Prime bank fraud can trace its origins to several roots. There is a long history in business of advance fee fraud concerning loans. With varying degrees of sophistication, promoters have for years promised access to low interest rate loans in exchange for the payment of an up-front fee. Closely related to this type of fraud is the self-liquidating loan. Former OCC staffer John Shockey states that he can remember self-liquidating loan proposals from as far back as 1959.

A second source lies in the area of commodity fraud. In the mid-to-late 1980s, one of the first popular computer bulletin boards for business was established by the World Trade Center in New York. This was a dial-up service. It listed offers to sell and offers to buy. Most of the items listed were commodities – scrap metal, jet fuel, Levi jeans, Marlboro cigarettes, sugar, urea, crude oil, and such. Many were "gray market" items that may have been sold outside established distribution channels. Undoubtedly, many were counterfeit. Some people at the time had the notion that they would simply compare the two lists and match buyers with sellers. It didn't work that easily: the sellers could rarely, if ever, perform, and the buyers were not much better. The business was attractive because the volumes offered were so staggeringly high that a person only needed to close one deal in order to be financially secure for life. In this environment, offers for the sale of currencies and an item unashamedly called "prime bank notes" or "collateral" grew exponentially.

The offers for the sale of collateral at that time listed a number of different types: Prime Bank Notes ("PBNs") were the most important. These came in four flavors. There were 7.5% x 10 year notes, 7.5% x 20 year notes, 14% x 10 year notes, and 14% x 20 year notes. The 14% notes were sometimes dubbed "Japanese notes" because they were supposedly issued only by the major Japanese banks to fund Third World development. At the time, Japanese banks were king of the hill in international banking, by far larger than their Western European and American counterparts. In addition to PBNs, the parties also offered one year, zero coupon Standby Letters of Credit ("SLCs"). Occasionally, one would see an offer for Bank of China notes "wrapped" by Barclays Bank.

The prices offered for these instruments were normally in the 80-85% range for SLCs and in the low to mid 70% range for 7.5% x 10 year PBNs. By today's standards, as well as the standards of the time, this was dirt cheap. Amazingly cheap. Unbelievably cheap. Even then, a distinction was made between offers for the sale of "collateral first" notes versus "funds first" notes. Always, the price of collateral first was higher.

In those days, it was very hard to find reliable information about the market for bank instruments. There was no internet, and communication was normally be fax. The personal fax machine, usually with a roll of uncut thermal paper, was just beginning to become popular. Few people knew very much, and they usually considered what they knew to be a trade secret. I met a large number of people trying to make this business work, and by and large they appeared to be decent, honorable people. Years later, however, I was surprised to learn just how many had criminal records of some kind or other, and how many would later end up being arrested for their activity in this business.

In the late 80s and early 90s, it was not unusual to learn that someone had been in a bank when a transaction went bust and was questioned by the Swiss police for a few hours and then released. In recent years, the consequences have become much more severe.

During Operation Desert Shield/Storm in 1990, the offers for PBNs slowed down while every night people received countless offers for the purchase and sale of Kuwaiti Dinars. As with the gray market goods, the quantities offered were fantastic, in the trillions of dollars. Thousands of offers for this relatively unknown currency were made. It is unclear whether any of these transactions ever closed. Phone service at this time was much more expensive than it is now, and many who participated in this market wound up spending more each month for their telephone than for their monthly housing expense. Russian rubles became an item of great interest at this time, as did hallmarked gold sold at unusual discounts.

During this time, a new instrument appeared on the scene that soon dominated the market: the Prime Bank Guarantee ("PBG"). The PBG was similar to the PBN in terms of interest rate and maturity, but was priced (usually) one point higher. If PBNs were offered for 73% of face, then PBGs would be offered for 74%. It was explained that this was because they had a higher priority among creditors in the event of bankruptcy. Soon, even though other instruments were still offered, PBGs supplanted the others and became the big kid on the block.

Many people didn't care where these instruments originated, or why they were issued, but for those who did ask such questions in the early 1990s, the answers given were that the notes were issued at a "cutting house" (separate and apart from the bank) pursuant to a "master collateral commitment." Could you look in the phone book under "C" for "cutting house"? Not exactly. Where were such cutting houses located? Few explanations were given, although many pretended to have "inside knowledge" and were sworn to secrecy.

What about the Master Collateral Commitments? Sometimes draft copies were circulated, but they were usually poorly drafted with numerous typing mistakes, re-faxed with important information whited-out, or obvious forgeries. Often people would try to explain that there were seven, or five, or three, or eleven or some other number of Grand Masters – the appointed few who controlled the world of collateral, and from whom all such notes were issued. Various theories were floated about how such a small number of people could secretly control such an important area of finance. There was no agreement.

I traveled extensively throughout Europe at this time, and can remember well one banker at a private bank in Geneva turning to me and asking, "Why would a top bank issue their instruments so cheaply?" He explained that he had seen numerous offers for the sale of these instruments, but had never seen one close. I didn't have an answer for him. We traveled to Zurich the next day to pick up the note we had confirmed the day before, but by the time we arrived it had somehow disappeared.

Zurich was a major hub of such activity, and I made many trips there. The hotels were full of people on the same quixotic quest. In the early 90s, I learned of a new opportunity. This was called the "roll program." In this scenario, instead of arranging a buy and sell of bank instruments, a "program manager" did all the work for you and all you needed to do was come up with the money. No expertise in banking or the selling of securities was needed. This idea soon caught fire and the number of offers for the sale of instruments declined dramatically as "programs" rose to prominence.

A number of programs were offered with different configurations at the time. Initially, an investor simply transferred the money to the "program manager" and that was it. No security was asked for or given. Even then, however, investors were wary, because so many offers to sell had turned out to be bogus. As a result, program promoters began to offer a 108% bank guarantee to secure the investor's funds. (One could legitimately wonder what money was available for trading if the investor's funds were used to purchase a bank guarantee.) This set up was eventually replaced by a 106% bank guarantee, a 104% bank guarantee, and all sorts of similar arrangements. Sometimes the program managers offered a “subaccount” or a “parallel account” or a “blocked funds letter” structure to assure investors their money would not be stolen. Despite their appearance of safety, many investors lost money through these schemes.

This was also the era of the “one day program.” In this scenario, the investor would walk into a bank in Zurich in the morning with a check for several million dollars, and return in the afternoon of the same day to pick up the un-cashed check and another bank check for many multiples of his original check. There was no investment, just profit. There were many variations on this theme, including “table top” closings. Thousands of people flew to Switzerland to pursue this dream.

Still, PBNs and roll programs were mired in controversy. Many investors lost their money, arrests were made, and some banks even became involved in the mess. For example, a bank in eastern Europe called Banka Bohemia issued hundreds of millions of false instruments at the behest of some crooked bank officers. The Salvation Army in London lost money in a highly publicized scandal. Many brokers became tired of chasing after uncooperative investors and chose to work on discounting notes from Russian banks, Indonesian and Brazilian banks, and counterfeit Italian CDs. Letters of credit and CDs from Mexican credit unions and “brass plate” Caribbean banks were circulated. This development led to a number of arrests.

US law enforcement authorities launched an attack to discredit these schemes by claiming that there is no such thing as a “prime bank” so there can be no such thing as a “prime bank note.” Although this may seem like hair-splitting, it is true that most HYIP promoters cannot describe the instruments they supposedly are trading. In 1994, the SEC launched a formal investigation of fraud in the offer and sale of prime bank notes. The fraudsters responded by changing their offers to be for “promissory bank notes.” The same people who only months earlier had offered “prime bank notes” explained in hushed tones that – technically – the proper term to be used was “promissory bank notes.” Offers were no longer made for the sale of prime bank notes, but rather for “top 25 Western European Banks (with normal exclusions)”. Problem averted. This was a logical response to a law enforcement initiative. There would be many more such transformations and evolutions.

In 1993, rumors circulated that the International Chamber of Commerce was going to revamp the rules for the collateral business in a new document entitled "ICC 500." What would these new rules provide? For one, excessive broker commissions would no longer be tolerated. Also, no transactions less than $50 Million USD would be permitted, and there would be no more "collateral first." I knew the ICC was in Paris, and was a real institution. Just as a matter of curiosity, I called the ICC and obtained a copy of the text of the new rules. They looked nothing like the faxes that had been circulating in the broker community. These were real rules regarding documentary credits, not roll programs. I obtained several other documents from the ICC and studied them. Again, nothing like the broker rumors.

In fact, there is a well-developed body of law on letters of credit and bank guarantees. There are numerous cases. There are well-known texts by John Dolan and Diane Wunnicke, and an excellent older book by a New York lawyer named Henry Harfield. There are monthly newsletters on developments in letter of credit law edited by Professor James Byrne. All of this contradicted the assumptions and stories heard in the hotels of Zurich and Geneva, received on faded faxes, and whispered over drinks in London and Lugano.

The notion that an SLC or bank guarantee could easily be traded like a security was difficult to maintain once knowledge of them was gained. For one thing, transferring ownership of SLCs is not a simple thing, as it is for a security. There are a number of ways it can be done, but none as easy as transferring a security. Also, Euroclear and Cedel at this time would not accept SLCs on their system, which were increasingly becoming the gold standard for securities settlement ("book entry"). It should come as no surprise, therefore, that soon new terminology came along to replace the old. The new instrument was the "Medium Term Note." No longer were trades done on SLCs or PBGs, but now exclusively on MTNs. Of course, when pressed one could always claim that MTNs were a generic name for any kind of instrument between 1 and 10 years term, so this could include SLCs and PBGs, but that argument was seldom made. At the same time, program promoters suggested that no one use the term "roll program" any longer and instead use High Yield Investment Program ("HYIP"). The term "roll program" had become discredited. The HYIP would later face competition from the term Private Placement Opportunity ("PPO"). Always one step ahead of the law. It was a logical response.

By this time, the mythology of PBNs/roll programs/HYIP/PPO had become sufficiently engrained in the public mind that no explanation was normally needed. On every continent of the globe, businessmen scrambled to find access to the bank generated wealth. It was a commonly accepted assertion that 99% of HYIP offers were fraudulent, but such statements only spurred people on to find that other 1%.

Many intermediaries grew weary of chasing after an investor with $10 Million. These investors were often difficult to work with, to say the least. Also, the deals never, ever closed. Accordingly, they developed several responses. As noted, many began to work with hard-to-place debt instruments from Russian banks, or Third World countries. Others searched out rented funds. If you can't locate a suitable investor, they reasoned, then why not rent the funds for a month and try the program out. A similar idea involved leasing Treasuries. Big securities firms lease Treasuries to their clients, so perhaps it could be done for entry into HYIP programs. This was a notorious failure. First, the Treasuries were simply not available to the type of individuals who wanted to lease them, and secondly the forms used by the promoters were shown to be patently wrong. The whole affair was a disaster, and indeed some of the firms engaged in this effort in the United States faced prosecution.

One very creative response to the need for raising capital was the historical bond fraud. For several years in the mid 90s historical bonds were taken quite seriously by many people. There were several forms. Some of the first to surface were pre-World War II German gold bonds. Sometimes referred to as “Dawes and Younge” bonds, they were researched extensively by some. Such bonds really did exist under the Weimar Republic, but the copies being circulated by brokers would not be honored by the German government. A truly outlandish fraud involved bonds issued by bankrupt US railroads from the 19th Century. These attracted a great deal of attention for about a year or so, but when the most prominent promoter of such bonds, James Rice (alias: Sloan Dupont) was arrested on fraud charges and the story was on page one of the Wall Street Journal, interest understandably waned. A similar story was the so-called Japanese Series 57 Certificate of Redemption Balance. These were counterfeit bonds that circulated in the mid-90s in staggering denominations and amounts. The story was told that if the truth came out about how much the government of Japan owed on these bonds it would shock the banking system and bring down the government. So, the government unjustly denied their existence and nobody thought to bring legal action. The story did not withstand scrutiny. Ultimately, a number of arrests were made and word got around that these were dangerous instruments to be associated with. Several promoters of the Series 57 certificates plead guilty in Florida, as well as in North Carolina. A similar effort involved old Argentine pesos that are no longer honored. Millions of such worthless currency still circulates in certain circles, together with stories about why they are being offered.

Another significant response, however, was the development of the program for "small" investors – those with less than $10 Million. By pooling a large number of small investors, promoters claimed, sufficient funds could be generated to participate in programs that once were available only to the rich. By the late 90s a number of small investor funds were promising big profits to investors with only modest amounts of money. Their names have become all too familiar – Omega, Tri-West, TAC, IFR, Le Club Prive, Elfindepan. Unfortunately, many individuals and families lost their entire savings to such a pitch, which was often coupled with either populist anti-government rhetoric or pronounced in the grip of religious fervor. The programs didn't exist, and the promoters generally skipped with the money or lost it to other promoters.

Regrettably, this is the true history of bank debenture trading, prime bank instruments, HYIP, and the collateral business. It has nothing to do with Bretton Woods, the Federal Reserve, or secret markets available only to the chosen few, and everything to do with old-fashioned greed and dishonesty. It began as a fraud, it developed as a fraud, and it continues as a fraud. The story changed, the justifications evolved over time, but the end result has always been that investors lost money and no trading took place.