still hoped up to a late hour last night was only temporary, although such hopes were entirely abandoned by other Directors, led to complete demoralization upon the Stock Exchange, where Mayer & Co. went down and prices crumbled without resistance under an avalanche of selling orders. It necessitated the formation of a big money pool by the leading Clearing House banks, helped out by the loaning of \$8,000,000 of Government money, brought Secretary of the Treasury Cortelyou hurriedly to this city, and led at once to conferences of Knickerbocker officers and the leading bankers of New York at Morgan & Co.'s offices, with Mr. Morgan presiding. The sole aim was to devise immediate plans to meet the situation thus created.

When Mr. Morgan left his office late in the evening at the close of this gathering he made this statement to the waiting reporters:

"We are doing everything we can, as fast as we can, but nothing has yet crystallized."

Asked whether any outside efforts were being made to enable the Knickerbocker Trust Company to resume Mr. Morgan said:

"I don't know anything about that; I am not talking about that."

Figure 5.2: Articles on Suspension of Knickerbocker

Source: *New York Times* 1907

The conditions that prevailed during the 1907 crisis appear similar to the conditions existing prior to the GFC. Both periods involved a considerable growth of financial assets within the banking system, a relatively lax regulatory environment for non-bank financial institutions, a spasmodically evolving framework for licensed bank supervision and a focus on low credit quality assets. Figure 5.3 outlines a timeline for the Panic of 1907.

Figure 5.3: Timeline of the Panic of 1907

Oct. 9, 1907	Failed attempt to manipulate share of United Copper.
Oct. 15, 1907	Shares start to tumble.
Oct. 21, 1907	National Bank of Commerce announced that it would stop accepting cheques for the Knickerbocker Trust Company, triggering a run of depositors demanding their funds back and the eventual collapse of the Knickerbocker Trust Company.
Oct. 22, 1907	The start of the bank-run of the Knickerbocker Trust Company.
Oct. 24, 1907	J. P. Morgan arranged for a number of bankers to provide the then substantial sum of USD 23 million to allow the New York Share Exchange to continue operating.
Nov. 2, 1907	Moore and Schley, a major brokerage firm, nears collapse because its loans were backed by the Tennessee Coal, Iron & Railroad Company (TC&I). Proposal is made for US Steel to purchase TC&I.
Nov. 4, 1907	President Roosevelt approves of the US Steel's acquisition of the TC&I.

Source: Chen et al. 2010

A final problem afflicted the US financial system, one of perception and image. As New York replaced Philadelphia as the money centre of the nation, other regions started to fear the financial influence located in New York City, especially among the largest banks. People used phrases such as the "House of Morgan" or the "Money Power" to characterise New York's growing financial presence, frequently with the assertion that a "conspiracy" to control the nation's money was directed from within the boardrooms of the banks (Chen et al. 2010). A reflection of the public sentiment towards the "Money Power" is depicted in Figure 5.4. The subtitle appearing on this editorial cartoon in *Puck* states: "The Central Bank—Why should Uncle Sam establish one, when Uncle Pierpont is already on the job?"

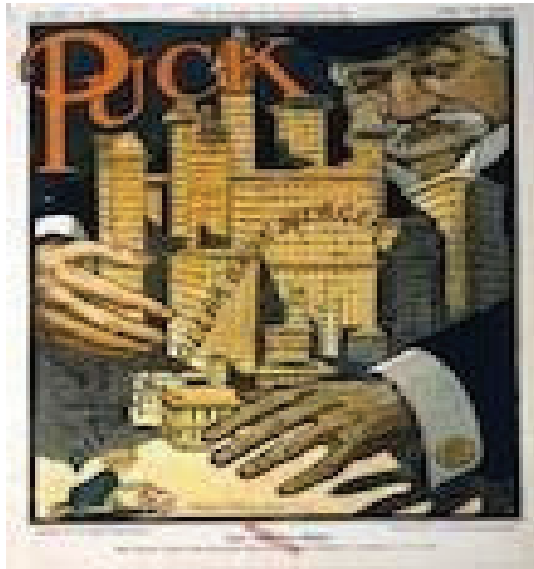


Figure 5.4: Front page of *Puck* magazine dated 2 February, 1910
 Source: Centre for History and Economics Harvard University 2010

Each new panic resulted in a search for scapegoats. The fact that individuals such as J.P. Morgan had saved the US Treasury on occasion only tended to exaggerate the fears of a New York money conspiracy, especially during the Populist era. Consequently, when designing any new system, the banking reformers of the late nineteenth century inevitably sought to reduce New York's influence. That concern, along with efforts to address the need for a lender of last resort for the nation's banks (in place of J.P. Morgan), and centralise some of the banking functions in the US, played a key role in shaping the legislation that became the Federal Reserve Act of 1913. The Panic of 1907 caused over two thousand companies to fail but possibly the greatest impact was that it gave impetus to the US Government to impose more federal regulation (Markham 2006, 146). The severity of the Panic of 1907 prompted a call for a commission to investigate the causes of the panic and suggest potential legislation to avoid future crises. This commission was known as the Pujo Committee (Miron 1986).

The Pujo Committee of 1913

In November 1910, Senator Nelson Aldrich, of Rhode Island, charged with the task to propose regulations for the banking system, arranged to have five men meet in secret on Jekyll Island, Georgia, to design a new financial system for the nation. Frank Vanderlip of the National City Bank, Paul Warburg a powerful partner in Kuhn, Loeb & Co., (later to be merged into Lehman Brothers), Henry Davison, a J.P. Morgan partner, and Harvard professor, A. Piatt Andrew, created a plan that provided the skeleton for the Federal Reserve System (Bruner and Carr 2007, 143). Their plan failed in Congress, partly because the concept was too centralised, and because it failed to address the problem of diminishing the power of New York. It became even clearer in 1912 that to succeed, any plan had to deal with the issue of New York's influence.

Widespread cynicism spread as the public grew wary of the wealthy few in New York. Commentators observed that whilst J.P. Morgan's bank had survived, a large number of "money trusts" failed. These commentators believed that the trust company failures (exacerbated by Morgan's refusal to support any of them) represented a conspiracy to advance the prospects of some New York-based banks. Pressure from the public relating to their distrust of the "money trust" culminated in the formation of the Pujo Committee, which was a sub-committee of the House Committee on Banking and Currency (Schweikart and Doti 1999, 241). In 1912, Louisiana congressman, Arsene P. Pujo, who was charged to lead the investigation on the "money trust", called witnesses including J.P. Morgan and gathered



Figure 5.5: Picture of Arsene Pujo
Source: US Library of Congress
c.1910 PD

more than 30,000 documents on the concentration of financial power among the nation's largest banks (Schweikart and Doti 1999, 241).

The committee's investigation, carried out by Samuel Untermyer, a New York corporate lawyer who had become increasingly "anti-big-business", tried to redefine "trust" as a monopolistic cooperation by bankers (Schweikart and Doti 1999, 241-2). Untermyer's questioning of J.P. Morgan produced testimony that

frustrated critics of the “big banks” and, indeed, of the entire business system. Untermeyer asked Morgan if he favoured cooperation over competition. Morgan replied that he liked a combination, but “I do not object to competition, either. I like a little competition....” (Pujo 1913a, 1050). At that point, Untermeyer asked J.P. Morgan, “Is not commercial credit based primarily upon money or property?” To which the Morgan responded, “No, sir, the first thing is character.... before money or anything else. Money cannot buy it... a man I do not trust could not get money from me on all the bonds in Christendom” (Pujo 1913a, 1084). This response indicated that credit decisions, in Morgan’s eyes, were principally subjective and dependent on the quality of the borrower’s character as perceived by the credit provider. Therefore, the response itself underlines Morgan’s belief that his own judgement was sufficient to either grant or deny a loan. This subjugated the loan applicant to the personal judgment and prejudices of the credit provider.

In another statement during the Pujo Committee hearings in 1912, Morgan likened his own personal financial welfare with “the best interests of the country” (Mallios 2013, 3). This comment accurately captures the nationalistic frame of Morgan’s view of himself. He considered his interests on a national level rather than on a familial, local or even state level, thereby suggesting a sense of self-importance and with that notion, an ownership of power and influence. Whether his view was justified, Morgan’s business interests were indeed national and moreover international, and J.P. Morgan himself had recognised his sphere of influence. In addition to his own sense of self-importance, a depiction of Morgan as “the most powerful private citizen in the world” (Mallios 2013, 3) had been in circulation in the US since at least 1902.

One of the lasting findings of the Pujo Committee which resonates following the recent GFC is the notion of concentrated power and influence through networks within industry and with the regulatory and governmental fraternity. The Pujo Committee found the concentration of wealth in the country through directorships, share ownership, and holding companies was worse than critics had alleged. The Pujo Committee found that 22 percent of the total banking resources of the nation was concentrated in banks and trust companies based in New York City (Foster and Holleman 2010, 3). For example, George F. Baker, the Chairman of First National Bank of New York, held 58 directorships in 1912. The Committee published information showing the lines of financial ownership and

control, focusing particularly on J.P. Morgan's far reaching financial and industrial empire, highlighting chains of interlocking directorships through which such control was exercised. It identified an 'inner group' associated with the trio of J.P. Morgan, George F. Baker from the First National Bank, and James Stillman from National City Bank, as well as the various other banks and firms they controlled. Collectively, the inner group held three hundred directorships in over one hundred corporations. The Pujo Committee claimed that it was not investment but rather control over US finance and industry that was the object of the extensive web of holdings and directorships (Foster and Holleman 2010, 3). It concluded that there was "[a] great and rapidly growing concentration of the control of money and credit in the hands of these few men" (Pujo 1913b, 129).

There was an irony to the Pujo hearings. Through the clearinghouse systems which represented the "close community", the nation's banks had taken important steps to reduce the likelihood and severity of financial disruptions. As it happened, the most crucial tool in defusing panic was the cooperation and collaboration of the major banks in the absence of a governmental body or central bank. In essence, Untermeyer attacked the bankers for protecting depositors. However, it was the public resentment over the power wielded by these few individuals in times of crisis without independent consultation that was at issue. The same power that alleviated the panic could also be used for profiteering, common in any monopolistic, or to a lesser extent oligopolistic, system. This period of the early twentieth century was the time when investment bankers launched the new era of monopoly capital. Consequently, according to Hilferding (1910), "the investment banks generated excess returns otherwise known as 'promoters' profits'".

One of the most critical indictments of the investment banking industry following the findings of the Pujo Committee was elucidated by Brandeis (1932) who, eloquently provided an unflattering description of the investment banker and highlighted the dangers of granting important government functions such as those of a central bank to private industry participants.

The dominant element in our financial oligarchy is the investment banker. Associated banks, trust companies and life insurance companies are his tools ... The development of our financial oligarchy followed...lines with which the history of political despotism has familiarized us: *usurpation*

*proceeding by gradual encroachment rather than violent acts, subtle and often long-concealed concentration of distinct functions which are beneficent when separately administered and dangerous only when combined in the same persons...*The makers of our own Constitution had in mind like dangers to our political liberty when they provided so carefully for the separation of governmental powers (Brandeis 1932, 6)[my italics].

Although Pujo left Congress in 1913, the findings of the committee inspired public support for ratification of the Sixteenth Amendment in 1913, passage of the Federal Reserve Act that same year, and passage of the Clayton Antitrust Act in 1914.

The new era of monopoly capital spurred an expansion in the banking industry in the early twentieth century. By the 1920s, the “money trusts” had reached a new peak of influence and commercial banks facing greater competition sought new avenues for profit generation. These areas included dealing in equities and some activities which were previously the traditional reserve of the investment banking industry. The consequent expansion of available funds for investment created asset bubbles which were to culminate in the stock market crash of 1929. As a mark of irony in the first half of the twentieth century, the undesirable themes that were prosecuted by the Pujo Committee consisted of conflict of interests, concentrated power through collaboration and anti-competitive behaviour. These were in stark contrast to those supported by Ferdinand Pecora, as counsel for the Senate Committee on Banking and Currency in the 1930s. “Pecora effectively blamed the competitiveness of the securities industry for the ‘evils’ that beset the market during the late 1920s” (Schweikart and Doti 1999, 240-2).

Post-Depression prudential legislation

One of the major outcomes of the Pecora hearings led to a reduction of the power and influence held by the joint commercial bank and investment bank conglomerates. The enactment of the Glass-Steagall Act of 1933 (GSA) was in response to the demise of the banking system during the Great Depression (Crawford 2011). In recognition of the additional risks commercial banks incurred in their investment banking activities, the GSA required the legal separation of bank, from investment bank activities. For example, J.P. Morgan divided its operations into three entities: J.P. Morgan, which continued as a bank; Morgan Stanley which operated the

US investment banking activities; and Morgan Grenfell, which operated the British merchant banking business. Almost immediately upon enactment, the financial community spearheaded by the banking/investment banking industry, lobbied to have the GSA repealed. Over the years, this persistent lobbying led to a continual reinterpretation and liberalisation of the GSA, until the Act was repealed in 1999 (Crawford 2011). Just prior to the repeal, Senator Paul Wellstone prophetically stated his misgivings in the Senate.

He said the repeal of Glass-Steagall would enable the creation of financial conglomerates which would be too big to fail. Furthermore, he believed that the regulatory structure would not be able to monitor the activities of these financial conglomerates and they would eventually fail due to engaging in excessively risky financial transactions. Ultimately, he said, prophetically, that the taxpayers would be forced to bail out these too-big-to-fail financial institutions (Crawford 2011, 127).

The Securities Act of 1933, “required that any offer or sale of securities using the means and instrumentalities of interstate commerce be registered pursuant to the 1933 Act, unless an exemption from registration exists under the law” (Sarkar 2014). The Securities Act was Congress' initial attempt to stem securities fraud, primarily targeting the issuers of securities and those firms selling the securities, such as investment banks. Issuers have an incentive to present the company and its plans in the most favourable light possible in order to engender appetite for their issues. To protect investors, the Securities Act serves the dual purpose of ensuring that issuers selling securities to the public disclose material information to investors, and that any securities transactions are not based on fraudulent information or practices. In this context, ‘material’ means information that would affect a reasonable investor's evaluation of the company's stock. The goal was to provide investors with accurate information enabling informed investment decisions (Sarkar 2014). Prior to the Securities Act, the states were responsible for the regulation of securities transactions. These laws were referred to as ‘Blue Sky Laws’ because the legislators naively expected full compliance without the stick of enforcement. The Securities Act initially co-existed with the various state laws partly due to a view that new federal law was unconstitutional (Sarkar 2014).

The Banking Act of 1933 also attempted to level the playing field between the big businesses of the large investment and commercial banks and the

smaller local banks by instituting a depositor insurance scheme. The scheme protected depositors up to USD 100,000, and therefore enabled the smaller banks to compete for deposits with their larger competitors. Consequently, the risks of bank failure were equalised between the two segments of the market (Skeel 2005a, 96).

Following the enactment of the Securities Act of 1933, which covered the primary trading of securities, the government needed to address the secondary trading of securities such as bonds, shares and debentures. This was achieved by The Securities Exchange Act of 1934 which established The Securities and Exchange Commission (SEC)—the institution primarily responsible for the effective and fair trading of securities in the US and which has survived to the present day (Morrison and Wilhelm 2007).

After the Depression, President Roosevelt initiated a series of economic and regulatory reforms known as the New Deal. The power of investment banks was further curtailed significantly. In particular, the enactment of the US Bankruptcy Act of 1938, known as the Chandler Act, eliminated the equity receivership technique that J.P. Morgan had used to restructure many of the country's railroads and large corporations. Investment banks would no longer control the process, instead a court appointed trustee would take charge of any large corporation that filed for bankruptcy. Further, the Trust Indenture Act of 1939, prohibited corporations from issuing bonds that could be restructured by a bondholder's vote. This made it difficult for investment bankers who underwrote bond issues to manipulate and control a restructuring outside of bankruptcy (Skeel 2005a, 96).

The Investment Company Act of 1940 defined an investment company and delineated the activities of investment companies such as mutual funds and investment banks. Furthermore, it established a limit on the number of investment bankers able to sit on the Board of an investment company and set strict criteria on transactions between investment companies and investment banks. Again, this Act reflected an attempt to curtail the breadth of the activities undertaken by investment banks and thereby limit their potential influence over the financial economy. The new legislation had the effect of transferring some powers to the regulators. The highly prescriptive nature of the new regulations restricted the operations of investment bankers and curtailed the freedoms they once enjoyed.

Consideration of reputation became less relevant in the solving of corporate problems by investment banks. (Morrison and Wilhelm 2007).

Within Clegg's (1989) framework of power, the series of successive restrictive legislation represented a new operational environment for the investment banks. Clegg's (1989) exogenous environment has the potential to redefine or refix the relations between the regulator and the regulated. Where once investment banks were able to dictate their own terms, they were now compelled to comply with a strict set of rules, which affected their day-to-day activities. The *laissez-faire* exogenous environment had changed. This change clearly established which parties were subjected to control and which could exercise dominance. The dynamics of this shift which refixed relations between the regulator and the investment banks are found in Clegg's (1989) facilitative circuit. The obligatory passage point through which this shift of power is transmitted is represented by the compliance process where the power is transmitted to the episodic circuit. In this circuit, the day-to-day activities of the investment banks changed and were subjugated to the wishes and oversight of the newly empowered regulators. From a wider perspective, the new interventionist approach advocated by President Roosevelt represented a backlash over decades of public mistrust of the 'money trust' and big businesses which operated without transparency in the pursuit of abnormally high profits. The foreshadowed shift in influence from the powerful elite to a government sponsored regulatory framework was prophetically expressed in 1905 by the New York Superintendent of Insurance who desired "elimination of Wall Street control" (Morrison and Wilhelm 2007, 13).

Pre-WWII the investment banking community was investigated by a number of Congressional committees and the industry's ability to influence the environment to generate favourable outcomes became increasingly constrained (Morrison and Wilhelm 2007). The post-depression backlash of heightened regulation new to the industry and the general distrust of participants continued to pervade the public, political and regulatory spheres throughout the 1940s and 1950s. A good reputation, traditionally a core asset of a firm, was hard to re-establish and protect. The focus on regulation was to diminish in the years following WWII due to the failure of an anti-trust case brought by the US Justice Department against a group of investment banking firms. The world economy grew during this period and as usual following such growth so did the fortunes of the investment banking industry. This modern era brought

with it new challenges for the industry such as: the diminishing importance of tacit skill; a simultaneous reduction in the importance of reputation; a period of innovation and technological advancement; the problem of staff mobility; the need for new capital to fund an expanding corporate sector; and increased competition from the commercial banking sector.

Post-World War II Transformation

The post-war years furthered the transformation of the investment banking industry by accelerating the trend for partnerships to incorporate in an effort to attract additional capital from shareholders. This was needed to support: a growing business base; an escalation in risk-taking activities; and the required investment in costly information technology. Additionally, the swing back to a liberal approach towards regulatory reform in the post-1950 era was found to be reactive in nature. The consequences of this transformation produced an industrial approach to the investment banking business which relied less on tacit skill and reputation. A less personal approach to business where physical distribution capacity overtook tacit skill was a key differentiator at a time when the business model evolved from an advisory-focused enterprise to a model that placed greater emphasis on securities trading. The trend to incorporate also led to an increase in staff mobility and a restructure in senior executive remuneration arrangements which promoted higher risk-taking business activities.

Power can be analysed from two perspectives. Firstly, the investment banking industry's use of power explains its influence when in 1953 the US Government was defeated in a landmark court case which set the scene for the ensuing "light touch" period of regulatory reform. Secondly, the source of power had shifted from one relying on the tacit skill of key personnel to a more hierarchical management structure where the power of the CEO replaced the democratic style decision-making typical of a partnership. Additionally, the trend to incorporate was influenced by mimetic isomorphism whereby the safe option of competing in an industry facing the challenges of a tough economic climate was to replicate the business model of other firms which were perceived as successful.

The reversal in the regulatory approach towards the investment banking industry was likely driven by the economic circumstances of the time which

required a stimulus following many years where industrial production was dedicated to the war effort. Focus in the new post-war era was directed towards the commercial sectors of the economy including the technological improvements which spurred demand in consumer and industrial production. The capital investment required was to be met by financial institutions and investors in general and the investment banking industry was seen as an important source of this capital. Too much regulation in this period was thought to interfere with this buoyant economic environment. However, the legacy of the anti-investment bank sentiments prevailing during the earlier part of the twentieth century persisted in certain government circles. The US Government attempted to challenge the investment banking industry in a 1950 court case by claiming seventeen firms were guilty of anti-competitive behaviour from 1915 onwards. The complaint was summarised by the prevailing judge as:

... beginning in or about the year 1915 and continuing thereafter up to and including the date of the filing of this complaint, the defendants named herein, have engaged, knowingly and continuously, in a wrongful and unlawful conspiracy to restrain unreasonably and to monopolize the securities business of the United States ... all in restraint and in monopolization of the interstate commerce described in this complaint ... (Whitney 1955, 325).

An example of unconscionable and uncompetitive behaviour involved Kuhn, Loeb & Co, which in 1945 was accused of having removed a client's securities issue from the market simply because the client had requested a lower underwriting commission (Whitney 1955, 323-4). This case, known as the "Investment Bankers' case" lasted for three years until 1953 when the court decided against the government by concluding that the seventeen investment banks brought to trial were innocent of any wrongdoing (Whitney 1955). In dismissing the government's case, the judge, Harold R. Medina, stated that "[t]he government case depends entirely upon circumstantial evidence" (Medina 1954, 9). Further, the judge concluded that even though the evidence suggested that investment bankers had attempted to collude in the earlier part of the century as a consequence of cultural practice, recent statistical evidence contradicted the US Government's allegations (Whitney 1955).

However, it is interesting to note that the statistical evidence was supplied by the investment bankers themselves, suggesting a possibility of them

providing filtered and biased statistics in support of their case. The success of the investment banking community reflected their power in resisting the might of the US Government's resources in prosecuting the case. The group of investment banks had matched the government's legal teams which would have required considerable financial resources given the longevity of the court proceedings.

This example of power exerted by the investment banking group rests on the might of their financial resources which facilitated an effective defence. The adversarial social relations with the government created a legal conflict where only one party could win. The probability of success was partly reliant on the quality of the case presented which was partly influenced by the quality of the legal defence team. It is assumed that given the gravity of the case and the dire consequences for key players such as J.P. Morgan, a high-quality top tier team of lawyers was engaged for the defence. Through the agency of the legal team and the resources applied, which constitute a "means" within the Clegg's (1989) episodic circuit, the investment banks were able to generate a positive verdict.

The idea that the investment banks were involved in a conspiracy to prevent competition failed to include the role of reputation as a natural barrier to entry. The importance of reputation as a concept in the survival and success of investment banks and as an obstacle to new entrants attempting to establish a foothold may not have been fully understood by the government in the post-war era. The seemingly strong grip on the investment banking business by existing participants had become the instigator for the government case. The government's decision to undertake legal action was also fuelled by strong public opinion and distrust of investment bankers. These bankers, many of whom were perceived as a privileged class exhibiting the usual trappings of wealth, presided over the sale of securities to unsuspecting investors, the value of which were to drop dramatically in the aftermath of the 1929 stock market crash and contribute to widespread distress during the Great Depression. Therefore, they seemed a suitable scapegoat for the government and the wider population (Morrison and Wilhelm 2007).

Reputation was an important element in the ability of investment banks to attract clients. The more observable the historic success of an investment bank, the greater the potential to grow reputation. An investment bank's success is due to the skill of the bankers and the techniques applied in each

transaction. Whitney (1955) suggests that in addition to skill and knowhow, investment bankers develop a reputation based on initiative and enterprise: “[e]ssentially, an investment banking firm is a combination of men of two different kinds—men with capital and men with a great deal of initiative and enterprise” (Whitney 1955, 322). As clients’ problems are solved or needs met, the investment banks develop an intellectual capital which can be used for subsequent transactions. The success of the investment banking industry in proving an absence of anti-competitive behaviour, in part provided justification for a liberal approach to future regulatory impositions.

As the US requirement for post WWII capital increased, the investment banking industry needed to address their ability to meet the associated funding demands. These demands not only included funds from their own balance sheets (which would prove insufficient), but also from public investors. To facilitate the flow of capital from investors to the industrial corporate sector, the investment banks needed to enhance their distribution networks and retail businesses. The greater emphasis on retail brokerage was supported by improvements in technology and coincided with a reduction in reliance on tacit skills largely required by the advisory departments, as this latter side of the business became relatively less important. The associated expansion of the investment banks’ business re-introduced a requirement for further capital which instigated a re-assessment of the investment banking model, and spurred a trend towards incorporation.

Transformation from Partnership to Corporation

The business model of investment banks up until the immediate post-WW II period largely comprised the partnership business structure. The ability of this structure to generate additional capital was limited to the capacity of the partners to inject their own funds or introduce new partners. As existing partners were generally reluctant to dilute their ownership in the firms, they sought an alternative business structure and resorted to incorporation. According to the Securities Industry and Financial Markets Association (2013), “[t]he CPI-adjusted capitalisation of the top 10 investment banks soared from USD 1 billion in 1960 to USD 194 billion in 2000”. This expansion coincided with an increase in the number of banking professionals employed by the top five investment banks (ranked by

capitalisation) from 56,000 to 205,000 between 1979 and 2000 (Securities Industry and Financial Markets Association 2013). Apart from a general increase in economic and financial market activity, the expansion in capitalisation and employee numbers was caused by a significant shift from the partnership form of business entity to the corporate form.

The major firms which had substantial wholesale trading and brokerage activities and proceeded to list on the stock exchange included: Donaldson, Lufkin & Jenrette (1970); Merrill Lynch (1971); Reynolds Securities (1971); Bache & Co (1971); Lehman Brothers (via the acquisition by American Express in 1984, and later independently in 1999); Bear Stearns (1985); Morgan Stanley (1986); and Goldman Sachs (1999) (Morrison and Wilhelm 2007, 50; Schellhorn 2011, 113). Gross (2010, 1) argues that it was inevitable for investment banks to seek public listing since, "[i]n order to have a capital base that would support the funding they needed, they had to be public". This transformation was largely driven by the potential for corporate executives to maximise their executive compensation through incentive schemes, an increasing emergence of the power of information technology and the need for risk capital.

The constant objective of the investment banker, "is to enforce private laws that support the exchange of critical information" as this requires "network and reputation management as the two core competencies that support this mission" (Morrison and Wilhelm 2007, 46). As networks are driven by social interaction and reputation is governed by personal decision-making and action, the implication for the role of an investment banker is that personal qualities including appropriate behaviour are important elements to the attainment of these attributes. It is difficult to learn such qualitative characteristics from technical training. Instead, these skills have been historically passed on through mentoring and supervision by superiors representing tacit skills as opposed to codifiable skills (Morrison and Wilhelm 2007, 12). The partnership business model is considered most effective as partners and senior members of the firm undertake the role of mentors and supervisors. Junior members are also introduced to existing networks upon which they can expand.

Tacit skill is also important to the corporate restructuring and mergers and acquisition parts of the business as these transactions require personal relationships that facilitate the origination of transactions, the gentle management of stakeholders and negotiations with external parties. The

reliance on tacit skill has been the foundation of the development of the knowhow inherent in investment banking firms during the past three centuries. Unique knowhow, combined with a good distribution network are amongst the most important factors which can differentiate the quality and competence and therefore the attractiveness of a firm to potential clients. The mentoring and training of junior members of a firm is primarily motivated by a desire of the partners to protect the capital invested in the firm. As a good reputation is an important attribute, a well-trained employee who will protect the reputation will also preserve the financial as well as social capital of a firm. Therefore, the more that tacit skill can be passed on within the firm, the greater the potential for an enhanced reputation (Morrison and Wilhelm 2007, 2008; Polanyi, 1966). A highly valued reputation, closely guarded by partners, is important for co-participation in syndicated transactions. In these situations, failure of the issue will impact adversely on clients. This could affect future business as new customers and transaction arrangers react to each investment bank's historical performance and behaviour.

During the 1960s, an era of corporate conglomerates emerged, where takeover activity was combined with a growing industrial corporate sector, operating under prosperous economic conditions. This environment created an increased demand for capital and in turn generated increasing levels of business for investment banking firms which had been arranging the related funding and advisory services. Furthermore, the investment banking industry was undergoing a period of monumental change where innovations in information technology led to an automation of previously manual processes. The nature of many investment banks' business had altered from an advisory and underwriting focus to one of trading and brokerage where information technology could provide efficiencies. An indication of the greater reliance on brokerage is reflected by this division accounting for 70% of Merrill Lynch's total revenue of USD 192 million by 1960, representing a reversal from decades earlier (Morrison and Wilhelm 2007, 50). The computers necessary for this transformation would require further capital investment. Whilst under a partnership structure this additional capital was limited to the personal wealth of its partners. As the need for capital started to outweigh the need for tacit skill, many investment banks began to incorporate their business structures whereby capital could be sourced by tapping the investing public (Morrison and Wilhelm 2007, 2008).

The process of incorporation also required a change to the management structure of the firm. Whereas the governance of a partnership normally rested with an executive committee of peers, the corporate form would entail a board of directors often with some representation of non-executive directors. Control by partners was ceded to boards which were subject to numerous regulations within Corporations Law and a term of office which is subject to a vote at a shareholders' annual general meeting. Boards could also approve incentive arrangements for key officers of the corporation. Normal practice would entail the board authorising a bonus pool, the distribution of which would be delegated to the CEO or a compensation committee of which the CEO was usually a key member. This was a significant attraction for CEOs who were the major beneficiaries of the bonus pool. As executive compensation was aligned with performance generally, the limited liability status of a corporation meant that CEOs could take abnormal risks with the expectation of generating abnormal profits and, in turn, abnormally high bonuses without placing themselves at personal financial risk. The distancing from personal liability from the perspective of a CEO is at odds from a partnership model where partners are usually jointly and severally liable for a firm's liabilities. Further a CEO was not compelled to allocate a share of the profits with other executives and could therefore monopolise the bulk of the available bonus pool. The incentives however for partners were limited to their drawing rights from their current account in the partnership and given a partner's direct ownership, there was a reduced propensity for risk-taking for fear of weakening the capital structure of the firm.

The transformation to a corporate form also introduced the problem of employee mobility which had the effect of increased staff turnover. The mobility problem followed from a lessening of staff loyalty, driven by the reduced level of close mentoring by superiors and management's greater access to departmental and employee key performance indicators (KPIs). KPIs enabled employees to be divided between those performing at or above expectations and those underperforming. Whilst the better performing employees were subject to poaching by competitor firms, underperformers were filtered out. The departure of key staff created the problem of a corresponding loss of their associated networks and knowhow.

The Capital Problem for Risk Taking

As the US corporate sector grew in the post WWII era, investment banks were called upon to underwrite an increasing volume and size of securities issues. (Refer to Figure 5.6 and Figure 5.7 for charts showing an increasing volume of both equity and debt securities outstanding.)

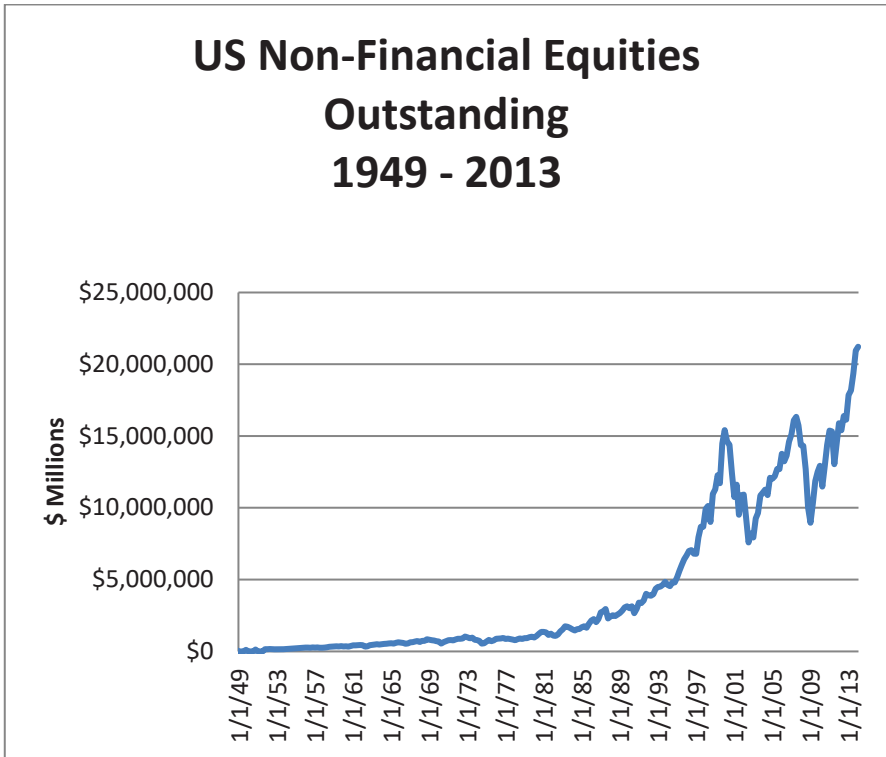


Figure 5.6: US Non-Financial Corporate Equities Outstanding, 1949-2013
 Source: Data for the graph were extracted from Federal Reserve database-
 Federal Reserve Bank of St Louis 2015d

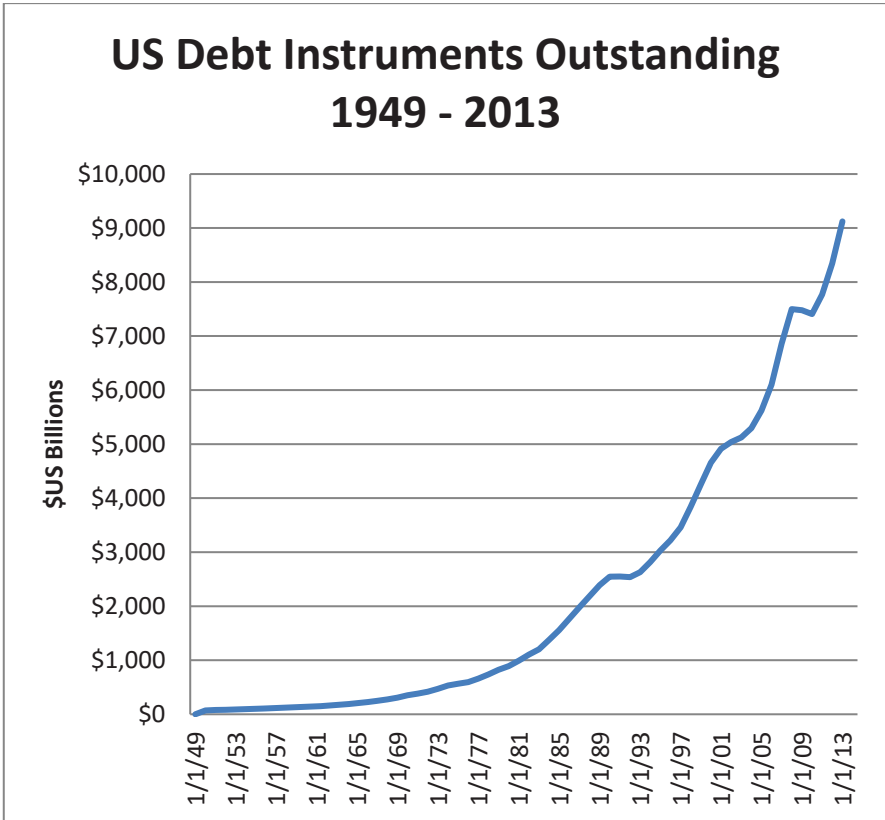


Figure 5.7: US Debt Instruments Outstanding 1949-2013

Source: Data for the graph were extracted from Federal Reserve database-
Federal Reserve Bank of St Louis 2015c

Most investment banks either operate as securities firms or would have a securities operation. When a securities firm underwrites a new issue of equities or bonds it would need to bear the risk of that undertaking until the securities are sold to the ultimate investor. The funds used to pay for the securities are normally obtained from either the firm's own cash resources or through borrowings, typically from banks. In their credit assessment of the underwriting firms, the banks would require acceptable levels of capital amongst satisfying themselves of other credit risk attributes. Traditionally, the capital was either supplied by the partners'

own funds or once incorporated, by the stockholders of the firm. Two advantages of the corporate form for a securities operation were firstly, the access to a potentially larger stockholder base to facilitate additional funding, and secondly, the limited liability of the corporate entity which was unavailable to the partners of a partnership firm. As new issues became larger during the latter part of the twentieth century, it became increasingly difficult for the partners of private partnerships to fund the increasing levels of capital needed to support the bank borrowings. Partnerships were able to last as long as the speed of economic growth remained slow to moderate and the demand for underwritings grew accordingly. Consequently, during the period between the 1960s and 1980s, which was a period of rapid economic growth and burgeoning mergers and acquisition activity, many partnerships succumbed to the ever-increasing need for capital and were either unwound, acquired by larger firms or began to incorporate.

The limitations of insufficient capital plagued Wall Street partnerships and provided an element of discontinuity to their development as partnership capital could be withdrawn upon a partner's death or retirement. When this occurred, firms found themselves in difficult financial positions. The recurring theme of capital constraints plagued many firms especially during financial crises which occurred periodically during the latter part of the nineteenth and early part of the twentieth centuries and specifically during the crisis years: 1869; 1873; 1884; 1893; 1903; and 1907 (Geisst 2001, 60). The flourishing corporate sector during the 1960s to 1980s encouraged non-traditional institutions, mainly large commercial banks, to encroach on some of the business segments which were the traditional domain of the investment banking industry. In response to this threat, partnerships gave way to the corporate form in order to grow and compete. The business of investment banking prior to the GFC was dominated by traditional firms which were able to adapt to the changing environment in the previous decades. Figure 5.8 represents the relative size of the major investment banks in 2007, the year acknowledged as the beginning of the crisis and the year before the collapse of Lehman Brothers.

Figure 5.8: Ranking of major US investment banks by market capitalisation in 2007

Investment Bank	Highest stock price 2007	Highest market value 2007 Billions	Average number of employees 2007
Merrill Lynch	USD 98.68	USD 150.89	64,200
Goldman Sachs	USD 246.40	USD 107.05	30,522
Morgan Stanley	USD 75.15	USD 83.34	56,000
Lehman Brothers	USD 86.18	USD 59.38	28,556
Bear Stearns	USD 170.62	USD 20.47	13,700
TOTAL		USD 421.13	192,978

Source: Arslan 2009, 5-6

After the first major firms incorporated in 1970, a wave of similar firms gradually incorporated as each firm experienced similar capital constraints. DiMaggio and Powell's (1983) New Institutional Theory suggests that firms tend to replicate business models and practices adopted by other successful industry participants if they are easily understood and provide legitimacy to external stakeholders. This theory further proposes that such isomorphism is undertaken regardless of whether economic benefits accrue. Given the uncertainty in dealing with these challenges in the 1970s and 1980s, firms looked to each other as to which strategic course to follow. Even with the negative consequences of staff mobility and loss of some tacit skill, incorporation was deemed a viable option to the challenges presented as it offered legitimacy from various perspectives. Parties who accorded this legitimacy included stockholders and creditors, regulators, customers, executive management, existing partners, and lastly, the co-participants in transactions.

For partners and stockholders, the corporate form enabled a potential increase in capital to expand business activities. Expansion would generate an increase in earnings and receive stockholder approval so long as the return on capital was not diluted. Naturally, the economic benefits would have been uncertain at the time of incorporation however the popular notion that "bigger is better" could have crept into the perceptions of both, the firm's partners, and the stockholders. Creditors, including bank

lenders, would view a potential increase in capital as an improvement to the balance sheet structure notwithstanding the removal of unlimited liability which is almost always a feature of the partnership structure. A better capitalised business generally translates to a more robust credit profile and therefore a lower probability of default on monies outstanding. A corporate form would subject the firm to a comprehensive corporate regulatory umbrella. Applicable regulations would oblige disclosure of relevant qualitative and financial information. As transparency is an important element of the financial system, any improvement in disclosure by investment banks would inform stakeholders and reduce uncertainty in the financial markets. Corporate regulation also imposes discipline on investment banks, covering matters from corporate governance to consumer protection. As potential additional capital would permit investment banks to diversify their service offering and increase underwriting capacity for new securities issues, customers would perceive incorporation as a positive development.

The transformation from the partnership form to the corporate form enabled many investment banks to face the challenges and opportunities of the 1970s and 1980s. The primary challenge was the need for extra capital necessary to meet the financing demands of the growing corporate sector, to shore up balance sheets in the face of increased risk levels, to fund the investment required in information technology and to compete with the larger commercial banks which had encroached on some of their traditional business activities. The corporate form also allowed investment banks to introduce generous executive compensation schemes which need not be shared equitably amongst partners. However, this evolution meant that the traditional reliance on reputation and tacit skills had diminished, removing the personal style and image traditionally imbued by the partners.

Ultimately, the rapid growth of the corporate sector attracted some Machiavellian characters seeking to exploit market conditions. This has been a pattern throughout the history of investment banking. The US corporate sector and the investment banking industry have been littered with a series of scandals whereby emboldened individuals took advantage of various stakeholders. The emerging scandals prompted a cycle of reactionary regulatory responses.

Regulation – Post WWII

Following WWII, the reconstruction of Europe combined with the retooling of US manufacturing and growing consumer demand led to a burgeoning US economy. This, combined with an absence of major corporate scandals up until the 1990s, engendered a liberal approach to regulatory reform. It was not until the late 1990s that a wave of new legislation was introduced – again largely prompted by corporate scandals. The public indignation that followed led to a series of legislative reforms.

The major pieces of legislation which impacted on the investment banking industry during this post war period include the Gramm-Leach-Bliley Act, the Sarbanes-Oxley Act, Regulation Analyst Certification (Regulation AC) and more recently, the Dodd-Frank Act (2010). Each piece of legislation was seen to be a reaction to a crisis or series of events which had an adverse impact on the investing public. In some cases, the ultimate legislation was seen to be a watered-down version of the Bill originally introduced to Congress, typically as a result of strong lobbying from the investment banking industry.

The Gramm Leach Bliley Act of 1999 essentially repealed the Glass Steagall Act of 1933 which prevented commercial banks from undertaking investment banking activities. The new Gramm Leach Bliley Act allowed commercial banks and investment banks to again operate within a single group. The larger combined group, it was argued, could withstand downturns better than if they were split. The complementary business models implied that in a thriving economy when cash levels were high, banks could improve profitability by increased lending funded by higher levels of deposits. Conversely, whilst the corporate sector was well-funded by internal cash generated during the buoyant conditions, demand for external funding via securities issues would be low, thereby impacting negatively on investment bank performance. The negative correlation between a commercial bank's and an investment bank's financial performance during an economic cycle was purported to lead to less volatile earnings for a combined entity and therefore a more stable financial system. A second argument centred on the unfair playing field that Glass Steagall had created. Whilst US investment banks had to comply with the separation principle, the European investment banks and commercial banks that were domiciled in the US, were able to continue to operate as combined units. In view of the globalisation of the industry,

amalgamations between investment banks and commercial banks were deemed necessary to compete with international participants.

The Sarbanes-Oxley Act of 2002 was a direct reaction to the corporate scandals of the late 1990s and covered wide ranging reforms focused on improving corporate governance. The Act impacted investment banks insofar as it intended to foster greater transparency. Investment banks were required to separate the activities of share analysts from the underwriting departments thereby lowering the risk of biased research reports. Other governance related sections of the Act impacted directly and indirectly on investment banks to include provisions for greater auditor independence. It required corporate executives to attest formally to any information made public, a greater disclosure by firms issuing securities, and a general improvement on corporate compliance provisions supervised by the SEC.

The following year, The Regulation Analyst Certification Act of 2003 was passed which intended to improve the quality of research reports produced by investment banks. This Act required analysts to certify that their research reports represented an accurate opinion of their view. Further, it was intended to improve transparency by requiring analysts to disclose any remuneration directly related to the research reports.

Most of the large corporate scandals in the US, from Jay Cooke's 1873 collapse to the scandals in the early 2000s such as those involving Global Crossing, Halliburton, Peregrine Systems, Tyco International, and WorldCom, can trace their causes to the confluence of the same three general factors: risk taking; competition; and manipulation of the corporate form (Skeel 2005a). Given that most CEO compensation structures involve a combination of shares and options, CEOs can expect a large payoff if the company's share price increases. However, if share prices decline, to the detriment of shareholders, the CEO's personal capital is not at risk. This can introduce a moral hazard problem whereby CEOs are motivated to take higher risks to take advantage of potentially large bonuses (Skeel 2005a). Therefore, theoretically, CEOs are generally incentivised to take risks up to a point where bankruptcy costs equal the marginal return of 'risking up' of the business.

The second factor is competition. Although competitive markets are generally viewed as healthy for an economy, they too can reinforce

managers' incentives to take risks. The US has had an historic dislike for concentrated economic power, generally favouring industries with a multitude of competing companies. In this kind of marketplace, the success of a business innovator attracts competitors. If an innovative company's profits are eroded by the influx of competitors, its managers may be tempted to respond by taking increasingly misguided and even illegal risks, or disguising their precarious finances, as they attempt to replicate their early success.

The final factor often linked to scandals is the manipulation of the corporate form to tap large amounts of capital for personal gain. The consequential impact of incurring excessive or fraudulent risks may jeopardise the financial lives of thousands of employees, investors, and suppliers of the business. The corporate form itself can also multiply the opportunities for mishaps. By permitting corporations themselves to hold shares of other corporations in the late nineteenth century, lawmakers gave corporate managers the ability to store assets in multiple legal entities. This corporate smoke and mirrors figured prominently in the collapse of Samuel Insull and other utility empires in the 1930s, and it was equally central to Enron's managers' efforts to keep investors in the dark as they ratcheted up the corporation's risks. Ultimately, this technique was also used by Lehman Brothers which made extensive use of special purpose vehicles and other unusual accounting interpretations such as those known as 'Repo 105'.

Once a corporate scandal is revealed, a public uprising often follows which incites extensive corporate reforms that simply would not be possible in a more imperturbable corporate and financial environment. For example, there were regulatory implications following many scandals, in the 1870s, the 1930s and the early 2000s. An early example is when Jay Cooke's business empire collapsed in September 1873, which followed a series of railroad scandals that also included a conflict over the Erie Railroad and corruption over the funding of the Union Pacific Railroad. The US Government responded by cancelling the subsidies that had been used to finance the railroads. In Pennsylvania, the state government responded to the scandals by amending the state constitution to prohibit the state from authorizing any government entities "to obtain or appropriate money for ... any corporation, association or individual" (Skeel 2005b, 157). Similar statutes in other states were, in a sense, an early effort to limit corporate influence over the political process. According to Skeel (2005b), the 1873

crisis spurred further regulation. The scandal would eventually contribute to railroad rate regulation through the enactment of the Interstate Commerce Act of 1887 and to federal regulation of antitrust issues under the Sherman Act of 1890.

In the early 1970s, following the Watergate scandal, investigators discovered that several major US corporations had allocated funds for bribing foreign officials. In response, the US Government enacted the Foreign Corrupt Practices Act, which forbids payments from US corporations to foreign officials. Most recently, scandals involving Enron and WorldCom inspired the Sarbanes-Oxley Act of 2002. Each of these reforms followed the same pattern of an alarming scandal which stimulated public outcry for action, usually in the form of legislative reforms that provide the regulatory framework for subsequent periods. As a new wave of scandals emerged in the late 1990s and early 2000s, the typical reactionary response of introducing new regulations was again triggered.

CHAPTER 6

THE GFC

Background to the GFC

This chapter provides a brief background to the GFC to set the economic, social and political context for part two of the book which tells the story of Lehman Brothers and explores the pitfalls of an overly interconnected financial network. We also address the problems of insufficient capital regulation and the neo-liberal approach to the overall financial market regulatory framework.

The GFC was sparked in July 2007 with the failure of two highly leveraged hedge funds managed by Bear Stearns due to their investments in subprime mortgages. The crisis that ensued was termed the ‘subprime crisis’ and effectively came to notice in early 2007 when lenders to the subprime borrower market began to experience rising levels of defaults as housing construction companies began to suffer from a deteriorating housing market. This affected banks’ balance sheet structures, causing a liquidity crisis. The follow-on effects of this liquidity crisis affected the global banking system universally, culminating in devaluations of numerous asset classes, predominantly in the equity, debt and real-estate segments. The cascading financial markets ultimately led to Lehman Brothers’ failure on 15 September 2008, recording the largest bankruptcy in US history.

Lucas highlighted the significance of the Lehman Brothers bankruptcy as a milestone in the crisis:

...until the Lehman failure the recession was pretty typical of the modest downturns of the post-war period. After Lehman collapsed and the potential for crisis had become a reality, the situation was completely altered (2009, 67).

Similarly, Blinder noted:

...everything fell apart after Lehman went over the cliff, no financial institution seemed safe. So lending froze, and the economy sank like a stone. It was a colossal error, and many people said so at the time (2009, 2).

Henry Paulson, the prevailing US Treasury Secretary, confirmed the magnitude of the problem which affected the financial system and the market confidence upon which it relies.

We had a system crisis. Credit markets froze and banks substantially reduced interbank lending. Confidence was seriously compromised throughout our financial system. Our system was on the verge of collapse, a collapse that would have significantly worsened and prolonged the economic downturn that was already under way (Paulson 2008).

In addition to the depth of the crisis, was the complexity associated with the various causes and their interrelationships. According to Brunnermeier (2009, 77) “[t]he financial market turmoil in 2007 and 2008 has led to the most severe financial crisis since the Great Depression and threatens to have large repercussions on the real economy”. Literature to date has explored and surmised the GFC as having multiple contributory factors with no unique cause (Acemoglu 2009; Arup 2010; Brunnermeier 2009; Calomiris 2009a; Diamond and Rajan 2009; Fahlenbrach and Stulz 2011; Grant and Wilson 2012; Masood 2009; Mian et al. 2013; Obstfeld and Rogoff 2009; Paulson 2011; Pol 2012; Reinhart and Rogoff 2009; Sinclair 2010; Swedberg 2010; Tarr 2010; Taylor 2009a). Moreover, in January 2011, the Financial Crisis Inquiry Commission which was appointed by the US Congress, issued a report on the causes of the GFC and identified eight main causes:

...widespread failures in financial regulation and supervision; dramatic failures of corporate governance and risk management at many systemically important financial institutions; a combination of excessive borrowing, risky investments and a lack of transparency; governments and regulators which were ill-prepared and inconsistent with each other in their approach to regulation; a systemic breakdown in accountability and ethics; the collapsing of mortgage lending standards and mortgage securitisation; over the counter (OTC) derivatives; and a failure of credit rating agencies (Financial Crisis Inquiry Commission 2011, xv-xxviii).

Although there is continuing discussion about the causes of the GFC, the Leaders of the Group of 20 concluded the following:

...During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions (Leaders of The G20 2008).

These sentiments were not inconsistent with those of the prevailing chairman of the US Federal Reserve, Ben Bernanke who offered the following explanation:

...[t]he proximate cause of the crisis was the turn of the housing cycle in the US and the associated rise in delinquencies on subprime mortgages, which imposed substantial losses on many financial institutions and shook investor confidence in credit markets. (Bernanke 2009, 1).

Bernanke also attributed the crisis to aspects of the credit boom including:

... widespread declines in underwriting standards, breakdowns in lending oversight by investors and rating agencies, increased reliance on complex and opaque credit instruments that proved fragile under stress, and unusually low compensation for risk taking (Bernanke 2009, 1).

Although there is general agreement that one of the main preliminary triggers of the GFC was the US housing market bubble, Reddy (2010, 131) goes further to suggest that the “main proximate sources of the crisis were 15 or 20 financial conglomerates”. These global financial institutions which fuelled the credit boom were complicit in the “unsound risk management practices” (Bernanke 2009, 1). McSweeney (2009) also directs blame towards the financial institutions sector and claims that with adequate financial reserves these institutions would have been able to withstand the shocks from the GFC.

But too many were over-exposed not only because of their careless acquisition of ‘toxic assets’ – often knowingly or unwittingly created by

sellers from their risky and even distressed liabilities – but also as a result of unwise and speculative activities (836).

Figure 6.1 shows the escalation of the housing bubble until its collapse in 2007.

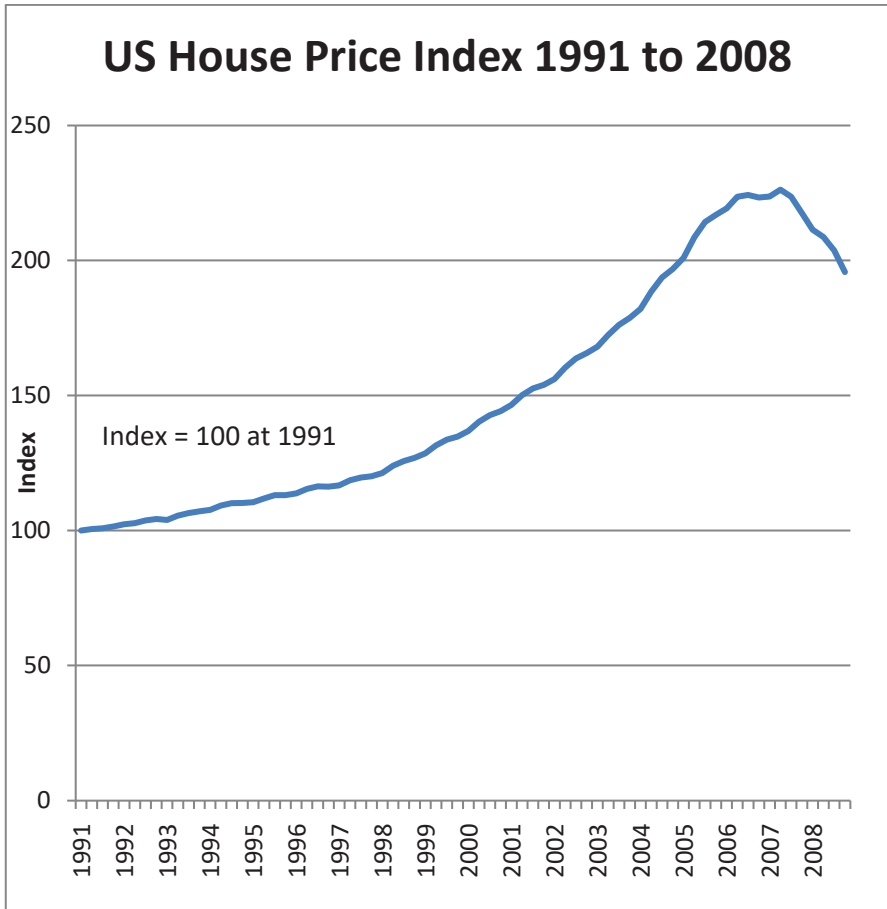


Figure 6.1: US House Price Index 1991 to 2008

Data Source: Data for the graph were extracted from the Federal Housing Finance Agency database-Federal Housing Finance Agency 2010

Naturally, no single factor can be attributed as a cause to such a calamitous failure of the financial markets. Other causes include: the inherent conflicts of interest between CRAs and financial institutions which led to problematic credit ratings; the Federal Reserve's accommodative monetary policy which produced an environment conducive to the formation of the asset bubbles which preceded the crisis; the US Government's inept attempts to regulate Government Sponsored Enterprises (GSEs) and the role played by financial institutions, in particular, the licensed banks which relaxed lending guidelines as a response to the Community Reinvestment Act (CRA Act) which had the effect of increasing home lending volumes refer Figure 6.2 for a graph of home lending volumes in the US from 1998 to 2008.

As lenders searched for more lending opportunities in the early 2000s, they lowered their credit risk standards and began to accumulate subprime mortgages which are considered the lowest grade of home loans in residential lending. Many of these loans had no deposit or documentation and surged in the period between 2001 and 2006. The use of securitisation as a vehicle in creating greater capacity for the industry to expand lending in this segment of the market was popularised by the investment banks. As higher volumes of subprime loans were written, those banks which were becoming heavily involved in this segment of the market experienced higher levels of problem loans. Dell'Ariccia et al. (2012) confirmed this trend and associated delinquency rates with areas in which credit risk criteria were lowered by home lenders.

Much of the blame for the unusually high lending volumes was directed towards the government. Furthermore, the government was also blamed in the aftermath as Taylor (2009a) claims that inconsistent government intervention worsened the crisis, citing government support of some financial institutions, such as the American International Group Inc (AIG) and their creditors, but not others. The government's inconsistent treatment of troubled organisations during the crisis was handled without a clear framework.

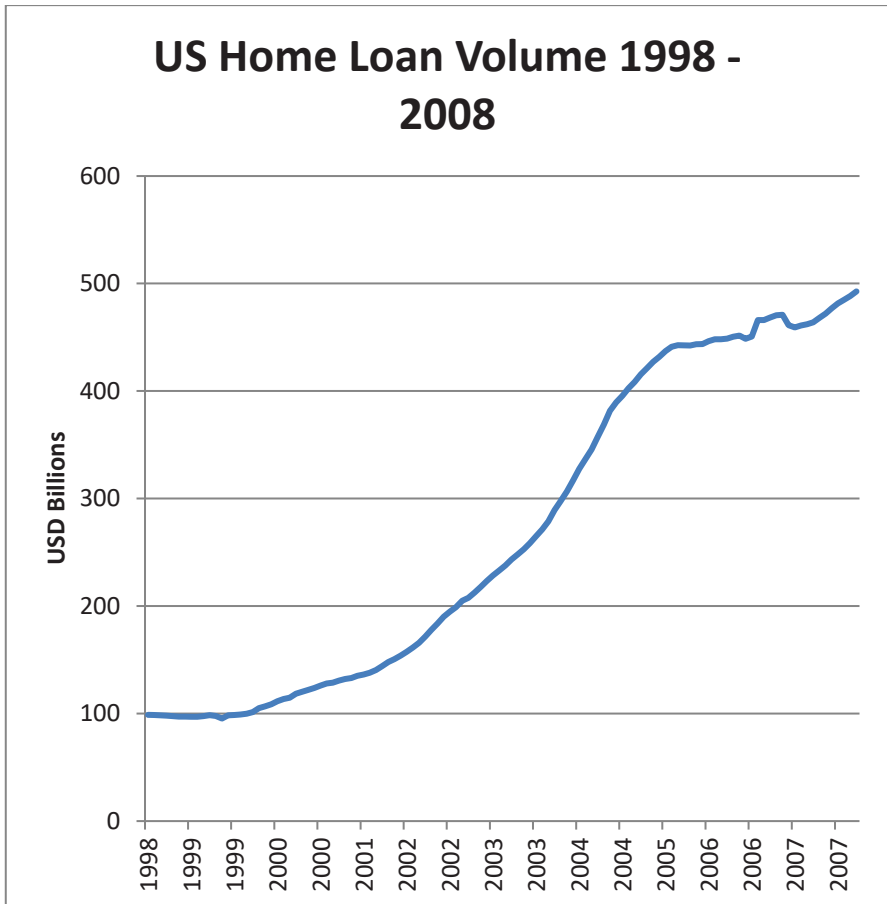


Figure 6.2: US Home Loan Volumes for Period 1998 to 2008

Source: The data for the graph were extracted from the Federal Reserve database-Federal Reserve Bank of St Louis 2015b

The government had also come into criticism during the crisis. Jaffee (2009) argued at the time that the government should regulate investment banks quickly to avoid the moral hazard which was exacerbated following the bailout of US investment bank Bear Stearns. At this time, regulators orchestrated a rescue through a merger with JP Morgan Chase. On the other hand, it could be argued that a government interventionist approach creates real “systemic risks (which) are due to the moral hazard

engendered from market expectations of a Lehman Brothers' bailout following the government bailout of Bear Stearns" (Rosenberg 2009, 78). The differing stance taken by Rosenberg (2009) compared to Jaffee (2009) highlights the inconclusive views in academic literature on whether more or less regulation is the answer to avoiding a repeat of the GFC.

Although the depth and nature of regulation is important, of equal importance are the perception and characteristics of the relationship between legislators, regulators and industry (Sinclair 2010). It is therefore worth asking the question whether the inconsistent approach to supporting organisations during the crisis was partly based on the influence and respective power of the actors. The answer to this question constitutes a contribution to the understanding of this era of financial history.

A deeper understanding of the various causes of a financial crisis will identify the underlying protagonists. Sinclair (2010) notes it is helpful to contrast two main ideologies of understanding crises; exogenous and endogenous perceptions. Firstly, Sinclair (2010) argues the exogenous approach to financial crises was originally espoused by free market thinkers such as Adam Smith, Friedrich von Hayek and Milton Friedman. The overriding principle is that markets, when unimpeded, are efficient allocators of resources and any deviation from a normal state of the market would explain a crisis. Given the assumption of efficient markets, this approach blamed external causes, such as government intervention, as the instigator of a crisis.

Secondly, Sinclair (2010) notes the contrasting endogenous approach, which claims that financial crises begin primarily within the financial markets' community.

Central to the endogenous perspective is the idea that market traders do not merely integrate information coming from outside the markets in the wider, real economy, but are focused on what other traders are doing, in an effort to anticipate their buy/sell activities, and thus make money from them (or at least avoid losing more money than the average) ... On this account, finance is subject to the pathologies of social life (Sinclair 2010, 95).

Thus, this alternative perception of how the financial markets function and produce crises features aspects of social interaction such as rumours, norms, and practices, and is subject to social phenomena such as interplays

of power and influence. This approach goes beyond much of the existing literature on technical causes that ignore the cultural and behavioural explanations which together with the exogenous factors are addressed in this book. An exogenous factor which reveals itself regularly prior to a financial crisis is the neo-liberal approach to financial market legislation, a key component of which relates to insufficient capital regulation for financial institutions. An understanding of this contextual background allows for a fuller understanding of the external environmental conditions within which the social interactions of financial market participants occurred.

Insufficient Capital Regulation

An important aspect of the GFC was the relatively high leverage, or expressed in terms of capital an insufficient level of capitalisation of financial institutions in general and in particular, the US investment banking industry. A requirement for minimum capital levels traditionally has been the primary prudential tool used by regulators around the world to manage risk profiles of banks. The concept is based on the principle that capital can act as a buffer against continued or abnormal losses. The higher the level of capital, the greater a financial institution could withstand losses before entering bankruptcy. This approach was first introduced on a global scale in 1988 by the Bank of International Settlements which is the global overseer of banking prudential regulations. In 2008, the capital adequacy ratio was set at 8%. This meant that banks were required but not impelled to set aside a minimum amount of capital equivalent to 8% of their risk weighted assets.

The regulatory framework for investment banks in the US, however, did not employ the same focus on minimum levels of required capital based on risk exposure as did the banking industry. The differences lay not only in the minimum levels of capital required but the types and extent of risks that were to be covered by such capital. This problem of insufficient capital in the investment banking industry was created by two factors: firstly, the push for higher leverage by investment banks so they could take advantage of the increased profitability from the “leverage effect” and secondly, the lax regulatory requirements relating to the capital adequacy of investment banks prior to the GFC.

The leverage effect is the process of generating additional income by increasing borrowings which are then used to either on-lend to customers or invest in securities to generate returns. As borrowings increase in proportion to the level of capital on the balance sheet, the leverage ratio, that is, the ratio of debt to equity (capital) also increases. Whilst additional borrowings could be used to generate additional income, investment banks would continue to pursue the profit generation machine of the 'leverage effect' voraciously. The only potential impediment to the investment banks exploiting this golden goose would be a regulatory capital adequacy ratio limit, the likes of which applied to banks.

Financial institution failures can generally be classified into two main categories: banks, and Non-Bank Financial Intermediaries (NBFIs). The number of US financial institution failures between 2007 and 2014 is set out in Figure 6.3.

Figure 6.3: US Financial Institution Failures 2007–2014

Year	2007	2008	2009	2010	2011	2012	2013	2014
Number of Financial Institution Failures	3	24	140	157	92	51	24	18

Source: Federal Deposit Insurance Corporation 2016

Figure 6.3 shows a steep escalation in the number of failures following the GFC period of 2007/2008, peaking in 2010 with 157 failures. These failures occurred despite the prevailing regulatory framework which suggests an inherent weakness in the ability of regulations to protect financial institutions from bankruptcy. Licenced banks (as opposed to investment banks) in the US are a highly regulated group whose risk management frameworks and practices are largely influenced by various regulators. The key regulator for US banks is the Federal Reserve System, which at the time of the Lehman Brothers' collapse adopted the prudential guidelines stipulated by the Bank of International Settlements known as Basel II. These are the same prudential guidelines adopted by most countries globally.

A major sub-group within the NBFIs sector comprises the investment banking industry. The activities of the US investment banks were however subject to a less stringent regulatory environment as they did not fall under the same regulatory umbrella as banks as illustrated by Figure 6.4. Instead, they were officially supervised by the US Securities and Exchange Commission (SEC) and this supervision was largely voluntary.

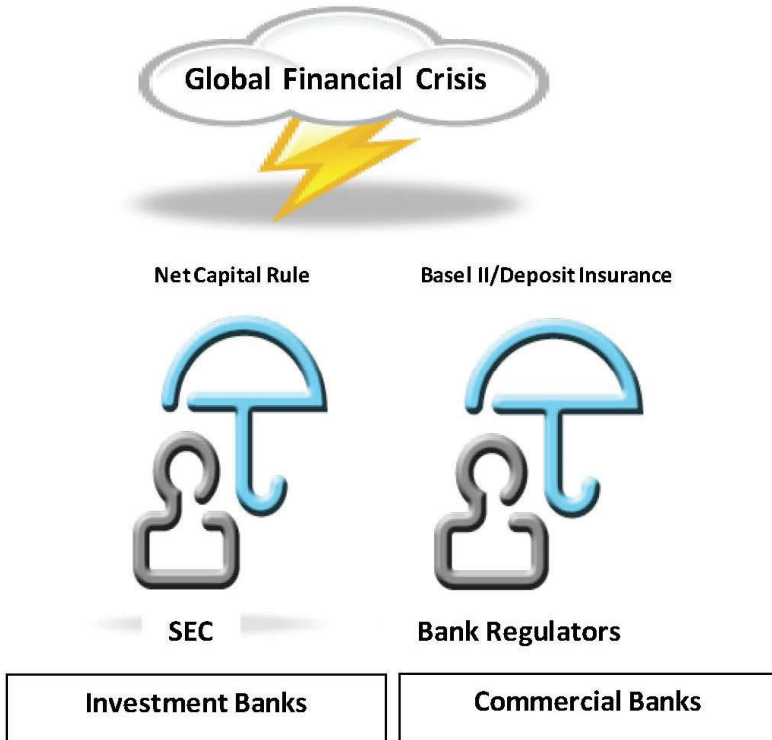


Figure 6.4: Regulatory Umbrellas for Banks versus Investment Banks

Capital Regulation

In the investment banking industry, the principal section of prudential regulation aimed at protecting stakeholders was a rule governing minimum capital levels—Rule 15c3-1 under the Securities and Exchange Act of 1934. In the period prior to the GFC, this rule was amended by the US

SEC in 1975 and revised in 1997 and 2004 (Securities and Exchange Commission 1975, 1997, 2004). A key amendment to this rule in 2004, commonly known as the “Net Capital Rule”, effectively permitted the larger investment bank groups to raise their allowable leverage from a level of 12 to 1 to over 30 to 1. The leverage ratio required a registered broker-dealer owned by an investment bank to maintain “aggregate indebtedness” to a maximum of 12 times (or 15 times if the investment bank provided an early warning to the SEC of a potential breach). This ratio can also be expressed as holding a minimum amount of net capital equal to at least 6.67 percent of total “aggregate indebtedness”. However, Sirri (2008) notes that broker-dealers subject to the 12-to-1 net capital leverage ratio effectively understated their ratios as the regulatory definition of “aggregate indebtedness” excluded securities financing transactions such as repurchase agreements which constituted substantial portions of an investment bank’s balance sheet. This technicality virtually enabled these groups to increase their leverage ratios to over 30 to 1. Moreover, the Net Capital Rule never applied at the investment bank holding company level, where the group would conduct risky transactions, such as originating and warehousing of real estate and corporate loans and derivatives transactions involving collateralized debt obligations (CDOs) and Residential Mortgage-Backed Securities (RMBS) outside the balance sheet structure of the broker-dealer subsidiary. Other prudential guidelines for investment banks were voluntary, and therefore not enforced. This allowed investment banks to take on substantial levels of debt, far in excess of that incurred by commercial banks, without breaching regulations.

According to Sirri (2008), no regulator in the US, as at 2008, was given explicit authority and responsibility for the supervision of investment bank holding companies with bank affiliates. Although the US regulatory framework included mandatory capital requirements by the Federal Reserve Board for commercial bank holding companies, holding companies of investment banks that did not have Federal government regulated US banks within the consolidated group, were subject to a voluntary regime of regulations. Therefore, there was a gap in the US regulatory framework for large US investment bank holding companies to meet net capital adequacy limits and maintain liquidity on a consolidated basis.

A history of the capital regulations for investment banks is useful in understanding their effect on the industry. The concept of a rule requiring a broker-dealer to maintain a liquidity buffer to protect customers’ claims

on the firm originated from the aftermath of the Great Depression of the 1930s when the SEC established Rule 15c3-1 under the Securities and Exchange Act of 1934. This Act required registered broker-dealers to maintain minimum levels of liquid net assets in order to liquidate positions speedily to meet client claims. In the late 1960s, US broker-dealers were inundated with unprecedented securities trades which caused processing failures. The broker-dealers relied on short-term debt to fund their portfolios of securities and as investors attempted to liquidate their holdings, these funding lines were placed under severe stress causing defaults amongst industry participants. The failures precipitated a financial crisis resulting in substantial losses for investors and a loss of confidence in the stock market. Following this crisis, the SEC amended the net capital rule in 1975. The amended net capital rule involved a process of two calculations. Firstly, net capital was calculated from the broker-dealer's balance sheet as total capital less deductions such as illiquid assets, unsecured receivables, charges for aged credit exposures and market risk haircuts. Secondly, the required net capital was calculated as a percentage of "aggregate indebtedness". Actual net capital was required to exceed the required net capital.

The 1980s represented a period of growth for the securities industry and as broker-dealers expanded operations, regulators began to focus attention on the solvency of the broker-dealers' holding companies as well as the broker-dealer subsidiaries. However, they continued to resist introducing specific regulations covering holding companies. Concerns were realised with the bankruptcy in February, 1990, of the Drexel Burnham Lambert group which operated as an investment bank with a broker-dealer division. Drexel Burnham Lambert's bankruptcy prompted the SEC to conduct assessments of groups which were affiliated to broker-dealers. Formally, these measures included: the establishment of the Market Reform Act 1990 requiring larger broker-dealers to report risk-related data of group entities to the SEC; persuading industry participants to form a Derivatives Policy Group to voluntarily supply information about their derivatives activities which were still unregulated; and, a program involving the supervision of "Over the Counter" derivatives transacted by broker-dealers.

The 2004 amendments to the Net Capital Rules addressed the need to recognise the requirement for calculating net capital for the wider investment banking group as well as the broker-dealer subsidiaries. When

Congress enacted the Gramm-Leach-Bliley Act in 1999, it neglected to authorise any government agency to regulate large investment bank holding companies such as Goldman Sachs, Morgan Stanley, Merrill Lynch and Bear Stearns. The 2004 amendment effectively established a class of larger investment banks to be known as Consolidated Supervised Entities (CSEs). The CSEs could volunteer to comply with the Net Capital Rule under SEC supervision. Otherwise, they could remain under the existing regulations which applied solely to their broker-dealer subsidiaries. The five main elements of the CSE program entailed the following.

First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission's staff examines the implementation of these controls. Third, CSEs are monitored for financial and operational weaknesses that might place regulated entities within the group or the broader financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the Basel Standard. Finally, CSEs are required to maintain significant pools of liquid assets at the holding company, for use in any regulated or unregulated entity within the group without regulatory restriction. This liquidity pool is sized to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows without access to unsecured financing for a period of at least one year (Sirri 2008).

Investment banks could qualify as CSEs if they had net capital of more than USD 5 billion and therefore take advantage of a key concession relating to the calculation of net capital. This concession allowed CSEs to calculate net capital using their own risk models. This flexibility basically provided the investment banks with the power to exercise a great deal of discretion in developing a model to facilitate a favourable outcome and potentially one which could be manipulated to ensure compliance. By the time of the GFC, four major investment banks, including Lehman Brothers, Goldman Sachs, Merrill Lynch and Morgan Stanley volunteered to be classified as CSEs and comply with the regulations (Review of Regulatory Proposals on Basel Capital and Commercial Real Estate 2006, 114).

Not only did the 2004 amendments increase the allowable leverage for CSEs, they contributed to a change in business direction of the investment banks. The 2004 amendments incorporated risk weightings for assets when calculating the net capital ratios. These were similar to those used in

the capital adequacy calculations used in the regulations for banks known at the time as the Basel II capital adequacy regulations. The risk weightings applied a percentage weighting to each asset based on its riskiness. For example, an asset with low risk of loss such as a cash holding would have a zero weighting, reflecting the negligible risk of loss. On the other hand, a loan to a corporation would have a risk weighting of 100 percent reflecting that the whole asset, that is the loan, could be subject to loss if the borrower failed to repay. The new regulations favoured the holding of mortgage assets which were risk weighted at 50 percent of the principal amount and investments in mortgage securities which were risk weighted according to the credit rating applied by the independent credit risk agencies such as Moody's or Standard and Poor's (S&P). For example, mortgage bonds with a credit rating of "BB" or "BBB" were weighted at 100 percent whilst mortgage bonds rated "A" were risk weighted at 50 percent and bonds rated at "AA" or "AAA" were risk weighted at 20 percent. Therefore, the higher a bond was rated, the lower the risk associated with the asset and the lower the required capital allocation. When capital was considered a scarce resource, banks and investment banks preferred assets with relatively lower risk weightings and therefore the issuance of mortgage-backed securities expanded significantly following the 2004 amendments. Accordingly, the balance sheets of investment banks accumulated higher proportions of mortgage-related assets. The pre-2008 accommodative legislative environment which included a generous capital adequacy requirement was sufficient to encourage the investment banks to maximise their leverage. It enabled them to take advantage of new and innovative business activities, which introduced new and heightened risks for the firms. These risks were found to be understated and misunderstood leading to dire consequences.

The 2004 amendment is viewed as a seminal point in the history of capital regulation for US investment banks as it allowed the large investment banks the choice to volunteer to be classified as a CSE, and in turn, the choice to utilise an internal model to calculate their own capital adequacy ratios. Unsurprisingly, all major investment banks elected to use the internal model approach which provided them with flexibility in their calculations of the components of the capital ratios, such as asset classifications, probability of defaults for different credit risks, and loss-given default rates. The decision to be classified as a CSE was also a legitimacy-seeking behaviour by agreeing to be subject to the newest

regulatory initiative. A testament to the inadequacy of this lax regulation is exemplified by the SEC's prompt reaction to the Lehman Brothers' bankruptcy. In just eleven days following the bankruptcy, the SEC introduced legislation requiring large investment banks to submit to compulsory regulation in acknowledgement of the previous inadequate rules (Cox 2008a).

The differences in the regulatory framework between the banking and investment banking industries, and the degree of the regulatory strictures, were to be tested during the GFC. In the timeline of the GFC, it was at the approximate point of Lehman Brothers' bankruptcy when the pendulum had swung from the neo-liberalist approach to a more interventionist approach as the government attempted to stave off an even deeper crisis. Examples of government intervention were the arrangements to rescue failing institutions such as AIG, the large government sponsored mortgage institutions—Freddie Mac and Fannie Mae, Morgan Stanley, Bear Stearns, Washington Mutual, Wachovia Corporation, and Citigroup. The US Government also provided its guarantee to enhance liquidity of financial institutions' money market accounts with Federal Reserve programs to purchase commercial paper issued by financial institutions. A more significant assistance package was established through The Emergency Economic Stabilization Act, which implemented the Troubled Asset Relief Program (TARP), enacted on October 3, 2008. This government intervention reintroduced a degree of liquidity to the market which assisted in the short-term funding needs of US banks, possibly preventing a complete loss of confidence in the financial markets and an even deeper crisis. The interventionist approach was an admission that the *laissez-faire* approach had serious shortcomings, especially in times of crises.

Ultimately, the remaining investment banks were taken under the Federal Reserve System's supervisory control by either being classified as bank holding companies or being merged with other bank holding companies. This move achieved a reprieve for both Morgan Stanley and Goldman Sachs from the liquidity crisis which affected all investment banks. The status of a bank holding company qualified both these investment banks for official protection and emergency funding by the Federal Reserve, as well as the associated market confidence that comes with the status and the capital regulations which applied to all banks. These and other subsequent financial aid programs represented a reversal from the neo-

liberalist approach to financial regulation which permeated through the government and regulatory sectors prior to 2008.

Neo-Liberal Approach to Financial Market Legislation

The US Executive Government has for decades been preoccupied with the affordability of housing for the underprivileged classes. In 1977, the Democratic Carter administration introduced the CRA Act which was intended to support the borrowing needs of low-income individuals and families residing in underprivileged communities. The CRA Act effectively designated geographic areas as zones of extreme poverty, a process called “redlining” and required banks to establish branches in those zones and allocate a proportion of their loan portfolios targeted to home mortgages. The CRA Act provided for penalties including bans on the establishment of additional branches in wealthier regions if banks failed to meet the required portfolio allocations (Hylton and Rougeau 1999, 164-6). The pressure applied to banks by the government was profound: “banks were told to use innovative or flexible methods in lending to meet the goals of the CRA Legislation” (Hossain and Rezaul 2004, 57). Given these directives, banks were lending to customers that would otherwise not meet their credit criteria and consequently, the quality of the banks’ home lending portfolios deteriorated. During this period, the Federal Reserve’s accommodative monetary policy kept interest rates relatively low. Homeowners took advantage of this to either purchase new homes or upgrade. As demand for home loans increased, so did the balance sheets of banks:

[r]iskier mortgage standards by banks were not the consequence of deregulation; rather the banks were compelled to change the standards by new regulations at the behest of community groups. Again, this was a political failure as the Administration sacrificed the greater social good to appeal to narrow constituencies (Tarr 2010, 2).

In 1982, the Republican Reagan administration, often cited as one of the most neo-liberal governments in the past several decades, introduced an Act known as the Alternative Mortgage Transactions Parity Act (AMTPA), which effectively permitted non-bank financial institutions to offer adjustable-rate mortgages (ARM). These mortgages were influential in spurring home loan growth, as the key feature of the product involved an interest rate which was heavily discounted in the initial period—usually 12

to 18 months—thereafter increasing substantially to a variable rate often many percentage points higher than the initial rate. This amendment offered the banking industry greater marketing power and flexibility for borrowers in their product choice. Combined, these enhancements provided greater access to home loan financing to borrowers.

The accommodating attitude towards the underprivileged segment of the community continued under the Democratic Clinton administration which in 1995 passed an amendment to the CRA Act commonly referred to as the CRA Expansion Act (CRA Expansion). Barr (2005) notes the CRA Expansion facilitated easier access to mortgage finance for low income and minority group households, and resulted in an increase in the proportion of the US banks' loan portfolios related to distressed inner-city areas. Naturally, as this segment of the banks' lending business grew, so did the credit risk of their portfolios.

Under GWB (2001-2009), the Republicans, presided over a period in which neo-liberal principles towards the investment banking industry prevailed. That Bush's presidency drew on earlier currents of Regan-omics embodying free market, laissez faire, deregulation, helped germinate the seeds sown leading to the GFC: “[t]his administration made decisions that allowed the free market to operate as a bar room brawl instead of a prize fight” (Becker et al. 2008).

During the Bush administration, US house prices increased significantly. Figure 6.5 shows the escalation of US house prices. Bush had established an ambitious goal to create housing for a large proportion of minority groups. According to Becker et al., (2008) “he had a plan to increase home ownership by US minority group families to 5.5 million by the end of the decade [2000s]”. His strategy was to use the financial institution sector to carry out his policy.

Through his homeownership challenge, the President called on the private sector to help in this effort. More than two dozen companies and organizations have made commitments to increase minority homeownership—including pledges to provide more than \$1.1 trillion in mortgage purchases for minority homebuyers this decade (United States White House 2004).

Low-income families however were still confronted with the challenge of meeting the initial deposit for a home loan. Bush solved this problem by establishing the American Dream Down-Payment Act which would provide

USD 200 million per annum to assist approximately 400,000 low-income families meet their deposit requirements (United States White House 2004).

According to Becker et al. (2008), Lawrence Lindsay, Director of the National Economic Council, and assistant to President Bush on economic policy, acknowledged that the White House was aware of the growing housing bubble, however, had ignored it given any action to deal with it would have affected the President's home ownership policy targets. The passing of new legislation to accommodate narrow constituencies and enable a deterioration of loan portfolio quality had as much a detrimental effect in the lead up to the GFC as did deregulation. Political influence is therefore considered a contributory cause of the GFC even though indirectly. Tarr (2010) goes further to associate the root cause of the GFC to a political malfunction.

Politicians, however, often prefer to mandate a regulation on firms to achieve a political objective, since this allows them to avoid exposure of the costs of their programs while obtaining support from narrow constituencies. In this further sense, the financial crisis is, at its root, a political failure (Tarr 2010, 3).

The repeal of another piece of legislation created an environment where the "too big to fail" syndrome encouraged riskier behaviour amongst the investment banking and banking industries. For the first time since the enactment of The Glass-Steagall Act (GSA) following the Great Depression of the 1930s, commercial banks, investment banks, securities firms and insurance companies were allowed to merge. The enabling Act, commonly referred to as The Gramm Leach Bliley Act (GLBA), also known as the Financial Services Modernization Act of 1999 effectively repealed, in part, the GSA. The combining of operations of banks with other non-bank financial institutions is often cited as a cause of the Great Depression. A major reason for the non-consolidation of investment banks and licenced banks was the concern that the relatively high-risk activities of an investment bank could adversely impact the operations of a licenced bank (potentially in the form of a bankruptcy) and this in turn, would harm the entity's depositors. The GBLA, for example, ratified the Citigroup consolidation of Citibank (Commercial Bank), Smith Barney (securities firm), Primerica (Insurance and loans) and Travellers (Insurance). Furthermore, the GBLA failed to provide any meaningful regulatory

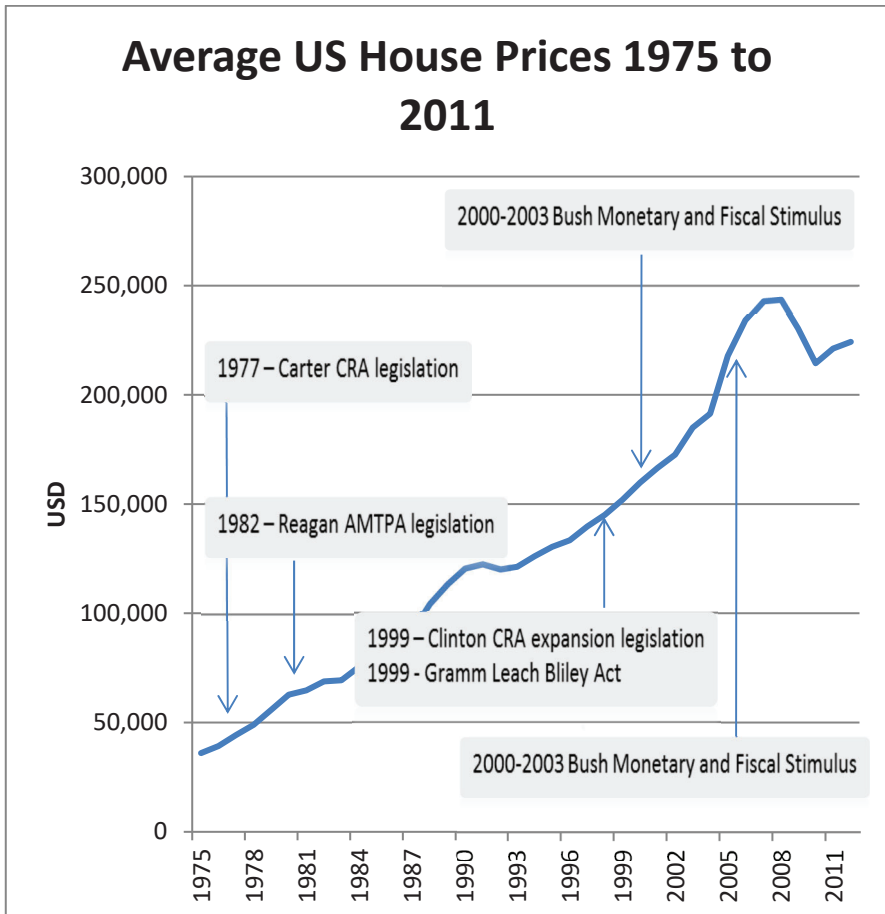
oversight of the investment banking industry either through the SEC or any other governmental agency leading to the voluntary regulatory regime.

One of the most accommodative pieces of legislation, favourable to the investment banking industry, was The Commodity Futures Modernization Act 2000 (CFMA). This Act exempted financial institutions from regulation in relation to their derivatives activities and importantly precluded risks associated with derivative positions from capital adequacy requirements. Without restriction, the investment banks were able to expand their derivatives trading businesses exponentially and thereby radically escalate their risk profiles without supervision.

The combined impact of the enactment of a selection of the accommodative legislation is represented in Figure 6.5. It is argued that this legislation fuelled an increasing house price cycle which culminated in the commonly referred to “housing bubble.” The graph below is merely intended to reveal the impact of some key pieces of legislation for illustrative purposes only and is not intended to represent a comprehensive compilation of legislation.

It is ironic that the financial institutions which contributed significantly to the credit boom were themselves counted amongst the casualties of the credit crunch that consumed many institutions. For example, Bear Stearns was forced to merge with JP Morgan Chase via an acquisition on 30 May 2008; Lehman Brothers filed for bankruptcy on 15 September 2008; AIG underwent a virtual nationalisation when the US Government acquired an effective 79.9% ownership interest on 16 September 2008; and Wachovia Bank was taken over by Wells Fargo on 31 December 2008 (Wells Fargo and Co. 2009).

Figure 6.5: US House Prices and selected US legislation 1975 to 2011



Source: The data for the graph were extracted from the Federal Reserve database-Federal Reserve Bank of St Louis 2015a

The second part of this book deals with the story of Lehman Brothers. Lehman Brothers is chosen as it was the only US investment bank officially allowed to fail by entering bankruptcy. It is differentiated from other failing investment banks which avoided bankruptcy such as Bear Stearns, which was forced to merge with JP Morgan Chase, and Merrill Lynch & Co. which was sold to Bank of America Corp. Regarding the remaining two major US

investment banks, Morgan Stanley shut down part of its trading desk as a consequence of the GFC whilst Goldman Sachs retained all its operating divisions and on September 22, 2008 together with Morgan Stanley, announced that they would become traditional bank holding companies, and as such, regulated by the Federal Reserve. Therefore, Goldman Sachs was the only investment bank of its peer group which survived the GFC in its original form.

PART TWO:

THE LEHMAN STORY

CHAPTER 7

THE PRE-FULD ERA (1850–1994)

A recurring trait in the early history of the firm is a trailblazing entrepreneurial culture driven by knowledge of products and markets and implemented through strategies often involving key relationships. The firm's innovative culture prompted the exploration of various markets at their very early stages of development. This pioneering spirit was coupled with the firm's constant search for business opportunities that were similar or adjacent to their existing operations. In entering these new businesses, the firm was willing to assume different and often higher levels of risk.

The Founders

Lehman Brothers was founded in 1850 in the US by three brothers, Henry, Emanuel and Meyer Lehman, who were Jewish emigrants from Bavaria (currently part of Germany). The Lehman brothers were sons of Abraham and Eva, where the father was a cattle and wine merchant in a small village. Henry started working for his father from the age of fourteen. Henry's maternal grandfather, Seligmann Low, was also a trader travelling around Germany selling skins, grains, wool and spices. The local law allowed only the eldest son of a Jewish family to remain in the village into adulthood, and as Henry was the sixth of 10 children and the second eldest son, he intended to leave the village as a young man. Henry, the eldest of the three brothers who emigrated, was the first to immigrate to the US in 1844. He was born under the name of Hayum Lehmann, as confirmed on the passenger list of the *Burgundy*, the ship which carried him to New York from Bavaria. Shortly after arrival, he changed his name to Henry Lehman (Chapman 2010). Henry sailed to Alabama, USA, in search of a new life, following two friends, Meyer and Arnold Goldschmidt, who were travelling to see a relative in Mobile, Alabama (Flade 1999). As a member of a minority group, Henry first learned to assimilate into the local society by changing his name and attending a Jewish school in the morning and a

Catholic school in the afternoon. This adaptability combined with his family's merchant and trading background laid a solid foundation for his future commercial exploits (Geisst 2001).

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Common to other German Jewish families, they immigrated to the US to pursue a better life and as often occurred, they established commercial interests. These families fell within the "Our Crowd" group and amongst others included: the Seligmans; Kuhns; Loeb's; Goldmans; Sachs'; Schiffs; and Lewisohns (Birmingham 1967; Geisst 2001). In their home countries many of these families were involved in the cattle trade and once in the US, they quickly established reputations as being successful in business, initially as merchants and traders. "Buying and selling was, for them, like mother's milk" (Libo 2008).

In an attempt to assimilate into US society, Henry anglicised his Christian name from Hayum to Henry whilst his surname took upon a less German look by dropping the last 'n'. Even the pronunciation of the surname changed from "Lay-man" to a more anglicised "Lee-man" (Chapman 2010). The simple act of changing his name signified a desire to conform to the American way of life which would facilitate his immersion into society. Further, the desire to assimilate into the US would help him avoid potential anti-Semitism and facilitate entry into the commercial networks which would promote his business empire.

Henry Lehman**Emanuel Lehman****Meyer Lehman**

Figure 7.1: Pictures of the Lehman Brothers

Source: Herbert Lehman Collection n.d. PD

The act of conforming to social norms to facilitate integration into society can be interpreted as an example of DiMaggio and Powell's (1983) normative isomorphism where legitimization by the business community was considered beneficial for business. Henry exhibited an emotional intelligence and adaptability to endear himself to various sectors of society. He was able to mix with anglicised society whilst retaining his intimacy with the Jewish community. The ability to conform to the values

and expectations of both groups was important for his commercial success. Henry soon established a business operating as a dry goods and grocery store which at the time was known as “H Lehman” (Wechsberg 1966, 233). He settled in Montgomery, Alabama, as the cotton industry in the state was experiencing significant growth. Henry predicted that the local economy would benefit from such growth and anticipated that the associated benefits would support a business involved in consumer supplies (Wechsberg 1966). Henry’s younger brother, Emanuel, arrived in the US in 1847 to join the firm, which then changed its name to “H. Lehman and Bro.”. Emanuel commenced working in Mobile, Alabama as a trader on behalf of the firm. He purchased supplies using credit from a Jewish wholesale supplier known to his family in Bavaria and sold the merchandise further down the Alabama River to farmers and local residents (Libo 2008). Thus, with the assistance of a family contact, reliance on Jewish connections and an instinct for trade, the firm established its roots.

The advantage gained from the trade credit enabled Emanuel to buy supplies without the need for his own cash resources or with any other financing arrangement which would incur interest. This would provide the firm with a competitive advantage against other merchants, many of whom had to pay for credit. In the episodic circuit where the application of resources is a precursor to the exercise of power, Emanuel was able to achieve a position of superiority through his financing strategy. Further, the practice of exploiting the Jewish community benefited their commercial interactions. This was a common practice within this minority group and akin to an unwritten rule to cooperate in a foreign and at times, hostile environment where outsiders were considered legitimate competitors. This “us-them” culture provided stability within the group, legitimized otherwise alien practices in the local context and empowered individuals who were able to exploit it for commercial gain.

Henry and Emanuel were soon followed by a third younger brother, Mayer who immigrated to the US in 1850. He immediately joined the business, and thus the firm was named Lehman Brothers, the name it carried until 2008. The merchant business sold a variety of manufactured cotton products and raw cotton which were often accepted as payment for other products sold by the store (Libo 2008).

The store was located in a prominent location in the commercial centre of Montgomery. The brothers’ innate trait for business was again revealed

The brothers split their responsibilities to cover a wider range of business interests and streamline the operations of the firm. In the early 1850s, whilst Emanuel sourced supplies of cotton from New York, Mayer supervised the Montgomery store which continued to trade with the local community. Henry was also involved in real estate investment and as their wealth increased, he augmented the practice of extending trade credit to offering long-term loans to farmers. The accommodating and innovative Henry accepted both cotton bales and other currency as repayment for the loans. This practice was an acknowledgement of the shortage of cash held by the farmers in pre-harvest periods. Following Henry's death in 1858, the remaining brothers established a branch in New York, which was considered the centre of the cotton broking industry. Located in close proximity to the branch were the offices of other Jewish families' businesses such as Kuhn, Loeb, Goldman, Sachs and Seligman, all of whom eventually established their own investment banks (Libo 2008).



Figure 7.3: Lehman Brothers Branch at 119 Liberty Street, New York
Source: US Slave c.1850

Mayer joined Emanuel in New York two years after Emanuel's arrival. They moved their premises to Pearl Street where they remained for ten years, after which they moved again to larger premises at 40 Exchange Place. Emanuel Lehman made New York City his permanent residence. He quickly developed a network and became a director with several prominent financial institutions and organisations such as: Mercantile National Bank, Queens County Bank, Metropolitan Ferry, The 10th and 23rd Streets

Railroad, the Third Avenue Railroad, the Alabama Mineral Land Company and the Berry Brice Cotton Company (Ingham 1983, 783).

This group of directorships exposed Emanuel to numerous executives who wielded influence in New York City. A valuable network of influential contacts was being developed which would become useful in the day-to-day business dealings of the firm. The early formation of this business network put Lehman Brothers in direct contact with potential customers, referrers of business and transaction partners. The transaction partners, who regularly shared in underwriting transactions as co-participants in securities issues, primarily consisted of other Jewish family firms who shared similar beginnings and were conveniently located within close proximity of Lehman Brothers' office. There were two forces coexisting that spawned the firm's influential power. They comprised the normative influence of the Jewish connections and the dispositional power generated from the board directorships.

Normative Influence of the Jewish Connection (Our Crowd)

Firstly, the connections with other Jewish firms provided for reciprocal business opportunities between the members of this group, known as "Our Crowd". This form of co-operation existed through a normative influence that permeated within the Jewish community. As many securities issues were too large for one firm to underwrite, a common practice was to syndicate the underwriting exposure amongst two or more firms. The efficiency and risk benefits resulting from this practice became normalised within the industry. By allocating a tranche of an underwriting commitment to a fellow Jewish firm, Lehman Brothers was able to achieve two advantages.

One advantage accrued from establishing an obligation for a continuing reciprocity of business within a close-knit community where cooperation was well regarded and highly visible; a second benefit involved efficiency in processing a transaction. The efficiency arose through a common tolerance, understanding and appreciation of the risks of each transaction allowing any analysis of the issuer to be expedited. If Lehman Brothers chose a co-participant firm with a different view of the risk, that firm was likely to decline the transaction leaving Lehman Brothers the arduous task of finding another firm willing to co-participate. These practices were

institutionalised so much so that they persist today, whereby lead arranging banks seek out banks with common credit standards to co-participate in transactions. This conformity of practice throughout the history of the professional field represents an example of DiMaggio and Powell's (1983) normative influence. The practice of risk sharing that followed allowed an expansion of the customer base and a commensurate growth of the business. The practice was determined collectively within the Jewish banking cohort and affected their cognitive approach to their day-to-day dealings and routines. For example, Supple (1998), referring to the friendship and business association between the Goldman and the Lehman families in relation to transactions, states that:

... the Goldman family had to rely more heavily on the intangible factor of friendship. For associates were needed to help supply capital and it was clear that in view of its inexperience, no established house would fully participate without the strongest of safeguards. In these circumstances it was only natural to turn to Lehman Brothers...[who] were not only a member of the German-Jewish elite, but a close personal friend of the Goldmans (1998, 173).

Cohen (2012) proffers three reasons to explain the rising prominence of the Jewish family-based investment banks in the period immediately following the Civil War. Firstly, many firms were already successful in the years prior to the war due to their common activity of starting out as merchants which enabled them to accumulate capital to take advantage and establish other finance-related businesses in the post-war period. Secondly, Cohen cites that:

... familial and ethnic networks were important in Southern Jewish economic life. Close-knit networks in the pre-Civil War period provided access to Northern capital and markets, and these networks were extended in the post-Civil War years, as well-established Jewish firms capitalized smaller Jewish businesses (2012, 130).

Additionally, German-Jewish families imported from their home country the concept of solidarity amongst their own ethnic community. In tandem with the close business associations, the families shared "common interests and aspirations—an identification of the family and the firm which in the early days...led to a continuous pooling of capital for both private and business use" (Supple 1998, 168). Thirdly, Cohen (2012) relates the

success of several Jewish firms, including Lehman Brothers, to their involvement in the prosperous cotton industry.

Cotton propelled the proprietors of strong antebellum businesses toward upper class status, and it allowed many new postbellum merchants to quickly reach the middle class...Thus, tracing the flow of capital that allowed these Jewish businesses to thrive suggests that cotton, capital, and ethnic networks were critical factors in their growth (Cohen 2012, 131).

Dispositional Power from Board Directorships

Membership of various boards of directors enabled Emanuel to attain power directly and indirectly. He did this directly within the firm of which he was a director, in the official capacity of a board member who can apply influence in strategic decision-making, and indirectly, through his relationships with other board members. Given the number of his directorships, this power permeated through the corporate circles of New York and is characteristic of power sourced from an elevated position within a community – an example of a precondition for power sourced through the dispositional circuit.

In this circuit of power, the clique of directors represented a small but influential group of individuals who largely controlled commerce in New York, the financial centre of the US. The unofficial membership of such a “club” bestowed a privileged status within the business world and society in general. The informality of these social relations permitted a transfer of favours and influence respectively between members. This process of exchanging favours is considered the passage point through which power was transmitted to the episodic circuit. The favours he was able to cultivate assisted Emanuel to generate successful outcomes in his day-to-day business affairs, such as, introductions to securities underwriting opportunities or appointments to other board directorships.

Profiting from the American Civil War

An important impetus for change was the American Civil War. With much of the firm’s operations tied to the economies of the southern states of the US, Lehman Brothers was severely affected by the Civil War (Birmingham 1967, 47). The Lehman family was close to the Southern cause during the

Civil War with Emanuel fighting in the Confederate Army and later helping to sell Confederate bonds in London (Birmingham 1967).

According to Ellis and Vertin (2003, 237), even though “Emanuel was the conservative inside man”, he was not afraid to run the blockade by travelling to Germany to sell cotton acquired in the southern states of America for considerable profit. Patriotism was not incongruent with business and Emmanuel’s activities “may even have involved smuggling...” (Ellis and Vertin 2003, 237). This behaviour goes beyond one of an entrepreneurial spirit, to include elements of risk which are deemed extreme. Not only was Emanuel engaged in commercial risk in his attempts to sell cotton in Germany, but he was also incurring personal and potentially legal risks in running the blockade and entertaining any semblance of smuggling.

In 1862, during the Civil War, when general commerce was constrained, LB was searching for alternative business activities and a means of capitalising on its knowledge of the cotton trading business. The firm established a partnership with John Durr, a cotton trader. Durr provided the additional capital required for the construction of a larger warehouse, enabling the firm to engage in higher volumes of cotton transactions (Ellis and Vertin 2003). This business strategy, dating back to the 1860s of warehousing commodities to enable larger transactions and therefore increased profitability, is a similar strategy undertaken by other investment banks during the modern era of warehousing subprime mortgages. Both strategies intended to take advantage of the leverage and economies of scale effects on profitability. In the former case, however, debt leverage was replaced by John Durr’s capital. The use of capital as opposed to debt reduced the overall risk of the venture to the firm. The brothers again exhibited canniness by using another investor’s capital as a means of expanding their business. The use of third-party capital for capital has long been a trait of investment bankers, and a useful means of managing risk.

The founders’ influence on the firm was to be significant. Early risks such as establishing a pioneering dry goods and grocery store in a growth corridor, selling cotton in Germany by running a blockade and the strategy to invest in cotton warehousing were consistent with the brothers’ vision for the firm. The process employed to engage in trading businesses where they could add value in terms of knowledge and/or relationships proved to

be successful. Naturally, the founders' influence was crucial in the early stages of the business, but does their influence persist?

Transformation to the Business of Investment Banking – an Exercise of Power

In 1867, after several years of operating as a merchant and trading business, Lehman Brothers undertook its first major investment banking transaction to sell bonds of the State of Alabama. This was not seen as a simple task given the state's poor financial condition following the war. The firm was also appointed as the state's principal financial advisor for its debt obligations, thus beginning a long tradition of Lehman Brothers' government and municipal finance (Nicholson and Pastor 2008). Lehman Brothers' financial expertise and access to financial resources enabled innovation, exemplifying Clegg's (1989) facilitative circuit. The financial techniques necessary to undertake the fundraising for the State of Alabama were not well understood. Any bond issue for a southern US state that was defeated in the Civil War required not only an acute assessment of the risk of that state's relatively poor financial condition but also an ability to market the bonds as a safe investment to potential investors. This process can be understood as a rare technology of production usually found in a facilitative circuit. The possession of this knowhow empowered Lehman Brothers to dominate the specific field of government finance during these early years.

The funding needs of the state government created an opportunity for an investment bank to offer a solution. The firm's established relationships with the state government officials and its broader business network constitute the obligatory passage point needed to transfer power to the episodic circuit where the day-to-day transactions were executed. Lehman Brothers' adaptability in changing strategy and adopting new businesses through the exercise of power using knowledge and relationships is evident during this period with the evolution from cotton trading to investment banking as a primary source of income after the Civil War.

In the years following the Civil War, railroad development assisted in the transformation of the US from an agrarian to an industrial economy (McPherson 1988, 24-5). The boom in railroad construction generated an extraordinary need for capital which up until then was traditionally met by

the equity capital markets. The use of railroad bonds met these additional funding needs, a trend identified and exploited by Lehman Brothers (Geisst 2001; Nicholson and Pastor 2008). The post-war period was also a time when Lehman Brothers focused on trading various commodities. In 1870, Lehman Brothers was instrumental in the establishment of the New York Cotton Exchange. Due to the firm's role in the Exchange's formation, Emanuel was granted a membership of the Board of Governors which lasted until 1884. Soon, Lehman Brothers began trading coffee and petroleum and was instrumental in the formation of the Coffee Exchange in New York in 1882 (Nicholson and Pastor 2008).

By this time, the firm was an established trader of commodities and debt securities and in 1887, realising that their trading and brokerage skills could apply to the trading of stocks, it became a member of the New York Stock Exchange. This development can be identified as the seminal moment in Lehman Brothers' history whereby the firm "completed its transformation from a merchandiser to a merchant banking firm" (Geisst 2001, 50). Lehman Brothers only gradually embraced the share issuance sector, waiting until 1899 to underwrite its first initial public offering for the International Steam Pump Company. Equity securities underwriting only became a mainstream line of business from 1906 under Philip Lehman, the son of Emanuel Lehman (Geisst 2001, 51).

Retention of Power through Family Control

Lehman Brothers had a policy of admitting only direct family members as partners until 1924. Even in-laws could not aspire to partnership level. An example of this focus on bloodline partnership access is as follows:

John L. Loeb Jr. recalled that his father, who was married to Mayer's granddaughter Frances, couldn't get a job at Lehman Brothers when he wanted to work on Wall Street. They wouldn't hire any in-laws, and in fact for years I don't think there was even a descendant who had a name other than Lehman who got the job (Libo 2008).

Employing family members was a practice of many Jewish family-controlled firms. According to Supple (1998, 168) "nothing was more natural than to find a place for a relative". The employment decisions were usually centralised with the patriarch, thereby maintaining their influence through a form of coercive control. "As long as decision-making could be

concentrated...the personality of the head of the firm, his ability, his contacts and reputation—was all important” (Supple 1998, 170). Due to their religious faith and race, it is likely that being employed within a family-controlled firm may have been the only means by which a German-Jew could have gained a role in investment banking. Supple (1998, 170) asserts that “it is a remarkable feature of the rest of the financial world that other prominent firms never had Jewish partners”.

The policy of employing exclusively Lehman descendants was an attempt to retain power through fixing membership to relations, a characteristic of a dispositional circuit (Clegg 1989). Admitting partners from outside the family would dilute family ownership, and therefore, family control. Although major decisions were often made by the head of the firm, they were often undertaken with some influence from other family members. This day-to-day decision-making reflected the intricate and intimate social relations between family members which ensured outcomes were sympathetic to the ambitions of the patriarch. Family control of the firm was thus safeguarded. The firm employed numerous family members over the years. A family tree showing the family members’ involvement is set out in Appendix B.

After Mayer’s death in 1897 and Emanuel’s retirement shortly afterwards, a second generation of Lehman’s – Philip, Sigmund, Arthur, Meyer H. and Herbert took over and steered the firm towards a pure investment banking business. Philip, the son of Emanuel, became a partner in the family-owned firm in 1887 and was the firm’s managing partner from 1901 to 1925. As discussed before, the Jewish firms preferred to work with each other in securities transactions. Philip continued the practice of working with other Jewish firms and in 1906 he formed an informal partnership with Henry Goldman, the leading partner in the Jewish firm, Goldman Sachs, to exploit the flourishing securities market. As an informal syndicate, the firms were able to fulfil the funding requirements of many Jewish corporations involved in the retail, textile, and cigarette manufacturing industries. The two firms co-participated in several high-profile securities underwriting transactions for corporations such as: Sears, Roebuck & Co.; F.W. Woolworth Co.; May Department Stores; Gimbel Brothers, Inc.; and R.H. Macy & Co. In this twenty-year period to 1926, Lehman Brothers underwrote approximately one hundred new equity issues, very often in conjunction with Goldman Sachs (Geisst 2001).

Bobbie Lehman: Head of Lehman Brothers Partnership 1925-1969



Figure 7.4: Picture of Robert (Bobbie) Lehman
Source: Barker Library
Historical Collections 2012

One of the longest serving Lehman Brothers managing partners of the twentieth century was Robert (Bobbie) Lehman who took over the leadership position in 1925 and continued in this role until 1969. Family control was assured when Bobbie succeeded his father Philip Lehman, following Philip's death.

The first exception to the family member partner policy occurred in 1924 when John Hancock (a non-Lehman family member) was admitted to the partnership, representing a more liberal management approach from the firm's new generation of leaders. Bobbie Lehman continued the firm's pioneering

spirit by backing companies in emerging industries. This strategy was encapsulated in Bobbie's business philosophy that the future of US economic prosperity would be based on mass consumption and not on production. He therefore developed a strategy of identifying and financing growth industries. Some of these industries were involved in developing high technology applications. Companies supported by Lehman Brothers included Digital Equipment Corporation, Allan B. Dumont Laboratories, the first television manufacturer, Radio Corporation of America (RCA), a pioneer in radio communications, and a number of corporations involved in the highly risky film and entertainment industries including RKO, 20th Century Fox and Paramount Pictures. Another example of the pioneering spirit of the firm at this time included the financing of a small airline, run by Juan T. Trippe, a fellow alumnus of Yale University. The service eventually became Pan American World Airways (Barker Library Historical Collections 2012). Bobbie Lehman directed the firm towards industries which more established firms considered to be too risky. The firm also continued to support the retailing industry where it had developed strong knowledge given its merchant trading background. The electronic and

petroleum industries were considered high-risk emerging industries for financiers given the uncertainty surrounding the sustainability and longevity of the natural resource or technologies employed. Lehman Brothers' ambitious strategies allowed it to venture into high-risk activities in search of perpetual growth (Geisst 2001).

The Great Depression of the 1930s made it difficult for many corporations to raise capital. In response to this difficult capital market environment, Lehman Brothers developed an alternative yet adjacent business activity. This activity involved circumventing a public bond issue by issuing securities of corporations with a strong credit profile to investors directly and privately. The practice was known as a private placement and contained conservative loan terms and conditions to provide a tolerable level of risk and an acceptable rate of return for the lenders, whilst enabling borrowers to raise large amounts. Although this is a standard financing technique today, it was quite innovative at the time. The institutionalised use of private placements represented a normative influence over the industry and legitimised Lehman Brothers' role as an expert in the field.

Meanwhile, the company's political power was rising. Herbert H. Lehman, who had been a partner for two decades, was elected Lieutenant Governor of New York in 1928 under Franklin D. Roosevelt. He succeeded Roosevelt as governor in 1932 and served in that role for ten years. In 1949, he was elected to the US Senate, a post he held until six years before his death in 1963 (Cole 1984). By the early 1970s, after Bobbie Lehman and other key partners died, the firm found itself struggling to survive. Bobbie Lehman took Lehman Brothers from a modest-sized firm to become one of the largest investment banks in the US. At the time of Bobbie's death, there were no other Lehman family members employed by the firm and no clear choice for a successor. In the four years following Bobbie's death, the firm struggled under the leadership of Frederick Eham, who had worked at Lehman Brothers since World War II. Eham's lack of authority coupled with a period of poor performance led to a board coup in 1973. Eham was removed as Chairman and replaced by Peter Peterson (Chapman 2010).

Peter Petersen: Chief Executive Officer 1973-1983



COURTESY: THE BLACKSTONE GROUP

Figure 7.5: Peter Petersen

Source: Alchetron

Encyclopedia 2015b

Petersen is credited with reviving Lehman Brothers, turning it into one of the most profitable investment banking firms in New York, and establishing it as an internationally powerful firm which often advised developing nations. During the 1950s and 1960s as the US economy experienced high levels of economic growth, the firm continued to prosper by continuing to fund companies in the risky high-tech industrial sector. The early 1970s however coincided with the onset of a severe recession and by 1973, the firm's operating income was in decline. Petersen was previously US Secretary of Commerce from February 29, 1972 to February 1, 1973 and CEO and Chairman of Bell and Howell Corporation from 1963 to 1971. He was recruited to

Lehman Brothers in 1973 with the titles of CEO and Chairman. Petersen was able to draw upon the authority gained from his experience to provide strong leadership and successfully turn the firm around (Geiss 2001, 77).

Petersen was well-connected, with associates at the upper end of New York society and within government departments. For example, he was often invited to fill casual roles in philanthropic and government organisations such as: in 1969 to the 'Commission on Foundations and Private Philanthropy' where his invitation to join was at the bequest of John D. Rockefeller III, Council of Foreign Relations Chairman, John J. McCloy, and former Treasury Secretary, Douglas Dillon. The Commission became known as the "Peterson Commission" (Brookhart 1998, 2); and in 1971, to the role of Assistant to the President for International Economic Affairs by US President Richard Nixon (Council on Foreign Relations 2016). Petersen's influence within political spheres, which he successfully utilised throughout his business career, was well-established by the time he joined Lehman Brothers. His humble upbringing produced an empathetic quality which was well recognised in Washington and New York and merited a vast network of

useful contacts. Malloch and Mamorsky (2013, 33) describe him as “warm, thrifty and a Wall Street outsider, having grown up in Nebraska, and as the son of Greek emigrant shop-keepers, it was his entry into Wall Street”.

Petersen inherited a significant challenge when he joined Lehman Brothers in the early 1970s. NYSE seat prices had reduced substantially from USD138,000 to USD35,000 over a two-year period to 1977 (Barrett 1999) on the back of lower trading volumes and in 1975, rules were introduced to cease the practice of charging minimum fixed commissions. This prompted a discounting war amongst brokers, which placed further financial pressure on firms. Furthermore, Wall Street faced increased competition in its traditional fields from a variety of sources such as industrial corporations, some of which began to underwrite their own issues. As a result, mergers and bankruptcies had driven the number of NYSE member firms down from the 1960’s high of 681 to 490 in 1975 (Kepos and Derdak 1994).

Petersen immediately set about formulating a strategy for a turnaround which involved expansion and diversification of products offered. Petersen restructured the firm’s product base by focusing the firm’s activities on capital markets trading with an emphasis on the commercial paper market. Petersen’s ultimate successor, Lewis Glucksman, was charged with building the Commercial Paper Division. Many firms dealt with the downturn in revenues by merging operations. Under Petersen’s leadership the firm merged with the Jewish firms, Abraham & Co. in 1975 and Kuhn Loeb & Co in 1977. The firm was renamed to reflect the enhanced domestic and international business lines. Whilst Lehman Brothers, Kuhn, Loeb Inc. was the business name of the US operations, Kuhn, Loeb, Lehman Brothers Inc. was the business name for its offshore operations reflecting the dominance of Kuhn & Loeb’s international presence. “The merged entity was the country’s 4th largest investment bank behind Salomon Brothers, Goldman Sachs, and First Boston” (Sloane 1977).

Kuhn Loeb & Co was one of the country’s pre-eminent investment banks which had also forged its reputation on financing the railway developments of the 19th century. However, like many of the other New York firms, it too was struggling during the 1970s. Abraham & Co was a smaller family-owned stock broking firm. As a result of these mergers, Lehman Brothers was able to turn around its performance. “Peterson led the firm from significant operating losses to five consecutive years of record profits with a return on equity among the highest in the investment-banking industry” (Geisst 2001, 78).

During the 1980s Petersen steered the firm to become increasingly involved in the emerging high-tech industries of personal computers and biotechnology by backing their fund-raising activities. This strategy represented a continuation fostered by Petersen's predecessor, Bobbie Lehman, who focused on seeking out new markets where small organisations could, with the expertise of design, engineering, new applied research and programming, develop into large companies.

Merger and acquisition activity increased in the 1980s as US corporations moved to expand both domestically and internationally. Lehman Brothers exploited this trend by participating in the associated advisory services needed to consummate these transactions. Lehman Brothers,

...advised on several notable US and cross border merger transactions including those between Bendix and Allied, Chrysler and American Motors, General Foods and Philip Morris and Genentech and Hoffman-LaRoche. Furthermore, Lehman Brothers increased its underwriting activity under Petersen and managed a total of 130 deals from 1973 to 1983 (Barker Library Historical Collections 2012).

Petersen's legacy as a turnaround expert lasted into his later years during which he co-founded the private equity firm, Blackstone Group. In 2008, Peterson was ranked as constrained, 149th on the "Forbes 400 Richest Americans" with a net worth of USD 2.8 billion and had subsequently in 2012, been named the most influential billionaire in US politics (Hiltzik 2012).

Lewis Glucksman Chief Executive Officer 1983 – 1984

Lewis (Lew) Glucksman joined Lehman Brothers in the Commercial Paper Trading Department in 1963. His alma mater was the College of William and Mary, Williamsburg, Virginia and later earned an MBA from New York University (Onaran and Baer 2006).

Although the firm's Investment Banking Division gained much prestige associated with its advisory roles, the Trading Division which was later headed by Lewis Glucksman was still generating the majority of income. Peterson, having a reputation as a distinguished banker, had traditionally supported the Investment Banking Division whose share of Lehman Brothers' profits was declining, generating in 1983 less than a third of the firm's profits against the approximately 60% generated by Glucksman's

Trading Division (Auletta 1985; Fishman 2008). However, partners from the Investment Banking Division still held 60 percent of Lehman Brothers' stock, and constituted 42 of the firm's 77 partners (Auletta 1985).



Figure 7.7: Picture of Lewis Glucksman

Source: Valuestockplayers.com 2015

Consequently, by the early 1980s serious friction emerged between the Investment Banking Division and the Trading Division. In order to reconcile the disparity between the profit contributions of the two divisions and their respective representation in senior management, Petersen promoted Lewis Glucksman, the representative of the Trading Division, to be a Co-Chief Executive Officer (CEO) of Lehman Brothers in 1983 alongside Petersen. Glucksman asserted his authority and quickly made changes to favour the traders. This reignited hostilities between the warring factions and coupled with the 1983 declining stock market, a battle for management control ensued between Glucksman and Petersen. According to Geisst (2001, 78) the struggle ended with Glucksman taking control as the sole CEO, “and just like that, the traders were in charge” (Fishman 2008, 3).

This ascension to the sole leadership position was akin to a coup, where a power struggle eventually favoured Glucksman:

Hostilities between the firm's investment bankers and equity and commodity traders caused internal strife. An ex-Chairman of the firm's M&A committee recalls in an interview that Lehman Brothers had an extremely competitive environment which ultimately became dysfunctional (Ryback 2010).

This was the first time in the history of Lehman Brothers where such a hostile coup had taken place and signalled the beginning of the overt appetite for power by a non-family member of the Lehman Brothers' leadership team. Glucksman's aggressive nature had driven him to corral support from other partners. Glucksman undertook concerted action to effect change by communicating the contributions of the Trading Division to the partners and through clandestine meetings of senior management he had gained the necessary power to elevate the Trading Division's status (Geisst 2001). Investment bankers at the time fell into two camps; those involved in the advisory side, and those within the Trading Division. Glucksman's position of co-CEO enabled him to exercise power over other subordinate advisory partners against their will. Glucksman's authority was legitimised not only through his formal position of authority but also through the Trading Division's recent profit contribution which exceeded that of the Investment Banking Division and contributed to all partners' bonuses. Partners could not ignore that the future of Lehman Brothers was inextricably reliant on the continued profits from the Trading Division. An increase in profits translated to higher income for the partners—a motivation for self-interest. However, for this power to be effective, the process of organising must be present (Boje and Rosile 2001). In this instance, the organising occurred through the intimate meetings with small groups of partners where Glucksman was able to exert his influence more easily than through the usual larger partnership meetings.

The process of Glucksman's exercise of power took place during a temporary downturn in the market for investment banking services. This background constitutes an environmental contingency consistent with Clegg's (1989) facilitative circuit. According to Boje and Rosile (2001), the facilitative circuit is a major conduit of variations in the circuits of power. The market downturn conferred the necessary power to Glucksman as partners searched for a way to emerge from the gloomy market conditions, thereby, looking to a leadership change as a possible solution. Ultimately, he challenged Petersen for the sole leadership of the firm and won. The overt exercise of power had established a pattern of acceptable behaviour for the future CEO, Richard Fuld, who had worked under Glucksman for most of his career. Eventually, his assertive and occasional Machiavellian management style would generate a degree of animosity amongst a cohort of investment bankers, leading to a change of fortune (Geisst 2001).

The American Express Takeover

Disaffected investment bankers left the firm and amidst this disintegration, Glucksman was left with few options, so resorted to selling the firm. He left Lehman Brothers following the sale and continued his career several years later with Smith Barney, later to become part of Citigroup. The partners sold the firm to Shearson American Express, a wholly owned subsidiary of American Express Group. Shearson American Express found the business activities of Lehman Brothers complementary to its own which focused on brokerage activities rather than investment banking. The acquisition was considered significant at the time with Shearson American Express paying USD 360 million for Lehman Brothers in 1984. The combined firm became known as Shearson Lehman American Express (Cole 1984). By 1990, Shearson Lehman Brothers, the investment banking arm of the Shearson Lehman American Express conglomerate, split its operations into a Shearson Retail division and a Lehman Brothers Investment Banking/Trading Division, whilst under continued ownership of the American Express group. At the time of this split, Richard Fuld assumed joint leadership of the Investment Banking/Trading Division with J. Tomlinson Hill, who headed the Mergers and Acquisition Division (Halpern 2011). The two executives were involved in a power struggle from the start. Ultimately, Fuld manoeuvred his way to become the sole CEO when Hill eventually departed in 1993 to join Petersen in the Blackstone Group (Halpern 2011).

Following the Lehman Brothers acquisition, there were some major management changes. An important appointment was that of Peter Cohen, who became the Chairman and CEO of the Shearson Lehman American Express division of the American Express Group (Forbes.com 2011). American Express had for several years during the 1980s and early 1990s been pursuing a financial services diversification strategy which involved several major acquisitions. The first involved the acquisition of the second largest brokerage firm in the USA, Shearson Loeb Rhoades, in 1981 to establish the group's brokerage arm to be known as Shearson American Express (Geisst 2001). In 1984, the American Express group acquired Investors Diversified Services. The target firm had been established for 90 years and consisted of a valuable team of financial advisors and a wide range of personal financial products. Shearson American Express then in 1988 purchased E.F. Hutton & Co., another well-established securities firm

dating back to 1904 and changed its name to Shearson Lehman Hutton Inc. (Cole 1987).



Figure 7.8: Picture of Harvey Golub

Source: Alchetron Encyclopedia, 2015a

In 1993, American Express, under its new Chairman, Harvey Golub, undertook a reversal of the previous expansionary strategy in an effort to improve its performance during an economic cyclical downturn and reduce its exposure to the securities industry. The financial conglomerate disposed of its retail brokerage and asset management operations known as Shearson to Primerica which merged it with its own retail brokerage business, Smith Barney, to form Smith Barney Shearson (Quint 1993). Soon thereafter in 1994, American Express divested itself of Lehman Brothers Kuhn Loeb. This was effected by way of an initial public offering (IPO), with the result being a

new entity to be known under its final name of Lehman Brothers Holdings, Inc. (Geisst 2001). Lehman Brothers was again independent of any parent company and now answerable to its own public stockholders as opposed to individual partners. Lehman Brothers continued to operate in many of the same business lines that it had done previously with a continued focus on mergers and acquisitions and trading. The focus between the two main areas of business would vacillate in the ensuing years depending on the economic circumstances and the firm strategy as dictated by Richard Fuld. A table listing the leadership of Lehman Brothers over the years since its inception is set out in Figure 51.

Figure 7.9: Leadership of Lehman Brothers 1850 – 2008

Period of Leadership	Leader	Summary
1850-1906	The Lehman Brothers	The founders who established an Alabama based dry-goods store and a New York headquartered commodity-brokerage
1906-1925	Philip Lehman	Expanded Lehman Brothers from a commodities business to an investment bank involved in new securities issues
1925-1969	Robert 'Bobbie' Lehman	Steered Lehman Brothers through the Depression by focusing on venture capital and supported innovative corporations in new industries. Managed LB through a prosperous period.
1969-1973	Frederick L. Ehrman	An interim Managing Partner
1973-1983	Pete G. Peterson	A well credentialed corporate executive who was employed to rescue Lehman Brothers. He led Lehman Brothers to become the fourth-largest US investment bank.
1983-1984	Lewis Glucksman	Ousted Peterson, by pursuing a greater influence for the Trading Division which accounted for the bulk of the profits. Subsequent poor performance led to the acquisition by American Express.
1984-1990	Peter A. Cohen	Cohen was the head of American Express. Fuld assumed the leadership once LB was listed by American Express.
1994-2008	Richard Fuld	CEO until its bankruptcy.

Source: Fishman 2008

The pre-Fuld era spanning the period from the founding of the firm to the listing on the NYSE witnessed various episodes of tumultuous change. However, despite the rollercoaster ride of fortunes and leadership, from a historical perspective, the firm endured a parallel course with the

investment banking industry. The underlying themes affecting the investment banking industry are analogous with those evident in the development of Lehman Brothers. Similar to the industry at large, the penchant to develop personal relationships with government authorities and officials, the influence exerted by investment bankers through their networks, and the thirst for power internally and over external parties, imbued the organisational culture of Lehman Brothers.

The Sticky Web of Power and Culture

The effective use of networks by Lehman Brothers began with the founders who exploited the Jewish connection and the influence gained through Emanuel's directorships of other corporations and membership of official institutions such as the New York Cotton Exchange. The Jewish network was helpful in obtaining commercial advantage through free trade credit and later by the club arrangements with other Jewish investment banks, whereby co-participation in one another's deals protected a segment of the market from external competition.

The extent to which the Lehman Brothers pursued acceptance by New York society to further their ability to penetrate the valuable commercial and social networks included changing their names and relocating their business premises to be close to their associates and competitors. The normative influence which spurred these actions only succeeded in cementing their key relationships, and therefore enhanced their power base. The emphasis on nurturing networks to facilitate further business and gain favour was no different for subsequent generations. This was evident in the 1970s, when the family appointed well-networked Petersen as the new CEO, in the hope that the combination of his business acumen and valuable corporate and political connections could turnaround the firm's fortunes during difficult times.

The value of political connections is also demonstrated when Lehman Brothers was appointed as the financial advisor to the State of Alabama. This achievement coincided with the first bond issue for the state following the Civil War. The transaction required particular knowhow and skill, firstly in arranging the bond structure and secondly, in convincing potential investors of the merits of the issue. Again, this knowhow differentiated Lehman Brothers from its competitors, which positioned the firm to be a

unique provider of the structuring needed, thereby gaining even further favour from government. The valuable networks provided the firm with the necessary influence to entrench itself in the commercial world and expand its business interests domestically and internationally.

The concept of taking elevated risks to generate a commensurate return was a concept understood well by the firm, and entrenched as a cultural behaviour by the founders. The Lehman brothers realised early the benefits of warehousing inventory. This innovative practice introduced risks associated with the exposure to a volatile price for cotton which could have resulted in losses magnified by the large volumes of inventory held, but on the other hand, provided the potential for enhanced profitability. It also facilitated a degree of power within the cotton industry as the warehousing strategy enabled Lehman Brothers to meet customer demand, take advantage of pricing cycles and even control supply.

The extending of credit to farmers, who themselves represented risky credit due to the uncertainty of the quantity and quality of harvests, was innovative. The creativity demonstrated by the brothers was also exemplified by accepting repayment in the form of cotton bales instead of cash. This practice represented an extension of the firm's previous experience of bartering general merchandise from their store in exchange for cotton goods from the public. Other evidence of the risk-taking culture exhibited by the founders included the running of the Union blockade during the Civil War, where their merchandise was at risk of piracy, ship damage or loss, or even confiscation by the Union army.

The risk culture established by the founders continued to the Philip and Bobbie Lehman eras. During these years Lehman Brothers was involved in servicing corporate clients by underwriting their securities issues. Both Philip and Bobbie pursued a strategy of supporting nascent industries such as the film, petroleum, high technology and biotechnology industries, in which corporations were less well established and therefore posed greater credit risks. However, the commissions earned for these transactions were also higher and linked to the riskiness of the exposures to the corporations. Coupled with this type of risk taking was the innovative approach to fundraising, which was developed by establishing the first private placement.

The exercise of power was an effective means of promoting the business and retaining control by the firm's leadership. The policy of restricting the appointment of partners to family members was an example of this type of power. It was not until decades after the formation of Lehman Brothers that a non-partner was admitted, and this was due to commercial necessity and a thinning of the Lehman ranks. Control was seen as important in pursuing personal goals as much by the Lehman family as it was for Richard Fuld. However, in the latter years of the pre-Fuld era, the exercise of power by certain individuals promoted episodes of dysfunction within the ranks of senior management. Firstly, the internal struggle for power between Glucksman and Petersen ended with the acrimonious departure of the latter. Then Glucksman departed after resorting to selling the firm following a virtual revolt by the other partners. This was followed by another similar pursuit of power by Fuld when as co-head of the Investment Banking and Trading Division, he ousted fellow co-head Tomlinson-Hill to assume the sole leadership position of the division.

This overtly aggressive culture continued even after Fuld was appointed CEO and Chairman—this period is known as the post-Fuld era. Fuld, whose tenure with Lehman Brothers overlapped both the pre-Fuld and post-Fuld periods, was able to assimilate the behavioural traits exhibited by his mentor, Glucksman. He was therefore able to transmit the observed experiences of social interactions within the firm and able to further mould the organisational culture to match his own personal objectives and values. The following section outlines the key personalities within Lehman Brothers during the post-Fuld era and analyses how Fuld was able to exert his influence throughout the firm by using subordinates as instruments of his design or according to Clegg (1989) as his “obligatory passage point” in the quest for power.

CHAPTER 8

THE POST-FULD ERA (1994–2008)

This section examines the history of the firm from the time Fuld ascended to the leadership position of CEO and examines the impact of some key events during this period on the development of the firm's business activities, performance, corporate culture and relationships within and external to the firm. The post-Fuld era is considered the period in which the beginning of Lehman Brothers' downfall was rooted. It was characterised by the appointment of like-minded individuals who followed Fuld's mantra of "growth at all costs" and a risk appetite clearly higher than had been prevalent in the past. The growth of Lehman Brothers during this period also coincided with the growth in innovation of financial products, corporate activity, and financial markets trading volumes. Whilst investment banking firms experienced remarkable growth, the partners in firms were well rewarded and found comfort in their job security. This environment generated a sense of satisfaction in leadership and ultimately engendered a degree of hubris, especially within Lehman Brothers.

Richard Fuld

Richard Fuld was born in 1946 and began his career in the US air force as a pilot (Bawden 2008). Fuld then moved to Lehman Brothers in the Trading Division as a commercial paper trader in 1969. Glucksman, similarly a trader by background, was the head of that division at the time and had become a major influence and mentor to Fuld. By the 1980s, Fuld was promoted as head of the Fixed Income and Equities Division. This was known as an important role heading a core activity of the firm (Halpern 2011). He served as CEO of Lehman Brothers from the time of its spin-off from American Express in 1994 until December 31, 2008. Since joining the firm, Fuld's career with Lehman Brothers had spanned 30 years. An extract from Lehman Brothers' prospectus reveals that at the time of Lehman

Brother's bankruptcy Fuld held numerous positions outside of the firm. Fuld served on:

... the Board of Directors of the Federal Reserve Bank of New York and is a member of the Executive Committee of the Board of Directors of The Partnership for New York City. He is a member of the International Business Council of the World Economic Forum and The Business Council. In addition, he serves on the Board of Trustees of Middlebury College and New York Presbyterian Hospital, as well as on the Board of Directors of the Robin Hood Foundation (Lehman Brothers Holdings 2008j, 48).

His roles with the Federal Reserve Bank of New York and International Business Council of the World Economic Forum provided him access to numerous influential executives in the regulatory and economic policy fields. Following the 1984 acquisition by American Express and amalgamation of Lehman Brothers with the Shearson subsidiary, the combined business then known as Shearson Lehman Brothers was structured into three divisions: investment banking, equities and fixed income (Halpern 2011). In 1990, the business split its operations into two divisions: a retail division under the name of Shearson; and Lehman Brothers Investment Banking/Trading Division. It was the latter division which was co-led by Fuld and J. Tomilson Hill, and later taken over by Fuld individually.



Figure 8.1: Picture of Richard Fuld CEO of Lehman Brothers 1993-2008
Source: *Daily News* 2010

Fuld was a very successful trader within the Fixed Income Division, however perceptions of his interactions with co-workers were decidedly limited throughout his career (Halpern 2011). As a manager, Fuld was severe and exacting. He is quoted as saying "I take it as a personal failure to lose money" (Fishman 2008, 3). In addition, Fishman (2008, 3) claims that Fuld managed by intimidation "he thought he could intimidate you out of losing money". A notorious

temper earned Fuld, who had been a weightlifter, the nickname of "gorilla" (Tully 1995). Fuld possessed a "palpable inner intensity, which gave him an almost animalistic presence ... [and] ... made it seem like [a situation] will lead to physical violence if you didn't relent" (Fishman 2008, 1).

As Fuld's direct manager for many years, Glucksman became an influential role model to him. Fuld's Jewish middle-class background differed from Glucksman's, who was resentful of the typical ivy-league educated investment bankers from the non-trading division whom he often referred to as "fucking bankers" (Fishman 2008, 3). Investment bankers as opposed to the traders were often perceived as elitists within the industry who commanded intellectual superiority. Traders, such as Glucksman and Fuld, were transaction-focused and prided themselves on generating quick profits, usually using a 'trader's instinct'. This contrasted with the perceptions of investment bankers who relied on time-consuming relationship building and sophisticated structuring and analytical skills (Auletta 1985). Glucksman was confrontational towards investment bankers, exuding authority and indignation. His outbursts became legendary within Lehman Brothers. "In a rage, he once ripped the shirt off his own back and Fuld followed in the master's footsteps" (Fishman 2008, 4).

Fuld readily accepted Glucksman's behaviour as normal within the Trading Division where an aggressive attitude befitted the image commonly portrayed in that environment. Traders were expected to make profits from betting on price movements of financial instruments and were required to beat their counterpart on the opposite side of the deal in the fast-paced market environment. Trading activity was considered combative and a weak demeanour was perceived as undesirable. Fuld understood the importance of sustaining a strong-willed appearance in the trading room environment. He enjoyed being referred to as 'the gorilla' and positioned a life-size image of a gorilla in his office near the trading floor (Fishman 2008). This behaviour is evidence of an aggressive corporate culture where dysfunctional behaviour was mimicked and condoned.

Fuld's nature can be traced to the early years of his career. He graduated with a Bachelor of Arts and Bachelor of Science from the well-regarded University of Colorado and a Masters of Business Administration from New York University's Stern School of Business, one of the prominent business schools in the US. Following his studies, Fuld entered the US Airforce to

train as a pilot. However, he was soon dismissed for engaging in a violent altercation with his commanding officer (Bawden 2008). The grounds for his dismissal represent early evidence of Fuld's aggressive nature and willingness, on an impulse, to sacrifice the valuable opportunity offered by his air force career.

In his first year as CEO, Fuld was faced with a challenging task. American Express group CEO, Harvey Golub, wanted to extricate the group from the volatile brokerage business and in doing so sold Shearson, its retail brokerage and asset management operations to Primerica and then divested of Lehman Brothers Kuhn Loeb through an initial public offering (IPO). In the process he burdened Lehman Brothers with excessive financial liabilities. Under the arrangements of the USD 2 billion IPO in 1994, American Express had transferred to Lehman Brothers potentially damaging liabilities for a number of failed limited partnerships that previously operated under the American Express Group umbrella. American Express had also contracted to receive some of Lehman Brothers' future profits and for Lehman Brothers to lease vast areas of floor space owned by American Express under long term leases. These arrangements were designed to improve American Express' return on its original investment in Shearson/Lehman 10 years earlier. Immediately following the IPO, investors reacted to the heavy financial burden imposed on Lehman Brothers by discounting its shares until they were trading at less than book value (Tully 1995).

Fuld's New Team

Fuld needed to react to the markets' negative perceptions of Lehman Brothers following the American Express disposal and set about forming an inner circle of executives who shared a similar background, both intellectually and socially. Fuld sought out executives who shared common attributes, such as an ambition to succeed. He however refused to appoint a second in charge, and for the following 8 years, Lehman Brothers operated without a deputy CEO. His reluctance to appoint a natural successor may be due to his experience of observing the struggle for leadership between Peterson and Glucksman. Lehman Brothers soon reverted to operating under three divisions and Fuld undertook a management restructure appointing new heads of the three main divisions of investment banking, equities, and fixed income. One of Fuld's first tasks

was to rank the divisions in terms of profitability and commit an increasing share of the firm's resources towards the best performer. Notwithstanding his contempt for the Investment Banking Division which he inherited from Glucksman, the mergers and acquisitions department (part of the investment banking team) generated the highest margins within the group. He therefore directed most of the firm's investments to this activity, also supporting the equities department by recruiting several expensive candidates. This restructure increased the firm's risk profile as the performance of the Mergers and Acquisitions and Equities Trading Divisions was highly subject to fluctuations in economic conditions. Fuld's commitment to surround himself by high achievers is reflected in the compensation he was prepared to pay to new recruits.

In January 1997 Fuld approved USD 48 million for additional executive compensation. From this amount, USD 46 million was earmarked for the Investment Banking, and Equities Divisions, with USD 2.4 million for the Fixed-Income Division. Fuld's strategy was to clearly reposition Lehman Brothers away from its traditional reliance on fixed income (Halpern 2011).

This strategy shows that Fuld, as an ex-division head of fixed income, did not allow sentimentality to interfere with a business strategy that he preferred to pursue. Fuld revealed in a speech in 2007, that he disliked disagreements amongst his senior management, emphasising that a team approach to a common goal was the attribute he most desired in an employee. "The most dissension [Fuld] will tolerate is an agreement to disagree. What [Fuld] needs is peace in the family" (Wharton School of the University of Pennsylvania 2007). Fuld selected key employees who, like himself, exhibited initiative. He therefore placed importance on leading by example. "Real power is the ability to empower others...a good leader brings out the best in others. The real reward is in seeing others' achievements" (Wharton School of the University of Pennsylvania 2007). The result was a team that largely consisted of individuals who shared similar leadership qualities with Fuld and therefore a propensity to make similar management decisions.

An avid squash player, Fuld preferred to recruit executives with a background in sport. "They know how to compete and lose, how to pick themselves up and go on to win again" (Wells 2004). Bonuses were largely paid in shares and for the executive committee were vesting after five

years. The long-term nature of the vesting provisions was an effort to retain successful employees who over the years had accumulated large bonuses. “You had to decide whether you were going to stay and try to make this work. A lot of people left” (Fishman 2008, 3). For those who remained, Fuld was able to generate intense loyalty, especially from the group of colleagues who followed his rise through the Fixed Income Division. The inner sanctum was selected from a pool of executives consisting of those on the executive committee and former heads of key divisions. They were influential in the formation of the firm’s culture and were therefore complicit in the financial decline of the business. An understanding of their backgrounds is helpful to provide an insight into the evolution of the dysfunctional culture.

Chris Pettit—Chief Operating Officer



Figure 8.2: Chris Pettit: Chief Operating Officer Lehman Brothers, 1996

Chris Pettit, President and Chief Operating Officer (COO), worked under Fuld for twenty years. As a long-serving ally, he was trusted by and worked closely with Fuld. Pettit, a graduate of West Point, served as a captain in Vietnam and was described as a high achiever considering his numerous accomplishments—twice all-American leading scorer, and captain of the lacrosse, football and basketball teams at Westpoint and named to the Long Island Lacrosse Hall of Fame (West Point Association of Graduates 1997). Fuld relied heavily on Pettit to run the business on a day-to-day basis and therefore Pettit held the most important and influential position after that of CEO. Pettit, a loyal employee of

Lehman Brothers had a personal objective similar to that of Fuld:

... to wind Lehman back closer to how he found it in 1977 when he signed on as a young salesman fresh out of teaching math in junior high school—a proud institution run by loyal partners. It's not a job, he seems to believe it is his destiny. ‘Many, many years from now,’ he says, ‘I want my name etched in granite in the corridors of Lehman (Tully 1995, 1).

On 15 March, 1996, Pettit resigned under circumstances which were kept confidential at the time. However, Lehman Brothers later publicly announced that the resignation was due to Pettit's disagreement over the direction of the company (Truell 1997). In reality, it had been discovered that Pettit had an extramarital affair which violated Fuld's unwritten rules on marriage and social behaviour (Truell 1997). Even as a loyal lieutenant, Pettit could not be protected from the drastic reaction of the firm to distance itself publicly on grounds of a personal matter occurring in a private domain. It was reported later that "friends and colleagues of Mr. Pettit said he eventually had a falling out with Richard S. Fuld Jr., the Chairman and CEO, over whether Lehman should be run by a committee or by one strong figure like Mr. Pettit" (Truell 1997). Pettit, a strong leader, obviously garnered support from his team and friends and appeared to pose a challenge to Fuld's overarching leadership. The true reasons for Pettit's resignation can therefore only be presumed, however, either way it represented the removal of a key executive that no longer fitted within Fuld's newly constructed organisation. Christopher Pettit died one year after his resignation in 1997 due to a snowmobile accident, at the age of 51 (Truell 1997).

Pettit's ousting is an example of the way Fuld's personal beliefs and values were inculcated into the firm's decision-making framework. Fuld exercised his power by justifying the dismissal to himself through the lens of his own values. The dismissal sent a clear signal to all staff that extramarital affairs would not be tolerated and thus became a "rule of practice". Fuld replaced Pettit with Bradley Jack and Joseph M. Gregory in 2002. Jack was soon demoted to head up the firm's investment banking relationships and left in June 2005 with a redundancy package of USD 80 million, leaving Gregory as the sole COO (National Public Library 2016). Bart McDade, previously in the position of head of equities, replaced Jack and continued in this role until the collapse of Lehman Brothers.

Bradley Jack—Co-Chief Operating Officer



Figure 8.3: Bradley Jack
Source: (legacy.com/us)

Fuld's cronyism extended to individuals from the Trading Division, where his own career had been established and where individuals mostly shared values similar to his own. In 1984, after completing his Bachelor of Arts from the University of California, Jack commenced with Lehman Brothers as an associate in the Fixed Income Division, part of the Trading. He soon became the head of the Fixed Income and Global Syndications Division and later, ascended to the role of Head of Investment Banking in 1996 where he

remained until 2002. There is little other information about Jack's involvement in Lehman Brothers including the circumstances around his demotion. However, according to a statement issued by Fuld, Jack retired in 2005 to pursue work in the not-for-profit sector and spend time with his family (Carmiel 2012).

In 2011, well after he retired from the firm, Jack, then 53, turned himself in and was charged with second-degree forgery for an incident at a pharmacy in which he faked the date on a doctor's prescription for a controlled substance (Dolmetsch and Dillon 2011). A further testimony to Jack's character is that he was forced to sell his home after having failed to pay property taxes on his property estate. The tax matter was resolved eventually, and the property was sold for USD 62 million in October 2013 (Budin 2013). Testament to his character, the official tax collector for Fairfield, Connecticut, described Jack as "the most delinquent taxpayer" (Carmiel 2012).

Joseph Gregory—Chief Operating Officer



Figure 8.4: Picture of Joseph Gregory

Source: DeCambre, 2009

Joseph Gregory was appointed sole President and COO in 2004 after sharing that position with Bradley Jack since 2002. Like Fuld, Gregory joined Lehman Brothers as a commercial paper trader, part of the Trading Division, following the completion of his Bachelor of Business Administration in 1974 at Hofstra University, New York. He was a loyal employee, spending his whole career with the firm until its collapse (Fitzgerald 2009). Gregory held several management positions from 1980 to 1991 and from 1991 to 1996 he became Co-Head of the Fixed Income Division. He moved to head the Equities Division from 1996 to 2000 and from this time until 2002, he was the Chief Administrative Officer.

Gregory complemented Fuld and openly declared he had no interest in the CEO position. “He was known as ‘Mr. Inside’ (Fuld was known as ‘Mr. Outside’), and ran the firm operationally on a daily basis” (Fishman 2008, 4). Gregory delivered on Fuld’s business strategy and focused on generating a culture of team outperformance believing this was the key to success. As explained by a former executive, it was Gregory’s view that “If you got the people and the culture right, they would run the firm day-to-day in a great way” (Fishman 2008, 4). Gregory was also reported as saying “[t]rusting your instincts, trusting your judgment, believing in yourself...and making decisions on the back of that trust is a remarkably powerful thing” (Fishman 2008, 4). This is considered a telling comment from the second in charge of a sophisticated investment bank. Common wisdom in management literature promotes rational decision-making, a process where decisions should be made on an informed basis using all available information and resources as opposed to the use of instincts. Instincts and personal judgement as opposed to informed decision-making was a common trait amongst traders at Lehman Brothers. Gregory was replaced by Bart McDade, shortly before the bankruptcy (Truell 1996).

Thomas Russo—Chief Legal Officer



Figure 8.5: Picture of Thomas Russo

Source: Equilar Atlas 2008

Since the early days of Lehman Brothers following the American Express separation, Thomas Russo held the position of Chief Legal Officer at the management level of Executive Vice President. In this role, he became a member of and counsel to the firm's executive committee. Prior to joining Lehman Brothers, Russo was a senior partner at Cadwalader, Wickersham & Taft (CWT), a New York law firm. His interests also lay in institutional and regulatory authorities such as: The Institute for Financial Markets where he was Vice Chairman of the Board of Trustees; The Regulatory Policy Committee of the Board of Governors of the Financial Industry Regulatory Authority (FINRA) where he was a member; The Federal Reserve Bank of New York where he was on the International Advisory Committee; and member of the Committee on Capital Markets Regulation (Equilar Atlas 2008). Russo was well-known within regulatory circles given these roles and during his time at CWT, he specialised in corporate law, Commodity Futures Trading Commission (CFTC) matters, SEC enforcement and broker-dealer operations. His interest in regulation was formed in the early part of his career when from 1969 to 1971 he was a lawyer in the market regulation division of the Securities and Exchange Commission and from 1975 to 1977 when Russo was the deputy general counsel and the first director in the Division of Trading and Markets of the CFTC. Russo's reputation in government circles also qualified him in 1987 to serve as an advisor to the Brady Commission. This career and extensive experience provided the firm with access to an extensive network of regulators and insights into the regulatory process and more importantly, the philosophical biases amongst regulators at the time.

Ian Lowitt—Chief Financial Officer

Figure 8.6: Picture of Ian Lowitt

Source: Carney & White 2010

Ian Lowitt graduated from the University of Witwatersrand in Johannesburg, South Africa, with a Bachelor of Science in Electrical Engineering and Masters of Science in Digital Electronics. He also gained a Bachelor of Arts in Philosophy, Politics and Economics and Masters of Science in Economics from the University of Oxford where he was a Rhodes Scholar. Lowitt moved to

Lehman Brothers from McKinsey and Co. in 1983 as Head of Corporate Development and from 2000 to 2008 had progressed through several senior management positions. He held roles such as: Treasurer and Global Head of Tax; Executive Vice President for Lehman Brothers Europe; Co-Chief Administrative Officer; and from June 2008 to the time of the bankruptcy, as the Chief Financial Officer. The role of Treasurer within any financial institution is a key position and important in the strategic and day-to-day funding activities of the firm. Therefore, Lowitt would have had a deep insight of the firm's liquidity management and therefore, aware of the precarious nature and unreliability of repurchase agreements, a treasury instrument used to raise short term funds. As it turned out, Lehman Brothers had an over-reliance on this funding source, the market for which had dried up for Lehman Brothers in the weeks leading to its bankruptcy (Bloomberg 2015b; Carney and White 2010).

Michael Gelband—Global Head of Fixed Income



Figure 8.7: Picture of Michael Gelband

Source: The Real Deal, 2015

Michael Gelband graduated from the University of Georgia with a Bachelor of Business Administration and from the Ross School of Business at the University of Michigan with a Masters of Business Administration. He commenced with Lehman Brothers in 1983 and held several senior positions within the Fixed Income Division culminating in the role of Global Head Fixed Income Division from 2005 to 2007. Gelband was also appointed to the most senior executive committees of Lehman Brothers (McDonald and Robinson 2009). Gelband proved to be a skilled operator within the Trading Division and his relevance in the Lehman Brothers story revolves more from the circumstance of his departure than his appointment. Gelband was removed for his disagreements with Fuld on the excessive risk taking by the firm (McDonald and Robinson 2009). Gelband left Lehman Brothers in May 2007 and was eventually employed by Millennium Management, a New York-based alternative investment manager (HedgeWeek 2008). Rather than publicly announcing Gelband's dismissal from Lehman Brothers, it was announced that he departed to pursue other interests (Mathiason et al. 2009). Gelband was one of only a few subordinates willing to challenge Fuld on the strategic direction of the firm. He also objected to some large property transactions which appeared profitable and prestigious at inception, however, were considered highly risky at a time when the property market was increasingly susceptible to a downfall. The following quote reveals that insiders of the firm considered Gelband as unique in his opposition to Fuld:

... The truth, though, was somewhat different. Gelband was, according to Lehman insiders, at loggerheads with Fuld's lieutenants. He had rallied against a huge buying of a collection of subprime mortgage lenders, and also in particular a USD 15bn property consortium bid, led by Lehman, to buy the US's biggest apartment company at the top of the market...

According to Lehman insiders, he was almost alone among the 26,000-strong organisation in being prepared to stand up to the now disgraced former chairman and chief executive of what has become the world's biggest bankrupt company (Mathiason et al. 2009).

Herbert 'Bart' H. McDade III—Chief Operating Officer



Figure 8.8: Picture of Herbert 'Bart' H. McDade III

Source: Bloomberg 2015a

Bart McDade joined Lehman Brothers in 1983 and similar to Fuld, Jack, Gregory and Gelband, he started in the Fixed Income Division. He graduated with a Bachelor of Arts from Duke University and a Masters of Business Administration from the University of Michigan. In 1991, MacDade was appointed as Head of the Corporate Bond Department and in 1998, he progressed to the position of Global Head of Debt Capital Markets and concurrently named

as a member of the Committee overseeing the Investment Banking Division. In 2000, McDade was elevated to the key Executive Committee, and at the same time, assumed the role of Co-Head of the Fixed Income Division. From 2005, he headed the Global Equities Division and eventually replaced Gregory as COO shortly before the bankruptcy (Plumb and Wilchins 2008b). During his period in executive management, McDade's responsibilities encompassed the mortgage business which after recording huge losses was a major contributor to Lehman Brothers' collapse. McDade later joined Barclays for a brief period following the British bank's acquisition of the US operations of Lehman Brothers following the bankruptcy (World Heritage Encyclopedia 2015).

Hugh E. ‘Skip’ McGee III—Head of Investment Banking



Figure 8.9: Hugh E. ‘Skip’ McGee III

Source: Levin 2015

Hugh (Skip) McGee graduated from Princeton University with a Bachelor of Civil Engineering and achieved a Juris Doctor degree with honours from the University of Texas Law School. He was considered an intellectual and continued his association with the university sector as a Member of the Advisory Council of McCombs School of Business at the University of Texas and a

member of the Advisory Council for the Bendheim Centre for Finance at Princeton University (Intrepid Financial Partners 2016). McGee joined Lehman Brothers in 1993, and became the Head of Lehman Brothers’ Global Natural Resources and Power Investment Banking Groups and a member of the Operating Committee of Investment Banking. He was then promoted to the executive in charge of the Global Investment Banking Division from 2002 until 2008 (Williams 2010). At the time of his promotion to Head of Global Investment Banking, he was the longest serving head of an Investment Banking Division in New York. During his time in the Investment Banking Division McGee presided over some significant transactions, including the largest leveraged buyout in history (former TXU Corp) and a USD 41 billion acquisition of XTO Energy by Exxon Mobil (Perlberg 2013). McGee also helped lead Lehman’s efforts to spin off toxic assets in the prelude to the crisis.

McGee was an executive who was responsible for the substantial increase in Lehman Brothers’ risk profile in 2006 and 2007, particularly through his advocacy of supporting leveraged buyouts. These transactions involved effecting a takeover with mostly borrowed funds. According to Valukas (2010, 58-9), “[a]long with Fuld and President Joe Gregory, and over the objections of other senior executives, McGee advocated that Lehman loosen controls and lend its own capital to private-equity companies for leveraged buyouts”. Despite his apparently impeccable reputation within the investment banking community in his early career, in later life,

McGee's ethics were questioned. Following his career at Lehman Brothers, and during his role as head of the US operations of Barclays, he was involved in a large fraud. McGee oversaw a trading operation which was found guilty of manipulating energy markets for profit. The Federal Energy Regulatory Commission commanded Barclays, including four of its former traders to pay a total of USD 488 million in penalties (Abelson 2013). The review of the incident conducted by Rothschild Vice Chairman Anthony Salz, stated that the "investment banker McGee helped lead a source of entitlement and ethical ambiguity...A few investment bankers seemed to lose a sense of proportion" (Abelson 2013). Steep bonuses and pay for senior executives were considered a root cause of the fraud. It "contributed significantly to a sense among a few that they were somehow unaffected by the ordinary rules" (Abelson 2013).

This chapter outlines a history of Lehman Brothers highlighting events and personalities that contributed to the development of the three overriding themes: reliance on official, personal and commercial networks; personal characteristics of key individuals; and the entrepreneurial culture of the firm. The chapter was divided between the pre-Fuld and post-Fuld era to delineate the influences of past leaders. Fuld had characterised his leadership by appointing to crucial positions like-minded, compliant staff who shared his values. These appointments almost exclusively originated from the trading side of the business, an area in which Fuld devoted much of his career and where he understood the trader transaction-oriented mentality. Of the eight executives described, six originated from the Trading Division, the exceptions being Russo whose position required a specific legal background and McGee who as Head of Investment Banking Division was appropriately promoted from that side of the business. Moreover, these appointments reflected an inner circle with whom Fuld could feel comfortable and avert conflict.

In Pettit, he found his original second in command, a loyal follower who eventually contravened Fuld's own personal values and was therefore cast adrift. In Gregory, he found a sycophant, who overtly confessed that he had no aspirations for the leadership role and therefore became a safe ally in Fuld's quest to retain his throne. In Jack, he found a fellow fixed-income trader with similar ideals, motivations and practices, especially a motivation for self-enrichment. In Lowitt, he found a malleable and skilled operator who could transform from the central role of a Treasurer which required a trader's skill base, to a Chief Financial Officer. In this latter role,

Lowitt was responsible for the preparation and presentation of financial information to the wider investment community and establishing a positive perception necessary to ensure continued funding. In Russo, he found a skilled regulator who had access to useful connections within the regulatory and legal spheres and who would be found to conform to the firm's ideological interpretations of regulations and accounting practices. In Gelband, McDade, and McGee, he found intellectuals highly skilled in their field, who were driven to succeed and could be relied upon to maximise the firm's profits. In summary, each appointee was useful to Fuld's ambitions and stated objectives of "growth at all costs".

The cohort of senior management afforded the CEO the power to pursue his personal agenda. This power can be located in Clegg's (1989) dispositional circuit where, as the most senior executive in the group, Fuld had the power to promote or dismiss any executive. Through Fuld's dominant position in the hierarchy, he was able to influence his personal relations with each individual and his social relations with them as a group representing the passage point to the episodic circuit where these subordinates would carry out the firm's tactical decisions. Each executive therefore represented an agency through which Fuld was able to carry out his strategic objectives. They were provided with the resources and motivation to generate the outcomes that Fuld desired. Any resistance was addressed by Fuld in one of three ways: a reprimand, usually involving aggressive behaviour by Fuld; a sidelining of the executive to an innocuous position; or in the worst case, dismissal.

Fuld was able to legitimise his power through the firm's rules of practice also found in Clegg's (1989) dispositional circuit and which included amongst others, the group accounting policy manual, personal compensation practices, the internal reporting framework and the firm's risk management policy documents (Lehman Brothers 2008e). These documents regulated work practices and guided behaviour within the firm. Breaking the rules incurred consequences. Apart from the rules of practice contained in formal internal documentation, Fuld had allowed a cultural and moral organisational culture to evolve in accordance with his own values that were driven by an insatiable desire for growth, even if that meant raising the risk profile of the firm. The written and unwritten rules of practice were integrated within the firm through individual and social relations established by Fuld and his executives. These rules of practice, which filtered down throughout the organisational hierarchy, fixed

relationships of meaning and membership amongst staff. A principal outcome of which was the loyalty Fuld generated amongst a large majority of his team. This enabled Fuld to prolong his grip on power and his claim to being the longest serving CEO in Lehman Brothers' history since Bobbie Lehman's reign.

At various points in Lehman Brothers' history, power was exercised within the firm to generate outcomes beneficial to the CEO and at times, arguably to the detriment of the firm—especially in terms of risk. The foundations of Lehman Brothers' business model and organisational culture were clearly established in the pre-Fuld era. In this era of Lehman Brothers' history, the founders' influence relating to innovation, business expansion, and effective use of networks and knowledge were combined with a focus on pursuing business activities consistent with the competitive strengths of the firm. A high degree of control exerted over subordinates and decision-making by the firm's leadership was integral to achieving the objectives of the managing partner or CEO. For example, the elevation to partnership of only Lehman family direct descendants in the early days of the firm's history, ensured tight control over the firm's strategic direction.

In the post-Fuld era, the inherited organisational culture emphasised the employment of individuals with sympathetic goals to those of the CEO. Key individuals were also required to have an attitude to risk taking arguably at the upper boundaries of the norms within the industry. Behaviour inconsistent with the values of the CEO was not tolerated and the exercise of power to shape the moral values within the firm was not withheld. In the following chapter, the consequences of the power exercised by Fuld and his executives in the period prior to the bankruptcy is revealed. The behaviour of executives within Lehman Brothers during this brief but critical period was influenced by the already established organisational culture. It was also impacted by institutional influences within the investment banking industry and the benevolence of regulators.

CHAPTER 9

HUBRIS: THE TERMINAL DISEASE

This chapter chronologically examines the last days, weeks and months prior to Lehman Brothers' collapse. In following the chronology, key events and developments are identified which precipitated the failures of a number of financial institutions. The analysis of the events reveals a repeated exercise of power and the effect of institutional influence on the activities of Lehman Brothers, the industry and regulatory and government attitudes. The dysfunctional behavioural and cultural influences on Lehman Brothers had established the foundation for a series of decisions which led to a deterioration of Lehman Brothers' risk profile and ultimately its bankruptcy. The chapter goes further to analyse the interactions involving power between Fuld, Lehman Brothers' employees and external parties.

It is difficult to pinpoint the commencement of the last days of Lehman Brothers as any date chosen would be arbitrary. A case could be made to plot the start of the firm's demise from Glucksman's overthrow of Petersen's leadership. The subsequent events leading to the sale of the firm to American Express highlighted the dysfunctional internal divisions between the "traders" and the "investment bankers" and signalled the emergence of the trader mentality into the strategic decision-making of the firm. Alternatively, the last days could be sign-posted by the American Express group spin-off of the firm, amassing Lehman Brothers with a heavy load of liabilities. This was a time when Fuld's leadership of the "new firm" commenced. For the sake of continuity an arbitrary timeline has been selected which portends that the last days of Lehman Brothers began during the latter part of 2006 when the number of rating downgrades issued by the major rating agencies, such as S&P, Moody's and Fitch for CDOs peaked.

The CDO Rating Route

CDOs had become a popular financial instrument in the 2000s as they enabled investors to access a complex financial product which was backed by home mortgages. Previously, access to these products was prohibitive to most investors or was gained through other securitised financial structures such as Residential Mortgage-Backed Securities (RMBS) or Mortgage-Backed Securities (MBS).

The combination of an exponential growth of the CDO market, in the two years prior to the collapse of Lehman Brothers, the sudden credit downgrading by the CRAs of most of these instruments and the deterioration of the quality of the subprime mortgage portfolios in general signalled the first publicly visible indications that Lehman Brothers was in trouble. Lehman Brothers had amassed a large quantity of CDOs and residential mortgages ready for packaging during this time and had therefore developed an overweight asset exposure to this market as shown in Figure 9.1.

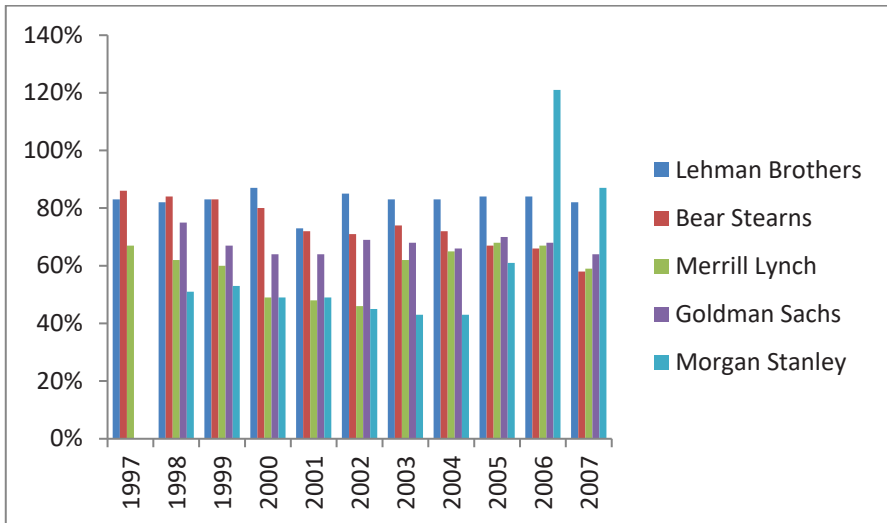


Figure 9.1: Warehouseled Mortgage Assets and Other Investments as % of Total Assets

Source: The data used for the graph were extracted from Osiris corporate database-Osiris 2014

Once the credit ratings of CDOs were downgraded, existing and potential investors and creditors possessed explicit information signalling the likely negative impact on Lehman Brothers' overweight position in these assets. These external stakeholders began to anticipate write downs on the value of the firm's CDOs and residential mortgage portfolio. Consequently, a negative sentiment of the firm's risk profile emerged as indicated by the firm's declining share price. This development also impacted other investment banks and most notably Bear Stearns which had a level of CDOs and subprime mortgage inventories similar to that of Lehman Brothers (Figure 9.1). Other hedge funds and commercial banks which were heavily exposed to these financial instruments were not immune to the market reaction. An atmosphere of nervousness and uncertainty permeated the market. Investors were starved for detailed financial information regarding the value of portfolios invested in credit derivatives and residential mortgages generally.

Warehousing and the Process of Securitisation

Securitisation usually starts with a financial institution accumulating a portfolio of assets, a process known as warehousing. The portfolios can consist of securities such as RMBS or financial products such as residential mortgages. The financial institution writing these loans or accumulating the securities for the portfolio is known as an originator. These assets are either recorded on the originator's own balance sheet or on the balance sheet of a special purpose vehicle (SPV). The SPV is a corporate structure often disassociated from the lender for accounting purposes but often under its management control. By recording the assets on the unconsolidated balance sheet of the SPV, the lender can avoid providing capital for the assets as is required by regulatory capital adequacy guidelines. To acquire the assets from the originator, the SPV needs to raise funds by issuing securities to third party investors. This is known as the securitisation process. Once the assets are transferred to the SPV, there is normally no recourse to the originating financial institution. In order to achieve this, the governing document of the issuer (SPV) restricts its activities to only those necessary to complete the issuing of securities.

The entity (either a SPV or financial institution) in which the pooled assets are being held during the accumulation process, is referred to as "a warehouse". The securitisation process as discussed above involves the

lender extracting the assets, that is, the loans, from the warehouse to on-sell them to investors in the form of new securities often categorised into tranches according to their credit ratings. Investors can then elect to invest in one or more of the different tranches, each having a different risk profile. Naturally, the riskier the tranche, the greater the return offered. Refer to Figure 9.2 for a diagrammatic representation of this process as it is applied to CDOs.

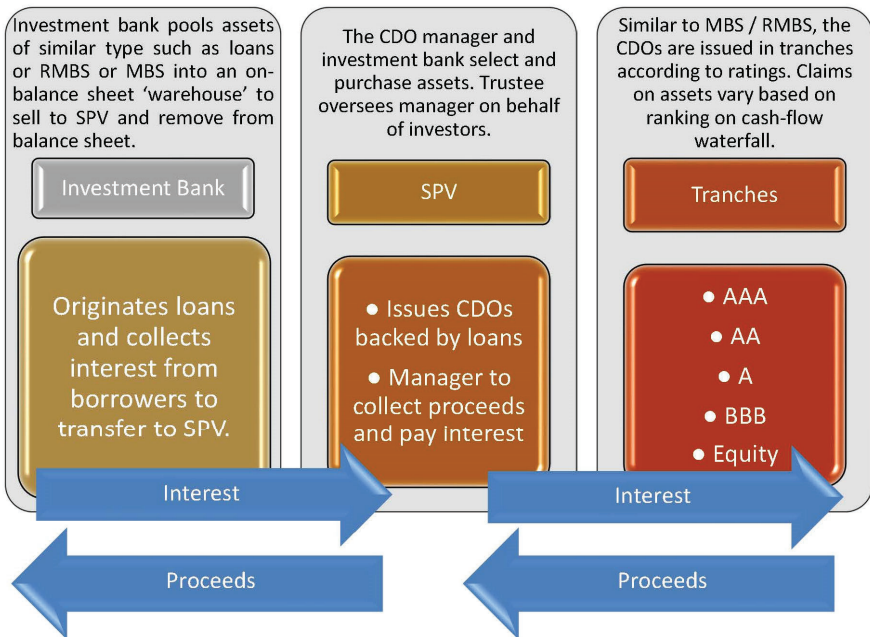


Figure 9.2: Typical CDO Structure

Source: Diagram developed from Financial Crisis Inquiry Commission 2011, 128

CDOs first appeared in the 1980s, however, it was not until the 1990s when volumes of issues began to rise (Fabozzi et al. 2006). Figure 9.4 illustrates the growth in CDOs issued from 2000 to 2007. CDO issues grew exponentially until 2006 and levelled off in 2007 which coincided with the tightening of credit conditions, known as the global credit crisis (Fabozzi et al. 2006). This growth paralleled the impressive growth in structured finance and credit derivative transactions generally during this period.

Refer to Figure 9.3 and Figure 9.4 for the evolution of the structured finance market in the period leading to the GFC.

Figure 9.3: Total Number of Structured Finance Tranches Issued

	1983	1990	2000	2006
Number of Tranches	29	1,581	9,353	47,055
USD	na	na	1,839	86,572

Source: Benmelech and Dlugosz 2010, 166-8

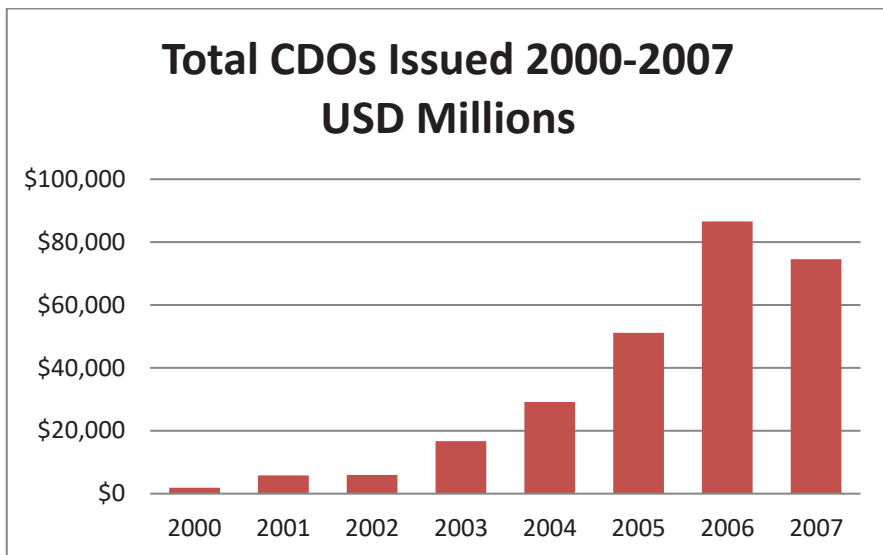


Figure 9.4: Total CDOs Issued 2000-2007

Source: The data used for the graph were extracted from SIFMA Global CDO Issuance Tables-Securities Industry and Financial Markets Association 2013

The credit rating agencies assigned the highest rating of 'AAA' to the majority of CDOs outstanding globally in 2006 but by 2007 30% of the 'AAA' tranches had been downgraded (Benmelech and Dlugosz 2010, 161). The number of downgrades accelerated between 1999 and 2007, reflecting the deteriorating credit profile of the CDO market during this period. During the four-year period between 1999 and 2002 inclusive, CDO downgrades by all major ratings agencies totalled 3,116. During the four-year period

between 2003 and 2006 inclusive, it amounted to 6,173 downgrades and in 2007 alone, downgrades totalled 8,109 (Benmelech and Dlugosz 2010, 161). Many downgrades occurred from “AAA” to “BB” or lower (considered junk bond quality) (McDonald and Robinson 2009, 200). Such sudden and steep downgrades were considered rare and therefore caught much of the market by surprise.

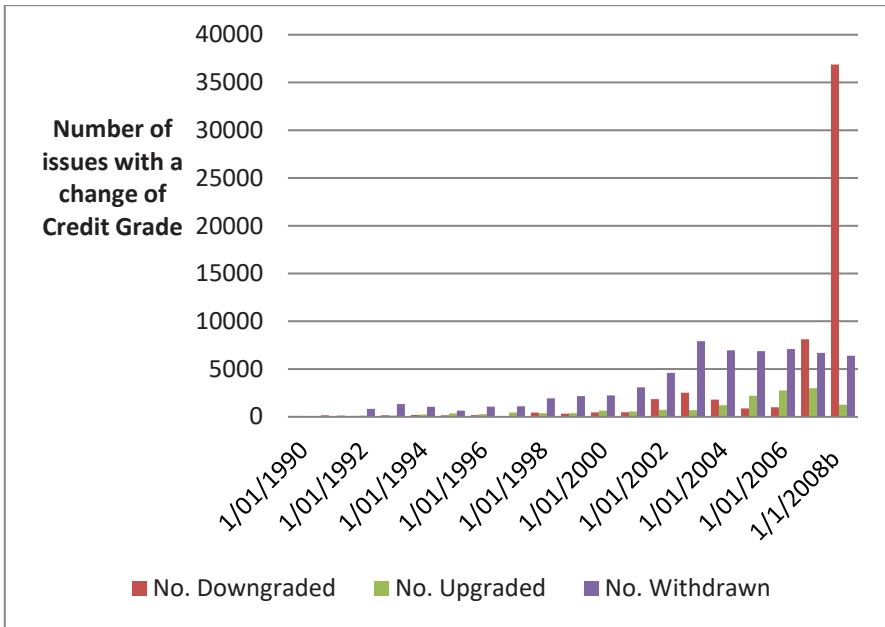
The downgrades were driven by an increasing default rate prevailing on home mortgages, which were the major asset class underlying the CDO instruments. Many of these CDOs had packaged subprime mortgages as their underlying asset and most of these mortgages were structured with adjustable interest rates. These were known as adjustable-rate mortgages (ARMs). Given these mortgages mainly originated within the previous two years, their interest rates were in the process of being reset above the original discounted “honeymoon” rate. Consequently, homeowners were experiencing increasing difficulty in servicing their repayments because of higher interest reset rates which reached a peak of 27% in December 2006 (McDonald and Robinson 2009, 201). These difficulties translated into higher loan delinquency levels. There were other reasons for the downgrades which are addressed by Ashcraft (2009) who contends that the ratings models used to assign the original ratings were flawed. He also argues that the CRAs were under pressure by the investment banks to increase the number of ratings for new issues which promoted munificence amongst rating staff. This issue was compounded by the deteriorating credit quality of the underlying assets. “CDO structures were willing to accept loans that traditional investors would not have accepted, and originators began originating riskier and riskier loans” (Ashcraft 2009, 638).

The problem started when the origination process was outsourced to commission agents who had little concern for the credit quality of the loans being accumulated. As they were not employed by the investment banks, their accountability for the credit quality was negligible and they were largely driven by the amount of commission they earned, which was based on volume of loans written. Further, the responsible executives within Lehman Brothers had a relatively low concern for the credit quality of the loan portfolios as their intention was to speedily securitise the assets and transfer the associated risk to the ultimate security holders. Whilst the securitisation process proceeded quickly, and the housing market remained

buoyant, the on-balance sheet credit risk to Lehman Brothers was considered low.

Lehman Brothers was a major instigator in the origination and selling of CDOs and mortgage-related structured assets generally. On November 30, 2006, Lehman Brothers had approximately USD 57.73 billion in mortgage-related assets, equivalent to 300% of the firm's total equity. Of the USD 57.73 billion in mortgage-related assets, USD 15.93 billion was subprime quality and mostly represented the remaining unsold portions of issues arranged earlier by Lehman Brothers. In other words, by the end of 2006, Lehman Brothers had 83% of its equity tied up in extremely risky mortgage-related assets (Deng et al. 2009). During 2007, Lehman Brothers' mortgage-related assets jumped from USD 57.73 billion to USD 89.11 billion, representing 25.5% and 28.5% of total financial instruments owned in 2006 and 2007 respectively. Of the USD 89.11 billion mortgage-related assets in 2007, approximately 46.5% had been repackaged into complex asset-backed securities. As of 30 November, 2007, Lehman Brothers had USD 17.31 billion in either subprime holdings or interests in low grade securitisations, and only USD 22.49 billion in total equity (Deng et al. 2009).

Figure 9.5 shows all outstanding CDO tranches as at 1 January for years 1990 to 2008 which were downgraded, upgraded or withdrawn. It is important to note that Figure 9.5 provides information for all outstanding tranches and not solely new issues for the year. In 2007, although CDOs outstanding grew by 31.7%, the number of downgrades increased by approximately 800%, indicating a serious credit problem associated with the underlying assets of the CDO structures. This trend continued into 2008 when "there were 36,880 downgrades of structured finance tranches in the first three quarters of 2008, overshadowing the cumulative total number of downgrades in 2005/07 ... Downgrades were not only more common but also more severe in 2007 and 2008" (Benmelech and Dlugosz 2009, 172).



Note: b = Rating actions between 01/01/2008 and 22/09/2008.

Figure 9.5: Credit Rating Downgrades, Upgrades and Withdrawn

Source: The data used for the graph were extracted from Benmelech and Dlugosz (2010, 181)

Lehman Brothers’ large mortgage holdings, especially subprime mortgage holdings and investments in the equity tranches of asset-backed securities caused major financial difficulties for the firm. In the fourth quarter of 2007, it recorded a USD 3.5 billion write down in mortgage assets, followed by another USD 4.7 billion mark-to-market loss in the first quarter of 2008. This revelation of the deteriorating quality of Lehman Brothers’ portfolios precipitated a decline in Lehman Brothers’ share price. See Figure 9.9 for a chart of Lehman Brothers’ share price.

A disturbing feature of this period is that Lehman Brothers had been made aware of the deteriorating quality of the CDO portfolios by internal and external sources. Despite these warnings, Lehman Brothers continued to issue new tranches of similarly structured CDOs. McDonald and Robinson (2009, 201) acknowledge that Alex Kirk, then Global Head of Credit at Lehman Brothers, had predicted the problems associated with Lehman

Brothers' portfolios. "[Kirk]...was the first to flag it, in May 2005—one year and seven months before it started to fall apart". Alex Kirk was well-qualified to comment, having held positions within Lehman Brothers of Global Head of Principal Investments, Global Head of Credit from 2006 to 2008, Chairman of the High Yield Committee from 2002 to 2005 and head of the Global Distressed Division from 1994-2001. Kirk had advised Fuld of the impending problems. Gelband also warned Fuld of the impending deterioration of the portfolio held by Lehman Brothers.

Mike Gelband (who at the time had responsibility for commercial and residential real estate), yelled it publicly, with facts and figures, for everyone to hear, from Fuld downward at 7.06am on June 7 2005—one year, six months, and three weeks before...many at Lehman Brothers had heard the warnings, and all through those months heard the rumours (McDonald and Robinson 2009, 202).

Lawrence Lindsay, an external consultant to Lehman Brothers, as president of The Lindsay Group, and a former director of President George Bush's National Economic Council also made presentations to Lehman Brothers' executive committee about the home lending market. He warned Lehman Brothers about the problems faced by borrowers as their interest rate resets were applied and about the potential negative impact these would have on the banks' distressed debt levels (Becker et al. 2008; McDonald and Robinson 2009). These warnings were ignored by Fuld and ran contrary to his stated ambition to invest further into hedge funds (holding subprime residential mortgages and CDOs) in order to increase profitability and hence the share price. Figure 9.6 is a slide in a Global Strategy Offsite Presentation setting out the firm's strategy to grow hedge funds at a compound annual growth rate of 17% between 2005 and 2009.

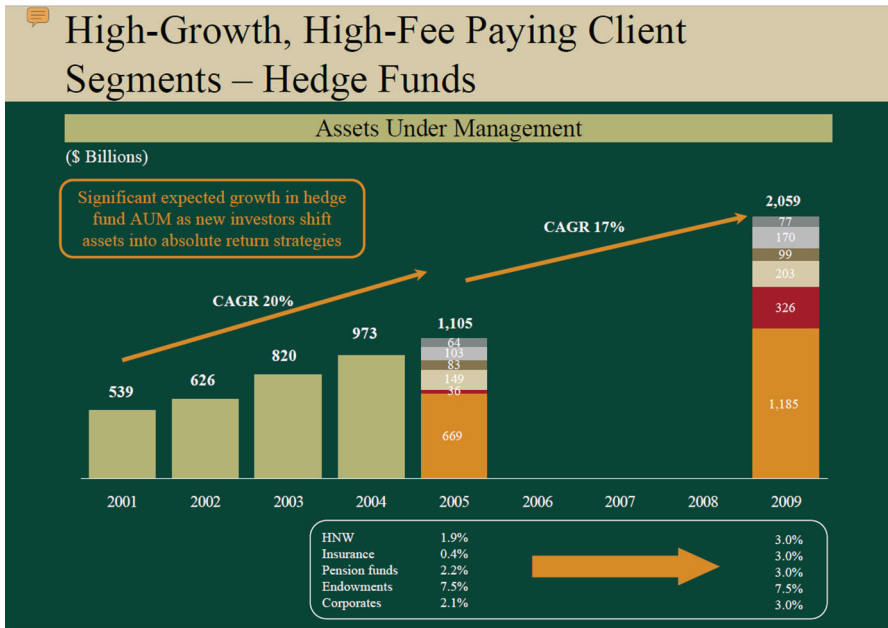


Figure 9.6: Lehman Brothers Global Strategy Offsite Presentation–March 2006

Source: Lehman Brothers Holdings 2006, 28

Fuld was preoccupied with Lehman Brothers’ share price, making it the focus of the firm’s strategy as depicted in the same presentation. Refer to Figure 9.7 for the presentation introduction which featured the overriding strategy of reaching a share price of USD 150. At that time, the average share price for March 2006 was USD 144, having increased from USD 128 on 1 January 2006 and USD 87 on 1 January 2005. Fuld also intended Lehman to rank first or second in targeted business segments. As the bulk of Fuld’s compensation was awarded in Lehman Brothers stock, he had a personal interest in maximising the firm’s share price.

Introduction

- ◆ The Road to \$150
- ◆ How We Did It
- ◆ The Road to \$150...Again

Figure 9.7: Introduction of Lehman Brothers Global Strategy Offsite Presentation, 2006

Source: Lehman Brothers Holdings 2006, 2

Consequently, Lehman Brothers continued to grow its exposure to the CDO and subprime mortgage market. Once these instruments were ultimately revalued by Lehman Brothers for financial reporting purposes, the write downs had to be brought to account. Figure 9.8 shows the latest announced write downs for Lehman Brothers during 2008. The ABS CDOs and RMBS write downs represented the majority of the firm's total write downs of USD 9 billion.

Figure 9.8: Structured Asset Write downs for Lehman Brothers, 2008.

Write down	2007/2008	ABS CDOs	Corporate Credit	RMBS	Other	Total
Lehman Brothers' Write downs (USDm)	Note (a)	200	1,300	4,100	3,400	9,000
% of Total Industry Write downs	Note (b)	0.09%	2.45%	4.83%	2.07%	1.73%
Total Industry Write downs (USDm)	Note (b)	218,215	53,325	84,809	163,735	520,084

Sources: a. Lehman Brothers' Quarterly Reports for quarters 1, 2 and 3, 2008-Lehman Brothers Holdings 2008b, 2008c, 2008d

b. Relates to write downs for 2007 (Benmelech and Dlugosz 2009, 163)

Resisting Warnings

The process of communicating concerns to Fuld was undertaken in the normal course of day-to-day business activities. The experts, Kirk and Gelband, viewed it as their duty to warn Fuld of the impending dangers to Lehman Brothers of developments in the subprime mortgage market and the associated exposures held by Lehman Brothers. The warnings also came from outside sources, such as Lindsay, and therefore were independently validated. Fuld's resistance to this advice is an example of hubris regarding the market environment. This perceived knowledge situates Fuld, a CEO with a long history in the financial markets, in a position of influence over the wider firm's employees, in particular, those without an expertise in the field claimed by Fuld. This confers power to Fuld over subordinates in the firm within Clegg's episodic circuit and allows him free reign to pursue his own strategy. This episodic power which is often exercised intermittently, involves power over another, in this case, Lehman Brothers' employees. Power in the episodic circuit usually "calls

forth resistance because of the power/knowledge nature of agency” (Clegg 1989, 208). The resistance offered by Kirk and Gelband was overcome by Fuld’s authority as CEO. This position of authority continued as long as Fuld’s perceived superior knowledge was able to convince the wider firm and attract the continued support of the Board of Directors who ultimately dictated whether Fuld continued in his role as CEO. “Kirk, Gelband and Lindsay had sounded warnings... you can never fix stupid” (McDonald and Robinson 2009, 202).

Effect on share price

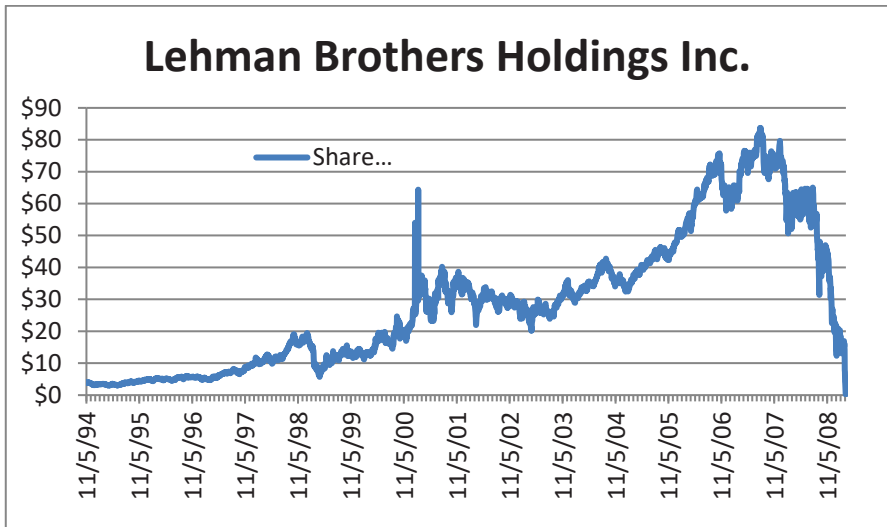


Figure 9.9: Lehman Brothers Holdings Inc. Adjusted Closing Share Price*, 1994 – 2008

Note: The share price indicated above is quoted as an adjusted share price, reflecting the stock split which occurred in April 2006.

Source: Data for graph obtained from share price database-Investorpoint Investor Information Systems 2016

Figure 9.9 plots Lehman Brothers’ split-adjusted share price from 1994 when the firm was spun off by American Express to September 15, 2008, the day of its bankruptcy. Lehman Brothers’ share price decline, from USD 78.12 on December 29, 2006, to USD 19.12 on June 30, 2008, and to USD

3.65 on 12 September, 2008, (the last trading day before the bankruptcy announcement) reflected an increasingly pessimistic assessment of Lehman Brothers' viability. This period also reflects the steepest decline in Lehman Brothers' share price history.

Selling and Shorting Lehman Brothers shares as Mimetic Isomorphism

In the introduction, two accounts were postulated as explanations for a financial crisis, exogenous and endogenous approaches. The exogenous approach supports the assumption that information sourced from outside the market is absorbed by the market, and trading based on this information is reflected in the price of a security. Alternatively, under the endogenous approach, the price of a security is influenced by the behaviour of other traders in the market. This emphasises that social interaction within markets can precipitate a crisis. Therefore, the markets are subject to the "herd mentality".

Dyer et al. (2008) discovered in scientific experiments that it takes a minority of just five per cent of a group to influence a crowd's direction and that the other 95 per cent follow without realising it. That is, where information is ambiguous, individuals are prone to make decisions based upon the actions of others. Swedberg (2010, 71) finds that "confidence plays a key role in financial panics and that confidence can be conceptualised as a belief that action can be based on proxy signs, rather than on direct information about the situation itself". While some proxy signs are official, others are unofficial, such as articles in the business press about a firm, or gossip from an acquaintance. Unobtrusive proxy signs belong to the category of unofficial signs and are often viewed as valuable, because they are thought to be difficult to manipulate (Swedberg 2010). This, of course, is also what makes them so attractive to manipulate.

According to Labaree (1961), Benjamin Franklin, in a *Letter to a Young Salesman*, 21 July 1748, gives the new owner of a carpentry business the following advice: "[t]he sound of your hammer at five in the morning, or eight at night, heard by a creditor, makes him easy six months longer" (Labaree 1961). The proxy sign in Lehman Brothers' instance, unlike the sound of the hammer, was a negative sign and included the rumours and press speculation that spread throughout the market. The rumours and

actions of other traders in shorting Lehman Brothers' stock perpetuated an already declining share value, almost self-fulfilling an eventual demise of the firm. Platt (2002, 8) observed "quite a substantial amount of short selling activity takes place when companies face bankruptcy...Shorting the stock of a distressed company puts extra financial pressure on it by devaluing its equity and pushes it to the verge of a fall".

The activity of the market participants in selling Lehman Brothers' shares was driven from limited information such as the credit rating downgrades, press reports and rumours. These relatively uninformed trades (uninformed at the time of trading) support the endogenous approach to understanding markets, which is consistent with an institutional view. It provides a rationale for selling a stock in the absence of explicit detailed financial information. When other traders are executing similar trades, this is interpreted as legitimate for no other reason as there being safety in following the herd. According to DiMaggio and Powell (1983), this is a form of mimetic pressure. The mimicking of trades gives comfort to traders, supporting their own decision-making because it is consistent with others in the market.

Talking Heads

On 14 March, 2007, in response to a demand for information by analysts on progress with the first quarter's results, Lehman Brothers organised a conference call for interested institutional investors and securities analysts. The Lehman Brothers representative on the call was the Chief Financial Officer, Chris O'Meara. It was clear from O'Meara's initial presentation that his objective was to obfuscate the details of Lehman Brothers' exposure to the subprime market. He briefly passed over Lehman Brothers' holdings of subprime mortgage securitisations by mentioning they only comprised less than 3% of Lehman Brothers' total revenues (McDonald and Robinson 2009, 221). What was revealing was what it failed to disclose rather than what it actually disclosed. O'Meara conveniently omitted any analysis of the relevant exposure as a percentage of equity or assets, which would have represented a more meaningful ratio relevant to the assessment of Lehman Brothers' financial position.

An excerpt of this conference call between Michael Mayo, an analyst from the Prudential Equity Group and O'Meara follows:

Michael Mayo Prudential Equity Group

Then, a separate question; subprime revenues are under 3% with your characterization, but if we are not talking about a housing crash or a recession but still a possible domino effect from subprime to other areas, what other exposure do you have to the subprime mortgage market?

Christopher M. O' Meara CFO Lehman Brothers

To the subprime mortgage? Okay, so there are situations—are you talking about warehouse lending or—

Michael Mayo Prudential Equity Group

More generally, what is your total balance sheet exposure to subprime mortgage, either direct or indirect?

Christopher M. O' Meara

We have a fair amount of exposure. We talked about the residual interests which represent a levered exposure. We also have whole loans, but all of it is subject to the same hedging principles that we talked about earlier and it has been working quite effectively.

Michael Mayo Prudential Equity Group

But when you said that the hedging offset the losses, the hedging offset the losses in which areas?

Christopher M. O' Meara

Essentially everything. Our objective is to try to offset the risks that sit in the business as we are moving these instruments and holding the instruments in what we will call our client warehouse as we are moving them from raw product into securitization, and then if we are making secondary markets and taking positions that we are distributing and sponsoring client activity, while that is in this warehouse and on the balance sheet, we are trying to hedge the components of risk that exist—the interest rate risk, the prepayment risk, the various risks that exist. We are actively, dynamically trying to risk-mitigate. (Seeking Alpha 2007)

The above exchange can be interpreted as a means of limiting information disclosure by O'Meara. The vague and convoluted responses supplied by O'Meara were clearly intended to obscure the severity of the problems being faced by Lehman Brothers. This interaction between Mayo, a

representative of a stakeholder group of investors and O'Meara, the representative of the firm and of Fuld, the Chairman and CEO, can be analysed by Clegg's (1989) dispositional circuit. In this circuit, the rules of practice are constituted by the typical verbal presentation followed by the question-and-answer pattern of communication between the listed entity (Lehman Brothers) and stakeholders. The call was the arena in which O'Meara decided to control the dissemination of vital information. If the information was not convincing, it could potentially have severe consequences on the firm's critical relationships and ultimately, its share price.

O'Meara's evasiveness in the "us and them" exchange was an attempt for him to influence Mayo and others listening to the call. The obligatory passage point in Clegg's (1989) framework is represented by the conference call, whereby the agency, in this case Mayo, contests O'Meara's responses, the tone of which is, in turn, refixed to disarm the agent. O'Meara had the benefit of a final response to each question and therefore had the ultimate ability to shape opinion. Further obfuscation was practised in the release of Lehman Brothers' third quarter results as reported by the media (Ellis 2008; Hamilton 2007). O'Meara was defending the accuracy of the financial results and sought to allay concerns that investment banks might be moving too slowly to write off potentially large amounts of troubled mortgage securities. O'Meara was content that the firm had a robust accounting process to produce accurate and reasonable financial statements (Hamilton 2007). Securities analysts were not convinced however and a securities analyst, Schiff commented:

... In any case ... the future isn't bright for Wall Street banks... They're not going to be making all these profits in their hedge funds ... They're not going to be making all these [merger] deals and private equity deals. They're not going to get all those tremendous fees and commissions (Hamilton 2007).

It is clear that O'Meara's assertions about the firm's robust process in checking its accounting of the mortgage securities was meant to divert attention from the actual results and instead focus on process, that is, to provide comfort to analysts that a conservative approach had been followed. Unfortunately for Lehman Brothers, Schiff and others were not convinced.

Fuld's Response to Market Disquiet

First Leg of Strategy: Expansion

In response to market rumours, which were particularly rampant following the March telephone conference call, Fuld pursued a new strategy of globalisation and undertook acquisitions of hedge funds internationally to convince the market that Lehman Brothers had other options to reverse its performance. "The foreign purchases were inspired by the avowed belief of Fuld...that globalisation meant decoupling from the US market because it was no longer all-powerful" (McDonald and Robinson 2009, 223). Since the late 1990s, Lehman Brothers had developed a large mortgage origination business, supplemented by a meaningful securities issuance and distribution business and a strong underwriting business. The strategy had been to originate and distribute securities as it had done during Philip and Bobbie Lehman's reign. Following its March 2006, Global Strategy Offsite, Lehman Brothers announced that its strategy had evolved. Rather than originating mortgage assets for eventual packaging and disposal to investors, Lehman Brothers would retain those assets on its balance sheet. Lehman Brothers effectively shifted its strategy from focusing on securitisation to a business of accumulating assets (Financial Crisis Inquiry Commission 2011, 177). This aggressive growth strategy also involved greater leverage and risk. The combination of the warehousing strategy supported by greater leverage would come to punish Lehman Brothers when the values of the underlying stored assets plummeted.

Shortly thereafter in 2007, Lehman Brothers acquired Europe's largest hedge fund, GLG Partners (London), based in London. By mid-year 2007 Lehman Brothers acquired a 20% interest in New York-based D.E. Shaw, a global investment and technology development firm, and a further 20% of the USD 5 billion London-based hedge fund, Spinnaker Capital, that were specialists in emerging markets. As well as Spinnaker Capital, Lehman Brothers continued to expand in the UK and acquired a 5% stake in Blue Bay Asset Management which had assets under management of USD 8 billion. Later, it acquired Grange Securities, one of the largest sellers of CDOs in Australia. These hedge funds were in addition to a previous acquisition of a major US commodity hedge fund, Ospraie Management, which managed about USD 2 billion of assets (McDonald and Robinson 2009).

Fuld was envious of the Blackstone Group, a private equity firm co-founded by Peter Petersen, following Petersen's exit from Lehman Brothers (McDonald and Robinson 2009; Reingold 2009). One of the main reasons for Fuld's envy was the fact that Peterson as one of two co-founders of Blackstone Group, benefited enormously from the 2007 initial public offering of Blackstone, valuing the firm at USD 4 billion. The listing enabled Blackstone to become one of the first major private equity firms to list shares in its management company on a public exchange (Anderson 2007). Fuld was aware that the Blackstone Group completed a USD 39 billion buy-out of Equity Office Properties Trust earlier in 2007 and viewed this transaction as a justification of his hedge fund strategy (McDonald and Robinson 2009). Fuld, however, was not aware that Blackstone's own strategy involved flipping the properties within the trust in the short term (Pristin 2008). Lehman Brothers instead was investing for the long term which represented quite a different strategy.

Mimetic Pressure a Solution to Financial Difficulties

Given Blackstone Group's strong reputation in the market, which was primarily due to the standing, character and experience of its co-founders, Fuld succumbed to a mimetic pressure of replicating a strategy undertaken by a competitor in order to achieve commensurate rewards. If the market was interpreting the Blackstone Group strategy as sound, then why wouldn't the market ascribe the same supposition to Lehman Brothers? Blackstone's practice as a hedge fund was to use high levels of leverage to make acquisitions of underperforming corporations or assets, turn around the performance, and dispose of the investment at a profit (Pristin 2008). Fuld's mistake was to ignore the short-term nature of the Blackstone Group strategy and instead, according to Lehman Brothers Holdings (2006), pursued a flawed long term hold strategy. Lehman Brothers continued to compound its property exposure during June 2007.

It [Lehman Brothers] partnered with Thomas Partners, a real estate investment trust based in Los Angeles, and the California State Teachers Retirement System in a USD 1.15 billion deal to purchase 10 office buildings that Blackstone was selling from its Equity Office Properties acquisition (Pristin 2008).

In July, 2007, just as the global credit crisis began, Lehman Brothers acquired, in partnership with Prologis, a publicly listed logistics company,

which owned a group of warehouses located throughout the US for USD 1.85 billion. Lehman Brothers financed the bulk of the transaction on its own balance sheet in order to accelerate the closure of the transaction (Pristin 2008). Not only was Lehman Brothers caught with the associated debt but was unable to securitise the asset (Pristin 2008). Consequently, the asset and the corresponding debt remained on its balance sheet, further weakening the leverage of the firm.

Lehman Brothers had a strong appetite for real estate investments, as Fuld believed the real estate asset bubble would continue indefinitely and in mid-June 2007, added high value commercial real estate assets from Texas to the portfolio. “One real estate investment broker described Lehman as the real estate ATM” (Pristin 2008). The expansion of the firm’s investment portfolio featured prominently in the firm’s strategy (Lehman Brothers Holdings 2006). Rubinstein (2008) notes that Lehman Brothers’ appetite for real estate assets encouraged the firm to use off balance sheet structures to house them and its comparative exposure to real estate outweighed those of its competitors. “You talk to Morgan Stanley, they have \$3 billion worth of [commercial mortgage-backed securities] exposure in the States. Lehman had \$30 billion” (Rubinstein 2008). Direct investments in real estate were supplemented by indirect exposures by way of extending loans against property mortgage security. Lehman Brothers’ search for opportunities in this sector was aggressive as it turned to riskier loans to fulfil its appetite. “The firm, according to one developer, became known as the lender of last resort on Wall Street, willing to loan money to just about anyone” (Rubinstein 2008).

The real estate binge continued in October 2007, when Lehman Brothers acquired a portfolio of almost 400 apartment buildings across the US in partnership with Tishman Speyer. Lehman Brothers invested equity of USD 250 million and led a syndicate of lenders, together with Fannie Mae and Freddie Mac, that contributed USD 4.6 billion in bridge equity for the USD 22.2 billion transaction (Pristin 2008). The deal represented the largest listed to private merger and acquisition transaction in the Real Estate Investment Trust (REIT) sector (Pristin 2008; Trainor 2007). This transaction was completed shortly after Standard & Poors and Moodys issued warnings on a weakening rental market and deterioration in mortgage lending standards (Pristin 2008; Wilcox 2012). Fuld’s rejection of the credit rating agencies’ warning was another example of hubris and a determination to

solve the firm's problems by pursuing a flawed strategy of expanding through an asset class which was at the top of its price cycle.

Fuld was not content with investing in hedge funds alone. Hubris led him to invest in other unrelated businesses through the firm's Private Equity Division. In August, Lehman Brothers was in negotiations to purchase 66% of Eagle Energy Partners, a Houston-based energy services corporation for USD 400 million; in addition, Lehman Brothers was involved in multi-billion-dollar commitments with TXU, Claires Stores, First Data Corporation, Home Depot and International House of Pancakes. "Both men [Fuld and Gregory] were devotees, apparently of the very suspect maxim that it's always possible to spend your way out of trouble" (McDonald and Robinson 2009, 262).

Second leg of strategy – Share Repurchase

The second leg of Lehman Brothers' strategy was to repurchase its own shares to counteract the rumours of Lehman Brothers' potential on-balance sheet problems. In creating the appearance of a strong balance sheet which could withstand share repurchases and payment of high dividends, Lehman Brothers acquired USD 2.6 billion worth of its own shares and paid dividends of USD 418 million during the financial year ended 30 November 2007. The issuance of new shares during this period totalled a meagre USD 84 million (Lehman Brothers Holdings 2008j). By increasing the demand for Lehman Brothers shares on the market, Fuld was hoping the share price would increase. This caused much discord amongst senior executives including Gelband, who on hearing of the repurchase exclaimed "Buying it? ... he should be fucking selling it to raise capital" (McDonald and Robinson 2009, 224).

The share repurchase strategy is an example of misplaced hubris and an abuse of power. The act of repurchasing shares with borrowed funds has a compounding effect on leverage. The leverage ratio which is a *de-facto* measure of the risk of a firm may be calculated as a ratio of total debt to total stockholders' funds. A higher ratio indicates more risk. Buying back the number of shares outstanding reduces the balance sheet value of stockholders' funds (on the basis that the same shares are subsequently cancelled). The combination of a reduction in stockholders funds whilst borrowing to effect the repurchase amplifies the increase of the ratio.

Abuse of Power in the Facilitative Circuit

In extending leverage, Fuld elevated the risk profile of the firm. In the process, he further jeopardised the survival of the firm and therefore the job security of its employees and safety of the financial claims of stakeholders, such as stockholders and lenders. Fuld attempted to fix perspectives about the firm, despite overt objections from other senior executives who deemed the action of share repurchase irrational but nonetheless were powerless to change Fuld's actions.

The position of Chairman and CEO gave authority to fix the standards of "leverage acceptability" within the firm in response to the prevailing exogenous environmental stimulus. This environment was characterised by the market rumours which prompted Fuld's action. The Chairman's authority was further strengthened as Fuld's decisions occurred during a time of crisis when decisive action is an accepted practice in corporate management as a means of appeasing stakeholders. Subordinates felt powerless to contest Fuld's authority through any communication or obligatory passage points available within the firm, such as the executive committee over which Fuld held a strong influence.

Ultimately, the disagreement between Gelband (a rationalist) and Fuld resulted in Gelband's and his subordinate, Kirk's removal from the firm (Fishman 2008). Fuld would not have senior executives question his actions, and therefore simply removed them from their positions. In removing such obstacles, Fuld refixed the relations of membership within the firm as depicted in Clegg's dispositional circuit. Gelband attempted to change the system of decision-making but changing institutional life is not simple. "To change social relations in the facilitative circuit means mobilising change in fields at the dispositional and episodic levels" (Boje and Rosile 2001, 95). Gelband was unable to achieve this given his lower status in the power hierarchy of the firm and therefore succumbed to the authoritative power of Fuld.

Following the announcement of the 31 May, 2008, second-quarter earnings—a USD 2.8 billion loss—Fuld finally capitulated to the need for additional capital (Lehman Brothers Holdings 2008c). He reversed his previous tactic and accepted that a rational response was required for the market and announced "the firm was raising USD 6 billion in new capital

from blue-chip investors” (Lehman Brothers Holdings 2008g). The press statement quoting Fuld, read as follows:

... Since we announced our expected second quarter earnings last week, we have begun to take the necessary steps to restore the credibility of our great franchise and ensure that this quarter's unacceptable performance is not repeated. We have raised an additional USD 6 billion of capital. I have asked Bart McDade, our best operator, to serve as the Firm's president and chief operating officer. I have also asked Ian Lowitt, our co-chief administrative officer, to be our chief financial officer. With these actions and our continued commitment to our client-driven franchise, we are positioned to take advantage of opportunities that lie ahead, and we are focused on maximizing shareholder value (Lehman Brothers Holdings 2008g).

Again, this was an attempt to manage perceptions. It suggested that there was investor appetite for Lehman Brothers' equity. Further, the statement that Fuld was appointing a new COO (replacing long-time COO, Gregory) and CFO was intended to portray that the desperate situation would be turned around. Notably, there is no mention that Fuld would be stepping aside partially or fully or that he accepted personal responsibility for the results. Again, the reluctance to accept responsibility is a form of power over subordinates. This power is evidenced by the differential treatment of his immediate subordinates whose employment was terminated whilst he retained his own position.

The conference call to investors to announce the second quarter results on 16 June 2008 was led by Fuld who was normally absent from such calls. At the beginning of the conference call Fuld stated:

... Now let me discuss our current asset valuation on those remaining positions. I am the one who ultimately signs off and I am comfortable with our valuations at the end of our second quarter, because we have always had a rigorous internal process (Seeking Alpha 2008).

Fuld started the conference call with a relatively unimportant comment on the valuation of a portion of the balance sheet, instead of commencing with a discussion on the headline poor performance. This was an effort to diminish the relevance or importance of the shocking profit result, and thereby, an attempt to manipulate perceptions—again an exercise of power over any potential reaction of stakeholders.

Lehman Brothers' share price of USD 27.20 as at 16 June, 2008 (the date of the second quarter results' conference call), was down 104% since 1 January, 2008. This drop would have placed many other CEOs in jeopardy of termination. However, Fuld was able to survive given his influence over the Board of Directors. "Lehman's Board of Directors, which included retired CEOs like Vodafone's Christopher Gent and IBM's John Akers were reluctant to challenge Fuld as the firm's share price spiralled lower" (Plumb and Wilchins 2008a).

Fuld had steered Lehman through the 1997/98 Asian Financial Crisis, a period where the firm's share price dropped to USD 22 in 1998, but kept his job as the subprime mortgage crisis took hold, while CEOs of rivals like Bear Stearns, Merrill Lynch, and Citigroup were forced to resign (Plumb and Wilchins 2008a).

Power Usurps Coercive Isomorphism in CEO Accountability

As Plumb and Wilchins (2008a) note, it was not uncommon in the midst of the global credit crisis for investment banking firms to sacrifice their CEOs following dire results. These organisations reacted to pressure from the markets including investors (both debt and equity), government agencies and the media generally. This pressure, a form of coercive pressure, is a consequence of an expectation of an organisation to act in a certain manner. The act in these cases involves retrenching the leader who is expected to take responsibility for the poor performance of the firm. Oliver (1990, 152) describes this as "conscious obedience to the incorporation of values, norms or institutional requirements". The pressure to replace CEOs for the failing fortunes of a company had affected Bear Stearns, Merrill Lynch, and Citigroup. However, Fuld managed to retain his position of Chairman and CEO. How did Fuld achieve this? This is a case where DiMaggio and Powell's (1983) New Institutional Theory intersects with Clegg's (1989) Theory of Power.

Although Lehman Brothers succumbed to the coercive isomorphic pressures in appointing a new COO (in the process removing Gregory) and CFO (in the process removing O'Meara), Fuld managed to prevent his own removal through power sourced from an atypical influence over the firm's Board of Directors. This power can be placed in Clegg's dispositional circuit where Fuld's historic influence over the board and expectation that his every decision would be ratified, was created within the socially

constructed environment of board meetings. Within this setting, where relations between members of the board and the chairperson are formal by way of a board charter and informal by way of expected rules of behaviour, it was customary for the board to follow the chairperson's recommendation. The board's habitual acquiescence to Fuld's wishes legitimised his authority. Therefore, through the obligatory passage point of the regular meetings, Fuld was able to control the board to generate his desired outcomes. As the board possessed the formal authority to remove the CEO, Fuld's exercise of power over the board limited the coercive isomorphic pressure within Lehman Brothers of removing him in the face of a financial crisis.

Although Fuld engineered his survival as CEO and Chairman, he started to lose control over Lehman Brothers after a prolonged process of unsuccessfully attempting to turn around the fortunes of the firm. In his role as COO, McDade had begun to assert some authority in view of the firm's continuing financial crisis. McDade decided to reinstate his colleagues, Gelband and Kirk who had previously warned Fuld of the impending disaster, in an attempt to rescue the firm. "I'm here because of Bart", Gelband pointedly told Fuld (Fishman 2008). This was an example of the first and one of only a few direct challenges to Fuld's authority, simply because Fuld was perceived as losing his power.

The facilitative circuit is where power and also disempowerment can occur. Fuld continued to hold his CEO and Chairman title and the authority it carries, governed by the hierarchical rules of organisational membership held within the dispositional circuit. However, this became increasingly superficial and was overridden by a process of disempowerment through the facilitative circuit. The desperate financial position of the firm required a new approach as all other attempts to stave off bankruptcy were failing. McDade filled the vacuum of thoughtful leadership left by Fuld. As Fuld was no longer visibly offering practical solutions. His ability to convince the team and the market that he had the "knowhow" to save Lehman Brothers had evaporated. This development is consistent with the notion of disempowerment in the facilitative circuit. The perceived knowhow that conferred power to Fuld was no longer evident.

Bear Stearns – Failure of the Hedge Funds and then the Firm

The failure and subsequent rescue of Bear Stearns, the fifth largest investment bank in the US in 2007 based on total revenue – refer to Table 74 for a comparison of total revenue of the five largest investment banks signalled the beginning of the liquidity crisis which immediately preceded the GFC. It conducted similar business to Lehman Brothers and possessed a similar financial structure especially in a key measure of financial risk-leverage. Bear Stearns was also one of the pioneers in securitising CDOs (Ryback n.d.). Through its subsidiary, Bear Stearns Asset Management (BSAM), it managed two hedge funds which invested in structured CDOs. These funds were managed on behalf of third-party investors; however, Bear Stearns had also invested approximately USD 25 million into the funds and had loaned the funds approximately USD 1.6 billion (Financial Crisis Inquiry Commission 2011, 240-1).

By April 2007, BSAM's internal risk exposure reports showed that one of the funds: "High-Grade Structured Credit Strategies Fund" (High-Grade) comprised approximately 60% of subprime mortgage backed CDOs, assets that were beginning to deteriorate quickly in value (Bear Stearns Asset Management 2007; Ryback 2010). The second fund: 'Enhanced Fund', which was similarly structured, had even more leverage and hence was deemed higher risk. These funds could only be valued on the basis of the underlying assets which comprised subprime mortgage CDOs, and were difficult to value when the market for CDOs became illiquid.

A common practice of tracking the values of such assets was to monitor the ABX Index, described as: "a Dow Jones-like index for credit default swaps on BBB-tranches of mortgage-backed securities" (Financial Crisis Inquiry Commission 2011, 233). The value of these funds came under pressure as the ABX Index fell 3% in the last quarter of 2006, followed by an 8% drop in January 2007 and a 25% drop in February 2007 (Financial Crisis Inquiry Commission 2011, 238). Consequently, investors began to redeem their investments in both funds. In June 2007, the funds' 'Repo lenders' declined to renew their funding. Despite the abovementioned equity and debt support provided by Bear Stearns, BSAM's parent had no legal obligation to rescue either the funds or the Repo lenders. By July, the two hedge funds had shrunk to negligible value with the High-Grade Fund having reduced by 91% and the Enhanced Leverage Fund, down by 100% (Financial Crisis Inquiry Commission 2011, 241). On 31 July, both funds filed

for bankruptcy. The bankruptcy of the BSAM funds would be viewed as a seminal point in the chronology of events of the last days of Lehman Brothers and the GFC generally. In an internal email in June 2007, Bill Jamison of Federated Investors, one of the largest mutual funds in the US, referred to the BSAM hedge funds as the “canary in the mineshaft” (Financial Crisis Inquiry Commission 2011, 241). Given that most of the CDOs in the funds were originally assigned ‘AAA’ ratings by the credit rating agencies, trust in the ratings and in the safety of similar assets was shattered.

Bear Stearns decided to take responsibility for the Repo contracts originated by the High-Grade Fund. It transferred approximately USD 1.6 billion of the liabilities and respective subprime loans onto its own balance sheet and repaid the lenders. In November 2007, the firm recorded USD 1.9 billion write down on the subprime assets which prompted investors to examine Bear Stearns’ financial statements more closely. Following the release of Bear Stearns’ fourth quarter loss of USD 379 million, the firm’s lenders progressively required Bear Stearns to lodge a higher percentage value and better-quality securities as collateral against their Repo loans, and also charged higher interest rates (Financial Crisis Inquiry Commission 2011, 280). On 13 March, 2008, a liquidity crisis generated by rapid claims for repayment by lenders forced Bear Stearns to inform the SEC that it would be unable to operate normally the following business day. On 14 March, 2008, in response to the elevated systemic risk arising from Bear Stearns financial difficulties, the Federal Reserve funded a USD 12.9 billion loan channelled through JP Morgan to Bear Stearns. Upon publication of this loan, Bear Stearns’ S&P credit rating dropped from “A” to “BBB”. At the close of business, Bear Stearns’ liquidity had evaporated and its stock price declined by 47% (Financial Crisis Inquiry Commission 2011, 289)

Ultimately, the Federal Reserve structured a deal involving JP Morgan Chase whereby the Federal Reserve purchased USD 29.9 billion of Bear Stearns’ assets via a special purpose vehicle owned by the Federal Reserve, thus removing the bulk of the toxic assets from the firm’s balance sheet. To fund the purchase, the Federal Reserve and JP Morgan Chase loaned USD 28.82 billion and USD 1.15 billion to the SPV respectively. The second leg of the deal involved JP Morgan Chase acquiring the shares of Bear Stearns at a price of USD 10 per share (Financial Crisis Inquiry Commission 2011, 290). The deal was so structured as “[t]he Federal Reserve and the Treasury Department would not support a transaction where Bear Stearns’

stockholders received any significant consideration because of the moral hazard of the federal government using taxpayer money to ‘bail out’ the investment bank’s stockholders” (Financial Crisis Inquiry Commission 2011, 290). It was clear that Bear Stearns’ failure was precipitated from a liquidity shortage driven by the abovementioned run by creditors. According to Cox (2008b, 1), in a letter to the Basel Committee of Banking Supervision relating to “Sound Practices for Managing Liquidity in Banking Organizations” the Chairman of the SEC, Christopher Cox wrote:

... Even at the time of its sale on Sunday, Bear Stearns’ capital, and its broker-dealers’ capital, exceeded supervisory standards. Counterparty withdrawals and credit denials, resulting in a loss of liquidity, not inadequate capital, caused Bear’s demise (Cox 2008b).

The recognition of the importance of liquidity would be a lesson unheeded by Lehman Brothers’ leadership team. In response to this concern, the Federal Reserve announced the creation of the Primary Dealer Credit Facility—a program allowing investment banks for the first time to borrow money directly from the Federal Reserve, which up until then provided liquidity facilities only to registered banks.

Investment banks had been relying on high levels of leverage to raise funds on their balance sheets. This practice was soon highlighted to the stockholders of investment banks and share prices of all the major investment banks began to decline during 2008 (Masood 2009). The problems mentioned above were not only limited to the investment banking industry as any financial institution holding mortgage-related assets, in particular, subprime mortgages, was negatively impacted. Two government sponsored institutions that faced similar challenges were Fannie Mae and Freddie Mac.

Fannie Mae and Freddie Mac’s Rescue

On 7 September, 2008, a week before Lehman Brothers’ bankruptcy, the Federal National Mortgage Association, (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) were taken over by the government and placed in a conservatorship which is the equivalence of a managed bankruptcy. They too were adversely affected by the bursting of the property bubble. Fannie Mae’s losses for the full year in 2008, were estimated at between USD 18 billion and USD 50 billion, whilst Freddie

Mac's losses were estimated at between USD 11 billion and USD 32 billion by the end of the year (Financial Crisis Inquiry Commission 2011, 320). Fannie and Freddie were considered "too big to fail". Although privately owned prior to their takeover, these institutions were known as government sponsored enterprises (GSEs) as they purportedly undertook activities supported by the government in underwriting new mortgages to the US public. These GSEs were highly leveraged, with mortgage exposures of USD 5.3 trillion backed by capital of under 2% (Financial Crisis Inquiry Commission 2011, 309).

The rescue of the GSEs involved a complex arrangement. Firstly, the Treasury would buy USD 200 billion of senior preferred stock issued by the GSEs and extend them short term secured loans. In addition, it pledged to buy GSE mortgage-backed securities from the investment banking industry and others until the end of 2009. The deal also involved the issuance of warrants over common stock to the Treasury representing 79.9% of the stock outstanding (Financial Crisis Inquiry Commission 2011, 320). In effect, this rescue effort resulted in the government owning a majority of the GSE's ordinary stock and all of their preferred stock. Notwithstanding the loss to equity investors, Treasury had once again managed to stave off a major crisis by direct intervention and the use of taxpayers' funds.

Lehman Brothers' Last Weekend

As mentioned above, investment banks relied heavily on short-term debt in order to operate. The continuing rolling over of short-term debt depended on a counterparties' faith in the firm's ability to honour its obligations. As soon as customers and creditors began to question the sustainability of the firm, they grew wary and either reduced their credit and/or trading limits or even worse, sought full repayment of outstanding loans (Financial Crisis Inquiry Commission 2011).

Within weeks of Lehman Brothers' second quarter earnings release on 16 June, 2008, several major financial institutions had reduced their exposure to the firm. These included "Natixis, a French investment bank that cut all activity with Lehman Brothers; Federated Investors—a large money market fund and one of Lehman Brothers' largest Repo lenders which had frozen all new transactions; other large pension funds and some smaller Asian central banks" (Financial Crisis Inquiry Commission 2011, 328). The

perception of weakness exacerbates the reality of weakness within an industry that relies on confidence between counterparties. Importantly, one of the most visible measures of a firm's weakness is a declining share price. Lehman Brothers' share price of USD 27.20 at 16 June, 2008, (the date of the second quarter results' conference call) was down 104% since 1 January 2008. By 29 August, 2008, Lehman Brothers' share price had declined further to USD 15.20. During this month, Fuld finally realised that the firm required a rescue plan and proceeded to search for a buyer for the firm. "We contacted virtually every financial institution in the world with the interest and capacity to deal, says a person close to the process" (Fishman 2008). Despite several attempts to find a buyer, the most serious of which was Barclays Bank in the UK, there were no institutions willing to invest in a less than transparent entity where asset values were obscure at best.

In a speech in April, 2008, David Einhorn of Greenlight Capital, which was then shorting Lehman Brothers' shares, and was an analyst who closely investigated Lehman Brothers' accounting practices commented on Lehman Brothers' real estate loans:

... Lehman does not provide enough transparency ... There is good reason to question Lehman's fair value calculation. Lehman responds to greater transparency begrudgingly. I suspect that greater transparency on these valuations would not inspire market confidence (Einhorn 2008b, 9).

In a foreboding presentation, Einhorn's discovery of accounting discrepancies also led him to comment as follows:

... My hope is that Mr. Cox and Mr. Bernanke and Mr. Paulson will pay heed to the risks to the financial system that Lehman is creating and that they will guide Lehman toward a recapitalization and recognition of its losses – hopefully before federal taxpayer assistance is required...I think that there is enough evidence to show how Lehman answered the difficult question as to whether to tell the truth and suffer the consequences or not. This raises the question, though, of what incentive do corporate managers have to fully acknowledge bad news in a truthful fashion? For the capital markets to function, companies need to provide investors with accurate information rather than whatever numbers add up to a smooth return. If there is no penalty for misbehaviour– and, in fact, such behaviour is rewarded with flattering stories in the mainstream press about how to handle a crisis—we will all bear the negative consequences over time. At a minimum, what message does this send to some of Lehman's competitors

that probably didn't have problems quite as acute as Lehman, but who took sizable write downs, and diluted their shareholders with significant equity raises? (Einhorn 2008a, 9).

JP Morgan Chase was Lehman Brothers' clearing bank and, in this capacity, acted as the banking intermediary between Lehman Brothers and its Repo lenders. As well as providing credit from time to time, JP Morgan Chase ran overnight exposures in the day-to-day activity of settling the firm's Repo transactions. On Tuesday, 9 September, 2008, JP Morgan Chase requested USD 5 billion in extra collateral. Instead, Lehman Brothers offered USD 3.6 billion which allowed it to operate for at least some time longer (Financial Crisis Inquiry Commission 2011). It was obvious that if Lehman Brothers did not lodge the extra collateral, JP Morgan Chase would essentially freeze its accounts and Lehman Brothers would cease trading. JP Morgan Chase had clients (the Repo lenders and other counterparties relying on it as Lehman Brothers' clearing bank) whose interests it had to defend.

Fuld continued to deflect responsibility for Lehman Brothers' difficulties claiming Jamie Dimon, JP Morgan Chase CEO, "was doing whatever was in his own personal interest. He knew the consequence was a huge blow to us, and he didn't give a shit...they drained us of cash...They fucked us" (Fishman 2008). This quote reveals Fuld's focus on personalities instead of the institutional relationship between JP Morgan Chase and Lehman Brothers. Fuld had resorted to personalise Lehman Brothers' problem making Dimon the source of Lehman Brothers' crisis instead of rationally examining Lehman Brothers' culpability and the underlying reasons for the firm's financial crisis. This emotional irrationality can be seen as an example of Fuld's state of mind at the time and his propensity to blame individuals who did not conform to his own expectations of practice. Fuld's power had been challenged and he did not like it.

On Wednesday, 10 September, 2008, Lehman Brothers reported a third quarter loss of USD 4.09 billion for the quarter ending 31 August 2008. This loss together with the previous second quarter loss of USD 2.87 billion for the quarter ending 31 May 2008, was accounted for after applying the newly released accounting standard, Statement of Financial Accounting Standards No. 157, (FAS 157). FAS 157 which applied to corporations after November 15, 2007, essentially required financial assets to be brought to account at "fair value" which was interpreted by the finance industry as market value. As a result of this new definition, and given the deterioration

in the market value of Lehman Brothers' assets, it brought to account the accompanying devaluation losses in the profit and loss statement (Financial Accounting Standards Board 2006a).

Simultaneously, in an effort to generate cash, Fuld developed a strategy to dispose of both the Investment Management Division and its distressed real estate portfolio. In an attempt to calm market sentiment, and in a tone of confidence and control, he announced to the market that the firm would recover: "We have a long track record of pulling together when times are tough...we are on the right track to put these last two quarters behind us" (Fishman 2008). More bad news was released to the market as potential investors in the firm retreated. When negotiations for an investment from the Korea Development Bank ceased, the market became increasingly wary of Fuld's ability to execute a survival strategy (Financial Crisis Inquiry Commission 2011, 330).

On Thursday 11 September, 2008, JP Morgan Chase once again demanded Lehman Brothers post another USD 5 billion in cash collateral. In an internal email circulated on Friday, 12 September, 2008, Lehman Brothers executives were informed that "[i]f we don't provide the cash [to JP Morgan Chase], they refuse to clear, we fail" (Financial Crisis Inquiry Commission 2011, 333). In a desperate attempt to stave off a default claim by JP Morgan Chase, Lehman Brothers undertook a fire sale of assets. It posted the USD 5 billion cash by selling virtually all remaining unencumbered financial assets it owned (Financial Crisis Inquiry Commission 2011, 333).

Starting Friday night, 12 September 2008 and continuing throughout the ensuing weekend, a series of meetings were convened at the Federal Reserve offices. These meetings involved US Treasury Secretary, Hank Paulson, the President of the New York Federal Reserve, Timothy Geithner, a number of government and regulatory officials and CEOs of the major US commercial and investment banks. Also attending some of the meetings representing Lehman Brothers were McDade and Kirk. Fuld was not invited to the meetings (Financial Crisis Inquiry Commission 2011, 334).

Various options to rescue Lehman Brothers were discussed, including plans for sovereign wealth funds, Bank of America (BoA) and Barclays Bank to absorb Lehman Brothers in one form or another. However, all negotiations failed due to potential rescuers requiring a government guarantee or investment (as occurred in the Bear Stearns rescue package), protecting

them from the potential losses resulting from the toxic assets. It became clear that the government's position as represented by Paulson and Geitner was not to inject any capital or provide other support by way of a guarantee to potential investors. According to Paulson, the assistance for Lehman Brothers:

... should be done in a way that requires minimal temporary support... no equity position by [the] Fed. Moral hazard and reputation cost is too high. If the Fed agrees to another equity investment, it signals that everything [the Fed] did in March in terms of temporary liquidity backstops is useless. Horrible precedent... bankruptcy, would be a mess on every level, but fixes the moral hazard problem (Mosser 2008).

Further for Paulson, "such a guarantee by the Fed was unequivocally out of the question" (Paulson 2011, 209-10). During the weekend, news spread of the financial difficulties of another major investment bank, Merrill Lynch. Further to a meeting between John Thain, CEO of Merrill Lynch and Ken Lewis, CEO of BoA, an agreement was reached whereby BoA would acquire Merrill Lynch by paying USD 29 a share. The payment to Merrill Lynch shareholders was to be made in BoA shares (Financial Crisis Inquiry Commission 2011, 335). Having participated in the weekend's meetings relating to Lehman Brothers, Thain was concerned that Merrill Lynch would soon follow Lehman Brothers into bankruptcy and therefore sought a rescue and agreed to the terms offered by BoA.

At the conclusion of meetings on Sunday night, 14 September, 2008, McDade returned to Lehman Brothers' head office with feedback to Fuld and the board that Geitner and Paulson had recommended the firm file for bankruptcy given that no rescue package had come to fruition. This news surprised the executives as the hubris which enveloped Fuld and others had blinded them to the ultimate possibilities of a bankruptcy. "Dick never believed zero was an option. He believed at the end of the day, good guys win" (Fishman 2008). Fuld's denial of the severity of the problem persisted until the very end as he was convinced, he was one of the "good guys". The next day, at 1.45am on Monday morning, Lehman Brothers filed for bankruptcy.

The Shifting Nature of Power and Institutional Influence

A combination of “exogenous environmental” and “endogenous” factors conspired to shift the direction of power away from Fuld. It also heightened an institutional shift away from the neo-liberalist approach adopted by the government and its agencies towards an increasingly interventionist approach with some incongruous consequences for Lehman Brothers.

Endogenously, the deteriorating performance of Lehman Brothers during 2007 and 2008 resulted in two particular outcomes. Firstly, it led to greater scrutiny of the firm, which precipitated increased market pressure to become more transparent. This in turn prompted the market sell-off of Lehman Brothers shares, adversely affecting the value of the firm. Secondly, an inconsistent bonus outcome for a segment of Lehman Brothers’ staff caused a degree of resentment which disrupted the historically resilient loyal relationship between employees and Fuld. These endogenous factors contributed to the shift of power between the two groups. The power previously held by Fuld and his well-compensated senior executive team had shifted to the firm’s other stakeholders, including its lower-level employees.

The underperformance during 2007 and 2008 created an atmosphere of disappointment, uncertainty and even scepticism amongst stakeholders including creditors, stockholders and their securities analysts. The actions of Lehman Brothers and its key executives experienced greater scrutiny by external observers, especially the security analysts, such as Einhorn. The common perception that the longest serving CEO on Wall Street, “could do no wrong” gradually disappeared. Fuld’s ability to make uncontested decisions was diminishing.

A study by Petukh (2009), found a reversal in broker recommendations from a positive stock “buy” recommendation before the release of Lehman Brothers’ 2008 second quarter results to either a neutral “hold” or negative “sell” recommendation afterwards. As analysts grew wary of Lehman Brothers’ financial position, their level of scrutiny over the firm increased. “They tracked every decision made by management and reported on positive and negative effects” (Petukh 2009, 32).

Fuld's social relations within and outside the firm (the agencies in Clegg's circuits of power) were weakening thereby reducing his means of directing outcomes. The increasing vigilance of securities analysts and the media demonstrated through their respective actions of shorting Lehman Brothers shares and increasing negative media reporting transformed the rules within which Lehman Brothers was accustomed to operate.

The pressure for enhanced transparency is interpreted as a refixing of the rules contained in Clegg's dispositional circuit. Transparency was required in the release of the third quarter financial results. The USD 4.09 billion loss represented the outcome of a newly refixed "transparency" rule transmitted through the obligatory passage point of the newly released accounting standard on "fair market value". The social relations between analysts and Lehman Brothers' financial control executives had changed and trust in Lehman Brothers' financial reporting had lessened.

Pursuant to the new accounting standard FAS 157, Lehman Brothers was pressured to disclose more details than usual, resulting in a clearer picture of their true financial predicament. In the process, a shift of power occurred from Fuld and his team to the external agencies comprising Lehman Brothers' stakeholders and the media. The new holders of power were finally able to make informed decisions based on a true and fair position of the firm.

The second endogenous factor is associated with the first and relates to bonus compensation. The declining performance of Lehman Brothers involved a commensurate decrease in compensation paid to employees. Throughout his tenure at Lehman Brothers, Fuld was admired by his employees. Even from a distance, Paulson observed that Fuld "was direct and personable, a strong leader who inspired and demanded loyalty, but like many founders his ego was entwined with the firm's. Any criticism of Lehman was a criticism of Dick Fuld" (Paulson 2011, 123). Hence, whilst Lehman Brothers performed strongly and paid generous bonuses, Fuld engendered gratitude and loyalty. Since the firm's listing, Lehman Brothers produced profits in each year until 2008, thereby perpetuating the strong loyalty commanded by Fuld.

Once the firm began experiencing financial distress late in 2007, there were signs of dissension within the ranks. This was exemplified by Gelband's and Kirk's attitudes towards Lehman Brothers' elevated risk

profile and their willingness to confront Fuld with their concerns. The dissension, although only acted upon by very few such as Gelband and Kirk who were pressured to leave the firm, was affecting numerous employees.

Despite the dramatic share price decline in the second half of 2007, the year was deemed successful from a financial reporting perspective. Lehman Brothers reported a record net profit after tax for the year ended 30 November, 2007, of USD 4.13 billion (up by 5% from the previous year) and total revenue of USD 59 billion (up by 26% over the previous year). 2007 represented the fifth consecutive year of record profits. When the bonus pool was announced for 2007, many employees were left dissatisfied. Lawrence McDonald, the Vice President of Distressed Debt and Convertible Securities at Lehman Brothers during 2007 commented on Fuld and Gregory as follows:

... It was however perfectly obvious that the two leaders had nothing but contempt for us. And when they sat down to work out the bonuses, they screwed us all. The traders' standard agreement on Wall Street had been a USD 20 million profit to earn a USD 1 million bonus. That went straight out the window. My bonus, after my second straight USD 30 million a year was way down, nowhere near my expectations. It was the same all through the department. Dick [Fuld] and Joe [Gregory] just cut us all back—Beggans, Gramins, Schellbach, Stafford, Castle. And now we had no one to fight for us (McDonald and Robinson 2009, 274).

Although the Total Annual Compensation Report dated 28 January, 2008, shows a number of executives with increased bonuses, a degree of resentment such as that displayed by Lawrence MacDonalld persisted from some quarters within Lehman Brothers. The resentment would have been amplified once staff discovered that Fuld and Gregory had received record bonuses in 2007 of USD 40 million and USD 34 million respectively (Lehman Brothers Holdings 2008f). Dissatisfaction at this disparity in compensation levels between Fuld and Gregory and the rest of the staff prompted further challenges to Fuld's authority. Consequently, the power that Fuld exercised by virtue of being the principal largely responsible for fixing the rules relating to compensation arrangements, had begun to diminish as disaffected staff viewed the exercise of this power as being inequitable and unfair.

The exogenous environment influencing Fuld's power base included the political atmosphere, the social relations between the investment banking

industry, key regulators, politicians, and the economic climate. Each of these factors would influence Fuld's power in their interaction as external exigencies through either the dispositional or facilitative circuits as explained below.

Economic Climate

Despite experiencing a cyclical downturn in 2001, the US economic climate from 1994 to 2007 had been positive without recording any negative Gross Domestic Product (GDP) growth rates (Figure 9.10).

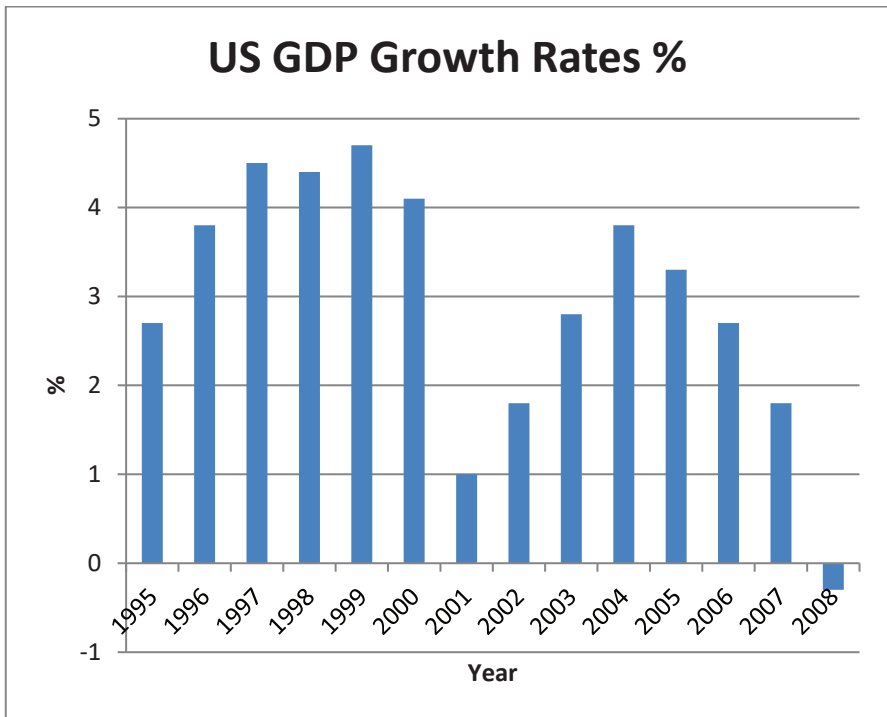


Figure 9.10: US Economic Growth 1994 – 2008

Source: The data used for the graph were extracted from the World Bank, International Comparison Program database (World Bank 2016)

This pattern of prosperity is confirmed as measured by Gross National Income (GNI) per capita which also improved consistently up to 2008 (Figure 9.1).

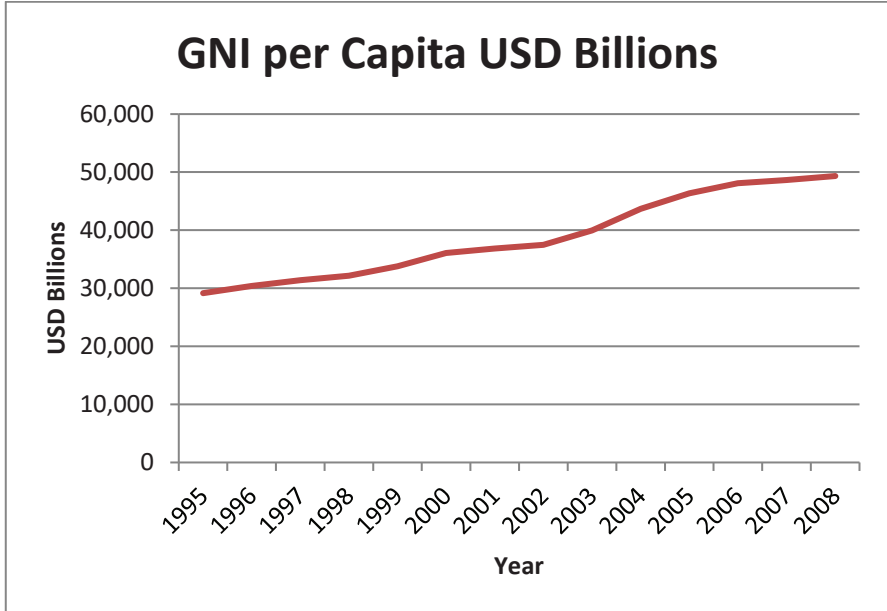


Figure 9.11: US GNI per Capita 1994 – 2008

Source: The data used for the graph were extracted from World Bank, International Comparison Program database (World Bank 2016)

From 2001 onwards, a credit bubble started to appear in the US. Significant amounts of capital moved into the US in search of higher returns. Much of the imported capital was directed to the financial institutions sector and used to fund home mortgage lending. A housing bubble was in the making, and through the process of securitisation, financial institutions replenished their balance sheet borrowing capacities and poured further money into the housing market.

The positive economic climate prevailing at the time of Fuld's leadership had convinced the various successive federal governments in the US to continue pursuing a neo-liberal approach spurred initially by its champion, Ronald Reagan, the 40th President of the US from 1981 to 1989. This

approach was characterised by a “low regulatory touch” and whilst the investment banking industry was thriving, a *laissez-faire* attitude towards regulation allowed the markets to virtually self-regulate. This political environment known as “Reaganomics” at its inception, provided relative autonomy to the industry and allowed the powerful lobby group to successfully prosecute the financial industry’s objective of influencing the regulatory framework.

Further, Alan Greenspan, the Federal Reserve Chairman during the period between 1987 and 2006, pursued an accommodative monetary policy which continued to support asset markets. The resultant lower interest rates permitted a cheaper financing of asset purchases including property contributing to the abovementioned property bubble of 2008. Refer to Figure 9.12 for a graph charting the declining trend of the Federal Reserve Funds Rate (Fed Funds Rate) during this period.

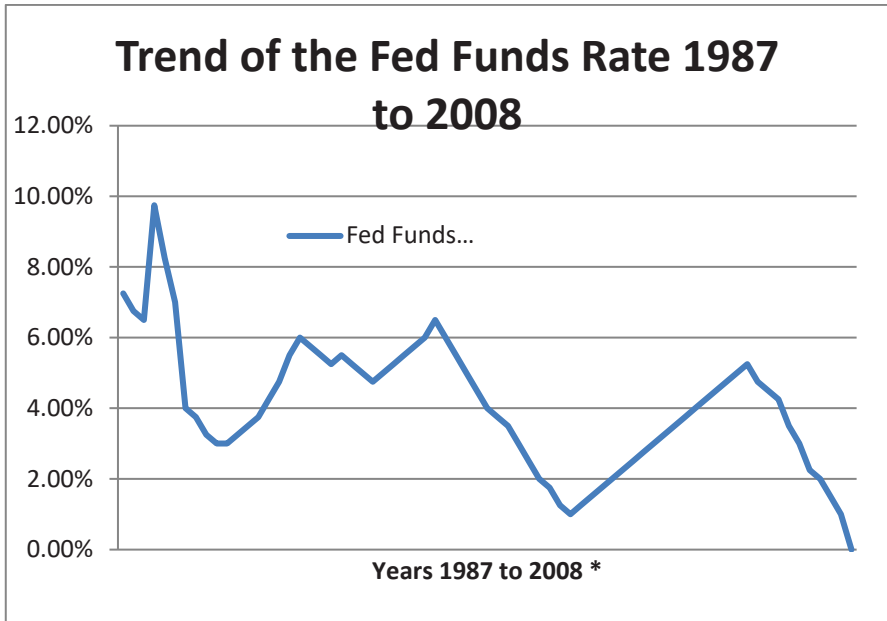


Figure 9.12: Fed Funds Rate 1987 to 2008

* For detailed changes in the Fed Funds Rate refer to Appendix C.

Source: Data for graph sourced from Federal Reserve Bank of St. Louis FRED Economic Data-Federal Reserve Bank of St Louis 2016

Economic Climate as an Exogenous Factor in the Facilitative Circuit

The economic climate, an exogenous factor, as depicted in Clegg's (1989) facilitative circuit was the external stimulus to empower the industry. The power to influence regulation by the investment banking lobby group met little resistance in the *laissez-faire* environment and the lobbyists who carried out the wishes of the industry represented the obligatory passage point between the facilitative circuit and the episodic circuit where the influence on legislators was exerted. As Chairman of one of the largest firms on Wall Street, this power which was facilitated by the economic climate, also flowed to Fuld.

However, as soon as the positive US economic climate began to turn during 2007/2008, the liberal approach previously adopted by regulators and legislators reversed. The Treasury and Federal Reserve were attempting to update the regulatory framework to ensure the activities and leverage of investment banks were effectively supervised and to rein in the worsening risk profile of participants. These actions were an acknowledgement that regulators had lagged the changing practices and innovation within the industry (Johnson and Kwak 2011; Paulson 2011). The regulatory structure, based on traditional lines had not kept up with the evolution of the markets. This was acknowledged by Paulson as follows: "As a result, the country had a patchwork system of state and federal supervisors dating back 75 years...which had led to counterproductive competition among regulators, wasteful duplication in some areas and gaping holes in others" (Paulson 2011, 125).

Accordingly, in March 2008, Paulson unveiled the "Blueprint for a Modernised Financial Regulatory System" (Paulson et al. 2008). This document proposed a new regulatory structure, not new regulations, though Paulson admitted that "we clearly needed some" (Paulson 2011, 126). Despite the efforts in preparing this report, Paulson emphasised that "no major regulatory changes should be enacted while the financial system was under strain" (Paulson 2011, 126).

Political Atmosphere

Following the government's bailout of Bear Stearns earlier in 2008, the government detected a backlash from the public to using taxpayer funds as a bailout for private industry. Moreover, an investment bank whose employees were remunerated far in excess of the US average wage represented the worst aspect of greed and avarice. This perception was heightened after the taxpayer funded rescue of Fannie Mae and Freddie Mac and the expansion of industry assistance provided by way of the Primary Dealer Credit Facility (PDCF). Treasury's major concern at this time was the moral hazard created following these government assisted bailouts. On 10 September, 2008, five days prior to the bankruptcy announcement, Paulson and Geithner agreed that Lehman Brothers should not be bailed out:

... All of us were well aware that after Fannie and Freddie, the country, Congress, and both parties were fed up with the bailouts. Obama and McCain, neck and neck in the national polls, each spoke out against them on the campaign trail. The previous day in fact McCain and Palin had published an op-ed in the Wall Street Journal entitled 'We'll Protect Taxpayers from More Bailouts'. And just before our conference call had begun, I'd spoken with Chris Dodd who told me, Fuld is a friend. Try to help, but don't bail Lehman out (Paulson 2011, 181).

Urged by politics, Paulson and Geithner heeded Dodd's advice. Paulson had also agreed with Cox from the SEC and Bernanke from the Federal Reserve that as representatives of the key regulatory authorities involved in the US financial system, they should keep close communication, and coordinate and seek consensus on all meaningful decisions and actions (Paulson 2011). Therefore, any legislative initiative by any one of them is deemed to have tacit approval from all three authorities before enactment.

Dodd as Chairman of the Senate Banking Committee was perceived within and outside of government as the political thought leader in the financial system. Therefore, he possessed authority within the dispositional circuit given his ability to influence rule making and the meaning of those rules, and fixing relations of membership between government and regulators. Ultimately, Dodd's power was facilitated by his influence over the US President's power to appoint The Secretary of the Treasury, the two Under Secretaries, an Under Secretary for Enforcement, and two Deputy Under-

Secretaries. The President relies on the Senate for his recommendations and the Senate was strongly guided by the Chairman of the Senate Banking Committee who at the time was Dodd (U.S. Code: Department of the Treasury 1947).

Changes in Social Relations between Industry and Government within the Episodic Circuit

Changes of social relations between agencies at the episodic level have the potential to impact the degree and direction of power to generate a different outcome. The social relations between Lehman Brothers and the regulatory community had changed during the onset of the crisis, resulting in outcomes detrimental to Lehman Brothers. Paulson had known Fuld for many years, since Paulson was ex-CEO of Goldman Sachs prior to his appointment as the Treasury Secretary and as a result they had many dealings on a professional level. Paulson (2011, 155) expressed concern about Lehman Brothers and claims that he “kept an eye on Lehman’s travails, speaking regularly with Dick about his options. The best of these were to sell his firm”. Paulson’s call log would show nearly fifty discussions with Fuld in the six months between Bear Stearns’ failure and Lehman Brothers’ collapse, and his staff would have had at least as many calls from Fuld (Paulson 2011, 137). On 9 September, Paulson expressed his frustration with Fuld in a conversation with Ken Wilson:

... Does he [referring to Fuld] know how serious the problem is? I asked? He’s still clinging to the view that somehow or other the Fed has the power to inject capital. Ken answered. I felt a wave of frustration. Tim Geithner and I had repeatedly told Dick that the government had no legal authority to inject capital in an investment bank. That was one reason I had been pushing him to find a buyer since Bear Stearns failed in March. Fuld had replaced Lehman’s top management, laid-off thousands of employees, and pitched restructured ideas, but the firm’s heavy exposure to mortgage-backed securities had discouraged suitors and had left him unable to make a deal. Ken had been telling Dick [Fuld] with increasing urgency that he needed to be ready to sell, but Dick did not want to consider any offer below USD 10 per share. Bear Stearns had gotten that, and he would accept nothing less for Lehman (Paulson 2011, 173).

Despite Paulson’s repeated efforts to convince Fuld to sell Lehman Brothers, a sale was never consummated. The personal antipathy and frustration towards Fuld by Paulson over this inaction promoted an

increasing indifference towards the survival of Lehman Brothers. After all, Fuld was placing the financial system at risk – a financial system over which Paulson had stewardship. Fuld had unsuccessfully negotiated with several potential suitors including Berkshire Hathaway, General Electric, Bank of America, Korea Development Bank, the Chinese government owned Citic Securities, Deutsche Bank, Morgan Stanley, HSBC and some middle eastern sovereign wealth funds, however most negotiations failed as a result of Fuld wanting too high a price (Johnson and Kwak 2011; McDonald and Robinson 2009; Paulson 2011). Paulson’s frustration towards Fuld was clear: “It was clear to Ken and me [Paulson] that Dick [Fuld] was looking for an unrealistic price” (Paulson 2011, 158). This attitude could be considered as a contributing factor to Paulson’s attitude towards allowing Lehman Brothers to fail.

As the Treasury Secretary, Paulson had executive powers under legislation to protect the financial system. Within the facilitative circuit, the legislation constitutes an exogenous stimulus. Paulson’s power differed between that available to enforce legislation and to influence any change in legislation. The power to enforce is afforded within the dispositional circuit given his role as head of the Treasury Department and his intimate knowledge of the applicable laws. The power could flow through to the episodic circuit where the implementation and enforcement of the existing legislation could direct the behaviours of the industry participants.

Paulson was however seeking to introduce new legislation to deal with the new financial industry environment, particularly with entities dealing in derivatives. His power to change legislation, however, was limited. This power requires agreement by both houses of Congress. To channel power to the episodic circuit, Congress would need to exercise its dispositional power inherent in its authority to enact legislation. The power would then need to pass to the external government agencies to enforce the applicable legislation. Paulson realised that to push for any new legislation, he would need political support within both houses of Congress. This power was concentrated within two committees, the House Financial Services Committee and the Senate Banking Committee. Paulson acknowledged the lagging regulatory response:

... The financial world had changed – with investment banks and hedge funds playing increasingly critical roles – but our [Treasury Department] powers and authorities had not kept up to date (Paulson 2011, 138).

In his attempt in July 2008 to establish new legislation to deal with troubled investment banks, Paulson sought the advice of Barney Frank, Chairman of the House Financial Services Committee:

... Barney Frank was supportive but cautioned us against trying to push legislation that was so complex substantively and politically. We concluded that there was no way we could get what we needed passed... We knew it wasn't going to be easy to work with the authorities we had... Instead Barney encouraged the Fed [Federal Reserve] and Treasury to interpret our existing powers broadly to protect the system, saying: If you do so, I'm not going to raise legal issues (Paulson 2011, 139).

Furthermore, Paulson complained: "I'm being called Mr. Bailout. I can't do it again" (Wessel 2010, 14). Geithner added: "There is no political will for a federal bailout" (Wessel 2010, 16). The lack of political will through either of the government's representative bodies, the House Financial Services Committee and the Senate Banking Committee, to introduce new legislation specifically to deal with Lehman Brothers' difficulties signalled a change of attitude. This attitude had the effect of disempowering the investment banking industry, by limiting its options to survive a crisis.

The Wash-up

Following Lehman Brothers' declaration of bankruptcy, liquidity in the financial markets had evaporated and securities began to trade at heavy discounts. The Treasury Department realised it needed to secure funding to buy the toxic securities held in the market to prevent a wider meltdown. This was enabled by new legislation known as the Emergency Economic Stabilisation Act which was passed on 3 October, 2008.

In addition, the Federal Reserve committed trillions of dollars to an expanding list of liquidity programs intended to support the financial system. These included the Term Auction Facility, the Term Asset-Backed Securities Loan Facility, The Money Market Investor Funding Facility, and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. The considerable government assistance would become the largest industry support package in US history. The US government realised the dire consequences to the larger economy if it was not prepared to act. The ultimate irony of this turn of events was that the support was directed to an industry which had for decades rejected and lobbied against

government intervention. Policymakers who once espoused a minimalist approach to industry supervision were encouraging intervention.

This chapter analyses the contributing factors immediately preceding Lehman Brothers' collapse such as the role played by innovation which included the use of CDOs and their credit downgrading; the practice of warehousing mortgage related assets, which left Lehman Brothers overexposed to this asset class and placed them in a precarious financial position; the lack of sufficient transparency by Lehman Brothers, considered important to maintain investor confidence; and the effect on Lehman Brothers' share price once confidence in them was lost. This chapter further reveals evidence of the behaviour of some Lehman Brothers employees and Fuld himself towards external partners in their attempts to stave off a crisis. Fuld's reaction to the firm's difficulties was subject to institutional influence and his attempts at an expansionary strategy and denial of his own accountability is shown as an exercise of power. The regulator's contrasting attitude towards other troubled financial institutions which were rescued and Lehman Brothers reflected the shifting nature of power between Lehman Brothers and the regulators. The dysfunctional behavioural and cultural influences on Lehman Brothers had established the foundation for a series of decisions which led to a deterioration of its risk profile which ultimately caused its bankruptcy.

CHAPTER 10

MODELS AND NUMBERS

The previous chapter covered the period prior to Lehman Brothers' collapse, analysing the institutional influences and the dysfunctional exercise of power and how these informed management decisions. This chapter examines the investment banking industry's shared business model, analysing it through the lens of DiMaggio and Powell's (1983) New Institutional Theory. Together with a financial overview of Lehman Brothers and its peer group, the chapter identifies mimetic pressure as the key influence on Lehman Brothers' business activities and financial structure. The mimetic influence explains why all the major US investment banks experienced similar financial difficulties albeit to various degrees. Further, this chapter argues that the excessive leverage Lehman Brothers accumulated was a root cause of its failure.

Lehman Brothers and some of its peers had reached a critical level of risk. In an effort not to underperform relative to their peers, the investment banks largely gravitated towards a common business model and financial structure. Any underperformance would jeopardise access to capital, new customers and potentially, employees with valuable skills. As a result, and in the common pursuit of growth, the peer group pursued the leverage effect as an easy mechanism to increase profitability. The institutional influence on the industry is reinforced by the common consequence of a weakening financial structure where the investment banks pushed their leverage to unsustainable levels.

The next section describes Lehman Brothers' business model as a one stop shop servicing the needs of a full array of clients from the corporate, governmental, institutional and retail sectors. It argues that the business model was subject to a mimetic influence which resulted in a very similar business model and activities adopted by the other large US investment banks. It then provides an overview of the financial structure of Lehman Brothers, which focuses on the firm's trend in profitability, which increased

from 2004 until 2007, culminating in significant losses in the last two fiscal quarters in 2008 preceding its collapse. The losses coincided with an increasing reliance on the firm's risky business of securities trading. This section also reveals Lehman Brothers' increasing leverage ratio during the period based on a capital structure which included some items of capital which, in nature, resembled debt. If this capital was reclassified as debt, a higher leverage ratio would have resulted. Finally, it is argued that the combination of increased debt and the use of securitisation and credit derivatives was a popular means of maximising profits amongst all investment banks. This common approach to exploiting the leverage effect is reflected in a range of similar returns generated by the peer group and supports the notion of a mimetic pressure amongst the banks to pursue similar strategies in their profit maximisation objectives.

Lehman Brothers' Business Model

The financial structure of Lehman Brothers is a consequence of its business model, strategy, activities and financial transactions. In their efforts to compete for valuable resources such as capital, reputation, prestige, skills and new customers, they attempted to avoid a negative perception associated with an underperforming firm. This strong desire not to be perceived as a low-ranking firm spawned a practice of replicating product and services offered by competitors, which resulted in similar divisional organisational structures between firms. However, under financial pressure towards the end of its corporate existence, Fuld deviated slightly from the traditional model. He expanded the property division which at the time was a riskier segment of the overall organisation, in the hope of generating superior returns in an uncertain environment.

By 2006, like many of its peers, Lehman Brothers operated in three major business segments. Firstly, it operated a division known as the Investment Management Division which included departments such as: Private Investment Management, which targeted products towards the retail market such as high net worth individuals; Institutional Asset Management which involved the management of portfolio investments on behalf of institutional, corporate and individual clients; Private Equity where the firm invested in the equity of businesses on behalf of, and alongside its customers; and Securities Services which involved brokerage activities on behalf of clients (Lehman Brothers Holdings 2008j, 8).

The second major business segment was the Investment Banking Division which comprised: Mergers and Acquisitions (M&A); Global Finance; and Corporate Services departments. The M&A department included the Advisory and Restructuring Services sections. The Advisory section was focused on providing advisory services which supported Lehman Brothers' clients' mergers and acquisitions activities, whilst the Restructuring section assisted corporations in distress to overcome financial difficulties. The Global Finance department generally supported the fund-raising activities of Lehman Brothers' clients. The Risk Solutions section within the Global Finance department identified and managed through their use of derivatives, various risks on behalf of clients including interest rates, inflation, commodities and currency risks. The Private Capital Markets section assisted clients by raising private equity and financing through the debt markets to optimise their capital structures. The Leverage Finance, Equity Capital Markets, and Debt Capital Markets sections were involved in client fund-raising, often with underwriting commitments. The major risk carried by Lehman Brothers in these sections involved the price risk associated with variations in a securities price (either debt or equity) during the underwriting period. The remaining department within the Investment Banking Division included: the Corporate Finance department which was organised into global industry groups such as the Communications, Consumer/Retail, Financial Institutions, Financial Sponsors, Healthcare, Industrial, Media, Middle Markets, Natural Resources, Power, Real Estate and Technology groups (Lehman Brothers Holdings 2008j, 7-8). These groups incorporated coverage bankers who were experts in their respective industry specialisation and who were the central point of contact to meet the financial objectives of clients.

The third major division was known as the Capital Markets Division. Through this division, Lehman Brothers operated a number of departments: the Equity and Fixed Income Brokerage department which offered brokerage and research capabilities to its clients; the Proprietary Investments and Trading department where the firm entered into proprietary securities and derivatives positions, thereby creating risks for its own balance sheet; the Mortgage Origination and Securitisation department which was the department which caused Lehman Brothers' major financial distress prior to its collapse, and where Lehman Brothers accumulated vast volumes of mortgage-related assets with the intention of removing them from its balance sheet through the securitisation

process. This area relied on the distribution expertise contained in the Capital Markets Global Distribution department which was involved in: the sales of securities in the primary and secondary markets and; the Capital Markets Prime Services department which covered the Secured Financing, Prime Broker, Futures and Clearing and Execution businesses (Lehman Brothers Holdings 2008j, 4-7).

The Capital Markets Division, specifically, the fixed income section of the proprietary investments department is the division where Fuld and most of his senior management team began their careers and developed their trading culture. Figure 10.1 illustrates the operational structure of Lehman Brothers. This chart is developed from data obtained from detailed descriptions of Lehman Brothers' activities included as part of its prospectus published for a German bond issue planned in 2008, and therefore represents the last formal comprehensive description of the firm's business activities prior to its bankruptcy.

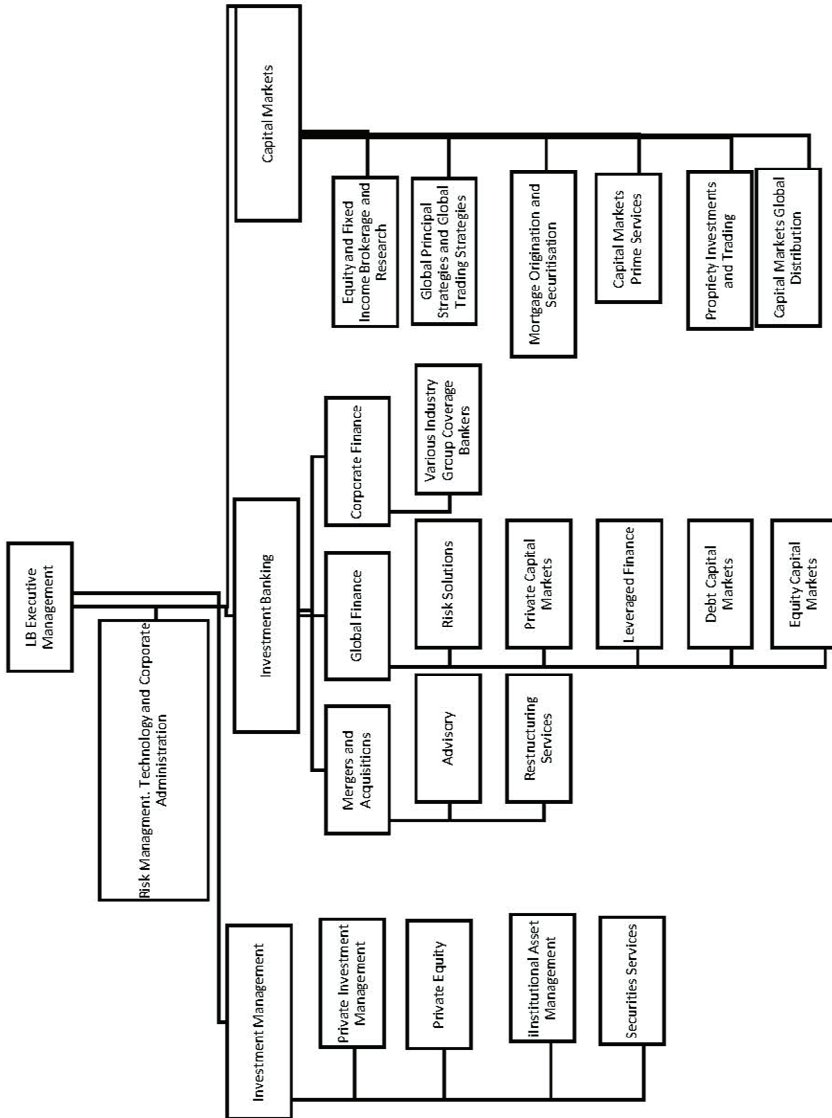


Figure 10.1: Operational Structure of Lehman Brothers
 Source: The data used for the chart were extracted from Lehman Brothers Holdings (2008j, 3-10)

Lehman Brothers serviced a full array of clients and their global headquarters was located in New York with other major offices in London and Tokyo. Other satellite offices were positioned in the US, Europe, the Middle East, Latin America and the Asia Pacific region. As a large investment bank, Lehman Brothers was a significant participant and market-maker in all fixed income and equity markets (Lehman Brothers Holdings 2008j, 3). Lehman Brothers' public trading activities were conducted through most of the major securities and commodities exchanges of which it was a member. These included the NYSE, and other exchanges in London, Tokyo, Hong Kong, Frankfurt, Paris, Milan, Singapore and Australia. Lehman Brothers also held a membership with the Financial Industry Regulatory Authority – FINRA.

Russo, Lehman Brothers' Chief Legal Officer, was a member of the Regulatory Policy Committee of the Board of Governors of the Financial Industry Regulatory Authority, which regulates securities firms and US exchange markets on behalf of the NYSE in accordance with SEC requirements. Therefore, by having an employee as a member of the policy committee responsible for regulating the activities of the securities industry, Lehman Brothers possessed the potential to influence policy debate relating to its own activities. FINRA is an independent not-for-profit organisation authorised by Congress to protect US investors by ensuring the securities industry: operates fairly and honestly; examines firms for compliance to rules relating to securities dealing; promotes market transparency; educates investors; resolves securities disputes; and deters misconduct by enforcing the rules by either imposing fines, suspending or barring firms from operating in the industry. An examination of the Financial Industry Regulatory Authority (2017) database of adjudications and decisions relating to non-compliance of regulations by securities firms which extends back to 1997 revealed no actions against Lehman Brothers.

Apart from its proprietary trading activities, Lehman Brothers conducted business with its clients through a client centric model where a team of coverage bankers maintained relationships with clients based on their industry. This entailed the allocation to clients of industry-expert individuals. An intimate knowledge of the challenges, opportunities, risks and strengths of the client and its industry could provide helpful insights in providing advisory services and generate fund-raising opportunities for Lehman Brothers. Product specialists were called in for assistance as required. Lehman Brothers' strategy was to be a one stop shop for its

clients and to diversify its range of activities in an attempt to withstand downturns in the global and domestic economic cycles.

Similarities in the Peer Group's Business Model

The large investment banks in Lehman Brothers' peer group included Bear Stearns, Morgan Stanley, Goldman Sachs and JP Morgan Chase. Generally speaking, they adopted very similar business models and activities. Although JP Morgan Chase undertook investment banking activities, the majority of its business comprised commercial banking activities. Therefore, any balance sheet or profit and loss comparisons within Lehman Brothers' peer group included in this section needs to account for the nature of JP Morgan Chase's different activities. The comparison should allow for the fact that a material portion of its balance sheet resembles that of a commercial bank whereby the majority of assets comprise loan receivables. This is not typical of an investment bank balance sheet. Operational descriptions of JP Morgan Chase in this section, however, specifically relate to its investment banking operations.

Figure 10.2 below, sets out the relative size of each investment bank based on market capitalization and number of employees as at 2007 in order to provide an overview of the relative position of each investment bank within the peer group.

Figure 10.2: Major US Investment Banks 2007 by Market Value and Number of Employees

Investment Bank	Highest market value 2007 USD Billions	Average number of employees 2007
Merrill Lynch	150.89	64,200
Goldman Sachs	107.05	30,522
Morgan Stanley	83.34	56,000
Lehman Brothers	59.38	28,556
Bear Stearns	20.47	13,700

Source: Arslan 2009

US investment banks operate in a competitive and ambiguous environment where economic cycles, and evolving technology and innovation are constant features and challenges. Firms rely heavily on valuable resources such as capital, reputation, prestige, and skills of employees to deal with the competitive nature of the industry. They are challenged to enhance performance, generate future revenue and portray compliance to industry standards and regulation, whether it be voluntary or imposed. Therefore, investment banks compete for the abovementioned valuable resources to provide them with any advantage. In order to compete effectively, firms also try to ensure they stay up-to-date on technology and product development. Not offering a similar innovative product suite as those of its competitors may indicate a neglect of 'best practice' in its customer service proposition resulting in a marketing disadvantage. Mimicking a new product development or customer service strategy of a competitor would reduce this risk.

Analysts, on whom stockholders regularly rely for stock selection recommendations, naturally analyse peer group performance as part of their overall assessment of an investment bank. Often included in their assessments, are the access an investment bank has to the abovementioned valuable resources. If an investment bank significantly underperforms relative to its peer group, the underperformance would be reflected in the analyst's recommendation, whose normal practice is to apply a sell recommendation if the underperformance was considered material. This practice, which particularly affects access to capital, places serious pressure on firms to publish accounts showing strong performance. Additionally, employees prefer to be associated with a market-leading employer not only because it would impact favourably on their bonuses, but because it would enhance their status and staff mobility, and in turn the potential opportunities of joining another firm on a higher compensation arrangement.

For these reasons, investment banks are motivated to replicate each other's business models in an effort to reduce comparative peer group underperformance. The process of replication of a business model is explained by DiMaggio and Powell's (1983) mimetic isomorphism. This arm of DiMaggio and Powell's (1983) theory argues that businesses pursue a similarity within their own sector, as this type of conformity draws on the perception that a common practice is perceived as risk averse. The conformity follows a process of "reverse observation" whereby firms

observe each other's behaviours and practices to identify those that have the potential to minimise the cost of human capital, and enhance prestige and reputation—the major features on which firms compete. The focus on comparing themselves to competitors is evidenced in their annual reports and strategy documents. Furthermore, the practice adds legitimacy in the eyes of stakeholders, in this case stockholders and employees.

Although each investment bank named and described each of their operating divisions slightly differently, for example using different business segment titles in their annual reports, this section has summarised their activities into three segments for comparison purposes. The process undertaken involved classifying the various business activities identified in the business segment reporting contained in the Form 10-K annual reports for each investment bank and categorising them into three broad segments: Wealth Management, Asset Management and Securities Services; Investment Banking and Total Principal Transactions and Trading as shown in Figure 10.3. The categorisation process involved allocating business segments to the broad categories which more closely resembled their activity. The classifications in Figure 10.3 summarises the segments used and their allocation into three broad categories. The investment banks all offered a similar one stop shop business model focused on providing a comprehensive suite of services to their clients across all investment banking activities. Additionally, within each division, there are the administrative areas known as the middle and back offices, which support the revenue raising departments which are known as the front offices.

Figure 10.3: Business Segment Classifications Used in Investment Bank Annual Reports

Business Segment Classification Used in Table 74	Businesses Descriptions Used in Annual Reports
Wealth Management, Asset Management and Securities Services	Private Client Services Institutional Asset Management Private Equity Account Administration
Investment Banking	M&A Fees Underwriting Fees Merchant Banking
Total Principal Transactions and Trading, or Similar	Equity Trading Fixed Income Trading Proprietary Transactions Brokerage Clearing Services Treasury Trading and Services

Figure 10.4 outlines reported net revenue attributed to the three broad business segments of each of the five selected peer group investment banks. Data are taken from the segment reporting sections of their annual reports for the latest full year reporting period prior to Lehman Brothers' bankruptcy. Businesses excluded from the segment reporting include: retail banking, commercial banking, and card services, all of which related to segments included in JP Morgan Chase's annual report. These businesses were not carried out by the other members of the peer group.

Figure 10.4: Net Revenue: Investment Bank Peer Group Segment Reporting for 2007/2008

Business Segment	Bear Stearns	Lehman Brothers	Morgan Stanley	Goldman Sachs	JP Morgan ²	Industry Average
	USD million NR ¹	USD million NR	USD million NR	USD million NR	USD million NR	% NR
Wealth Management Asset Management Securities Services (or similar)	830	3,097	6,519	7,206	12,880	
% of NR	14	16	27	16	52	34
Investment Banking (or similar)	3,849	3,903	6,368	7,555	13,761	
% of NR	64	20	27	16	36	36

Total Principal Transactions and Trading (or similar)	1,323	12,257	11,150	31,226	11,354	
% of NR	22	64	46	68	12	30
Total Revenue	6,002	19,257	24,037	45,987	37,995	100

Source: Data were extracted from 2007 Form 10-K Annual Reports for each corporation: (Bear Stearns 2006, 109; Goldman Sachs Group 2008a, 3; JP Morgan Chase 2007, 41; Lehman Brothers Holdings 2007, 47; Morgan Stanley 2008a, 49)

Notes:

1. NR = Net Revenue
2. JP Morgan Chase has been included in the comparison even though it had merged with the bank, Chase Manhattan Corporation in 2000, thereby, not officially classified as a non-bank financial institution. However, as it did carry out investment banking activities it is included in the comparisons.

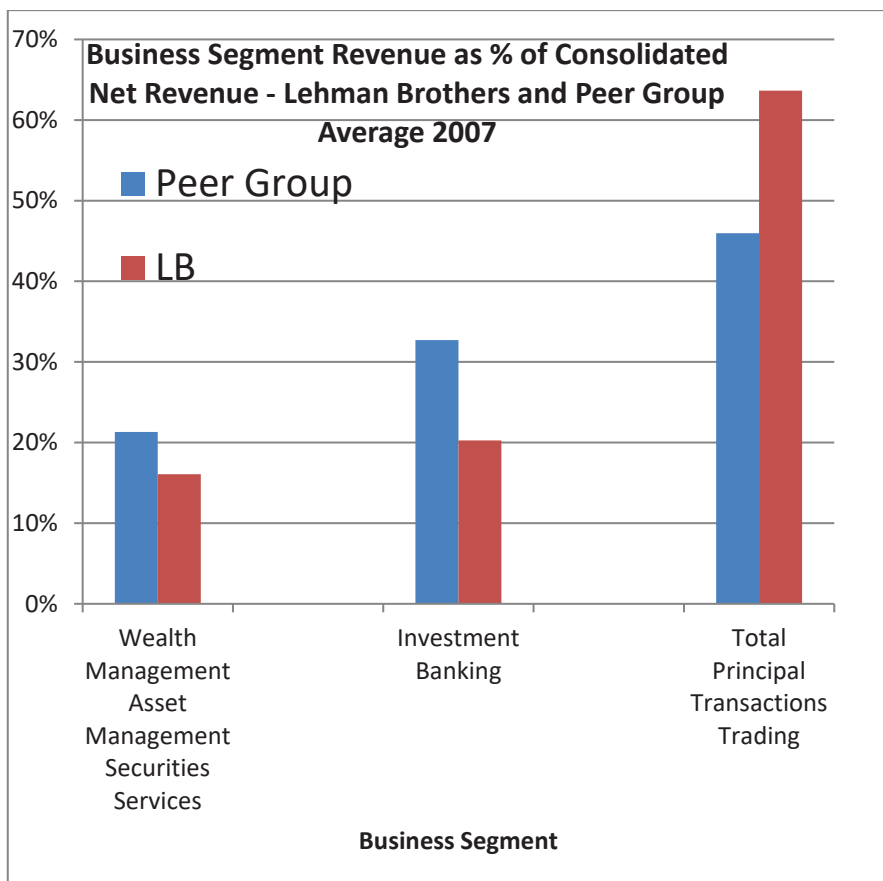


Figure 10.5: Average Business Segment Size Based on Consolidated Net Revenue for Lehman Brothers and Peer Group, 2007

Source: Data were extracted from 2007 Form 10-K Annual Reports for each corporation: (Bear Stearns 2006, 109; Goldman Sachs Group 2008a, 3; JP Morgan Chase 2007, 41; Lehman Brothers Holdings 2007, 47; Morgan Stanley 2008a, 49)

Business segments were common for each investment bank (refer Figure 10.5) even though the proportion of net revenue generated by each respective segment differs (refer Figure 10.4). The differing proportions of segment net revenue reflect the subtle differing strategic objectives of

each investment bank at the time. These strategic objectives align with each firm's respective comparative advantages. For example, Lehman Brothers' traditional strengths in trading are reflected in the larger proportion of their net revenue generated by the Total Principal Transactions and Trading Division. Rhee (2010) argues that the business models of investment banks remain stable during prosperous economic cycles. This is explained by the lack of pressure to change strategy due to an ongoing recording of superior returns in such a growth environment. This was the case during the period between 1996 and 2000 when returns on equity for the major investment banks averaged 25% (Rhee 2010, 181).

The discussion of the historical context of the economic cycle during the decade prior to the GFC is relevant. A major impetus to growth for the industry arose from The Gramm Bleach Bliley Act of 1999, which removed the barriers to cross-selling of investment banking and commercial banking products. As a result, investment banks could seek banking licences or merge with bank holding companies, and therefore offer a wider range of products and services. However, after the 2001/2002 stock market collapse which was precipitated by the "Tech Bubble", and the 11 September 2001 terrorist attack, the consequent drop in overall US investment activity negatively impacted the business segments most susceptible to economic downturns. These included the Wealth Management, Asset Management and Securities Services and Investment Banking segments, whose proportion of the combined industry's net revenue declined. In response, most of the industry diverted its focus towards the Total Principal Transactions and Trading Divisions, which contributed 69% of Net Revenue by 2006 compared to 15% for investment banking and 16% for asset management (Rhee 2010, 81-2). Contributions from the Total Principal Transactions and Trading Divisions in 1997 were much lower—approximately 40% (Rhee 2010, 85).

Lehman Brothers' Financial Structure

This section presents a financial analysis of Lehman Brothers and the US investment banking industry. It commences with a trend analysis of Lehman Brothers' financial position based on a financial data summary and a time series of financial ratios to understand the evolution of the firm's risk profile. The time series covers a term of four years concluding in 2007, representing the last full year that audited financial statements were

published by Lehman Brothers. This provides for a meaningful period to analyse management's medium-term decision-making leading up to 2008. Interim quarterly financial statements for February, May and August 2008 were also analysed to show a continuing deterioration of the firm's financial position prior to its bankruptcy on 15 September, 2008.

Secondly, the financial structure of each investment bank in the peer group for their respective financial year ending in 2007 is analysed to identify the differences between those banks that survived in their own right and those that effectively failed. Finally, a discussion of the mimetic influences affecting the financial structure of the participants in the industry explains why more than one bank effectively failed.

Financial Ratios of Lehman Brothers

This section presents a trend analysis of Lehman Brothers' financial position showing fluctuations in Lehman Brothers' risk profile using selected financial ratios over the four years to 2007.

Figure 10.6: Selected Financial Ratios for Lehman Brothers for the Financial Years 2004 to 2007

LB Key Financial Ratios	Year Ended 30 November			
	2004	2005	2006	2007
Current Ratio (Current Assets/Current Liabilities)	0.93x	1.01x	0.99x	0.91x
Liquid Asset Ratio (Liquid Assets/Total Assets)	0.38x	0.41x	0.43x	0.42x
Capital Ratio (Equity/Total Assets) (%)	4.18	4.10	3.81	3.25
Long Term Debt Ratio (Long-term Debt/Total Assets) (%)	14	13	16	18
Debt to Equity (Total Liabilities/Total Equity less Intangible Assets)	29x	29x	31x	36x
Warehoused Mortgages and other investments/Total Assets (%)	10.81	10.69	11.46	12.89
Warehoused Mortgages and other investments/Total Equity (%)	258.69	260.99	300.80	396.20

Return on Equity (Net Profit before taxation / Equity) (%)	23.58	28.75	30.77	26.74
Return on Assets (Net Profit before taxation / Total Assets) (%)	0.98	1.18	1.17	0.87

Source: Ratios calculated from data contained in Lehman Brothers Holdings 2005a, 71-3; 2007, 85-7

Figure 10.7: Key Financial Data for Lehman Brothers for the Financial Years 2004 to 2007

LB Summary Financial Data	Year Ended 30 November			
	2004	2005	2006	2007
	(USD Millions)	(USD Millions)	(USD Millions)	(USD Millions)
Total Revenue	21,250	32,420	46,709	59,003
Net Profit After Tax (NPAT)	2,297	3,191	3,941	4,125
Net Profit Before Tax (NPBT)	3,518	4,829	5,905	6,013
Total Equity	14,920	16,794	19,191	22,490
Total Assets	357,168	410,063	503,545	691,063
Total Liabilities	342,248	393,269	484,354	668,573
Long Term Borrowings	49,365	53,899	81,178	123,150
Warehoused Mortgages and other Investments	38,597	43,831	57,726	89,106

Source: Lehman Brothers Holdings 2005a, 71-3; 2007, 85-7

Lehman Brothers' Balance Sheet Structure – 2004 to 2007

Figure 10.7 depicts a deteriorating trend of Lehman Brothers' balance sheet structure. The firm's liquidity ratios appear stable up until 2007 however more recent data necessary for an analysis of liquidity ratios in

2008 were not included in the Lehman Brothers' quarterly financial reports which provided summary balance sheet data only. However, a loss of market confidence led to a recall of liquidity lines. This diminished Lehman's ability to meet the demands of creditors towards the latter part of 2008, thereby, allowing for a reasonable assumption that liquidity ratios would have been impacted.

The critical ratio representing a proxy for the risk profile of Lehman Brothers is the Debt-to-Equity ratio—an indication of leverage. As shown by Figure 10.6, this ratio climbed from 29:1 in 2004 to 36:1 in 2007. A commensurate increase in the long-term debt ratio from 14% in 2004 to 18% in 2007 shows the increase in leverage was not only limited to short term debt. The increasing trend in long-term debt which occurred over several years indicates a conscious management decision to increase the firm's leverage. The capital ratio, effectively an inverse of the leverage ratio, exhibits a gradual decrease from 2004 to 2007, again reflecting an increased reliance on debt as opposed to equity in financing the firm's investments. Despite its increasing leverage, the firm explicitly claimed to comply with all capital regulations in its latest 2007 Form 10-K Annual Report (Lehman Brothers Holdings 2007, 134). Lehman Brothers noted the regulatory framework under which it operated as follows:

... The SEC has granted us permission to operate under its CSE rule, a voluntary framework for comprehensive, group-wide risk management procedures and consolidated supervision of certain financial services holding companies. The rule allows LBI [broker-dealer subsidiary] to use an alternative method, based on internal models, to calculate net capital charges for market and derivative-related credit risk. Under this rule, Lehman Brothers is subject to group-wide supervision and examination by the SEC and is subject to minimum capital requirements on a consolidated basis consistent with the Basel II Accord published by the Basel Committee on Banking Supervision. The CSE Rules are designed to minimize the duplicative regulatory requirements on U.S. securities firms resulting from the EU Directive (2002/87/EC) concerning the supplementary supervision of financial conglomerates active in the EU. This Directive permits non-EU financial groups that conduct business through regulated financial entities in the EU to demonstrate that they are subject to equivalent consolidated supervision at the ultimate holding company level; the FSA has determined that the SEC undertakes equivalent consolidated supervision for Lehman Brothers (Lehman Brothers Holdings 2007, 13).

Certain other subsidiaries are subject to various securities, commodities and banking regulations and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. As at November 30, 2007, these other subsidiaries were in compliance with their applicable local capital adequacy requirements (Lehman Brothers Holdings 2007, 134).

In line with Fuld's strategy, the amount of mortgage assets and other investments swelled from USD 38.6 billion in 2004 to USD 89.1 billion in 2007 (Figure 10.8). As a percentage of total equity, this portfolio of risky assets increased consistently from 259% in 2004 to 396% in 2007. In summary, Lehman Brothers' balance sheet structure weakened over the period 2004 to 2007 as evidenced by an increasing reliance on leverage, and maintaining an asset composition containing an increasing proportion of low-quality assets.

Lehman Brothers' Performance – 2004 to 2007

Lehman Brothers' profitability increased year on year from 2004 to 2007. NPAT increased significantly, rising by 39%, 24%, and 5% for the years to 2005, 2006 and 2007 respectively. This performance was based on increases in total revenue of 53%, 44%, and 26% for the same respective periods. 2007 was a record year for Lehman Brothers in terms of total revenue and NPAT. Refer to Figure 10.8 for trends of Lehman Brothers' NPAT and total revenue.

However, the year-on-year percentage increase in NPAT declined significantly from 2006 to 2007 due predominantly to a decreased contribution from the Fixed Income Division which recorded a decline in net revenue of 29% to USD 6.0 billion in 2007 from USD 8.4 billion in 2006. Division contributions to NPAT however, are not available. This deterioration in performance parallels the weakening of the US residential mortgage market and the associated fall in value of the wider credit derivatives market during 2007.

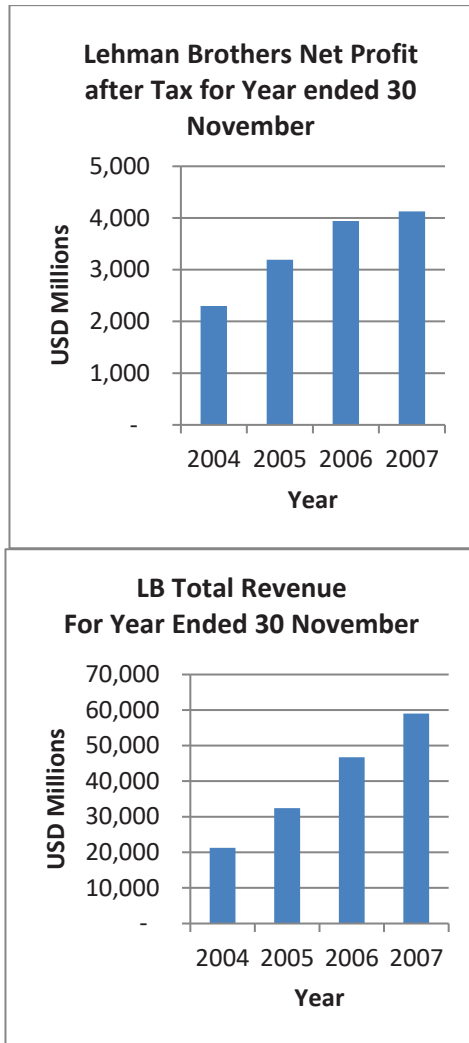


Figure 10.8: Lehman Brothers NPAT and Total Revenue for Period 2004–2007

Source: Lehman Brothers Holdings 2005a, 71-3; 2007, 85-7

Lehman Brothers' Interim Results – 2008

An analysis of Lehman Brothers' results for the quarters ending February, May and August 2008 is set out in Figure 10.9.

Figure 10.9: Lehman Brothers' Quarterly Financial Data-2008

	For Quarter Ended		
Summary Financial Data	29-Feb-08	31-May-08	31-Aug-08
	(USD Millions)	(USD Millions)	(USD Millions)
Balance Sheet Structure			
Total Equity	24,832	26,276	28,443
Total Assets	786,033	639,432	600,000
Total Liabilities	761,201	613,156	571,557
Capital Ratio	3.16%	4.11%	4.74%
Debt to Equity Ratio	31x	23x	20x
Performance			
Net Revenue	3,507	- 668	- 2,903
NPAT	465	- 2,873	- 4,090
NPBT	663	- 4,087	- 5,824
Return on Equity (ROE)	2.67%	(15.55)%	(20.48)%
Return on Assets (ROA)	0.08%	(0.64)%	(0.97)%
% increase (decrease) in NPAT		(718)%	(242)%
% increase (decrease) in Net Revenue		(119)%	(535)%

Source: Lehman Brothers Holdings 2008b, 4-6; 2008c, 3-6; 2008d, 10

Lehman Brothers' balance sheet structure, at first glance, exhibits an improvement during 2008. In support of this perceived strengthening, the capital and leverage ratios both improved from 3.16% and 31 times to 4.74% and 21 times respectively from 29 February, 2008 to 31 August, 2008. The improvements resulted from a combination of several instances of raising capital in the form of debt and equity securities totalling USD

11.5 billion during 2008 and a drastic reduction in total assets. However, the fund-raising was predominantly in the form of securities which included a redeemable feature in their terms and conditions and therefore could be considered as debt securities. Furthermore, the assets as at the interim reporting dates represented a portfolio whose value was in a continual decline during 2008.

Although the US investment banking industry was not subject to compulsory capital standards, it is noteworthy that Lehman Brothers' capital ratios for all three quarters in 2008 which ranged from 3.16% to 4.74% were significantly lower than the minimum capital adequacy ratio guideline of 8% issued by the Basel Committee on Banking Supervision which applied to commercial banks globally at that time. This deficiency in capital persisted despite Lehman Brothers' classification of the USD 11.5 billion in new securities as equity. Figure 10.10 describes some key terms of the securities issued. If the security included a redemption requirement, that is an obligation to repay, or potential for redemption, it is classified as debt in the table below. A key feature of any debt instrument is the requirement to repay the principal sum. Otherwise, the security is classified as equity. Convertible stock is classified as debt in the table below given the uncertainty relating to its conversion into equity. This is consistent with a conservative approach to reporting which characterises instruments as debt where there is ambiguity surrounding its nature and therefore presents a worst-case scenario.

Figure 10.10: Lehman Brothers' Securities Issues in 2008

Date of Issue	Amount USD Millions	Nature of Issue	Debt/Equity	Term of Issue Years
30 April 2008	1,000	Senior Notes	Debt	10
2 May 2008	2,000	Subordinated Notes	Debt	30
2 May 2008	2,500	Senior Notes	Debt	10
12 June 2008	2,000	Convertible Stock	Debt	Potential to convert to equity

12 June 2008	<u>4,000</u>	Common Stock	Equity	Permanent capital
Total Debt	7,500			
Total Equity	<u>4,000</u>			
Total Amount	<u>11,500</u>			

Source: Federal Deposit Insurance Corporation 2011, 2; Valukas 2010, 639-40

Given the securities issued comprised mostly senior notes, subordinated debt and convertible stock, the permanency of most of this capital is questionable. That is, that the amounts were all repayable. As issues totalling USD 5.5 billion possessed expiry dates and therefore redeemable at some point in the future, and a further amount of USD 2 billion had only a potential, and not a guarantee of convertibility into equity, they possessed some critical characteristics of debt. That is, the amounts raised were eventually required, or potentially required, to be repaid. A recalculation of the capital ratio by treating these amounts totalling USD 7.5 billion as debt whilst retaining the common stock as equity, results in a lower capital ratio of 3.49% instead of 4.74% as at 31 August, 2008. Using this revised ratio, Lehman Brothers' leverage shows very little improvement during 2008. These calculations do not include the effect of accounting for Repo 105 transactions as sales as opposed to debt which again would further worsen the capital ratio.

The reduction in assets during 2008 was mostly attributable to a sale of liquid assets to meet creditor claims and the devaluation brought about by the implementation of the new accounting standard FAS 157. This standard required Lehman Brothers to mark-to-market the firm's financial instruments, which mostly comprised commercial and residential mortgage related assets and CDOs, and to bring to account any related loss to the profit and loss account. The reduction in asset value amounted to USD 7.8 billion comprising USD 5.3 billion in home mortgage assets, USD 1.7 billion in commercial property assets, and USD 800 million of other asset backed instruments and acquisition finance exposures. The trend of devaluations had continued from 2007 and progressed throughout 2008

(Lehman Brothers Holdings 2008b, 4-6; 2008c, 3-6; 2008d, 10; Valukas 2010, 203, 28, 335).

Lehman Brothers' performance in the quarters prior to its bankruptcy deteriorated at an increasing rate with consecutive reductions in ROE and ROA. Lehman Brothers recorded a ROE for the quarter ending 31 August, 2008 of negative 20.48%, reflecting a net loss of USD 4.90 billion. The ROE recorded in the previous quarter was a negative 15.55%. These results signified the turning point for investor sentiment towards Lehman Brothers. Therefore, 2008 represented a continuing deterioration of Lehman Brothers' financial structure and downward trend in performance which commenced in 2007.

Risky Business

Figure 10.11 plots Lehman Brothers' increased reliance on trading activity to generate a larger proportion of total revenues from 2001 until the end of 2006. This activity generated various risks including credit risk, price risk on financial instruments including equities and commodities, foreign exchange risk, and interest rate risk. With increasing volatility in the prices of the underlying instruments which were traded by the trading department, the firm was exposed to potential losses if positions remained unhedged. Figure 10.12 outlines the measure of volatility for these risks.

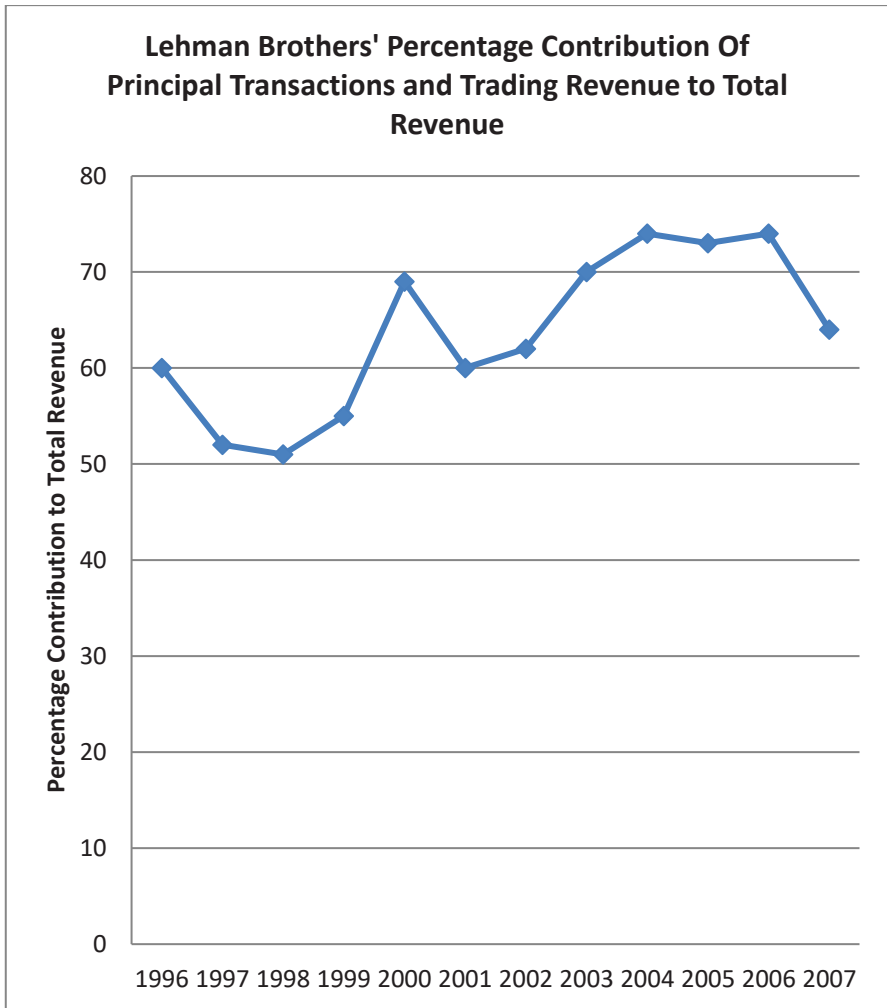


Figure 10.11: Trend of Lehman Brothers' Principal Transactions and Trading Revenue

Source: The data used for the graph were extracted from Rhee (2010, 88)

Figure 10.12: Revenue Volatility of Lehman Brothers' Trading Division

	Trading Division Revenue Volatility		
	Average Revenue Volatility Three Months Ended		
Risk	31-May-08	29-Feb-08	30-Nov-07
	USDm	USDm	USDm
Interest Rate Risk	129	77	58
Equity Price Risk	49	47	41
Foreign Exchange Risk	8	6	6
Commodity Risk	6	5	4
Diversification Benefit	-50	-32	-34
Total Revenue Volatility	142	103	75

Source: Lehman Brothers Holdings 2008j, 33

The amounts in Figure 10.12 represent the net revenue volatility of the various trading activities arising over a period of one day for Lehman Brothers. Data for the quarter ending 31 August were not available. The calculations are based on variations around a rolling 250 day mean, measured at a 95% confidence level. The amounts in the table above represent the potential loss to net revenue from trading activities in one day over a 250-day period.

Figure 10.12 also shows Lehman Brothers' willingness to incur an increasing daily loss level over the 6-month period since 30 November, 2007. Trading net revenue volatility measured using this approach amounted to USD 142 million for the three months ended 31 May 2008. This level of volatility represents a 38% increase from the previous quarter ending 29 February, 2008, which itself represented an increase over the quarter ending 30 November, 2007 of 37%. The period covered above coincides with the mounting asset devaluation problems experienced during 2008. Therefore, the increased level of risky trading transactions which were expected to generate commensurate higher returns

represents an attempt by Lehman Brothers to offset the losses associated with the valuation problems.

Trading represents a risky activity where large sums can be gained or lost due to small variations in underlying prices or rates. Variations of this magnitude do not normally exist in either the Asset Management or Investment Banking segments of the business, which generate income streams predominantly from fees and commissions. It is no surprise, therefore, that two of the three banks that technically failed, Morgan Stanley and Lehman Brothers, focused heavily on the risky business of trading as depicted in Figure 10.13. The following section outlines a comparison of the financial position of Lehman Brothers' peer group drawing some similarities in certain aspects of their balance sheet structures.

Figure 10.13: Selected Financial Ratios for Peer Group for the Financial Year Ended in 2007

Ratios	Lehman Brothers	Bear Stearns	Merrill Lynch	Goldman Sachs	Morgan Stanley
Balance Sheet Ratios					
Current Ratio (times)	0.91x	0.98x	0.58x	1.41x	0.8x
Liquid Asset Ratio (times)	0.42x	0.39x	0.30x	0.43x	0.5x
Capital Ratio %	3.25%	2.98%	3.00%	4.47%	2.99%
Long-term Debt Ratio %	18%	15%	20%	15%	15%
Debt to Equity Ratio (times)	36x	35x	37x	24x	32x

Performance Ratios					
ROE (%)	26.74	5.49	-42.88	35.16	8.88
ROA (%)	0.87	0.16	-1.34	1.57	0.27

Source: Data used in calculations were extracted from Form 10-K reports for each corporation (Bear Stearns 2007a, 80-2; Goldman Sachs Group 2007a, 107-10; JP Morgan Chase 2007, 104-5; Lehman Brothers Holdings 2007, 29; Morgan Stanley 2007, 101-4)

Follow the Leader: Financial Structure

Figure 10.13 sets out a comparison of key financial indicators for US investment banks for the year ended 2007. This ratio analysis reveals the peer group shared a similar financial structure as most balance sheet ratios lie within a narrow range. The most revealing feature in the financial structures is the common use of high levels of leverage as illustrated in Figure 10.14. The combination of increased debt and the use of securitisation and credit derivatives was a popular means of maximising profits amongst commercial banks and investment banks alike. The process of using debt to finance additional income generating activities is known as the 'leverage effect'. As the US investment banks realised, they could increase profits simply by expanding this cycle of increased borrowings to expand their securitisation warehouses, portfolios of credit derivatives, and trading activities, their balance sheets and leverage levels swelled along with their levels of profitability.

Important to CEOs was the return on equity measure, which constituted a key metric in their bonus calculations. Activities which produced a higher margin than the interest expense incurred on additional debt were pursued by all banks. As long as the equity levels remained at least relatively constant (not increased), return on equity would increase. The increase in return on equity encouraged all investment banks to maximise borrowings in the absence of mandatory capital regulations. This mimetic pressure to maximise returns was driven by a common desire to maximise stockholder wealth and CEO compensation. In turn, employees would benefit from the cascading bonus structures and employee satisfaction would be maintained, thereby safeguarding the executive leadership team.

As each investment bank observed returns could be enhanced from the implementation of the leverage effect, the maximisation of borrowing capacity by each bank was replicated. This is evident in the escalation of leverage by a constant rate for all investment banks from 2003 to 2007. Figure 10.14 clearly shows the ramping up of leverage since 2003 with Lehman Brothers, Bear Stearns and Merrill Lynch recording the highest increases. The higher levels of firm risk were justified on the grounds that all other large investment banks were following the same strategy. This mimetic process legitimised the pursuit of the leverage effect in the eyes of other investment banks, regulators and stakeholders.

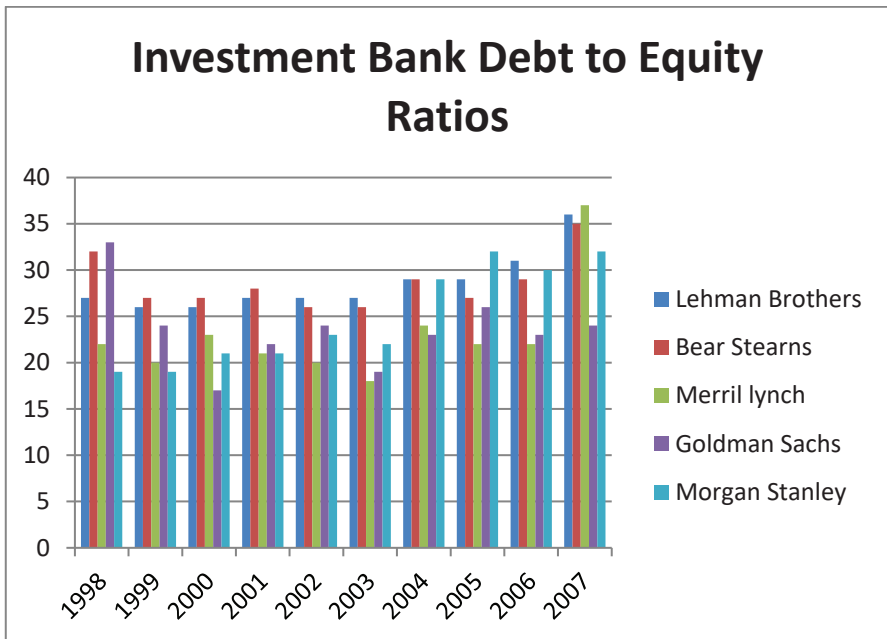


Figure 10.14: US Investment Banks' Leverage Ratios (Debt to Equity)

Source: The data used for the graph were extracted from Bankscope database (Bankscope 2014)

As well as financial structures, the investment banks shared similar returns. Figure 10.15 sets out the return on equity for each investment bank. In the 10 years to 2007, all banks generated positive returns except for 2007 when Merrill Lynch recorded a major loss. The industry average returns on

Figure 10.15: Return on Equity of Investment Banks 1998 to 2007

Investment Bank	Return on Equity %									
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Lehman Brothers	19.43	23.92	29.20	18.45	11.68	17.01	23.42	28.75	31.01	26.74
Bear Stearns	19.43	23.92	29.20	18.45	11.68	17.01	23.42	28.75	31.01	5.49
Merrill Lynch	15.49	25.01	26.27	6.36	12.31	17.03	18.06	20.31	26.71	42.88
Goldman Sachs	45.76	19.64	33.88	20.27	17.12	19.40	24.83	26.54	35.91	35.16
Morgan Stanley	26.63	42.94	43.19	25.44	20.00	19.23	22.19	25.37	31.62	8.88
Peer Group Mean Return	25.35	27.09	32.35	17.79	14.56	17.94	22.38	25.94	31.25	6.68
Peer Group Standard Deviation of Returns	12.10	9.10	6.65	7.00	3.80	1.26	2.59	3.47	3.26	30.31

Source: The data used for the calculations were extracted from Bankscope database (Bankscope 2014).

equity during this period (excluding 2007 due to the outlying return recorded by Merrill Lynch) ranged from a low of 14.56% in 2002 to a high of 32.35% in 2000. The lower returns for 2002 were a result of the lower market activity in the aftermath of the “Tech Bubble” crisis and the September 11, 2001 terrorist attack.

More interesting is the narrow band of returns between the members. Excluding 2007 and 1998, the standard deviation of returns for the group ranged from a low of 1.26 in 2003 to a high of 9.10 in 1999. This range of returns supports the notion that the firms pursued similar performance objectives based on replicate operations to reduce any comparative peer group underperformance. Not doing so could risk a backlash from disappointed stockholders and employees.

According to the key ratios, Goldman Sachs is the standout investment bank with the lowest debt to equity ratio and highest capital ratio, indicating a relative position of strength. Morgan Stanley follows with the second lowest debt to equity ratio. Similarly, Goldman Sachs and Morgan Stanley recorded the highest liquid asset ratio of the peer group. These two banks were the only members of the peer group that survived the GFC in their current form, albeit in a much weaker position. The investment banks that failed comprised: Bear Stearns, which was forced to merge with JP Morgan Chase; Merrill Lynch & Co., which was sold to Bank of America Corp. and, Lehman Brothers which entered bankruptcy. The undoing of Lehman Brothers, together with the other failed investment banks, related to their exploitation of the “leverage effect”. The many years of pursuing a risky growth agenda was crystallised in the last days of Lehman Brothers as creditors and investors awoke to the strategy and punished the firm by selling its shares and recalling credit lines. The ratio analysis provided above, provides evidence that measures of leverage and liquidity were key determinants of investment bank failure. As such, questions relating to the prevailing lack of a mandatory regulatory constraint on leverage and liquidity arose in the aftermath of the GFC and have since been considered a major weakness of the regulatory framework at the time.

This chapter examined the business model adopted by the US investment banks and provided an overview of the financial structure of Lehman Brothers along with a comparison to its peer group. The investment banking business model is analysed through the lens of DiMaggio and Powell’s (1983) New Institutional Theory and found to be subject to a

mimetic influence which led to divisional units undertaking similar lines of business. US Investment banks operate in a competitive and ambiguous environment where economic cycles, evolving technology and innovation are constant features and challenges. In their efforts to compete for valuable resources such as capital, reputation, prestige, skills and new customers, they attempted to avoid a negative perception associated with an underperforming firm. This strong desire not to be perceived as a low-ranking firm spawned a practice of replicating product and services offered by competitors, which resulted in similar divisional organisational structures. An outdated product suite or service offering could have exposed a firm that had not embraced innovation and best practice, important features for an industry in a rapidly evolving environment. Mimicking competitor practices and business models therefore reduced the risk of portraying a negative perception to the market. Submission to mimetic influence often occurs when the correct course of action is ambiguous. The fast-paced business environment created the need for urgent management decisions. Time was critical in launching new products or services, otherwise, market share was at risk. In this environment, mimicking behaviour of another firm perceived to be successful was time and cost efficient.

In Lehman Brothers' attempt to pursue an aggressive growth strategy, it departed slightly from conforming to the standard business model by expanding the activities of its Trading Department, which represented the riskiest part of the firm. This strategy was undertaken in the expectation that the additional risk would generate commensurate high returns. Fuld's hubris and denial of a potential economic cycle downturn combined with an optimistic view that financial assets would continue to gain in value persisted for decades. The combination of high leverage and the exploitation of the securitisation loan recycling machine was a popular means of maximising profits amongst all investment banks. This common approach is reflected in a range of similar returns generated by the peer group. Fuld's strategies were validated by the similar strategies adopted by most of the peer group and reinforced the hubris which characterised his leadership. Higher leverage was pursued regardless of the risk impact on the firm. As long as Lehman Brothers' creditors abstained from recalling credit, the strategy was sustainable. Those banks which replicated the aggressive leverage effect strategy suffered a similar fate. Succumbing to a mimetic influence led to disastrous consequences for most of the

investment banking peer group. The exceptions, Goldman Sachs and Morgan Stanley, maintained more moderate levels of leverage and higher levels of liquidity. Despite the potential opportunity cost of pursuing a less risky strategy, these banks survived. The following section relates the role that connections and influential forces assisted the industry to maintain conditions conducive to their objectives. The chapter therefore examines the relationships between the investment banking industry and other players that had an impact on their business such as regulators, politicians, standard setters and credit rating agencies.

PART THREE:

CONNECTIONS & INFLUENCE

CHAPTER 11

BEDFELLOWS

The previous chapter described the investment banking model as one influenced by institutional forces, steering the firms to mimic each other in various ways from organisational to financial structures. The major investment banks' organisational structures converged to operate in similarly structured business units, which in aggregate, served as one-stop shops for customers. The competitive environment where the desire to be ranked at the top of league tables for each specialisation, and the need to be perceived as one of the best investment banks to the outside world including customers, shareholders and regulators, created a fear of underperformance. The aspiration to extend financial performance year-on-year also fuelled the pursuit of the leverage effect which resulted in unsustainable levels of debt for most firms. The theme of DiMaggio and Powell's (1983) institutional influence of the previous chapter, as it affected the business model and financial structure of the US investment banks, continues to be explored in this chapter. New Institutional theory assists with our understanding of how investment banks co-opted legislators, regulators, credit rating agencies (CRAs) and accounting standard setters, in accepting a stance extolled by the investment banking industry. This influence created a business environment relatively free of obstacles and conducive to aspirations of producing ever-increasing profits.

This chapter commences with an identification of the participants in the financial network. The sections that follow discuss the influences applied to the political process and regulatory framework by the use of political contributions and lobbying which produced a type of regulatory capture. Political contributions are argued to have resulted in coercive pressure applied to politicians involved in the legislative process to produce the regulatory outcomes desired by industry. The environment which allowed the application of coercive pressure was constructed by the investment banking industry as a *quid pro quo* for fulfilling the need by politicians to perpetuate perceptions of currency in the latest developments affecting

industry. Repetitive contributions to the same politicians would be interpreted as legitimising their decision-making which was important for election and re-election prospects.

This chapter further asserts that mimetic pressure fuelled the industry's attempts to influence the political process by its common use of lobbying. The unified behaviour of participants in the investment banking industry follows a mimetic pressure to adopt the practice of lobbying, which in turn, supported the normative influence of spreading an acceptance of the *laissez-faire* attitude towards regulation. The benefits of a united front, using a combination of influential industry associations, established lobbyists and their own firms' resources, led to an intensive attempt to sway political opinion in favour of the industry. Normative pressure was also applied to align beliefs and values between the investment banking industry and the regulatory and legislative communities through the "revolving door". The constant switching of positions between different employers such as investment banks, regulatory agencies and the executive branch of government was found to be a common practice. The consequent intermingling of values and beliefs between various "revolving door" participants, tended to permeate a popular view that a "light touch" to regulation was good for the investment banking industry.

Lobbying by the industry is argued to be a legitimate way of persuading points of view in public policy debate. Therefore, politicians allowed themselves to accommodate the opinions of industry in their deliberations of bills related to the finance industry. The existence of a knowledge asymmetry between the investment banking industry and the regulators also exerted a normative pressure on regulators that allowed a general *laissez-faire* approach to regulating the industry. In the absence of superior knowledge of the complex and innovative derivative products, financial structures and their resultant risks, the regulatory community presupposed that the investment banking industry "knew best" and would therefore self-regulate.

The *modus operandi* of the CRAs and the coercive pressure to which they were subjected by the investment banking industry are discussed in this chapter. The investment banking industry's commercial support of the CRAs and their direct input to the credit rating models, helped to drive an increasing number of investment grade ratings for borrowing vehicles which then ultimately failed. The influence exerted over CRAs to supply

investment grade ratings, which were later discovered to be flawed, was also inadvertently supported by the regulatory framework at the time.

The chapter concludes with a content analysis of comment letters submitted to the FASB regarding two important draft exposures for accounting standards – FAS 125 and FAS 140, which were to apply to the important financing technique known as repurchase agreements (Repos). This analysis finds the investment banking industry, as a concerned interest group, were intent on retaining their ability to interpret, at their discretion, the applicable accounting standards. The resulting institutional influence over the FASB produced a final standard, FAS 140 which permitted the “window dressing” of Lehman Brothers’ financial statements, thereby concealing important information from stakeholders.

The US Financial Network

The major participants within the frame termed the “financial network” include: the investment banking industry; other financial institutions (such as hedge funds, commercial banks, money market corporations and other financial institutions); the regulators; the government (including individual politicians); CRAs; and lobby groups representing the investment banking industry. This section examines how the investment banking industry through their connections and interactions with the “financial network” attempted to influence policies, regulations and credit ratings. Influence over regulations through a “regulatory capture” was particularly important to the industry to ensure a regulatory framework which was conducive to generating stronger financial performance.

The prosperous years enjoyed by the investment banking industry prior to the GFC coincided with a period when regulations, accounting standards and the approach to credit ratings minimised constraints on the industry. The theme of “connections” is used in this chapter to identify and analyse the interactions of the investment banking industry with the “financial network”. The enactment of key legislation encouraged lending and home ownership. The most notable legislation included: The Community Reinvestment Act 1977; The Alternative Mortgage Transactions Parity Act 1982; and the Community Reinvestment Act 1995 (amended) also known as the Community Reinvestment Expansion Act 1995. The Gramm Leach Bliley Act 1999, which is also considered an important milestone in the

legislative timeline, offered opportunities for the investment banking industry to expand into other areas such as direct lending. This Act repealed The Glass-Steagall Act, which came into force following the Great Depression of the 1930s and prevented commercial banks, investment banks, securities firms and insurance companies from merging. The final important liberal legislation affecting the investment banking industry prior to 2008 included The Commodity Futures Modernization Act 2000, which excluded derivatives from regulation, supervision, trading on exchanges and most significantly exempted these instruments from capital adequacy requirements. Therefore, it provided an unrestricted environment for US investment banks to pursue derivative transactions such as CDOs which, as already discussed, played an important role in the lead up to the GFC.

Following the corporate scandals of Enron and WorldCom between 2001 and 2002, the previous liberal approach to regulation was largely reversed with the enactment of the Sarbannes-Oxley Act of 2002 which is discussed later in this book. However, shortly thereafter, political pressure to generally support financial institutions during the period spanning 2002 to 2009 was led by President George W. Bush who encouraged the adoption of neo-liberal principles. This period of political support together with an era of low interest rates overseen by the Federal Reserve at the time, coincided with a cycle where US house prices and lending increased substantially and created the housing bubble. In a speech at the Risk Management Association Conference in October, 2008, Randall Kroszner, who was a member of the Board of Governors of the Federal Reserve and Chairman of its Committee on Supervision and Regulation of Banking Institutions acknowledged the interconnectedness of the banking industry and financial markets as contributing to the severity of the GFC and the collapse of Lehman Brothers:

At the heart of that transformation lays a much more intense emphasis on funding and liquidity. Additionally, we are all witnessing the extent to which banking and financial markets are interconnected (Kroszner 2008).

Kroszner (2008) was referring to the interconnectedness of financial institutions operating in the financial markets. The GFC highlighted the critical role of these networks in providing liquidity within the market. Many liquidity lines provided on an interbank basis, and on which the banks relied for their day-to-day business, froze during the crisis period.

Kroszner (2008) suggests these financial networks have far-reaching ramifications for the financial markets and the economy. He argues this aspect of the industry needs to be tackled so that appropriate risk management frameworks are established in the global marketplace.

Historically strong personal and institutional networks were considered beneficial in the investment banking industry. However, Kroszner (2008, 6) highlights the dangers of a global marketplace entrenched in a convoluted web of connections:

Since banking and financial markets are so interconnected, the fundamental transformation in financial services is affecting all types of financial institutions, even those less directly affected by recent events. Importantly, in developing strategic risk management frameworks, institutions must not only understand the direct consequences to their own firms of such shifts, but must also recognize that consequences to other firms can have effects on the broader market.

A diagram representing the interrelationships of the “financial network” is shown in Figure 11.1.

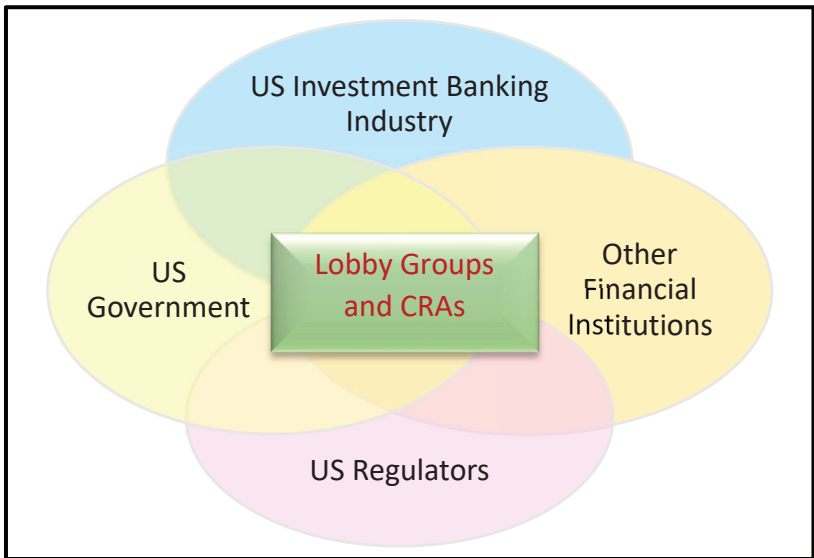


Figure 11.1: The Interrelationships within the US Financial Network

Figure 11.1 represents the intersecting relationships between various groups in the financial network. The principal lobby groups which represented the investment banking industry included the various industry associations such as: the Securities Industry Association which merged with the Bond Market Association to form the Securities Industry and Financial Markets Association in 2006; the Investment Company Institute; the Security Traders Association; the American Bankers Association; and, the International Swaps & Derivatives Association. A specific industry lobby group based in Washington known as The Financial Services Roundtable (FSR), formerly known as the Bankers Roundtable prior to 2000, had access to all participants in the “financial network” and played an active role as an institutional force (Froomkin and Blumenthal 2012). The CRAs were also central to the relationships between participants as their credit ratings were relied upon by investors, regulators and issuers (and their sponsoring/underwriting investment banks). The largest credit rating agencies were Standard & Poor's (S&P), Moody's, and Fitch. All three are privately owned corporations and whilst S&P and Moody's are both US-based corporations, Fitch operates from both the US and the UK. Their influence originates from their role in collectively assigning credit ratings to over 90% of global corporations, governments (including state governments), state-owned enterprises, and structured finance SPV's (Coffee et al. 2010, 1). These ratings have an influence on the demand for securities as they are purported to be a measure of the issuer's financial strength. Furthermore, the pricing of securities is generally aligned to the ratings, rewarding stronger rated issuers with lower pricing on their financing transactions. Methodologies employed by CRAs in determining a credit rating are therefore considered to be an important component of their intellectual capital. The resultant ratings are also important to government and regulators who want to ensure that investors and the market are well-informed.

The principal regulators within the “financial network” include the Federal Reserve and the Securities Exchange Commission. Other regulators include the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Financial Institution Examination Council. The following sections discuss the types of influence and the conduits through which such influence was exerted by the investment banking industry on the members of the “financial network”. The discussion commences with the role those

political contributions played in the creation of a liberal attitude towards the regulatory framework within which the investment banking industry operated.

Political Contributions

Politicians require funding to contest their first election as well as for re-election. A seat in the House of Congress costs an average of approximately USD 1 million, and Senate seats often require funding of tens of millions (Senate Office of Public Records Government of the USA 2011). The cost of running the 2016 US Federal election, for example, is shown in Figure 11.2.

Figure 11.2: Cost of Running the US Federal Election in the 2016 Election Cycle as represented by Total Contributions

Type of Group	Total Spent USD	% of Total
Super Political Action Committees (Super PACs)	1,104,481,088	66%
Political Parties	246,159,843	15%
Social Welfare Groups	147,333,276	9%
Other (corporations, individual people, other groups)	128,863,700	8%
Trade Associations	33,912,224	2%
Unions	21,621,827	1%
Total	1,682,371,958	100%

Source: The data used for the table was extracted from the Centre for Responsible Politics (2008)

Campaign contributions to a politician may oblige the recipient to support the contributor by either support for its regulatory agenda, friendly political appointments, lucrative government procurement contracts, or tax concessions. In the US, statistics relating to political contributions and industries' lobbying expenditures are collected by an independent organisation known as the Centre for Responsive Politics (CFRP) which began recording data in 1974. The CFRP is funded by individual contributions and institutional grants. Statistics used in the following figures are sourced from the CFRP database. Amounts included in the

statistics represent the historic value of USD dollars and do not represent constant dollars adjusted for the time value of money.

Figure 11.3 shows a growth in political contributions made by the investment banking industry from 1998 to 2008 representing the 10-year period prior to the GFC, and which reached a peak of USD 178 million in the calendar year 2008. A calculation of the data reveals aggregate contributions by the investment banking industry for the period 1998 to 2008 exceeded USD 575 million (Centre for Responsible Politics 2008). Lehman Brothers' political contribution to George W. Bush's 2004 election campaign is detailed in Figure 11.8. Additionally, evidence of Lehman Brothers' political lobbying spending is shown in Figure 11.11.

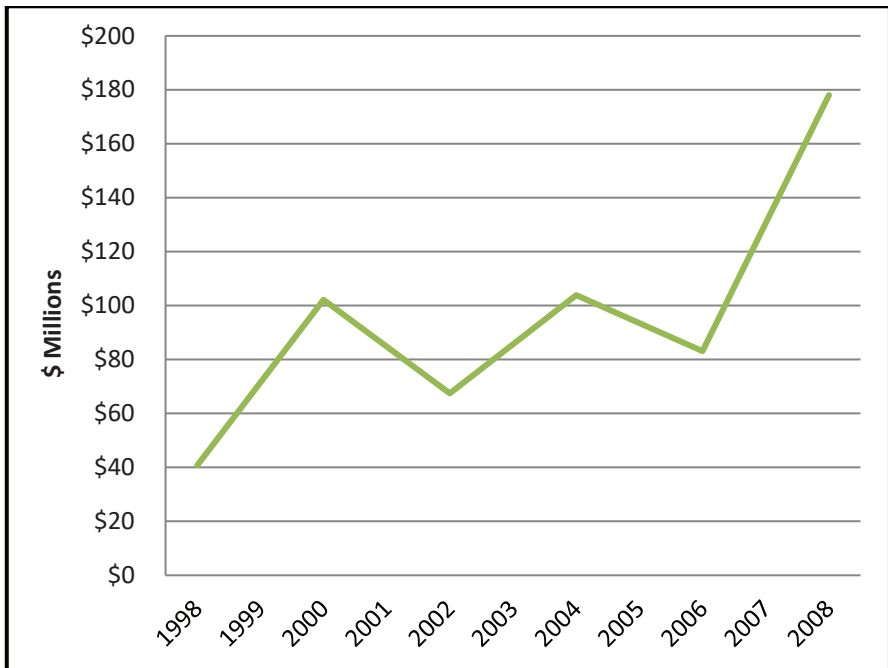


Figure 11.3: Total Political Contributions from Investment Banking Industry 1998 – 2008

Source: The data used for the graph were extracted from the Centre for Responsible Politics database (Centre for Responsible Politics 2008)

The top 10 recipients of these contributions are included in Figure 11.4, which also includes each politician's special roles within government and private industry. The roles have been split between those that are finance-related and those that are not. In some instances, politicians held roles in consulting firms and/or financial institutions. This is provided to establish those donor recipients who may have a closer relationship with the "financial network". Prior to the GFC, the preferred party for contributions from the investment banking industry was often the incumbent majority party, swinging between the Democrats and Republicans as leadership in Congress switched. This pattern of supporting influential politicians is a cornerstone of the US political system (Centre for Responsible Politics 2008).

A number of the top 10 donor recipients had close relationships with the financial network. An example of some of the political views held by some of the top 10 donor recipients is set out in Figure 11.5.

Figure 11.4: Top 10 Recipients of Campaign Contributions 1998-2008

Name	Total Political Contributions from Investment Banking Industry 1998 to 2008 USD	Special Government Roles (not related to Financial Services)	Special Government and Private Roles (related to Financial Services)
<p>Democrat Republican Independent</p> <p>State</p> <p>Senator John McCain Republican Arizona</p>	14,562,427	<p>Chairman of the Senate Commerce Committee, Presidential Candidate 2000, Sponsor of the McCain-Feingold Act in 2002, Chairman of the Senate Armed Services Committee, Chairman of the Senate Indian Affairs Committee</p>	
<p>Senator Charles Schumer Democrat New York</p>	10,543,147	<p>Chairman of the Senate Rules Committee, Chairman of the Democratic Senatorial Campaign Committee, Vice Chairman of the Democratic Caucus, Joint Committee on the Library, Vice Chairman, Joint Committee on Printing, International Narcotics Control Caucus, Select Committee on Intelligence</p>	<p>Member Financial Services Committee & Banking Committee</p>

Senator John Kerry Democrat Massachusetts	8,178,389	United States Secretary of State, Chairman of the Senate Foreign Relations Committee, Presidential Candidate 2004	
Senator Chris Dodd Democrat Connecticut	7,961,570	Chairman of the Democratic National Committee, Chairman of the Senate Committee on Rules and Administration, Committee on Foreign Relations, Joint Committee on the Library, Commission on Security and Cooperation in Europe	Chairman of Committee on Banking, Housing, & Urban Affairs from 2007–2011, Subcommittee on Securities, Insurance, & Investment
Senator Joe Lieberman Independent Connecticut	4,775,168	Attorney General of Connecticut, Chairman of the Senate Committee on Homeland Security and Governmental Affairs, Committee on Armed Services, Committee on Small Business and Entrepreneurship	
Senator Richard C. Shelby Republican Alabama	3,384,175	Chairman of the Senate Intelligence Committee, Senate Committee on Appropriations, Senate Committee on Rules and Administration	Chairman of Senate Committee on Banking, Housing & Urban Affairs from 2003–2007 & 2015–2017

<p>Representative John Boehner Republican Ohio</p>	<p>3,334,661</p>	<p>Speaker of the United States House of Representatives, House Minority Leader, House Majority Leader, Chairman of the House Education Committee</p>	
<p>Senator Evan Bayh Democrat Indiana</p>	<p>3,224,911</p>	<p>Committee on Armed Services, Committee on Energy and Natural Resources, Committee on Small Business and Entrepreneurship, Select Committee on Intelligence</p>	<p>Committee on Banking, Housing, & Urban Affairs, Subcommittee on Financial Institutions, Subcommittee on Securities, Insurance, & Investment Senior adviser Apollo Global Management (Asset Management), Partner at Law & lobbying firm McGuireWoods, Adviser U.S. Chamber of Commerce</p>

Representative Eric Cantor Republican Virginia	3,181,842	House Majority Leader, House Republican Chief Deputy Whip, Chairman of the Congressional Task Force on Terrorism & Unconventional Warfare, House International Relations Committee and the House Ways & Means Committee	House Financial Services Committee, Vice Chairman of investment bank Moelis & Company
Senator Mitch McConnell Republican Kentucky	2,818,657	Majority Leader of the Senate, Senate Minority Leader, Senate Majority Whip, Committee on Agriculture, Nutrition, and Forestry, Committee on Appropriations, Committee on Rules and Administration, Select Committee on Intelligence (<i>Ex officio</i>)	

Source: The data used for the table were extracted from the Centre for Responsible Politics (2008)

Figure 11.5: Political Views of Selected US Recipients of Large Political Donations

Name (party/state)	Political View	Reference
Senator Charles E. Schumer Democrat New York	<p>In favour of bailouts for US investment banks.</p> <p>A proponent of a deregulatory agenda for the banking industry. In particular led initiatives to deregulate derivatives and to lower capital reserves for the banking industry.</p> <p>Supported tax savings for financial institutions.</p> <p>Attempted to limit efforts to regulate CRAs in favour of self-regulation.</p> <p>Advocated revisions to regulations intended to improve transparency of corporate financial statements.</p> <p>Opposed a bill that proposed to increase personal income taxes for executives at hedge funds and private equity firms.</p> <p>Prioritised regulatory relief for the finance industry.</p>	(Lipton 2008)
Senator Richard C. Shelby Republican Alabama	<p>Objected to the Government Office of Financial Research collecting financial data necessary to regulate the banking industry.</p>	(Flaherty 2015) (Cover 2010)
Representative John Boehner Republican Ohio	<p>Maintained close relationships with lobbyists and former employees representing large corporations such as Goldman Sachs, Google, Citigroup, R.J. Reynolds, Miller Coors and UPS. Was in favour of light regulations on the financial services and tobacco industries.</p>	(Lipton 2010)

Political Contributions during the 2004 Election Cycle

The 2004 election cycle was the last before the onset of the GFC. The period between 2004 and the following election cycle in 2008 represented a period of significant profitability for the investment banking industry, which thrived under positive economic conditions. Figure 10.15 depicts the economic environment and the positive returns on equity of the US investment banks respectively during this period. Given the strong performance of the industry and accommodating policy settings during these four years, an analysis of political contributions made for the 2004 election cycle is warranted.

Figure 11.6 lists the top 10 donors (excluding lobby groups) of political contributions to both major parties in the US—the Republicans and the Democrats. Interestingly five of the top 10 list of contributors to the 2004 elections consisted of individuals involved in the finance industry (including funds management, insurance and financial services), whilst owners of home construction corporations comprise three of the top 10. These construction groups would benefit from government favouritism towards the housing sector, whilst the four funds management corporations which featured in the top 10 list would generally benefit from lighter finance related regulation.

Figure 11.6: Top 10 donors (excluding lobby groups) of political contributions in 2004 US election

Rank	Donor Name City / State	Corporation Affiliation	Industry	Contribution Amount (USD)
1	Herb & Marion Sandler	Sandler Foundation / Golden West Financial Corporation	Charity / Funds Management	11,050,944
	Oakland, CA			
2	Perry, Robert J. & Doylene	Perry Homes	Home Construction	8,050,000
	Huston, TX			
3	Arnall, Roland E. & Dawn L.	Ameriquest Capital	Subprime Mortgage Lender	5,000,000
	Los Angeles, CA			
4	Spanos, Alex G. & Faye	AG Spanos Companies San Diego Chargers	Home Construction	5,000,000
	Stockton, CA			
5	Pickens,T. Boone & Madeleine	BP Capital	Fund Manager	4,600,000
	Dallas, TX			

6	*Perenchio, Jerrold & Margaret	Chartwell Partners	Executive Search	4,000,000
	Los Angeles, CA			
7	Simmons, H. C. & A. C.	Contran Corp	Diversified Industrial	3,500,000
	Dallas, TX			
8	McHale, J. F. & Mattson, C. L.	Tipping Point Technologies	Information Technology	3,000,000
	Austin, TX			
9	Lewis, Peter B.	Progressive Corp	Insurance	2,985,000
	Cleveland, OH			
10	Soros, George	Soros Fund Management	Funds Management	2,950,000
	New York, NY			
* Specialising in finance industry				

Source: The data used for the table was extracted from the Centre for Responsible Politics (2008)

As expected, the incumbent government (the Republicans), obtained most donations for the 2004 election cycle as shown in Figure 11.7. The Republicans who already displayed a preference for less regulation towards the finance sector accounted for 75% of total donations over USD 100,000.

Figure 11.7: Political Contributions per Political Party over USD 100,000 in 2004 Election

Total Contributions	Republican Contributions	Republican	Democrat Contributions	Democrat
USD	USD	% of Total	USD	% of Total
114,752,979	86,379,491	75%	28,373,488	25%

Source: The data used for the table was extracted from the Centre for Responsible Politics (2008)

According to the Centre for Responsible Politics (2008), George W. Bush personally received approximately USD 6,623,961 from the top 20 donors to his second presidential election campaign in 2004. Featuring prominently in this list are all four major US investment banks, and a number of other banks and financial institutions which, in aggregate, constitute 13 of the top 20 contributors. The amount contributed by financial institutions in the 2004 election cycle was triple that made in the 2000 cycle (Becker et al. 2008). This indicates a strong preference of the investment banking and wider financial services community for another term of a Republican government led by George W. Bush. This would ensure a continuance of neo-liberal policies.

Figure 11.8: Top 20 Donors of Political Contributions to George W. Bush in 2004 US Election

Rank	Donor Name	Industry	Contribution Amount
			USD
1	Morgan Stanley	Investment Banking	604,280
2	Merrill Lynch	Investment Banking	558,804
3	PricewaterhouseCoopers	Accounting	508,500
4	UBS AG	Bank / Investment Banking	442,325

5	Goldman Sachs	Investment Banking	396,350
6	Lehman Brothers	Investment Banking	355,525
7	US Government	Government	334,611
8	Citigroup Inc.	Bank / Investment Banking	317,375
9	MBNA Corp	Bank	313,600
10	Ernst & Young	Accounting	304,340
11	Bear Stearns	Investment Banking	302,850
12	Deloitte LLP	Accounting	293,050
13	Credit Suisse Group	Bank / Investment Banking	279,590
14	Wachovia Corp	Non-Bank Financial Institution	273,760
15	Bank of America	Bank / Investment Banking	258,361
16	JPMorgan Chase & Co	Investment Banking	228,005
17	Blank Rome LLP	Law Firm	225,150
18	US Department of State	Government	220,280
19	Ameriquest Capital	Non-Bank Financial Institution	208,130
20	Blue Cross/Blue Shield	Insurance	199,075
Total			
			6,623,961

Source: The data used for the table was extracted from the Centre for Responsible Politics (2008)

Lobbying

Skeel (2005a, 157) summarises the interaction between business leaders and regulators succinctly as “an ongoing cat-and-mouse game between regulators, whose job is to rein in excesses... and business leaders, who push back against regulatory strictures in order to promote flexibility and innovation”. This section discusses the institutional influence exerted by the investment banking industry over politicians (legislators) through the lobbying process to either prevent problematic legislation, or to promote legislation favouring their industry. As an increasing volume of important legislation affecting the investment banking industry entered the political debate in the pre-GFC era, the analysis finds that the investment banking industry increased its spending commitment on lobbying. This trend was replicated by Lehman Brothers whose lobbying expenditure increased markedly from 2001 to 2007.

US Industry participants are well-organised, through groups such as industry associations, the Chamber of Commerce, the Business Roundtable and specific lobby groups whose role is to provide resistance to unwanted legislation, and to steer public policy, ideologies and strategic initiatives which benefit an industry, or a particular organisation. Comparing the industrial sector and the public at large, Skeel (2005a) suggests that an industry representative usually possesses greater influence than groups of individuals, due to the efforts of lobby groups. Although the US public are valid participants who are potentially affected by outcomes of government legislation, their influence is more thinly spread and difficult to mobilise. Mobilisation is costly, and ordinary US citizens generally do not have enough at stake to justify a campaign for reform (Skeel 2005a).

Regulatory capture involves winning a regulatory agency’s support by influential and often large commercial or political interest groups whose industry or activities the agency is charged to regulate. The support is usually at the expense of the public in whose interests the regulatory agency is supposed to act, and may take the form of regulations which are advantageous to the interest group. This process leads to the notion that the regulatory agency is being ‘captured’ or allowing itself to be influenced by the interest group and therefore represents a failure of the regulatory agency (Stigler 1971).

Engstrom (2013) proposes two forms of capture: materialist and non-materialist. The materialist type is defined by the regulator's motive being driven by material gain either through the "revolving door", political contributions, concealed payments, or need for continuing government funding. Non-materialist capture is likened to a normative influence affecting the regulator whereby the regulator behaves in a similar manner to the regulated industry and inherits some of its values and culture. The normative influence can arise from a knowledge asymmetry between the regulatory environment and industry. Engstrom (2013) suggests that this form of regulatory capture is often linked to lobbying.

The failure of regulations to provide adequate discipline to the finance industry is often linked to political influence (Acemoglu 2009; Calomiris 2009a; Johnson and Kwak 2011). It has been cited as being one of the key contributors to the GFC (Dagher and Fu 2011; Obstfeld and Rogoff 2009). Stiglitz, a Nobel Prize winning economist stated in 2009, "But I think that mindsets can be shaped by people you associate with, and you come to think that what's good for Wall Street is good for America" (Veltrop and de Haan 2014, 2).

Igan et al. (2012, 5) defines lobbying as "a legal activity aimed at changing existing rules or policies or procuring individual benefits". Literature on lobbying focuses on two forms. The first category examines the impact of lobbying on specific policies which impact on industries generally (Facchini et al. 2011; Goldberg and Maggi 1999; Grossman and Helpman 1994). In the banking sector, Kroszner and Stratmann (1998) found a pattern of specialised standing committees being formed in government to deal with interest groups when considering proposed finance legislation. These dealings often result in high levels of political contributions which equally contribute to high levels of political effort in furthering interest group causes. An example cited by Kroszner and Stratmann (1998, 1163) found that the level of contributions by the banking lobby group was instrumental in garnering legislative support for banks entering new businesses. The second category of literature relates to the specific lobbying efforts by individual firms seeking favourable outcomes related to their own corporate performance (Bertrand et al. 2004; Claessens et al. 2008).

In the US, lobbyists and interest groups are mostly represented in Washington, close to the legislators and policymakers. The finance industry is one such

interest group which employs a number of lobbyists. Igan et al. (2012) cites a number of reasons for the finance industry's use of lobbyists. Firstly, it may signal to regulators that they are vulnerable to financial shocks in view of their limited capacity to absorb risks and therefore require preferential treatment. Preferential treatment may not only come in legislative terms but also in economic ones. For example, there was continual pressure applied to the Federal Reserve System by investment banks in order to maintain loose monetary policy and in turn, continue supporting financial and property related asset prices.

Cognitive regulatory capture of the Fed by Wall Street resulted in excess sensitivity of the Fed not just to asset prices (the "Greenspan-Bernanke put") but also to the concerns and fears of Wall Street more generally (Buiters 2008, 4).

The second reason for financial institutions' use of lobbying is to rally against regulations which would restrict their lending activities and impact on financial performance (Igan et al. 2012). This would especially apply to publicly-listed financial institutions which are focused on short term profit maximisation strategies. Specialist bankers, who operate in specialised market segments with higher risk, may use lobbyists to convey their superior knowledge to regulators of a market, financial instrument, financial process or risk. In this instance, the uncertainty created in the minds of regulators of their knowledge may convince them to abstain from regulating a complex market such as the derivatives market (Burger 2006). The knowledge asymmetry can persuade regulators to adopt the investment banking industry view of a regulatory approach to certain innovative practices. Financial institutions may also wish to create barriers to entry in their market segment, with the aim of limiting competition. Lobbyists could also be used in this regard to encourage tighter regulation for new entrants.

The influence of corporations and their lobbyists is reflected both in the legislative process and in the actual legislation that is enacted by Congress. In the 1990s, for example, business leaders pushed through two separate federal reforms that were designed to make it harder to bring securities law claims against companies that were alleged to have made misstatements to the markets (Armour and McCahery 2006). Another example which had important implications to the investment banking industry was the passing of The Commodity Futures Modernization Act of

2000 (CFMA). This Act effectively protected OTC derivatives transactions from regulation and oversight. Following its enactment, derivatives trading expanded dramatically – refer to Figure 63 for an indication of the growth of CDOs, a derivative which was widely adopted. Apart from legislators, a judge ruling on complaints by investors at the CFTC - the regulatory agency charged with overseeing the derivatives industry—was also found to be in support of the same industry by protecting it against investor complaints:

... In a notice recently released by the CFTC, Judge Bruce Levine...had a secret agreement with Wendy Gramm, [then Chairwoman] of the agency [CFTC] to stand in the way of investors filing complaints with the agency...Gramm, wife of former Senator Phil Gramm, was accused of helping Goldman Sachs, Enron and other large firms gain influence over the commodity markets. After leaving the CFTC, Wendy Gramm joined the board of Enron (Hilzenrath 2010).

Other examples of effective lobbying by the financial sector involved the defeat of proposed bills relating to mortgage lending which would otherwise impose restrictions on the financial sector. The consequent lack of protection for mortgage borrowers contributed to the creation of the property bubble and the growth in subprime lending. Examples of bills related to mortgage lending and which were defeated are set out in Figure 11.9.

Figure 11.9: Examples of Defeated US Government Bills 2000-2008

Bill Number	Bill Name	Topic	Outcome
H.R. 3901	Anti-Predatory Lending Act of 2000	Adds the following disclosure requirement to the Home Mortgage Disclosure Act of 1975: 'the annual percentage rate of mortgage loans and home improvement loans originated by the institution grouped according to census tract, income level, racial characteristics, and gender'. The bill restricts certain rates and fees and mandates that any borrower who would like to obtain a high-cost mortgage complete home ownership counselling. Prepayment penalties, negative amortization, flipping home loans, extending credit without regard to ability to repay, encouraging default, payments to appraisers by creditors, and creditor-financing of credit insurance are disallowed.	Introduced March 9, 2000; Never passed by House or Senate; Never signed into law.
H.R. 3915	Mortgage Reform and Anti-Predatory Lending Act of 2007	Introduces licensing and training requirements for individuals wishing to become loan originators. In addition, the bill stipulates that certain federal agencies are to regulate mortgage lenders so that they do not encourage borrowers from taking on loans that they do not have the ability to repay. Good faith estimates must include the total loan amount, the type and length of the	Introduced October 22, 2007; Passed by House November 15, 2007; Never passed by Senate; Never signed into law.

		loan, the annual percentage rate, the total estimated monthly payment, the percentage the monthly payment is of the borrower's monthly income, and other disclosures.	
H.R. 1461	Federal Housing Finance Reform Act of 2005	The Federal Housing Finance Reform Act of 2005 creates the Federal Housing Finance Agency (FHFA) which would have oversight of Freddie Mac, Fannie Mae, and Federal Home Loan Banks. FHFA would become the single regulator for Freddie Mac and Fannie Mae; the Department of Housing and Urban Development would no longer have oversight. The bill requires Freddie Mac and Fannie Mae to set aside funds directed at increasing home ownership among low-income individuals or in low-income areas.	Introduced April 5, 2005; Passed by House October 26, 2005; Never passed by Senate; Never signed into law.
H.R. 1295	Responsible Lending Act	Defines 'higher-cost mortgage' and includes requirements for mortgage product evaluation software and appraisals for properties secured by higher-cost mortgages. In addition, mortgage pamphlets distributed to consumers are to be updated and simplified and explain topics such as balloon payments, escrow accounts, and consumer responsibilities; furthermore, information should be provided in multiple languages and formats to reach vulnerable populations.	Introduced March 15, 2005; Never passed by House or Senate; Never signed into law.

Source: The data used for the table were extracted from Igan et al. (2012, 57-64).

A Rallying Cry

The combination of an increased industry spending, and an expanding use of lobbying firms by an increasing number of industry participants is indicative of a normative pressure, fuelled by mimetic behaviour amongst industry participants, to rally against regulatory structures affecting their businesses. The total lobbying expenditure by the investment banking industry (including all investment banks, investment management companies and securities firms) for years 1998 to 2008 can be seen in Figure 11.10. Figure 11.10 also shows that lobbying expenditure by the investment banking industry had grown by 300% for the ten-year period from 1998 to 2008, an average of 20% per annum. This growth however accelerated significantly in the two years prior to the Lehman Brothers' collapse, recording an average annual increase between 2006 and 2008 of 24%.

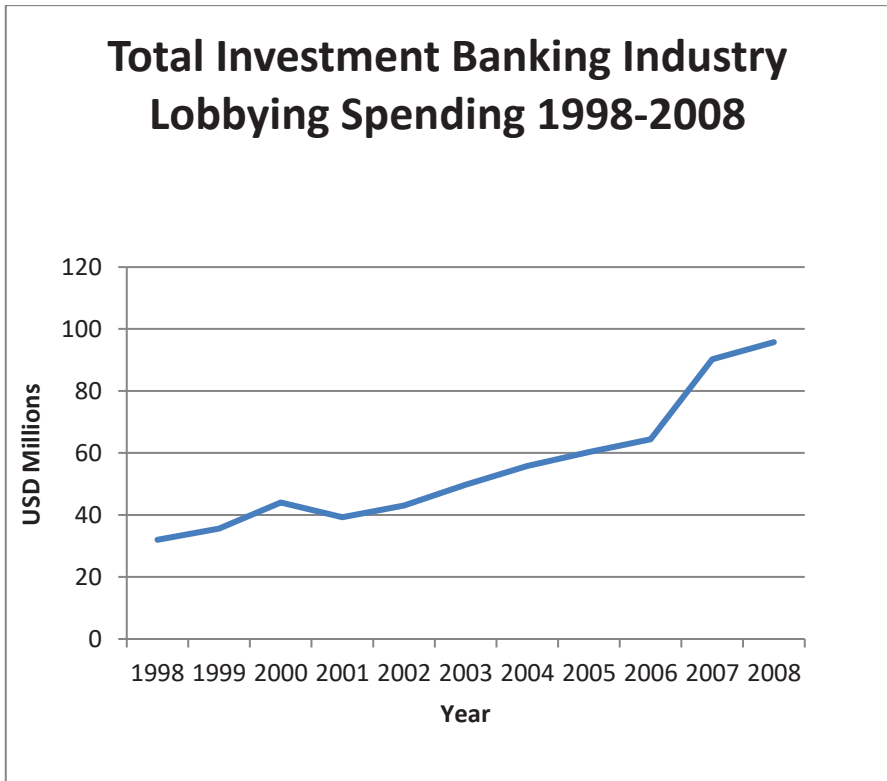


Figure 11.10: Total Lobbying Expenditure by the Investment Banking Industry

Source: The data used for the graph were extracted from the Centre for Responsible Politics (2008)

Lehman Brothers' contribution to various lobby groups also increased in the decade prior to 2008 as shown by Figure 11.11, declining after 2006 once the deterioration in its financial performance became apparent.

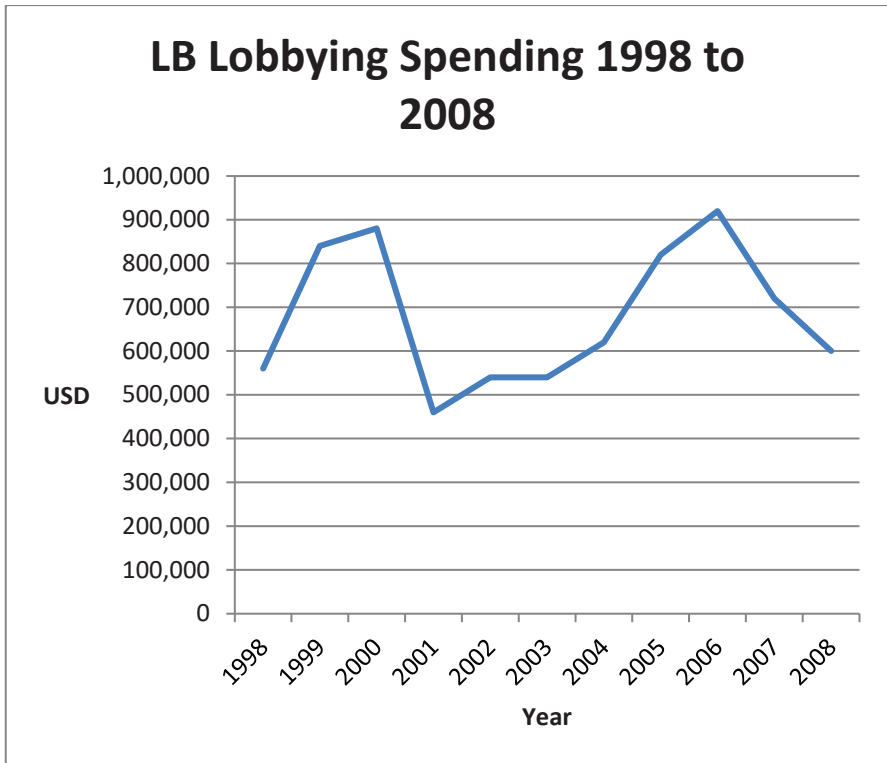


Figure 11.11: Lehman Brothers' Lobbying Spending from 1998 to 2008

Source: The data used for the graph were extracted from the Centre for Responsible Politics (2008)

According to the Centre for Responsible Politics (2017), the lobby firm mostly used by Lehman Brothers was DLA Piper, a global law firm with an office in Washington. This firm was used by various interested parties from several industries. DLA Piper was particularly active and in addition to Lehman Brothers, in 2007 represented investment banks and securities firms such as Goldman Sachs, Merrill Lynch Charles Schwab Corp, Parkwood Group, and Stanford Financial Group (Centre for Responsible Politics 2008). Therefore, DLA Piper would have been familiar with the topics of interest to the “financial network”.

In order to ascertain the major US investment banks' and related industry associations' lobbying spending during the decade prior to the GFC, data was extracted from the Centre of Responsible Politics database for each major investment bank and major industry association for the years 1998 to 2008. Figure 11.12 shows that the lobbying spending for the US investment banks followed the same increasing trend until 2006/2007 as shown in Figure 11.10. A similar pattern of lobbying spending is also evidenced by the main associations representing the investment banking industry as depicted in Figure 11.13.

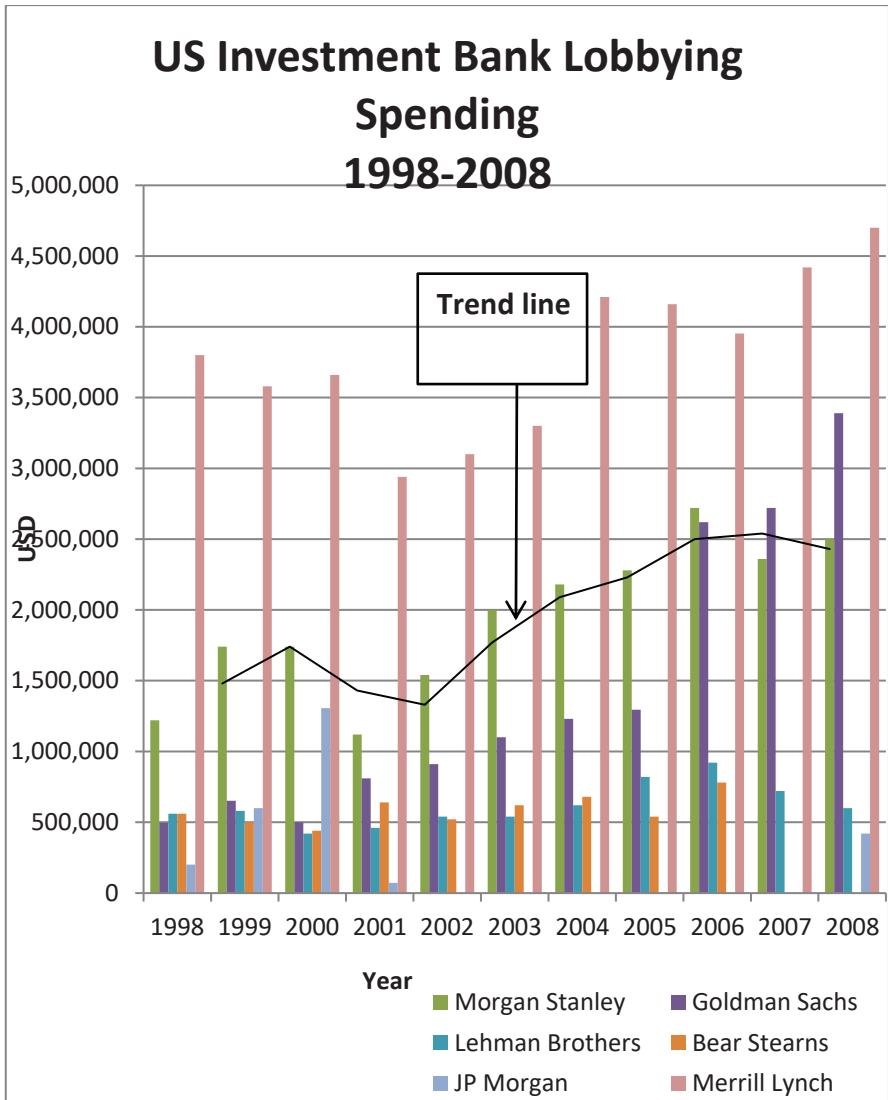


Figure 11.12: Lobbying Spending of Major US Investment Banks 1998-2008
 Source: The data used for the graph were extracted from the Centre for Responsible Politics (2008)

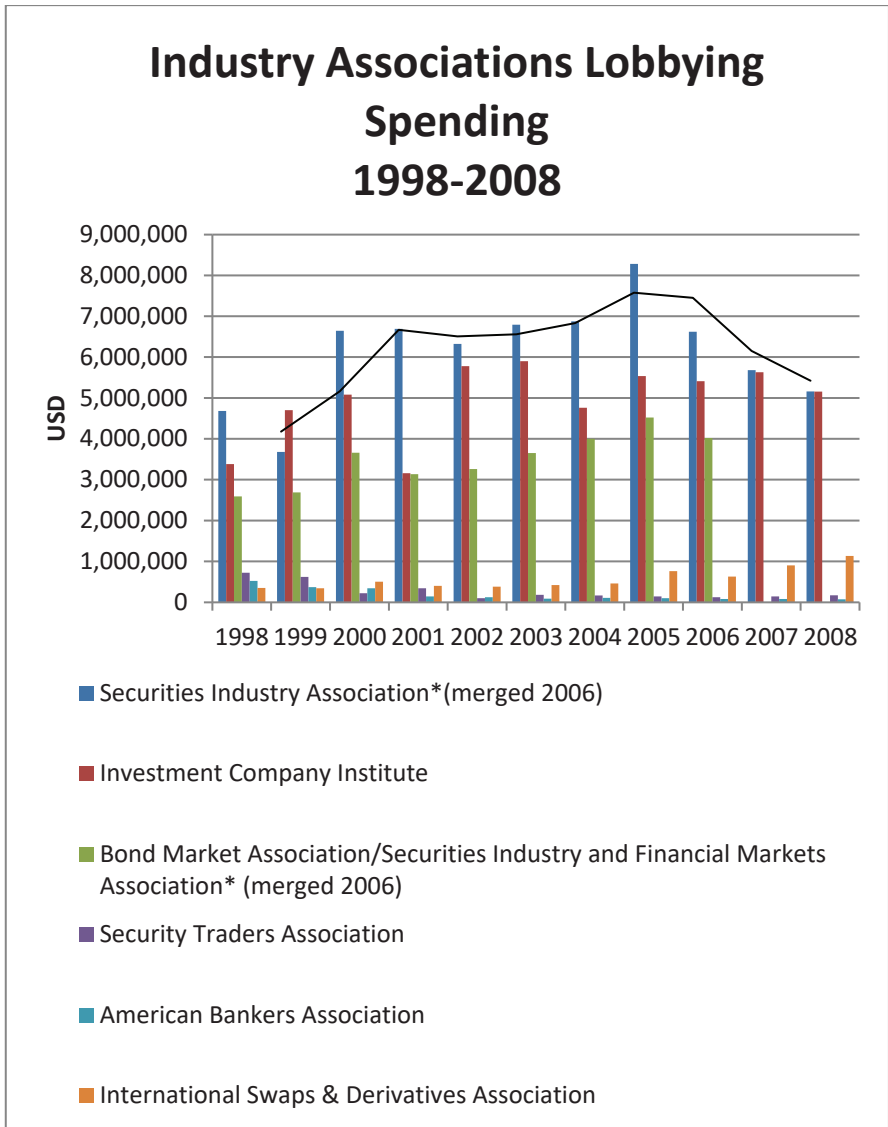


Figure 11.13: Lobbying Spending of Major Industry Associations 1998–2008

Source: The data used for the graph were extracted from the Centre for Responsible Politics (2008)

As the investment banking industry expanded and the number of political issues affecting the industry increased in the pre-GFC period, the number of investment banks and securities firms which employed lobby groups (clients) also increased, as depicted in Figure 11.14.

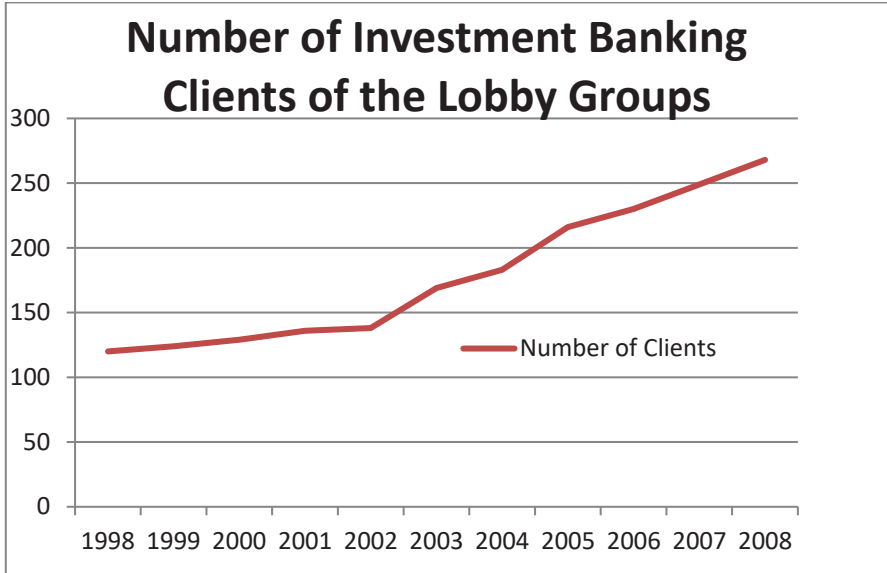


Figure 11.14: Number of Investment Banking Clients of the Lobby Groups
Source: The data used for the graph were extracted from Centre for Responsible Politics (2008)

Figure 11.15 shows a commensurate growth in the number of lobby groups servicing the investment banking industry. This growth in the number of lobby groups was driven by the increased demand for lobbyists and the growth in the number of political issues being faced by the industry (Centre for Responsible Politics 2011).

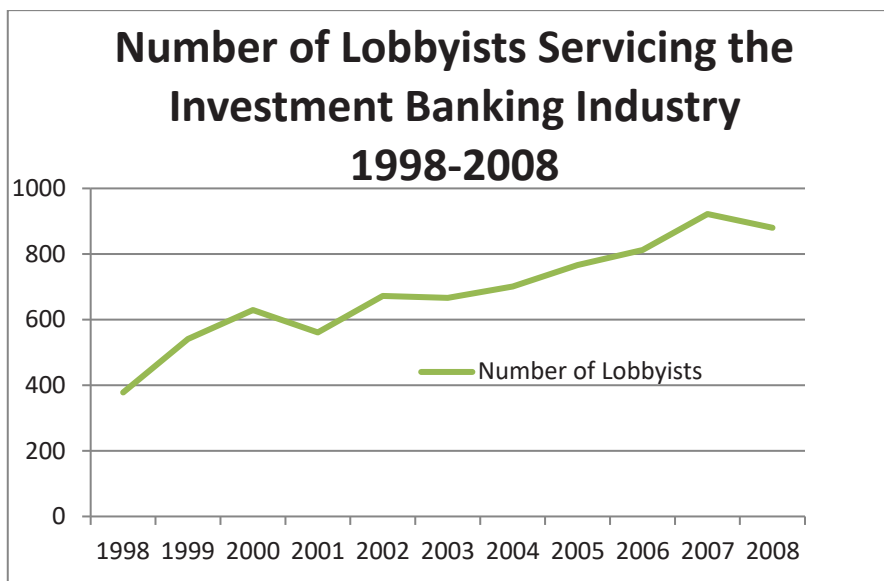


Figure 11.15: Number of Lobbyists Working for the Investment Banking Industry

Source: The data used for the graph were extracted from the Centre for Responsible Politics (2008)

According to the Centre for Responsible Politics (2011), the investment banking industry's primary issue for lobbying was market trading business activities such as stockbroking and bond dealing. In this case the industry attempted to either postpone or prevent interventionist legislation. Additionally, given the focus on expanding the investment banks' business of securitising pools of mortgages, a concerted effort was made to engender demand for mortgages, including removing barriers to entry as evidenced by the defeated bills noted in Figure 11.9.

Given that the preservation of favourable business conditions advantaged financial performance, lobbying became a social norm. It was affected by a normative influence, that is, an acceptable way for all major institutions to lay the foundations for achieving objectives within the US political arena. Lobbying had been an historic customary practice enshrined in the US, not only by financial institutions but industry in general. It was not only sustained for a long period, but intensified in the decade preceding the

GFC. A social acceptance permeated the industry that a sustained lobbying effort was necessary to ensure growth at best and survival at worst by ensuring a sympathetic regulatory framework.

Legislators also came to accept this practice as socially acceptable and therefore normal, just as political contributions were deemed acceptable as a systemic way of funding elections. The view on both sides of the lobbying fence reflected a common understanding amongst professionals, that a constructive debate should take into account a diversity of views. Politicians were receptive to lobbying efforts as they desired to be viewed as open to all special interest groups wanting to convey a message, and therefore appear as legitimate political representatives in the eyes of constituents. As with many debates, however, those with the loudest voice and greatest resources could often put forward the most compelling point of view.

The investment in lobbying could be likened to a moral obligation to support the common effort of maintaining trading conditions sympathetic to the industry. Given that lobbying was successful in preventing certain bills being passed as outlined in Figure 11.9, it is deemed a successful instrument in the arsenal of the investment banking industry and an acceptable form of communicating a point of view.

As the larger investment banks increased their commitment to lobbying spending, the rest of the industry followed suit as they sought direction for the best course of action from their professional network—a concept proposed by Galaskiewicz (1985).

The increase in industry lobbying spending, and the increasing number of lobby firms engaged by an increasing number of investment banks provides evidence that industry participants were responding similarly and with greater intensity to regulatory issues as an interest group. Industry associations championed the same efforts which carried the weight of an organised representative group with deeper resources as shown by Figure 99. Presumably, this enhanced their access to policymakers. The common push to preserve the relatively liberal operating environment supports the notion of a mimetic behavioural pattern amongst investment banks.

The transfer between firms of the norm associated with lobbying spending usurped any internal preference to behave differently and spawned

mimetic behaviour. Conformity to the practice of lobbying therefore became institutionalised and accepted by many industry participants. It became a practice of conventional wisdom which would assist in providing standardised conditions favourable to the individual firm as much as to the industry at large.

Igan et al. (2012) also suggests that underperforming financial institutions may use the same lobbyists to lobby on the same issues as successful financial institutions in order to persuade regulators that they should also be regarded as successful. Through the application of political pressure as a unified group, the investment banking industry was able to harness a greater influence on policy formulation. This behaviour is particularly found in underperforming organisations in the same field who wish to enhance prestige and reputation, both attributes critical elements for an investment bank.

Political Contributions and Lobbying as Coercive Pressure

The US process of enacting legislation involves a review by specific Congress committees prior to being submitted for voting. As committee members hold important positions in this process, they are subject to special attention and offers of contributions from lobby groups representing industries over which they have a regulatory influence. Figure 11.4 shows that most of the top 10 recipients of political contributions are members of either a congressional or senate committee related to the finance industry. Members of Congress are continually raising funds for re-election purposes by attending fundraising events and soliciting funds from wealthy donors. This is a normal practice in the US. However, it brings with it the risk of undue influence in the legislative making process. Moreover, committee members and other politicians are subject to a barrage of competing petitions from interest groups.

Dobbin and Sutton (1998) Edelman (1992) and Edelman et al. (1999) noted that organisations are active in influencing the content of legislation. Often this occurs when legislation covers complex matters and the intention of organisations is to ensure the proposed legislation reflects best practice. This book is supported by the notion that New Institutional Theory involves “a political process, and the success of the process and the form it takes depends on the relative power of the actors who strive to steer it” (Powell

2008, 5). This notion of New Institutional Theory reflects the way the investment banking industry sought to influence the regulatory and legislative process through coercive pressure. Sahlin-Andersson and Engwall (2002) also suggest that institutionalisation is subject to political forces. The same study argued that management consultants, accounting standard setters and the media are important transmitters of opinions to encourage institutional change.

Political groups and house committees—part of government—are claimed to be subject to the coercive pressures associated with the abovementioned political contributions and lobbying. The government subjects may succumb to this pressure from a threat of a reduction, or at worst a cancellation of future re-election support. The support is mainly in the form of political contributions or in a more subtle method, by way of negative campaigning against the committee, group or politician being lobbied. Given the political contributions of the investment banking community had been substantial, any withholding of future contributions upon which politicians relied, would have exerted significant financial pressure on the chances for election or re-election as funds are needed for a variety of reasons in the election process, such as advertising.

This pressure was directed to individuals in the relevant committees and to those in senior executive positions within the respective political parties. Compliance to the wishes of the donors and the lobby groups would have improved the probability of securing ongoing future funding, hence long-term political survival. A tenet of DiMaggio and Powell's (1983) coercive pressure involves an organisation acting in a certain manner to impose its will, whether subtly or directly, on another organisation to comply with certain actions or behaviours in return for legitimacy and its subsequent benefits. Investment bankers imposed their will on the political system through their lobbying efforts and increasing levels of political contributions. In return, politicians gained legitimacy through the repetitive practice of attracting and accepting political contributions. As long as donors continued to offer contributions, and directed them to their preferred political party, they held certain power over election outcomes. Donors also reinforced the perception of politicians as important decision makers vital to the well-being of the financial community. A continuance of contributions sent signals to the wider community that certain politicians were pursued by large industry players and therefore validated their worth. As donors from the investment banking industry generally

comprise educated professionals with expertise in economics and the financial markets, their support for Bush in 2004 was viewed by many voters as a validation of his neo-liberal economic approach.

Revolving Door

Influence in the legislative process is not only achieved through political contributions and well-orchestrated lobbying, but also through a practice of revolving personnel between the key participants in the financial network and government offices. In the US the term “revolving door” refers to this practice. The most successful university graduates seeking employment with investment banks often seek out those investment banks leading the published industry league tables. The league tables are published in respected industry journals and rank investment banks by the type, number and size of the deals they execute during the year. The higher the ranking, the greater the perception of being a successful investment bank and therefore the greater the appeal to prospective employees. The reverse of this is also the case where leading investment banks are able to attract the “cream of the crop” (McDowell 1997). Consequently, investment banks are staffed with high quality individuals who are keenly sought within the finance and commercial sectors, as well as in senior government positions. Given the vast opportunities available to the pool of high achieving investment bankers, staff mobility amongst the profession is considered high, leading to an industry which is subject to the “revolving door” (Rajan 2010). As Rajan (2010) noted, “an investment banker’s view of the world is unlikely to change. This phenomena [sic] leads to cognitive capture”.

Lobby groups gain personal access and exert influence through strong connections with public servants. The latter group consists of politicians and regulators formed by former federal employees some of whom are later employed in industry or as lobbyists, consultants and strategists. The opposite also applies as professionals with positions in industry switch between private and public sectors. As connections are developed, so too does privilege, power, access and funding (Senate Office of Public Records Government of the USA 2011). Investment banking professionals and their lobbyists are considered useful employees for government and regulators given their knowledge and experience in the financial and commercial sectors and their connections and influence within their own and their

clients' industries. These attributes are desired by the government as it attempts to develop the knowhow to initiate relevant regulations affecting the finance industry or to gain political support in the form of validation of policy or donations from the private sector. On the other hand, the investment banking industry has an appetite for hiring government employees to facilitate personal access to key regulators and policymakers, in an attempt to influence regulatory outcomes. The regulators have been accused of using a 'light touch' with investment banking regulation as they hope to seek more lucrative remuneration with those they regulate in later life after their public service employment (Tammy 2014). Additionally, Burger (2006) and Tammy (2014) suggest that Federal Reserve avoids complex regulation as they recognise a divergence between the skill levels of professionals in the industry and the regulators. The appointment of an ex-government official can also assist in winning lucrative government contracts such as major financing or advisory mandates for clients of the lobby groups.

An examination of the Centre for Responsible Politics database reveals that since data collection commenced in 1974, between the three key regulatory agencies (the Department of the Treasury; the Federal Reserve System; and the Securities & Exchange Commission) which interacted with the investment banking industry, a total of 353 officers had also worked either in the investment banking industry or for an associated lobby group up to 2008 (Centre for Responsible Politics 2011). Figure 11.16 sets out the number of staff who have been through the "revolving door" where their current or former place of employment was with one of the three agencies.

Figure 11.16: "Revolving door" Staff of Regulatory Agencies

Government Agency	Number of Staff	% of Total
Department of the Treasury	203	57
Securities & Exchange Commission	116	33
Federal Reserve System	34	10
Total	353	100

Source: The data used for the table was extracted from the Centre for Responsible Politics (2008)

Hilzenrath (2010) conducted an empirical study examining the SEC's track record of enforcement against investment banks and brokerage houses before 2007, and found indirect evidence that some financial institutions

received favourable treatment by regulators once agency employees were employed in the finance industry at higher salaries (Hilzenrath 2010, 725). The finding indicated a systemic pattern of the “revolving door” practice between SEC employees and industry. The Project on Government Oversight (POGO) which is a US non-partisan independent watchdog that advocates good government reforms investigated some impacts of the “revolving door” on the SEC and produced a report for use by the US Congress. POGO specifically examined former SEC employees who after leaving the SEC were employed by organisations overseen by the SEC. Its findings included that:

... between 2006 and 2010, 219 former SEC employees sought to represent clients before the SEC. Former employees filed 789 statements notifying the SEC of their intent to represent outside clients before the commission, some filing within days of leaving the SEC (Smallberg 2011, 2).

A case was made by Smallberg (2011) that implicated SEC employees as subjects of a conflict of interest between the SEC and industry:

... The SEC Office of Inspector General has identified cases in which the revolving door appeared to be a factor in staving off SEC enforcement actions and other types of SEC oversight, including cases involving Bear Stearns (Smallberg 2011, 2).

The “revolving door” practice was entrenched in the investment banking industry for some time. Figure 11.17 illustrates the employment history of a sample of recent US Treasury Secretaries such as Tim Geithner, Henry Paulson, Robert Rubin, and Lawrence Summers which shows them passing through the “revolving door”.

Figure 11.17: Selection of US Treasury Secretaries Passing through the “Revolving Door”

Tim Geithner		
Period of Employment	Employer	Title
2014-present	EM Warburg, Pincus & Co (Investment Bank)	President and Managing Director
2009-2013	Department of the Treasury	Secretary of the Treasury
2003-2009	Federal Reserve System	President, Fed Reserve Bank of New York
2001-2003	International Monetary Fund	Director, Policy Development & Review
2001-2001	Council on Foreign Relations	Senior Fellow, International Economics
1988-2001	Department of the Treasury	Undersecretary for International Affairs
1985-1988	Kissinger Associates	Consultant

Henry Paulson		
Period	Employer	Title
2009-present	Johns Hopkins University	Distinguished Visiting Scholar
2006-2009	Department of the Treasury	Secretary of the Treasury
1974-2005	Goldman Sachs (Investment Bank)	CEO
1972-1973	White House	Employee/Staff
1970-1972	Department of Defence	Staff Assistant

Robert Rubin		
Period	Employer	Title
2007-present	Council on Foreign Relations	Vice Chairman
1999-present	Citigroup (Commercial / Investment Bank)	Executive Committee Chairman
1995-1999	Department of the Treasury	Secretary of the Treasury
1993-1995	National Economic Council	Director
1966-1992	Goldman Sachs (Investment Bank)	Co-Chairman

Lawrence Summers		
Period	Employer	Title
2009-present	National Economic Council	Director
2006-2008	DE Shaw & Co (Investment Bank)	Managing Director
2002-present	Brookings Institution	Board of Trustees
2002-present	Committee for Economic Development	Board of Trustees
2001-present	Council on Competitiveness	Member
2001-2001	Brookings Institution	Senior Fellow
2001-present	Centre for Global Development	Board of Directors
2001-2005	Global Fund for Children's Vaccines	Board of Directors
2001-2006	Harvard University	President

2001-present	Partnership for Public Service	Board of Governors
2001-present	Trilateral Commission	Member
2001-present	Bretton Woods Committee	Member
2001-present	Institute for International Economics	Board of Directors
2001-present	Inter-American Dialogue	Member
1999-2001	Department of the Treasury	Secretary of the Treasury
1997-present	Group of 30	Member
1995-1999	Department of the Treasury	Deputy Secretary
1993-1995	Department of the Treasury	Undersecretary
1991-1993	World Bank Group	VP of Development Economics
1989-1992	American Economic Association	Executive Committee
1989-present	Council on Foreign Relations	Member
1988-1990	American Economic Association Commission on Graduate Education	Member
1987-1991	Harvard University	Professor of Political Economy
1986-1990	Congressional Budget Office	Board of Advisors
1983-1987	Harvard University	Professor of Economics
1982-1983	Council of Economic Advisers	Domestic Policy Economist
1982-1982	Massachusetts Institute of Technology	Associate Professor of Economics

Source: The data used for the table was extracted from the Centre for Responsible Politics (2008)

Other notable Secretaries of the Treasury passing through the “revolving door” include: Robert Kimmit, ex-Managing Director of Lehman Brothers; Douglas Dillon and Nicholas Brady of Dillon Read and William Simon of Salomon Brothers (Inside Gov. 2017). Even Peter Peterson, former CEO of Lehman Brothers, served as Secretary of Commerce before joining Lehman Brothers. Historically, the relationship between investment banks and government has been important since government has also relied heavily on the industry to finance a large part of their borrowings, even as far back as the Revolution.

Apart from the Treasury Department, key leaders from the Federal Reserve System also worked in the investment banking industry prior to and after ascending to their influential government positions. Alan Greenspan was one of the key regulators during the critical pre-GFC period as Chairman of the Federal Reserve from 1987 to 2006. The normative influence affecting the Federal Reserve was also evident in the loose monetary policy it initiated during this period which was considered dangerous:

... Both the 1998 LTCM and the January 21/22, 2008 episodes suggest that the Fed has been co-opted by Wall Street—that the Fed has effectively internalised the objectives, concerns, world view and fears of the financial community. This socialisation into a partial and often distorted perception of reality is unhealthy and dangerous (Buiter 2008, 106).

The intensive lobbying efforts of the investment banking industry had ‘co-opted’ the Federal Reserve into a culture of continued growth for the financial markets. This culture was consistent with the strategy driving the industry and moreover, that of Lehman Brothers. The actions of the Federal Reserve were socially sanctioned not only by the investment banking industry but by other members of society who had an interest in escalating asset prices. The Federal Reserve complied with the expectations of industry and considered its actions represented a proper course of action for the good of society generally. Support for the Federal Reserve’s position came from professionals with a wide industry representation, especially the financial markets. As well-educated, professional individuals, the financial market experts validated the Federal Reserve’s monetary policy stance. This wider group of beneficiaries of the loose monetary policy settings only reinforced the Reserve Bank’s resolve and belief that

lower interest rates were good for the economy and therefore continued to promote them for almost a decade. The term associated with this policy was the “Greenspan-put” or later referred to as the “Greenspan-Bernanke put”. The view that a continuation of low interest rates would benefit the financial markets by buoying asset prices, particularly in the equity and debt securities and property markets, was founded on the belief that these markets were essential to the continued prosperity of the financial network which was essential to a healthy economy:

... it seems pretty evident to me, that the Fed under both Greenspan and Bernanke has cut rates more vigorously in response to sharp falls in stock prices than can be rationalised with the causal effects of stock prices on household spending and on private investment, or with the predictive content of unexpected changes in stock prices (Buiter 2008, 106).

Greenspan had a long association with the finance industry. Following his studies, Greenspan worked with Brown Brothers Harriman, in the firm's equity research department (Greenspan 2007, 41). Greenspan had a high regard for the firm which had a history of participating in the “revolving door”:

... Brown Brothers Harriman was among New York's oldest, largest, most prestigious investment banks—W. Averell Harriman, the legendary statesman, had been a general partner before going to work for President Roosevelt and Prescott Bush, father of President George H. W. Bush and grandfather of President George W. Bush, served there as a partner both before and after his tenure in the U.S. Senate from 1948 to 1953 (Greenspan 2007, 31).

Greenspan also worked for a finance industry consultancy and think tank known as The Conference Board from 1955 to 1987 (Greenspan 2007). During his tenure with the Federal Reserve, Greenspan concurrently held the position of Chairman and President of another economics consultancy firm, Townsend-Greenspan & Co which also provided services to the finance industry (Greenspan 2007). Greenspan's involvement with industry extended to Board memberships on corporations such as Aluminium Company of America (Alcoa); Automatic Data Processing; Capital Cities ABC Inc.; General Foods; Mobil Corporation; the Pittston Company and the large US investment banks, J.P. Morgan & Co and; Morgan Guaranty Trust Company (Pottruck 2005).

Ben Bernanke was Chairman of the Federal Reserve during the height of the GFC, between 2006 and 2014. Although Bernanke's career prior to commencing in his role at the Federal Reserve was in academia, he succumbed to the temptation of working in industry after retiring from the Federal Reserve. In 2015, Bernanke joined a hedge fund known as Citadel as a senior advisor. The fund managed USD 25 billion in assets and was considered one of the largest funds of its type in the US at the time (Sorkin and Stevenson 2015).

Other recent president and chief executive officers of the Federal Reserve Bank of New York who immediately preceded Geithner, included Gerald Corrigan who served in that capacity from 1985 until 1993 and William McDonough who served from 1993 to 2003. Immediately following his career at the Federal Reserve, Corrigan was appointed Managing Director at Goldman Sachs in 1994 and soon became Chairman, retiring in 2016 (Federal Reserve Bank New York 2017a). Prior to joining the Federal Reserve, William McDonough worked for US bank, First Chicago Corporation and its subsidiary bank, First National Bank of Chicago for 22 years. McDonough retired from First Chicago Corporation in 1989. Upon his retirement from the Federal Reserve, McDonough was appointed to serve as the first chairperson of the Public Company Accounting Oversight Board (established by the Sarbanes-Oxley Act of 2002) in Washington, DC. He served in that post until 2005. McDonough eventually returned to the investment banking industry as Vice-Chairman and special advisor to the Chairman at Merrill Lynch & Co. until his retirement in 2009 (Federal Reserve Bank New York 2017b).

Fuld also carried a degree of influence. In addition to his other roles, Fuld was a member of the Board of Directors at the Federal Reserve Bank of New York. He held this position from March 2005 and was re-elected in January 2008, resigning a short time before the failure of Lehman Brothers (Federal Reserve Bank New York 2007). Further, Lehman Brothers was able to maintain a connection with regulators through its Chief Legal Officer, Russo, whose influential connections are documented earlier in this book.

Empirical Evidence that Connections Count

Using an empirical analysis, Igan and Mishra (2011) found that political contributions, the "revolving door" and the use of lobby groups had an

effect on the legislative and regulatory process. Their findings confirm two important propositions. Firstly, that lobbying expenditures by financial firms, including investment banks, influenced the votes within government on industry related legislation proposed in the years prior to the crisis. As lobbying on proposed financial legislation intensified, Igan and Mishra (2011) found that a legislator would alter their position to favour a more liberal legislative stance in a subsequent reintroduction of the related piece of legislation to the House of Representatives. This link was found to be statistically significant. Secondly, they found that the stronger the connection between lobbyists and legislators, the greater the probability of a legislator changing their vote in favour of the lobbyists position. The strength of the connection was associated with the amount of political contribution donated by the lobbyist to the legislator. Thirdly, Igan and Mishra (2011) found that a politician's party affiliation influenced whether a legislator was in favour of deregulation. The propensity to support deregulation was higher for a Republican legislator than for a Democrat and greater still, if the legislator had previously worked in the investment banking industry. This empirical analysis is supplemented by other studies on this phenomenon. Malmendier and Schmidt (2011), for example, in a study using an experimental methodology, found that the giving of a donation or gift is able to persuade the decisions of the recipient in a way that benefits the giver. The favourable response by the recipient is achieved despite knowing that the intention of the giver is to influence the recipient.

The culture of an organisation also has an impact on whether they engage in lobbying to affect a regulatory stance. Igan et al. (2012) found that those financial institutions whose lending policies supported riskier credits and processes during the period between 2000 and 2006 were more inclined to use lobbyists. These same more credit risk-aggressive financial institutions experienced a higher level of financial distress from the GFC. Igan and Mishra (2011) and Igan et al. (2012) therefore established an empirical foundation for the link between lobbying by the finance industry to the establishment of a lenient regulatory environment, permitting a less conservative lending culture. Stratmann (2002), with an empirical study, established that campaign contributions affected voting choices by legislators on bills related to financial regulation. Mian et al. (2013) in a study of six bills introduced prior to the GFC, also found that subprime mortgage lenders influenced government policy toward subprime

mortgage credit expansion. Bertrand et al. (2014) found that lobbyists form connections with particular politicians and follow their various committee roles in government in order to influence their respective committee's decisions. Therefore, the case for the influence over the regulatory and legislative process is confirmed by the research literature.

Knowledge Asymmetry

The pace of financial innovation which emerged in the 1980s had accelerated during the 1990s and 2000s. This particularly affected the securitisation field which spawned a variety of derivative products and complex financing structures. These structures were even found to be too complex for the CRAs to fully comprehend and assign appropriate credit risk ratings as was later revealed in the financial crisis inquiry (Financial Crisis Inquiry Commission 2011). In this environment, where rampant innovation was a hallmark of the investment banking industry, a natural knowledge asymmetry developed between industry participants and the regulators. After all, in the absence of a formal consultative process with industry, how could the regulators understand the complex financial products prior to their distribution? The notion that 'industry knows best' in a fast-paced environment where no immediate risks were discerned was considered a safe option by the regulators and consistent with the neo-liberal political atmosphere at the time.

The professionals employed by the regulatory agencies were expected to have a knowledge and skill base commensurate with those in the industry they were supposed to regulate. However, a knowledge asymmetry existed which gave rise to normative pressures being exerted upon the regulators. Normative pressures are present as a consequence of professionalism. As the formal qualifications (consisting of tertiary education in the business, economic and finance fields) required for individuals in the two groups consisting of regulators and the financial network are largely similar, it is suggested that employees of both groups were members of the same professions in a broader technical sense. Whilst the finance industry originally developed complex products and structures for financial transactions, the accounting profession was involved in their accounting and auditing; the legal profession was concerned with their documentation; and the CRAs developed methodologies to apply the respective ratings. In the meantime, regulators were

responsible for overseeing their regulatory compliance. All groups therefore were required to share the same professional knowledge necessary to fully understand these innovations. The condition for normative pressure to exist accepts the concept that individuals within certain professions exhibit norms and cultural behaviours that are linked to their occupation.

The complex derivative products and financial structures deployed in the marketplace found acceptance by industry and their customers generally. The pressure was on the professionals within the regulatory agencies to accept these practices as information about them filtered through the professional networks, the same networks that were affected by the “revolving door”. As the financing practices became norms amongst professionals within the private enterprise groups, the normative pressure exerted resulted in these “practice” norms being adopted by the same professionals within the regulatory agencies which included the Securities Exchange Commission, Federal Reserve, NYSE, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, Federal Financial Institution Examination Council.

The resultant adoption of these practices, challenges the principle that regulators have a responsibility to act in the public interest, given society bears the cost of regulation. This notion is proposed by public interest theory which proffers that regulation is necessary to protect the public interest (Deegan 2009). The regulator has a responsibility to balance the costs of regulation with its social benefits especially with regards to more effective financial markets (Scott 2003, 448). The responsibility to the public can be viewed from a number of perspectives. Deegan (2009) suggests that regulation is necessary due to the following reasons: markets are inefficient and without comprehensive information available to the markets, individual investors could be negatively impacted from relying on insufficient disclosures; there are power imbalances between investors which may affect their relative access to reliable information; investors can be affected by fraudulent organisations publishing misleading information; and regulation encourages comparability between organisations due to requirements to produce information using uniform methods. These responsibilities entail “professional” conduct, an attribute which encompasses ethical considerations. Key features of the expected professional conduct by regulators include transparency and independence in their everyday activities (Dellaportas et al. 2005).

Not only were the investment bankers innovative with products and financial structures, they also introduced new concepts in corporate finance. An example of the contribution of new knowledge from the investment banking industry include the concept of value at risk (VaR), which provides a measure of expected loss on a financial instrument resulting from the variation of an underlying price or rate. JP Morgan Chase was responsible for the development of the VaR concept which has since been commonly applied by the finance industry. It is also used by the peak bank supervisory body, the Bank of International Settlements in its Basel guidelines governing market risk (Ferguson 2008). Further examples of investment banking influence on institutional practices include: the classification by Goldman Sachs of an emerging economic grouping known as BRIC (acronym for Brazil, Russia, India and China). Additionally, Morgan Stanley developed a set of indices used to categorise and provide a measure for equity markets known as MSCI indices. Investment banks have also been involved in introducing and developing the corporate finance concept of economic value, and using stock prices as an essential forward-looking measure of the valuation of a corporation (Ho 2009).

The attitude whereby professionals within the investment banking industry were viewed as thought leaders within their profession fostered a lax approach to the regulatory process. Regulators deferred the development of intellectual capital to the industry they were supposed to be supervising. They obviously did not fully understand the consequences or implications of such innovation as was proved with the subsequent corporate and banking failures. In the modern era, the emergence of CRAs in the financial network introduced another party potentially subject to normative influence. As CRAs became an essential conduit for investment banks to successfully execute their securities transactions, any influence over their activities would become advantageous. The following sections explore the means by which this influence was exercised.

Credit Rating Agencies

This section explains how investment banks were able to exert influence over the CRAs, not only through their commercial support, but by providing direct feedback on the rating models employed. Coffee et al. (2010, 1) define credit ratings as symbols that “provide an opinion on the relative ability and willingness of parties with debt obligations to meet financial

commitments". They claim that credit ratings have three functions: "to measure the credit risk of the issuer; to provide a means of comparison; and to provide a common standard" (Coffee et al. 2010, 1). The international credit rating market is dominated by three major agencies, S&P, Moody's and Fitch which together constitute a natural oligopoly, representing more than 90% of the market (Coffee et al. 2010, 1). The ratings provided by CRAs are designed to inform investors with independent and well researched information on the risk profile of issuers of debt securities. CRAs however failed in these responsibilities, exacerbating the 2007/2008 financial crisis. Their contributory role extended from publishing inflated ratings of financial institutions and more significantly, securitisation vehicles holding risky mortgage-related products such as subprime mortgages. This indictment is promoted by a view that CRAs are fundamentally subject to conflicts of interest (Coffee 2011, 232). This allegation came to a head in a case filed by the US Department of Justice and subsequently settled by S&P (the defendant):

... Department of Justice and 19 states and the District of Columbia have entered into a USD 1.375 billion settlement agreement with the rating agency Standard & Poor's Financial Services LLC, along with its parent corporation McGraw Hill Financial Inc., to resolve allegations that S&P had engaged in a scheme to defraud investors in structured financial products known as Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs). The agreement resolves the department's 2013 lawsuit against S&P, along with the suits of 19 states and the District of Columbia. Each of the lawsuits allege that investors incurred substantial losses on RMBS and CDOs for which S&P issued inflated ratings that misrepresented the securities' true credit risks. Other allegations assert that S&P falsely represented that its ratings were objective, independent and uninfluenced by S&P's business relationships with the investment banks that issued the securities (US Office of Public Affairs 2015).

In the process of settling the lawsuit, S&P admitted facts demonstrating that it misrepresented itself to investors and the public, by issuing biased ratings in its attempts to maximise profits (US Office of Public Affairs 2015). The above statement issued by the US Department of Justice alludes to the complicity of the CRAs in disseminating misleading ratings on CDOs arranged by various investment banks prior to the GFC. Although the lawsuit focused on S&P as the defendant, the assertions mentioned

therein are relevant to other major CRAs operating in the industry (Coffee et al. 2010; Leaders of The G20 2009; US Office of Public Affairs 2015).

The major criticism of the CRAs' approach revolves around the "issuer-pays" model used prior to the GFC. The model involves an issuer of securities paying the CRA for their rating. The ratings, once published are made available to the investors without fees. During the 1970s, CRAs used a 'subscriber pays' model, whereby they generated income by charging the users of the ratings. However, as the issuance of debt securities expanded, the demand for ratings grew commensurately and CRAs discovered it increasingly profitable to charge a fee directly to issuers. "This practice grew to the point where, by 1987, nearly 80% of S&P's revenues came from issuer fees. The balance came from selling research and ratings information to large institutional investors, corporations, and libraries" (Coffee et al. 2010, 7).

There are two major reasons for issuers to use credit ratings to support their debt securities issues. Firstly, issuers can access a wider investor base as the credit assessment is portrayed as independent and reliable given the assessment is carried out by a third party. Therefore, the resultant confidence generated amongst investors, maximises the potential for a fully subscribed issue. Secondly, through the access to the public markets, the issuer may benefit from an improved cost of capital as public debt issues are traditionally less expensive than bank loans. These reasons for using CRAs sustained a continuation of the issuer pays model and contributed to the CRAs ongoing profitability. There was little incentive for CRAs to change business model as observed by Coffee et al. (2010, 39):

... For a variety of reasons, including the shared oligopoly that the major rating agencies enjoy, their virtual immunity from liability, and the conflicts of interest surrounding their common 'issuer pays' business model – the major credit rating agencies simply had too little incentive to get it right.

The question remains then, how did the investment banks that relied on the inflated credit ratings to successfully distribute their securities influence the CRAs to do their bidding?

Coercive Pressure over CRAs

As arrangers of securities issues, investment banks are often instructed by clients to negotiate with CRAs on their behalf and arrange for the rating. It is the arranger's role in any issuer to provide advice and guidance to the client throughout the issuance process. In this position of power, and given that ratings agencies often compete with each other, there exists a natural arena for influence to be exerted. An investment bank could for example refuse to contract with a particular CRA unless the investment bank's expectations are met. These expectations could include the cost of the rating, the timing of its publication or the level of the rating itself. The investment banking industry is motivated to pursue the highest possible rating for their clients for various reasons. Firstly, there is the reputation factor. If an investment bank is routinely perceived as achieving a higher rating for its client than was expected, this skill would enhance its reputation in the market and therefore potentially attract a greater number of clients seeking to minimise their cost of capital. Secondly, as returns from a security are inextricably linked to the risk and therefore the rating of an investment, there exists arbitrage opportunities when a formal rating is out of step with the "true" risk of a security. This infers that the market's view of the risk of a security could differ from the CRAs' view at any given point in time. This can occur as a result of the infrequent and irregular publication of ratings compared to the timely absorption of information by the market in a security's price or the inaccurate rating being issued in the first place.

A rational investor would therefore be motivated to invest in any security whose credit rating is expected to be upgraded within an acceptable time horizon. As the credit rating is upgraded, the return offered in the market is adjusted by way of a price adjustment to reflect the improved credit profile as judged by the CRA. This usually translates into an increase in price, reflecting a premium for a stock or the narrowing of the credit spread for a bond. An investor holding the security would benefit by the instrument's price rise in either case. The rational investor would therefore purchase the security in anticipation that the market will adjust its price to the risk commensurate with the CRAs' upgrade of a rating. This behaviour by investors would therefore predispose a preference from the investment community to encourage CRAs to re-rate issuers at the top end of the arbitrary band established by the CRAs' rating framework. As investment

banks are also large investors in securities in their own right, there is a natural motivation for them to push for these higher re-ratings.

In search of commercial success, S&P was motivated to solicit feedback from the investment banking industry—the key go-between between CRAs and the issuer. The importance placed on feedback from investment banks is illustrated when S&P was developing a new ratings model. S&P had relied on a model known as CDO Evaluator Version 2.4.3 for its rating process involving CDOs. During 2004/2005, this model was subject to review with the intention of improving its functionality and accuracy and the new model was to be known as CDO Evaluator Version 3.0 (E3). Following a testing phase, the newer model was found to have produced lower ratings for CDOs. It was therefore resisted by S&P senior management due to the affect it would have on revenue and market share:

... The initial update efforts, throughout 2004, were directed in part by the then head of S&P's Global CDO group, whose experience was that the risk of losing transaction revenue was a factor that affected updates of CDO Evaluator ... during the initial update efforts, he and, according to him the then Managing Director in charge of the Cash CDO group, pushed back against updates to CDO Evaluator proposed by one of S&P's senior analysts because they believed these changes would have had a significant negative effect on S&P's market share and ratings business (US Government Department of Justice Office Public Affairs 2015, 2).

According to the US Government Department of Justice Office Public Affairs (2015), given the potential negative impact on existing ratings, ultimately, the E3 model was postponed. Prior to the intended release of a revised E3 model, S&P sought feedback from investment banks. Emails forwarded internally to senior executives within S&P dated 18th and 19th July 2005, outlined feedback from one of these investment banks. This feedback was noted as follows in the 'Statement of Facts' forming part of the documents in the case initiated by the US Department of Justice against S&P:

... S&P's ratings generated by using CDO Evaluator Version 2.4.3 [this version preceded the proposed new version: E3] had been the 'best' (by comparison to Moody's and Fitch) with respect to CDOs comprised of certain 'more lowly rated' asset pools; S&P would be giving up its market advantage with respect to these CDOs by moving to E3; and S&P would not make up for this with any increase in business in 'the high quality sector' because with respect to this sector Moody's and Fitch can do better than E3 already (US Government Department of Justice Office Public Affairs 2015, 2).

Following the opposition to the new model from the investment banking industry, an S&P senior executive stated that:

... the roll out of E3 to the market had been 'toned down and slowed down'
... pending further measures to deal with such negative feedback (US Government Department of Justice Office Public Affairs 2015, 2).

The investment banks had effectively coerced S&P to cease development of the new version of E3 under the threat of the industry refusing to seek ratings from the CRA given that the new version would result in lower ratings. These sentiments are noted as follows:

... the basis for this decision, noting in particular one investment bank's comments that E3 would result in S&P missing potential business opportunities (US Government Department of Justice Office Public Affairs 2015, 2).

The above evidence in the "Statement of Facts" issued by the US Department of Justice demonstrates the coercive institutional influence exerted by the investment banking industry in its feedback relating to the development of a revised ratings model. In effect the pressure from the investment banks ensured that ratings downgrades were kept to a minimum or avoided altogether during that period.

The instinct for generating greater profits at the expense of issuing accurate ratings was also expressed by David Tesher, a Managing Director of S&P, who in March 2007 addressed ratings analysts in directing their approach to future ratings:

... Wall Street clients were under pressure to move souring mortgages into new securities called CDOs before the market crashed. Issuers needed the highest grades on the repackaged bonds to sell them to pension funds, banks and other investors (Smith and Ivry 2013).

This message, an example of the coercive pressure placed on ratings analysts to inflate their ratings. Coercive pressure is more likely and effective on organisations which are financially dependent on one another. For example, sporting organisations who were more reliant on state funding are also more willing to accept the pressures applied by the state to accept change in organisational practice (DiMaggio and Powell 1983; Slack and Hinings 1994).

CRA's relied on investment banks to issue large volumes of debt securities to sustain their business model. CDOs and MBS represented a significant amount of total debt securities issued in the pre-GFC period. Representatives from the investment banking industry comprised the major underwriters of these securities and required credit ratings in order to effectively distribute them to their customers. Figure 11.18 shows the top 12 underwriters of US MBS in 2007. Interestingly, Lehman Brothers is the top-ranked underwriter based on market share and as a group, the investment banking industry accounted for over 80% of the market share. The industry and Lehman Brothers, in particular, as the leading underwriter, would have possessed an influential voice in their dealings with the CRA's.

Figure 11.18: Top 12 US Mortgage-Backed Securities (including CDOs) Underwriters in 2007

Rank Based on Amount Issued	Investment Bank Arranging Issue	Number of Issues	Market Share Based on Amount Issued*	Amount Issued USD Millions
1	Lehman Brothers	120	10.80%	100,109
2	Bear Stearns	128	9.90%	91,696
3	Morgan Stanley	92	8.20%	75,627
4	JP Morgan Chase	95	7.90%	73,214
5	Credit Suisse	109	7.50%	69,503
6	Bank of America	101	6.80%	62,776
7	Deutsche Bank	85	6.20%	57,337
8	Royal Bank of Scotland Group	74	5.80%	53,352
9	Merrill Lynch	81	5.20%	48,407
10	Goldman Sachs	60	5.10%	47,696
11	Citigroup	95	5.00%	46,754
12	UBS	74	4.30%	39,832

*Note: As other securities firms were involved in arranging MBS issues, the total of market share data does not equal 100%.

Source: The data used for the table was extracted from Coffee et al. (2010, 9).

In support of the evidence of undue pressure being exerted internally within S&P, the executive in charge of S&P's RMBS Surveillance Group frequently protested:

... that she was prevented by S&P executives from downgrading subprime RMBS as she and the surveillance group wanted because of concern that S&P's rating business would be negatively affected if S&P were to announce severe downgrades (US Government Department of Justice Office Public Affairs 2015, 3).

The investment banking industry had successfully exerted its influence over the CRAs. As a result, it facilitated the promotion of debt issues by falsely inflating their respective credit ratings and perceptions of borrowers amongst the investing community. The consequent fee feeding frenzy continued for both the industry and the CRAs.

There are numerous examples where credit ratings are included in regulations to guide government authorities in their assessment of an organisation or to restrict investments—these are known as regulatory ratings. Langohr and Langohr (2008) noted that the use of regulatory ratings damages market discipline as there is an artificial bias established by regulation to invest in higher rated issues. Coffee et al. (2010) have criticised the prevalence of regulatory ratings as they tend to defer the responsibility of credit decisions to a third party. “Ratings have become so embedded in guidelines and regulations that the safety judgement of an investment has de facto been outsourced to the CRAs” (Coffee et al. 2010, 7). Appendix D details examples of regulations from 1931 to 2000 which required the adoption by US organisations of minimum credit rating thresholds for their investment activities. An example of such a restriction involves the 1991 SEC amendment to rule 2a-7 under the investment company act of 1940 which required US Money Market Mutual Funds to restrict their investments of debt securities to those with a minimum rating of A1 (Coffee et al. 2010).

The minimum rating thresholds indicated in Appendix D had been set by regulators. Therefore, for many investors who were required to invest in rated securities and were bound by the minimum rating standards, their investment universe became limited. An investment universe for these investors needs to meet the regulatory minimum standards and be sufficiently diverse and with a market depth to meet their investment criteria. This creates a natural and skewed demand for higher rated issues—

at least equal to or higher than the minimum “investment grade” band of “BBB”, which is the lowest rating for many of the relevant regulations (Coffee et al. 2010, 8).

For an underwritten issue to be successfully placed, the underwriting investment bank’s job is made easier if the credit rating of its issuer meets the minimum levels described above. This scenario adds to the potential for investment banks to exert coercive pressure on the CRAs to rate an issue which meets the minimum threshold. The CRAs are also under pressure to ensure there is an acceptable volume of issues that meet the minimum, so as to meet the market demand and thereby support their own survival.

The influence over the CRAs was symptomatic of the self-perception of the industry as a powerful assemblage prepared to exercise its power to achieve advantageous outcomes. It also extended to the successful lobbying of the Financial Accounting Standards Board (FASB) in the development of a key accounting standard—FAS 125 and its successor FAS 140 which was instrumental in the accounting for Repos—a financing tool frequently used by financial institutions and particularly, investment banks to assist with their short-term liquidity management.

Institutional Influence over FASB

This section addresses the influence the investment banking industry applied in the standard setting process for a key accounting standard relating to the accounting of Repos, which are important financing transactions for financial institutions. The influence was analysed using a content analysis which concludes that the accounting standards enabled Lehman Brothers’ financial “window dressing”. The FASB adopts a thorough and independent process for the development and updating of US accounting standards. This process fosters extensive public participation, incorporates views from various stakeholders and is conducted under the supervision of the Financial Accounting Foundation’s Board of Trustees. The US accounting standard setting process is outlined in Figure 11.19.



Figure 11.19: Process for Establishment of US Accounting Standards
Source: Information was extracted from Financial Accounting Standards Board (2017)

The consultation stage of the accounting standard setting process may be considered from two main viewpoints. It could be viewed from a technical process, or a political process or both (Larson 2007). Whilst the technical interpretation generally focuses on selecting the most appropriate accounting practice for purpose, the political perspective implies that subjective choices of practices are made between conflicting interests (Larson 2007, 214). The consultation process can also be interpreted as an important step in an organisation's attempt in seeking legitimacy (Larson 2007, 207). This concept is consistent with Riaz's (2009) notion of reverse legitimisation discussed earlier in this book.

Key accounting standards for financial institutions during the decade preceding the GFC included FAS 125 and FAS 140 which both dealt with

accounting for transfers and servicing of financial assets and extinguishment of liabilities and which covered Repos. FAS 140 which was the accounting standard prevailing at the time of Lehman Brothers' collapse, was adopted by the FASB in September 1999, and effectively replaced FAS 125, however carried over most of its provisions without reconsideration (Financial Accounting Standards Board 2000, 4). This standard was important because it guided the accounting treatment for Repos which was one of the main instruments used by Lehman Brothers and the investment banking and securities dealer industries generally. Repos involve a short-term assignment of assets (normally a debt security) to the counterparty in return for cash, thereby creating a funding source for the assignor. The contract also includes a clause requiring the assignor to repurchase the asset at a pre-negotiated price at a pre-determined date in the future (usually between one and two weeks). At that later date (that is at expiry) the counterparty returns the securities to the borrower who repays the cash loan with interest.

Previous to FAS 125, the accounting treatment for Repos was covered by FAS 115, which provided alternative accounting treatments at the discretion of the user and relied on the intent by the user (Financial Accounting Standards Board 1996a, 6-7). The alternatives could be to account for the transaction as a sale or as a liability. For preparers of financial statements, it could be advantageous to record the transactions as sales and avoid their inclusion in borrowings which would inflate liabilities in the balance sheet and affect leverage ratios. The exposure draft for FAS 125 attempted to change the notion of intent to a structural test known as the "90-day bright-line test". This prescriptive test defined whether a Repo would be classified as either a sale or a borrowing based on the maturity of the Repo. Repos which had maturities over 90 days were classified as a sale whilst Repos which had maturities less than 90 days were categorised as "assuredly temporary" and classified as a secured borrowing. (Financial Accounting Standards Board 1997a).

Ultimately, the industry was able to convince the FASB to reject the proposed "90-day Bright-line test" approach. FAS 140 based the accounting treatment on a principle of "control" of the collateral. If an assignor surrenders control of the transferred collateral, then the transferor can account for the transaction as a sale and not a borrowing. This allows the assignor to in fact, disguise a borrowing as a sale in the financial statements. This was addressed in the guidance notes to FAS 140

which, to satisfy the control criteria, requires the value of the assets to be repurchased to be substantially equal to the original assets transferred. FAS 140, however, like FAS 125 allows some judgement from the user in determining the quantum of the sufficient value between the transferred asset and that which is subsequently repurchased and thereby provided a significant degree of flexibility (Financial Accounting Standards Board 2000, 4).

Analysis of Submissions to FASB for FAS 125 and 140

As shown by Figure 11.19, the process of issuing standards by the FASB involves a consultation process where interested parties invited by the FASB are able to make submissions on the exposure drafts. The key criteria of control featured prominently amongst the submissions (comment letters) within the consultation process for both FAS 125 and FAS 140.

Submissions received by the FASB originated from several different broad interest groups including: representative organisations such as associations (representing the accounting and financial markets industries in particular); participants in the financial markets industry (of which the investment banking industry was prominent); corporations; insurance groups; law firms and academia. Figure 11.20 and Figure 11.21 illustrate a breakdown of the industry responses.

Masocha and Weetman (2007) claim attention to the content of documents such as published submissions to exposure drafts, increases the explanatory power of an analysis. An examination of submissions received by the FASB is therefore useful in locating those interested parties who would benefit from having an influence in the standard setting process. Grinyer and Russell (1992) found that parties involved in writing submissions are interested in furthering their economic welfare and that such lobbying influence is able to mitigate the intended purpose of designing accounting standards consistent with accounting concepts. Larson (2007) found that parties lobbying the International Accounting Standards Committee overwhelmingly included large corporations and multinational organisations from developed countries, thereby allowing more powerful organisations that are in a stronger economic position to exert influence. Therefore, categorising authors of submissions and their positions within industry groups is a useful way of identifying any inherent

biases introduced into the standard setting process. The submission stage in the accounting standard setting process can be considered as a type of lobbying of the FASB in that certain points of view are communicated to decision makers (Georgiou 2004).

The content analysis involved analysing 193 submissions containing a total of 1,083 pages. According to Duriau et al. (2007, 6), a number of theoretical frameworks, methods and analytical techniques claim to use content analysis in explaining phenomena in the social sciences. A helpful definition of content analysis used in this analysis can be described as: “any methodological measurement applied to text (or other symbolic materials) for social science purposes” (Duriau et al. 2007, 6). The content analysis approach used in this section, helps with an understanding of the influences on the accounting standard setting process for the relevant standards and includes an analysis of the submission input as measured by number of submissions and number of pages per submission made by various interest groups and an analysis of the positions taken by various interest groups in their submissions.

Analysing the respective percentage of total submissions and percentage of the number of pages submitted by each interest group leads to an understanding of the investment in resources devoted to the relevant topic. The greater the detail incorporated in the submissions as reflected in the number of pages written, generally translates to a greater investment in resources. The greater the number of submissions from a particular interest group is also an indication of the level of interest and applicability of the subject matter contained in the exposure draft to that interest group. The relative importance of the subject matter to each interest group provides an indication of the level of commitment to influencing the process. An analysis of the written content of each submission reveals the particular position taken by each author in relation to the standard being proposed. Aggregating these positions by interest group, reveals a commonality in the thinking around the proposed standard and signals a self-interest in influencing an outcome beneficial to the interest group (Guenther and Hussein 1995; Kenny and Larson 1993; Kwok and Sharp 2005).

An analysis of the industry participation of the submission process for the exposure drafts to FAS 125 and 140 is summarised in Figure 11.20 and Figure 11.21 respectively. The method used in compiling these data

involved counting the number of submissions per interest group which provided a relative contribution to the total number of submissions received. Additionally, the number of pages per author were calculated, which were aggregated by interest groups to provide another measure of the weight of each interest groups' submissions. The data in each figure are set out in descending order of percentage of submissions received by the FASB. All publicly available comment letters in response to FASB's consultation request were examined.

A number of law firms' submissions were made on behalf of clients which were in all cases financial institutions. To accurately reflect the number of submissions, each party represented by a law firm's submission has been included separately in the statistics even though the view of all parties included in the law firms' submission letters was the same. The similarity of views in the one submission can be explained by all interested parties sharing a common law firm or by the parties forming a lobby group with the intention of reinforcing a united common position in the hope that it would carry greater weight. The drafting of submissions by a professional law firm, which is governed by its own professional code of conduct, would also convey greater legitimacy to the FASB and therefore represent an attempt to convey a concentrated degree of influence. This manifestation of lobbying constitutes the same type of normative pressures described by DiMaggio and Powell (1983) as a type of social influence leading to commonality.

Figure 11.20: Industry Analysis of Submissions to Exposure Draft to FAS 125

Submissions to Exposure Draft for FAS 125 dated 13 January 1997			
Interest Group	% of Total Submissions	% of Total Pages in all Submissions	Average Number of Pages per Submission
Banks and Investment Banks	36%	38%	5.0
Industry Associations	22%	23%	4.7
Non-Bank Financial Institutions	11%	8%	3.2
Other*	9%	11%	20.3
Accounting Firms	8%	11%	6.8
Insurance Companies	7%	5%	3.2
Corporations	7%	4%	2.6
Totals	100%	100%	4.3
	Total Number of Submissions	Total Number of Pages	
	152	719	

*Note: The group titled 'Other' includes law firms, academia, CRAs, and individuals.

Source: The data used for the table were extracted from Financial Accounting Standard Board – Index to submissions for Exposure Draft to FASB Statement Number FAS No. 125 (Financial Accounting Standards Board 1997b)

Figure 11.21: Industry Analysis of Submissions to Exposure Draft to FAS 140

Submissions to Exposure Draft for FAS 140 dated 7 December 1999			
Interest Group	% of Total Submissions	% of Total Pages in all Submissions	Average Number of Pages per Submission
Banks and Investment Banks	39%	26%	6.4
Industry Associations	33%	27%	7.5
Accounting Firms	12%	30%	21.6
Non-Bank Financial Institutions	2%	1%	3.0
Corporations	10%	9%	8.5
Insurance Companies	2%	1%	3.0
Other	2%	6%	21.0
Totals	100%	100%	10.1
	Total Number of Submissions	Total Number of Pages	
	41	363	

Source: The data used for the table were extracted from Financial Accounting Standard Board–Index to submissions for Exposure Draft to FASB Statement Number FAS No. 140, (Financial Accounting Standards Board 1999a)

Although banks and investment banks, and non-bank financial institutions are separate categories, they represent the financial market community which is the largest combined group that uses Repos. The following analysis therefore combines these two categories under one group, “financial institutions”. It is notable according to Figure 11.20 and Figure

11.21, that FAS 125 attracted a larger number of submissions than FAS 140. The attention from industry towards the exposure draft for FAS 125 may be due to it being the first time that a more prescriptive treatment for Repos was introduced. FAS 140 merely represented a minor revision of the same standard, without materially altering the notion of 'control' (Financial Accounting Standards Board 2000). As the industry group mostly affected by FAS 125 and FAS 140, it is not surprising that the financial institutions group in aggregate for both exposure drafts, accounted for the greatest number of submissions (44%) which also contained the most content (37%) from submissions made by any other group. Through their representation in the process, the financial institutions group were clearly interested in the formulation of the standards and desired to have an influence in the final outcome.

Analysis of the positions taken by the respective interest groups relates to the exposure draft for FAS 125 only, as it diverged significantly from the previous applicable accounting standard, FAS 115.

Figure 11.22: Position Analysis of Submission Letters to Exposure Draft on FAS 125

Group	Reject Exposure Draft	Support Exposure Draft	No Comments	Reject Exposure Draft but with Recommendations	Total By Group
	(a) Number of Submissions	(b) Number of Submissions	(c) Number of Submissions	(d) Number of Submissions	
Banks and Investment Banks	22	0	3	11	36
Non-Bank Financial Institutions	6	0	12	6	24
Industry Associations	12	1	1	5	19
Industrial Corporations	0	2	7	1	10
Insurance Companies	4	2	0	4	10
Accounting Firms	2	1	0	4	7
Other	3	1	2	1	7
Total	49	7	25	32	113

Source: Financial Accounting Standard Board—Submission Letters to Exposure Draft to FAS No. 125 (Financial Accounting Standards Board 1996b)

An analysis of the positions taken by interest groups in relation to the exposure draft for FAS 125 appears in Figure 11.21. This analysis identifies four categories of responses: (a) a rejection of the exposure draft, with respondents preferring the prevailing accounting treatment; (b) support for the exposure draft; (c) no comments relating to the Repo component of the exposure draft; and (d) a rejection of the exposure draft with recommendations for an alternative approach. Column (d) combines two main alternative approaches: a risk reward approach which allocates accounting treatments for transactions according to the risks and rewards assigned to each party to the transaction; and an approach which accounts for transactions based on their economic substance. As these alternatives are similar in nature, they are both classified under column (d).

Figure 11.22 convincingly shows that 94% of submissions rejected the prescriptive nature of the “90-day bright-line test”. Financial institutions and their representative bodies (mostly comprising associations of financial institutions and accounting firms) clearly favoured a non-prescriptive approach to classifying Repos and to preserve their freedom to use a subjective measure under the prevailing accounting standards. Further, no banks and investment banks were in support of the exposure draft, with 61% preferring the *status quo*.

In its background discussion contained in FAS 140, the FASB outlined its rationale of omitting the “90-day Bright-line test” as a response to the overwhelming position held by respondents to the exposure draft for FAS 125. Instead of the “90-day Bright-line test”, the FASB established the “surrender of control” requirement for a Repo to constitute a sale, and listed three key criteria for its determination including:

- a) The transferred asset being isolated from the transferor;
- b) The transferee obtaining a right (free of conditions) to pledge or exchange the transferred asset or exchange the transferred asset; and
- c) The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (Financial Accounting Standards Board 1996a, 4).

The financial community managed to resist an attempt by a regulatory body to diminish their control over the process to represent their financial position through their financial statements. Their victory would ultimately lead to the misrepresentation of Lehman Brothers' balance sheet and concealment of USD 50 billion of debt.

Lehman Brothers' role in the consultation process

The consultations for FAS 125 included a letter submitted by Lehman Brothers and signed by its CFO, David Goldfarb. Lehman Brothers acknowledges in its submission that it also worked with the Public Securities Association (PSA) in drafting its response to the exposure draft and fully supported the association's position (Goldfarb 1996, 1).

The PSA is the predecessor association to The Bond Market Association (TBMA), which subsequently merged with the Securities Industry Association (SIA) to form the Securities Industry and Financial Markets Association (SIFMA). The PSA was the professional representative body for the international bond market industry, accounting for 44% of the global securities market (The Association for Financial Markets in Europe 2015). The merged PSA/TBMA which was headquartered in New York and had offices in London and Washington represented a diverse mix of securities firms and banks. The merged PSA/TBMA was considered one of the most important lobby groups representing the investment banking industry and regularly participated in debates relating to the development of the bond industry on behalf of issuers and traders (Securities Industry and Financial Markets Association 2015).

An analysis of the submission letters attempted to discover any joint submissions and in particular whether comment letters which were submitted by industry associations and investment banks were co-authored or acknowledged a joint approach. The analysis revealed no other investment banks acknowledged they had worked with an industry association or the PSA in the preparation of the PSA submission (DeRoma and Guba 1995; Financial Accounting Standards Board 1996b). Therefore, Lehman Brothers was in a unique position to influence the PSA's view on the exposure draft. In fact, submissions for both Lehman Brothers and PSA appear similar and proffer the same arguments relating to Repos (DeRoma and Guba 1995; Financial Accounting Standards Board 1996b; Goldfarb

1996). This suggests that Lehman Brothers was either in agreement with the PSA, or one of the parties had an influence over the other's position on the exposure draft. If Lehman Brothers was influencing the PSA, it was in a position to exert an even greater power over the standard setting process than had it solely relied on its own submission. As the representative body of the global bond markets, the PSA's view would have been interpreted as representing the views of the bond market in general and therefore carried added weight.

As expected, Lehman Brothers' essential objection to the exposure draft related to the "90-day bright-line test". Lehman Brothers (and the PSA in its submission) clearly favoured the previously existing standard advising in their submission that they "are not aware of shortcomings in how secured financings are currently reported" and "do not see any logical reason to change present accounting model" (Goldfarb 1996, 1). The implications were that Lehman Brothers acquired greater power to interpret the standard, thereby allowing it to interpret the standard to the advantage of the firm.

Objection to Exposure Draft an Exercise of Institutional Influence

The proposal presented in the exposure draft to FAS 125 of limiting the flexibility of options in the accounting treatment for Repos may be perceived by Lehman Brothers and other financial institutions as placing a limitation on their power to represent the firm through their financial statements to external stakeholders. Bradbury (2007) acknowledges that accounting standards subject to interpretations signal a weakness and have the potential to undermine a principles-based approach. Submissions to exposure drafts document the interpretation process and participation in the standard setting process. Therefore, in accordance with the findings of Georgiou (2004), submissions can be viewed as a representation of lobbying efforts to which the standard setter is subjected. Westbrook (2013, 58) claims that in modern society, "we have a financial culture that consists largely of communications about relative social standing defined by a dubious system of accounting". If we measure the status of an organisation by the strength of its financial statements then there is an inherent motivation for the same organisations to influence the system of accounting in their favour. The ability to influence the accounting standard

setting process is made easier by a cultural bias which naturally affects the standard setters. As standard setters need to know a lot about accounting, and in most cases employed by the accounting and finance industry, they are by definition “within the culture they seek to regulate” Westbrook (2013, 58).

Young and Mouck (1996, 133) argue that:

... the close mirroring of the FASB processes with those of administrative agencies may be interpreted as an effort to construct these processes as rational and objective and thereby to reduce the politics surrounding the accounting standard setting process.

In the course of pursuing its rules and procedures in the accounting standard setting process, the FASB attempts to avoid critique and claims of bias. The carefully constructed consultation and review process adopted by the FASB is purposefully followed to emphasise the appearance of independence and objectivity and to distance itself from any perception that the FASB establishes public policy or is in any way political. This is because being categorised as political infers that decisions are made as a “manipulative and emotional process in which favours were [are] traded” (Young and Mouck 1996, 134). Excessive claims of objectivity may be intended by the FASB to manage perceptions that its decision-making represents a universal perspective (Young 2003; Young and Mouck 1996). Having established in the previous section that the financial markets industry would be motivated to influence the accounting standard setting process in its favour, and the fallibility of the process itself where the accounting standards guardians, the FASB, are susceptible to possible political influence and bias, then how is this industry influence conveyed?

New Institutional Theory is helpful in explaining the exertion by industry and submission by the FASB to the influence in the accounting standard setting process. Three concepts are at play in this process: firstly, the normative pressures exerted on the FASB by industry in general; secondly, the reverse legitimisation sought by the FASB and thirdly, a subtle coercive pressure exerted by the industry over the FASB. The FASB and the accounting industry (including organisations which are compelled to apply accounting standards) need to be understood in terms of one another, mutually rather than confrontationally. A suitable metaphor used by Westbrook (2013) to describe this notion is that of a referee of a game who

represents the institution. In this analogy, the referee is the FASB. “A referee does not exist without the game. Conversely, games cannot be won without a set of conventions to determine the bounds of the field, what counts as a point and the like” (Westbrook 2013, 58). Similarly, the FASB cannot exist without the practitioners and corporations who apply the rules. Conversely, those relying on financial statements, whether they are users or preparers, without a ‘referee’ cannot benefit from the consistency, rigour and discipline provided by the application of those standards. This mutual reliance between the standard setter and the practitioner is an important aspect of the relationship which incubates a culture of similarity and commonality. The normative pressures described by DiMaggio and Powell (1983) is a type of social influence leading to commonality. The notion described earlier that the FASB is “within the culture they seek to regulate” (Westbrook 2013, 58) and therefore subject to a natural bias, supports the contention of a common world view within a profession. This common view construes professionalism by members collectively and defines the appropriate ways in which to behave and act.

The FASB, the members of which originate from the accounting and finance profession, is subject to these same pressures of accepting institutional norms, which can be conveyed through the instrument of the submission letters. Since the standard setters and the practitioners are members of the same professional community, they are able to collectively determine a set of practices and cognitive frameworks in which organisational routines are shaped. This type of normative pressure is heightened particularly if a large volume of submissions is conveying the same recommendation.

The second concept which allows the conveyance of influence is that of reverse legitimisation. Riaz (2009) contends that if organisations such as investment banks are successful, the credibility and legitimacy of institutions such as the FASB are endorsed as they are the responsible entities which supported those successful organisations under their authority. For reverse legitimisation to exist, industry participants would be expected to support the FASB as long as its standards are valuable to those participants. This is consistent with the concept that the involvement of industry participants in the consultation process through the writing of comment letters is an important factor in imparting legitimacy on the standard setting process and in turn, the supervisors of this process – the FASB (Durocher et al. 2007; Fogarty 1992; Larson 2002; Olusegun Wallace

1990). The case for reverse legitimisation is also contingent on the power of the industry participants and their willingness to manipulate entities and processes that interfere with their primary objectives. Riaz (2009, 28) recognises this latent power of financial institutions noting that:

... business and financial organizations today are powerful beyond imagination, and have a role in influencing, shaping and manipulating anything that happens to be in the way of their survival and success. And what else could be more 'in their way' than institutions? While institutions attempt to impose their constraints on organizations, organizations are busy twisting the iron cage inside-out over the institutions.

The interdependence between institutions such as the FASB and the organisations and practitioners who rely on accounting standards allows for the transferral of influence both ways. The perception of power held by practitioners which is used to influence the institutions that oversee them is influenced by which side of the "iron mesh" the power is viewed (Riaz 2009, 28).

The FASB was keen to deeply and carefully consult the financial markets industry, given the subject of the proposed accounting standard was considered highly technical. Without a thorough consultation process, the new standard may have had unintended consequences. The FASB therefore canvassed a high number of industry participants as evidenced by the number of organisations invited by the FASB to comment on the exposure drafts. The number of responses to direct invitations totalled 152 (including several respondents represented by single law firms who were counted separately) and 41 for FAS 125 and FAS 140 respectively. Submissions highlighted some unintended consequences from the 90-day Bright-line test. The main problems identified by industry practitioners related to the artificiality of the 90-day Bright-line test. The 90-day Bright-line test was to determine whether a financial instrument transfer could be deemed a sale or a financing simply by its term to maturity. This was a misalignment of the planned recording of the transaction with its intention or its economic substance.

The third concept of a subtle coercive pressure is demonstrated through the enthusiasm of the financial institutions to appear in front of the FASB during direct hearings over the exposure draft to FAS 125 to declare their views and recommendations. According to the Financial Accounting Standards Board (1996b), there were 60 respondents (representing almost

40% out of a total of 152 parties who made submissions), who spoke at public hearings for the exposure draft to FAS 125. There were no respondents (out of a total of 41 parties who made submissions) for the exposure draft to FAS 140 (Financial Accounting Standards Board 1999a). As mentioned previously the relative disinterest in FAS 140 was due to the relatively minor amendments it incorporated.

Coercive pressures may take various forms and be disguised or restrained. Although it may resemble exercise of force or persuasion, it may also be more subtle (Devin and Bartlett 2011, 5). Further, coercive pressures may result from power relations that come in various forms, formally or informally, directly or indirectly, from externally codified rules, norms or laws, from political influence and from a variety of external entities.

The subtle coercive pressure over the FASB to follow the wishes of the financial markets in their opposition to the 90-day Bright-line test can be interpreted as a political influence. The influence was derived from the overwhelming number of participants who in addition to forwarding documentary submissions, contributed in the direct hearings that followed. The option to appear in person involved a commitment of resources and an opportunity to prosecute a case in person with all the persuasive capacities of an in-person representation.

Tolbert and Zucker (1983, 25) suggest that an indicator of institutionalised practice includes a “practice that is widely followed, without debate, and exhibits permanence”. The actions of the financial markets industry represented a concerted and largely unified effort to influence the FASB and, in this regard, resembled a widely followed view. The respondent presentations at the FASB hearings were seemingly accepted without a significant debate given the absence of further documented commentary by the FASB on the exposure draft to FASB 125. Finally, given the recommended compliance required by accounting standards in general and the acceptance by practitioners that they represent the rules that govern their practice, there appears a sense of permanency to the resolutions of the FASB. Therefore, Tolbert and Zucker’s (1983) indicators of institutionalised practice seem to have been satisfied. In meeting Tolbert Zucker’s (1983) indicators of institutionalised practice, as well as representing DiMaggio and Powell’s (1983) normative pressures and subtle coercive influence over the FASB, and finally fulfilling Riaz’s (2009) characterisation of reverse legitimacy, the financial markets industry, in

dealing with the exposure draft to FAS 125 are found to have exerted influence over the FASB in shaping a critical accounting standard to the advantage of the industry as a whole.

This chapter is concerned with the role of connections and relationships in influencing outcomes favourable to the investment banking industry. It commenced with a discussion of the financial network that existed which encompassed the investment banking industry, the political and regulatory fields, CRAs, lobby groups, and other financial institutions. It is argued that the connections with these participants in the financial network led to: a regulatory capture by the investment banking industry which influenced the regulatory process to produce an environment conducive to generating stronger financial performance; influence over the CRAs which published favourable yet flawed credit ratings for customers of the investment banks and the firm sponsored securitisation vehicles; and influence over the accounting standard setters which through a consultation process involving the investment banking industry issued an accounting standard – FAS 140 which allowed Lehman Brothers the flexibility to avoid the accounting of Repos as debt, thereby allowing a ‘window dressing’ of its financial statements.

The investment banking industry was found to have exerted coercive pressure on legislators. This was facilitated through a combination of their political contributions which are part of a system entrenched in the US political arena and the use of their extensive use of lobbying in shifting public policy. It was used to either defeat unwanted bills which would have otherwise further restricted the activities of investment banks or the passing of bills which afforded further protection or greater liberalisation in their operating environment. The “regulatory capture” of legislators and regulators by the investment banking industry was also facilitated by a normative influence found to exist due to knowledge asymmetry. The possession of superior technical capability exerted a normative influence over the regulatory framework by the investment banking industry. The subjugation by regulators to industry professionals of the expertise required to understand innovations in product, process and complex risk, led to a regulator’s perception that “industry knows best”. This perception allowed a continuation of a “light touch” approach to financial regulation. A further normative influence was exerted over the regulatory framework due to the practice of the “revolving door”. As members of professions employed in the financial network switched between regulatory agencies,

legislative bodies and industry, a common view of the world was formed. Common values and beliefs permeated an increasingly intertwined financial network so that a common understanding and attitude existed to sustain a regulatory environment and economic policy setting conducive to favourable business conditions. A common desire for strong financial performance by investment banks spurred a common approach to the employment of lobbyists to push a shared agenda. Mimetic pressure also spurred investment banks to pursue relationships with the government with the intent of a continued stream of large and lucrative government funding and advisory transactions. These connections were useful for future business and as an instrument in pushing a point of view with government and regulators.

The investment banking industry was also found to exert coercive influence over the CRAs by way of their commercial support. The CRAs preference for an issuer pays model introduced inherent conflicts of interest. The influence was principally exerted by an investment bank's threat of withdrawing the commercial support from the CRAs. Given the choice available between S&P, Moody's et al. investment banks could simply 'shop around for a CRA that was willing to comply with the wishes of the investment bank. A loss of market share, particularly for securitisation vehicles arranged by their sponsoring investment banks, would mean a loss of potential income for the CRAs. The intimacy of the relationship between the two groups is portrayed by a consultation process whereby investment banks sought to provide direct feedback to CRAs on the credit rating models employed. The industry feedback enabled investment banks to influence the model development process which ultimately produced the most desirable outcomes for the issuers they represented. However inadvertently the regulatory framework was structured, it also influenced inflated ratings.

Finally, the chapter explored the influences the investment banking industry applied over the FASB in attempts to generate accounting standards favourable to preparers of financial statements. A content analysis revealed a concerted effort by the investment banking industry to exert an institutional influence over the FASB by objecting to the original exposure draft resulting in an accounting standard favoured by industry. The benefits of avoiding a highly prescriptive accounting standard as originally proposed by the FASB in the exposure draft allowed for greater flexibility in the treatment of Repo transactions. Lehman Brothers was able

to capitalise on this flexibility by accounting for Repos as sale transactions instead of borrowings. This accounting treatment ultimately led to an understatement of the firm's debt and leverage ratio and ensured the continued supply of credit during a period of financial distress.

CHAPTER 12

WINDOW DRESSING

This chapter includes a discussion of the window dressing practised by Lehman Brothers to conceal a substantial level of debt from external stakeholders. This deceptive practice, identified as a symptom of the firm's culture, is exposed as an exercise of power to ensure the continued survival of the firm. This strategy was considered important to maintain the perception that Lehman Brothers was financially sound which was necessary to secure continued funding for the firm. Sufficient capital was also necessary to meet compliance with financial covenants contained within debt agreements and maintain an appearance that the firm was complying with the voluntary capital-based regulations. Additionally, capital and an acceptable balance sheet structure was necessary to maintain an acceptable credit rating from the CRAs which is also important for future fundraising.

A key to satisfying financial stakeholders was to ensure the firm's financial statements reflected an ongoing financially sound position. An immediate concern was the firm's liquidity and financial leverage—key metrics popularly used in financial covenants within debt agreements and used by the credit rating agencies as important determinants of financial strength. Generally, finance was sourced directly from banks, a high proportion of which was short term in nature including short term money market instruments mostly consisting of Repos. A soundly structured balance sheet was crucial to avoid concerns by creditors who could otherwise decline additional credit, cancel unused credit facilities, refuse to roll-over existing lines of credit or ultimately, demand repayment of outstanding debt. Given financial institutions typically rely on relatively high levels of leverage, any such consequence would be catastrophic and potentially lead to severe financial difficulties.

Therefore, Lehman Brothers' management desperately believed they needed to present an acceptable financial structure. This would pressure

senior management to consider a window dressing of the financial statements if there were concerns of weakness. Valukas (2010) acknowledged management's focus on leverage and identified a number of staff who confirmed that Lehman Brothers' management was actively engaged in managing the firm's leverage towards the end of 2007 and early 2008:

... Tonucci recalled that McDade wanted to bring down Lehman's firm-wide balance sheet by a few turns ... McDade, who was named balance sheet czar, said that deleveraging was 'absolutely' a critical issue to Lehman in early 2008 ... Ed Grieb, Lehman's former Global Financial Controller, stated that 'the focus on balance sheet and net leverage gained much more importance' beginning in mid-2007 ... Murtaza Bhallo, Business/Risk Manager in Proprietary Trading Group for Liquid Markets, said that beginning in 2007, there was a 'squeeze' on Lehman's balance sheet, and that Lehman personnel were worried about reporting the level of Lehman's assets against Lehman's equity (i.e., leverage ratio) ... Anuraj Bismal, a former Senior Vice President in Lehman's Balance Sheet Group, said that Lehman's meeting of its leverage ratio target was the most critical piece (a very hot topic) for senior management by the end of 2007. Bismal said that balance sheet targets and leverage ratio targets were absolutely about how rating agencies would view Lehman, and also creditors and the investing public ... John Feraca, the former head of the Secured Funding Desk in Lehman's Prime Services group, said that in late 2007, as the industry was changing and entering a crisis period, Lehman made certain commitments to deleverage ... Marie Stewart, Lehman's former Global Head of Accounting Policy, confirmed that Lehman set balance sheet targets with any eye to reaching certain leverage ratios that rating agencies used to measure and gauge Lehman's performance (Valukas 2010, 808-9).

This chapter explains the benefits accrued under the "leverage effect", which encouraged the accumulation of debt. More importantly this chapter questions why and how Fuld and his management team made the decisions to use these accounting techniques.

Repo 105 Transactions

A Repo 105 transaction is a variety of Repo. The term "105" in a Repo 105 transaction signifies that upon exchange, assets (in the form of securities) transferred have a current market value of 105% of the cash received. The term "haircut" often used in Repo 105 transactions refers to the difference between the amount of cash received and the market value of securities assigned. Therefore, in a Repo 105 transaction the haircut is 5%. This

overcollateralisation of 5% arose from the definition applied to the term “effective control”, which is required to be maintained by the assignor/transferor over the securities. The assignor is commonly known as the transferor or borrower.

In FAS 140, the FASB defines effective control as follows:

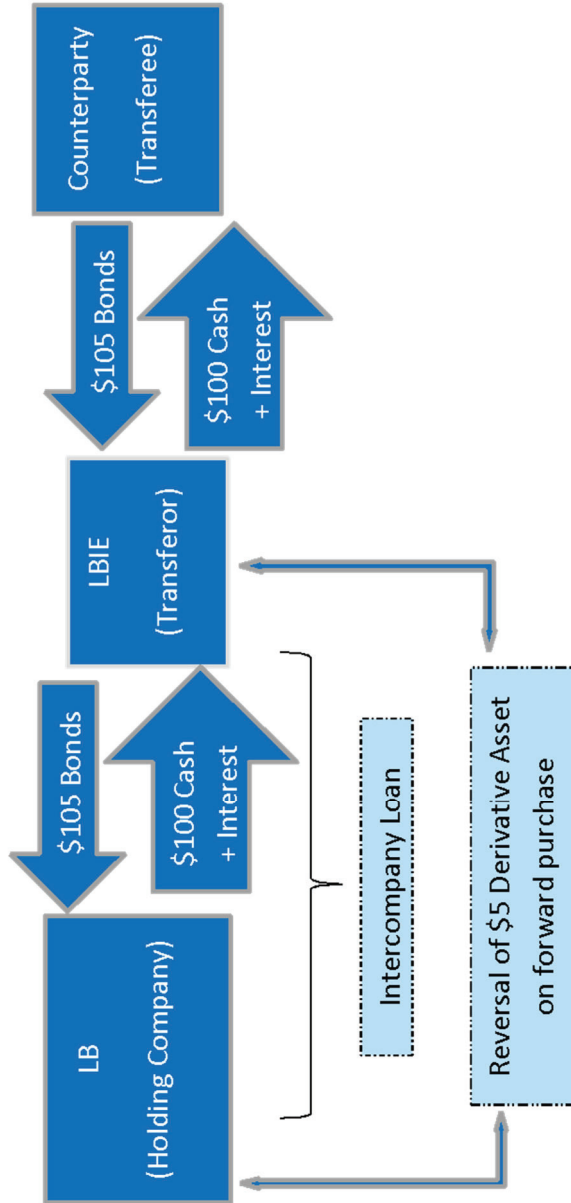
... to maintain effective control, the transferor must have both the contractual right and the contractual obligation to reacquire securities that are identical to or substantially the same [in quantum] as those concurrently transferred ... The transferor’s right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract (Financial Accounting Standards Board 2000, 91).

As an example, if the assignor/transferor (Lehman Brothers) is giving up securities worth USD 105 in return for cash worth USD 100 (in ratio terms), Lehman Brothers would be able to argue that it could not meet the requirements of FAS 140 of “re-acquiring securities that are identical to or substantially the same [in quantum] as those concurrently transferred” (Financial Accounting Standards Board 2000, 91). This means that the cash loan of \$100 that Lehman Brothers had initially received was insufficient to repurchase the \$105 worth of securities that it had originally pledged in the first leg of the transaction. The discrepancy between the value of securities transferred and the amount of cash received (that is, 5%) was the justification used by Lehman Brothers to argue the loss of control criteria. Therefore, Lehman Brothers was able to argue a “loss of control” over the securities and consequently, able to record the leg of the transaction involving the assignment of collateral as a sales transaction which did not need the raising of a liability. Otherwise, without this treatment as a “sale” Lehman Brothers would have been required to treat the assignment of collateral and receipt of cash as a loan. Although in its guidance notes, FAS 140 suggests a haircut of 2% was sufficient to render loss of control (commonly referred to as the 98%-102% test) (Financial Accounting Standards Board 2000, 97), Lehman Brothers ensured it qualified for the “sale” interpretation by applying a higher haircut of 5%. Lehman Brothers offered more collateral in a Repo 105 transaction than is normally necessary for a standard Repo, to ensure it unequivocally achieved the off-balance sheet treatment for the debt."

It is interesting to note these sales did not give rise to any losses in Lehman Brothers' statement of income. It would be common accounting practice for a sale transaction involving exchanging USD 105 in bonds for USD 100 in cash to record a USD 5 loss. Lehman Brothers however used a future purchase commitment account in its asset section of its balance sheet equal to the amount of over collateralisation, since Lehman Brothers was required to purchase the sold securities back under a futures contract. Similar to an ordinary Repo, Lehman Brothers received the interest income (the coupon payments) from the securities which were transferred to the counterparty which partly offset the interest charged by the counterparty which was paid by Lehman Brothers at expiry of the transaction (Valukas 2010, 732). Furthermore, Lehman Brothers decided not to disclose the effect of these transactions as recognised subsequent events in the notes to the accounts, based on their view that it represented an immaterial consequence to the firm's financial statements.

Implementation of FAS 140 had been problematic given that it allowed alternative treatments of Repo transactions depending on how loss of control is substantiated. A loss of control threshold (for example between 2% and 5%) allowed an entity to de-recognise the asset whilst continuing to have "beneficial interest" subsequent to it being transferred. Further, allowing de-recognition, while at the same time allowing the transferor to retain an effective continuing "beneficial interest" in the transferred financial asset, permitted for varying accounting treatments between the two parties to the transaction.

A diagrammatical representation of a Repo 105 transaction undertaken by Lehman Brothers is set out in Figure 12.1:



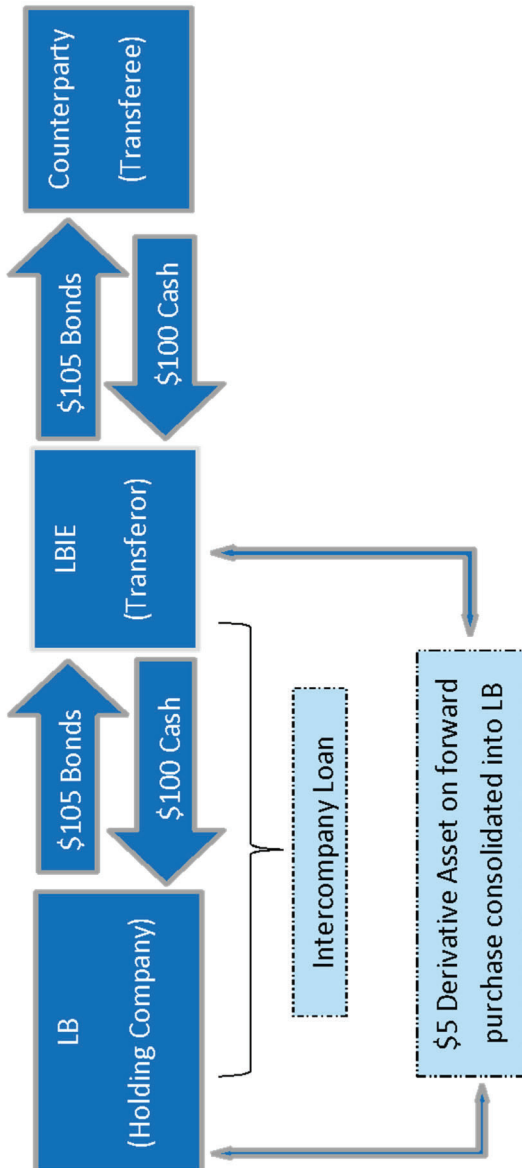


Figure 12.1: Repo 105 Transaction

In the lead up to its collapse, Lehman Brothers attempted to stave off a liquidity crisis and became increasingly reliant on the use of Repos for its short-term borrowings. Repos are an important financing technique in the financial markets, in particular for securities firms, investment banks and commercial banks. “The ability of Repos to provide parties with secured short-term funding has resulted in such transactions becoming an essential part of the global financial system” (Chircop et al. 2012, 657). Much of the Repo market uses US Treasury securities as the preferred form of collateral, as they represent government obligations and are therefore one of the most secure and liquid security instruments in the market. Other instruments used in a Repo transaction include corporate bonds and stocks. The Repo market represented approximately 54% of the pre-GFC inter-dealer short term money market using US Treasury instruments (Fleming and Garbade 2003, 1). The reliance on the Repo market for short-term financing is reflected by its volume of transactions of approximately USD 14 trillion in 2008 (Chircop et al. 2012, 661). This represents a significant increase from 2002 when the volume was USD 2.48 trillion (Fleming and Garbade 2003, 1).

According to the bankruptcy examiner, Lehman Brothers understated its leverage through the use of Repo 105. Lehman Brothers’ global financial controller, described the transactions as possessing “no substance—their only purpose or motive ... was reduction in the balance sheet” (Financial Crisis Inquiry Commission 2011, 177). Repo 105 transactions were also portrayed as an “accounting gimmick ... a lazy way of managing the balance sheet as opposed to legitimately meeting balance sheet targets at quarter-end” (Financial Crisis Inquiry Commission 2011, 177). Bart McDade, Lehman Brothers President and COO, in June 2008, described Repo 105 transactions as “another drug we R on” (Financial Crisis Inquiry Commission 2011, 177). This comment related to the addictive reliance Lehman Brothers had on the continuing use of Repo 105 transactions to decrease liabilities, in turn, reducing the leverage ratio for each successive quarter-end at a time when quarterly financial statements were routinely published. Furthermore, McDade had recommended to Lehman Brothers’ Executive Committee that the firm set a cap on the use of Repo 105 transactions (Financial Crisis Inquiry Commission 2011, 3-4). A senior member of Lehman Brothers’ Finance Group also believed that Lehman Brothers’ Repo 105 transactions were designed for “window-dressing that

was based on legal technicalities” (Financial Crisis Inquiry Commission 2011, 2).

Offshoring and impact of Lehman Brothers’ Repo 105 Transactions

In order to justify an interpretation of an accounting treatment, it is common practice to seek a legal opinion. Lehman was unable to obtain a legal opinion to substantiate their treatment of Repo 105 as a “true sale” under US law which would allow it to book the transactions as “off-balance sheet”. Therefore, it resorted to go offshore to obtain their legal opinion which was available under English law. Consequently, Lehman Brothers used a European subsidiary (LBIE) to conduct Repo 105 transactions.

As mentioned earlier, Repo 105 transactions enabled Lehman Brothers (the transferor / borrower) to remove debt from the balance sheet during the term of the Repo 105 transaction. But that’s not all. The incoming cash from the transferee (lender) was used by Lehman Brothers to repay other liabilities on Lehman Brothers’ balance sheet. This meant that not only was Lehman Brothers able to hide the new debt from the Repo 105, but it was able to reduce existing debt as well. A “double whammy” reduction of the level of debt. As long as Lehman Brothers could rollover these Repo 105 transactions at expiry, the perception of a reduction in debt, theoretically, could be extended indefinitely. The transfer of securities in the first leg of a Repo 105 to the transferee/lender was accounted for as a reduction of on-balance sheet assets. This “typical” practice by Lehman Brothers resulted in a temporary double reduction of debt, and a reduction in assets equivalent to half the reduction in debt. This had the effect of improving the leverage and capital ratios. A capital ratio is simply a firm’s capital divided by its total assets. A leverage ratio is commonly calculated by dividing total debt by capital. These ratios are a measure of the level of capital held by a firm relative to its debt. The higher the level of capital relative to debt, the stronger the balance sheet. These ratios are used by investors, banks and CRAs in determining the creditworthiness of the firm. Moreover, the ratios are routinely included in loan agreements by banks as financial covenants with which the borrower must comply. Lehman Brothers’ loan agreements contained these types of ratios. The intention is for the borrower (Lehman Brothers) not to breach these ratios. That is, the calculations obtained from the balance sheet should not be below the

minimum ratios contained in the loan agreements, otherwise the borrower is deemed to be in default. Therefore, breaching a financial covenant would provide the lender the ultimate right to demand repayment of the loan. Lehman Brothers did not include any detailed disclosure of the accounting impact of using Repo 105 in its financial reporting. A key consideration for Lehman Brothers as to whether it would disclose this accounting treatment would have been whether the Repo 105 application would materially affect the financial statements. If the use of the Repo 105 accounting treatment was considered immaterial, then detailed disclosure would not be needed in accordance with Generally Accepted Accounting Principles (GAAP). In any case, interim financial statements are not audited. However, the impact of the Repo 105 accounting treatment could be deemed material if measured by its sheer nominal dollar amount. Lehman Brothers had at one point borrowed up to USD 50 billion in Repo 105 transactions just prior to its collapse. The relatively low capitalisation of the investment banking industry in general magnifies the net impact on the capital ratio when compared to other industrial corporations whose capitalisation rates are generally higher. It would have been advantageous for Lehman Brothers to use the Repo 105 accounting treatment in order to present a more favourable financial profile to its creditors.

Lehman Brothers' reclassification of a Repo 105 transaction as a sale immediately led to an understating of Lehman Brothers' leverage ratio. Lehman Brothers had borrowed, in aggregate, over USD 50 billion by using Repo 105 and temporarily reduced its on-balance sheet debt at quarter end by approximately: USD 38.6 billion in the fourth quarter 2007; USD 49.1 billion in first quarter 2008; and USD 50.38 billion in the second quarter 2008 (Valukas 2010, 733). Refer to Figure 12.2 for a graph of the volumes of Repo 105 transactions undertaken in the 12 months preceding the bankruptcy.

Importantly, Figure 12.2 shows this balance sheet manipulation occurred prior to quarter end dates (in particular November 2007, February 2008 and May 2008) in line with the firm's quarterly reporting obligations. As a result, Lehman Brothers' net leverage was understated by between 9% and 13% between fourth quarter 2007 and second quarter 2008.

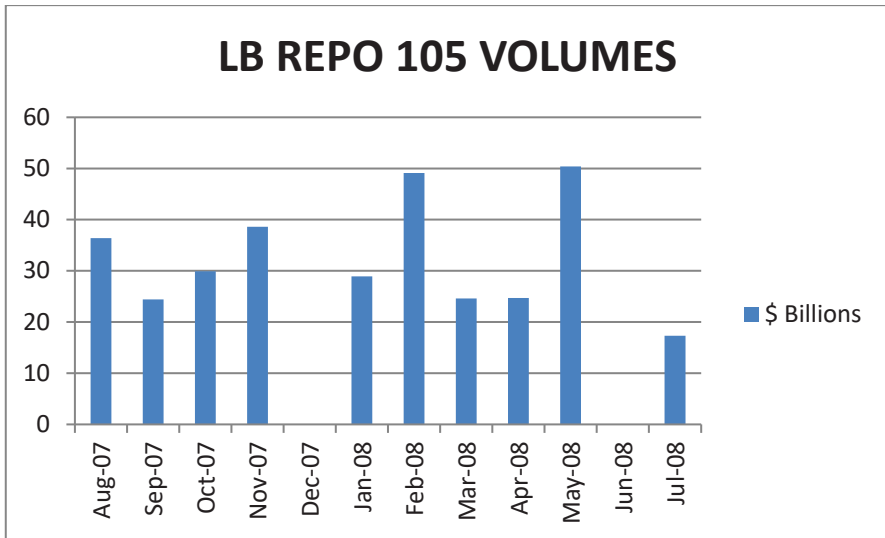


Figure 12.2: Lehman Brothers' use of Repo 105 Transactions 2007-2008
 Source: The data used for the graph were extracted from Valukas (2010, 733)

Linklaters' True Sale Opinion Letter

Lehman Brothers validated the sale treatment of its Repo 105 transactions by obtaining a legal opinion. Apart from the haircut mentioned above, another criterion used to substantiate the notion of “surrender of control” of the transferred asset included isolating the securities from the transferor in the event of the transferor’s bankruptcy.

The legal opinion is ordinarily referred to as a true sale opinion letter. Lehman Brothers resorted to obtaining its legal opinion from Linklaters, a UK law firm. Linklaters would address the legal opinion to Lehman Brothers’ UK subsidiary—LBIE, which was the Lehman Brothers subsidiary that entered into the Repo 105 transactions. In its accounting policy relating to Repo 105 transactions, Lehman Brothers discloses that: “We generally cannot obtain a true sale opinion under US law ... Repos generally cannot be treated as sales in the US because lawyers cannot provide a true sale opinion under US law” (Lehman Brothers Holdings 2008e, 1). To avoid

any potential breach, the Linklaters' true sale opinion letter did not refer to US GAAP or FAS 140.

In practice, the UK subsidiary would carry out a Repo 105 transaction with an external European counterparty (including the haircut) and concurrently, carry out a back-to-back transaction with a Lehman Brothers' US subsidiary (excluding the haircut). As LBIE was a fully owned subsidiary of Lehman Brothers, the transactions were ultimately consolidated into the group financial statements giving effect to the sale treatment at the consolidated group level, thereby ameliorating the group leverage ratio.

In essence, Lehman Brothers was able to conduct regulatory arbitrage by exploiting the UK legal environment which allowed 'true sale' opinions and by subsequently consolidating the resultant accounting treatment into its US based consolidated financial statements. This was a practice, which if conducted within the US, would have resulted in a less than favourable accounting treatment with regards leverage. Undertaking such an elaborate and pre-meditated process is an indication of the extent to which Lehman Brothers was motivated to manipulate its balance sheet structure to manage the perceptions of stakeholders. Details of Repo 105 transactions were not disclosed in Lehman Brothers' Form 10-K or 10-Q financial reports resulting in an effective window dressing of the net leverage of the firm. After the collapse of Lehman Brothers, the FASB introduced FAS 166, which superseded FAS 140. This revised accounting standard applies a test based on the intent behind a Repo in relation to transfers of risk for reward to distinguish between a sale or on-balance sheet treatment of a Repo.

Concealment as Power

Lehman Brothers' concealment of debt from its financial statements withheld critical information with which third parties would make important financial decisions, such as to invest or lend to Lehman Brothers. An internal email from Anthony Jawad, a Lehman Brothers' employee, to Keiran Higgins, another Lehman Brothers' employee, intimated a degree of apprehension regarding Lehman Brothers' accounting treatment of Repo 105 transactions. The email revealed that internally, employees questioned the accounting treatment adopted:

Hello mate, sorry to pester you on your time off, but I have to run this by you. In our quest for more counterparties for 105, we have lined up the Reserve Bank of Australia as a c/party. This is good from a credit perspective because credit will obviously be happier giving margin to a Central bank than a commercial bank. However, they asked why we were doing this. I spoke to Mark Cosaitis about this and he obviously would like us to give a vague reason about getting better net down treatment, which isn't a lie. However, if they want a deeper explanation then we may have to get down to the nitty gritty of the truth. Do you want us to go down this line or want us to just give it a miss. Having more c/parties is obviously good going forward because we both know how liquidity can be pulled, but the more people that know the truth, the more dodgy it can be. What is your take on what to do? Thanks (Jawad 2008).

The routine practice of using the Repo 105 accounting device is governed internally by inclusion in the Lehman Brothers' accounting manual. The power to influence stakeholder decision-making is viewed as an exercise of power through Clegg's (1989) dispositional circuit where rules and pre-determined procedures, as contained in the accounting manual, are fixed. The existence of the accounting manual as well as the Linklaters' "true sale opinion" legitimised the accounting treatment of Repo 105 transactions for all employees. The accounting manual represented the rules of practice which were socially constructed within the firm. Therefore, it represented the instrument which fixed the relations of meaning, in an accounting sense of the Repo transactions. These internally constructed rules [accounting manual] are used to affect the accounting entries which are considered the passage point through which the Repo transactions were integrated within the financial statements. Once transmitted through the passage point, management's power was exerted over external stakeholders in the episodic circuit where stakeholders' perceptions of management and the firm were positively influenced through the manipulation of the firm's risk profile.

The development of the accounting manual, through the firm's hierarchy, was the responsibility of the executive management. This responsibility and the associated authority, was the source of power for Lehman Brothers' executive management. The senior team relied on the accounting standard, FAS 140 which allowed for alternative accounting interpretations of Repo 105 transactions resulting in meaningful implications for the balance sheet. The use of the internal accounting manual, can also be seen as an act of job design found in Clegg's (1989)

facilitative circuit. The use of job design was useful in applying power through internal relationships between senior management and those accounting practitioners within the firm whose responsibility was to record the Repo transactions. FAS 140 had facilitated senior management's concealment of leverage and the internal technical interpretation of this standard as guided by the Lehman Brothers' accounting manual legitimised the accounting treatment.

This level of power in the facilitative circuit affected the organisational morality as evidenced in the abovementioned email from Anthony Jawad. Any influence over the operation of the accounting standard translated as an exertion of power over accounting staff permitting the distortions in the financial statements. Was the senior management team culpable for the concealment? In his statement at the Hearing before the Committee on Financial Services, Fuld denied any knowledge of the Repo 105 series of transactions:

... I have absolutely no recollection whatsoever of hearing anything about or seeing documents related to Repo 105 transactions while I was the CEO of Lehman (Hearing before the Committee on Financial Services U.S. House of Representatives, Testament of Richard Fuld 2010).

Fuld's above-mentioned denial contradicted evidence offered by McDade to the Bankruptcy Examiner's proceedings. In his role as COO in the months prior to Lehman Brothers' bankruptcy, McDade had responsibility for the firm's balance sheet. A report known as the Daily Balance Sheet and Disclosure Scorecard which kept senior management abreast of daily balance sheet movements was distributed by McDade on a daily basis in the 6 months prior to the bankruptcy. Amongst other data, the report included information on the firm's Repo 105 transactions (Valukas 2010). According to Valukas (2010), an interview with McDade revealed that in June 2008, he reviewed with Fuld, an internal document known as the Balance Sheet and Key Disclosures document:

... McDade specifically walked Fuld through the presentation ... McDade discussed page three of the presentation with Fuld, which identified that Lehman used USD 38.6 billion, USD 49.1 billion, and USD 50.3 billion of Repo 105 transactions, at quarters-end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively. McDade said that, as referenced on page three of the Balance Sheet and Key Disclosures document, he also told Fuld that he [McDade] recommended that Lehman

reduce its firm-wide Repo 105 usage to USD 25 billion in the third quarter 2008. McDade observed that Fuld “was familiar with the term ‘Repo 105’”. McDade recalled that Fuld’s response to the entire document was ‘good, good, good; he was nodding approval’ and that Fuld was ‘supportive of reducing the firm’s use of Repo 105.’ More specifically, regarding McDade’s recommendation to cut Lehman’s use of Repo 105 in half in the third quarter 2008, McDade recalled Fuld asked, ‘Is it doable? Is it necessary? If so, [Fuld] said, go do it.’ McDade concluded that Fuld knew about the accounting of Repo 105 (Valukas 2010, 820-1).

The inconsistency between Fuld’s testimony at the 2010 hearing before the Committee on Financial Services and McDade’s detailed record of interview with the Bankruptcy Examiner casts significant doubt on the veracity of Fuld’s testimony. The overwhelming evidence obtained by the bankruptcy examiner supported by documentary evidence, suggested that Fuld was willing to mislead the Committee on Financial Services in 2010, thereby casting even greater doubt over his integrity.

Figure 12.2 shows an increasing volume of Repo 105 transactions at the quarterly reporting dates from August 2007 to May 2008. Continuing use of Repo 105 during a period when market liquidity is tightening and the firm’s access to internal cash resources is diminishing means the firm needed to continue refinancing these transactions at higher volumes each successive quarter end to maintain the façade of acceptable leverage. Unless the firm’s performance was going to turn around, eventually its excessive leverage would be discovered as interest serviceability would become strained. Reliance on Repo 105 therefore became a vital component to Lehman Brothers’ survival during this time. As the actual leverage of the firm increased, there was greater incentive to disguise it.

Fuld’s resolve in maintaining the firm’s use of Repo 105 during this difficult period which involved its unethical interpretation of FAS 140 can be interpreted as a turning point in his empowerment. The slippery slope of Repo 105 on which the firm began its concealment program could not persist indefinitely. As the risk of discovery approached, Fuld’s capacity to “fool” the market diminished. This gradual slide is tantamount to an ongoing disempowerment, where Fuld’s economic environment and the firm’s fiscal predicament are considered changes in Clegg’s (1989) facilitative circuit where power can be created or dissipated through changes in environmental contingencies. As the firm’s financial dependency on Repo 105 grows, its bankruptcy costs grow commensurately. The power

to convince creditors to continue refinancing debt is therefore diminished. The passage point needed for the disempowerment is represented by the potential discovery of the firm's real position. This was evident through the scrutiny from investment analysts and media reports of the firm's financial transactions and reports. The irony of the creation of power is that through environmental contingencies, it can also be taken away through the same circuit of power.

The concealment of an enormous level of debt from the firm's balance sheet is shown as the unethical practice of "window dressing" which violates a director's duty of care towards the stewardship of the firm. It disguised a "true and fair" economic view of Lehman Brothers' financial position. The firm adopted extreme measures to achieve the debt concealment by its interpretation of accounting standard FAS 140 to its benefit which understated its leverage. The measures involved the conducting of Repo 105 transactions through offshore subsidiaries and obtaining the associated legal opinions from an offshore jurisdiction, when they were unavailable domestically.

The act of debt concealment is argued as an exercise of power found in Clegg's (1989) facilitative and dispositional circuits. The accounting rules which were authorised by management were fixed in the dispositional circuit, transmitted through the passage points constituting the accounting function to the episodic circuit where external perceptions of management and the firm were influenced. The development of the accounting manual, an ultimate responsibility of management conferred power to Fuld by way of defining the accounting staff's job design thereby creating power in the facilitative circuit which affected organisational morality. The accounting function also served to transmit power to the episodic circuit where accounting staff were pressured to adopt the "sale" interpretation of FAS 140. Lehman Brothers' interpretation and application of FAS 140 to account for and report Repo 105 transactions was authorised and perpetuated by Lehman Brothers' senior management and was used to legitimise the firm as creditworthy, a going concern and compliant with applicable contractual covenants and capital-based regulations. In summary, Lehman Brothers' senior management exercised power to influence the growth strategy of the firm involving an elevation of its risk profile in expectation of greater individual rewards in the form of incentive compensation. The following chapter analyses the management style adopted by Richard Fuld in his day-to-day stewardship of Lehman Brothers.

The chapter will also draw on a theme of power to explain Fuld's motivation of self-interest. Ultimately Fuld's objectives to grow the firm in terms of size and profit gave way to a desire for survival at all costs.

PART FOUR:

CORROSIVE CULTURE

CHAPTER 13

GOVERNANCE

This chapter addresses the extent to which the culture within Lehman Brothers and the investment banking industry contributed to the failure of many firms at the height of the GFC. It analyses Lehman Brothers' CEO, Richard Fuld's management style, the actions of the board and the organisational culture which emanated from the top. The methods used to explain these factors include an examination of the rhetoric used in the communications of the firm and a critical analysis of: the corporate governance framework; the firm's management processes, organisational policies; key internal relationships and; the CEOs and board's decisions and behavioural patterns.

The chapter also covers the impact on corporate culture from corporate governance with a focus on board structure. Corporate governance is an important aspect of ensuring appropriate behaviour is exhibited throughout the organisation—an attribute this chapter will show to be lacking at Lehman Brothers. Literature covering the benefits of the features traditionally considered as corporate governance good practice, have offered some mixed views. Therefore, an analysis against all the benchmarks offered by traditional conventions of good practice to measure Lehman Brothers' governance practices may prove incomplete. Instead, the chapter selects the factors considered relevant in Lehman Brothers' case and focuses on the leadership of the firm. The adoption by the US of a regulatory approach as a minimum standard for corporate governance, following a series of corporate failures in the early part of the 2000s is addressed. The minimum standards set by the regulations became the framework by which Lehman Brothers portrayed to the outside its adoption of good practice, regardless of its effectiveness.

Lehman Brothers' board structure is compared to that of Goldman Sachs, one of the more successful investment banks. The comparison suggests that investment banks attempted to comply with regulations and official

guidelines to represent proper conduct to the market. This approach of uniform compliance is also augmented by some commonality in certain board structure features, which suggests a normative institutional influence applied between certain investment banks. Despite the similarity in Board structure, the two firms performed quite differently. That is, whilst Lehman Brothers collapsed, Goldman Sachs survived. This incongruity reveals the existence of other underlying influence(s) apart from the superficial Board structure which affected the performance of Lehman Brothers.

Key features of board structure as factors influencing Lehman Brothers' culture and performance including the relationship between Fuld and the Board of Directors, showing a distinct exercise of power is analysed. This power was exerted through: the process of Board member appointment, in which Fuld had an influence; the Board composition which was structured to minimise confrontation with Fuld's aspirations; the background and experience of some Board members which lacked specific exposure to complex investment banking products and services; a deficient level of director engagement reflected by the composition of the various Board committees and the relative input from each committee to the decision-making at Board level; and, a generous Board compensation structure which was influenced by Fuld and exceeded the national average of members of US publicly listed Boards and ranked above most of the other major US investment banks.

The chapter further investigates Fuld's relationships with employees. It draws on the early influences on Fuld's management style which is described as one driven by his motivation to generate growth for the firm and succeed at all costs. As demonstrated by examples, any employee who offered obstacles or resistance to this objective would suffer his scorn, or worse still, dismissal. Fuld's influence in overcoming these impediments is shown to be generated in Clegg's (1989) dispositional and episodic circuits. The resulting culture also affected the families of employees, which served to entrench employees' behaviours to fall within the CEO's expectations. Lehman Brothers' compensation arrangements are also scrutinised to reveal a "greed-centric" attitude amongst many executives who were subject to Lehman Brothers' incentive schemes. It explains the role of compensation as a motivation for employee behaviour and as a mechanism to maximise the wealth of senior management including Fuld.

This section of the chapter proposes that the CEO used financial incentives as a means of generating loyalty to pursue his own growth agenda.

A further insight into the firm's culture is achieved through a rhetorical analysis of internal communications. Key documents such as the firm's *Global Strategy* document and various internal emails are analysed to reveal a management style reliant on the centralisation of power, a siege mentality, hubris regarding the risks faced by the firm, and a perpetuation of the "greed-centric" culture. Finally, the chapter questions whether the firm followed its published code of ethics.

Corporate Governance

The lack of effective corporate governance has been linked as a causal factor of the GFC (Aluchna 2013; Isaksson and Woodside 2016; Kennedy 2014; Yeoh 2010). Yeoh (2010) relies on observations of relevant banking practices to support this contention. A large component of CEOs and a Board's role is to practice, oversee and engender good corporate governance. In a general sense, good governance can be thought of as how individuals, groups, organisations, societies, and governments are responsible for outcomes and ethical behaviours (Pitsis et al. 2014, 1287). Cadbury (1992, 15) defines corporate governance as "the system by which companies are directed and controlled". This latter definition aligns responsibility for corporate outcomes closer to the leadership of the firm. However corporate governance is difficult to define as the associated literature adopts different theoretical perspectives. These include for example agency, stewardship, resource dependency and stakeholder theories (Chambers et al. 2012).

Corporate governance can be viewed from an agency perspective (Cadbury 1992; Denis 2001; Fama and Jensen 1983; Jensen and Meckling 1976; Shleifer and Vishny 1997). That is, "effective separation between ownership and control" (Shleifer and Vishny 1997, 738). The basis of agency theory is maximisation of stockholder wealth. This long-standing theory traces its origins to the paper by Berle and Means (1934), which represents a seminal publication soon after the onset of the financial crisis of the 1930s. Berle and Means (1934) evaluated the financial crisis in the context of the evolution of the modern corporation and the concept of "the twin phenomenon of ownership of wealth without appreciable

control and control of wealth without appreciable ownership" (Lewis 1935, 548). Fama and Jensen (1983) argue that the process of operational decision-making is the responsibility of senior management and should be separated from the process of consent and monitoring which is undertaken by Boards of Directors. This separation, according to Fama and Jensen (1983), ensures an effective monitoring of the organisation's decision-making process. As Boards have the ability to structure the compensation arrangements of a CEO, and limit his or her tenure, they possess the ultimate power in the decision-making process.

Jensen and Meckling (1976) claim that tension exists between management and stockholders and view management as being opportunistic. Referred to as the 'agency problem', management are motivated by self-interest as they do not always make decisions based on the economic interests of stockholders (Deegan 2009; Jensen and Meckling 1976). The agency approach maintains that a key to solving this agency problem and creating an effective monitoring process is the inclusion of non-executive directors on boards and board committees to protect the interests of stockholders. This is achieved through the impartiality of non-executive directors who can provide an independent check on management decision-making and behaviour. Apart from their impartiality, non-executive directors can offer specific expertise that is not available within the organisation and arbitrate in cases of internal conflict. The alternative approaches to understanding corporate governance are listed in the following section, including a brief critique of the agency theory approach.

Critics of agency theory claim that it understates the complexity of individual motivations and organisations. Agency theory, which focuses on self-interested human behaviour has come under challenge (Perrow 1986; Weidenbaum and Jensen 1992). Weidenbaum and Jensen (1992) supported by Shughart (1996), concur that "it is foolish to believe that owners of valuable resources systematically relinquish control to managers who are not guided to serve their interest" (Weidenbaum and Jensen 1992, 102). Weidenbaum and Jensen (1992) offer a critique of Berle and Means (1934) and argue that the concept of conflicts of interest that arise in agency theory ignores the following factors: discipline imposed on managers to fairly represent the interests of stockholders by potential mergers and acquisitions which often displace incumbent underperforming management; the latent powers and activism of institutional investors which often possess voting power to eject directors who support the management

direction adopted; management incentives linked to stockholder returns are often sufficient to align the interests of management and stockholders; and the power of bondholders, bankers and other creditors of a corporation who impose management accountability through regular meetings with management. Where creditor influence can be exerted, imposition of financial covenants in debt agreements and a requirement by the corporation for a fixed return of interest and repayment of principal encourages a minimum level of financial performance to generate the necessary liquidity to service the debt. Weidenbaum and Jensen (1992) also argue that agency theory ignores corporate responsibility as espoused by stakeholder theory explained below.

Stewardship theory provides an alternative view and purports that the executive manager performs a custodianship for social standards (Davis et al. 1997; Donaldson and Davis 1991). "The manager, far from being an opportunistic shirker, essentially wants to do a good job, to be a good steward of the corporate assets" (Donaldson and Davis 1991, 51). Consistent with this approach, is the notion that executive management should be represented on the Board of Directors. Executive management are perceived as possessing superior technical knowledge and operational expertise and therefore exercise decision-making responsibly and support accountability (Muth and Donaldson 1998). Consequently, stockholders could expect a superior organisational performance from their inclusion on the Board than that of a non-executive director, due to the associated knowledge asymmetry which exists between executive and non-executive directors.

Stakeholder theory, supported by Mitroff (1983) and Solomon (2007), can also explain corporate governance. It involves a social responsibility which includes social and environmental issues in addition to the maximisation of stockholder wealth as important factors in corporate governance. This theory accepts that stakeholders are both inside and outside the organisation. Examples of stakeholders include governments, the community, suppliers, customers and employees, all of whom can be impacted by organisational decision-making. Stakeholder theory argues that the organisation should be accountable to all such stakeholders (Freeman 1984). Ultimately, these stakeholders can affect the corporation. For example: customers could cease purchasing goods if they or their environment is treated adversely by the corporation; employees could strike and therefore cease production if their working conditions do not

meet acceptable standards; a government which relies on taxation revenue could impose penalties due to the corporation's potential tax evasion; and, suppliers could cease delivery of essential goods if the corporation excessively delays creditor payments.

Resource dependency theory as espoused by Pfeffer and Salancik (1978) and supported by Nicholson and Kiel (2007) provides a framework which takes into account ambiguity caused by events outside the control of the organisation such as external environmental factors and reliance on external entities, and proposes that these factors can be minimised. This could be achieved by reference to professional advice, access to information, special access to resources and legitimacy.

Despite the various theoretical frameworks mentioned above there is no conclusive evidence that one framework is more effective than the others in explaining corporate governance. Alina and Bogdan (2015, 682) assert that "the best practices refer to those methods, techniques and instruments adopted by the company which ensures success and avoids failure in the future". Given that Lehman Brothers eventually failed, an examination of corporate governance practiced at Lehman Brothers is required to assess whether it did indeed reflect good practice or was impacted by either institutional forces and/or the exercise of power by the leadership of the organisation. Overriding all frameworks however, is the concept that professionalism encompasses consideration of all ethical matters. Was there a divergence between the appearance of corporate governance best practice and professional behaviour within Lehman Brothers?

A critique of Lehman Brothers' Board and its committees, including their composition, size, specific knowledge, experience and frequency of meetings follows. These factors are considered important as they offer an indication of the effectiveness of a board's monitoring function (Abbott et al. 2004; Abbott et al. 2003; Carcello et al. 2002; Chen and Jian 2007; Krishnan and Jong Eun 2009). Zahra and Pearce (1989) emphasise the importance of the effective monitoring function of Boards in general. Zahra and Pearce (1989, 291) propose that there is a direct association between four board features such as characteristics, composition, structure and process and three critical board roles such as service, strategy and control. They find these links, specifically board size, board member attributes, the number and type of committees and elements of board meetings such as communication, agendas and documentation, affect the efficiency of the

board monitoring role. This is particularly relevant to corporate performance. Walker (2004) also identifies the importance of board member attributes to corporate performance in the context of board committee membership. He noted that: “the performance of audit committees necessarily depends on the people involved, their knowledge, skills, critical capacities, scepticism and determination” (Walker 2004, 158).

Agency theory which Shleifer and Vishny (1997) applied in their assessment of corporate governance, claims that the only ethical action is the maximisation of shareholder wealth. This traditional approach offers a limited perspective to examine Lehman Brothers’ attempts at practicing good corporate governance. This chapter extends Schleifer and Vishney’s (1997) approach by explaining the practice of corporate governance as a social practice that reflects broader influences other than an agent / principal relationship. The analysis draws upon New Institutional Theory and Clegg’s (1989) Theory of Power to explain firstly, the institutional influences that spurred Lehman Brothers to approach governance in a particular way and secondly, the power exerted by the CEO in shaping the governance structure to achieve his personal ambitions. The standards of corporate governance vary from country to country. However, Shleifer and Vishny (1997, 737-8) acknowledge that the corporate governance systems applied in the US, Germany, Japan and UK are amongst the best in the world. Although Lehman Brothers was based where high standards for corporate governance existed, there may still have been room for failure in this regard.

The adoption of corporate governance principles by US corporations has been strongly influenced by a regulatory approach. As mentioned above, there is a vast amount of literature that identifies the organisational factors necessary for good corporate governance. From a political perspective, the approaches could be separated into two groups along a regulatory versus neo-liberal spectrum. Some studies draw on the notion that market competition substitutes for a formal corporate governance system (Alchian 1950; Stigler 1958). An opposing view, suggests a prescriptive approach where legal systems which confer voting rights on stockholders are sufficient to protect stakeholders including minority interests (Easterbrook 1991; Hart 1995; Manne 1965). Protection is needed from mismanagement and manager self-dealing such as fraud, excessive compensation, or issues of equity to management. Consistent with this latter notion, the US has embraced a regulatory response to

corporate governance to ensure that at least a minimum level of governance is achieved. The implementation of these standards has largely entailed a combination of a statutory approach represented by the Sarbanes-Oxley Act of 2002 (SOX) and an industry supervisory approach included in the NYSE corporate governance standards and guidance (New York Stock Exchange 2012, 2014; Securities and Exchange Commission 2002). In addition to the abovementioned statutory and supervisory approach, US financial institutions are subject to extensive corporate governance responsibilities stemming from other government agencies listed in Figure 13.1.

Figure 13.1: Corporate Governance Responsibilities for U.S. Financial Institutions

Organisation	Corporate Governance Document
Office of the Comptroller of the Currency (OCC)	OCC's Manual of Examination Procedures, in addition to the bank director guide.
Office of Thrift Supervision (OTS)	OTS's Thrift Activities Handbook and Thrift Holding Company Handbook.
Federal Deposit Insurance Corporation (FDIC)	FDIC's Division of Supervision Manual of Examination Policies.
Federal Financial Institution Examination Council (FFIEC)	Information handbooks on individual topics related to Information Technology.
Federal Reserve	Bank Holding Company Examination Manual.
	Trading and Capital Markets Activities Manual.
	Federal Reserve SR Letter 04-18, 'Bank Holding Company Rating System', December 6, 2004 (stating that the board's involvement will factor into the overall risk and composite ratings).
	Federal Reserve SR Letter 95-15, 'Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies', November 14, 1995.

Source: Baret et al. 2009

The following sections outline the main US regulatory and supervisory guidance which applied to Lehman Brothers in constructing its corporate governance framework.

Sarbanes-Oxley Act of 2002 (SOX)

Following the collapse of major US corporations such as WorldCom and Enron, the US Government acknowledged the failure of corporate governance in certain corporations and sought to introduce legislation to cover perceived gaps in governance practice. An analysis of corporate failures signal corporate governance issues which need to be addressed. This resulted in the enactment of the SOX (Securities and Exchange Commission 2002). This act represented a pivotal event in the development of good corporate governance in the US (Baulkaran 2014). The sections incorporated within the act are briefly outlined in the following table:

Figure 13.2: Sarbanes-Oxley Act of 2002, Summary of Provisions

Section Heading	Description
Public Company Accounting Oversight Board (PCAOB)	The PCAOB provides independent supervision of public accounting firms which conduct audits. It is also responsible for registering auditors and outlines various requirements for audits.
Auditor Independence	This section deals with acceptable standards for external auditor independence, including the need for rotation of partners and reporting requirements.
Corporate Responsibility	Outlines the concept of individual responsibility by senior executives and their role in ensuring the publication of accurate and complete financial statements.
Enhanced Financial Disclosures	Specifically covers financial transactions, transactions of corporate officers, and timely reporting of material changes. It also covers a requirement for audits of internal controls and the ability for SEC reviews.

Analyst Conflicts of Interest	This section requires securities analysts to disclose conflicts of interest and lists their codes of conduct.
Commission Resources and Authority	The Commission Resources and Authority deals with the SEC's authority to bar or censure individuals including brokers, advisors, or dealers.
Studies and Reports	Requires the SEC and Comptroller General to conduct studies and reports covering the effects of consolidation of public accounting firms, the role of credit rating agencies in the operation of securities markets, securities violations, and enforcement actions.
Corporate and Criminal Fraud Accountability	Outlines penalties for manipulation, destruction or alteration of financial records or perverting the course of official investigations. It also provides protection for whistle-blowers.
White Collar Crime Penalty Enhancement	Represented by the White-Collar Crime Penalty Enhancement Act of 2002, this section highlights the penalties associated with white-collar crimes incorporating tougher sentencing guidelines.
Corporate Tax Returns	Requires the CEO to sign the corporate tax return.
Corporate Fraud Accountability	Represented by the Corporate Fraud Accountability Act of 2002, this section identifies corporate fraud and deems certain types of manipulation as a criminal offence which attract more severe penalties.

Source: A summary of Securities and Exchange Commission (2002)

Figure 13.2 offers a broad view of corporate governance from the perspective of the regulators. This chapter, however, focuses on the social practice of corporate governance, in particular that practiced by Lehman Brothers. As explained in the following sections, the Lehman Brothers' approach to corporate governance entailed a tick-a-box approach to regulatory compliance instead of an overall system which encompasses a combination of values consistent with a social responsibility approach and actions reflecting fiduciary obligations.

NYSE Response to Corporate Governance

The US regulatory response is contained in The NYSE Listed Company Manual, and in SOX. In addition to the manual—New York Stock Exchange (2012), the NYSE has published a detailed NYSE Corporate Governance Guide for the creation of an effective corporate governance system (New York Stock Exchange 2014). The provisions contained in New York Stock Exchange (2012) as opposed to the NYSE Corporate Governance Guide, are mandatory (refer below for details).

New York Stock Exchange (2012) represents the NYSE's critical collection of policies, practices and procedures for US listed corporations (New York Stock Exchange 2012, 1). These regulations specifically cover various compliance requirements with matters relating to corporate governance contained in section 303A.09 (New York Stock Exchange 2012). In addition to requiring listed companies to adopt and disclose corporate governance guidelines, it provides a detailed listing of compliance provisions. An excerpt from New York Stock Exchange (2012) which outlines the mandatory subjects in a corporation's governance guidelines is set out below (Figure 13.3):

Figure 13.3: NYSE Corporate Governance Standards

Subject	Description
Director qualification standards	These standards should, at minimum, reflect the independence requirements set forth in Sections 303A.01 and 303A.02. Companies may also address other substantive qualification requirements, including policies limiting the number of Boards, on which a director may sit, and director tenure, retirement and succession.
Director responsibilities	These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at Board meetings and advance review of meeting materials.

Director access to management and, as necessary, appropriate, independent advisors.	N/A
Director compensation.	Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The Board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The Board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.
Director orientation and continuing education	N/A
Management succession	Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.
Annual performance evaluation of the Board	The Board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.

Source: A summary of New York Stock Exchange (2012-section 303A.09)

The NYSE acknowledges the existence of various systems of corporate governance, and the potential confusion this may cause the corporate community (New York Stock Exchange 2014, 7). In response, it analysed a body of literature on the subject and incorporated its findings in the NYSE Corporate Governance Guide (Baukaran 2014). Compliance with the principles in the guide is not mandatory, however, it simply provides a best practice framework for the voluntary adoption by US corporations. It outlines the NYSE view of aspirational best practices. The NYSE states that the aim of Boards should be to:

Oversee the successful, profitable, and sustainable operations of their companies. But the pressures that confront directors, from activism and short-termism, to ongoing shifts in governance, to global risks and competition, are many (New York Stock Exchange 2014, iii).

The New York Stock Exchange (2014) identified issues based on its review and noted that out of the 15 Board attributes analysed, 10 had either mixed results from the literature, or were determined to have no impact on the Board feature. A summary of the NYSE's review is presented in Figure 13.4.

Figure 13.4: NYSE Summary of Corporate Governance Literature

Board Attribute	Explanation	Findings from NYSE Research
Independent chairperson	The chairman of the board meets NYSE standards for independence.	No evidence that this matters.
Lead independent director	The board has designated an independent director as the "lead" person to represent the independent directors in conversation with management, stockholders, and other stakeholders.	Modest evidence that this improves performance.

Number of outside directors	Number of directors who come from outside the company (non-executive).	Mixed evidence that this can improve performance and reduce agency costs. Depends primarily on how difficult it is for outsiders to acquire expert knowledge of the company and its operations.
Number of independent directors	Number of directors who meet NYSE standards for independence.	No evidence that this matters beyond a simple majority.
Independence of committees	Board committees are entirely made up of directors who meet NYSE standards for	Positive impact on earnings quality for audit committee only. No evidence for other committees.
Bankers	Directors with experience in commercial or investment banking.	Negative impact on company performance.
Financial experts	Directors with experience either as public accountant, auditor, principal financial officer, comptroller, or principal accounting officer.	Positive impact for accounting professionals only. No impact for other financial experts.
Politically connected directors	Directors with previous experience with the federal government or regulatory agency.	No evidence that this matters.
Employees	Employee or labour union representatives serve on the board.	Mixed evidence on performance.
'Busy' boards	A 'busy' director is one who serves on multiple outside boards (typically three or more). A busy board is one that has a	Negative impact on performance and monitoring.

	majority of busy directors.	
Interlocked boards	An executive from Company A sits on the board of Company B, while an executive from Company B sits on the board of Company A.	Positive impact on performance, negative impact on monitoring.
Board size	The total number of directors on the board.	Positive impact on performance to have smaller board if company is 'simple,' larger board if company is 'complex'.
Diversity	The board has directors that are diverse in background, ethnicity, or gender.	Mixed evidence on performance and monitoring.
Classified (or staggered) boards	A board structure in which directors are elected to multiple-year terms, with only a subset standing for re-election each year.	Mixed evidence on performance and monitoring.
Director compensation	The mix of cash and stock with which directors are compensated.	Mixed evidence on performance and monitoring

Source: New York Stock Exchange 2014

Following its review, the NYSE noted a disparity in the literature relating to corporate governance whereby the traditional notions of best practice had been challenged. An assessment by van den Berghe (1999) of global codes of corporate governance revealed a lack of consistency amongst countries and inconclusive evidence of a “single” best practice approach. In commenting on the available literature, they concluded that “the research results, as well as opinions on the subject, are by no means unanimous” (van den Berghe 1999, 14). A more recent study by van Essen et al. (2013) supports van den Berghe (1999) and found that there is no universal prescription for good corporate governance and that “the efficacy of governance mechanisms

may be contingent upon organisational and environmental circumstances” (van Essen et al. 2013, 201). There is inconclusive evidence in the literature for any one approach to establish a checklist for effective corporate governance. The problem with much of the literature relates to several factors (Zahra and Pearce 1989). Firstly, there is the tendency to relate board attributes and roles universally to corporate performance. Secondly, there is the relatively scant attention to the impact on board variables from contextual forces such as the size of the corporation or its life cycle. Thirdly, there is disagreement on what constitutes best practice for board processes and structure, and acceptable board objectives. Many variables play a part in determining “when boards exercise their power, how their actions may influence the direction the firm takes, and how directors bring about changes in the strategic initiatives advanced or implemented by senior executives” (Zahra and Pearce 1989, 325). Fourthly, there has been an over-reliance on univariate analytical approaches which ignore the antecedents and after effects of the variables chosen. This leads to the risk that the causal effects are not adequately identified and therefore any reliance on previous findings may extend the probability of diverse results. Fifthly, as the study of corporate governance covers a broad range of subsidiary topics, the range of samples used to conduct empirical analysis has been inadequate. Most studies relate to the US Fortune 500 corporations, whilst ignoring smaller and non-profit corporations. Sixthly, the definition of board structure variables has been inconsistent. For example, the definition of an outside director still differs amongst researchers. Further, questions such as the differentiation between the roles of the CEO to that of the board and the extent of the board’s expected strategic contribution to the corporation remain unresolved. Lastly, Zahra and Pearce (1989) identify the problem of a common tendency to measure corporate performance in a financial sense. Moreover, common measures ignore other perspectives such as the social and systemic responsibilities of the corporation.

According to the New York Stock Exchange (2014, 8), there are certain contexts in which corporate governance may be considered favourable. Taking its review into account, the (New York Stock Exchange 2014) reached four broad recommendations in applying best practice corporate governance. Firstly, it recommends that boards should adopt governance practices where there exists sufficient empirical evidence that those practices benefit the organisation. Given the plethora of literature with

different views on this subject, incumbent boards could be excused for being confused as to which practice to adopt. The New York Stock Exchange (2014) attempts to accommodate this difficulty by outlining board attributes that are supported by academic studies and their findings.

Secondly, the New York Stock Exchange (2014) advises that the context in which corporate governance systems are applied should be considered. This contextual argument is supported by Millstein Center for Corporate Governance and Performance Yale School of Management (2009).

It could be detrimental to an organisation applying a completely standardised governance system as a system's design should correlate to its setting. For example, a non-executive chairperson may be preferred upon the appointment of a new CEO, particularly when the appointee has no experience at CEO level and is internal. An independent chairperson can also benefit the organisation when a significant overhaul in strategy, culture or operations is required following a severe deterioration in performance. In this case, major decisions such as a change in the leadership or a sale of the organisation can be undertaken without undue influence, and management distraction of strategic matters can be minimised.

However, on the other hand, according to New York Stock Exchange (2014), a non-executive chairperson may be disadvantageous when an effective CEO/chairperson is already in place. The recruitment of a new CEO can be difficult when the incumbent holds both titles. Further, an independent chairperson could lead to inefficient strategic decisions, especially when technical expertise is required and such knowledge is not easily transferable from the CEO to the chairperson. Finally, separate CEOs and chairpersons can undermine leadership during a crisis (New York Stock Exchange 2014, 10).

Thirdly, the New York Stock Exchange (2014) suggests that the functions of a governance system should take priority over its features. This avoids the superficial notion that the mere presence of a diverse, independent board with a standard set of board committees is sufficient for a corporate governance system to function. Similarly, the feature of a documented succession plan may be based on an assumption that it is a good one; and if the board has a risk committee, an assumption could be made that the

organisation exercises careful risk management. Likewise, it may be assumed that an optimal compensation structure for directors and management includes forms of equity as it provides appropriate incentives. As outlined in Figure 13.4, the research is not so definitive and boards should therefore avoid simply applying a standard governance system or feature and instead adopt a governance system that will indeed add value.

There is no evidence of any regulatory breach by Lehman Brothers of the New York Governance Standards, however Aluchna (2013) identifies a number of weaknesses in Lehman Brothers' corporate governance practice. Of interest is the impact that institutional forces and/or the undue influence of power in relationships had on the performance of Lehman Brothers. As stated by Alina and Bogdan (2015, 682) "the best practices refer to those methods, techniques and instruments adopted by the company which ensure success and avoid failure in the future". This broad definition linking corporate governance to the future failure of a business is appropriate in the Lehman Brothers case study in view of the role played by Lehman Brothers' board in the lead up to its bankruptcy. In summary, an important function of an effective corporate governance system is an effective mechanism for the oversight and monitoring of management to avoid a future failure. This function is ordinarily carried out by a Board of Directors and therefore the structure of a board is a vital component in its implementation. The following section analyses the influences which shaped the board structure of Lehman Brothers.

Board Structure

There is evidence to suggest that attributes of Lehman Brothers' board structure were influenced by normative pressure. Larcker and Tayan (2010) suggest that an ideal Board structure should start with a board containing the following three characteristics. Firstly, a chairperson independent from management and preferably not concurrently acting as the CEO. This separation of dualities is commonly preferred as part of best practice corporate governance in view of the different responsibilities for each position. Another attribute includes a board representation of sufficient size as to cover the requisite skills, knowledge and diversity of perspectives necessary to promote balanced and informed discussion. The diversity should cover professional expertise, ethnicity, age and gender.

The board should also comprise a number of independent directors who can serve the best interests of stockholders. Finally, Larcker and Tayan (2010) suggest that an ideal board structure should include a compensation structure designed to avoid any agency problem. This is often achieved by including a substantial portion of board members' compensation with corporate stock and/or options. Despite its compliance with the New York Governance Standards and adoption of certain features of traditional corporate governance as suggested by Larcker and Tayan (2010), how did Lehman Brothers' board fail to mitigate the firm's escalating financial difficulties and disregard a growing dysfunctional corporate culture?

Normative and Mimetic Influence over Board Structure

The adoption prior to the GFC of a similar board structure to that of Goldman Sachs, widely regarded as a successful US investment bank as was later found by its survival of the GFC in its original form (except for its eventual conversion to a bank holding corporation), could be viewed as the result of DiMaggio and Powell's (1983) normative and mimetic influence. This influence impacted the majority of US investment banks who were more concerned with regulatory compliance than practising good corporate governance by instilling appropriate values in the day-to-day operations of the firms and at the top level of supervisory control—the Board of Directors.

Despite similarities in board structure, the effectiveness of the corporate governance of two organisations may vary considerably (Larcker and Tayan 2010, 1). Lehman Brothers' board structure was not vastly different from that of Goldman Sachs. In analysing Lehman Brothers' board structure, on the surface, it complied with the New York Governance Standards (New York Stock Exchange 2012). For example, 10 of the 11 directors on Lehman Brothers' board in 2007/2008 were classified as non-executive, reflecting an overwhelming number of non-executive directors; Lehman Brothers' Directors were a group whose backgrounds and experience were diverse; Lehman Brothers' Directors' compensation arrangements, which consisted of a mix of equity (restricted stock units and options) and cash, provided a level of performance incentive; and the Directors had a moderate workload imposed from membership of other boards which ensured sufficient focus could be devoted to the matters of Lehman Brothers.

Figure 13.5 compares board structural attributes of Lehman Brothers with those of Goldman Sachs. It is noteworthy that the board structures appear quite similar.

Figure 13.5: Board Structural Attribute Comparison between Lehman Brothers and Goldman Sachs as at 2005

Structural Attribute	Lehman Brothers	Goldman Sachs
Chairperson	Dual Chairperson/CEO	Dual Chairperson/CEO
Number of Board members	10 (increased to 11 by 2008)	11
Number of current CEOs/Chairmen/President of other corporations	3	4
Number of retired CEOs and years since their retirement	3 retired, average 12 years	2 retired, average 3.5 years
Independent Board members (according to NYSE)	8	9
Professional background of independent Board members	Former CEO Sotheby's	Former CEO Sara Lee
	Former Chairman IBM	Former Assistant to the President of the U.S.
	Theatrical Producer	Former CEO Medtronic
	CEO American Red Cross	CEO Allstate
	Chairman GlaxoSmithKline	President Brown University
	Vice Chairman RKO Pictures / Actress	CEO BP
	Former CEO Halliburton	Chairman Investor AB
	Principal JDM Financial	Vice Chairman Perseus
		Vice Chairman Colgate-Palmolive
Average age of Board members	68.4 (increased to 68 years by 2008)	59.4

Number of men vs. women	Men: 8; Women: 2 (2008: 10 men and 1 woman)	Men: 9; Women: 2
Number of other Boards, trusteeships, committees and other appointments they currently serve on.	Boards: 19; Trusteeships: 12; Advisory Committees: 5; Other Affiliations: 10	Boards: 17; Trusteeships: 7; Advisory Committees: 4; Other Affiliations: 27
Average annual cash retainer (does not include committee fees)	USD 55,000	USD 75,000
Average annual equity compensation	USD 195,000 (either restricted stock units or options)	USD 260,000 (either restricted stock units or options)
Number of full Board meetings per year	8	7
Number of executive sessions (independent directors only) per year	3	5
Committee meetings per year	Audit: 7; Compensation and Benefits: 8; Nominating and Governance: 5; Finance & Risk: 2; Executive: 11	Audit: 11; Compensation: 5; Nominating and Governance: 5

Source: Data for the table were extracted from each corporation's annual reports (Goldman Sachs Group 2005; Larcker and Tayan 2010, 3; Lehman Brothers Holdings 2005b).

As stated by Aluchna (2013), Lehman Brothers' board structure mostly superficially resembled a model of good practice as defined by the regulatory environment. However, from the perspective of efficient monitoring and control, it incorporated vital deficiencies in the context of Lehman Brothers' history and financial predicament just prior to its collapse. By ticking the regulatory boxes, Lehman Brothers' board structure resembled that of Goldman Sachs. The fact that the board structures of both firms were similar may imply a mimetic pressure in an attempt to seek legitimacy amongst the banking, regulatory and investment communities. If Lehman Brothers mimicked the board structure of Goldman Sachs, it sought to imitate an organisation which was

deemed to be successful, thereby attracting legitimacy. It also generated a sense of security for investors, management and the board, supporting a proven tactic for survival. Appearing to adopt a similar board structure to its peer group, an investment bank avoids differentiation at this level of corporate structure from other investment banks. Any substantially different board feature may indicate non-compliance with socially accepted norms and potentially attract closer scrutiny by investors and regulators especially in cases of underperformance to a peer group benchmark. Closer scrutiny relative to the peer group runs the risk of detecting a lack of transparency, unexpected or extraordinary management practices or financial anomalies, which in turn, could affect stakeholder confidence in the firm.

Additionally, similarity in board structure also implies that both firms were intent on complying with regulations. If they breached regulations, then not only would they face the associated regulatory penalties, they would portray an image to the public and stakeholders of a firm that did not have adequate management control. Such a perception could not only damage the firm's reputation, thereby impacting future business, but could infer to creditors, CRA's and other financial counterparties on whom the firm was reliant for ongoing funding, that the firm's credit risk profile had worsened.

A normative influence may have also affected Lehman Brothers and was potentially spurred by Riaz's (2009) concept of 'reverse legitimisation'. The setting for 'reverse legitimisation' existed, as prior to the GFC all major investment banks were recording healthy profits. Their relative success and perceptions of full compliance attracted legitimacy. This also created an environment whereby the regulatory authorities such as the NYSE and SEC, from which the investment banks sought legitimacy, were publicly endorsed for sustaining the development of such successful organisations. This 'mutual legitimisation' perpetuated an impression that corporate governance practice was effective and proper in the investment banking industry. This perception was sustainable providing the corporate governance *modus operandi* of the investment banking peer group was consistent and did not deviate from established practices.

Aluchna (2013) identified governance weaknesses in three of the four major US investment banks. These weaknesses are amongst those which New York Stock Exchange (2014) attempted to overcome. They also represent the weaknesses that Monks and Minow (2011) attempt to

address. These include: an efficient board in which the CEO and Chairperson are different people; a sufficient number of non-executive directors to protect the interests of stockholders; board committees such as nomination, audit and compensation committees with the necessary experience and expertise to cover decisions relating to the organisation; a compensation structure adequate to incentivise directors; and an active stockholder base willing to question the Board. In referring to Monks and Minow (2011) features, Aluchna (2013) concluded that these key features of good corporate governance attributes in general were inadequate for the three deficient investment banks examined.

“Self-interest” and “Short-termism”

The normative influence affecting the investment banking industry stems from two overriding sources. Firstly, the inclination for self-interest in preference to a responsibility to stockholders, and secondly the tendency for a “short-termism” approach to management decision-making. Jensen (1994) argues that economic self-interest is driven by incentives which may cause irrational behaviour and is mostly favoured above altruism. Jensen (1994) further argues that individuals may have other motives. The industry’s choice to resort to high levels of monetary incentives created a tendency during the pre-GFC period to incorrectly discern the appropriate balance between financial incentives driven by self-interest and the opposing motive of prudential management of risk. This problem, identified by Jensen (1994), is blamed for system failures leading to large corporate collapses. “This phenomenon, for example, lies at the heart of the failure of the internal control systems that has led to the waste of hundreds of billions of dollars of resources and the failure of many of the crown jewels of corporate America over the last several decades” (Jensen 1994, 8).

Secondly, there existed ambitions for each investment bank to practice “short-termism”. This phenomenon is related to the first factor, as “short-termism”, which drives the achievement of high short-term profits, generally translates to higher executive and director short term compensation. Although these behaviours could relate to employees in an investment bank, the responsibility that led to this dysfunctional culture at Lehman Brothers must be at least partly ascribed to the Board of Directors which has ultimate responsibility for compensation policies. As the normative

pressure affected the organisation as a whole, the Board of Directors were not immune to its effects.

Each major US investment bank, like all US publicly listed corporations, was required to report its financial statements on a quarterly basis in accordance with the Form 10-Q reporting requirements of the SEC (*Securities and Exchange Act 1934*). The Form 10-Q quarterly report consists of unaudited financial statements intended to report on the continuing financial state of affairs of the corporation during its fiscal year. Stockholders, creditors and other stakeholders would be interested in following the progress of the corporation. Most importantly, creditors would be interested in the impact the financial statements would have on the corporation's credit risk profile, and stockholders would be interested in the impact on returns. Financial results were therefore closely scrutinised by these stakeholders including investment managers and securities analysts whose comments were often quoted in the media.

The quarterly scrutiny of financial results generated pressure on each investment bank and in turn, their Board of Directors, to produce a higher result in each successive quarter to meet investor expectations. The inevitable comparison of each investment bank against its peer group's performance by analysts compounded this pressure. Evidence of the focus on peer group comparison especially on key financial metrics by Lehman Brothers is found in the Lehman Brothers Global Strategy Offsite Presentation (Lehman Brothers Holdings 2006, 5-7, 14-5, 30, 4). This focus on peer group comparison represents 8 out of 38 pages of Lehman Brothers' Corporate Strategy Presentation for 2006. Goldman Sachs' peer group comparisons focused on a combination of equity performance and divisional performance (Goldman Sachs Group 2006, 13-4,5,7,9). Bear Stearns' comparisons mostly related to divisional performance in terms of market rankings (Bear Stearns 2006, 9-12, 8, 23, 112); Morgan Stanley focused on peer group comparisons relating to divisional performance and staff quality (Morgan Stanley 2006); and Merrill Lynch focused on comparing its dominance in executing large transactions as well as its equity performance (Merrill Lynch 2008a, 5-15, 158). In each case, the investment banks were trying to establish a perception that they were performing satisfactorily and in line with or better than the peer group average in at least one performance metric.

In this competitive environment, it was tempting to make management and strategic decisions to facilitate the objective of short-term quarterly outperformance. In view of the industry peer group comparisons, a similarity of approach in dealing with decision-making of the business operations would not be unexpected. The consequence for being the lowest ranked investment bank in terms of performance could have resulted negatively on the firm's stock value relative to the peer group. The normative influence driven by a common "short-termism" approach sanctioned the internal decision-making of the firms. In the absence of any negative commentary from the public either in the media, directly from stakeholders, or through sanctions imposed by regulators, the investment banking firms appeared to comply with social norms. The commonality in approach by the peer group was spurred also by the circles, both informal and formal, in which the employees, senior executives and Directors mixed. For example, it would not be unexpected for Directors of different firms to socialise at formal and informal events such as conferences or social clubs. The high level of contestability for employees meant that they rotated between employers through the "revolving door" as they shopped around for better compensation packages. The intermingling of employees between different firms, within professional forums and in educational settings resulted in the importation of employee values to the same firms (Galaskiewicz and Wasserman 1989; Slack and Hinings 1994). Ultimately these values would merge on an industry-wide basis and the same values would influence decision-making, leading to a common approach to "short-termism" and tendency for self-interest. Other examples where the same normative influence fed into decision-making included the common pursuit of the "leverage effect", which helped boost profitability at the expense of elevated risk levels; the growth in the use of credit derivatives which allowed the banks to expand risk exposures to relatively illiquid assets; and the practice of warehousing mortgages and CDOs, often through off-balance sheet structures, with the expectation of offloading these assets through securitisation. The latter practice generated a concentration of exposures to the real-estate market and in particular, the subprime mortgage market. Finally, Directors and employees would be attuned to the practices of other major investment banks given the media exposure associated with performance reporting and publicity surrounding major transactions, often involving merger and acquisitions and large-scale corporate financings.

CHAPTER 14

INTERNAL RELATIONSHIP

CEO and the Board

Fuld's interactions and relationship with the board reflected Fuld's management style. It created a power base from which he was able to influence board members to implement strategic initiatives which were consistent with his own. This section covers the subtle organisational processes, structures and behaviours which enabled the CEO to influence the Board. Specifically, this section examines: the problem of duality of CEO and Chairperson roles and how this influenced the appointment process of board members; the risks posed to director independence by board member longevity of tenure; board composition, and questions relating to its suitability for a complex and innovative business; the level of director engagement in the decision-making process which devolved matters to a Board Committee whose priorities as a whole were misplaced; and finally the attractive level and structure of board compensation, and its effect on board compliance to the CEO's wishes.

According to New York Stock Exchange (2014, 75-6) it is a common modern day governance practice to include independent directors on a board to protect the interests of stockholders and other stakeholders. This practice is also included as a requirement of US corporate governance rules (New York Stock Exchange 2012-303A.01). In compliance with the NYSE requirement, Lehman Brothers' board consisted of ten independent directors out of a total of eleven directors. The only non-independent director was Fuld, who sat on the board as Chairperson. A further factor considered as best practice by the NYSE Corporate Governance regulations, is to incorporate a range of board committees to supervise certain operational aspects of an organisation's activities (New York Stock Exchange 2012-303A.04-303A.07). Lehman Brothers also complied with this NYSE Corporate Governance regulation having a number of such committees including: an executive committee; an audit committee; a

compensation and benefits committee; a nominating and corporate governance committee; and a finance and risk committee (Lehman Brothers Holdings 2007, 2). In addition, Lehman Brothers was compliant with regulations requiring independent directors to regularly meet without the presence of executive management (New York Stock Exchange 2012-303A.03).

According to testimony before the US House of Representatives Financial Services Committee investigating the role of Lehman Brothers in the GFC, Thomas Cruikshank, a longstanding board member of Lehman Brothers since 1996, described the board as a competent and involved body of advisors. "Board meetings were an active and dynamic affair. Board members probed management, asked numerous questions and demanded and received detailed, cogent answers" (Hearing before the Committee on Financial Services U.S. House of Representatives, Statement by Thomas H. Cruikshank 2010, 3). His testimony could be interpreted as one which either attempted to deflect blame from the Board for Lehman Brothers' collapse, or a true belief that the board performed acceptably in its overseeing role of the firm. If the latter is to be believed, then given Lehman Brothers' collapse, Cruikshank's belief in a well-functioning board could be considered misplaced.

However, following an exhaustive examination of the fiduciary duties that board members owed to the firm and their actions, Valukas (2010) found that "colorable" claims or actions did not exist with respect to their handling of the level of risk that Lehman Brothers had assumed and its liquidity issues (Valukas 2010, 52). This examination took into account whether the board carried out its fiduciary duties according to the requirements of the regulatory framework existing at the time, which principally included compliance to SOX and the requirements under the New York Stock Exchange's regulations (New York Stock Exchange 2012). For example, Title III of Securities and Exchange Commission (2002) obliges public corporations to apply standards for audit committee independence and responsibilities. Further, the audit committee is required to commission the auditors, agree on the audit fees and oversee their activities with a final report to be reviewed by the board. Audit committee members were required to be members of the Board of Directors and be independent. Finally, the audit committee had a responsibility to establish procedures for the processing of complaints related to financial reporting including those from employees who sought confidentiality. As long as the Lehman

Brothers' board complied with its regulatory obligations, which it did according to a statement in Lehman Brothers Holdings (2007, 9), the bankruptcy examiner could not find "colorable" claims against them.

Although the examination by Valukas (2010) exonerated the board, it found that "colorable claims" existed against Lehman Brothers' executive management including: Fuld; O'Meara; Callan; and Lowitt, for decisions regarding the use of Repo 105 and for filing misleading financial statements that did not disclose such usage (Valukas 2010, 990-1027).

Despite the findings of Valukas (2010) specifically relating to the board, questions remain regarding broader issues which were not examined by Valukas in detail, such as the appointment process for board members, the board composition, longevity of tenure and level of engagement of directors, their qualifications and relevant experience and whether their compensation structure was appropriate. These questions have even greater relevance given the increasingly sophisticated and complex business environment and innovative products involved in the investment banking industry. The board's deficiencies and susceptibility to Fuld's influence is examined in the following section.

Duality of Role

As well as holding the position of CEO, Fuld was the Chairman of the Board—thereby contravening the first criterion of a well-functioning Board (Larcker and Tayan 2010). Aluchna (2013) is also critical of the duality of roles of CEO and Chairperson, explaining that this represents a major component of the "inadequacies of the Boards of Directors". The dual title not only afforded Fuld operational control of the firm through his role as CEO, but also a strong influence over the monitoring of management and strategic decision-making through his role as chairperson.

Fuld assumed the position of CEO and Chairman soon after incorporation in 1994, following Lehman Brothers' spin-off from American Express. As the Co-CEO of the Lehman Brothers division of American Express since 1990 up until its public listing, Fuld shared the top executive position in the Lehman Brothers' organisation with J. Tomilson Hill prior to the spin-off. It was a natural succession to the CEO role of the newly incorporated Lehman Brothers as Fuld was the dominant leader of the division at that time.

Fuld was concurrently appointed Chairman presumably as the corporation had only just been listed and required a senior executive in the role with the experience and background necessary to steer the board with its early strategic decision-making. At the time of his appointment as Chairman, Lehman Brothers was confronted with major challenges. Immediately after the Lehman Brothers' spin-off by American Express, Lehman Brothers was burdened with significant financial liabilities, a dysfunctional team where animosity existed between the investment banking and trading divisions and an economic downturn which affected revenues. In this environment, the appointment of an internal chairperson seemed reasonable. Most of the criteria set out by Vo (2010) in justifying a combined CEO and chairperson, applied to Lehman Brothers. These include: the incumbent CEO, Fuld, was already in place as the leader of the firm in a situation when there was no chairperson; Fuld possessed technical expertise and knowledge which would have been difficult to transfer to a new chairperson; and finally, the appointment of a separate chairperson could have destabilised the leadership of Lehman Brothers during the crisis that prevailed during the early 1990s.

The popularity of duality of CEO and chairperson has waned since the GFC as US corporations have attempted to implement the notion of good corporate governance by separating the two positions. Approximately seventy five percent of the Fortune 500 list of US corporations had a combined CEO and chairperson in 2004. This proportion reduced to approximately fifty percent in 2014 (Hodgson 2014).

However, this justification for the dual role of CEO and chairperson can only be defended in the absence of duplicity between the operational management of the firm which is shared in the role of the CEO, and the effective monitoring role of the board. That is, the situation should be avoided where the chairperson possesses abnormal power in the monitoring process of himself or herself in the role of CEO. If such power exists, then a conflict of interest arises and the suitability of a duality in the role is inappropriate. The duality of roles was tolerated by the investing public as it stemmed from a normative influence where such duality was seen as socially acceptable within the investment banking field and wider throughout the US corporate domain as mentioned above. Bear Stearns and Goldman Sachs were also led by individuals that held the dual title of CEO and Chairperson which generated a social acceptance of this feature amongst stakeholders. Fuld continued in this dual role until Lehman

Brothers' collapse suggesting that this acceptance by stakeholders continued whilst the firm performed strongly, thereby avoiding closer scrutiny of the firm's organisational structure. Possessing the dual title of CEO and Chairman permitted Fuld to exert his influence not only over the management and employees of the firm, but also over the board members. Therefore, the board structure weakness of 'inefficiencies of boards of directors' identified by Aluchna (2013) was manifested in Lehman Brothers by the conflict of interest by the duality problem.

Appointment of Board Members

As demonstrated by Lehman Brothers Holdings (2008h, 6), Lehman Brothers' corporate governance practice relating to the appointment of Board members through an election process was in accordance with best practice as dictated by the New York Stock Exchange (2014, 72). Considerations for appointment of a director included the following process:

... In evaluating any potential candidate, the Nominating Committee considers the extent to which the candidate has the personal characteristics and core competencies discussed above, and takes into account all other factors it considers appropriate, which may include strength of character, mature judgment, career specialization, relevant technical skills, diversity and the extent to which a candidate would fill a present need on the Board of Directors. In addition, the Nominating Committee considers independence and potential conflicts issues with respect to Directors standing for re-election and other potential nominees, and whether any candidate has special interests that would impair his or her ability to effectively represent the interests of all stockholders. The Nominating Committee also takes into account the candidates' current occupations and the number of other boards on which they serve in determining whether they would have the ability to devote sufficient time to carry out their duties as Directors (Lehman Brothers Holdings 2008h, 12).

Lehman Brothers also complied with the New York Stock Exchange (2012) requirement of an annual rotation:

... All of the company's directors are elected annually for a one-year term expiring at the Annual Meeting of Stockholders in the following year. Each Director will hold office until his or her successor has been elected and qualified or until the Director's earlier resignation or removal (Lehman Brothers Holdings 2008h, 6).

Directors at Lehman Brothers were appointed through a process involving a Nominating and Corporate Governance Committee (the Nominating Committee) (Lehman Brothers Holdings 2008h). The responsibilities of the Nominating Committee were incorporated within Lehman Brothers' associated committee charter (Lehman Brothers Holdings 2008h, 11). Apart from covering the appointment of Directors, the Nominating Committee was also responsible for the corporation's general governance practices:

... The Nominating Committee is responsible for overseeing the Company's corporate governance and recommending to the Board of Directors corporate governance principles applicable to the Company. The Nominating Committee also considers and makes recommendations to the Company's Board of Directors with respect to the size and composition of the Board of Directors and its Committees and with respect to potential candidates for membership on the Board of Directors (Lehman Brothers Holdings 2008h, 11).

The Nominating Committee was allowed to accept recommendations from the CEO for potential board candidates. This provided the CEO with some power in relation to the nomination process:

... The Nominating Committee...will consider in a timely fashion, potential candidates for directors that have been recommended by the Company's Directors, Chief Executive Officer and other members of senior management (Lehman Brothers Holdings 2008h, 11-2).

For example, in 2004, Sir Christopher Gent was initially recommended to the Nominating Committee by Fuld and a senior executive. The nomination was supported by the executive search firm, Spencer Stuart. It was usual practice for Lehman Brothers to employ executive search consultants to assist with the search of board member candidates. For example, in 2007, Lehman Brothers employed Ridgeway Partners LLC, in 2005 Russell Reynolds Associates, and in 2004, Spencer Stuart (Lehman Brothers Holdings 2004, 9; 2005b, 10; 2007, 6). Ideally, the search firm would be independent and without a conflict of interest. However, Ridgeway Partners was routinely used by Lehman Brothers as a consultant (Bloomberg 2008). The relationship between Fuld (and his senior executives involved in general recruitment) and Ridgeway Partners LLC suggests that the independence of this executive search firm may have been compromised. As it would be in the interests of the executive search firm to accommodate the needs of

its client [Lehman Brothers] in its business relationship, a potential motivation existed for Ridgeway Partners LLC to be strongly guided by Fuld in the selection of a board candidate. This layer of influence over board nominations was augmented by the power of the CEO and senior management to conduct interviews of potential director candidates. Baulkaran (2014, 459) shows that:

... firms with individual director election and detailed disclosure of voting results in director elections have a higher firm value or performance. Firms with independent chairman, majority voting, and detailed disclosure of voting results in director elections have lower idiosyncratic risk.

There is insufficient evidence of this level of transparency regarding director elections at Lehman Brothers. However, Fuld possessed potential influence over the board through his power to recommend board candidates for nomination and to be involved in the interview process. This authority was contained in the Nomination and Corporate Governance Committee charter since 1994 (Lehman Brothers Holdings 1995, 7).

As evidenced by Lehman Brothers Holdings (1995, 7), Fuld was a member of the Nominating Committee from the beginning. The fact that Fuld was a member of the Nominating Committee at the time of incorporation allowed him to influence board nominations from the start of the conversion process from a division of American Express to a publicly listed corporation. During those early stages of the corporation's life, the Nominating Committee could be considered vital as it was responsible for appointing new board members during the firm's infancy and therefore indirectly influence the long-term agenda of the firm. More importantly, the newly formed board and committees would set the tone for their ongoing approach to monitoring management. Fuld filled this committee with members whom he considered would approach their role with a strategic view of the firm in a manner consistent with his own.

The Chairman of the four-member Nominating Committee at the time of incorporation in 1994 was John MacComber, who remained on the committee until Lehman Brothers' bankruptcy. Therefore, from the four members on the Committee in 1994, one was the CEO and one was a long serving Director who largely owed his board appointment to Fuld. MacComber, who was also a member of the two-man Executive Committee, alongside Fuld, could therefore be considered an ally and able to influence

the Nominating Committee in a way that suited Fuld for the duration of Lehman Brothers' corporate existence.

Fuld's power to nominate directors is understood within the context of Clegg's (1989) dispositional and episodic circuits. The process of appointing a board member involved the nomination process which started with recommendations from either board members, executive search consultants or the CEO/senior management to the Nominating Committee which would then make its recommendation to the board. Following a vote approving the recommendation, the board would propose the candidate to stockholders at the annual general meeting, where following approval, the director was formally appointed. The key steps in the process included the support for the candidate at the Nominating Committee and later from the majority of the incumbent board. Stockholder meetings habitually approved the board's recommendation. As Chairman, Fuld had an influence in both key decision forums of the Nominating Committee and the board over which he presided. The nomination and interview processes represent passage points which relayed Fuld's authority and therefore impose his preference for a particular type of director. Without this ability, Fuld would have been disempowered.

The committee charter defined, formalised and fixed relations between the board and the Nominating Committee. The board merely ratified board nominations presented by the Nominating Committee. The charter granted Fuld the authority to recommend and interview candidates and therefore constituted the source of the latent power emanating from the dispositional circuit. The committee members, who were subject to Fuld's influence, exercised their power over board appointments in the episodic circuit, during their routine deliberation of candidates. In their meetings, committee members would discuss potential candidates whose suitability would be assessed. The forum of the committee meetings therefore represented the passage point where Fuld's power was exercised. In turn the committee forwarded their recommendation to the board who would then ratify the candidate for election by stockholders.

The ability granted to Fuld to recommend potential directors would have been tolerated given the board presided over a successful period of superior financial results up until the year prior to its bankruptcy. This reflected well on Fuld and his team, who possessed the operational control. The crediting by the board of the successful performance to its

CEO is also recognised by the compensation arrangements under which Fuld was employed. The arrangements stipulated the major objectives of the CEO role, and methods to evaluate Fuld's management capabilities against key performance indicators (Lehman Brothers Holdings 2008h, 24-7). A consequence of the firm's ongoing success was the creation of a perception to the outside, of a well-functioning Board. Lehman Brothers' continuing success validated the board's decision-making to internal and external stakeholders. A well-functioning board therefore implied a well-considered director nomination process.

Board Tenure

An argument exists that a long-term director on a board can offer greater experience, commitment and competence in view of the intimacy they develop of the corporation's operations and interest in its continuing survival, either due to loyalty or long-term compensation arrangements. However, studies have found the opposite phenomenon. Katz (1982) finds that long term tenure diminishes internal communication effectiveness and engenders complacency amongst directors in seeking out key information sources. Katz (1982) also finds that although a new director's learnings of a corporation increase in the early years of their tenure, which can positively affect firm performance at that time, performance deteriorates thereafter. Stobaugh (1996) suggests that to enable new ideas and critical thinking which encourage positive performance, the maximum term of a director's tenure should be approximately ten years, a term which is shorter than the average tenure of eleven years for Lehman Brothers' directors (Lehman Brothers Holdings 2008h, 48-52). Lipton and Lorsch (1992, 66) also support the notion of a limit to a director's tenure to avoid relationship issues with the CEO.

Vafeas (2003) finds that as director tenure lengthens, the potential for a sociable relationship with management increases, which in turn impacts on director independence. He also suggests that longer serving directors are more likely to support management decisions, and as they become friendlier are less likely to monitor senior management. Vafeas (2003) further suggests this is more likely to occur in firms with more powerful CEOs, especially those who have a role in board member nominations. "Independent directors or not, if you've been on the board for a while, there is a possibility that some of the directors do get closer to

management” (Goodlad 2014). The tenure of individual members of Lehman Brothers’ board and the Nominating Committee varied, however it was considered lengthy given that board rotation was annual. Lehman Brothers’ longevity of board tenure of eleven years was not unusual for major US investment banks. For example, the average tenure of directors at the surviving Goldman Sachs was eight years (Goldman Sachs Group 2007b, 8-10); and for the failed Bear Stearns, it was thirteen years (Bear Stearns 2007b, 3-2).

The tenure of the Nominating Committee as a group was also lengthy. In 2008, this Committee consisted of the Committee Chairperson, Ms. Evans, and two other independent Directors, Cruickshank and MacComber (Lehman Brothers Holdings 2008h, 11). Ms Evans, the exception, had been a board member for four years, Cruickshank twelve years and MacComber fourteen years. With an average of fifteen years, it was longer than the board average of eleven years. Figure 14.1 details the tenure of all board members. Another influential committee, the Executive Committee, had two members in 2007/2008: Fuld and MacComber. MacComber was the longest serving independent director on the board, having been appointed at the time of incorporation in 1994 (Lehman Brothers Holdings 2008h). Having MacComber on the Executive Committee, Fuld potentially captured the director with the greatest degree of loyalty given his longevity of tenure. Further, he was a member of the Nominating Committee which conferred influence over director appointments. The Executive Committee met frequently, more than any other board committee. It convened sixteen meetings during fiscal 2007 and at each meeting during that year unanimously approved all resolutions. The fact that each Executive Committee meeting acted with unanimous consent every time it met implied that MacComber was in full agreement with Fuld on every decision undertaken by the Committee. The Executive Committee possessed significant power given it could exercise the Board’s authority on all matters between board meetings, except for those matters that required specific board approval.

Therefore, given MacComber was the longest serving board member, his propensity to succumb to Vafeas’ (2003) notion of ‘director friendliness’ was greater than all other board members. Occupying key positions on the Executive and Nominating Committees, MacComber was the conduit for Fuld’s influence over important committee level decisions. Given the longevity of tenure of the board as a whole, all directors had the

opportunity to create personal relationships with senior management and employees. These personal relationships could have been nurtured through various interactions between management and the board, for example, during board presentations, corporate functions, board dinners, external conferences, offsite strategy meetings, seminars and intimate meetings for technical instruction on specific operational matters relating to the business. This potential familiarity could have extended to a point where directors could have acquiesced to requests by senior management for action on routine or strategic decisions.

The Chairman's dominant role on the board, and his social relations with board members, created potential power over incumbent board members. Fuld could have been perceived by board members as the individual largely responsible for their appointment. This perception would create a sense of obligation by a board member, to support Fuld's future board member nomination recommendations. This cycle of behaviour which entailed the creation of a sense of obligation perpetuated Fuld's power over the board. The relations between directors and Fuld and expectations of compliance with Fuld's wishes represent socially constructed rules created within the dispositional circuit. That is, once the sense of obligation spurs repetitive compliance, the behaviour is transformed into a socially constructed rule which is routinely adhered to by directors. Fuld's power sourced from this routine behaviour was facilitated through the passage point of the nomination process. In the ongoing stewardship of Lehman Brothers, the extent to which Fuld was able to influence specific decisions depended on the complicity of board members.

Under US common law, directors have a fiduciary duty of care on behalf of stockholders (*Burt v. Irvine Co* 1965) and loyalty to the corporation (*Cede & Co. v. Technicolor* 1993). These duties are intended to discourage any conflicts of interest of the director which may affect the corporation. As the corporation is owned by stockholders, then any conflict of interest is deemed as one against the stockholders as well as the corporation. However, to the extent directors have more direct and frequent personal contact with senior executives than with stockholders, they may tend to develop better social and interpersonal relations with the former. Director contact with stockholders on the other hand would be often conducted on an impersonal basis and through indirect channels, such as annual general meetings, through corporate executives, investment or public relations firms and departments, and printed documents. A potential conflict

therefore is more likely to arise when a director establishes a more intimate relationship with management, who themselves are the subject of the board's monitoring, than with the stockholders. The influence over director nomination could be also exerted via external search consultants who may be beholden to the CEO for future business. The same consultants could also be engaged to provide recommendations for directors' expulsion. Consequently, the tenure of directors, through these intermediary business and social relationships could have been controlled by the CEO.

Within a culture where employees and board members were relatively powerless against the dominant wishes of the CEO, the authoritative role of the board is transmitted to the CEO – the opposite of what is considered good corporate governance practice. "Interaction between board directors and corporate executives that is markedly supportive and accommodating may signal the board's improper deference to, and mere rubber-stamping of, executive decisions and conduct" (Vo 2010, 82). Therefore, the first of Aluchna's (2013) board structure weaknesses is found to exist in Lehman Brothers given the potential for a conflict of interest between the directors acting in the best interests of stockholders and their acquiescence to the CEOs personal objectives.

Board Composition

An analysis of the Directors' backgrounds reveals that most directors did not have direct senior executive or board backgrounds in either banking or financial services. This is despite Lehman Brothers' statement that the Nominating Committee should consider board candidates who will:

... contribute knowledge, expertise or skills in at least one of the following core competencies: a record of making good business decisions; an understanding of management best practices; relevant industry-specific or other specialized knowledge; business experience in international markets; a history of motivating high-performing talent; and the skills and experience to provide strategic and management oversight, and to help maximize the long-term value of the Firm for its stockholders (Lehman Brothers Holdings 2008h, 11).

As confirmed by Lehman Brothers Holdings (2008h, 11), an important competency for a board member of an investment bank includes relevant

“industry-specific” or other “specialised” knowledge. As investment banks operate in a fast-moving environment where product innovation is a key feature, specific knowledge of products and credit exposures and their associated risks is considered fundamental. For those directors who had some related experience, Berman (2008) suggests it was not recent. Until Jerry Grundhofer, a former US Bancorp CEO, was appointed no other independent director with recent experience specifically covering banking and financial market activities and products existed on Lehman Brothers’ board until 2008 (Lehman Brothers Holdings 2008h). Although some board members possessed a certain amount of finance industry experience, Berman (2008) suggests it was well-outdated, given the rate of innovation occurring during the 1990s and 2000s. The currency of knowledge required to stay abreast of innovations and related risks of financial products such as securitisations, credit-default swaps, or derivatives trading was beyond the mostly retired members of the board.

The question then arises as to whether directors were actually selected for their lack of experience in complex investment banking activities, so as to facilitate Fuld’s control. Examples of board appointments of unqualified directors include that of Roger Berlind (director at the time of collapse) who was a theatrical producer; Dina Merrill (director until 2006), a career actress who was 85 years old upon retirement and Marsha Evans, a former head of the Red Cross and retired navy admiral (Berman 2008). Although this composition of directors meets the diversity criteria of good governance, the inexperience in financial markets and products is considered an overriding quality necessary for an investment bank which operates in a complex environment. There is no evidence that any of these directors had backgrounds with such expertise.

Another feature of the board was their age. The average age of Lehman Brothers’ directors was 68 years as at 2008. This exceeded the average of 61 years for directors of large US corporations as at 2008 (Spencer Stuart 2012, 17). According to the Alzheimer's Disease Research Centre (2017), certain cognitive abilities deteriorate at varying rates, as individuals age, in particular after 60. The cognitive abilities which experience deterioration and considered important for directors include:

- ... fluid intelligence or abilities not based on experience or education;
- recent memory or the formation of new memories; paying attention to electronic devices; word retrieval or the process of getting words out;

problems that have not been encountered during your life; and the speed with which cognitive and motor processes are performed (Alzheimer's Disease Research Centre 2017).

Further, five of the 10 independent directors in 2008 were aged over 70 and 6 directors had been retired from their previous executive roles, several of whom for an average period of over 12 years (Berman 2008). Importantly, Lehman Brothers' board did not include any members who were concurrently in a CEO role elsewhere (Lehman Brothers Holdings 2008h, 6-8). A final question over the composition of the board was the gender imbalance which favoured males by a ratio of 10 to 1.

Figure 14.1: Lehman Brothers Board of Directors as at 2008

Name	Director Since	Experience	Age
Richard Fuld	1990*	He was President and Co-Chief Executive Officer of the Lehman Brothers Division of Shearson Lehman Brothers Inc. from August 1990 to March 1993. Fuld was a Vice Chairman of Shearson Lehman Brothers from August 1984 until 1990 and has been a Director of Lehman Brothers since 1984. Fuld joined Lehman Brothers in 1969. Fuld serves on the Board of Directors of the Federal Reserve Bank of New York and is a member of the Executive Committee of the Board of Directors of The Partnership for New York City. He is a member of the International Business Council of the World Economic Forum and The Business Council. In addition, he serves on the Board of Trustees of Middlebury College and New York Presbyterian Hospital, as well as on the Board of Directors of the Robin Hood Foundation.	62
Michael L. Ainslie	1996	Michael Ainslie, a private investor, is the former President, Chief Executive Officer and a Director of Sotheby's Holdings. He was Chief Executive Officer of Sotheby's from 1984 to 1994. From 1980 to 1984, he was President and Chief Executive Officer of the National	64

		Trust for Historic Preservation. From 1975 to 1980, he was Chief Operating Officer of NRen Corp., a Cincinnati-based chemical manufacturer. From 1971 to 1975, he was President of Palmas Del Mar, a real estate development company. He began his career as an associate with McKinsey & Company. Michael Ainsle is a Director of The St. Joe Company and Lehman Brothers Bank, FSB. He is a Trustee of Vanderbilt University and a member (and the Chairman Emeritus) of the Board of Directors of The Posse Foundation, Inc.	
John F. Akers	1996	Akers, a private investor, is the retired Chairman of the Board of Directors of International Business Machines Corporation. Akers served as Chairman of the Board of Directors and Chief Executive Officer of IBM from 1985 until his retirement in 1993, completing a 33-year career with IBM. Akers is a Director of W. R. Grace & Co. He is a former member of the Board of Trustees of the California Institute of Technology and The Metropolitan Museum of Art, as well as the former Chairman of the Board of Governors of United Way of America. Akers was also a member of former President George Bush's Education Policy Advisory Committee.	74
Roger S. Berlind	1985	Berlind, who is also a private investor, has been a theatrical producer and principal of Berlind Productions since 1981. Berlind is also a Governor of the Broadway League and has served as a Trustee of Princeton University, the Eugene O'Neill Theater Center, the MacDowell Colony and the American Academy of Dramatic Arts.	77
Thomas H. Cruikshank	1996	Cruikshank was the Chairman and Chief Executive Officer of Halliburton Company, a major petroleum industry service company, from 1989 to 1995, was President and Chief Executive Officer of Halliburton from 1983 to 1989, and served as a Director of Halliburton	76

		from 1977 to 1996. He joined Halliburton in 1969, and served in various senior accounting and finance positions before being named Chief Executive Officer. Cruikshank is a Director of Lehman Brothers.	
Marsha Johnson Evans	2004	Ms. Evans served as President and Chief Executive Officer of the American Red Cross from August 2002 to December 2005. She previously served as National Executive Director of Girl Scouts of the USA from January 1998 until July 2002. Ms. Evans was a career officer in the United States Navy, retiring as a Rear Admiral in January 1998. She served as superintendent of the Naval Postgraduate School in Monterey, California from 1995 to 1998 and headed the Navy's worldwide recruiting organization from 1993 to 1995. She is a director of Weight Watchers International, Inc., Huntsman Corporation and Office Depot, Inc. She also serves on the Advisory Boards for the Ladies Professional Golf Association and the Pew Partnership for Civic Change, a project of the Pew Charitable Trusts, and is a director of the Naval Academy Foundation and America's Development Foundation.	60
Sir Christopher Gent	2003	Sir Christopher Gent has been non-Executive Chairman of GlaxoSmithKline plc since January 2005. He was Non-Executive Deputy Chairman of GlaxoSmithKline plc from June 2004 to January 2005. Prior to his retirement in July 2003, he had been a member of the Board of Directors of Vodafone Group Plc since August 1985 and its Chief Executive Officer since January 1997. Sir Christopher joined Vodafone as Managing Director of Vodafone Limited in January 1985 when the mobile phone service was first launched, and held that position until December 1996. Prior to joining Vodafone, Sir Christopher was Director of Network Services for ICL. In this role, he was Managing Director of Baric, a computer services company owned jointly	59

		by Barclays and ICL, and was responsible for ICL's computer bureau services worldwide. Sir Christopher was Knighted for his services to the mobile telecommunications industry in 2001. He is a Director of Ferrari SpA, a Senior Advisor to Bain & Company, Inc. and a member of the Advisory Board of Reform. He served as the National Chairman of the Young Conservatives from 1977 to 1979, and was Vice President of the Computer Services Association Council at the time he left ICL.	
Jerry A. Grundhofer	2008	Grundhofer is the Chairman Emeritus and retired Chief Executive Officer of U.S. Bancorp. Grundhofer served as the Chairman of U.S. Bancorp from December 2002 until December 2007. Grundhofer also served as President and Chief Executive Officer of U.S. Bancorp from February 2001 until October 2004 and December 2006, respectively. From 1993 until February 2001, he served as Chairman, President and Chief Executive Officer of U.S. Bancorp predecessors Firststar Corporation and Star Banc Corporation. Grundhofer is a director of Ecolab, Inc. and The Midland Company, Inc.	63
Roland A. Hernandez	2005	Hernandez is the retired Chairman and Chief Executive Officer of Telemundo Group, Inc., a Spanish-language television station company, where he served from August 1998 to December 2000. From March 1995 to August 1998, he served as President and Chief Executive Officer of Telemundo Group, Inc. Prior to that position, Hernandez was founder and President of Interspan Communications, a company engaged in a variety of services related to Spanish-language media. Hernandez is also a Director of MGM Mirage, The Ryland Group, Inc., Vail Resorts, Inc. and Wal-Mart Stores, Inc. In addition, Hernandez serves on advisory boards for Harvard University's David Rockefeller Center for Latin American	50

		Studies and Harvard Law School, as well as the board of Yale University's President's Council on International Activities.	
Henry Kaufman	1995	Dr. Kaufman has been President of Henry Kaufman & Company, Inc., an investment management and economic and financial consulting firm, since 1988. For the previous 26 years, he was with Salomon Brothers Inc., where he was a Managing Director, Member of the Executive Committee, and in charge of Salomon's four research departments. He was also a Vice Chairman of the parent company, Salomon Inc. Before joining Salomon Brothers, Dr. Kaufman was in commercial banking and served as an economist at the Federal Reserve Bank of New York. He is a member (and the Chairman Emeritus) of the Board of Trustees of the Institute of International Education, a Member of the Board of Trustees of New York University, a member (and the Chairman Emeritus) of the Board of Overseers of the Stern School of Business of New York University and a Member of the Board of Trustees of the Animal Medical Center. Dr. Kaufman is a Member of the International Advisory Committee of the Federal Reserve Bank of New York, a Member of the Advisory Committee to the Investment Committee of the International Monetary Fund Staff Retirement Plan, a Member of the Board of Governors of Tel-Aviv University and Treasurer (and former Trustee) of The Economic Club of New York.	80
John D. Macomber	1994	Macomber has been a Principal of JDM Investment Group, a private investment firm, since 1992. He was Chairman and President of the Export-Import Bank of the United States from 1989 to 1992, Chairman and Chief Executive Officer of Celanese Corporation from 1973 to 1986 and a Senior Partner at McKinsey & Company from 1954 to 1973. Macomber is a Director of Collexis	80

		Holdings, Inc., Stem Cell Innovations, Inc. and Stewart & Stevenson LLC. He is Chairman of the Council for Excellence in Government and Vice Chairman of the Atlantic Council. He is a Trustee of the Carnegie Institution of Washington and the Folger Library.	
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* Director prior to public listing on NYSE.

Source: Lehman Brothers Holdings 2008h, 48-52

Director Engagement

In addition to the lack of appropriate qualifications, diversity and the above average age compared to directors of other large corporations, is the issue relating to the level of engagement of directors in monitoring the activities of Lehman Brothers' management. As a qualitative question, it is difficult to assess. Media reports suggest that Fuld was "aggressive, confrontational and blunt" (Serwer 2006, 1). These characteristics suggest dealings with the CEO would have been problematic. Such a character would have required a strong-willed board willing to question the CEO. However, Serwer (2006, 2) suggests that "there is evidence the Board was not particularly structured to provide either oversight of management or strategic advice. Instead, the responsibilities of independent directorships appeared to be perfunctory".

As a whole, the board should possess core competencies which include relevant industry-specific or other specialised knowledge. If this concept is extended to the membership of a Board committee, then it would be expected that a board committee should consist of at least one member that is expert in the area for which the committee is responsible. The membership of the various board committees is set out in Figure 14.2.

Figure 14.2: Lehman Brothers' Board Committees

Committee	Members	Committee Function
Executive Committee	Chairman- Richard Fuld John Macomber	Has the authority, in the intervals between meetings of the Board of Directors, to exercise all the authority of the Board of Directors, except for those matters that the Delaware General Corporation Law or the Company's Restated Certificate of Incorporation reserves to the full Board of Directors. The Executive Committee acted by unanimous written consent 16 times during the fiscal year ended November 30, 2007 (Fiscal 2007)
Audit Committee (Must be independent under NYSE corporate governance and SEC rules)	Chairman- Thomas Cruikshank Sir Christopher Gent Michael Ainslie Roger Berlind	The Audit Committee assists the Board of Directors in fulfilling its oversight of the quality and integrity of Lehman Brothers' financial statements and its compliance with legal and regulatory requirements. The Audit Committee is responsible for retaining (subject to stockholder ratification) and, as necessary, terminating, the independent registered public accounting firm. The Audit Committee annually reviews the qualifications, performance and independence of the independent registered public accounting firm and the audit plan, fees and audit results, and pre-approves audit and non-audit services to be performed by the independent registered public accounting firm and related fees. The Audit Committee also oversees the performance of the Lehman Brothers' corporate audit and compliance functions. The Audit Committee held 11 meetings during Fiscal 2007.

<p>Compensation and Benefits Committee</p> <p>(Must be independent under NYSE corporate governance, SEC and the Internal Revenue Code rules)</p>	<p>Chairman-John Akers</p> <p>Sir Christopher Gent</p> <p>Marsha Evans</p> <p>John Macomber</p>	<p>The Compensation Committee has general oversight responsibility with respect to compensation and benefits programs and compensation of the Lehman Brothers' executives, including reviewing and approving compensation policies and practices, such as salary, cash incentive, restricted stock unit awards (RSUs), long-term incentive compensation and other programs, and grants under such plans. The Compensation Committee evaluates the performance of the CEO and other members of senior management and, based on such evaluation, reviews and approves the annual salary, bonus, share and option awards, other long-term incentives and other benefits to be paid to the CEO and such other members of senior management. The Compensation Committee also reviews and discusses the Compensation Discussion and Analysis with management and, if appropriate, recommends to the full Board of Directors that it be included in the Lehman Brothers' filings with the SEC. As a part of its review and establishment of the performance criteria and compensation of senior management, the Compensation Committee generally meets separately at least annually with the CEO, Lehman Brothers' principal human resources executive and any other corporate officers as the Compensation Committee deems appropriate. The CEO and the COO provide annual performance reviews and compensation recommendations to the Compensation Committee for</p>
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		each of the other executive officers, and the CEO does so for the COO in the latter's absence. The Compensation Committee held seven meetings and acted by unanimous written consent twice during Fiscal 2007.
Nominating and Corporate Governance Committee (Must be independent under NYSE corporate governance rules)	Chairperson – Marsha Evans Thomas Cruikshank John Macomber	Is responsible for overseeing Lehman Brothers' corporate governance and recommending to the Board of Directors corporate governance principles applicable to Lehman Brothers. The Nominating Committee also considers and makes recommendations to The Lehman Brothers' Board of Directors with respect to the size and composition of the Board of Directors and its Committees and with respect to potential candidates for membership on the Board of Directors.
Finance and Risk Committee	Chairman- Henry Kaufman Roland Hernandez John F. Akers Roger Berlind Marsha Evans	The Finance Committee reviews and advises the Board of Directors on the financial policies and practices of Lehman Brothers, including risk management. The Finance Committee also periodically reviews, among other things, budget, capital and funding plans and recommends a dividend policy and Common Stock repurchase plan to the Board of Directors. The Finance Committee held two meetings during Fiscal 2007.

Source: Lehman Brothers Holdings 2008h, 9-11

Two of the most important committees in the period preceding the collapse included the Audit and the Finance and Risk committees as they were responsible for the firm's financial position and risk profile. These committees were viewed as important in the oversight of the firm's accounting, finance and risk functions and therefore relevant to Lehman Brothers' eventual bankruptcy. Accordingly, members would be expected

to possess some experience in at least one of these fields of expertise. In view of the rapidly evolving nature of the investment banking industry, a current knowledge of the products and activities would be required to fully understand the corresponding risks and impacts on the financial position of the firm.

The Finance and Risk committee consisted of its Chairman, Henry Kaufman, president of Henry Kaufman & Company, Inc., an investment management and economic and financial consulting firm; John Akers, retired Chairman of International Business Machines Corporation; Roland Hernandez, retired Chairman and CEO of Telemundo Group, Inc; and Roger Berlind, and Marsh Evans whose relative inexperience was described above. One of the five committee members, Dr. Kaufman, possessed relevant financial markets industry experience (Lehman Brothers Holdings 2007). Members of both the audit and finance and risk committees were personally endorsed by Fuld (McDonald and Robinson 2009). Inadequate risk management practices were prevalent at Lehman Brothers (Valukas 2010 Vol 8, Tabs 8-22). A Finance and Risk committee lacking the necessary expertise and understanding of the complex risks faced by a modern investment bank could easily lead to a systemic risk management failure as experienced by Lehman Brothers. Fuld had a stated objective of growing the firm aggressively, and generating increasing profits on a quarterly basis. Any restrictions on this objective posed by the Finance and Risk Committee would have represented an obstacle to Fuld. Major transactional and balance sheet risks would be routinely assessed by senior management and brought to the Finance and Risk Committee, for endorsement or approval. As CEO, Fuld would have supported his senior management's recommendations on the proviso they were consistent with his own objectives. Therefore, it was in Fuld's interest to also have the Finance and Risk Committee approve the risks he supported. Given the shortage of expertise on the Finance and Risk Committee, the knowledge asymmetry, whereby management's expertise exceeded that of the overseeing Committee, represented fertile territory for Fuld to exercise his influence in the Committee's decision-making process.

The possession of superior knowledge and expertise over the Finance and Risk Committee enabled management to exercise power generated in Clegg's (1989) facilitative circuit. For the power to exist, the knowledge asymmetry needed to represent technology or innovation necessary in the business operations of the firm. In this scenario, management

recommendations relating to risk could be pushed through the Committee, whose potential to challenge the technical aspects under consideration were limited. The Finance and Risk Committee meetings represented the passage point for decisions to be implemented by management as evidenced by the minutes of the committee meetings. The approved recommendation would pass through the passage point to the episodic circuit where the action of implementing the recommendation would be carried out in the normal course of business. The authority to act in the episodic circuit was officially granted to the relevant employees—the agents—by the instrument of the committee minute which was generated under the influence of management. As a result, management were able to achieve the risk and credit exposures and balance sheet leverage it desired to maximise profits.

Lehman Brothers' Board of Directors conducted eight meetings during the fiscal year 2007. "Each Director attended 75% or more of the aggregate of (a) the total number of meetings of the Board of Directors held and (b) the total number of meetings held by all Committees of the Board of Directors on which he or she served. Overall Director attendance as a group at Board and Board Committee meetings during Fiscal 2007 was 96%" (Lehman Brothers Holdings 2008h, 18). Although these statistics appear acceptable when measured in aggregate, the focus of the Board's attention and relative pro-activeness of a committee can be gauged by the frequency each committee met. Figure 14.3 sets out the number of meetings for each board committee in the latest fiscal year prior to Lehman Brothers' collapse:

Figure 14.3: Number of Committee Meetings

Board Committee	Financial Year ended 30 November 2007
Executive Committee	16
Audit Committee	11
Compensation and Benefits Committee	7
Nominating and Corporate Governance Committee	Not available
Finance and Risk Committee	2

Source: Lehman Brothers Holdings 2008h, 9-11

During the 2007 fiscal year, a period when risks were escalating, and the financial markets were experiencing increased volatility, the finance and risk committee met only twice. Lehman Brothers' compensation committee instead convened seven meetings (Lehman Brothers Holdings 2008h, 9-11). The frequency of committee meetings could have reflected the relative importance to Lehman Brothers of the area covered by each respective committee. Based on this assumption, compensation arrangements were more important to Lehman Brothers than risk matters. As McDonald and Robinson (2009, 226) states: "King Richard had even turned Lehman's Board of Directors into a kind of largely irrelevant chamber. This was yet another group to rubber stamp his decisions and collect generous fees".

Referring to the failed financial institutions during the GFC, Gross (2010, 1) claims that "These companies had Board members who either weren't paying attention or, at Lehman in particular, were deliberately selected because they were unqualified or out of it". Gillespie and Zweig (2011) also find that directors were obliged to CEOs for their positions and were disengaged from the operations of the firms they were supposed to monitor.

Board Compensation

Lehman Brothers' board members were well compensated. Figure 14.4 for a table of Lehman Brothers' board members' compensation for the full year prior to Lehman Brothers' bankruptcy.

Figure 14.4: Lehman Brothers' Board Compensation in 2007

Non-Executive Directors ¹	Fees	Stock Awards	All Other Compensation	Total
	USD	USD	USD	USD
M. L. Ainslie	95,000	245,038	² 57,500	397,538
J. F. Akers	115,500	245,038	0	360,538
R. S. Berlind	107,500	245,038	0	352,538
T. H. Cruikshank	140,000	245,038	0	385,038
M. J. Evans	128,000	245,038	0	373,038
C. Gent	120,500	245,038	0	365,538
R. A. Hernandez	80,000	245,038	0	325,038
H. Kaufman	95,000	254,388	0	349,388
J. D. Macomber	132,000	245,038	0	377,038
Average				365,077

Notes:

1. Grundhofer is absent from the above list as he was appointed at the 2008 annual general meeting of Lehman Brothers.
2. In relation to serving as a Director, Chairman of the Audit Committee and a member of the Compensation and Benefits Committee of Fiscal 2007 for other Lehman Brothers' associated corporations, Lehman Brothers Bank and FSB, Michael Ainsle received additional cash compensation.

Source: Lehman Brothers Holdings 2008i

The above director compensation levels appear attractive when compared to the average non-executive director compensation for US corporations in 2006/2007. Figure 14.5 outlines the median of the non-executive director's compensation for the Fortune 500 list of US corporations in the 2006/2007 fiscal year. Compensation levels listed in Figure 14.5 include fees for participation in audit and compensation committees, which are two of the more common board committees in the US. The average amount paid to Lehman Brothers' directors of USD 365,077 represents more than double the national average of USD 181,250.

Figure 14.5: 2006/2007 Average Compensation Non-Executive Directors of Major US Corporations

Fortune 500 Non-Executive Board Director Compensation Median for 2006/2007	
	USD
Directors Fees*	165,000
Audit Committee	10,000
Compensation Committee	6,250
Total	181,250

Note* Directors' fees are defined as the sum of annual retainers and Board meeting fees, excluding any committee fees.

Source: Compensation Force 2017

Further, Lehman Brothers directors' compensation levels for 2007 ranked as the second highest of the peer group. This ranking is not considered extraordinary as Lehman Brothers was ranked second highest based on return on equity (ROE) for 2007. However, comparing compensation levels to returns ignores the other major factor in firm survivability (a responsibility of directors), which is the firm's level of risk. Figure 14.6 compares the US investment bank peer group's average compensation levels for directors to each firm's leverage which is considered a simple and appropriate measure of risk for this exercise. Any statistical analysis of the variables affecting compensation is complex and is outside the scope of this book. Therefore, the data in Figure 14.6 and related commentary are presented as observations of factors which may be considered as important in motivating director behaviour. Return on equity which is a measure of firm performance is also included in Figure 14.6 for comparison purposes. A firm which values prudent stewardship would reward effective risk management practice and attempt to adjust its director compensation level to account for a measure of risk.

Goldman Sachs stands out amongst the peer group as its director compensation level is significantly higher than all other investment banks. This is expected given its higher performance as measured by ROE. Moreover, Goldman Sachs was able to outperform its peers whilst maintaining the lowest leverage. This means that it is paying its directors a

proportionally higher multiple per unit of risk (as measured by leverage) indicating a reward for effective risk management.

However, this association is not clear for the other banks. A minimum level of director compensation would be required to attract board candidates regardless of the risk level of a firm. This implies there is a “fixed component” to compensation regardless of risk and return. Lehman Brothers had the second highest leverage of the peer group (behind Merrill Lynch) and yet paid the second highest director compensation (behind Goldman Sachs). Excluding Goldman Sachs, the firms’ leverage ratios are grouped within a narrow range of 32 to 37 times, whereas the ROE ratios vary considerably from -42.9% to 26.7%. Figure 14.6 shows the association between board compensation and return is strong, whilst the same cannot be said for the association between compensation and risk.

Figure 14.6: Director Compensation Compared to Firm Leverage

Investment Bank	Average Compensation per Director	*Leverage Ratio	Return on Equity (ROE)
	USD’000	Times	%
Goldman Sachs	641	24	35.2
LEHMAN BROTHERS	365	36	26.7
Morgan Stanley	343	32	8.9
Merrill Lynch	265	37	-42.9
Bear Stearns	226	35	5.5
Peer Group Average	368	32.8	6.7

*Note: Leverage = Total Liabilities / (Total Equity–Intangible Assets).

Source: Bear Stearns 2007b; Goldman Sachs Group 2008b; Lehman Brothers Holdings 2008i; Merrill Lynch 2008b; Morgan Stanley 2008b

The relatively high level of compensation earned by Lehman Brothers’ directors indicates two issues which support one of Aluchna (2013) concepts of board structure weakness– “inappropriate compensation

structure". Firstly, as mentioned above, the compensation structure seemingly ignores risk. Secondly, the compensation levels, representing a level well above the national average of US corporations, and the second highest level for the peer group, creates an incentive for Lehman Brothers' directors to remain on the board. This is borne by the relatively high longevity of tenure. An additional enticement not to resign from the board included a compensation structure which included options exercisable over the long term:

... The options have a ten-year term, are not forfeitable, and become exercisable in one-third instalments on each of the first three anniversaries of the grant date or sooner upon termination of service (Lehman Brothers Holdings 2008h, 14).

The above average level of compensation earned by Lehman Brothers' non-executive directors empowered the CEO by encouraging directors not to defect to Lehman Brothers' competitors.

Fuld's Power over the Board

Fuld was the linchpin between executive management and the board and appeared to have orchestrated the composition of the board. The combined factors of: a CEO also possessing the title of Chairman; a board whose members occupied their roles for a considerable number of years sufficient to build a familiarity with management; ageing directors mostly retired from their previous executive roles lacking in the currency of modern investment banking innovations; a major lack of relevant expertise and experience of most board committee members necessary to make informed decisions in their area of responsibility; attractive board compensation arrangements which enticed board members to remain on the board and perpetuate their longstanding friendly relationships with the Chairman; and a committee meeting schedule favouring compensation over finance and risk matters led to a less than optimal monitoring role and level of engagement from the board.

In analysing this orchestration, it can be seen that Fuld was able to exert his influence through all three of Clegg's (1989) circuits of power. In the episodic circuit, Fuld established social relations with the board as a group and individually, with its members. These relations were established informally through Fuld's intermittent interaction with each member on a

day-to-day basis. The board became Fuld's agency in generating the outcomes he wanted. His influence over the board's frequent decision-making was realised through his assembly of a board with limited capacities and means. Any of the abovementioned limitations could have contributed to the performance of the board. It could have included the lack of skill and expertise of members, or their ageing profile which potentially affected their cognitive abilities. In either case, Fuld harnessed this power to achieve his desired outcomes.

By arranging the directors' contractual appointments and related generous compensation packages which encouraged a degree of acquiescence, he fixed relations with the board. This fixing of relations is a condition for the generation of power in Clegg's (1989) dispositional circuit. Moreover, Fuld's social relationship with the board was formalised through his capacity as a formal leader of the group represented by his title of Chairman. Whether formalised, conveyed through various presentations or informally during board gatherings, the board were made aware of Fuld's strategy of growth (Lehman Brothers Holdings 2006). This type of communication reinforced Fuld's intentions for the firm, implying that any challenge to his strategy would be met with resistance.

Through interactions in the facilitative circuit where power is generated with knowledge and skill which is described by Clegg (1989) as a 'technology of production', the board was found to be deficient. It lacked the necessary experience, skill and knowledge to be abreast of the latest technologies of production, that is, the financial innovations occurring during the previous decade. A knowledge asymmetry existed between senior management who routinely operated in this complex environment and maintained currency, and certain board members, many of whom had no recent experience in the financial markets and some of whom were retired.

As this section illustrates, it is not only the structural elements of corporate governance that are important, but the qualitative aspects of a board such as skill currency, director engagement, effective independence and an ability to resist strong personalities within management. The following section explores how the relationship between the CEO and the firm's employees would shape the firm's culture into one which reflected the CEO's own set of values and beliefs.

CEO and the Employees

Fuld's overriding strategy was "growth". This strategy presumed that profitability would follow growth and with an increase in profitability would come an escalation in bonuses and firm reputation. Fuld's interactions with employees, viewed as a reflection of his management style, defined the firm's culture. This section analyses certain interactions and events which characterise his management style and its impact on the firm's culture. In order to fully understand the source of Fuld's management style, it is important to explore the influences on his early career.

Fuld developed a similar management style to that of Glucksman, his former boss, whom he revered. Auletta (1985, 16) describes Glucksman as a "jungle fighter" and according to an observation of a fellow board member at the time: "Glucksman's flaw was that there was an angry pig inside the man. He wasn't after money. He was after power, complete control" (Auletta 1985, 16). As Fuld had worked under Glucksman for an extended period, it is not surprising that some of his former boss' traits and prejudices were assimilated.

Glucksman's ascent to power occurred whilst presiding over the Trading Division, which generated the majority of the firm's profits in the early 1980s. Fuld shared this experience, where generating ever increasing profits ensured the retention of power and the enjoyment of large bonuses. An autocratic and dismissive management style which Fuld brought to his interactions with internal advisors could have stemmed from his observations of Glucksman. His suspicion of internal power struggles and fear of being usurped in a similar manner as Glucksman and Petersen beforehand, encouraged Fuld to value his hold over the leadership of the firm and taught him the benefits of possessing power. A key element of generating and maintaining power involved the way he interacted with employees.

Fuld's treatment of employees was generally driven by his motivation to generate growth for the firm and any employee who presented resistance or obstacles to this objective would suffer his scorn or worse still, dismissal. To gain an understanding of how Fuld's treatment of employees reflected his management style, a series of examples are presented below.

Madelyn Antoncic, 55 years old in 2007, and a PhD from The Stern School of New York University, was an experienced risk professional who prior to joining Lehman Brothers had worked for several well-known institutions. These included: The Federal Reserve Bank of New York as an economist; Goldman Sachs where, for twelve years she worked as a mortgage-backed structured products trader and later, headed the department of market risk management; and Barclays Capital New York Branch where, as the Treasurer for the Americas, she established the market risk function and later became a member of the executive committee and the board of directors. She was also a senior figure in the Girl Scout Movement of New York. In 2005, Antoncic was voted the 'Risk Manager of the Year' by Risk, an international risk journal, and she was also named among the US top one hundred most influential people in finance. Antoncic joined Lehman Brothers in 1999 and from 2002-2007, she served as Chief Risk Officer (CRO) reporting directly to Fuld. (Mathiason et al. 2009; McDonald and Robinson 2009).

It was common practice at most banks including Lehman Brothers to eject the originating deal team from any risk considerations relating to major transactions during an executive committee meeting. This was a common practice in view of the inherent bias to influence a deal approval by the deal team as more deals translated to higher potential bonuses. By late 2006, it was staggering when executive committee meetings convened to consider deals for approval, started to exclude the firm's highest risk specialist, Antoncic. This highly unusual move, initiated by Fuld, coincided with her cautionary advice and recommendations of a reduction in risk exposures. Her concern was that markets, especially the property market had become overheated (Onaran 2008). In September 2007, following her advice of caution to the executive committee, Antoncic was sidelined from her role as CRO, to occupy the position of Global Head of Financial Policy Relations where she remained until Lehman Brothers' bankruptcy. Valukas (2010, 46) in his report found that:

... Emails written by Lehman Brothers risk management personnel suggest that Lehman senior management disregarded its risk managers, its risk policies, and its risk limits. Press reports prior to Lehman's bankruptcy stated that in 2007 Lehman had removed Madelyn Antoncic, Lehman's Chief Risk Officer (CRO), and Michael Ge Lehman Brothers and, head of its Fixed Income Division (FID), because of their opposition to management's growing accumulation of risky and illiquid investments.

Two months after her transfer, at a risk management conference in New York, Antoncic declared that it was difficult for top management to accept the hedging of Lehman Brothers' mortgage positions as the hedges would curtail the firm's profit (Mathiason et al. 2009; Onaran 2008). In an interview in 2016, Antoncic revealed a glimpse of Lehman Brothers' risk culture describing it as one that did not prioritise the risk management function and that transactions involving credit risk were facilitated with a relatively easy approval process:

... The fabric was torn away little by little. We were encouraged to take more and more risks and it was not making a lot of sense. The biggest risk is complacency. By the beginning of 2007, I was sidelined because I was considered old fashioned...It's about culture...It sends a signal message to the rest of the teams and minimises authority of people in risk management. The head of the commitment committee wanted to approve anything that came in at the front door...This doesn't make a lot of sense. Everybody was working in silos, building up risks that were additive (Antoncic 2016).

Antoncic also expressed the difficulties in communicating with Fuld regarding risk matters, emphasising the need for a strong, confident character to overcome Fuld's resistance to prudent risk considerations. Antoncic implied that Lehman Brothers' risk culture should have emanated from the board and risk committee level, however, she herself questioned whether Lehman Brothers' board fully appreciated the appropriate risk tolerances for an investment bank:

... It was so important to have someone with a not shy, strong personality and confidence to be a risk manager to speak up...possess the right set of morals. A risk culture depends on having the right board and appropriate risk committee and needs to be strong to be able to challenge the chairman (Antoncic 2016).

Antoncic's comments confirm the findings of a weak risk committee, which together with the board did not possess the requisite expertise in risk matters, were unable to establish an appropriate risk culture and were allowed to be influenced by Fuld's strong character. Michael Gelband, who headed the Fixed Income Division was also induced to leave in May 2007 following his resistance to taking additional risk (Valukas 2010, 149). Gelband warned Fuld of an imminent market correction in the property market in line with Antoncic's advice and the CRAs' warnings, and during a

meeting with Fuld was told “You’re too conservative... You don’t want to take risk” (McDonald and Robinson 2009, 235).

Joe Gregory, COO and the second in command, held the same optimistic view on risk and growth as Fuld. He understood that to perpetuate growth in profitability, an increased level of risk was desirable. Gregory suited Fuld’s management style given that Gregory posed no threat to Fuld’s leadership and would carry out Fuld’s bidding unflinchingly (McDonald and Robinson 2009). In a similar warning as given by Gelband, Alex Kirk, the Global Head of Convertible Trading, cautioned Gregory of the unacceptable risk that Lehman Brothers was incurring. In a discussion about risk, and in taking his lead from Fuld, Gregory responded by telling Kirk, “You can stay if you want, but there’s no place for you” (McDonald and Robinson 2009, 279). Soon after this conversation in February 2008, Kirk resigned (RTT News 2008).

The above examples highlight Fuld’s use of power within two of Clegg’s (1989) circuits of power. The CEO or through his deputy, could hire, promote, transfer or dismiss subordinates, in accordance with the authority granted by the organisation’s established hierarchical reporting lines. The formal reporting lines represented obligatory passage points between the dispositional circuit and the episodic circuit. Fuld’s power was transmitted from the dispositional circuit where the power to hire or dismiss is established by formal rules contained in employment agreements. These agreements establish the hierarchy within the organisation. As CEO, Fuld was at the top of the management hierarchy and in this position held the ultimate power to dismiss an employee.

However, as senior advisors to Fuld and the executive committee, Antonic, Gelband and Kirk possessed authority sourced from their technical knowledge, expertise and relative seniority within the firm. This authority by each of the experts was formalised through their job design contained in their employment contracts and associated job descriptions. Both job design and technical knowledge are common traits which enable the generation of power in the facilitative circuit. They were therefore empowered to influence decision-making in the firm. As the experts projected a severe deterioration in the property market from 2007 onwards, the external environment in which Lehman Brothers operated, posed a significant challenge to the continuing strong financial performance of Lehman Brothers. In fact, the experts predicted excessive

financial losses given Lehman Brothers' over-exposure to mortgage-backed derivatives. Against this expected change in external economic conditions, the experts' power is reinforced within the facilitative circuit, where such power can be constituted through environmental contingencies. The facilitative circuit becomes a means of allowing variation in the circuits of power (Clegg 1989, 233). The expected change in economic conditions enriched the experts' power as their advice in such adverse conditions made it even more valuable. The transmission of this enhanced power through the passage point of the executive committee meetings was usurped by Fuld's disregard of their advice. Through the resolutions of the executive committee, Fuld could activate his decisions within the episodic circuit where such decisions would be carried out by operational staff under the passage points of routine instructions in the day-to-day activities of the firm.

The nullification of the experts' authority by Fuld exercising formal power obtained under the firm's hierarchical structure carried unintended consequences. Fuld could have exercised a consultative style of management by acceding to the learned advice and be a leader who respects others' opinions and applies measured and well-informed judgement. These leadership traits are often valued in an environment where innovation and initiative are important. However, by admonishing the experts, through the exercise of formal power, Fuld ran the risk of creating a culture of fear, and worse still, a culture potentially invisible to his organisational surveillance. Fuld's capacity to be remote from employees had already been recognised by staff who thought that "he was in some kind of ivory tower" (McDonald and Robinson 2009, 97). The CEO could be forgiven for pursuing a particular route which offered the path of least divergence to his own biased views. However, all three experts offered the same views on the risks posed by the mortgage and property markets in the US at the time. An opposition to an intellectual authority posed by a united and consistently strong view of the risks to the firm only heightened the animosity towards Fuld and created a catalyst for a change in the degree of loyalty. Ultimately, in their challenges to Fuld's views on risk, Antoncic, Gelband and Kirk experienced retribution in the form of either a transfer from their current position, reprimand or a persuasion to exit the firm.

The act of dismissal is viewed as an exercise of power transmitted from the dispositional circuit through to the episodic circuit. Clegg (1989) notes that

power can be transmitted in the episodic circuit as individuals attempt to address interpersonal conflicts. In the examples above, when Fuld or his deputy Gregory were confronted with opposing views to their own on the topic of risk, they exercised power simply by the act of removing dissenters from their positions. Gregory's (COO) own dismissal is another example of Fuld's exercise of power as a means of pursuing his own ambition to survive the leadership of the firm. Gregory was Fuld's trusted lieutenant of 30 years and not immune to Fuld's ire in this circumstance. On 12 June, 2008, Gregory was dismissed from Lehman Brothers following the announcement of a loss of approximately USD 2.8 billion for the second quarter of the 2008 fiscal year. McDade, a younger man known for his cautious approach to risk-taking was installed as the replacement COO (Plumb and Wilchins 2008b). This act of using Gregory as a scapegoat was carried out at a time when Fuld was fighting for survival and needed to convey a perception to the market that he was addressing the firm's risk profile. The severity of the decision to dismiss such a long-standing ally and the second most senior executive in the firm signalled a desperate attempt by Fuld to retain control. Ironically, it was engineered to appear as a sacrifice of a senior executive who was responsible for the excessive risk-taking of the firm yet the same attitudes to risk were shared by Fuld. The fact that Fuld remained as CEO signalled to the market his relative lack of culpability for the firm's financial difficulties.

The period following the announcement of such a large loss marked a point in time when the market's confidence in Fuld was in decline as reflected in Lehman Brothers' stock price. The decline in the fortunes of investors, the escalating risk to creditors and the increasing probability that staff would be compelled to forsake bonuses, led to a reduction in Fuld's apparent power. To neutralise the appearance of a loss of power, Fuld had decided to seek a scapegoat in the form of Gregory. Fuld's hope was that decisive action would quell an unsettled group of investors and creditors and increasingly disgruntled employees. The incongruity of the decision to dismiss Gregory was that both Gregory and Fuld had concurred on the same agenda of pursuing growth based on an elevated risk profile for the firm. However, Fuld appeared to take none of the responsibility. This inequitable imposition of responsibility for the loss was made possible by Fuld's power not only through his position in the hierarchy, but through the dramatic change in the firm's circumstances. The loss in the second quarter of fiscal 2008 was the first loss recorded by Lehman Brothers in

many years and therefore represented a massive change not only in the perceptions of the firm from an external viewpoint but also from an internal perspective. In order to retain the confidence of external investors and creditors as well as employees, Fuld needed to draw on his formal power to act. Given the severe change in the financial markets which contributed to the loss, Fuld was able to generate some power constituted through the change in environment, which is found in the facilitative circuit. The problem however arises that once the change in environmental condition is well-known and accepted as an existing condition, how would Fuld continue to generate sufficient power to overcome any further loss of confidence in his ability to lead the firm?

Mathiason et al. (2009, 1) observed in Lehman Brothers a “corporate culture that saw professional, knowledgeable risk managers sidelined in the rush to catch a rising market and gain ground on Lehman's pre-eminent rival, Goldman Sachs”. This observation is consistent with Fuld's ambition for continuous growth and a driver in his treatment of employees. Fuld's management style, through his interaction with employees, was characterised by a pattern of squashing dissenting opinions, a very insular view of the world and the hubris to think he possessed superior knowledge on risk.

Family comes Second

An analysis of power is useful to explain ways in which Fuld and his senior executive team were able to influence staff and their families on a day-to-day basis. The culture of Lehman Brothers and the values of its CEO were imposed on the families of employees. There were rules of behaviour expected of employees that also extended to spouses. An example of an event that characterises this feature is described below.

According to Ward (2010), Bradley Jack's wife Karin, recalls a time when she was invited along with other Lehman Brothers' executives and their spouses to inspect a house which Gregory, COO was building. Gregory sent his helicopter to pick up the party of executives. However, Karin Jack's son had just experienced a seizure and she declined to go, instead insisting she needed to visit a doctor. Notwithstanding Karin Jack's protests, Gregory still landed his helicopter near his guest's home and waited, assuming that the Jacks were still joining the Lehman Brothers' group. Karin Jack was

quoted as saying: “Can you imagine the pressure? I have this really sick child, but I know that if I don’t get on that helicopter it’s going to hurt Brad...If you made a personal choice that hurt Lehman, it was over for you” (Ward 2010, 133). Gordon (2010) recognises the dysfunctional culture at Lehman Brothers and the pressure for employees to dedicate a large portion of their lives to the firm:

... This company pretended to be united but they were ruthless, they couldn’t wait to knife each other in the back. What is really heinous about it is the hypocrisy. This was a place that had a diversity programme that was much lauded, yet they tried to get one guy to go to Asia, knowing he had a child with cerebral palsy ... In a welcoming ceremony with spouses present, he [Fuld] would thank them for all the cancelled dinners, weekends, and vacations they were about to experience.

Another example involved a direct report of Fuld. Fuld placed a great deal of importance on marital harmony, exemplified by the treatment of Chris Pettit who had an extramarital affair which defied Fuld's inferred rules on marriage (Truell 1997). Pettit’s error was compounded as his affair involved a Lehman Brothers’ female employee which had the potential to tarnish the reputation of the firm. Pettit’s dismissal was an exercise of Fuld’s power. As a senior executive, Pettit’s dismissal would have attracted the attention of the firm at large and potentially influence the firm’s culture by reinforcing socially constructed rules reflecting Fuld’s own values. The dismissal sent a clear signal to all staff that extra marital affairs would not be tolerated and thus became a “rule of practice”.

The above examples reinforce the potency of Fuld’s influence within the firm and with those connected to his employees. The evident coercion to behave in a certain manner is symptomatic of the exercise of power of one over another. Employees clearly understood, through their observation or knowledge of the treatment of Jack’s wife and the dismissal of Pettit, that certain expectations applied to their behaviour in order to survive in their roles. Ultimately, the rules reflected Fuld’s expectations of morals and values in his staff which he communicated clearly, whether by the welcoming speech to employees or through actions such as dismissals relating to behaviour inconsistent with Fuld’s view of the world. Fuld also manipulated the firm’s culture through an employee compensation plan. The following section explains how Fuld’s goal of becoming a pre-eminent US investment bank involved the attraction of the best talent available

within the market and remunerating them accordingly, with a bonus structure which encouraged an aggressive culture.

Employee Compensation

Nash (2003, 6) suggests there are four fundamental variables which dictate the amount of an employee's bonus: "The degree of individual power of the employee; the economic value that is being created; the complexity of that value; and finally, the degree of teamwork required". This section justifies a fifth element missed by Nash (2003). It involves the personal objectives of the CEO who in Lehman Brothers' case used financial incentives as a means of generating loyalty in order to pursue his growth agenda. This element is similar to the concept of bonding costs in agency theory as the additional cost of incentives assumed by the agent (manager) as a result of attempts to align their interests with those of the principal (stockholders). This is intended to assure the principal that the agent will not take inappropriate actions to the detriment of the principal. In this analogy, the concept of bonding costs relates to the payment of incentives to employees in order to align employee interests with that of the CEO.

The first of Nash's (2003) factors warrants discussion due to its relevance to the investment banking industry. Individual power is described by Nash (2003) as the power an employee possesses in their compensation negotiations with the firm. An employee's negotiating power arises from the scarcity of relevant skills available in the market place and the value an employee can generate for the firm. According to Nash (2003, 6) "their [investment banks] strategy for allocating the bonus pool was to protect the 'crown jewels' and prevent them from leaving the organisation". 'Hold-up capital' is a term used by Wang et al. (2009), which is similar to the individual power factor proposed by Nash (2003). In this instance, the premium over the average salary commanded by a skilful employee is referred to as hold-up capital which according to Nash (2003) is amplified for employees in the financial services industry.

In instances where competition for an employee's skills exists industrywide, the hold-up capital increases commensurately. The consequences for a valuable employee leaving the firm are costly. The investment banking industry has traditionally attracted high achieving and skilled employees who are often in high demand within industry generally. In such an

environment, relatively high hold-up capital in the form of salary and bonus levels are commonly observed. Figure 14.7 draws a comparison between the average salary for the US investment banking industry and the average for all non-government industries in the US for 2008.

Figure 14.7: Comparison of Investment Banking and All US Industries Salaries for 2008

Salaries Excluding Bonus	Investment Banking Industry	All US Industries (excluding government)	Premium over Total US Average
	USD	USD	
Mean Salary	84,000	42,270	99%
Median Salary	62,250	32,390	92%

Source: United States Bureau of Labour Statistics 2008

Nash (2003) ignores the influence of the CEO as a variable in determining the amount of an employee's bonus. A CEO may have personal ambitions of positioning the firm as a market leader, consequently willing to offer employee compensation well above the market clearing level. This desire could be driven by a range of motivations from market strategy to personal ego, however, whatever the reason, the CEO of a publicly listed corporation would need to exercise a high degree of influence to ensure compensation outcomes are met. From persuading the compensation committee to impelling the Board of Directors to follow the CEO's personal preferences requires a persuasive ability that is associated with a position of power.

Fuld understood the advantage of employing top performing staff in an industry where the quality of employees and the tacit skills they possess are considered a valuable resource. In an interview Fuld stated that one of his main strategic objectives was to surround himself with top performing employees. "You can't be afraid that if the people you hire look good, that diminishes you ... if you want to run an 'A' firm, 'B' people can't get it done" (Wharton School of the University of Pennsylvania 2007). Fuld's determination in competing for top performing staff is evidenced by his

recommendation to Lehman Brothers' Compensation Committee for the 2008 fiscal year which is captured by the Compensation Committee Report (CCR) (Lehman Brothers Holdings 2008f). This annually produced report sets out the recommended level of cash compensation (salary plus cash bonuses) for the firm's group of employees in total. The cash compensation level was expressed as a ratio of total cash compensation proposed to gross revenue achieved for the past year. This ratio was the basis used to determine the ensuing year's compensation for all employees and was separated at a divisional level. The formula was known as the Compensation Ratio (Comp Ratio). The key determinant of the total cash compensation proposed factor in the formula included the relative changes in gross revenue and earnings per share for the divisional group and the relative standing of compensation per employee within the same group. Other subjective measures were used such as growth opportunities and general business conditions (Lehman Brothers Holdings 2008f, 2-4). Equity based bonuses were granted in addition to total cash compensation (Lehman Brothers Holdings 2008f, 2). Figure 14.8 shows the equity compensation granted to employees in 2006 and 2007.

Figure 14.8: Equity Awards Granted to Staff as Part of Lehman Brothers' Incentive Scheme

Equity Awards Granted	2006	2007	% Increase
	Shares in Millions	Shares in Millions	
Awarded during the fiscal year	11	38.8	
Adjustments:			
Earned in 2006 but reported in 2007	35	-35	
Earned in 2007 but reported in 2008		50	
Net Equity Awards Granted	46	53.8	17%

Source: (Lehman Brothers Holdings 2008k, 6)

The objective variables used for Lehman Brothers' 2008 Comp Ratios include data set out in Figure 14.9.

Figure 14.9: Variables Used in Determining Lehman Brothers' 2008 Compensation Ratio

Variables	Goldman Sachs	Lehman Brothers	Morgan Stanley	Bear Stearns	Merrill Lynch
% Change in Revenue 2006 to 2007	22%	10%	-6%	-36%	-67%
% Change in EPS 2006 to 2007	26%	70%	-60%	-89%	-250%
2007 Compensation per Head (USD)	661	332	343	242	248
2006 Compensation per Head (USD)	622	334	324	320	300

Source: Lehman Brothers Holdings 2008f, 3

An important feature of the CCR was the relative standing of Lehman Brothers' Comp Ratio with those of its peer group. A comparison of 2006 and 2007 Comp Ratios of all major US investment banks is outlined in Figure 14.10.

Figure 14.10: Comparison of Compensation Ratios of US Investment Banks – 2006/2007

	Goldman Sachs	Lehman Brothers	Morgan Stanley	Bear Stearns	Merrill Lynch
2007 Comp Ratio	43%	49%	59%	57%	141%
2006 Comp Ratio	44%	49%	47%	47%	49%

Source: Lehman Brothers Holdings 2008f, 3

For the 2008 fiscal year, Fuld recommended to the Compensation Committee a Comp Ratio of 52.8%, placing it at a level above the 2006

Comp Ratios of all peer group members even though it represented a level below those recorded by the peer group in 2007 (Lehman Brothers Holdings 2008f, 2). At the recommended level it would also result in a 5% increase in compensation per employee for 2008 (2007: -1%). Fuld feared that any Comp Ratio selected for 2008 which was below that of its nearest competitors' 2006 Comp Ratio could generate a flight of key staff. Lehman Brothers' 2007 Comp Ratio of 49% seemed out of line with that of its competitors and was the second lowest of its peer group. The relatively low Comp Ratio in 2007 was acknowledged by Fuld as a means of maintaining discipline (Lehman Brothers Holdings 2008f, 2). However, this lower Comp Ratio was offset by a 17% increase in long-term stock awards for the same year – refer to Figure 14.7. Only the most senior of executives were awarded stock incentives, therefore, despite the Comp Ratio remaining relatively low for 2007, senior executives, including Fuld and his direct subordinates, were able to achieve an increase in the combination of short term and long-term incentives from the previous year—well above those of its peer group.

Fuld's 2008 CCR recommendation was based on the importance of surpassing the peer group's anticipated 2008 Comp Ratios. His main argument focused on the importance of keeping talented staff members and attracting other leading operatives in the industry. Fuld's objective was for:

... repricing key talent to retain at Lehman if bid away... and to take advantage of a significant pool of talent [which] will become available, as many of our competitors top performers become disillusioned with their firms' strategies and risk management (Lehman Brothers Holdings 2008f, 2)

The reference to disillusionment with risk management is an inference to Lehman Brothers' higher appetite for risk relative to the peer group and therefore an environment where potential new high performing staff could increase their bonuses. The propensity to award equity-based compensation to employees is evidenced by the growth in employee ownership of the firm since its incorporation. "When the firm went public, employees owned four per cent of the firm, worth USD 60m. By 2006, they owned around 30 per cent, equivalent to USD 11 billion, at least on paper" (Oliver and Goodwin 2010, 80). A lucrative employee compensation structure is often viewed as the most effective incentive available. Fuld remunerated top performers who exhibited entrepreneurial traits and those who showed inclinations for risk taking (McDonald and Robinson 2009). This

is supported by the firm's stated strategy originated in 1994 which encouraged an alignment of compensation with the maximisation of returns:

... Lehman Brothers' human capital strategy is to attract and retain the most talented employees and to strongly align their interests with maximizing Company performance and stockholder return. Our strategy regarding our employees has remained consistent since becoming a public company in 1994 and, we believe, has been instrumental in helping the Company achieve its goals over time (Lehman Brothers Holdings 2008h, 19)

Although the concept of linking compensation to the maximisation of returns is not unusual from an agency perspective, there is no mention of achieving an acceptable level of risk in the quote above or in any other official documentation describing Lehman Brothers' compensation policy.

From the time he became CEO and Chairman in 1994 to the time Lehman Brothers filed for bankruptcy on September 15, 2008, Fuld presided over an increase of personnel expense per employee of 100%, an almost 6% per annum compounded growth rate—refer to Figure 14.11 for a graph showing the escalation of expense per employee between 1994 and 2007.

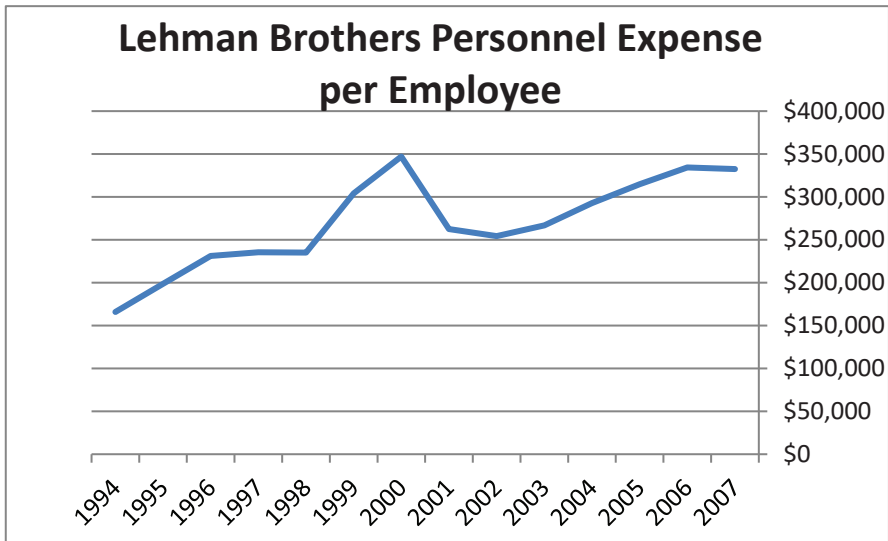


Figure 14.11: Lehman Brothers' Personnel Expenses per Employee 1994-2007
Source: The data used for the graph were extracted from Lehman Brothers Holdings (2008f, 5)

A further analysis of the trend in personnel expenses is gauged by the proportion they constituted of the firm's performance indicators of net revenue and net profit after tax. Refer to Figure 14.12 for a table of the relative attribution of employee expenses to these performance indicators.

Figure 14.12: Employee Expenses as a proportion of Net Revenue and Net Profit After Tax

	2006	2007
	USD Millions	USD Millions
Net Revenue (after interest expense)	17,583	19,257
% Increase from 2006 to 2007		10%
Net Profit After Tax (NPAT)	3,941	4,125
% Increase from 2006 to 2007		5%
Employee Expenses (EE)	8,669	9,494
% Increase from 2006 to 2007		10%
EE/NPAT	220%	230%
EE/NR	49%	49%

Source: Lehman Brothers Holdings 2007, 85

The increase in personnel expense per employee is consistent with the increasing proportion of personnel expenses to net profit after tax, increasing from 220% in 2006 to 230% in 2007. Personnel expenses were also able to track the significant increase in Lehman Brothers' Net Revenue (gross revenue less interest expense) whereby it remained at 49% of net revenue from 2006 to 2007.

Fuld advanced his career mostly in a trading environment where problem solving skills and an aggressive risk-taking attitude are considered positive attributes. He therefore appreciated personnel who displayed these same attributes in a business where financial outcomes are transparent and easily measurable (McDonald and Robinson 2009). His preferred means to motivate staff was through an employee compensation structure which

grants equity in the firm. "One of the most important elements of Fuld's plan to develop a culture of teamwork at Lehman Bros. has been to link compensation to the overall performance of the firm through equity awards" (Wharton School of the University of Pennsylvania 2007). Fuld also understood that to motivate staff to pursue higher performance they needed to think like stockholders. "A culture built on teamwork leads to the best business decisions for the firm as a whole, and paying employees in stock helped reinforce that culture. I wanted them all to think and act and behave like owners" (Wharton School of the University of Pennsylvania 2007). Consistent with Jensen and Meckling (1976) agency theory maxim of "management's objective to maximise stockholder wealth", Fuld ensured senior management accumulated a large portion of equity in Lehman Brothers. As stockholders, management were incentivised to take risks so long as Fuld's optimistic view regarding the economic environment prevailed and the firm's risk limits allowed. It was therefore important that if Fuld wanted to motivate staff, and generate the desired level of "bonding", senior management were to be allowed to operate within flexible risk limits and possess a large amount of equity. As equity awards were vested on an average of 3.8 years as mentioned below, Fuld intended to hold onto good performers for the long-term (Lehman Brothers Holdings 2008h, 32).

Lehman Brothers operated a number of equity-based incentive compensation schemes which applied to the senior executive team including Fuld. Equity incentives accounted for the bulk of the senior executives' overall compensation. "Fuld, Gregory, Russo, O'Meara and Lowitt received 88%, 85%, 64%, 70% and 70% respectively of their total annual compensation in equity. The weightings of cash and equity were determined collaboratively by Fuld, Gregory and the Compensation Committee" (Lehman Brothers Holdings 2008k, 4). Whilst the stock price of Lehman Brothers climbed, these senior executives' wealth increased dramatically. According to Lehman Brothers Holdings (2008k, 4), Lehman Brothers stated that "the repurchase program has prevented stockholder dilution, while allowing the Firm to benefit from the employee commitment generated by broad based employee ownership". This public comment seems to justify the relative high level of stock award bonuses paid to senior executives by assuring stockholders that their value of stock had remained unaffected by the bonuses, thereby abiding by the firm's code of ethics.

The equity-based incentives are in addition to the abovementioned personnel expenses (Lehman Brothers Holdings 2008f). According to Lehman Brothers Holdings (2008h, 25-7), for the year ended 30 November 2007, Lehman Brothers expensed incentive costs of USD 1.3 billion related to these equity-based incentive schemes, up from USD 1.0 billion in 2006—representing a substantial 30% increase. Excluded from this amount was another expense of USD 514 million which related to extra stock awarded to employees during the month of December 2007. This additional stock-based compensation was accrued as compensation expense in the financial year ending 30 November 2007 as it was argued it related to staff performance during fiscal 2007. Therefore, the total amount of stock incentives awarded during the 2007 fiscal year had reached over USD 2 billion, which was over and above the cash compensation allocations. Stock incentives which had not vested as at 30 November, 2007, and therefore remained unrecognized in the financial statements totalled another USD 2.0 billion. This amount, included in the notes to the Lehman Brothers' 2007 annual report, was expected to be expensed over a weighted-average period of 3.8 years. This was in accordance with the vesting provisions and with the prevailing accounting treatment for stock-based compensation found in accounting standard Accounting for Stock Based Compensation—FAS 123, prevailing in 2007/2008 (Financial Accounting Standards Board 2004).

A major portion of the firm's incentive-based compensation was awarded to Fuld and his team of senior management (Lehman Brothers Holdings 2008h, 25-7). Although the details of the formula used for Fuld and his direct subordinates is not disclosed, Lehman Brothers acknowledges that it was based on a percentage of pre-tax profit. "The Fiscal 2007 incentive formula for each executive officer was based on percentages of Pre-tax Income, which declines as the amount of Pre-tax Income increases up to USD 5.3 billion (beyond which the percentage is fixed). The incentive formula is expected to yield a bonus payment, except in the event of a loss" (Lehman Brothers Holdings 2008h, 24). The rates on the sliding scale are not disclosed. However, the maximum percentage at the end of the sliding scale payable to senior executives once the target of USD 5.3 billion is reached is represented in Figure 14.13.

Figure 14.13: Senior Executive Incentive Scheme Formula

Executive Name	Maximum Percentage of Pre-tax Profit
Richard Fuld	0.75%
Joseph Gregory	0.57%
Tomas Russo	0.50%
Christopher O'Meara	0.25%
Ian Lowitt	0.25%

Source: Lehman Brothers Holdings 2008h, 25-7

According to Lehman Brothers Holdings (2007, F-10), Lehman Brothers' pre-tax profit of USD 6.01 billion for 2007 exceeded the threshold of USD 5.3 billion, thereby enabling each senior executive to receive their maximum compensation payment at the rates depicted in Figure 14.13. In establishing the above formula, Fuld with the assistance of the Compensation Committee established key performance objectives for his executive team. These objectives were intended to drive the team to pursue Fuld's growth strategy and included:

Expanding the firm's international franchise; strengthening the Company's brand; exploring and creating strategic opportunities; diversifying and building business units; improving employee programs; and the firm's budgetary goals (Lehman Brothers Holdings 2008h, 25).

The compensation paid to the senior executive team for the year ended 30 November 2007 is included in Figure 14.14.

Figure 14.14: Senior Executive Compensation-2007

2007 Lehman Brothers Executive Compensation					
Executive		Salary	Cash Bonus	*RSUs	Total
		USD	USD	USD	USD
R. S. Fuld, Jr.		750,000	4,250,000	35,000,000	40,000,000
J. M. Gregory		450,000	4,550,000	29,000,000	34,000,000
T. A. Russo		450,000	4,550,000	9,000,000	14,000,000
C. O'Meara		200,000	2,650,000	6,642,857	9,492,857
I. T. Lowitt		200,000	2,650,000	6,642,857	9,492,857

Note: *RSU's = restricted stock unit awards

Source: Lehman Brothers Holdings 2008h, 26

Fuld's own compensation was set by the Compensation Committee. Key factors taken into consideration in formulating his compensation included the same objectives used for the senior executive team mentioned above, in addition to projected and historical financial performance as well as the following as stated in Lehman Brothers' Schedule 14A Statement lodged with the SEC on 5 March 2008:

... the firm's financial performance in Fiscal 2007, his role in leading the Company through the challenging market environment, and orchestrating the Company's strategic direction and objectives including the continued diversification of the Company across businesses, regions and products which was important to the Company's financial performance in Fiscal 2007 (Lehman Brothers Holdings 2008h, 26).

The above shows that there is a focus in Fuld's compensation criteria to pursue growth and diversification. Fuld pursued both, including his continued push for acquisitions. According to information included in SEC filings governed by the Code of Federal Regulations, the top five executives at Lehman Brothers received substantial bonuses as part of their overall compensation arrangements for the period 2000 to 2008. The group of executives included in the top five changed slightly from year to year and as identified by SEC filings included: "Richard Fuld, CEO from 1993 through 2008 and chairman of the Board from 1994 through 2008; David Goldfarb, CFO from 2000 through 2004 and CAO from 2004 through 2006; Joseph Gregory, co-COO from 2002 through 2008 and COO from 2000 through 2002; Christopher O'Meara, CFO from 2004 through 2007 and previously in various management positions at the firm (since 1994); and Thomas Russo, CLO from 1993 through 2008. Fuld and Gregory were NEOs throughout the 2000-2008 period, Russo from 2003 through 2008, Goldfarb from 2004 through 2007, and O'Meara in 2007 and 2008" (Lehman Brothers Holdings 2008i, 14-8). In aggregate the group "earned approximately USD 1 billion, in cash bonuses and equity sales during 2000-2008" (Bebchuk et al. 2010, 4). This excludes stock that they continued to hold.

An example of the preparedness of the Compensation Committee to reward Fuld was during the major US financial crisis of 2001. As a result of the financial crisis, most investment bank CEOs including those at Goldman Sachs, Morgan Stanley, and J. P. Morgan Chase, had their compensation packages reduced. At the same time, Lehman Brothers, which outperformed

the industry, rewarded Fuld with a compensation package valued at USD 105 million representing the fourth highest for a US CEO in 2001 (Reference for Business 2017). This exorbitant level of compensation was awarded despite Lehman Brothers recording a significant reduction of 30% in net profit after tax as shown in Figure 14.15.

Figure 14.15: Net Profit After Tax for Fiscal Years 1999, 2000, and 2001

	2001 USD million	% Change	2000 USD million	% Change	1999 USD million
Net Profit After Tax	1,161	-30%	1,667	61%	1037

Source: Lehman Brothers Holdings 1999, F2; 2002, F2

Comparing the returns of the senior executives to stockholders over the period 2000 to 2008 reveals an incentive problem inherent in the compensation arrangements at Lehman Brothers. The problem relates to the absence of a risk adjustment mechanism within the performance-based compensation of Lehman Brothers' employees and senior executives. Risk adjustment could entail the profiling of the risk of the firm using a variety of techniques including alignment with balance sheet risk (as measured by leverage), credit ratings, stock beta, or a combination of several measures. Further, a large portion of bonuses could have been calculated retrospectively. Retrospective bonus payments could allow sufficient time to ensure current business written did not cause subsequent losses in future periods. In these instances, bonuses could be withdrawn thereby aligning compensation with sustainable business performance. Whilst Lehman Brothers included a deferred stock component in the compensation plan for employees and senior executives, some of this stock could not be withdrawn except in certain employment termination cases. The deferred stock plan was intended to retain employees over the medium-term rather than provide a risk adjusted incentive. Further, none of the independent directors were compensated on a risk-adjusted basis (Lehman Brothers Holdings 2008h, 14-26).

Rational stockholders according to Modern Portfolio Theory undertake investments based on a trade-off between expected risk and return. Consistent with this theory, as Lehman Brothers' performance deteriorated, the value of Lehman Brothers' shares decreased accordingly, ultimately

resulting in a complete loss of value by the time of bankruptcy. However, as mentioned above, during the final years of Lehman Brothers, the senior executive team were rewarded handsomely, with performance-based compensation of approximately USD 2 billion. The difference in compensation between stockholders and Lehman Brothers' executives implies that "the executives' pay arrangements provided them with excessive risk-taking incentives" (Bebchuk et al. 2010, 4). Any sign of deterioration in net profit would have resulted in lower stock compensation therefore it would have been in management's interest to avoid publishing a decline in net profit after tax—the key determinant of stock awards. Further as Modern Portfolio Theory suggests, there is an incentive for executives to increase risk if they seek higher returns.

The disparity between stockholder and executive returns is explained by the flawed compensation plan which neglected to adjust bonuses for the underlying risk carried by the relevant business unit or employee. The need for a consistent approach to the linking of risk to compensation was acknowledged in the aftermath of the GFC. "A risk-sensitive compensation framework provides the appropriate incentives for employees, and establishes a superior link between the actions of those employees and the firm's overall risk profile" (Kroszner 2008). The absence of a risk-sensitive compensation framework led to risk-taking behaviours in an effort to maximise bonus levels. The year-on-year expectation of abnormally high bonuses, generated a culture of excessive risk-taking in order to maximise short-term profits. Downside risk to the employee was minimal. Employees were not required to repay bonuses once awarded if performance in the ensuing period erased all the gains of the period on which the bonuses were calculated (Bebchuk et al. 2010). At worst, the employee would be terminated, however, given the scarcity of skills in the investment banking industry during that same period, the consequences for an employee were deemed relatively immaterial.

Fuld understood the advantage of employing top performing staff in an industry where the quality of employees and the tacit skills they possess are considered a valuable resource. As a service industry which relies heavily on the performance of its employees, the investment banking industry generally values an effective compensation framework. The effectiveness of a compensation framework in an industry which also deals with multiple and high risks needs to balance the performance of the

individual with the risks they incur for the firm. This is particularly noted within the risk management profession:

... An effective risk-sensitive compensation regime, properly embedded in a strong strategic risk management framework, can generate changes in behaviour so that the firm's employees refrain from taking on risk beyond the firm's stated risk appetite. Most importantly, such a compensation regime must offer the appropriate incentives to assume appropriate levels of long term and short-term risks during various economic cycles (Kroszner 2008).

Lehman Brothers awarded especially attractive compensation ratios during the period between 2004 and 2006. "Lehman Brother's Compensation Committee cited record net revenues, pre-tax income, net income, and earnings per share, as well as an increase in the firm's share price of 17% during the fiscal year 2006, in its decision to award bonuses for fiscal year 2006" (Bebchuk et al. 2010, 267). The use of only one year's performance, in this case that of 2006, supports the view that the Compensation Committee was using short term performance as its primary performance indicator for the establishment of a particular year's incentives.

Therefore, we can partly disassociate Lehman Brothers' incentive scheme from the long-term risk-related decision-making process compatible with the long-term interests of stockholders. Risk-related decisions were taken without the benefit of foresight of an impending collapse. However, Fuld would not be paying large incentives unless there was a dollar return to the firm or himself. Short-term incentives can create more immediate and self-serving behaviour which suited Fuld in a fast-paced industry which is characterised by pressure to generate good results on a quarterly basis, and a reactive share price.

The excessive compensation arrangements also encouraged teamwork and a consensus view of the direction of the business (Nash 2003). Serwer (2006) quotes Skip McGee, a previous head of investment banking as saying: "Instead of trying to divide fees up and allocate them to different bankers and departments, for purposes of compensation calculations, we just double-count revenues". Although this practice inflated the basis of bonus calculations due to the 'double' counting of team and individual bonus allocations, it had incentivised employees to help one another, supporting the group capture by Fuld of the loyalty of his employees and fuelled a transaction-oriented investment banking operation. Lehman

Brothers' employees were driven by the same forces which drove Fuld's own self-interest, thereby, enabling Fuld to inculcate the culture of the organisation with his own values and beliefs. It could be said that Fuld was 'drinking out of the same trough as staff' and his entrenched and shared belief system within the firm could explain the unusual loyalty he generated. In enriching his staff, he was able to enrich himself.

Excessive optimism, combined with a behavioural pattern shaped by a culture highly influenced by the CEO created an elevated state of hubris at the core. The hubris of the CEO and the power he exerted over employees and the board infected the decision-making of key executives who had a genuine interest in the survival of the firm and the continuation of their careers. At the centre of the hubris was Fuld's faith that the power of the CEO and the firm would overcome any obstacles. The following section illuminates the culture of Lehman Brothers by exploring the rhetoric used in certain communication devices used by the firm such as presentations and internal emails. By influencing culture, Fuld was able to exercise power over his employees with the aim of encouraging conformity to his own values and beliefs.

Communication as a Window

Communication through language establishes meaning within an organisation. The language can be conveyed either verbally, in print, or physical expression, such as a frown. Meanings can affect the culture within by establishing expectations of behaviour. In return, culture can have an effect on meanings, as a particular use of language can be interpreted differently by different cultures. Cultures can be influenced especially if the language emanates from an organisation's leadership who possess power over behaviour (Eccles et al. 1992; Westbrook 2013). Westbrook (2013, 57) establishes the nexus between communication and culture and asserts that "one cannot think of communication (one cannot speak) outside of a culture". Therefore, selecting the language and the environment in which it is delivered to express expected morals, values and beliefs is deemed an important method of shaping a culture of an organisation. Fuld's internal and external communication, a key component which defined his management style, also contributed to the intensification of a culture which began with the founders of the firm and perpetuated by successive leaders. The communication represented

passage points through which Fuld was able to transmit power. This section analyses certain examples of communication used at Lehman Brothers and covers formal visual presentations, verbal and email communications. Rhetoric, including the tones and underlying meanings within the language used, is analysed to illuminate the direct and underlying messages conveyed to employees by the senior leadership of the firm.

Fuld avoided direct contact with employees: “our battlefield commander [Fuld] was an extremely remote and watchful character surrounded by a close coterie of cronies, with almost no contact with anyone else” (McDonald and Robinson 2009, 90). This type of introverted behaviour exemplified by physical remoteness was Fuld’s preferred *modus operandi*. It was clear that Fuld made the key decisions whilst using his immediate subordinates to communicate them to the general staff. “The environment has become so insular... Fuld OK’d decisions, but Gregory packaged material so that the choice was obvious. And the executive committee offered no counterweight” (Fishman 2008, 5). Fuld was CEO of one of the major US investment banks with a staff complement of 25,000, and total revenue of over USD 53 billion (Cook 2009). Many CEOs of large corporations prefer to circulate amongst employees to gauge feedback and monitor operational issues including staff morale. Avoiding direct communication with the wider staff, Fuld needed alternative channels to convey his messages.

“Extremely Doable” and other Rhetoric

In 2006, one year before the deterioration in Lehman Brothers’ performance, Fuld and Goldfarb Chief Administrative Officer (CAO), delivered the firm’s global strategy at an offsite conference for senior executives using a slide presentation, known as the Global Strategy document (Lehman Brothers Holdings 2006). This is a key document as it presented Lehman Brothers’ strategy for the three years up to 2009. It can therefore be viewed as the guiding template used by management to execute their operational and strategic decisions immediately prior to the firm’s bankruptcy. It represented Fuld’s vision and objectives for the firm. Of interest, is how it was communicated, which metrics and concepts are included, and just as importantly, that are excluded from this narrative? The Global Strategy document reinforced Fuld’s growth agenda in a variety of ways. An

examination of the rhetoric used reveals an unequivocal intent to convey the “growth” message to all senior executives.

Rhetoric is a useful tool to influence others to the “viability, credibility and plausibility of...positions, beliefs, problems solutions and perspectives” (Young 2003, 623). The Global Strategy document was written in such a way as to persuade the audience consisting of senior executives to follow and understand the stated path of “growth”. Although some of the persuasive elements within the document are subtle, a rhetorical analysis reveals how they establish meanings, communicated in a way that could be clearly understood by the intended audience. The selection of certain words was intended to complement this persuasive process and according to Summa (1992, 138), to construct a power “to change the world, giving rhetoric both philosophical and political importance by demonstrating its connections with forces that shape reality”.

The Global Strategy document comprises thirty-eight slides. The communication style incorporates dot points and punchy sentences presented with colour and many statistics, figures, graphs, and financial terms which could only be understood by those with a professional financial background. This style of communication appealed to the audience who, as senior executives of an investment bank, would boast similar backgrounds. Operating in a time poor environment, the style suited their use of day-to-day communication. In this atmosphere where efficiency is rewarded, any tool which saves time, such as clear, economical and concise communication would be preferable. Immediately, the appeal of the mode of communication would have the effect of engaging the audience.

The content of the slide presentation is divided into two parts: the first part detailing the historical record of achievement to date [2006], including measures dating back to incorporation in 1994; and the second part outlining the future strategy for the ensuing three years. The introduction page of the whole document is set out in Figure 14.16.

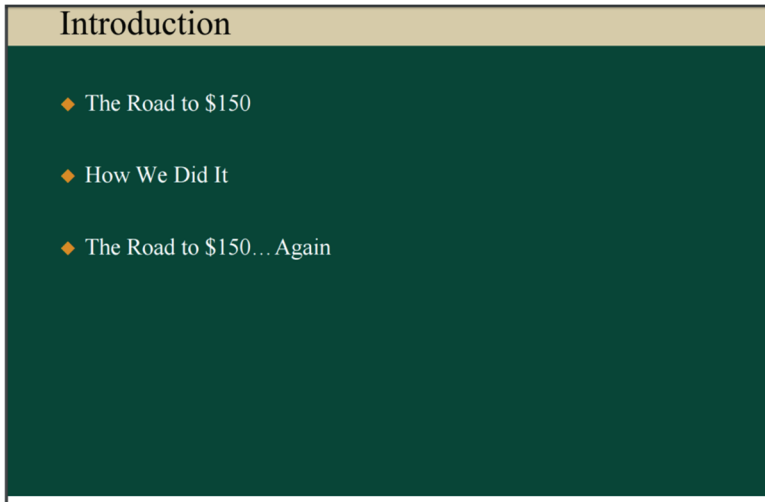


Figure 14.16: Introduction to Global Strategy Presentation March, 2006
Source: Lehman Brothers Holdings 2006, 2

The first page of the second part of the presentation dealing with forward looking strategy is set out in Figure 14.17.

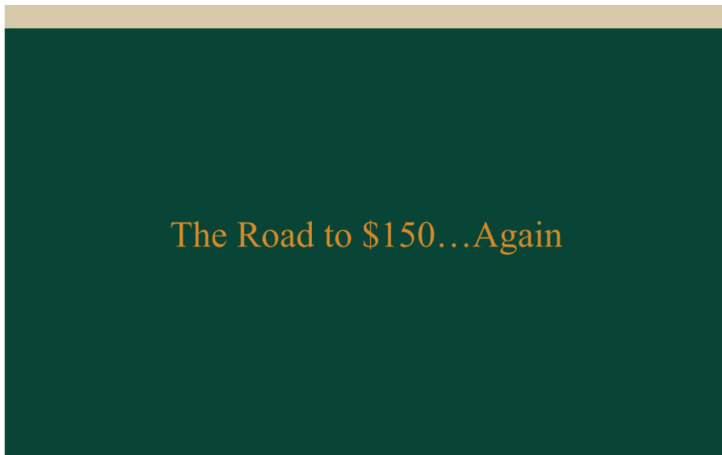


Figure 14.17: Introduction to Future Strategy Section of Global Strategy Presentation March, 2006
Source: Lehman Brothers Holdings 2006, 22

The reference to \$150 applies to the stock price of Lehman Brothers in both the introduction to the whole presentation and to the introduction of the future strategy section. Reference to the stock price of USD 150 is after accounting for the stock split on 23 October 2001 when the stock was split 2:1 and the price decreased from USD 125.50 to USD 62.50. The document was presented in March 2006, when the share price hovered around USD 141. The focus in the Global Strategy document was clearly on the firm's stock price. Reference to the stock price was included in four pages out of the first 6 pages and continued throughout the document. Therefore, the implied strategy was focused on the firm's stock price above all other measures. Even though this measure of management performance is not unusual for a publicly-listed corporation, occupying such a prominent position as an objective has meaning. Not only did management want to maximise stockholder wealth in accordance with agency principles, the maximisation of stock price also translated to the maximisation of the major bonus components of employee and senior executive compensation.

The other feature of the document was the reference to the word "growth". This term appeared in 9 slides out of the 15 slides devoted to the future strategy section. Moreover, "growth" was included as part of the heading of seven out of the 15 slides in this section. The word "upside" used in the context of "growth" was used in a further two slides. The introductory summary page of the future growth section appears in Figure 14.18.

The Road to \$150...Again

- ◆ Three drivers of growth
 - Growth of the global economy
 - Growth in global capital markets
 - Growth of Firm market share

Figure 14.18: Introductory Summary Page of Global Strategy Presentation March 2006

Source: Lehman Brothers Holdings 2006, 23

The summary page of the future strategy of the firm clearly emphasises the intention for growth and relates this element to the drivers expected for the ensuing three years. The expectation of growth in the global capital markets and economy is a forecast and merely represents the firm's own view on which the whole future strategy is based. There is no mention throughout the document of contingencies if such growth did not occur. Therefore, it could be surmised that the firm's strategy was based on a singular optimistic view of the future external environment. This is another example of the hubris exhibited by senior management where no consideration was given to an alternative scenario as evidenced by the document.

The preoccupation of comparing itself to its peer group is evident in the document. Reference to a peer group comparison appears in approximately a third of the slides in the presentation. Lehman Brothers was subject to a normative influence which caused it to monitor its competitors' performance and activities. Any significant deviation to the peer group's financial performance, corporate structure, divisional

activities or modus operandi could risk an “outlier” result and attract unwanted scrutiny. Peer group comparisons also sought to legitimise past management decisions, particularly if the firm outperformed the peer group as shown in some of the slides. An example of the narrative in this regard is shown in Figure 14.19.

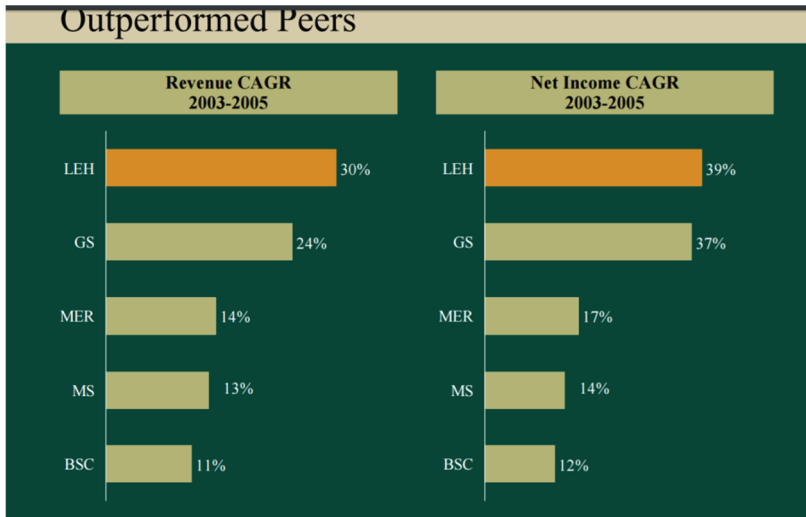


Figure 14.19: Peer Group Comparison 2003 – 2005

Source: Lehman Brothers Holdings 2006, 5

Figure 14.19 depicts Lehman Brothers as the standout performer based on compound average growth rate (CAGR) in revenue and net income compared to its peer group. However, two issues are important. Firstly, the selection of the period coincides with a leading CAGR. If other periods were selected, the CAGR would not have not been so attractive. Secondly, there is no measure indicating this performance relative to risk. There is only one slide in the whole presentation dealing with risk which is set out in Figure 14.20.



Figure 14.20: Risk Management Measures of Lehman Brothers 2003-2005
Source: Lehman Brothers Holdings 2006, 17

This slide dealing with the firm's risk management is telling that it uses only one measure of risk—Value at Risk (VaR) which is described below. Lehman Brothers' business involved trading in securities and debt which included loans. VaR is only useful in measuring risk on a portfolio of market-priced debt and equity securities and is inapplicable to illiquid loans or other credit exposures within the balance sheet. Many of Lehman Brothers' investments were included in Special Purpose Vehicles (SPV) which were standalone corporate entities outside the consolidated group over which Lehman Brothers exercised control. Shares in these SPVs were not quoted and therefore they represented illiquid assets which relied on management's assessment of value for inclusion in any VaR calculation.

VaR is mostly used as a measure for risk associated with a securities portfolio where the measure is calculated using a sample of historical market price movements. The VaR model is a probability-based model and therefore is a statistical measure dependent on arbitrary selection of variables. It measures the potential for loss, not the actual loss of a firm, by assessing the probability of loss (for example a 1 in 20-day occurrence) and the time frame—often used in one year time intervals. Therefore, longer-term measures are usually ignored. Further, uncertainty surrounding

this measure includes no definitive approach in selecting the variables in question to determine the appropriate level of risk to be tolerated. For example, when selecting a time period for analysis of the probability of loss, the sample selected may include data obtained from a period of low volatility. This would result in a more conservative risk measure than if the sample period covered a more volatile period. As this is a mean-based measure of volatility, extreme events are generally ignored when assumptions of normal distribution probabilities are used. Also, as a market-to-market based measure which relies on market prices, it encounters difficulty when market prices are unavailable such as during a financial crisis.

The risk management slide ignored other risk metrics applicable to Lehman Brothers' balance sheet such as leverage, capital adequacy or a measure of credit risk using traditional credit risk metrics such as ratios relating to problem and past due loans, bad debts and credit risk grading within the investment and loan portfolio. The use of the VaR model as opposed to any other risk model reinforces the trading mentality of the firm. This cultural trait can be observed as far back as the founding of the firm when the Lehman brothers traded a variety of goods including commodities such as cotton which were subject to market price risk. Additionally, given the VaR model was a recently used measure in the financial markets some executives may not have been familiar with the concept.

The slide takes into account the effect on revenue from a potential downside movement in market prices relevant to Lehman Brothers' portfolio using a sample of historical data. This level of expected loss was quantified as USD 21.9 million in 2003 and rising to USD 31.4 million in 2005. The other reference to VaR is its expression as a percentage of tangible equity which remained stable from 0.21% in 2003 to 0.20% in 2005. These latter statistics are intended to show that although the absolute level of VaR increased, the firm was able to contain it at a constant level relative to tangible equity. The effect was to allay any fears of the audience that the firm was unduly increasing its risk profile. Importantly, the slide does not include any assumptions of the variables used in the VaR calculation as mentioned above. For example, a time frame covering a period of high volatility would have produced a relatively higher VaR. Therefore, the one-page slide devoted to risk management could be considered an abbreviated representation of the firm's risk profile using a narrow measure intended to downplay the level of risk incurred by the firm.

The use of particular words such as “Extremely Doable” in the headings of another two slides involved in the setting of revenue and stock price targets, again establishes an expectation that the targets are entirely realistic. There is no doubt in the message conveyed by the word “Doable” as it relates to the audience in a colloquial form, and as it is separated by a colon from the first part of the heading, appears highlighted as a message on its own. The consequent attention to this phrase creates the perception of it constituting a “command” rather than a “suggestion”. The implied message is that the targets are easily achievable and the underperformance to this target would be deemed a failure by any team or individual in carrying out their role. Fear of failure to this expectation, is used as a motivator at least, and a coercive pressure at worst. Therefore, the communication of the slide during the offsite meeting is considered a passage point between the dispositional circuit where the rule of practice of performing to an expected target is formed, and the episodic circuit where the day-to-day activities of staff are directed to achieving the targets.

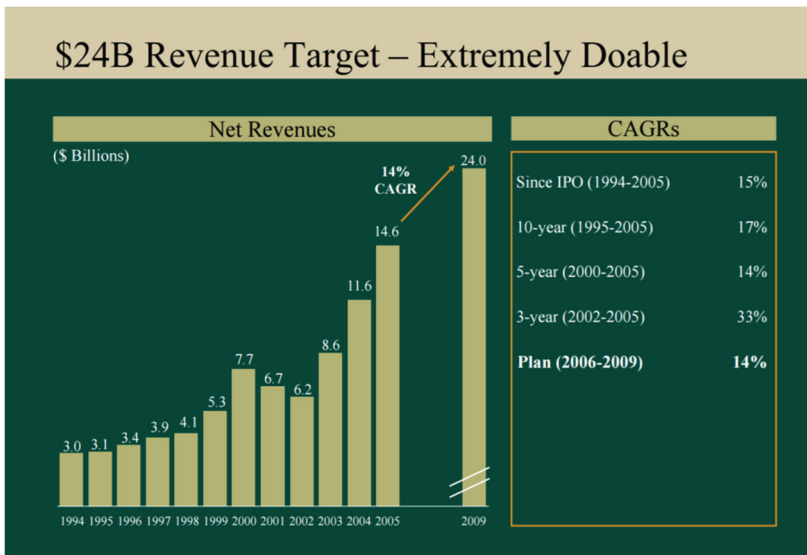


Figure 14.21: Revenue Target for 2009

Source: Lehman Brothers Holdings 2006, 34

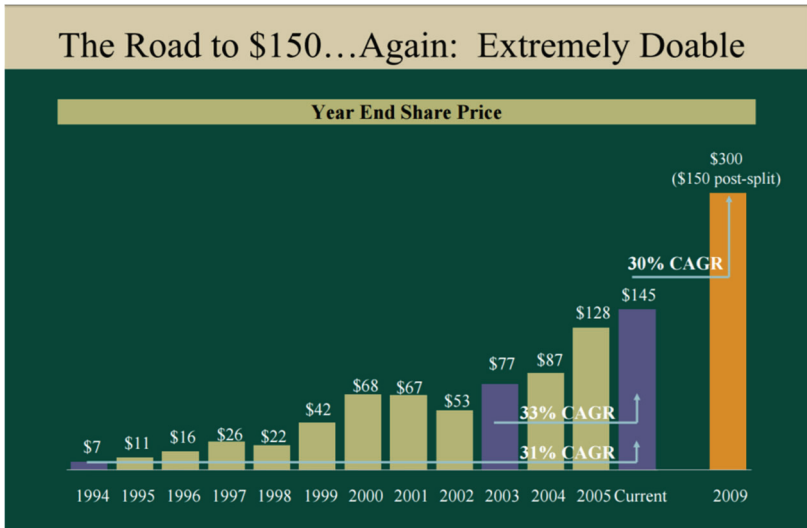


Figure 14.22: Stock Price Target

Source: Lehman Brothers Holdings 2006, 37

Figure 14.22 is important as it also shows the actual CAGR used by Lehman Brothers to depict an exceptional performance by the firm. However, there appears a discrepancy between the CAGR depicted in the slide and the CAGR calculated using the standard formula used for calculating CAGR which is presented in Figure 14.23:

Figure 14.23: Standard Formula for CAGR

$$CAGR = \left(\frac{\text{Ending Value}}{\text{Beginning Value}} \right)^{\left(\frac{1}{\text{No of Years}} \right)} - 1$$

A comparison of the results between the calculation of CAGR using the above standard formula and percentage shown on its slide are presented below:

Figure 14.24: Comparison of CAGR Calculations for Lehman Brothers' Stock Prices

Calculation Method	Period		Period		
	Column 1	Column 2	Column 3	Column 4	Column 5
	1994–2006 (current)	*2003–2006	*1994–2006	*2006–2009	*1994–2009
Shown by Lehman Brothers	31.0%	33.0%	33%	30.0%	30%
Actual using formula in Figure 14.23	28.7%	23.5%	28.7	27.4%	28.5%
Difference	2.3%	9.5%	4.3%	2.6%	1.5%

Note: * There is ambiguity in the slide as to whether the CAGR in these columns are calculated using 1994 as the beginning value, or 2003 and 2006 as shown in columns 2 and 4 respectively. Therefore, calculations for both periods have been shown to avoid doubt.

The difference between the Lehman Brothers' version of CAGR and that calculated by the standard formula varies. The differences in all circumstances represent an overstatement by Lehman Brothers which are in a range of 1.5% to 9.5% depending on the beginning periods used. This is either due to a mistake in Lehman Brothers' calculation process, the use of data different to that provided in the slide, or worse still an intentional attempt to mislead the audience. Either way, the information in the slide is misleading with the Lehman Brothers' version exceeding the correct calculation in every period used. If management's purpose was to create a misleading perception, this unethical practice could have been driven by two different motives depending on the period covered.

For historical data, the intention could have involved the creation of a perception that management had been very successful, thereby instilling extra confidence and loyalty in the firm's leadership. The overstatement of the forecast CAGR to 2009 could have resulted from a rounding up to the nearest multiple of 10 so as to provide a clearly understood CAGR target

that the senior executives could easily remember and act upon. A simply stated objective would assist in its achievement. If this scenario was the case, Fuld would have been complicit in managing perceptions in order to achieve a stretch target. Consequently, the failure to achieve the target, even one that was stretched, could attract negative outcomes for the staff member.

Fuld's attempt to extend the "growth" culture throughout the firm can be observed in Figure 14.25. The title of this slide refers to the intention to sustain the high growth rates of market share for the firm. Highlighted as a key to achieving this growth is the phrase "Aggressively grow and diversify our franchise and strengthen our capabilities" (Lehman Brothers Holdings 2006, 31). The key word "aggressively", apart from describing the growth target for "new initiative" investments, is not quantified with reference to the other items earmarked for growth. Resources for balance sheet, capital and risk appetite, have not been identified either. Importantly, growth intended for "risk appetite" has not been quantified, leaving it an open target for management to determine dynamically and opportunistically. The discretion to impose a risk appetite on the firm at a level and at a time preferred by management represents a manifestation of power also generated in the dispositional circuit. In effect, the ability to change the risk appetite of the firm is like changing the rules relating to risk management. Barring unforeseen events, an elevation of risk normally translates to an increase in returns. Therefore, by socially integrating the rules relating to risk amongst staff, management was empowered to elevate the returns of the firm. This power is transmitted via a passage point represented by risk limits within which traders and deal makers are required to maintain risk exposures. The power is subsequently exercised in the episodic circuit where the routine transactions that reflect the revised risk levels are executed.

Figure 14.25 also encourages Fuld's vision of the firm's culture by stating the goal to "continue to strengthen the culture" and instil this strong cultural push to the entire team with phrases such as "one team" and "one firm mindset". The incentive to collaborate with this push for a singular culture is neatly linked to the objective of applying "significant equity compensation – 30% employee ownership...All employees acting like owners" (Lehman Brothers Holdings 2006, 31). As clearly outlined in the slide, senior management are also considered substantial owners of the

firm, and therefore participate on both sides of the agency relationship spectrum, which presents opportunities for conflicts of interest.



Figure 14.25: Summary of Strategy – March 2006

Source: Lehman Brothers Holdings 2006, 31

The messages and meanings directed to the audience of senior executives by the Global Strategy document is clarified through the analysis of rhetoric contained therein. This analysis elucidates Fuld’s mission of achieving outperformance to its peer group, with a benign attitude to risk, supported by conformity to a unified “aggressive culture”. Further evidence of the firm’s culture can be gauged by communication modes such as internal and external conversations and emails. The following section examines some examples of these modes of communication to further illustrate the culture Fuld attempted to engender.

Internal Emails

The power Fuld possessed in influencing culture is established through various types of communication. Adhering to the method of rhetorical analysis used in the Global Strategy document, the following analysis focuses on internal emails as a form of communication. The analysis will use metaphors and analogies to extract meanings in senior management's attempts to "persuade others about the correctness of [a] particular view of reality" (Young 2003, 623). The reality being constructed continues to consist of a view of the firm as an unfailing organisation that will survive at all cost using whatever means necessary. The analysis reveals the hubris relating to both management's abilities and their flawed view of the economic circumstances that prevailed until the final days of Lehman Brothers.

Fishman (2008, 4) describes Fuld's siege mentality and instincts by quoting excerpts from some of his conversations:

... Sometimes, that instinct meant that Lehman would 'decide that we should be doing the exact opposite of what the analysis said', as one analyst put it. At the top of the organization, Fuld instilled his pugilistic, paranoid view of the world: It's us against them. 'Every day is a battle', he told his managing directors. 'You've got to kill the enemy. They tried to kill us'. Lehman, as he saw it, was always in danger, never getting respect even as it became the country's fourth largest investment bank. 'We're going to keep showing people not to underestimate us', he said. And the troops, as Fuld called them, bought in.

As shown above, Fuld's communication style was at times direct and poignant. Phrases such as "You've got to kill the enemy", exhibit a raw and emotional attitude towards business and a mentality of winning at all costs. This attitude, coming from the top, likely permeated throughout the organisation, engendering a highly competitive and aggressive spirit within the firm. Internal emails of Lehman Brothers can offer a view on the culture operating within the firm. The Committee on Oversight and Government Reform (2010) set out excerpts of certain key Lehman Brothers' internal emails in their report.

two steps are necessary. First we must identify what went wrong, then we must enact real reforms for our financial markets.

Over the next 3 weeks, we will start this process in this committee. We will be holding a series of five hearings on the financial meltdown on Wall Street. We'll examine how the system broke down, what could have been done to prevent it, and what lessons we need to learn so this won't happen again.

Today's hearing examines the collapse of Lehman Brothers, which, on September 15th, filed for bankruptcy, the largest bankruptcy filing in American history. Before the Lehman Brothers bankruptcy, Treasury Secretary Paulson and Federal Reserve Chairman Bernanke told us our financial system could handle the collapse of Lehman. It now appears they were wrong. The repercussions of this collapse have reverberated across our economy. Many experts think Lehman's fall triggered the credit freeze that is choking our economy, and that made the \$700 billion rescue necessary.

Lehman's collapse caused a big money market fund to break the buck, which caused investors to flee to Treasury bills and dried up a key source of short-term commercial paper. It also spread fear throughout the credit markets, driving up the costs of borrowing.

Over the weekend we received the testimony, the written testimony, of Richard Fuld, the CEO of Lehman Brothers. Mr. Fuld takes no responsibility for the collapse of Lehman. Instead he cites a, "litany of destabilizing factors," and says, "in the end, despite all our effort, we were overwhelmed."

In preparation for today's hearing, the committee received thousands of pages of internal documents from Lehman Brothers. Like Mr. Fuld's testimony, these documents portray a company in which there was no accountability for failure. In one e-mail exchange from early June, some executives from Lehman's money management subsidiary Neuberger Berman made this recommendation: Top management should forego bonuses this year. This would serve a dual purpose. First, it would represent a significant expense reduction; second, it would send a strong message to both employees and investors that management is not shirking accountability for recent performance.

The e-mail was sent to Lehman's executive committee. One of its members is George H. Walker, President Bush's cousin, who is responsible for overseeing Neuberger Berman. And here is what he wrote the executive committee. "Sorry, team. I'm not sure what is in the water at 605 Third Avenue today. I'm embarrassed, and I apologize."

Mr. Fuld also mocked the Neuberger suggestion that top management should accept responsibility by giving up their bonuses. His response was, "don't worry, they are only people who think about their own pockets."

Another remarkable document is a request submitted to the compensation committee of the board on September 11th, 4 days before Lehman filed for bankruptcy. It recommends that the board give three departing executives over \$20 million in, "special payments." In other words, even as Mr. Fuld was pleading with Secretary Paulson for a full rescue, Lehman continued to squander millions on executive compensation.

Figure 14.26: Excerpt from Hearing before Committee on Oversight and Government Reform

Source: Committee on Oversight and Government Reform 2010, 2

The above commentary on Lehman Brothers' communications, clearly demonstrate Fuld's disdain of a plan to forgo bonuses to "top management" (including himself) and his natural inclination to distrust those Neuberger Berman executives who would suggest such a tactic. The objective of the Neuberger Berman executives was to generate savings and send a clear message to investors of the intended conservative stewardship of the firm. Further, Fuld's audacity of recommending extra compensation to some top management four days before Lehman Brothers filed for bankruptcy clearly demonstrates the greed and self-interested attitudes pervading the senior ranks of the hierarchy. Alternatively, Fuld could have been attempting to signal to the market Lehman Brothers' confidence in a turnaround by increasing its compensation expenses. Both of the above incidents reported by the Committee on Oversight and Government Reform provide a window into the 'greed-centric' culture Fuld was perpetuating. This culture is further exemplified by a series of other Lehman Brothers' internal emails sourced by the bankruptcy examiner. An analysis of these emails follows.

"This is not the B-team"

A March 2007 email forwarded by Michael Gelband, Lehman Brothers' Head of Capital Markets to Fuld refers to advice provided by respected investment managers, Stanley F. Druckenmiller of Duquesne Capital Management LLC and Paul Tudor Jones of Tudor Investment Corp confirming Gelband's previously mentioned concerns regarding the risks of the firm and that consideration should be given to the balance of risk versus return:

... This is not the B-team, Gelband wrote. I heard your view at the risk meeting that odds are in your favour but risk/reward is not good here so I'm trying to get out of as much illiquid risk as possible (Valukas 2010, 46).

Further examples of emails from risk managers to senior management warning of the inappropriateness of the firm's risk limits and risk policies, are presented below:

... Email from Kentaro Umezaki, Lehman, to Herbert H. (Bart) McDade III, Lehman, et al. (Sept. 10, 2008) (noting history of end arounds on risk decisions, risk management's lack of authority and lack of authority over balance sheet and inability to enforce risk limits); Email from Vincent

DiMassimo, Lehman, to Christopher M. O'Meara, Lehman (Sept. 1, 2008) (whatever risk governance process we had in place was ultimately not effective in protecting the firm. Risk Appetite measures were not effective in establishing clear enough warning signals that the Firm was taking on too much risk relative to capital. The [Risk Management] function lacked sufficient authority within the Firm. Decision-making was dominated by the business); Email from Satu Parikh, Lehman, to Michael Gelband, Lehman, Sept. 15, 2008 (I am shocked at the poor risk management at the highest levels, and I don't think it started with Archstone. It is all unbelievable and I think there needs to be an investigation into the broader issue of malfeasance. Management gambled recklessly with thousands of jobs and shareholder wealth) (Valukas 2010, 46).

An email dated 18 April, 2007 to O'Meara amongst others from Kentaro Umezaki, Head of Fixed Income Strategy for Lehman Brothers confirmed the confusion of the Fixed Income Division following a verbal presentation by Fuld the night before. In his presentation, Fuld urged an increase in risk. In describing his team's reaction to Fuld's speech, Umezaki wrote:

... the majority of the trading businesses focus is on revenues, with balance sheet, risk limit, capital or cost implications being a secondary concern. The fact that they [the traders] haven't heard that those items matter [in] public forums from senior management recently reinforces this revenue-oriented behaviour implicitly... Example which we've debated for years: was even a topic in [the Turnberry meeting in] FLA: Do we or don't we have a limit on how much [HY LBO] related lending/commitment exposure we can have at any given time? There has been no real 'one firm' outcome to date in my opinion. I'm not the only one who has this view in FID (Valukas 2010, 100).

The above email confirms three important points: firstly, that consideration of risks was secondary to the priority given for the generation of revenues; secondly, senior management had avoided communicating the "revenue over risk" priority to the financial markets; and thirdly there was no clear communication of risk limits relating to high yield leverage buyouts (HY LBO) to staff in the trading department. The ambiguity over the communication to both external and internal stakeholders created an environment which encouraged the treatment of risk limits as a "soft" constraint and capable of being easily adjusted. The underlying message conveyed was that an increase in risk levels was plausible. Fuld's obvious intention was to perpetuate an elevated "risk culture" of the firm as a means of increasing its returns.

The creation of the above-mentioned ambiguity regarding risk limits is an expression of power emanating from what is “not communicated” and found in the dispositional circuit. Risk limits are a common feature used in investment and commercial banks. They constitute restrictions on traders’ behaviours, limiting their ability to exceed the firm’s pre-determined risk appetite. However, in Lehman Brothers’ case, these limits were unclear, which is extraordinary for a firm whose major portion of revenue was generated from the Trading Division. Therefore, traders were required to interpret their own acceptable risk limits through their establishment of a socially constructed meaning created from their communication with senior management. As no communication was evident or at best ambiguous, traders were left to establish their own rules. Fuld’s power in this circumstance was exercised in his decision to remain silent on the topic of risk limits. In doing so, he enabled traders to trade up to their own discretionally imposed limits. The temptation naturally would be for a trader to incur as much risk as possible under these circumstances, as higher risk limits translated to more or riskier trades thereby increasing the potential for greater bonuses. Fuld understood this driver, being a former trader, and created the setting for this behaviour through his silence on the matter which in itself represented the passage point where power was transmitted to the episodic circuit.

In expressing the power exerted by Japanese management as a cultural practice Clegg and Bailey (2007, 732) observed the influence on a team of management silence:

... management owes very little to formal rules. Rather the power to guide practice... is mediated—informally—by close knit relationships by insiders who come to know each other well. The slightest nuance of body language or the significance of what is not said can convey important information to a fellow insider.

The trades executed by the traders within their own “set of rules” were carried out in their routine activities, which they considered normal and acceptable within the risk management framework of the firm.

“How do you spell stupidity in Chinese!!!”

During the second half of 2007, as certain assets such as CDOs held by many investment banks were devaluing, there was a search for additional

capital to counter the associated losses and increased risk levels. Three similarly financially distressed financial institutions including Citigroup, Bear Stearns and Lehman Brothers, had approached the Citic Group, a leading Chinese investment bank seeking a strategic stockholder which could inject additional capital into their failing firms (Valukas 2010).

Although a potential investor the size of Citic Group presented as an ideal “White Knight”, given their access to capital, an email exchange between Fuld and Goldfarb revealed little interest in Citic Group and a degree of arrogance and hubris. The following initial email from Goldfarb to Fuld signalled a view that Lehman Brothers did not need assistance:

... This will signal a major sign (which obviously isn't true and will feed into rumours, etc.) and put us in a category of those who needed an infusion to help them out of this market mess (Goldfarb 2007).

Fuld's response reveals crudeness in the use of language such as 'NFI' (abbreviation for 'no fucking interest'):

... Sounds to me like another non-starter. If it's just about price [and] who is the right partner then tell them NFI (Fuld 2007).

Goldfarb replied:

... Agreed 1000 percent ... How do you spell stupidity in Chinese!!! (Goldfarb 2007).

The above email exchange exemplifies a degree of arrogance and misguided faith that the firm did not need assistance in the form of a “White Knight”. Young (2003, 624) acknowledges that text can be the result of calculated thoughts by managers who purport to have a superior understanding of a situation. The absoluteness of the expression used to signify full confidence: “1000 percent” indicated that Fuld and Goldfarb knew what they were doing, even though the search for a “White Knight” had become an urgent matter. The exchange continued displaying a high degree of macho condescension with an email by Fuld indicating a trace of racism:

... What happened, ...u didn't like my sumdum spelling? (Fuld 2007).

Goldfarb responded in an arrogant vernacular:

... I love it, better said than I could have. I think Mizuho is the best option for a strategic partner. Any potential investor that would consider BS Bear Stearns in the same breath as Lehman Brothers should go fungoo themselves!!! (Goldfarb 2007).

Fuld replied, again with a degree of unprofessional overconfidence, this time conveyed in a “hood-like” expression with an indolent use of grammar:

... I agree we need some help but the Bros always wins!! (Fuld 2007).

Goldfarb agreed, responding with the following:

... Absolutely, will and skill always win, and that be us!!!! (Goldfarb 2007).

Fuld concluded:

... Got it so do u (Fuld 2007).

The style of communication reveals two of the most senior executives in the firm as self-congratulatory, arrogant and misguided. It also exposes the executives’ lack of seriousness and urgency in confronting the problems of the firm. The rhetoric used reveals a similarity in the crude and assertive culture that existed at Lehman Brothers. The texts also exhibit a common understanding amongst two of the most senior executives at Lehman Brothers, who use a similar vernacular tending to confirm each-others’ beliefs that Lehman Brothers can afford to be selective in selecting a “White Knight”. The reciprocal encouragement to pursue a course of action reinforces a confidence in their conviction. Young (2003, 624) notes the power of texts to modify or reinforce convictions:

... Texts perform actions as they encourage certain beliefs and behaviours. The various arguments within texts are intended to modify the convictions or disposition of specific audiences through persuasive discourse rather than through an overt imposition of will or through constraint.

Had Fuld and Goldfarb not persuaded each other to dismiss the alternative “White Knights”, the path to bankruptcy could have been avoided. In January 2008 when Lehman Brothers perceived an opportunity to again raise capital, this time from the Kuwait Investment Authority, Goldfarb, CFO, wrote to Fuld:

... Only issue would be that if they bought newly issued equity we would join the bad company of the many who had to raise equity. Perception issue (Goldfarb 2008).

At a time when a capital-raising was desperately needed by Lehman Brothers, and there was a dearth of institutions willing to invest, Fuld exhibited a degree of hubris by suggesting charging the Kuwait Investment Authority a premium for Lehman Brothers' stock and responded to Goldfarb as follows:

... Not if it were at a premium (Fuld 2008).

Consequently, the intended capital raising failed. This is not surprising given the probable unwillingness of the potential investor to pay a premium in such a tight capital market. Fuld's hubris prevented a much-needed capital-raising as confirmed by Paulson's opinion that Fuld's perceptions of the firm's problems were unrealistic. Fuld and Goldfarb believed Lehman Brothers would survive, by advising the board in January 2008 that:

... During the last downturn [2001-02] ... the firm outperformed its competitors and established a platform for further growth... The firm pursued a counter-cyclical strategy, investing in talent while its competitors were in retrenchment mode (Lehman Brothers Holdings 2008a, 6-7).

The above statement indicated that Lehman Brothers could repeat the turnaround strategy of 2008 that it employed during the economic downturn of 2001/2002. At the board meeting in January, 2008, Fuld was able to influence the board in agreeing to pursue growth as a counter-cyclical strategy which was contrary to the strategy employed by the rest of the major US investment banks. Other investment banks pursued a strategy which involved raising capital in anticipation of future losses. Fuld justified his growth strategy by explaining that:

... while other Wall Street firms were raising significant capital in the past three months, for Lehman aggressive capital raising is not necessary because the firm remains strongly capitalized thanks to capital generated by earnings (Lehman Brothers Holdings 2008a, 16).

The retained earnings on which Fuld relied for extra capital were never realised. In fact, a massive loss was about to be recorded in the ensuing quarter ending May 2008 (Lehman Brothers Holdings 2008c). Fuld's refusal

to follow the other investment banks which undertook capital raisings in anticipation of losses further signifies Fuld's conviction that he knew better. The other investment banks imitated each other as a survival tactic intended to also comfort their investors and creditors. The common view of impending danger was not shared by Fuld who was blinded by hubris and a disregard of his own firm's stockholders to whom he owed a responsibility under agency principles.

Lehman Brothers' cultural problems indicated by its internal communications were compounded by a question over its ethical practices. Despite the external appearance of an ethical best practice, the following section discusses certain shortcomings. It is argued that the questionable ethical practices emanated from the abovementioned cultural atmosphere.

Code of Ethics – What ethics?

Lehman Brothers disclosed in its 2007 Form 10-K report submitted to the SEC that it possessed a Code of Ethics with which it complied. The report specifically mentions that:

... We [Lehman Brothers] recognize that maintaining our reputation among clients, investors, regulators and the general public is critical. Maintaining our reputation depends on a large number of factors, including the selection of our clients and the conduct of our business activities. We seek to maintain our reputation by screening potential clients and by conducting our business activities in accordance with high ethical standards (Lehman Brothers Holdings 2007, 76).

Further the report states that Lehman Brothers acknowledges its "other" risks as follows:

... We are exposed to other risks having an ability to adversely impact our business. Such risks include legal, geopolitical, tax and regulatory risks that may come to bear due to changes in local laws, regulations, accounting standards or tax statutes. To assist in the mitigation of such risks, we monitor and review regulatory, statutory or legal proposals that could impact our businesses (Lehman Brothers Holdings 2007, 76).

Despite maintaining a formally documented modern day corporate governance policy, an organisation may not actually adopt best practice. Lehman Brothers Holdings (2007, 76) described Lehman Brothers' ethical standards as high. However, Lehman Brothers' ethical standards were far

from high. Examples cited in this chapter which indicate an ethical standard less than optimal include: the firm's "window dressing" of financial statements; the treatment of employees and their families; and the firm's internal emails discussing risk and potential investors. It is expected that a firm's ethical practices would have an impact on the culture within an organisation. Yet Lehman Brothers managed to contravene some key ethical considerations.

Greenfield (2009) asserts that Lehman Brothers' aggressive culture allowed it to avert a financial disaster during past economic downturns such as in 2001/2002. Most of the incumbent management team in 2008, occupied senior management positions during 2001/2002, including Fuld who occupied the CEO and Chairman positions. The same aggressive culture said to exist in 2001/2002 also existed up to 2008. Management's aggressive culture, supported by Fuld's hubris, blinded senior management from the risks posed by the firm's excessive leverage incurred during the pre-GFC period.

Fuld ignored critical advice from expert staff in some key decision-making. Apart from ignoring expert advice, Lehman Brothers' dysfunctional management style disregarded the firm's code of ethics. "The code of ethics became an artefact; something external to the culture and existed because companies like Lehman Brothers needed a code for public relations purposes and to protect themselves from conduct against the firm" (Stevens 2008, 53).

A legalistic approach to the adoption of a code of ethics by US firms was found to be a common finding by Pelfrey and Peacock (1991, 17). Farrell and Cobbin (1996) analysed the content of codes adopted by Australian, US and UK enterprises and found that for many organisations, the codes were a "reiteration of the legal obligations of staff" (Farrell and Cobbin 1996, 55). This indicates a perfunctory approach to the adoption of a code of ethics as opposed to an independent and holistic approach with a purpose to instil appropriate values. Further, Farrell and Cobbin (1996, 55) found that 83 per cent of the codes of ethics examined addressed the behaviours of employees and ignored standards for directors. This study also concluded that the codes examined did not directly promote the adoption or support of ethical cultures. It is not surprising therefore that Lehman Brothers treated its code of ethics as a necessary document to

fulfil the expectations of regulators and investors rather than to provide an ethical influence over the culture of the firm.

Stevens and Buechler (2013) used two different methodologies to ascertain whether Lehman Brothers' code was instrumental in management decision-making. They used the "Competing Values Framework" developed by Quinn et al. (1991) in conjunction with the "Ethisphere benchmark" created by Erwin (2011). They argue that Lehman Brothers' code was similar to codes found in similar documents of other US public corporations. The code "addresses the basic issues found in most corporate codes such as conflict of interest, retaliation, stealing and use of proprietary information, non-retaliation, compliance with laws, EEO issues and fairness" (Stevens and Buechler 2013, 51). According to Stevens and Buechler (2013), Lehman Brothers' code appeared standardised and authored by lawyers as opposed to being specifically prepared for Lehman Brothers.

Although appearing as a template document, the code of ethics offered a clue to Lehman Brothers' aggressive culture. Lehman Brothers' relentless pursuit of growth is reflected in a phrase used in its code of ethics: "to compete aggressively in furthering the interests of the firm" (Stevens and Buechler 2013, 51). The choice of the word "aggressively", in this section of the code of ethics clearly establishes a guiding principle that aggressive behaviour in furthering the interests of the firm was acceptable. Similar references alluding to an "aggressive" pursuit of businesses are also found in the documented code of ethics of another failed US investment bank, Bear Stearns (Greenfield, 2009). However, Greenfield (2009, 53) observes that it is "absent from one of the two surviving firms' codes—Goldman Sachs' Code of Conduct and Business Principles". Stevens and Buechler (2013) state that although Lehman Brothers' code dictates that the firm should "compete aggressively", it neglects to mention how this can be done in an ethical context. Therefore, how could an employee clearly ascertain the boundaries of their expected ethical behaviour in pursuing their day-to-day activities?

Evidence suggesting unethical practices by Lehman Brothers is contained in a letter dated 18 May, 2008, authored by Matthew Lee, then senior Vice President, Financial Control and in charge of the firm's global balance sheet and accounting, addressed to Erin Callan CFO, and Christopher O'Meara

Chief Risk Officer at Lehman Brothers. The letter stated that Lee had become aware of unethical practices at Lehman Brothers:

... I have become aware of certain practices... that require me as a Firm employee to bring to the attention of management conduct and actions on the part of the Firm that I consider to possibly constitute unethical and unlawful conduct (Lee 2008, 1).

Lee's complaint targeted a misstatement of assets published in the previous quarters' financial statements leading up to May, 2008. In his opinion the value of assets published in the financial statements misled the public as they had been devalued due to market corrections. "I believe the manner in which the firm is reporting [certain] assets is [sic] potentially misleading to the public and various governmental agencies" (Lee 2008, 2). He claimed that a substantial level of assets may have been overstated as they should be classified as either non-performing or bad. The quantum of the overstatement was considered significant: "Tens of billions of dollars of unsubstantiated balances, which may or may not be "bad or non-performing assets" (Lee 2008, 1). This criticism by an employee of 14 years was ignored by senior management who retrenched Lee a few days after the date of his letter (Corkery 2010).

The culture of Lehman Brothers largely emanated from the values and beliefs of the leadership team and not from a published code of ethics reflecting best practice. The values of the CEO and other senior executives were embedded in the firm. The code of ethics, like the corporate governance structure, was a mere construct. Fuld relegated the practice of the published code of ethics, through his refixing of the meanings of appropriate behaviour. The divergence of meanings from the published code to Fuld's socially constructed code was carried out through his various forms of communication which acted as passage points. These conduits of values influenced behaviours which were expressed in daily work routines. In the process, the intent of the code of ethics was effectively revoked.

This chapter examined the management style of Fuld and his senior executive team and its impact on the important management decisions which led to Lehman Brothers' bankruptcy. The management style is found to contribute to the "greed-centric" culture of the organisation which was encouraged by institutional influences and the exertion of power. These

influences which were nurtured within an overall less than perfect corporate governance practice were manifest in Fuld's relationship with the board and the institutional forces which shaped board structure; Fuld's influence over employee behaviour; the various forms of communication used by Fuld and his senior executives; an ethical practice at odds with the firm's formal code of ethics; and an employee compensation structure which encouraged risky behaviour and a general compliance with Fuld's values and beliefs.

Fuld is shown to have had an influential role in the appointment of a submissive and compliant board. Structuring the board with members whose ages, longevity of tenure, limited financial expertise in financial markets and above average compensation, contributed to a relative disengagement in the risk affairs of the firm and created a subservient attitude towards Fuld's strategic intentions. In addition, the mimetic and normative institutional influences to which Lehman Brothers was subjected concealed a corporate governance framework, including board structure, which, although complied with the regulatory framework, did not engender professional and ethical practice.

Fuld was able to engender loyalty from his staff, principally by ensuring they were remunerated at the top end of the industry's pay scale, including a generous incentive compensation plan. This loyalty produced mostly compliant subordinates who largely adopted Fuld's strategy of "growth at all costs". Fuld's behavioural traits can be traced to his earlier career where he learned the value of loyalty and the dangers associated with strong personalities with potential to challenge the authority that comes with leadership. Those who challenged Fuld's values or views, especially in relation to the firm's direction and its associated risks, were punished. The resultant culture empowered Fuld to pursue his growth objective with the aim of perpetuating generous bonuses for his key staff and himself.

The chapter also provided an insight to the firm's culture aided by a rhetorical analysis of the manner and style of communication adopted by Fuld and his close associates. It is shown to offer a deeper understanding of how communication devices and the use of language and discourse can impact meaning to foster certain behaviours and influence values consistent with those of the author. The resultant culture was coloured by a hubris associated with a denial of Lehman Brothers' escalating risk profile and the worsening financial difficulties.

Finally, the chapter questions the firm's ethical values as exposed by its application of its published code of ethics, which although presented as an example of best practice, was found to be somewhat ignored at the firm. The treatment of employees and their families, the style and content of the firm's communications, and the attitudes expressed in communications towards creditors and potential investors attest to the firm's relative disregard of ethical practice. This disregard is also reflected in Lehman Brothers' unethical accounting of repurchase agreements used as a temporary financing tool in an effort to overcome the firm's reliance on excessive debt.

CHAPTER 15

CONCLUSION

This book delves into the culture and behavioural practices of the participants in the investment banking industry from an historical perspective and goes further to offer a rich insight by presenting a case study of Lehman Brothers. Similar cultures and behavioural practices have been found to persist in the industry since its early beginnings and played a part in the management decision-making crucial to the viability of businesses in the lead up to the GFC. Furthermore, it demands attention from legislators and regulators who routinely deal with individual firms and systemic risks. If not adequately controlled, these risks could adversely impact the wider economy as they did in 2008. This book shows an example where legislators and regulators have failed to manage their prudential supervisory responsibilities and therefore protect the public interest. As regulatory structures and economic policies continue to be subjected to various influences and swing from loose to tight settings, this book will continue to have relevance. Additionally, as unchecked concentration of power and deficient corporate governance systems continue to exist in large organisations the danger of other catastrophic bankruptcies will persist.

The historical context in which this story is told is important as it offers an understanding of the origins of the behaviours and culture found in modern day investment banks. It reveals the organisational evolution of Lehman Brothers in parallel to the development of the investment banking industry which had its foundations in the American War of Independence of 1775. The latter period covered by this book is characterised by a period governed by a neo-liberal political environment, a burgeoning economy and a “light touch” to investment banking regulation. Three overarching themes are developed in the historical chapters. The first recurring theme deals with the empowerment of investment bankers through their knowledge, expertise and innovation. The second recurring theme involves the value of close relationships which enabled investment banks to grow

their business and solve complex problems for their customers. Thirdly, it reveals the effect of externalities, such as economic cycles, and political and regulatory developments on the fluctuations of power between regulators and industry.

Traditionally, investment bankers have been able to add value in arranging funding for customers or providing advisory services. These activities could be sustained as long as they offered specialised knowledge, expertise and innovation which otherwise was largely unavailable. The attributes of knowledge, expertise and innovation commonly found amongst all members of the investment banking peer group supports the argument that various institutional influences contributed to the culture, practices and behaviours found throughout the industry. The effective use of novel funding techniques such as the first bond issues, the adoption of effective distribution networks in selling financial instruments, the development of risk transfer instruments such as credit derivatives, and the methods of assessing credit risk of borrowers were able to set participants apart. The application of New Institutional Theory and the Theory of Power is useful in explaining how knowhow and networks emerged as forces in investment banking and why they were keenly sought to gain financial advantage. It allowed innovative practices to survive until the modern era. The influential roles played by key historic personalities, such as John Pierpont Morgan, show that power sourced from the application of knowledge, expertise, innovation and networks enabled beneficial outcomes. Selected individuals are highlighted since they represent a sample of prominent US investment bankers operating during the formative years of the industry. They were therefore the early leaders who were able to shape the culture and practices which have survived until today.

Since the industry's inception, investment bankers have realised the importance of business and government relationships for the development of their enterprise. The book finds the strategy of pursuing relationships with important individuals within larger organisations and especially government was mimicked for three reasons. Firstly, it was hoped such clients would provide a continued stream of large and lucrative transactions. Secondly, given the high social and commercial status of the individuals involved, these relationships would help with the firm's image and reputation, and expand the networks useful for potential future business. Lastly, networks were also useful as an instrument in pushing a point of view with government and regulators. The exploitation of

relationships also worked in reverse whereby government officials used investment bankers to meet their needs, for example, Albert Gallatin, US Secretary of Treasury who used Stephen Girard, John Jacob Astor and David Parish to assist with the financing of the War of 1812.

The book also finds that externalities such as economic cycles, and political and regulatory developments had an effect on the fluctuations of power between regulators and industry throughout US modern history. Attitudes towards regulatory structures tended to vary according to economic conditions. Following a financial crisis for example, public outcry would prompt politicians who, sensitive to public opinion, were prone to tighten financial markets regulation or censure influential personalities. Conversely, the “light touch” approach to regulation coincided with prosperous economic conditions such as those which prevailed prior to the 1929 stock market collapse and the period prior to the GFC. The hubris which is generated by a period of economic expansion tends to lure legislators into a *laissez-faire* mentality which is often influenced by forces within industry. History has shown that any period of prolonged accommodative regulatory and monetary conditions creates asset bubbles which commonly precede a financial crisis.

The exertion of institutional influence, if unchecked, can contribute to dire consequences. The book revealed that institutional influence was meaningfully applied in four areas: the business models and financial structures of the major US investment banks; the legislative process and regulatory framework; the CRAs and the accounting standard setting process.

As investment banks operate in a competitive and ambiguous environment, where economic cycles, evolving technology and innovation are constant features and challenges, mimetic pressure emerges. When business models of investment banks converge and their financial structures similarly take advantage of inadequate regulation such as the Net Capital Rule, the resultant systemic risk adds to the probability of industry failure.

The business model of investment banks up until the immediate post WWII period largely comprised the partnership business structure, with its disadvantage of a partner’s restricted capacity to contribute capital to the firm. Due to the increasing need for capital to sustain business expansion, firms sought to incorporate. Unlike a partnership, this structure with its

limited liability protection meant that CEOs could take abnormal risks with the expectation of generating abnormal profits without placing themselves at personal financial risk, as would a partner in a firm. As executive compensation structures were aligned with performance generally, executives were incentivised to push the boundaries of acceptable organisational risk levels. CEOs at the helm of the firm could also monopolise potential bonus pools in contrast to the typical profit-sharing model of a partnership. These factors led to the concentration of power to the CEO and allowed for an elevation in the firm's risk profile. Additionally, in pursuit of ever-increasing profits, all the major US investment banks exploited the temporary benefits of the "leverage effect" which placed undue strain on their balance sheet structures and liquidity positions. This ultimately contributed to their financial distress and as a combined group added to systemic risk within the financial markets.

A common theme found in this book is that regulators were subject to a "regulatory capture" by the investment banking industry. Political contributions, the revolving door, the lobbying process and exploitation of knowledge asymmetry were instrumental in influencing the regulatory process. The ultimate purpose of the industry's significant expenditure of resources to these processes was to engineer a regulatory environment conducive to optimising financial success. The book also reveals the limitation of regulations to control behaviour. The major restrictions on investment banks constituted: the capital regulations, which were found to be lenient and were effectively subject to voluntary compliance; NYSE's corporate governance rules and guidelines; and SOX, all of which failed to prevent the failure of the largest US investment banks. Influence either through the exercise of power or institutional pressure is an immeasurable phenomenon and therefore difficult to control.

The role played by the CRAs in publishing excessively positive and flawed credit ratings was one of the many factors that contributed to the GFC. The key finding is that it was in the best interests of the investment banking industry to exert its influence coercively over the CRAs. Ultimately, the investment banks were able to achieve their desired outcomes of influencing the production of over-inflated ratings for their customers and more importantly for their own securitisations of MBS and CDOs. As a result, they were able to achieve superior securities prices and timely issues to ensure the highest possible throughput of transactions.

The industry influence on accounting standard setters resulted in the production of an accounting standard which favoured investment banks by potentially allowing them to conceal debts in their financial statements. The book outlined the development of FAS 140, and its predecessor FAS 125 relating to the accounting of repurchase agreements. The standard setters and practitioners who are usually members of the same professional community, are able to collectively determine a set of practices and cognitive frameworks in which organisational routines are shaped. This setting allows for subtle influence to be exerted, and in this case, it emanated from the financial network which as a united force was able to convince the FASB to issue a standard that provided industry with a high degree of interpretation and flexibility.

The theme of how the dysfunctional use of power can adversely influence firm culture, is revealed through an in-depth case study of Lehman Brothers. It was found to lead to suboptimal management decisions, leading to financial distress. Fuld's strategy tended to push the risk boundaries even further than his predecessors in the areas of leverage, product innovation and most notably, asset positions such as an ill-informed overexposure to the property market during the formation of a housing bubble. This objective of attempting to generate ever increasing profits was also self-serving as a large portion of Fuld's compensation consisted of bonuses aligned with firm performance. The book finds that Fuld's management style in attempting to achieve his personal goals such as maximising personal compensation, reputation and position longevity involved the exertion of power. Fuld's power, which flowed from Clegg's (1989) episodic, dispositional and facilitative circuits, was exerted over the firm's corporate governance system and his employees and their families. Fuld's credibility and power diminished with the declining fortunes of the firm. Ironically, the power that facilitated the realisation of Fuld's ambitions eventually backfired. Instrumentally, shareholders, creditors and regulators, who were earlier subjected to Fuld's influence, had gained the ascendancy and ultimately triggered his downfall.

This book therefore constitutes an alternative means of understanding the GFC and failure of one of the largest investment banks in the US. The qualitative factors revealed by this book offer an understanding of the influences on the evolution of the regulatory field and the challenges and potential weaknesses confronting the investment banking industry, which in turn, can enlighten the industry's *modus operandi*. The investment

banking industry has been linked to repeated financial crises. Although discussion on financial and economic factors contributing to financial crises have been well-covered elsewhere, this book is a reminder to governments, regulators and industry participants that crises are induced by human decision-making, which are naturally shaped by organisational culture and individual values, beliefs and behaviour. Therefore, it urges vigilance by governments to better frame and implement policies, legislation and regulations and warns investment banks against a dysfunctional organisational culture in order to mitigate a repeat catastrophe of the GFC and the consequential failure of large financial institutions.

In conclusion, the GFC represented a massive failure of institutional practice and the human condition. Quantitative analysis alone cannot account for the forces which impacted on the important decisions made by participants in this financial network. The theoretical perspectives of Clegg's Theory of Power and DiMaggio and Powell's New Institutional Theory represent a way to understand these forces. In view of the many casualties, both corporate and public, it is up to the officially mandated bodies to mitigate a repeat of the GFC. This implies an appropriate legislative response and a reflection on our human frailties which cause us to disproportionately prioritise self-interest over the public good. Gordon Gekko, an infamous investment banking character in the 1980's movie "Wall Street" famously stated "greed is good". Twenty years on, in the context of this story, Gekko, the insatiable investment banker would surely change his mantra to "greed, power and influence is good". As we've seen, this is a flawed belief given the costs to society. If the human condition and institutional practices are unchangeable, then the world is doomed to repeat the failures of the past and guarantee a future financial crisis.

APPENDICES

Appendix A: Table of Abbreviations

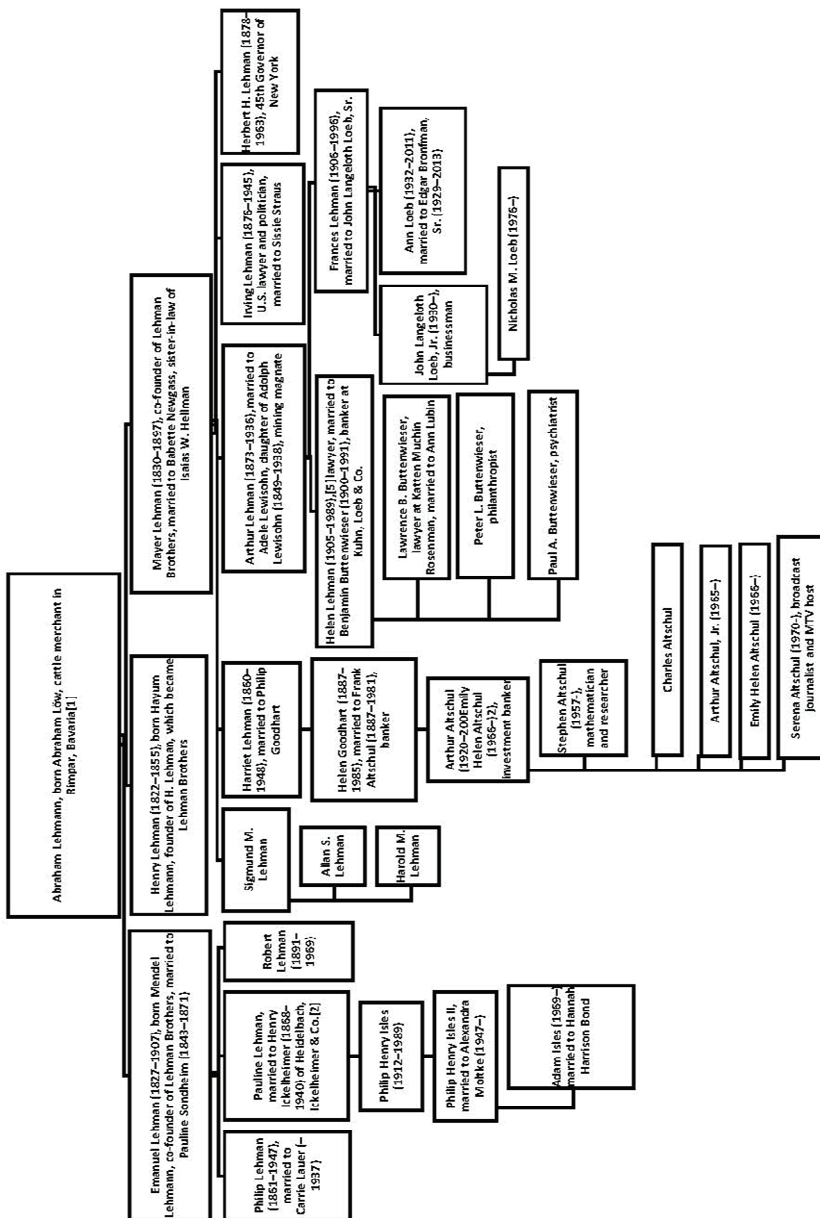
Abbreviation	Meaning
AIG	American International Group Inc.
ARM	Adjustable-Rate Mortgages
BoA	Bank of America
BRIC	Brazil, Russia, India and China
BSAM	Bear Stearns Asset Management
CAGR	Compound Annual Growth Rate
CAO	Chief Administrative Officer
CCR	Compensation Committee Report
CDO	Collateralised Debt Obligation
CEO	Chief Executive Officer
CFMA	The Commodity Futures Modernization Act 2000
CFO	Chief Financial Officer
CFRP	Centre for Responsive Politics
CFTC	Commodity Futures Trading Division
Comp Ratio	Compensation Ratio
COO	Chief Operating Officer
CRA	Credit Rating Agency
CRA Expansion	CRA Expansion Act 1999
CRA Act	The Community Reinvestment Act 1977
CRO	Chief Risk Officer
CSA	Confederate States of America
CSE	Consolidated Supervised Entity

CWT	Cadwalader, Wickersham & Taft
E3	CDO Evaluator Version 3.0
Fannie Mae	Federal National Mortgage Association
FAS 125	Statement of Financial Accounting Standard Number 125
FAS 140	Statement of Financial Accounting Standard Number 140
FAS 157	Statement of Financial Accounting Standards Number 157
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
Fed Funds Rate	Federal Reserve Funds Rate
FFIEC	Federal Financial Institution Examination Council
FHFA	Federal Housing Finance Agency
FID	Fixed Income Division
FINRA	Financial Industry Regulatory Authority
Freddie Mac	Federal Home Loan Mortgage Corporation
FSR	Financial Services Roundtable
GAAP	Generally Accepted Accounting Principles
GBP	British Pounds
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GLBA	The Gramm Leach Bliley Act
GNI	Gross National Income
GSA	The Glass-Steagall Act
GSE	Government Sponsored Enterprise
High-Grade	High-Grade Structured Credit Strategies Fund
HY LBO	High Yield Leverage Buyouts
IASC	International Accounting Standards Committee
	International Financial Reporting Interpretations Committee
IFRIC	
IPO	Initial Public Offering

JP Morgan	John Pierpont Morgan
KPI	Key Performance Indicators
LBI or LBIE	Lehman Brothers International (Europe)
MBS	Mortgage-Backed Securities
MSCI	Morgan Stanley Capital International
NBFI	Non-Bank Financial Institution
NPAT	Net Profit After Tax
NPBT	Net Profit Before Tax
NR	Net Revenue
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OTC	Over the Counter
OTS	Office of Thrift Supervision
PCAOB	Public Company Accounting Oversight Board
POGO	Project on Government Oversight
PSA	Public Securities Association
RCA	Radio Corporation of America
Regulation AC	Regulation Analyst Certification
REIT	Real Estate Investment Trust
Repo 105	Repurchase Agreements 105
Repos	Repurchase Agreements
Revolution	American Revolutionary War in 1775
RMBS	Residential Mortgage Backed Securities
ROA	Return on Assets
ROE	Return on Equity
RSU	Restricted Stock Unit awards
SEC	Securities Exchange Commission
SIA	Securities Industry Association
SIFMA	Securities Industry and Financial Markets Association

SOX	Sarbanes-Oxley Act of 2002
S&P	Standard & Poor's
SPV	Special Purpose Vehicle
TARP	Troubled Asset Relief Program
TBMA	The Bond Market Association
TC&I	Tennessee Coal, Iron & Railroad Company
Union	Northern States of America
US	The United States of America
USD	United States Dollars
VaR	Value at Risk
WWI	World War 1
WWII	World War 2

Appendix B – Lehman Family Tree



Appendix C - Fed Funds Rate Changes

Year	Month	Fed Funds Rate	Comments
Federal Reserve Board Chairman - Alan Greenspan (August 1987 - January 2006)			
1987			1987: GDP = 3.5%, Unemployment = 5.7%, Inflation = 4.4%
	Sep	7.25%	
	Nov	6.75%	
1988			1988: GDP = 4.2%, Unemployment = 5.3%, Inflation = 4.4%
	Feb	6.50%	
	Dec	9.75%	
1989			1989: GDP = 3.7%, Unemployment = 5.4%, Inflation = 4.6%
	Dec	8.25%	H.W. Bush took office. Fed lowered rates.

Year	Month	Fed Funds Rate	Comments
1990			1990: GDP = 1.9%, Unemployment = 6.3%, Inflation = 6.1%
	Dec	7.00%	
1991			1991: GDP = -0.1%, Unemployment = 7.3%, Inflation = 3.1%
	Dec	4.00%	
1992			1992: GDP = 3.6%, Unemployment = 7.4%, Inflation = 2.9%
	Apr	3.75%	
	Jul	3.25%	
	Sep	3.00%	
1993			Clinton took office in 1993. Fed made no changes.
1994			1994: GDP = 4.0%, Unemployment = 5.5%, Inflation = 2.7%
	Feb	3.25%	
	Mar	3.50%	

Year	Month	Fed Funds Rate	Comments
1995	Apr	3.75%	
	May	4.25%	
	Aug	4.75%	
	Nov	5.50%	
1995			1995: GDP = 2.7%, Unemployment = 5.6%, Inflation = 2.5%
1996	Feb	6.00%	
	Jul	5.75%	
	Dec	5.50%	
			1996: GDP = 3.8%, Unemployment = 5.4%, Inflation = 3.3%
1997	Jan	5.25%	
	Mar	5.50%	1997: GDP = 4.5%, Unemployment = 4.7%, Inflation = 1.7%

Year	Month	Fed Funds Rate	Comments
1998	Sep	5.25%	1998: GDP = 4.5%, Unemployment = 6%, Inflation = 1.6%
	Oct	5.00%	
	Nov	4.75%	
1999	Jun	5.00%	1999: GDP = 4.7%, Unemployment = 6%, Inflation = 2.7%
	Aug	5.25%	
	Nov	5.50%	
2000	Feb	5.75%	2000: GDP = 4.1%, Unemployment = 6%, Inflation = 3.4%
	Mar	6.00%	
	May	6.50%	
2001	Jan	6.00%	2001: GDP = 1.0%, Unemployment = 6%, Inflation = 1.6%. George W. Bush took office. Jan-03

Year	Month	Fed Funds Rate	Comments	
	Jan	5.50%	Jan-31	
	Mar	5.00%		
	Apr	4.50%		
	May	4.00%		
	Jun	3.75%		
	Aug	3.50%		
	Sep	3.00%		
	Oct	2.50%		
	Nov	2.00%		
	Dec	1.75%		
	2002			2002: GDP = 1.8%, Unemployment = 6%, Inflation = 2.4%
	2003	Nov	1.25%	
			2003: GDP = 2.8%, Unemployment = 6%, Inflation = 1.9%	
2004	Jun	1.00%		
	Jun	1.25%	2004: GDP = 3.8%, Unemployment = 6%, Inflation = 3.3%	

Year	Month	Fed Funds Rate	Comments	
	Aug	1.50%		
	Sep	1.75%		
	Nov	2.00%		
	Dec	2.25%		
2005			2005: GDP = 3.3%, Unemployment = 6%, Inflation = 3.4%	
	Feb	2.50%		
	Mar	2.75%		
	May	3.00%		
	Jun	3.25%		
	Aug	3.50%		
	Sep	3.75%		
	Nov	4.00%		
	Dec	4.25%		
	Federal Reserve Board Chairman - Ben Bernanke (February 2006 - January 2014)			
	2006			2006: GDP = 2.7%, Unemployment = 6%, Inflation = 2.5%.
		Jan	4.50%	

Year	Month	Fed Funds Rate	Comments
	Mar	4.75%	
	May	5.00%	
	Jun	5.25%	
2007			2007: GDP = 1.8%, Unemployment = 6%, Inflation = 4.1%
	Sep	4.75%	
	Oct	4.50%	
	Dec	4.25%	
2008			2008: GDP = -0.3%, Unemployment = 6%, Inflation = 0.1%
	Jan	3.50%	Jan-22
	Jan	3.00%	Jan-30
	Mar	2.25%	
	Apr	2.00%	
	Oct	1.50%	
	Oct	1.00%	
	Dec	0%	

Source: Federal Reserve Bank of St Louis, Washington DC Effective Federal Funds Rate Database.

Appendix D: Examples of regulations from 1931 to 2000

Year	Ratings Dependent Regulation	Minimum Rating	Regulator/ Regulation	Reason for Regulation
1931	Required banks to mark-to-market lower rated bonds	BBB	OCC and Federal Reserve Examination Rules	Prudence
1936	Prohibited banks from purchasing 'speculative securities'	BBB	OCC, FDIC and Federal Reserve joint statements	Prudence
1951	Imposed higher capital requirement on insurers' lower rated bonds	Various	NAIC mandatory reserve requirement	Capital Adequacy Requirement
1975	Imposed higher capital haircuts on broker dealers below investment grade bonds	BBB	SEC amendment to rule 15c3-1, the uniform net capital rule	Capital Adequacy Requirement
1982	Eased disclosure requirements for investment grade bonds	BBB	SEC adoption of integrated disclosure system	Easier Market Access
1984	Eased issuance of non-agency mortgage-backed securities	AA	Congressional promulgation of the secondary Mortgage Market Enhancement Act of 1984	Easier Market Access
1987	Permitted margin lending against MBS and (later) foreign bonds	AA	Federal Reserve regulation T	Prudence
1989	Allowed pension funds to invest in high rated ABS	A	Department of Labour relaxation of ERISA restriction	Investor Protection

1989	Prohibited S&Ls from investing in below investment grade bonds	BBB	Congressional promulgation of the Financial Institutions Recovery and Reform Act of 1989	Investor Protection
1991	Required money market mutual funds to limit holding of low rated paper	A1*	SEC amendment to rule 2a-7 under the investment company act of 1940	Investor Protection
1992	Exempted issues of certain ABS from registration as a mutual fund	BBB	SEC adoption of Rule 3a-7 under the Investment Company Act of 1940	Easier Market Access
1994	Imposes varying capital charges on banks and S&Ls of different tranches of ABS	AAA and BBB	Federal Reserve, OCC, FDIC, OTS Proposed Rule on Recourse and Direct Substitutes	Capital Adequacy Requirement
1998	Department of Transportation can only extend credit assistance to projects with an investment grade rating	BBB	Transport Infrastructure Finance and Innovation Act 1998	Prudence
1999	Restricts the ability of national banks to establish financial subsidiaries	A	Gramm-Leach-Bliley Act of 1999	Prudence

2000	Loan by non-profit corporation eligible for guarantee under the Act provided that such corporation has one or more issues of outstanding long-term debt that is rated within the highest three rating categories of an NRSRO (District of Columbia – Appropriations Legislation)	A	Public Law 106-553	Prudence
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