WOLF POPPER LLP

PRESENTATION TO:

IPPFA MIDWEST PENSION CONFERENCE

IPPFA
An Association of Police and Fire Pension Funds

By
Wolf Popper LLP

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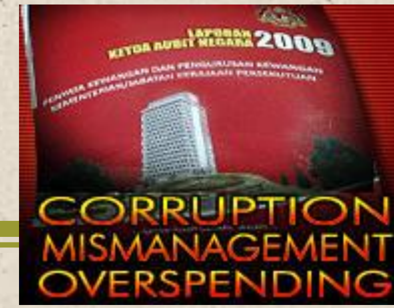
October 3, 2012

Lake Geneva, WI

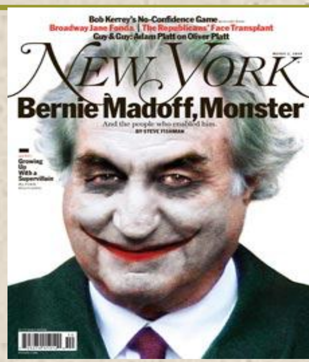
Recent Scandals

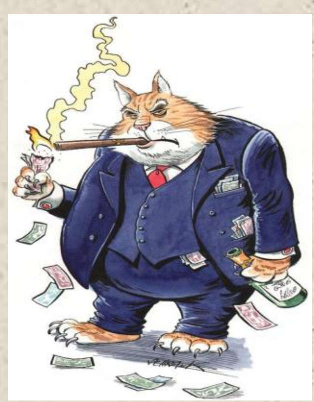


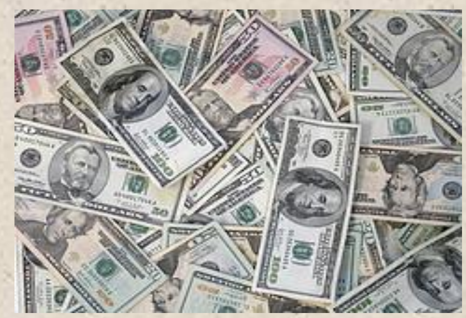
Recent fraud scandals which have affected your funds' investments:

- Excessive executive compensation/stock option backdating
- Mutual fund market timing and late trading
- Madoff Ponzi scheme
- 2008 financial collapse
- Insider trading scheme – Galleon Group (Raj Rajaratnam)

A New Chapter in the Grand Schemes of Corporate America: Welcome to 2012







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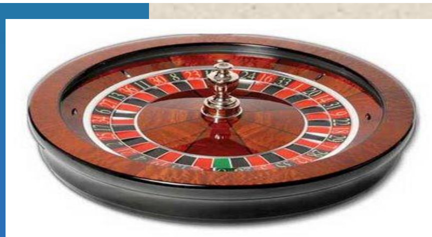
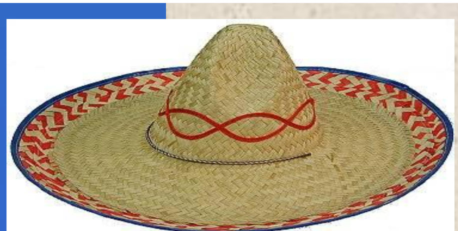
The Scandals of 2012

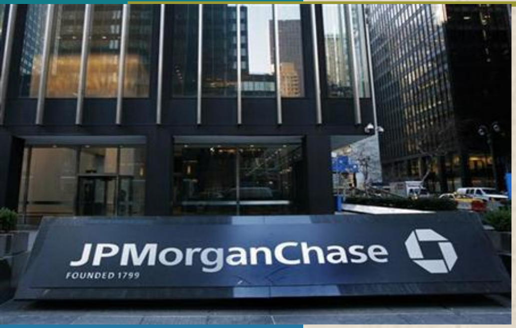
1. J.P. Morgan Chase & Co.'s Costly Multi-Billion Dollar Bet



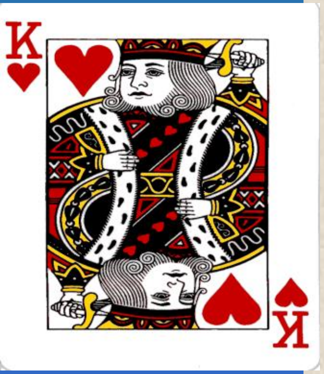
2. Wal-Mart's Mexican Indigestion



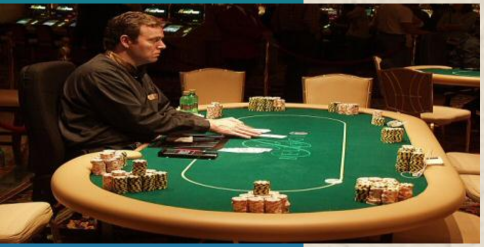
J.P. Morgan: The Pillar of Wall Street?



- J.P. Morgan is the **biggest U.S. bank** by assets.
- J.P. Morgan has **assets** over **$2.3 trillion dollars** and operations in more than **60 countries**.
- **Jamie Dimon**, J.P. Morgan Chase's CEO, was considered a deft manager of risk for the bank after steering the Company through the financial crisis in far better shape than its rivals. Some called Dimon the **"King of Wall Street."**



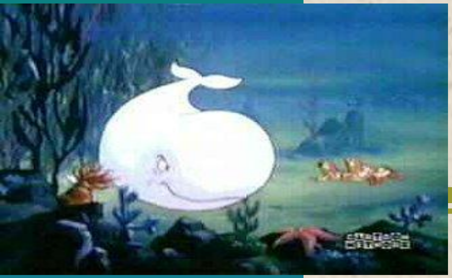
J.P. Morgan's Hedge That Didn't



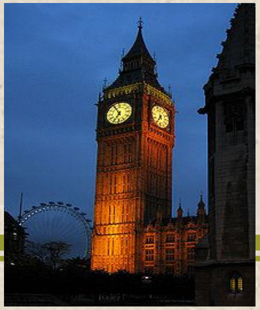
- On May 10, 2012, J.P. Morgan announced that it had accrued **$2 billion** in losses from trading in the **credit derivatives market** that it characterized as "hedging" transactions.

- Following this announcement:
  - J.P. Morgan's stock lost **24%**, or **$23 billion**, of its market value;
  - The **government** (DOJ/FBI and SEC) announced **investigations** into whether J.P. Morgan's trading, disclosures and accounting complied with applicable laws and regulations; and
  - The Company's **Chief Investment Officer**, who oversaw the group responsible for the trading (the "Chief Investment Office"), abruptly left the Company.

- On June 28, 2012, it was reported that J.P. Morgan's losses from trading could go as high as **$9 billion**.



What happened? The London Whale Goes Wild



- **Bruno Iksil** was a trader in J.P. Morgan's Chief Investment Office ("CIO") in London. Due to his **huge, concentrated bets** in the credit markets n/k/a the **"London Whale."**

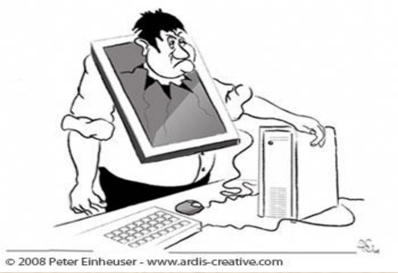
- The CIO invests **excess deposits** for J.P. Morgan, a bank, and was created to **hedge interest rate risk** (*i.e.* to minimize risks).

- However, the London Whale and the CIO embarked on a **complex strategy** that exposed the bank to **"greater risks,"** rather than "lower risks."

- As one critic described it: "Essentially, J.P. Morgan has been operating as a hedge fund with federal insured deposits within a bank."*

*Mark Williams, Boston University Finance Professor.

What happened? Boy Is This Complicated.

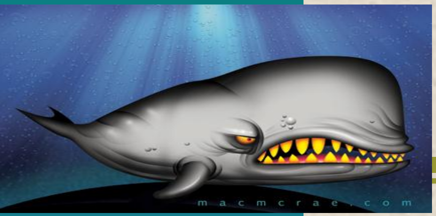


- **Corporate bonds**: debt issued by companies to raise money promising investors a stated rate of return.
  - **Investment grade** (blue chip companies)
  - **Junk bonds** (companies that are on shakier financial ground – riskier)

- Certain institutions (*e.g.*, banks, hedge funds) buy corporate bonds, or indices of corporate bonds, in such **large quantities** that they want **"insurance,"** as a **hedge**, if the company issuing the bonds' defaults (*e.g.*, declares bankruptcy).

- A **credit derivatives market** has emerged where large institutions have created such "insurance" through products called **credit-default swaps** or **"CDS."** Few know about or understand this market and there are very few participants.

- Certain market players agree to **insure** (compensate) a "basket" of corporate bonds for a price by **selling CDS contracts** while other participants **buy** the insurance (CDS contract) in case companies within the basket default on their bonds.



What happened? The London Whale Goes Wild

- Specifically, the London Whale made a big losing bet (**$100 billion** or more) that the 125 companies in a specific index would do well in the future (*i.e.* would not default) by **selling protection** insuring others if the companies in the index defaulted. **Hedge funds** were **buying** default protection on these bonds. These hedge fund purchases made the London Whale's position **unprofitable** by **raising** the **cost** to **protect** the **indexed companies**.

- Because the positions were so big, they were also **illiquid** (*i.e.* could not be sold off quickly). J.P. Morgan lost money, as much as **$200 million a day**, as it tried to scale back on its trade.

- In 2010, a **senior executive** at the Chief Investment Office wrote a detailed report **warning** that **potential losses** on trades that the London Whale had made could be huge. He recommended the bank should put aside **reserves** to deal with these potential losses. The warnings were ignored.

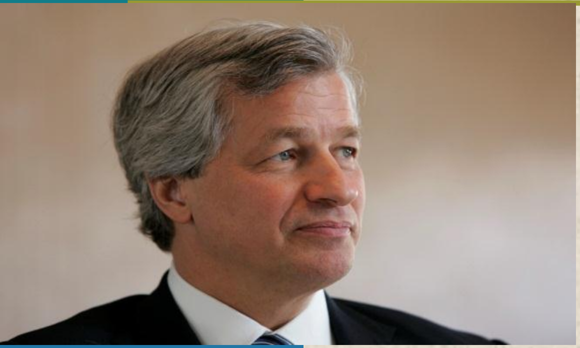
Why did this happen?

- The Chief Investment Office of J.P. Morgan brought in more than **$4 billion in profits** in the last 3 years, roughly **10%** of the bank's profits during that period. Iksil alone earned around **$100 million** a year for the CIO.

- Traders and executives often have their compensation tied to profits they generate and/or the stock price of the Company (if it goes up they make money). This provides an **incentive** to **take risks**, since if they hit big, the compensation is rich. If the risk fails, it usually fails after a period of years and does not come out of the executive/traders' pocket.

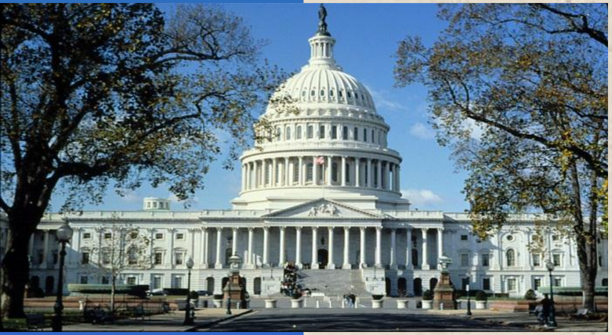
- "Too big to fail."

Isn't it Ironic?

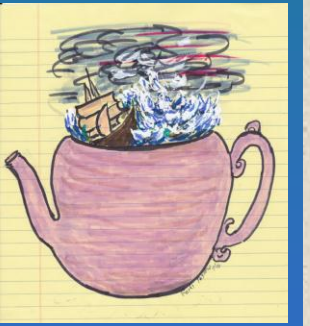


- Jamie Dimon has been a leader in fighting major regulatory changes (*i.e.* the "Volcker rule") that **limits** the kind of **risk-taking** that led to the bank's mega-trading losses.

- However, this J.P. Morgan trading debacle has heightened concerns that the biggest banks still pose risks to the U.S. financial system even years removed from 2008 financial crisis.



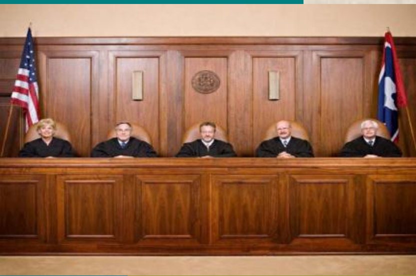
The Fallout: Shareholder Lawsuits And More



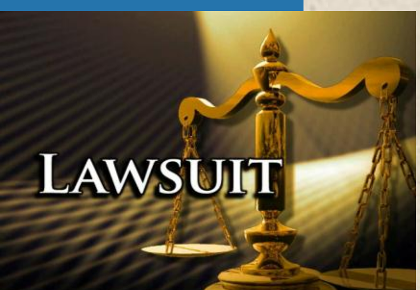
- On April 6, 2012, The N.Y. Times wrote an article titled **"London Whale Rattles Debt Market"** explaining the risk that J.P. Morgan was taking on its credit-default swaps.

- On April 13, 2012, on a conference call announcing J.P. Morgan's 1st Q, 2012 earnings, **Dimon downplayed** the **risks** associated with the bank's large position in the credit derivatives market calling media reports about the London Whale's trading a **"tempest in a teapot."**

- Less than a month later, the multi-billion dollar losses on these trades were announced. In the second "bad news" announcement, Dimon admitted the Company's trading strategy was **"flawed, complex, poorly reviewed, poorly executed and poorly monitored."**

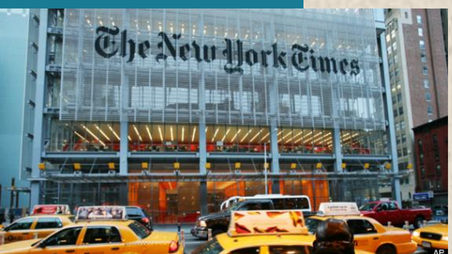


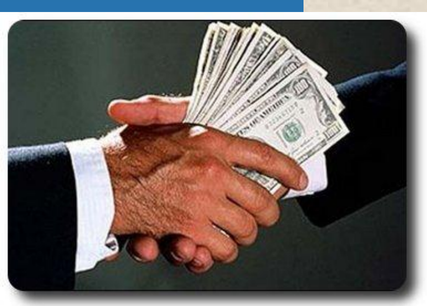
The Fallout: Shareholder Lawsuits And More



- Shareholders have brought class action lawsuits seeking to recover damages for, among others, anyone who purchased J.P. Morgan stock during that one-month period for fraud.
- Shareholder derivative lawsuits have challenged why the bank shifted its **"allowable risk model"** to become much more aggressive, and turning the CIO from a unit charged with **reducing risk** through hedging into a **risky, short-term trading enterprise**, as well as how J.P. Morgan's **controls failed** to stop the London Whale's accumulation of such huge, illiquid positions.
- The bonds of J.P. Morgan have been downgraded.

Wal-Mart Bribes Mexican Officials

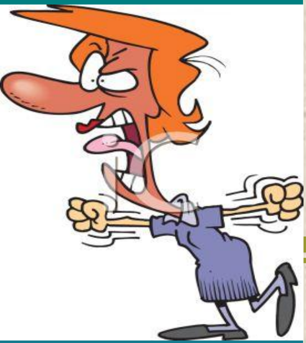


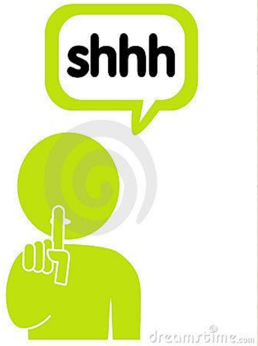


- In April 2012, The N.Y. Times posted an article reporting that Wal-Mart officials had engaged in **systematic bribery** to **further expansion** of its Mexican operations and **covered up** an internal probe into the matter.

- Specifically, executives from Wal-Mart routinely bribed officials to receive **building permits** across Mexico. If true this violates the **Foreign Corrupt Practices Act** (FCPA) that prohibits bribing overseas officials.

- Reportedly, after Wal-Mart learned of the bribes it **stalled** an **internal investigation** into the situation and **failed to promptly report** the problems **to** the **U.S. government**.





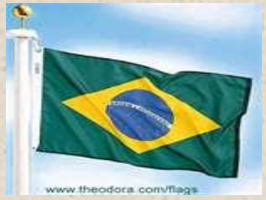
It Gets Worse!

- Subsequent news reports that Wal-Mart executives first learned of allegations of widespread bribery in **2005**, but kept it quiet for **7 years**.

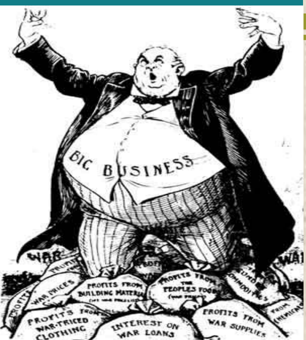
- The U.S. DOJ has a long-standing policy of **punishing** violators of the FCPA **less** if they **report** any misbehavior **early**. Wal-Mart did not report the misconduct until its executives learned that The N.Y. Times was about to issue its article on the bribery scandal.

- Consequently, the DOJ is likely to come down hard on the Company.

- Wal-Mart is now probing whether Company officials also bribed government officials in **South Africa, Brazil, China and India**.

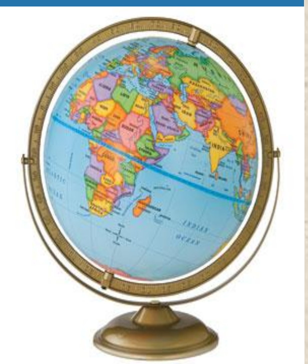


Why Would Wal-Mart Officials Bribe Foreign Governments?



- **Company's Greed:**
  Wal-Mart's international operations make up **more than 25%** of its **revenue**. These international operations also remain the Company's **"growth engine."** Bribing officials speeds the growth.

- **Individuals' Greed**
  Executives at these international offices of Wal-Mart are compensated, in part, by how well their offices perform. Bribing officials expands growth and, consequently, personal profit.



The Reaction to the Scandal

<u>Stock Market</u>: Wal-Mart's stock dropped nearly **5%** immediately following <u>The N.Y. Times</u> article.

<u>Government</u>:

– <u>DOJ</u> and <u>SEC</u> commenced investigations into the Company. Past penalties for similar violations by these agencies is **1%-2% of annual sales**. For Wal-Mart, this would equal, at least: **$4.5 billion**!

– <u>Congress</u> commenced an investigation of the Company.

<u>Shareholders</u>: More than a dozen lawsuits, class and derivative actions, have been filed.

<u>Business</u>:

- Through mid-August Wal-Mart had spent **$34 million** in expenses related to the bribery investigations and expected those expenses to **triple** by year-end.

- Wal-Mart also **delayed new store openings** in Mexico by 90 days. This slowdown in new store openings in Mexico could mean a 5% decrease in growth, a **$1.3 billion** loss according to a financial analyst.

What Is A Shareholder To Do About These Scandals?

- Let’s find out from our next speaker.

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