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# Risk, recklessness and policing the financial markets

In 'The law of financial crime – Fighting financial crime in the global economic crisis' published by Routledge on 4th November 2014, Jonathan Fisher QC devotes a chapter to policing the financial markets and demonstrates that the conventional perception concerning the impotence of the criminal law is misconceived.

In an article published by the Financial Times on 29th October 2012 under the heading "US housing: After the Gold Rush",[1] Lanny Breuer, Assistant Attorney General in the United States Department of Justice, is quoted as saying that "the securitisation cases at the corporate level are challenging because the things that are so disheartening and contributed to the financial crisis are not activities which violated the criminal law". This is a common perception, with the impediment to criminal prosecution attributed to the difficulty of proving that financial market participants acted dishonestly, this being the badge of criminal intent.

Certainly there have been a myriad of civil settlements arising out of misconduct associated with the global financial crisis, but criminal prosecutions have been rare. Indeed, it is true to say that the criminal law has barely engaged with the global financial crisis at all. As Charles Ferguson, the renowned film director who produced Inside Job, a feature length documentary about the global financial crisis, indicated when accepting his winning nomination at the Oscars ceremony[2] in Los Angeles on 27 February 2011, "I must start by pointing out that three years after our horrific financial crisis caused by massive fraud, not a single financial executive has gone to jail, and that's wrong."[3] In this, Mr Ferguson was reflecting no more than the weight of public opinion whose patience has been exhausted by the emergence of financial wrongdoing on a massive scale. On 9th October 2012 the Evening Standard published details of a public opinion survey conducted by YouGov on behalf of Avaaz,[4] a global non-government campaigning organisation, which revealed that 89% of a sampled group in the UK wanted sentences of imprisonment for bankers who manipulated the financial markets. The language used by Alex Wilks, Avaaz's campaign director, when publishing the results of the opinion poll is particularly apposite in any consideration of criminal responsibility for reckless risk-taking. Mr Wilks noted that people across Europe want to see bankers behind bars because "[bankers] are massively rewarded for their reckless gambles and get off far too lightly when caught."[5] Writing in the Financial Times on the 22rd May 2013,[6] John Kay, a highly respected economic commentator, expressed the position more bluntly: "The financial crisis left a few individuals responsible for it very rich while its consequences made many millions not responsible for it much poorer. If this involves no crime, then we have failed to define or prosecute crime appropriately".

The purpose of this chapter is to demonstrate that the conventional perception concerning the impotence of the criminal law is misconceived. Much of the conduct in the securitization cases, and other cases of brazen wrongdoing committed in connection with the financial markets, was characterised by blatant instances of recklessness which the criminal law could properly have captured. Not only are the boundaries of the criminal law sufficiently wide to punish instances of reckless behaviour by financial markets participants where they cause loss to others, criminal justice theory demands that it does so. The case for criminal responsibility for reckless risk-taking on the financial markets is a strong one, as the United Kingdom Parliament has recently recognised with the creation of a new criminal offence of taking a risk which causes a bank to fail contrary to section 29 of the Financial Services (Banking Reform) Act 2013. The enactment of a provision limited to the failure of a bank begs a broader question as to whether reckless risk-taking on the financial markets should also be criminalised where consumer interests are adversely affected.

## Recklessness risk-taking, securitization and the global financial crisis

It is difficult to know where to start with any demonstration of the extent of reckless risk-taking on the financial markets which helped to precipitate the global crisis, in particular with regard to the securitization cases to which Mr Breuer made reference. In his serious and somewhat entertaining review of the global financial crisis, Michael Lewis, a financial journalist and non-fiction author, develops an argument that serious problems were caused because in some cases senior management in investment banks were so reckless they did not even understand the risks they were running.[7]

In layman's terms, securitization is the financial practice of pooling various types of contractual debt, such as residential mortgages, commercial mortgages, car loans, or credit card debt obligations, and selling the pooled debt on the financial markets as investments to investors. Cash collected from the underlying debt, including interest and proceeds from the repayment of the debt, is then paid to the investors who purchased the pooled product. In this way, the income can be said to be derived from the pooled product, which is classified as a financial instrument and commonly referred to as a derivative investment or more simply a derivative. But a derivative investment is a wide term and it can also include a variety of financial contracts, including contracts involving the purchase or sale of shares and here the terminology becomes almost impenetrable as references are made to contracts for futures, forwards, swaps, options, and variations of these contractual arrangements involving caps, floors, collars, and credit default swaps which are often known by their acronym "CDS". Understanding the nature of a CDS is a little complicated but essentially this derivative is a financial swap agreement under which the seller of the CDS, as the holder of a financial instrument which is composed of a collection of pooled loans, agrees to compensate the buyer in the event of a loan default or other credit event. The buyer of the CDS makes a series of payments known as the CDS "fee" or "spread" to the seller and, in exchange, receives a compensatory payment if the loan defaults. The scale of the derivate market is enormous. The volume of cleared "over-the-counter" derivatives (excluding foreign exchange transactions) in the year ending 31st December 2012 is estimated to have totalled $346.4 trillion.[8]

### RBS – a paradigm example

Certainly, Michael Lewis's argument is borne out by the evidence which emerged in response to the Financial Services Authority's investigation into the collapse of the Royal Bank of Scotland (RBS) in 2011. RBS's experience is perhaps the paradigm example of the consequences of reckless risk-taking by a financial markets participant, leading to the bank's collapse in October 2008 and a Government bail-out to the tune of £45.5bn paid through the acquisition equity capital. The bank had played a significant role in precipitating the financial crisis, and the Financial Services Authority was concerned to explore the reasons why the bank had failed. In particular, the Financial Services Authority sought to discover whether the failure resulted from a level of incompetence, a lack of integrity, or dishonesty which could be subject to legal sanction. The key finding was that RBS's failure amid the systemic crisis in the global banking system had resulted from poor decision-making by its management and board of directors. One aspect of poor decision-making related to the accumulation of substantial losses in credit trading activities, with credit trading losses of £12.2bn having driven RBS's £8.5bn overall trading loss for 2008. More generally, losses for 2008 were concentrated in RBS's investment banking division within Global Banking and Markets (GBM). Large GBM losses were incurred on structured credit and leveraged finance, while other credit trading activities eroded both capital and market confidence and were a factor in RBS's failure in 2008. The problems stemmed from a strategic decision taken in the middle of 2006 for RBS to expand aggressively its structured credit and leveraged finance businesses. By early 2007, this strategy had resulted in the accumulation of significant credit risk exposures in its trading portfolio, in particular via RBS's holdings of super senior tranches of derivatives structured out of US sub-prime mortgages.[9] Unfortunately, though, there was serious concern amongst the shareholders, which turned out to be correct, that Sir Fred Goodwin, RBS's Chief Executive Officer (CEO) at the time, did not fully appreciate the large, single name risks which arose from RBS's rapidly growing exposures in the syndicated and leveraged loans markets which principally involved the purchase and sale of financial derivative instruments known as collateralized debt obligations (CDOs) and the impact of this growing accumulation of risk across the bank.[10] But it was not only the CEO who failed to appreciate the risk and made little, if any, attempt to find out. Johnny Cameron, the Chairman of RBS's Global Banking and Markets which was responsible for this area for trading was equally in the dark. During an interview with the FSA's Enforcement Division, Mr Cameron admitted that he did not understand the risks inherent in trading these types of derivative instruments:

> "I don't think, even at that point, I fully, I had enough information. Brian may have thought I understood more than I did… And it's around this time that I became clearer on what CDOs were, but it's probably later"[11]

The reference to Brian is to Brian Crowe who was the CEO of GBM, reporting to Mr Cameron in his role as GBM's chairman.

In fairness, the regulators did not fully understanding the risks either. As Sir Howard Davies, an economist and former chairman of the Financial Services Authority, recently noted when commenting upon the causes of the global financial crisis:

> "While in principle these new products allowed risk to be dispersed, there were two significant drawbacks. First, the products were highly complex and hard to understand, both in themselves and in terms of their interaction with other balance sheet risks. And, second, the growing complexity of financial networks made it difficult for regulators to understand where risks were held in the financial system and the consequences of financial failure".[12]

**The traders**

Whilst senior management and the regulators bear a significant share of the blame for a reckless indifference to the risks inherent in derivative trading and their consequential impact on the stability of the banks, primary responsibility for reckless risk-taking on the financial markets must rest with the traders who buy and sell derivative instruments in incredibly high volumes and with astonishing rapidity. Very little, if any, due diligence is undertaken with regard to the valuation of the underlying assets, or the accuracy of these valuations and the basis on which they have been put forward, with traders preferring to make a wager on the price rising or falling (if "short-selling)"[13] and cross-purchasing or selling in order to "hedge"[14] their exposure to any losses which they might incur. In these circumstances, the decision whether or not to purchase or sell a financial instrument is rarely if ever influenced by the value of the underlying assets which the derivative represents. Rather, the decision is taken on the basis of the trader's perception of market sentiment and whether he is likely to make a swift profit by the purchase or sale of the instrument in question. With a huge volume of trading, the smallest price movements can yield enormous profits, although by the same token they can inflict severe losses where the price moves in the opposite direction to that which the trader had expected. Where traders are acting responsibly, they will not spend much time exploring the value of the underlying assets but they will develop their own technical analysis of the financial instrument and the way in which the financial markets have been moving. Access to reliable data, coupled with careful consideration of data and the injection of some independent thought, are the trademarks of a responsible market trader. Accordingly, a sound decision to purchase or sell derivative instruments on the financial markets should be capable of rational justification based on defensible criteria. If the position were otherwise, the decision whether or not to purchase or sell a financial instrument would become a matter of speculation and little more than a gamble, akin to the placing of a bet on a randomly selected horse or the purchase of a lottery ticket.

Whilst it would be wrong to make broad and unsustainable assertions about the activities of traders on the financial markets as a category, there is evidence which suggests that reckless behaviour by derivative traders is not an unknown phenomenon and in the period prior to the global financial crisis there were traders who were gambling with the purchase and sale of derivative instruments instead of making their decisions on a more considered basis. As Geraint Anderson, a former City of London utilities sector analyst and newspaper columnist, recently explained when describing the culture in a bank trading room:

> "Most bankers possess the arrogance to believe that they can beat the odds no matter what game they're playing … We used to gamble on all sorts of things … dreadful things, like a graduate trainee would come in and you'd have a bet on what bra size she had. It's a competitive environment and gambling is the perfect amalgam of making money, which is what the City is about …".[15]

There is, however, more than anecdotal evidence available which establishes the point.

**J P Morgan and the London Whale**

The story of J P Morgan and the London Whale is a totemic example of reckless trading on the derivative markets which resulted in more than $6 billion of losses, meriting a financial penalty of $100 million imposed by the US Commodity Futures Trading Commission in October 2013. Taking the facts from the Order instituting enforcement proceedings against J P Morgan,[16] the case involved trading on the CDS market where market participants rely on the notion that CDS prices are established based on legitimate forces of supply and demand. However, on 29 February 2012, J P Morgan traders undermined this key principle by employing an aggressive trading strategy concerning a particular type of CDS known as "CDX." The trading desk, known as the Chief Investment Office (CIO), was based in London and as at 31st December 2011 it held a substantial position in CDX and other credit default indices, with a net notional value of more than $51 billion, including $217 billion in long risk positions and $166 billion in short risk positions. At the end of each trading day, traders in the CIO "marked" the positions in this swaps portfolio "to market," assigning a value to the portfolio's positions using various measures including market prices for the credit default index positions. The traders' marks were used to calculate profits and losses. Although previously quite profitable, in late January 2012 the portfolio's value began to fall and by mid-February 2012 daily losses were increasing rapidly. Internal portfolio valuations were distributed at the end of each month, and in order to improve their position the traders in London employed an aggressive trading strategy on 29th February in connection with one particular CDX, the CDX.NA.IG.9 10 year index ("IG9 IOY"). As the value of the portfolio stood to benefit as the IG9 IOY market price dropped, on 29th February the CIO in London sold more than $7 billion of the stock, with $4.6 billion of the stock sold during a three hour period as the trading day came to a close. The trading followed sales of more than $3 billion of this index in the previous two days. To put the quantity sold by the CIO into perspective, the net volume sold by the CIO over these three days amounted to roughly one-third of the volume traded for the entire month of February by all other market participants. During this same period at month-end, the market price on IG9 1OY dropped substantially and the CIO was selling at generally declining prices. The value of the position that the CIO held benefited on a mark-to-market basis from the declining market prices. J P Morgan's controls and supervision over the CIO did not prevent the London traders from first accumulating the massive portfolio of positions in certain CDX and other credit default indices, and then from taking the steps to conceal the losses. In July 2012, J P Morgan's parent company disclosed that it had lost confidence in the integrity of the traders' marks and acknowledged that it ultimately lost more than $6 billion in 2012 in connection with the CIO's CDS index trading. Against this background, the Commodity Futures Trading Commission had no difficulty in concluding that J P Morgan had been guilty of reckless trading. Operating out of desperation to avoid further losses, the London traders developed a resolve to limit their losses and recklessly sold massive amounts of protection on the IG9 1OY during a concentrated period. In particular, the traders disregarded the possible consequences of selling an unprecedented volume of stock, demonstrating a reckless disregard to obvious dangers to legitimate market forces from their trading. The Commission made clear that the imposition of liability for reckless conduct was an important safeguard for international derivatives markets and will help promote the integrity of the markets and protect market participants.[17]

**Kweko Adoboli**

The history of the experiences of numerous rogue traders speaks with the same voice. Rogue traders such as Kweku Adoboli (UBS, $2.3 billion loss, London, 2011), Jerome Kerviel (Societe General, $6.9 billion loss Paris, 2008), Yasuo Hamanaka (Sumitomo, $2.6 billion loss Tokyo, 1995) and Nick Leeson (Barings, $1.3 billion loss London, 1995) are prosecuted and punished by lengthy sentences of imprisonment for their conduct in fraudulently concealing their losses, but it is their reckless conduct as traders which caused the losses in the first place. Yet it is not the reckless risk-taking which engages the criminal law. In these cases, the prosecutors stigmatized the cover-up as more culpable than the underlying misconduct which it sought to conceal.

The trial judge’s remarks when sentencing Mr Adoboli to seven years imprisonment for offences of fraud are especially apposite to consider in this context. Mr Justice Keith began his remarks by reminding Mr Adoboli that he would forever be known as the man who had been responsible for incurring the largest trading loss in British banking history. [18] The judge described how he had amassed huge positions when trading on behalf of the bank, well beyond his risk limits, without protecting the bank from the risk of loss by hedging his trades. The judge accepted that Mr Adoboli genuinely thought that the market would rally but in fact it fell, exposing the bank to the risk of enormous losses, at one stage to the risk of losses amounting to an unbelievable $11.8bn. This led Mr Adoboli to take larger positions in a desperate attempt to recoup these losses and throughout he concealed what he was doing by booking fictitious hedging trades to give the back office the impression that your trades were hedged when they were not. As Mr Justice Keith explained:

> "There is the strong streak of the gambler in you, borne out by your personal trading. You were arrogant enough to think that the bank's rules for traders did not apply to you. And you denied that you were a rogue trader, claiming that at all times you were acting in the bank's interests, while conveniently ignoring that the real characteristic of the rogue trader is that he ignores the rules designed to manage risk".[19]

**Nick Leeson**

Reckless risk-taking by traders on the financial markets is not a new occurrence and pre-dates the global financial crisis without question. The collapse of Barings Bank in 1995 was precipitated by the activities of a rogue trader, and as with Mr Adoboli's case, the rogue trader in question was sentenced by a court in Singapore to five years imprisonment for his conduct in dishonestly concealing his losses.[20]

Barings Bank was the oldest merchant bank in London, founded in 1792 and owned by the Barings family. The bank collapsed in 1995 after one of the bank's employees, Nick Leeson, lost £827 million due to speculative derivatives trading in futures contracts at the bank's office in Singapore. At the time the losses were incurred, Mr Leeson was supposed to be engaged in arbitrage trading by seeking to profit from differences in the prices of Nikkei futures contracts listed on the Osaka Securities Exchange in Japan and prices of comparative contracts on the International Monetary Exchange in Singapore. The essence of this form of arbitrage trading was the buying of futures contracts on one market and simultaneously selling them on another at a higher price. However, instead of buying on one market and immediately selling on another market for a small profit, Mr Leeson bought on one market and then retained the contracts, gambling on the future direction of the Japanese markets. When the value of the contracts increased, healthy profits were made. But when the markets began to fall, contrary to Mr Leeson's expectations, the gamble failed and significant losses were incurred. Instead of "closing his positions" and drawing a line under the losses, Mr Leeson believed he could trade out of trouble by speculatively purchasing increasing numbers of futures contracts, in the hope that the markets would change direction and revert to an upward trend. This did not happen for a number of reasons, and ultimately Mr Leeson's rogue trading activities were exposed. Initially, Mr Leeson had been able to conceal the losses by using one of the bank's error accounts which enabled him to represent the losses as errors rather than the disastrous consequences of his unauthorised trading. The criminal offences for which Mr Leeson was convicted in Singapore related to his dishonest use of the error account and his deception about the scale of his losses rather than the risky nature of the activities which caused them.[21]

## Reckless risk-taking and dishonesty

**Dishonesty**

The consensus of opinion amongst legal practitioners and academic lawyers is that reckless risk-taking on the financial markets does not amount to a fraudulent activity because dishonesty is the litmus test of fraudulent conduct and reckless behaviour, however reprehensible it may be, falls short of dishonesty. This, of course, begs the critical question as to what is meant by the word "dishonest". The Oxford English Dictionary defines a dishonest person as somebody who is "behaving or prone to behave in an untrustworthy, deceitful, or insincere way", and a secondary meaning as a person who "intended to mislead or cheat". The etymology of the word suggests that it derives from the Latin word "dehonestus" which meant some "unbecoming, improper, vulgar, or low-class".

Unquestionably, dishonesty is a central element in the definition of any serious form of acquisitive crime, and it is the pivot around which the offences set out in the Theft Act 1968 turn. That said, Parliament shied away from including a definition of dishonesty in the Act. Instead, Parliament approached the matter in a negative manner, by including a provision in section 2(1) which states that three particular types of conduct are not to be regarded as dishonest.[22] This indication is accompanied by a solitary positive provision in section 2(2) which declares that a person's appropriation of property belonging to another may be dishonest notwithstanding that he is willing to pay for the property. The heart of the problem for Parliament and the courts is that as a state of mental awareness the element of dishonesty is sometimes very hard to establish. Is it sufficient for a prosecutor to establish that a defendant is acting dishonestly where most people would consider that his conduct is dishonest but the defendant himself quite genuinely thought that he was not acting dishonestly, perhaps because he has a warped view of what is, and what is not, "untrustworthy, deceitful or insincere" conduct? This form of dishonesty is known as "objective dishonesty", since a person is judged to have acted dishonestly by applying the objective standards of other people. The alternative approach is for the law to determine that a defendant acts dishonestly only in circumstances where the prosecutor can prove that defendant knew full well that he was behaving dishonestly, and intended to do so. This form of dishonesty is known as "subjective dishonesty", since it applies a solely subjective assessment of a person's state of mind at the time when the offending conduct was committed. In an effort to provide a workable definition of dishonesty against this background, the English courts have adopted a compromise solution whereby the test of dishonesty incorporates both objective and subjective elements. The position was set out by Lord Lane CJ in the seminal case of *R v Ghosh*[23] in the following terms:

> "In determining whether the prosecution has proved that the defendant was acting dishonestly, a jury must first of all decide whether according to the ordinary standards of reasonable and honest people what was done was dishonest. If it was not dishonest by those standards, that is the end of the matter and the prosecution fails. If it was dishonest by those standards, then the jury must consider whether the defendant himself must have realised that what he was doing was by those standards dishonest. In most cases, whether the actions are obviously dishonest by ordinary standards, there will be no doubt about it. It will be obvious that the defendant himself knew that he was acting dishonestly. It is dishonest for a defendant to act in a way which he knows ordinary people consider to be dishonest, even if he asserts or genuinely believes that he is morally justified in acting as he did."

**Recklessness**

The key question in the context of reckless risk-taking on the financial markets is whether it is possible for reckless conduct to satisfy the criterion of dishonesty for the purposes of the criminal law. As a concept reflecting a person's state of mind, as with dishonesty the notion of recklessness can also be defined in objective or subjective terms. Whilst there are circumstances where the law has approached recklessness through an objective prism,[24] it has been settled law for the last ten years that recklessness should be determined by applying a subjective approach in cases where serious criminal activity is involved. As Lord Bingham explained in *R v G*:[25]

> "… it is a salutary principle that conviction of serious crime should depend on proof not simply that the defendant caused (by act or omission) an injurious result to another but that his state of mind when so acting was culpable. This, after all, is the meaning of the familiar rule *actus non facit reum nisi mens sit rea*. The most obviously culpable state of mind is no doubt an intention to cause the injurious result, but knowing disregard of an appreciated and unacceptable risk of causing an injurious result or a deliberate closing of the mind to such risk would be readily accepted as culpable also. It is clearly blameworthy to take an obvious and significant risk of causing injury to another. But it is not clearly blameworthy to do something involving a risk of injury to another if … one genuinely does not perceive the risk. Such a person may fairly be accused of stupidity or lack of imagination, but neither of those failings should expose him to conviction of serious crime or the risk of punishment"[26]

Here, Lord Bingham drew on established principles of criminal law which treated a deliberate disregard of risk or deliberate closing of the mind to risk as equivalent to intention in terms of satisfy the fundamental rule that a defendant's offending conduct must be accompanied by a culpable state of mind. The notion that a defendant is reckless in the sense required when he carries out a deliberate act knowing or closing his mind to the obvious fact that there is some risk of damage resulting from that act but nevertheless continuing in the performance of that act is an uncontroversial one.[27] As Professor Glanville Williams pithily explained:

> "A person cannot, in any intelligible meaning of the words, close his mind to a risk unless he first realises that there is a risk; and if he realises that there is a risk, that is the end of the matter."[28]

In a manner wholly consistent with these principles, the criminal law has been content to permit conscious risk-taking to satisfy the requirement of dishonest intent in cases involving fraudulent conduct where the taking of risk prejudices another person's economic interests. This proposition is borne out by a consideration of a number of cases involving the criminal offence of conspiracy to defraud at common law.

The conventional definition of conspiracy to defraud is the making of an agreement by two or more defendants to fraudulently deprive another person of something which is his, or to which he is, or would be, or might be entitled. As the House of Lords explained in *Welham v. DPP*,[29] "to defraud" or to act "fraudulently" is to act in a manner which prejudices or to take the risk of prejudicing another's right, knowing that you have no right to do so. Interestingly, although dishonesty is frequently substituted for a reference to fraudulently,[30] there is no mention in *Welham v DPP* of any need for a judge to tell a jury they must be satisfied that the accused was acting dishonestly. As the learned editors of Archbold[31] point out, it seems that the House of Lords must have considered it beyond argument that deliberately taking the risk of prejudicing another's right, knowing there is no right to do so, is necessarily dishonest. Consideration of the Court of Appeal decisions in the cases of *R v Sinclair* and *R v Allsop*[32] neatly illustrate this line of analysis.

In *R v Sinclair,* the appellants had been convicted of conspiracy to defraud a company, its shareholders and creditors by using the company's assets for purposes other than those of the company. The prosecution case was that the appellants, along with one of the company directors and persons unknown, were guilty of the offence because they had dishonestly agreed to take a risk with the company's assets in a manner which was prejudicial to the interests of the minority shareholders. The appellants contended that the trial judge had misdirected the jury by equating negligence, or gross negligence, with fraud when he directed the jury in the following terms:

> "To prove fraud it must be established that the conduct was deliberately dishonest. In the circumstances of this case what sort of test should be applied as to whether the conduct was dishonest? It is fraud if it is proved that there was the taking of a risk which there was no right to take which would cause detriment or prejudice another."

The appellants argued that the effect of this direction was to invite the jury to convict of conspiracy to defraud irrespective of whether the appellants had an honest belief that the defrauded company would ultimately benefit as a result of their conduct. The Court of Appeal rejected this submission, making clear that "to cheat and defraud is to act with deliberate dishonesty to the prejudice of another person's proprietary right." The Court stated, the trial judge "had properly directed the jury as to the difference between the normal business risks taken honestly and the dishonest risk deliberately taken with knowledge that there was no right to take such risk." The rejection of the appellant's argument that there was relevance in their belief that the company's shareholders would ultimately benefit from their risky conduct has obvious resonance in so far as reckless risk-taking on the financial markets is concerned.

A similar approach was taken by the Court of Appeal in *R v Allsop* when the Court affirmed the principle that a defendant could be guilty of participating in a conspiracy to defraud in circumstances where he did not intend that any actual loss would occur. The appellant was a sub-broker for a hire-purchase company, with responsibility for introducing prospective car purchasers and completing their application forms for credit. From time to time, the appellant included false particulars in the application forms so as to induce the hire-purchase company to accept applications which they might otherwise have rejected. But the appellant always believed that the transactions would profit the hire-purchase company. On appeal, the appellant argued that the trial judge had erred when he failed to direct the jury that it was necessary for the prosecution to prove the purpose of the conspiracy was to cause economic loss to the hire purchase company before a guilty verdict could be returned. Rather, the judge had directed as follows:

> "…you must also be sure that the defendant realised that the making of the false statements in question was likely to lead to the detriment or prejudice of the hire-purchase company.'

After the jury had retired, they returned once more to ask the judge to clarify the law regarding the appellant's position. In response, the judge expanded on his earlier direction:

> "... you must also be sure that the defendant realised that the making of the false statements in question was likely to lead to the detriment or prejudice of the hire-purchase company: detriment or prejudice in the sense of economic loss, but that does not necessarily mean loss of money in the ultimate analysis."

The appellant's conviction was upheld. In giving the Court's judgement, Shaw LJ explained that economic loss may be ephemeral and not lasting, or potential and not actual, and that even a threat of financial prejudice while it exists it may be measured in terms of money:

> "Generally the primary objective of [fraudsters] is to advantage themselves. The detriment that results to their victims is secondary to that purpose and incidental. It is 'intended' only in the sense that it is a contemplated outcome of the fraud that is perpetrated. If the deceit which is employed imperils the economic interest of the person deceived, this is sufficient to constitute fraud even though in the event no actual loss is suffered and notwithstanding that the deceiver did not desire to bring about an actual loss."

Whilst it is true that reckless risk-taking on the financial markets does not necessarily involve behaviour which is deceitful, the affirmation of the principle that it is sufficient for the defendant's conduct to imperil the economic interests of another is significant in this context. Again, this is entirely consistent with the principle established in *DPP v Welham* that intentionally to take the risk of prejudicing another's right, knowing that there is no right to do so, is treated as necessarily dishonest. Professor David Ormerod QC goes further and suggests that where conspirators know the effect of carrying out an agreement puts a person's property at risk, they are to be treated as if they intended to prejudice that person. If it subsequently turns out that the person's property is unimpaired, or even that the person at risk makes a profit from the transaction, it is none to the point.[33]

The notion that actual knowledge can be established in criminal cases by a deliberate closing of the eyes to the risks of adverse consequences is to be found more broadly in other areas of the criminal law. For example, in *Atwal v Massey*,[34] a case involving handling stolen goods where the establishment of guilty knowledge or belief for the purposes of section 22 of the Theft Act 1968 (handling offence) was in issue, the High Court made clear that requisite mental element of the offence would be satisfied where it was shown that the defendant, "suspecting the goods to be stolen, deliberately shut his eyes to the consequences".[35] This approach is entirely consistent with the formative analysis of knowledge in criminal law articulated some years earlier by Devlin J in *Taylor's Central Garages (Exeter) Limited v Roper*.[36] In that case, Devlin J made some general observations about the meaning of 'knowingly' and about how knowledge may be established under the criminal law:

> "There are, I think, three degrees of knowledge which it may be relevant to consider in cases of this sort. The first is actual knowledge, and that the justices may infer from the nature of the act that was done, for no man can prove the state of another man's mind, and they may find it, of course, even if the defendant gives evidence to the contrary. They may say: 'We do not believe him. We think that was his state of mind". They may feel that the evidence falls short of that, and, if they do, they have then to consider what might be described as knowledge of the second degree. They have then to consider whether what the defendant was doing was, as it has been called, shutting his eyes to an obvious means of knowledge … The third sort of knowledge is what is generally known in law as constructive knowledge. It is what is encompassed by the words 'ought to have known' in the phrase 'knew or ought to have known …. The case of shutting the eyes is actual knowledge in the eyes of the law; the case of merely neglecting to make inquiries is not actual knowledge at all, but comes within the legal conception of constructive knowledge, which is not a conception which, generally speaking, has any place in the criminal law".[37]

These cases do not establish the proposition that dishonesty can be established by proof of reckless risk-taking where a person closes his eyes to the risk, but they are highly supportive of this proposition since they make clear that the requisite state of mental awareness for serious criminal offences can be established in this way.

**Fraud by abuse of position**

Section 4(1) of the Fraud Act 2006 provides that a person is guilty of fraud where he (a) occupies a position in which he is expected to safeguard, or not to act against, the financial interests of another person, (b) he dishonestly abuses that position, and (c) he intends, by means of the abuse of that position, to make a gain for himself or another, or to cause loss to another or to expose another to a risk of loss. The offence is punishable by a maximum of ten years imprisonment. The Explanatory Notes which accompanied the Fraud Bill when it was presented to Parliament make clear that the offence was drafted widely to capture a variety of diverse situations where a person takes unfair advantage of his position at the expense of another person's financial interests:

> "Clause 4 makes it an offence to commit a fraud by dishonestly abusing one's position. It applies in situations where the defendant has been put in a privileged position, and by virtue of this position is expected to safeguard another's financial interests or not act against those interests. For example, the defendant may have been given the authority to exercise discretion on the other's behalf or to have access to the other's assets, premises, equipment or customers. Therefore the defendant does not need to secure any further co-operation from him in order to commit an offence of fraud against him. The defendant would be guilty of an offence if he abused his privileged position by dishonestly acting against the other's financial interests for his personal gain. The term "abuse" is not limited by a definition, because it is intended to cover a wide range of conduct …"[38]

Accordingly, the offence can cover a situation where a defendant makes a high-risk investment on behalf of another person in circumstances where the investment is inappropriate for their requirements and the defendant is abusing his position for his personal benefit when making the investment in question. Indeed, this situation was posited by the Home Office explained in a Circular issued by the Law and Sentencing Policy Directorate shortly before the Fraud Act was implemented:

> "Section 4 would cover, for example, a case where an employee of a software company uses his position to clone software products with the intention of selling the products to make a profit for himself, or a case where an employee copies his employer's client database for the purpose for setting up a rival company. It would also cover a case where a person is employed to

care for an elderly or disabled person has access to that person's bank account and abuses his position by transferring funds to invest in a high-risk business venture of his own."[39]

The elasticity of the offence to cover dishonest risk-taking is unexceptional and the Law Commission in its report on Fraud which preceded the enactment of the legislation had always envisaged that a defendant who acted in a manner which put another person's economic interests at risk would be guilty of the offence of fraud.[40] In his critique of the Fraud Act 2006, Professor David Ormerod QC notes that the potential range of defendants under section 4 is vast since the term "abuse" is deliberately left undefined in order to maximise the breadth of the offence. Moreover, the nature of the defendant's position which is abused is not limited to the case where there is fiduciary relationship between the defendant and the victim. The necessary relationship will therefore be present whenever there is a relationship between a professional person and his client and between an employer and an employee.[41] Professor Ormerod concludes that section 4 could be used in the prosecution of public officials for mismanagement of public funds since such individuals are expected to safeguard the financial interests of other people.[42] This being so, presumably there is no reason why section 4 should not be deployed in a prosecution of the employees of a financial institution such an investment bank where an employee is expected to safeguard the financial interests of his employer as well as the bank's clients whose money they are handling.[43]

**A new criminal offence**

Irrespective of whether or not section 4 of the Fraud Act 2006 is sufficiently wide to capture the activities of reckless risk-taking on the financial markets, there are strong arguments for enacting a new criminal offence to this effect.

First, the creation of an offence involving reckless risk-taking on the financial markets would send a clear message to financial markets participants, both traders and their managers, that decisions involving the purchase and sale of investment securities including derivatives must be based upon rationally defensible criteria. It would make absolutely clear that speculative trading has no place on the financial markets, and it would enable a rogue trader to be prosecuted for the offending nature of his underlying conduct, in addition to criminal offences which are focussed on the dishonest concealment of this conduct. A new offence would also mean that senior managers who themselves turn a blind eye to a trader's speculative trading would also find themselves criminally responsible and vulnerable to indictment as a principal party by reason of his aiding and abetting,[44] or as a secondary party for encouragement or affording assistance in the commission of a criminal offence.[45] Moreover, as well as protecting financial institutions such as banks and their customers from the risk of incurring spectacular losses in cases where a trader has unsuccessfully gambled on market movements, the new offence would assist in safeguarding the markets against unexpected movements caused by large volumes of speculative trading.

Secondly, the creation of an offence involving reckless risk-taking would be entirely consistent with the most elementary principles which underlie the invocation of the criminal law. As John Stuart Mill explained in the first chapter of his seminal work On Liberty in 1859:

> "The object of this Essay is to assert one very simple principle, as entitled to govern absolutely the dealings of society with the individual in the way of compulsion and control … That principle is, that the sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number, is self-protection. That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others …"

The harm wrought by the global financial crisis is colossal, and whilst it is impossible to estimate the extent to which reckless risk-taking precipitated the economic catastrophe which beset the world in 2008, common sense dictates that it was undoubtedly a contributory cause. The IMF has estimated the cost of the global financial crisis at $11.9 trillion (£7.12 trillion) which is enough money to finance a £1,779 payment for every man, woman and child on the planet. The IMF figures also show that the UK has been the biggest of all the spenders on emergency measures to support its financial sector, with its total bill for the clean-up amounting to 81.8% of its gross domestic product, equivalent to £1,227 billion. The UK's record bill is also unique in that it has also already spent much of it already, with 20% of GDP having already supported struggling institutions.[46] The harm caused in the context of wrongdoing on the UK's financial markets is truly breath-taking. In these circumstances, it is difficult to see why the criminal law should remain impotent to hold to account financial market participants, both traders and senior management, who facilitate reckless trading on the financial markets, without making a considered assessment of the risks involved or worse still, without having an iota of understanding of the risks involved. A new criminal offence would also ensure that powerful City traders and their managers are held to account in the same way as those who commit smaller acts of financial misconduct.

Thirdly, reckless behaviour has long been acknowledged in criminal law as an appropriate standard by which a person's culpability can be assessed. If it is a criminal act to recklessly damage physical property,[47] recklessly make a misleading, false or deceptive promise or forecast to induce the making of a financial investment,[48] or even recklessly transmit a sexual disease,[49] there is no reason in principle or practice why there should not be a workable criminal offence of recklessly making decisions to buy or sell a financial instrument on the financial market.

The most potent argument against the creation of a new criminal offence of reckless risk-taking on the financial markets rests on the premise that risk-taking is key component of the financial system in any capitalist market economy. Since the taking of risk when purchasing or selling financial instruments on the financial markets, recognising that the value of the instruments can rise or fall, is an inherent feature in the way in which the financial markets operate, it follows, so the argument runs, that there is no role for the criminal law to play here. As two leading academic economists explained:

> "Unfettered capital markets are not simply an efficient way of allocating existing resources; they also promote all sorts of innovations … The market allows people and firms to take risks in order to obtain the rewards which markets potentially offer. Innovation is a gamble, and markets provide one way of letting people engage in gambles which potentially have significant social benefits in the form of new products and technological improvements … Risk-taking is key here, for most innovations are the result of investing time, energy and resources without any assurance these will generate a pay off".[50]

The answer to this objection is extremely simple. Nobody is suggesting that the taking of risk with a view to making a profit should be criticised, any more than there is a suggestion that driving a motor car should be criminalised because occasionally there are crashes which result in serious injury or death. The proposal is to criminalise the reckless taking of risk, which is an entirely different matter. Just as a reckless motorist who takes a risk when overtaking blindly on the other side of the road is held criminally responsible for his action, there is no reason why a reckless trader and his manager should not also be held to account in the criminal courts when they act in the same way in relation to the financial markets.

**Recklessly managing a bank**

The UK Government, as one element in its response to the global financial crisis, has accepted the logic of these arguments and enacted a criminal offence which punishes the reckless management of a bank. The new offence is contained in section 36 of the Financial Services (Banking Reform) Act 2013 and provides that a senior manager of a financial institution commits a criminal offence punishable by a maximum period of seven years imprisonment if the following four elements can be proved. First, he must make a decision concerning the financial institution's business. Secondly, when he makes the decision it must be shown that he is aware of a risk that the implementation of the decision may cause the financial institution to fail. Thirdly, the decision must fall far below the standard which could reasonably be expected of a person in the senior manager's position. Fourthly, the implementation of the decision must cause the financial institution to fail. Paraphrasing, a person is a senior manager in relation to a financial institution if he performs a senior management function. This function is defined in section 19 to mean that the person is responsible for managing one or more aspects of the financial institution's affairs relating to the activity and those aspects involve a risk of serious consequences for the manager or for the financial institution's interests in the United Kingdom. A financial institution is defined for the purpose of the criminal offence as a business which has permission under the Financial Services and Markets Act 2002 to carry on the regulated activity of accepting deposits or is an investment firm within the meaning of section 424A of that Act. A financial institution will be deemed to have failed where it becomes insolvent, or where stabilisation measures need to be taken in relation to it under Part 1 of the Banking Act 2009, or whether it is regarded by the Financial Services Compensation Scheme as being unable, or likely to be unable, to satisfy any claims made against it.

Although recklessness is not included as a definitional element of the offence, the linguistic shorthand is clear since the offence is committed only where the manager senior recognised the risk and decided to ignore it, by deliberately closing his eyes to it. This reflects the statutory intention foreshadowed by the Parliamentary Commission on Banking Standards when it concluded that there was a strong case in principle for a new criminal offence of reckless misconduct in the management of a bank.[51] As the Commission explained:

> "The Commission has concluded that there is a strong case in principle for a new criminal offence of reckless misconduct in the management of a bank. While all concerned should be under no illusions about the difficulties of securing a conviction for such a new offence, the fact that recklessness in carrying out professional responsibilities carries a risk of a

criminal conviction and a prison sentence would give pause for thought to the senior officers of UK banks".[52]

Unquestionably, the Government has broken new ground with the enactment of a reckless banking offence.[53] In an article in the Financial Times, a respected financial journalist noted that the creation of this offence has the potential to galvanise senior management, asking rhetorically how many British banks would have survived if cavalier senior managers had faced the risk of criminal prosecution for mismanagement on their watch?[54] But the legislative initiative is limited, since the criminal offence is engaged only where it is committed by a senior manager and the reckless risk-taking leads to a financial institution's failure. These are unnecessary restrictions, for once the principle of criminal liability for reckless risk-taking on the financial markets has been established, logic dictates that it should apply to market traders as well as senior managers. Moreover, if the criminal offence is to have any practical bite, precipitating the collapse of the financial institution for which the trader and senior manager are working should be abandoned as a prerequisite requirement. The victim's total devastation does not need to be established in other financial market crimes and there is no reason why it should be required in this case. If it is to respond more effectively to the challenges presented by the global financial crisis, the UK Government needs to do more than dip its toe in the water in so far as reckless risk-taking on the financial markets is concerned.

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**Footnotes**

[1] Kara Scannell, US housing: After the Gold Rush, Financial Times, 29 October 2012 . Availbale HTTP: http://www.ft.com/cms/s/0/11aa9914-1d36-11e2-abeb-00144feabdc0.html#axzz2ruBQ7U2M (accessed 31 January 2014)
[2] Charles Ferguson's Oscar Speech Rips Wall Street: 'Inside Job' Director Levels Criticism During Acceptance, Huffington Post, 28 February 2012 Availbale HTTP: http://www.huffingtonpost.com/2011/02/28/charles-ferguson-oscar-speech-inside-job_n_828963.html (accessed 31 January 2014); Speech can be viewed on: http://www.youtube.com/watch?v=yB--kY3vsqE
[3] On 17 January 2013, Mr Andrew Tyrie MP, Chairman of the United Kingdom's Parliamentary Commission on Banking Standards, asked the same question: "Despite the financial crisis and the spate of mis-selling scandals, we still have not seen anybody sent to jail. Is that because nobody ought to go to jail, or because there is a fundamental failure in the sanctions regime or the legal system in the UK?" Corrected Transcript of Oral Evidence 17 January 2013, Q2626
[4] Nine out of ten want to see bankers jailed (if they are found guilty of crimes), London Evening Standard, 9 October 2012. Available HTTP: http://www.standard.co.uk/news/uk/nine-out-of-ten-want-to-see-bankers-jailed-if-they-are-found-guilty-of-crimes-8203103.html (accessed 31 January 2014)
[5] Ibid
[6] John Kay, Prosecutors must uphold the law, not cut deals with the accused, Financial Times, 21 May 2013. Available HTTP: http://www.ft.com/cms/s/0/a913569e-be1a-11e2-9b27-00144feab7de.html#axzz2ruBQ7U2M (accessed 31 January 2014)
[7] Michael Lewis, *The Big Short, Inside the Doomsday Machine*, W W Norton (2010) at page 140
[8] OTC Derivatives Market Analysis Year-End 2012, 20 June 2013, Available HTTP: http://www2.isda.org/functional-areas/research/studies (accessed 30 January 2014)
[9] The failure of the Royal Bank of Scotland, Financial Services Authority Board Report, December 2011, paragraphs 15, 267
[10] Ibid, at paragraph 612
[11] Ibid, Part 3, paragraph 124, page 387, from the compelled interview with Mr Cameron, 19 November 2009, part 7 of 8, lines 403 to 409
[12] Howard Davies, *The Financial Crisis, Who is to Blame*, 2010, Chapter 25, Too Complex to Trade Derivatives, pages 138-9
[13] Short selling is the practice of selling a financial instrument that is not currently owned by the seller, and purchasing it at a later stage when the instrument needs to be transferred to the purchaser. In the event of an interim price decline, the short seller makes a profit, since the cost of purchasing the instrument will be less than the proceeds which received on the initial short sale. There is always the possibility that the short sale will make a loss if the price of the financial instrument rises prior to its purchase. It is for this reason that traders "hedge" their deals.
[14] Hedging is the practice of purchasing a financial instrument with the intention of offsetting potential losses or gains that may be incurred by the purchase or sale of a parallel instrument
[15] Billy Kenber, *City traders 'gamble on anything even bras size of new trainee,'* The Times, 24 November 2012 Available HTTP: http://www.thetimes.co.uk/tto/news/uk/article3610147.ece (accessed 30 January 2014)
[16] Order Instituting Proceedings Pursuant To Sections 6(C) And 6(D) Of The Commodity Exchange Act, Making Findings And Imposing Remedial Sanctions, In the Matter of J P Morgan Chase Bank NA, 16 October 2013, CFTC Docket No. 14- 01
[17] At the time of writing, US prosecutors have brought criminal charges against two former J P Morgan employees, Javier

Martin-Artajo and Julien Grout, alleging they deliberately tried to hide hundreds of millions of dollars in losses. The UKJ's Serious Fraud Office is liaising with its US counterparts with regard to the investigation

[18] Sentencing remarks of Mr. Justice Keith, *R v Kweku Adoboli*, Southwark Crown Court, 20 November 2012. Available HTTP: http://www.judiciary.gov.uk/Resources/JCO/Documents/Judgments/kweku-adoboli-sentencing-remarks-20112012.pdf (accessed 30 January 2014)

[19] Ibid

[20] Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, ordered by the House of Commons, 18 July 1995, Available HTTP: http://www.official-documents.gov.uk/document/hc9495/hc06/0673/0673.pdf (accessed 30 January 2014)

[21] For a full account of Mr Leeson's activities and the collapse of Barings Bank, see the Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings *supra* note 20 at 673

[22] Theft Act 1968 section 2(1): A person's appropriation of property belonging to another is not to be regarded as dishonest—

(a)if he appropriates the property in the belief that he has in law the right to deprive the other of it, on behalf of himself or of a third person; or

(b)if he appropriates the property in the belief that he would have the other's consent if the other knew of the appropriation and the circumstances of it; or

(c)(except where the property came to him as trustee or personal representative) if he appropriates the property in the belief that the person to whom the property belongs cannot be discovered by taking reasonable ste

[23] *R v. Ghosh* [*1982*] EWCA Crim 2

[24] See, for example*, R v. Caldwell* [1982] AC 341

[25] *R v. G* [2003] UKHL 50

[26] Ibid, at paragraph 32

[27] Ibid*,* at paragraph 14

[28] Glanville Williams *Textbook of Criminal Law*, 1978, at page 7

[29] *Welham v. DPP* [1961] A.C. 103

[30] see *R v Sinclair* (1968) 52 Cr App R. 618; *Wai Yu Tsang v R* [1992] 1 AC 269

[31] Archbold, *Criminal Pleading Evidence and Practice*, Sweet & Maxwell (2014) at paragraph 17-62

[32] *R v. Allsop* (1977) Cr App R 29

[33] D. Ormerod and D. Williams, *Smith's Law of Theft*, Oxford: OUP, 9th edition 2007, paragraph 5.28

[34] *Atwal v. Massey* (1972) 56 Cr. App. R. 6

[35] Ibid, at page 7. See also *Westminster City Council v Croyalgrange Limited* [1986] 1 WLR 674 and *R v Ali (Siraj)* [2008] EWCA Crim 2653 for an application of these principles in different contexts

[36] *Taylor's Central Garages (Exeter) Limited v. Roper* (1951) 115 JP 445

[37] Ibid

[38] Explanatory Notes, Fraud Bill Session 2005-06, at paragraph 18

[39] Home Office Circular 042 / 2006, The Fraud Act 2006: repeal of the deception offences in the Theft Acts 1968 – 1996, 27th December 2006, at paragraph 14

[40] The Law Commission, (Law Com No 276), Fraud, Cm 5560, at paragraph 7.46

[41] For an example of an employer / employee case, see *R v. Knowles (Ross)*[2013] EWCA Crim 646

[42] Professor David Ormerod, Legislative Comment: The Fraud Act 2006 — Criminalizing Lying [2007] CLR 193-219, at pages 207 to 210

[43] See *R v. Woods* [2011] EWCA Crim 1305 for an interesting example of a case where a defendant's conviction for an offence contrary to section 4 of the Fraud Act 2006 was upheld. There was an issue in the case as to whether the defendant was acting dishonestly when she acted in breach of company rules. The case involved the activities of a deputy manager of a betting shop and not trading activities on the financial markets. It was her employer's financial interests which the prosecution alleged that she had failed to safeguard.

[44] Accessories and Abettors Act 1861, section 8

[45] Serious Crime Act 2007, sections 44 to 46

[46] Edmund Conway, IMF puts total cost of crisis at £7.1 trillion, Daily Telegraph, 8 August 2009, Available HTTP: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5995810/IMF-puts-total-cost-of-crisis-at-7.1-trillion.html (accessed 30 January 2014)

[47] Criminal Damage Act 1972, section 1

[48] Financial Services and Markets Act 2000, section 397

[49] Offences Against the Person Act 1861, section 20; see *R v Dica* [2004] 2 Cr. App. R. 28

[50] Eric Olin Wright & Joel Rogers, *American society: How it really works*, W W Norton & Co, July 2010, Chapter 3, The Capitalist Market

[51] Parliamentary Commission on Banking Standards, Changing Banking for Good, HL Paper 27-I HC 175-I, June 2013, summary, page 10

[52] Ibid, page 71, paragraph 243

[53] In a briefing paper (Law and Financial Markets Project Briefing 1/13, London School of Economics), Professors Julia Black & David Kershaw recognise that recklessness is the most appropriate state of mental awareness required for commission of the offence. Whilst recognising the argument in favour of enacting the offence, Black and Kershaw raise doubts about its long-term impact.

[54] Philip Augur, *Reckless banking should be a criminal offence*, Financial Times 18th June 2013. Available HTTP: http://www.ft.com/cms/s/0/b529695e-d810-11e2-9495-00144feab7de.html (accessed 30 January 2014)