

# Economic crime and the global financial crisis

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*Looking through the prism of three paradigm cases which emerged during the course of the global financial crisis, the writers discuss whether the parameters of criminal law are sufficiently wide to capture the conduct of financial markets participants who have acted recklessly, not caring whether or not they cause financial loss to others and turning a blind eye to this outcome in circumstances where the risk is real and not fanciful. In order for the criminal law to be more effective, the writers suggest that the regulatory authorities need to impose stricter obligations requiring greater disclosure of conflicts of interests and methodologies for determining the valuation of underlying investments.*

“Forgive me, I must start by pointing out that three years after our horrific financial crisis caused by financial fraud, not a single financial executive has gone to jail, and that’s wrong.”<sup>1</sup>

## A. Overview

In the aftermath of the global financial crisis, this article addresses the thorny issue of whether economic crime contributed to the crisis in any way. We scrutinise the activities of the investment banks and credit-rating agencies in an effort to determine whether their conduct crossed the line between legitimate commercial practice and criminal recklessness in connection with the promotion of investments, the valuation of investments, the valuation methodology which was adopted, and the level of information which was disclosed to the investor community.

With general agreement amongst economists that serial overvaluation of investment instruments such as collateralized debt obligations (CDOs) and residential mortgage-backed securities (RMBSs) played a central role in precipitating the global financial crisis, the article explores whether notions of criminal dishonesty are sufficiently wide to embrace reckless indifference to investment valuation and risk-taking. Noting that none of the regulatory responses to the global financial crisis have included an expansion of the criminal law to capture the vice of reckless risk-taking in the financial markets, in so far as England and Wales is concerned we ask whether there is a case for expanding legal obligations of disclosure for financial markets participants in order to trigger potential criminal liability under section 3 of the Fraud Act 2006 (fraud by failing to disclose information). We demonstrate that the perceived reckless risk-taking evident in the period prior to the global financial crisis related not only to the overvaluation of investment instruments but also the failure to disclose significant information regarding conflicts of interest on the part of investment banks when promoting the sale of investment instruments to investors.

In the G20 Declaration issued at the Summit held in Washington DC on 15 November 2008 which followed the events triggering the global financial crisis, there was common agreement that the credit-rating agencies needed to be regulated to require them to avoid conflicts of interest, provide greater disclosure to investors and issuers, and publish differential ratings for complex products.<sup>2</sup> We consider how these objectives have been developed in the US and Europe and whether disclosure obligations need to be broadened in England and Wales in this respect too.

Without a significant expansion of disclosure obligations in England and Wales, we do not believe that the proposed new architecture for regulation of the credit-rating agencies is sufficiently stringent to prevent a recurrence of the problems which have been experienced. We recommend that disclosure obligations should be expanded to compel credit-rating agencies to provide more detailed information to investors and regulators about the underlying value of their investments and the valuation methodology adopted when preparing these valuations, so as to achieve equivalence with the recently revised regulatory requirements in the US. If implemented, these recommendations would have significant implications for the application of the criminal law in England since they would expose investment banks and credit-rating agencies to potential criminal liability under section 3 of the Fraud Act 2006 in circumstances where financial markets participants have conflicts of interest and/or fail to disclose sufficient information to investors about the underlying value of their investments and the methodology used in preparing the valuations in question. The public interest would be served by this development and we should welcome it.

### 1. Background

The global financial crisis in 2007 was triggered by the bursting of the housing boom in the US and quickly spread to the rest of the world through the global trading of bonds and credit default swaps (CDSs) on subprime mortgages in the US. During the housing boom, lenders engaged in predatory lending of mortgages as they were unaffected by the eventual

defaults of these loans due to lax Federal laws.<sup>3</sup> Once the loans were issued, the issuers passed them on to a bundler who then securitised them and sold them as CDOs to investors. The securitisation of these loans meant it was the buyers of these new securities that would have an interest in the repayment of the loans, not the actual originators. Meanwhile, purchasers of these CDOs had very little information regarding the underlying quality of the loans and depended on the credit agencies for guidance.<sup>4</sup> In order to cover the risk of defaults on mortgages, particularly RMBSs, the holders of CDOs purchased CDSs, as a form of insurance.

In 2006, the housing boom in the US collapsed due to increases in interest rates and a slow-down in economic growth. This in turn triggered a rise in default rates of subprime mortgages and other securities.<sup>5</sup> Credit-rating agencies promptly downgraded AAA ratings on approximately \$1.9 trillion in RMBSs from mid-2007 to mid-2008.<sup>6</sup> These downgrades forced companies to post more collateral under the Basel II agreements, and, unable to raise the required liquidity, companies were forced to rely on government bail-outs or go into liquidation.

## B. Investment banks and investment managers

In this section of the article, we identify the problems experienced with the overvaluation of investment instruments such as CDOs and RMBSs which are said to have played a major contributory role in causing the global financial crisis. We explore from information in the public domain how investment banks were conducting their business, with particular reference to the valuation of investment instruments and whether their approach was influenced by conflicts of interest between the interests of the banks and their investors. As our paradigm cases, we take the circumstances emerging from two unrelated cases in the US involving civil proceedings (Goldman Sachs and Lehman Brothers) and the circumstances emerging from a consideration of the civil action against JP Morgan brought in the US by Bernard Madoff's liquidator.

### 1. Goldman Sachs

In 2006, Goldman Sachs & Co was the fourth largest CDO underwriter in the US, underwriting securities and investments to the value of \$16bn.<sup>7</sup> Goldman Sachs not only marketed and sold these investment instruments, but during this time owned substantial interests in the "mezzanine" or higher rated tranches (first or second). Once Goldman Sachs became aware of a serious decline in value of RMBS assets, it began purchasing short positions for its own account. Goldman Sachs was essentially betting on the fall of the RMBS market, but according to the US Securities and Exchange Commission (SEC) was still marketing and selling CDOs.<sup>8</sup>

On or about 16 April 2010, the SEC filed a civil enforcement action in the US District Court for the Southern District of New York against Goldman Sachs and one of its executives, Vice President Fabrice Tourre, alleging an undisclosed conflict of interest. The SEC complained that in late

2004/early 2005, Goldman Sachs created a "product correlation trading desk" which provided, *inter alia*, the structuring and marketing of synthetic CDOs commonly referred to as "ABACUS".<sup>9</sup>

In 2006, Paulson & Co, Inc ("Paulson"), a hedge fund, shifted its investment strategy on the belief that "certain mid-and-subprime RMBS rated 'Triple B,' meaning bonds rated 'BBB' by S&P or 'Baa2' by Moody's would experience negative events causing their value to significantly fall".<sup>10</sup> In fact, Paulson believed that not only subprime RMBSs, but also more senior AAA-rated tranches, would soon be worthless.<sup>11</sup> Paulson targeted several triple-B rated RMBSs that it expected to experience significant troubles.<sup>12</sup> Paulson then approached Goldman Sachs and asked them to help it buy protection, through CDSs, by effectively shorting an investment portfolio consisting of these RMBSs.<sup>13</sup>

In short, the SEC alleged that Paulson, with the aid of Goldman Sachs, created a synthetic CDO which contained a portfolio of assets selected by Paulson that Goldman Sachs would market to investors. These solicited investors would be counterparties to Paulson's short position – thus funding any expected failure of the portfolio.<sup>14</sup> The SEC Complaint alleged that at this time Goldman Sachs knew that negative market conditions for RMBSs made it difficult to successfully market CDO transactions backed by RMBSs.<sup>15</sup>

The SEC Complaint provided several examples of Goldman Sachs's knowledge of the demise of the CDO industry dating back as early as January 2007 when approached by Paulson. For example, the SEC cited an e-mail from defendant Tourre to a friend dated 23 January 2007:

"More and more leverage in the system, the whole building is about to collapse anytime now. . . . Only potential survivor, the fabulous Fab[rice Tourre] . . . standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!"<sup>16</sup>

With this knowledge, the SEC alleged that Goldman Sachs and Tourre undertook steps to hide the participation of the short investor, Paulson, to other investors by representing that "an experienced and independent third-party collateral manager" selected the portfolio of assets.<sup>17</sup> Goldman Sachs approached ACA – a manager they allegedly believed would agree to the selections of Paulson – to serve as the "Portfolio Selection Agent".<sup>18</sup> ACA's role was central to the marketing and distribution of this CDO.<sup>19</sup>

At the same time, Paulson conducted an analysis of triple-B RMBSs which favoured "RMBS that included a high percentage of adjustable rate mortgages, relatively low borrower FICO scores, and a high concentration of mortgages in states like Arizona, California, Florida and Nevada that had recently experienced high rates of home price appreciation".<sup>20</sup> On 9 January 2007, 123 RMBSs from the Paulson analysis were e-mailed to ACA for their review.<sup>21</sup> On 26 February 2007, Paulson and ACA agreed to a reference portfolio of 90 RMBSs for ABACUS 2007-AC1 – comprised almost entirely of Paulson's choices.<sup>22</sup> The SEC alleges that at this time ACA had no knowledge that

"Paulson intended to effectively short the RMBS portfolio it helped select by entering into CDS with [Goldman

Sachs] to buy protection on specific layers of the synthetic CDO's capital structure. Tourre and [Goldman Sachs] of course, were fully aware that Paulson's economic interests with respect to the quality of the reference portfolio were directly adverse to CDO investors."<sup>23</sup>

Thereafter, several months after key Goldman Sachs executives predicted the end of the RMBS industry, a 178-page offering memorandum for ABACUS 2007-AC1 was finalised. The document failed to name Paulson and repeatedly references ACA as the "Portfolio Selection Agent".<sup>24</sup> In addition, the term sheet and flip book made no mention of Paulson.<sup>25</sup> The SEC alleged that Goldman Sachs's marketing materials for ABACUS 2007-AC1 were "false and misleading because they represented that ACA selected the reference portfolio while omitting any mention that Paulson, a party with economic interests adverse to CDO investors, played a significant role in the selection of the reference portfolio".<sup>26</sup> The SEC further contended that during the structuring of this deal, Goldman Sachs "misled ACA into believing that Paulson was investing in the equity of ABACUS 2007-AC1".<sup>27</sup> This is significant because a holder of equity is the first to experience a loss if the portfolio underperforms; thus an equity holder has the same long-term interest as other investors. In fact, as early as 10 January 2007, Tourre emailed ACA information that described Paulson as a holder in the "equity tranche" – not a shorting counterparty.<sup>28</sup>

During the structuring of ABACUS 2007-AC1, Goldman Sachs and Tourre were actively recruiting investors. In February, March and April 2007, Goldman Sachs sent IKB – a commercial bank headquartered in Düsseldorf – the term sheet, flip book and offering memorandum, respectively.<sup>29</sup> The SEC alleged that neither Goldman Sachs nor Tourre ever informed IKB of Paulson's participation in the selection process of assets and its short position.<sup>30</sup> On 26 April 2007, ABACUS 2007-AC1 closed and IKB purchased \$50 million worth of Class A-1 notes – rated AAA by S&P – and \$100 million worth of Class A-2 notes – similarly rated AAA by S&P.<sup>31</sup> Goldman Sachs was expected to earn between \$15 and \$20 million for structuring and marketing ABACUS 2007-AC1.<sup>32</sup>

The poor performance of ABACUS 2007-AC1 and the resulting payout to Paulson are staggering:

"Within months of closing, ABACUS 2007-AC1's Class A-1 and A-2 Notes were nearly worthless. IKB lost almost all of its \$150 million investment. Most of this money was ultimately paid to Paulson in a series of transactions between [Goldman Sachs] and Paulson."<sup>33</sup>

On or about 7 August 2008, the Royal Bank of Scotland (RBS), which subsequently acquired a super senior position in ABACUS 2007-AC1 through various acquisitions, paid Goldman Sachs approximately \$840 million to unwind its position; most of this money was paid by Goldman Sachs to Paulson.<sup>34</sup>

The SEC Complaint alleged in pertinent part:

"[Goldman Sachs] and Tourre knowingly, recklessly or negligently misrepresented in the term sheet, flip book and offering memorandum for ABACUS 2007-AC1 that the reference portfolio was selected by ACA without

disclosing the significant role in the portfolio selection process played by Paulson, a hedge fund with financial interests in the transaction directly adverse to IKB, ACA Capital and ABN. [Goldman Sachs] and Tourre knowingly, recklessly or negligently misled ACA into believing that Paulson invested in the equity of ABACUS 2007-AC1 and, accordingly, that Paulson's interest in the collateral selection process were closely aligned with ACA's when in reality their interest were sharply conflicting."<sup>35</sup>

On 27 April 2010, just over a week after the SEC Complaint was filed, the Permanent Subcommittee on Investigations to the Committee on Homeland Security and Government Affairs ("the Subcommittee") held "a series of hearings examining some of the causes and consequences of the recent financial crisis".<sup>36</sup> The fourth instalment focused on the role of investment banks and revolved around the testimony of several executives from Goldman Sachs. The hearing came after the Subcommittee conducted a thorough year and a half investigation of records received by Goldman Sachs and other institutions related to the RMBS market.<sup>37</sup>

In his opening statement, Senator Carl Levin described the findings of the Subcommittee in relation to the actions of Goldman Sachs and other investment banks:

"[T]he evidence shows that Goldman repeatedly put its own interests and profits ahead of the interests of its clients and our communities. Its misuse of exotic and complex financial structures helped spread toxic mortgages throughout the financial system. And when the system finally collapsed under the weight of those toxic mortgages, Goldman profited from the collapse. . . . The firm's own documents show that while it was marketing risky mortgage-related securities, it was placing large bets against the U.S. mortgage market. The firm has repeatedly denied making those large bets, despite overwhelming evidence. . . .

"[The problem here] is that Goldman Sachs profited by taking advantage of its clients' reasonable expectation that it would not sell products that it didn't want to succeed, and that there was no conflict of economic interest between the firm and the customers it had pledged to serve. . . . This matters because instead of doing well when its clients did well, Goldman Sachs did well when its clients lost money. . . .

These facts end the pretence that Goldman's actions were part of its efforts to operate as a mere 'market-maker,' bringing buyers and sellers together. These short positions didn't represent customer service or necessary hedges against risks that Goldman incurred as it made a market for customers. They represented major bets that the mortgage securities market – a market Goldman helped create – was in for a major decline."<sup>38</sup>

At the hearing several Goldman Sachs executives were questioned by and provided testimony to the Subcommittee. "Goldman executives argued they did not place a massive bet against the housing market but conceded in 2007 they made a half a billion dollar profit on their mortgage investments."<sup>39</sup>

On 14 July 2010, just three months after the SEC Complaint was filed, Goldman Sachs consented to entry of a final judgment.<sup>40</sup> As part of the final judgment, Goldman Sachs

paid \$300 million in fines and \$250 million in restitution to investors. IKB will receive \$150 million and RBS will receive \$100 million.<sup>41</sup> Furthermore, while stating that it neither admits nor denies the allegations of the Complaint, Goldman Sachs did admit the following:

“Goldman acknowledges that the marketing materials for the ABACUS 2007-AC1 transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was ‘selected by’ ACA Management LLC without disclosing the role of Paulson & Co Inc in the portfolio selection process and that Paulson’s economic interests were adverse to CDO investors. Goldman regrets that the marketing materials did not contain that disclosure.”<sup>42</sup>

The SEC enforcement action against Goldman Sachs demonstrates the difficult task confronted by regulators in sorting out complex securities transactions that involve numerous parties and substantial conflicts of interest. Any attempt by the Department of Justice to file a similar complaint in a criminal proceeding would have been met with a strong defence that Goldman Sachs lacked any intent to defraud IKB or other investors. However, the availability of a reckless theory of liability in this civil action demonstrates the flexibility that could be provided to a criminal prosecutor in cases where market participants acted with reckless disregard for the interests of those they should be protecting.

## 2. Lehman Brothers

A similarly dismal picture of the conduct of financial markets participants emerges from a consideration of the *débâcle* involving Lehman Brothers Holdings Inc (“LBHI”). LBHI was the holding company for hundreds of individual corporate entities. Lehman Brothers International Europe (“LBIE”) was the principal trading company within Europe and the main UK trading subsidiary.

On 15 September 2008, LBHI sought Chapter 11 protection in what is now recognised as the largest bankruptcy proceedings ever filed. The Valukas Report<sup>43</sup> noted:

“There are many reasons Lehman failed, and the responsibility is shared. Lehman was more the consequence than the cause of a deteriorating economic climate. Lehman’s financial plight, and the consequences to Lehman’s creditors and shareholders, was exacerbated by Lehman executives, whose conduct ranged from serious non-culpable errors of business judgment to actionable balance sheet manipulation.”<sup>44</sup>

The growth strategy adopted by LBHI in 2006 included increasing risk and substantially increasing leverage on its capital.<sup>45</sup> Exposures to the subprime mortgage crisis and the attendant ripple effect on other areas of business were slow to be recognised and, in response, LBHI opted to “‘double down’ hoping to profit from a counter-cyclical strategy”.<sup>46</sup> This approach significantly contributed to the collapse of the firm. Huge amounts of capital were invested in commercial real estate, leveraged loans and private equity assets which significantly increased LBHI’s risk exposures and which then proved virtually impossible for LBHI to sell.<sup>47</sup>

After the near collapse of Bear Sterns in March 2008, LBHI was “widely considered to be the next bank that might fail”.<sup>48</sup> The maintenance of market confidence and retaining favourable credit ratings were crucial to its survival. Aware that credit-rating agencies were particularly focused on net leverage, LBHI utilised an accounting device known within the company as a “Repo 105”<sup>49</sup> to reduce the balance sheet and ultimately indicate sufficient liquidity.<sup>50</sup> While Repo 105 did not instigate the demise of LBHI, it “window dressed” the financial position of the firm. Crucially, LBHI did not reveal its use of Repo 105 or the magnitude of that use to the government, credit-rating agencies, investors, or to its board of directors.<sup>51</sup> However, its auditors, Ernst & Young, were aware that LBHI was using this device to manage its balance sheets but did not query the fact that this practice remained undisclosed to interested parties.<sup>52</sup>

While this overcollateralization obviously cost LBHI more than a traditional repo, it was necessary so that LBHI could demonstrate that it had relinquished control of the transferred assets and thus record the transfers as sales.<sup>53</sup> Repo 105 required LBHI to repurchase transferred securities upon maturation but, by providing more collateral than was necessary, LBHI limited its ability to fund replacement of the assets (by virtue of the haircut) and thus relinquished sufficient control of the assets for Financial Accounting Board Standard 140 (SFAS 140).<sup>54</sup>

The overcollateralization of these transactions was a unilateral move on behalf of LBHI so that Repo 105 could be classified as a sale on the balance sheet. Counterparties to these transactions were told that this overcollateralization was due to LBHI’s desire to remove the securities in question from the balance sheet.<sup>55</sup> LBHI, in order to classify a Repo 105 as a sale under SFAS 140, had to establish that transferred securities were “put presumptively beyond the reach of the transferor and its creditors, even in the event of the transferor’s bankruptcy”. For the purposes of SFAS 140, there has to be a true sale at law and this needed to be verified by a true sale opinion letter.<sup>56</sup>

LBIE became the conduit through which Repo 105 actions were executed or where they originated.<sup>57</sup> The role that LBIE played in reducing the balance sheet was significant:

“When the Repo 105 transaction matured, LBIE repaid the cash plus interest and received its collateral back. Because Lehman was a consolidated business and LBIE’s financial results were rolled into the consolidated financial statements LBHI filed in the United States, the LBIE-only Repo 105 practice impacted LBHI’s reported balance sheet and leverage ratios.”<sup>58</sup>

The recharacterisation of a Repo 105 as a sale allowed LBHI to acquire cash to pay off other liabilities. But the requirement to repurchase was not recorded and thus “the ‘borrowing’ is not reflected on the balance sheet, even though the economic substance of the transaction is a borrowing, and thus, the transferor’s total liabilities do not increase”.<sup>59</sup> Furthermore, at the moment of the transaction the transferor’s total assets remain the same even though the inventory has decreased. This is because of the cash borrowings received.

As mentioned previously, the increase in the execution of Repo 105 transactions was instigated by the increased

market scrutiny of the leverage of investment banks from mid-2007.<sup>60</sup> Prior to this it had been the firm's revenues and profit and loss (P&L) that were the indices examined by credit-rating agencies and the market. However, the collapse of the structured finance markets placed significant strain on bank balance sheets.<sup>61</sup> For LBHI this sudden emphasis on leverage came at a time when it was struggling to divest itself of "sticky" inventory. The usage of Repo 105 was significantly expanded in the context of its increasingly "sticky" balance sheet.<sup>62</sup> While only highly liquid securities were permitted for inclusion in a repo transaction, later unsuccessful attempts were made to include mortgage-backed securities in these transactions.<sup>63</sup>

In effect, this increased Repo 105 usage was deployed "as a shortcut for meeting quarter end balance sheet targets".<sup>64</sup> There is no doubt that there was a failure of senior management and the proper discharge of their disclosure requirements. The Valukas report noted:

"There is sufficient evidence to support a determination by a trier of fact that Lehman's failure to disclose that it relied upon Repo 105 transactions to temporarily reduce the firm's net balance sheet and net leverage ratio was materially misleading. In addition, a trier of fact could find that Lehman affirmatively misrepresented its accounting treatment for repos by stating that Lehman treated repo transactions as financing transactions rather than sales for financial reporting purposes, despite the fact that Lehman treated tens of billions of dollars in repo transactions—namely Repo 105 transactions—as true sale transactions."<sup>65</sup>

In addition, it was declared that members of senior management within LBHI breached their fiduciary duties to the LBHI Board of Directors by failing to inform them of both the firm's usage of Repo 105 transactions to reduce net leverage at the approach of quarter end and the significant increase in the frequency of these transactions throughout 2007/08 and the failure by LBHI to disclose this usage publicly in reported financial statements.<sup>66</sup>

Whether LBHI technically satisfied SFAS 140 has no bearing on whether a financial statement is materially misleading "even when they do not violate GAAP".<sup>67</sup> Technical compliance with GAAP alone is not sufficient to prevent liability attaching as the overarching objective of these standards to ensure fairness and accuracy is not necessarily best achieved by accepting technical compliance as sufficient.<sup>68</sup> Section 13(a) of the Securities Exchange Act 1934<sup>69</sup> required LBHI to file reports with the SEC including annual and quarterly reports (on Form 10-K and Form 10-Q, respectively). Under the SEC rules promulgated under the Exchange Act, LBHI filed registration statements about public offering of securities in the US.<sup>70</sup> Under Part 230 General Rules and Regulations of the Securities Act, Item 303 requires management to discuss and analyse the company's financial statements and their context.<sup>71</sup> The recharacterisation of some transactions as sales was not disclosed in any of these filings between 2000 and the third quarter of 2007, and thus LBHI did not account for the liabilities attached to the obligation to repurchase.<sup>72</sup> Again nowhere in its filings in 2007, either in the annual report or first- and second-quarter reports for 2008, did LBHI disclose the practice of Repo 105.<sup>73</sup> It is remarked that

"Lehman's omissions, including its lack of disclosures regarding Repo 105 derivatives, precluded a reader of the periodic reports from ascertaining that Lehman used temporary off balance sheet repo transactions to impact its net leverage."<sup>74</sup>

This evidence led the court-appointed examiner to conclude that the reports filed by LBHI pursuant to section 13(a) of the Securities Exchange Act of 1934 were "deficient and misleading".<sup>75</sup> Furthermore, despite "the professed ignorance by witnesses of virtually any of these issues central to the scope of Repo 105 programs",<sup>76</sup> the documentary evidence supports the finding of a "colorable" claim<sup>77</sup> against various members of senior management within LBHI under the Act and for breach of fiduciary duty.<sup>78</sup>

The Valukas Report was also damning in its criticism of Ernst & Young LLP, auditors of LBHI. Its "failure to follow professional standards of care with respect to communications with Lehman's Audit Committee, investigation of the whistleblower claim, audits and reviews of Lehman's public filings" gives substantial support to the existence of a "colorable" claim for professional malpractice.<sup>79</sup>

The Sarbanes-Oxley Act 2002<sup>80</sup> established the Public Accounting Oversight Board (PCAOB).<sup>81</sup> PCAOB Rule 3100 requires "a registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards".<sup>82</sup> The basis of the malpractice claim stemmed from the failure of Ernst & Young to update the LBHI Audit Committee of allegations made in a letter of 16 May 2008 by whistleblower Matthew Lee highlighting "a number of possible accounting irregularities, including balance sheet substantiation discrepancies, valuation issues, and the lack of competence and independence of Lehman's internal audit department".<sup>83</sup>

Crucially, the letter itself contained no reference to Repo 105. Failure to notify the Audit Committee of the totality of Lee's claims fell below the expected level of professional duty of care. Furthermore, Ernst & Young "was required to discuss with the Audit Committee the quality of Lehman's accounting principles as applied to financial reporting".<sup>84</sup>

A securities class action is currently pending in the US District Court for the Southern District of New York on behalf of "all persons and entities who acquired various securities of Lehman Brothers Holding Inc between 13 February 2007 and 15 September 2008". There are numerous defendants, but in light of the recommendations of the Valukas report, it is noteworthy that members of the senior management of LBHI are defendants (listed as "Insider Defendants"). LBHI, however, filed for bankruptcy and is therefore not a named defendant. The claims against these defendants are based on provisions of the Securities Act 1933 and "are not based on any allegation that any Defendant engaged in fraud or any other deliberate intentional misconduct and Plaintiffs specifically disclaim any reference to or reliance upon fraud allegations".<sup>85</sup>

### 3. Madoff and JP Morgan's alleged conflict of interest

The information which has recently come into the public domain regarding JP Morgan's handling of investment securities offered by Bernard Madoff raises different, although related, considerations. On 2 December 2010, the Trustee

for Liquidation of Bernard L Madoff Investment Securities, LLC filed a lawsuit in the US Bankruptcy Court in Manhattan against JP Morgan Chase & Co seeking \$6.4bn.<sup>86</sup> The content of the Complaint is most revealing.

The Complaint alleges that JP Morgan, Madoff's main investment bank, continued banking and investing with Madoff for years, up to and including two months before his arrest, despite suspecting that his investment returns were probably "too good to be true" and built on a Ponzi scheme.<sup>87</sup> In support of this allegation, the Complaint relies on e-mails from JP Morgan employees, due-diligence reports, and a "Suspicious Activity Report" (SAR)<sup>88</sup>, made public by ABC News, that the London office of JP Morgan Chase filed with the Serious Organized Crime Agency in October 2008 – two months prior to Madoff's arrest.<sup>89</sup>

In particular, the Complaint alleges that JP Morgan only submitted the SAR because it realised its own financial stake could be at risk.<sup>90</sup> The SAR stated that JP Morgan had concerns

"based (1) on the investment performance achieved by its funds which is so consistently and significantly ahead of its peers year-on-year, even in the prevailing market conditions, as to appear too good to be true – meaning that it probably is; and (2) the lack of transparency around Madoff Securities trading techniques . . . ; and (3) its unwillingness to provide helpful information."<sup>91</sup>

The SAR further states that JP Morgan began redeeming its investments with Madoff and his "feeder funds" at or around this time. The Complaint further alleges that JP Morgan successfully withdrew its investments prior to Madoff's arrest.<sup>92</sup> It was reported that a similar notification was not provided to US regulators.<sup>93</sup>

Based on statements from counsel, the newly filed lawsuit contends that JP Morgan "had clear, documented suspicions about the legitimacy of [Madoff's] operations. Instead of acting on that information, it simply continued to collect fees and profit from the fraud". It is alleged that "JP Morgan was wilfully blind to the fraud, even after learning about numerous red flags surrounding Madoff."<sup>94</sup> With the emergence of the SAR and other internal documents clearly showing notice of a possible fraud, it is distinctly possible that the failures of similar lawsuits against JP Morgan related to a lack of notice can now be overcome.<sup>95</sup>

Based on the allegations in the most recent Complaint, if JP Morgan had continued to generate fees while turning a blind eye to a fraud it suspected, the extent to which reckless behaviour and disregard for customers is a criminal, or even civil violation, could be tested in the this lawsuit and any resulting criminal actions brought by the Department of Justice. This case brings into sharp focus the question of whether criminal law is sufficiently broad to capture conduct where there is reckless behaviour by a financial markets participant for the purposes of financial gain.

### C. Credit-rating agencies

In this section of the article, we explore the role of the credit-rating agencies, and more particularly the legal framework

within which they operate. As mentioned previously, RMBSs and CDOs were at the centre of the 2007 financial crisis. As the crisis proved, credit-rating agencies had overrated these financial derivatives by rating speculative junk as investment grade, commonly using the AAA rating rather than BBB– and below. It can be conceived that these products attracted more investment attention throughout the global banking community as the demand for highly rated products continued to rise. These agencies provided flawed ratings as they relied on an inappropriate rating model that did not account for declining market conditions.<sup>96</sup> Also, credit-rating agencies relied heavily on historical statistical data instead of personal information about each borrower and were unable to cope with the significant growth in quantity and complexity of structured finance deals since 2002.<sup>97</sup>

Credit-rating agencies eventually downgraded the credit ratings on nearly \$1.9 trillion in RMBSs from mid-2007 to mid-2008.<sup>98</sup> These downgrades forced companies such as AIG to post more collateral under the Basel II agreements. As such, many companies were unable to raise the required liquidity, which resulted in government bail-outs.<sup>99</sup> In certain cases, such as Lehman Brothers, credit-rating agencies issued investment-grade ratings up until the day the company filed for bankruptcy.<sup>100</sup>

Credit-rating agencies, over the last decade of deregulated financial markets, purported to function as independent organisations providing objective analysis on the financial soundness of mortgages and other debt traded on the market for investors and governments alike. Ratings measure the likelihood of a borrower paying back debts on a loan on a timely basis. The more creditworthy a borrower, the higher a credit-rating agency will rate it. Credit ratings serve five principal purposes: (i) to determine capital adequacy requirements for financial institutions; (ii) to identify assets as eligible investments; (iii) to evaluate the credit risk of assets in securitization; (iv) to determine disclosure requirements for rated entities; and (v) to determine prospectus eligibility.<sup>101</sup>

Until the 1970s, investors paid for ratings, but the SEC adopted Rule 15c3-1 to mandate that banks employ credit-rating agencies rather than investors. Further, the Credit Rating Agencies Reform Act of 2006, which amended the Securities Exchange Act 1934, relied on credit-rating agencies to essentially self-regulate.<sup>102</sup> Over the last several decades, the credit-rating industry has been dominated by three companies: Moody's Investors Service, Standard & Poor's and Fitch Ratings Ltd, accounting for approximately 95% of the market share.<sup>103</sup>

Prior to the crisis the US attempted to further regulate credit agencies, but failed to address core problems with the system. Section 702 of the Sarbanes–Oxley Act 2002 required the SEC to prepare and publish a report related to credit-rating agencies.<sup>104</sup> The SEC's initial Section 702 report was issued in January 2003. The SEC identified issues raised during preliminary diligence and stated it would issue a follow-up report for public comment. The most pertinent issues were: (i) whether Nationally Recognized Statistical Rating Organizations (NRSROs) should disclose more information about the key bases of, and assumptions underlying, the ratings decision; and (ii) whether NRSROs should publicly disseminate their ratings on a widespread basis.<sup>105</sup>

On 4 June 2003, the SEC issued a Concept Release seeking comments from the public on a litany of questions relating to credit-rating agency regulation.<sup>106</sup> In response to the SEC's report and hearings before the Committee on Banking, Housing, and Urban Affairs of Senate and the Committee on Financial Services, Congress enacted the Credit Rating Agencies Reform Act of 2006. Specifically, this Act amended the Securities Exchange Act of 1934, adding section 15E. Section 15E(a) sets out the registration procedures for a NRSRO. In particular, subsection (1)(B) of the Act required an applicant to disclose information regarding:

- “ (i) credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of the applicant;
- (ii) the procedures and methodologies that the applicant uses in determining credit ratings; . . .
- (vi) any conflict of interest relating to the issuance of credit ratings by the applicant; . . .
- (viii) on a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received therefrom in the fiscal year immediately preceding the date of submission of the application.”

Subsection 15E(c) states that the SEC must grant an application to be registered unless it finds that “the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed under paragraph (1)(B)”. Moreover, once registered, section 15(c)(3) requires an NRSRO to make all information presented to the SEC in its application public on its website, including its methodologies and procedures. However, the SEC's enforcement rights are limited by section 15E(c)(2). This provides:

“Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings.”<sup>107</sup>

The legislative history reveals that this significant restriction of SEC power in section 15E(c)(2) was added as part of a Manager's Amendment at the insistence of the leading credit-rating agencies.<sup>108</sup> On 12 July 2006, Representative Oxley stated that the proposed Act called for substantial disclosures by credit-rating agencies, but was written to “insulate the rating agencies from overreaching legislation, HR 2990 affirms that the Federal Government may not intrude into rating agencies' methodologies or the ratings process”.<sup>109</sup> The insistence of such a restriction by the largest credit-rating agency was highlighted during Congressional debate:

“A few of the currently designated rating agencies have claimed that Congress and the SEC must be cautious not to intrude into the ratings procedures and methodologies. HR 2990 does not intrude into these procedures and the Manager's Amendment expressly affirms that the SEC may not intrude into the ratings procedures and methodologies.”

The SEC has tried to mitigate the effect of this restriction by ensuring that NRSROs disclose substantial information to the public regarding the methodologies and procedures, specifically related to derivative ratings. In June 2007, the SEC promulgated rules under the Credit Rating Agencies Reform Act.<sup>110</sup> As part of the SEC's final rules, it adopted Rule 17(g)2, which increased CRA bookkeeping

“to allow examiners to review whether an NRSRO is following its stated procedures and methodologies and otherwise complying with Section 15E of the Exchange Act and the rules thereunder. It is important that users of credit ratings be given the opportunity to understand how a specific NRSRO determines its credit ratings. . . . The Commission's role is to examine whether an NRSRO has accurately disclosed this information so that users of credit ratings can assess its credit rating procedures and methodologies.”<sup>111</sup>

The 2006 Act and resulting SEC Rules certainly required greater disclosure of methodologies by credit-rating agencies, but limited the SEC's enforcement capabilities.

#### D. Reckless risk-taking and criminal dishonesty

Although it must be acknowledged that the facts in these cases have not been proved and to this extension any discussion is a matter of speculation, arguably the common denominator running through the paradigm cases would seem to be the notion of recklessness, in the sense that each operator appeared to have behaved without regard to the consequences of their actions in so far as the underlying investors were concerned. If Goldman Sachs continued to market CDOs whilst at the same time dealing with Paulson and purchasing short positions for its own account, surely there would be a strong argument condemning this conduct as reckless since, in this scenario, Goldman Sachs would have been consciously turning a blind eye to the interests of the CDO purchasers. Potentially, there is a parallel here with the manner in which JP Morgan Chase could also be said to have recklessly turned a blind eye to the interests of the investors in Madoff Investment Securities, when, after having filed a SAR and appreciated the risk that a Ponzi fraud was taking place, it nevertheless continued to market the Madoff investments to investors. At first blush, the conduct of Lehman Brothers and Ernst & Young does not seem to fare much better, since again the evidence which has emerged into the public domain would appear to suggest a strong inference that the risks to the bank's financial stability and those associated must have been appreciated by senior management but nevertheless ignored.

As for the role of the credit-rating agencies, if, as appears to be the case, they produced flawed ratings on the basis of an inappropriate rating model which relied too heavily on historical data, the same point can be made. The evidence seems to bear a strong inference that they must have appreciated the risks they, and those relying on their valuations, were running.<sup>112</sup>

This raises a pertinent question as to whether the parameters of criminal law, and in particular the legal definition

of dishonesty, are sufficiently wide to embrace conduct by financial market participants where they have acted recklessly, not caring whether or not they cause financial loss to others and turning a blind eye to this outcome in circumstances where the risk is real and not fanciful. For if the parameters of the criminal law are sufficiently wide, some uncomfortable questions for the enforcement authorities fall to be asked, lending considerable credence to the comment made by Charles Ferguson when accepting his Oscar.

### 1. Dishonesty in criminal law

The notion of dishonesty is the pivot around which the law of theft in England and Wales currently revolves. In 1966 the Criminal Law Revision Committee published a report in 1966 on theft and related offences<sup>113</sup> in which it recommended that “fraudulently and without a claim of right made in good faith” which had been contained in section 1(1) of the Larceny Act 1916 should be replaced by “dishonesty” in the definition of theft contained in clause 1(1) of the Theft Bill.<sup>114</sup> Parliament accepted the recommendation and legislated to define theft as the dishonest appropriation of property belonging to another with the intention of permanently depriving the other of it. However, the legislature omitted to include a definition of dishonesty, leaving it to the courts to expound upon its meaning.

Accordingly, in the course of his judgment in *R v Ghosh*,<sup>115</sup> Lord Lane CJ explained that:

“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, however, the defendant’s conduct was dishonest by that light, then the jury must consider whether the defendant himself must have realized that what he was doing was by those standards dishonest.”<sup>116</sup>

A greater insight into the meaning of dishonesty can be gained from a consideration of cases where conspiracy to defraud has been in issue, since the concept of dishonesty is an integral component of an agreement to defraud. The offence of conspiracy to defraud can be described by way of two alternative formulations: “agreeing dishonestly to prejudice another’s economic interests”, or “agreeing to mislead a person with intent to cause him to act contrary to his duty”.<sup>117</sup>

The interesting question for our consideration is whether the prejudicing of another person’s economic interests is sufficiently wide to embrace a situation in which two defendants agree to act in a manner which runs the risk of prejudicing those interests. Is the taking of the risk sufficient to constitute prejudice which would engage the criminal offence. There are two cases which shed light on the answer to this question.

In *Allsop*,<sup>118</sup> the judge had directed the jury that

“[T]he offence of conspiracy to defraud was sufficiently made out if the conspirators knew that they were inducing the other party to act in circumstances in which they (the conspirators) might cause or create the likelihood of economic loss or prejudice.”<sup>119</sup>

A challenge to the judge’s direction failed, with Shaw LJ making clear that

“[W]here a person intends by deceit to induce a course of conduct in another which puts that other’s economic interests in jeopardy he is guilty of fraud even though he does not intend or desire that actual loss should ultimately be suffered by that other in this context.”

A similar situation arose in the second case, *R v Sinclair*,<sup>120</sup> where the trial judge directed the jury that the behaviour of the appellants had to be deliberately dishonest and the “test was whether there had been the taking of a risk which there had been no right to take and which would cause detriment or prejudice to another”.<sup>121</sup> Again, following a challenge to the trial judge’s direction, the appeal was dismissed. The appellants argued that the “judge equated negligence or gross negligence from which fraud might be, but is not necessarily to be, inferred with fraud itself, whereas fraud involves deliberate dishonesty and nothing short of deliberate dishonesty amounts to fraud”.<sup>122</sup> This argument was met by the prosecution contention that

“[I]t is fraudulent to take a risk to the prejudice of another’s rights, which risk is known to be one which there is no right to take, and that, if such a risk is taken, it is no defence to say that the person taking the risk has an honest belief that no prejudice, but only benefit would result.”<sup>123</sup>

### 2. Dishonesty in civil law

The notion that dishonesty may embrace consciously turning a blind eye to risk is supported by the way in which dishonesty is defined in civil law. In *Baden*,<sup>124</sup> the degree of knowledge necessary to make a bank, which was a stranger to a trust, liable as a constructive trustee was discussed. It was held that the requirement was one of actual knowledge of dishonest design or imputed knowledge that would have been obtained by a reasonable banker in that position. Peter Gibson J set out different categories of knowledge which would be considered dishonest in civil law:

“What types of knowledge are relevant for the purposes of constructive trusteeship? Mr Price submits that knowledge can comprise any one of five different mental states which he described as follows: (i) actual knowledge; (ii) wilfully shutting one’s eyes to the obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man; (v) knowledge of circumstances which would put an honest and reasonable man on inquiry. More accurately, apart from actual knowledge they are formulations of the circumstances which may lead the court to impute knowledge of the facts to the alleged constructive trustee even though he lacked actual knowledge of those facts. Thus the court will treat a person as having constructive knowledge of the facts if he wilfully shuts his eyes to the relevant facts which would be obvious if he opened his eyes, such constructive knowledge being usually termed (though by a metaphor of historical inaccuracy) ‘Nelsonian knowledge’. Similarly the court may treat a person as

having constructive knowledge of the facts – ‘type (iv) knowledge’ – if he has actual knowledge of circumstances which would indicate the facts to an honest and reasonable man.”<sup>125</sup>

Subsequently, in *Agip (Africa) Ltd v Jackson*,<sup>126</sup> Millett J, again in the context of determining the degree of knowledge required for imposition of constructive trusteeship, disagreed with the categorisation set out above:

“According to Peter Gibson J, a person in category (ii) or (iii) will be taken to have actual knowledge, while a person in categories (iv) or (v) has constructive notice only. I gratefully adopt the classification but would warn against over refinement or a too ready assumption that categories (iv) or (v) are necessarily cases of constructive notice only. The true distinction is between honesty and dishonesty. It is essentially a jury question. If a man does not draw the obvious inferences or make the obvious inquiries, the question is: why not? If it is because, however foolishly, he did not suspect wrongdoing or, having suspected it, had his suspicions allayed, however unreasonably, that is one thing. But if he did suspect wrongdoing yet failed to make inquiries because ‘he did not want to know’ (category (ii)) or because he regarded it as ‘none of his business’ (category (iii)), that is quite another. Such conduct is dishonest, and those who are guilty of it cannot complain if, for the purpose of civil liability, they are treated as if they had actual knowledge.”<sup>127</sup>

At this juncture, it must be mentioned that there is ample case-law regarding the parameters of dishonesty required for determining whether or not a person should be designated a constructive trustee. It is tangential as to whether the concept of dishonesty can embrace turning a blind eye as the case-law is primarily concerned with the standard to be applied – objective or subjective. It begins essentially with the seminal judgment of Lord Nicholls in *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming*.<sup>128</sup> This judgment was a notable shift from the previous case-law that considered the degree of knowledge crucial in attaching liability as a constructive trustee. However, the dictum of Lord Nicholls has proved controversial as it has been debated as to whether he intended the concept of “dishonesty” to be interpreted either wholly objectively or subjectively. After the controversial decisions of *Twinsectra Ltd v Yardley*<sup>129</sup> and *Barlow Clowes International Ltd (in liquidation) v Eurotrust International Limited*<sup>130</sup> a degree of consensus has been established by the judgment of Arden LJ in *Abou-Ramah v Abacha*<sup>131</sup> in which she stated that: “[T]he test of dishonesty is predominantly objective: did the conduct of the defendant fall below the normally acceptable standard?”<sup>132</sup>

## E. The regulatory response

Both the US and Europe have responded to the financial crisis with new legislation which increases the level of regulatory and civil liability for market participants.<sup>133</sup> Our concern, however, is that these responses fall short of addressing the

actual failures in the market and are unlikely to prevent similar incidents in the future.

We have already noted that the Credit Rating Agency Reform Act 2006 sought to regulate credit-rating agencies concerning a wide range of issues, particularly disclosure and transparency of methodologies. However, such regulations had little effect in deterring the undervaluing of derivative securities that played a major role in the financial crisis since the SEC still does not interfere with methodologies,<sup>134</sup> with investors and governments alike no wiser about the underlying credibility of the valuation process.

The US post-crisis response related to credit rating agencies, namely the Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd–Frank),<sup>135</sup> still ineffectively addresses the disclosure obligations and transparency of credit-rating agencies. Specifically, it does not require credit-rating agencies to disclose how they achieve certain ratings, but rather requires them to submit a retrospective list of their predictions along with the followed outcomes.<sup>136</sup> While Dodd–Frank emphasises independent board members and moves oversight responsibilities to the SEC across a wide range of financial service sectors, there is little evidence that either of these bodies will be provided with full access to the models, methodologies and general practices employed by credit-rating agencies, hedge funds, investment firms, etc. Moreover, despite a finding by Congress that credit-rating agencies had serious conflicts of interest, Dodd–Frank does not address this issue through regulations, but rather offers an eighteen-month study to explore alternative means to compensation.<sup>137</sup>

The only regulation to directly confront the problems posed by credit-rating agencies in the US in Dodd–Frank is the repeal of Rule 436(g) of the Securities Act of 1933, which forces major credit-rating agencies to be accountable to investors. This was a clause that protected registered credit-rating agencies from liability if they prepared misleading statements in connection with securities registration.<sup>138</sup>

The European response to credit-rating agencies has been equally uninspiring. The EU Directives concerning the crisis have been directed at addressing gaps and inconsistencies in national regulatory frameworks of Member States rather than focusing upon disclosure obligations for credit-rating methodologies and where financial markets participants have conflicts of interest. After several years of study and negotiations, the European Commission released a draft proposal of its derivatives legislation on 15 September 2010. The proposal is similar to Dodd–Frank with the exception of the classification of financial and non-financial businesses (notable differences in roles of credit-rating agencies, for example).

A revision of Basel II is currently being drafted, referred to as Basel III. It is expected that the new version will allow for alternatives to credit ratings, such as bank-internal models.<sup>139</sup> However, this defeats the purpose of having an independent agency monitoring banks. Basel III proposals rely heavily on credit-rating agencies particularly concerning securitisation and measuring both liquidity and counterparty risk. This contrasts with Dodd–Frank which in section 939A limits the powers of credit-rating agencies by granting one year to regulators to abolish any reference to ratings in their regulations.<sup>140</sup> It is feared that a lack of a unified front in regulation

will create opportunities for regulatory arbitrage and further undermine government efforts.<sup>141</sup>

The EU Parliament has passed legislation transferring direct supervision of credit-rating agencies to the European Securities and Markets Authority (ESMA). On 1 January 2011, ESMA replaced the Committee of European Securities Regulators (CESR). ESMA is now one of three European Supervisory Authorities (ESAs) that work with national regulators to make sure EU rules are being enforced. The two other authorities will supervise the insurance and banking sectors.<sup>142</sup> Despite its increased powers, ESMA will not have significantly greater resources than its predecessor. Staffing levels at the three ESAs will rise to 150 people in 2011 and then to 300 in 2015. By comparison, the UK's Financial Services Authority has 3,300 staff.<sup>143</sup> On this note, it seems entirely unrealistic to expect ESMA to properly supervise and enforce regulations in all EU Member States.

Finally, the EU Commission has proposed drafts concerning CDSs, but this will likely be negotiated and redrafted by the European Parliament and ESMA at least until 2012. The European Commission is also currently reviewing changes concerning UCITS depositaries and the remuneration of UCITS managers.<sup>144</sup>

In short, the effect of the regulatory response to the global financial crisis in the EU has been to shift responsibilities to new regulatory bodies without bearing down on the root of the problem, namely credit-rating agency failures, deficient methodologies in derivative valuations, and failure by financial markets participants to disclose conflicts of interest.

## F. The Fraud Act 2006 and the legal duty to disclose

Although the meaning of dishonesty is sufficiently wide in both criminal law and civil law to embrace the notion of reckless conduct where a financial market participant consciously closes his eye to the risk of investor loss, application of the Fraud Act 2006 in England and Wales to the paradigm cases we have considered in this article discloses a significant lacuna in the reach of the legislation. This is because the offence of fraud can be committed under the Act only where there has been a false representation, where a person has failed to disclose information to another person in circumstances where he was legally obliged to do so, or he has been guilty of an abuse of trust.<sup>145</sup>

The term "legal duty" is neither defined in the Act nor in the Home Office explanatory notes. The Law Commission proposed in 2002 that duties can arise:

"[U]nder statute, (eg obligations of accuracy in company prospectuses); in transactions of the utmost good faith, (eg insurance); from general contractual terms or from the custom of a particular trade or market; and from the existence of a fiduciary relationship between the parties."<sup>146</sup>

Based on the Law Commission's comments and the decision of Parliament in adopting only portions of the proposed Fraud Act, it is clear that only a known duty under civil law can give rise to criminal liability for a failure to disclose material information under section 3 of the UK Fraud Act. The

heart of the problem, therefore, is that civil law requirements do not impose sufficiently stringent regulatory requirements upon financial market participants to make disclosures regarding potential conflicts of interest (eg Goldman Sachs) or concerns about the underlying value and/or credibility of the investment (eg Lehman Brothers, JP Morgan, the credit-rating agencies).

As it happens, the Law Commission had proposed the inclusion of an additional provision which would have covered this point. For as well as triggering a duty to disclose by legal obligation, the Law Commission suggested that a person should also be obliged to make a disclosure where (a) the information is the kind of information that an investor trusts a financial market participant to disclose to him, (b) the financial market participant knows that the investor is trusting him in this way or is aware that he might be, and (c) any reasonable person would expect the financial market participant to disclose the information to the investor.<sup>147</sup> If this proposed provision been adopted, the questionable actions in our paradigm cases could have been more easily proven in a criminal court.

Prior to the economic crisis, the legal duties owed by investment banks selling CDOs and other investment instruments were not expressly addressed, particularly related to conflicts of interests and specific disclosures in CDOs and other derivative transactions. Pre-crisis, duties to disclose conflicts of interest to counterparties (in the case of Goldman), valuation techniques to investors (in the case of credit-rating agencies), or turning a blind eye to fraudulent investment schemes (in the case of JP Morgan) were certainly not express.

These duties of disclosure are regulated by the FSA in England and Wales. The starting-point when determining the extent of these obligations is the FSA's somewhat generic Principles for Business:

"[The] FSA's Principles for Businesses provide a general statement of the fundamental obligations of firms under the regulatory system. The FSA has made it clear that it will rely on a number of the Principles for Businesses, including but by no means limited to, Principle 8 which is directed specifically at conflicts of interest, in order to ensure that firms pay due regard to having effective systems and controls to identify, manage and mitigate risks arising from conflicts."<sup>148</sup>

Specifically, Principle 8 provides that "[a] firm must manage conflicts fairly, both between itself and its customers and between a customer and another client". Christa Band explains that in the case of investment banks, Principle 8's attempts to monitor intermediary conflicts of interest did not apply to market counterparties – such as Paulson and IKB in the ABACUS transaction.<sup>149</sup> Thus, when acting under Principle 8, a firm was obliged to manage conflicts between itself and customers, but not market counterparties.

Historically, a "market counterparty" has been defined as "a trading member of an investment exchange . . . in respect of . . . any related derivatives".<sup>150</sup> Thus, any professional or institutional investors trading in derivatives, like CDOs, and intermediaries were not subject to express duties to disclose conflicts of interest. Therefore, financial market participants

operating as market counterparties during the global financial crisis did not breach any express duty to make disclosure of conflicts of interest as at law in the UK. Regulations alone have failed to address the causes of the crisis. This is an absurd state of affairs and it needs to be rectified at the earliest opportunity.

Criminal prosecution has an important role to play in bringing to account financial market participants who recklessly take risks with the purchase, sale and/or valuation of derivative instruments.<sup>151</sup> This is particularly the case in circumstances where there are obvious conflicts of interest and/or adherence to inadequate methodologies when determining the valuation of those investments. Until the regulatory authorities impose stricter obligations on financial market participants to make such disclosures, section 3 of the Fraud

Act 2006 will remain neutered. Further, the reach of regulatory authorities continues to stop short of any supervision of valuation methodologies or an understanding of the models on which credit-rating agencies are basing their valuations. Legislators in the US and Europe may give the appearance of responding proactively to the challenges of the global financial crisis, but in so far as the underlying causes are concerned, we fear it is a case of *plus ça change plus c'est la même chose*. ■

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<sup>1</sup> Charles Ferguson, accepting his winning nomination at the Oscars ceremony in Hollywood on 27 February 2011, [www.zerohedge.com/article/acceptance-speech-charles-ferguson-oscar-winner-best-documentary-feature-inside-job](http://www.zerohedge.com/article/acceptance-speech-charles-ferguson-oscar-winner-best-documentary-feature-inside-job) (accessed 10 March 2011).

<sup>2</sup> G20 Declaration at the summit on financial markets and the world economy, Washington DC, 15 November 2008, [www.g20.org/Documents/g20\\_summit\\_declaration.pdf](http://www.g20.org/Documents/g20_summit_declaration.pdf) (accessed 10 February 2011).

<sup>3</sup> H Davies, *The Financial Crisis: Who is to Blame?* (Cambridge University Press, 2010), 135.

<sup>4</sup> RA Jarrow, *The Economics of Credit Default Swaps (CDS)*, July 2010, <http://kamakuraco.com/LinkClick.aspx?fileticket=Mvp5AadRwGo%3D&tabid=208&mid=735> (accessed 26 February 2011).

<sup>5</sup> C Weller, "The End of the Great American Housing Boom", *Center for American Progress*, December 2006, [www.americanprogress.org/issues/2006/12/end\\_of\\_the\\_boom.html/issues/2006/12/pdf/housing\\_boom\\_report.pdf](http://www.americanprogress.org/issues/2006/12/end_of_the_boom.html/issues/2006/12/pdf/housing_boom_report.pdf) (accessed 17 March 2011).

<sup>6</sup> J Surowiecki, "Ratings Downgrade", *The New Yorker*, 28 September 2009, [www.newyorker.com/talk/financial/2009/09/28/090928ta\\_talk\\_surowiecki](http://www.newyorker.com/talk/financial/2009/09/28/090928ta_talk_surowiecki) (accessed 26 February 2011).

<sup>7</sup> Levin–Coburn Memorandum to the Members of the Permanent Subcommittee on Investigations, "Wall Street and the Financial Crisis: the Role of High Risk Loans" at 7, 13 April 2010, [http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=f07ef2bf-914c-494c-aa66-27129f8e6282](http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=f07ef2bf-914c-494c-aa66-27129f8e6282) (accessed on 19 February 2011) ("Subcommittee Memorandum").

<sup>8</sup> *Ibid.*, 5.

<sup>9</sup> Complaint, *SEC v Goldman Sachs & Co*, US District Court for the Southern District of New York, 10-cv-3229 (BSJ), 16 April 2010 ("SEC Complaint"), para 10.

<sup>10</sup> *Ibid.*, para 12.

<sup>11</sup> *Ibid.*, para 14.

<sup>12</sup> *Ibid.*, para 15.

<sup>13</sup> *Ibid.*, paras 15–16.

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*, para 18.

<sup>16</sup> *Ibid.*; The SEC also cited an e-mail with similar ominous predictions from the head of the Goldman Sachs structured product correlation trading desk to Tourre dated 11 February 2007: "[T]he CDO biz is dead we don't have a lot of time left."

<sup>17</sup> *Ibid.*, para 19.

<sup>18</sup> *Ibid.*, paras 21–22.

<sup>19</sup> *Ibid.*

<sup>20</sup> *Ibid.*, para 25.

<sup>21</sup> *Ibid.*, para 27.

<sup>22</sup> *Ibid.*, para 35.

<sup>23</sup> *Ibid.*, para 32.

<sup>24</sup> *Ibid.*, para 41.

<sup>25</sup> *Ibid.*, paras 37–38.

<sup>26</sup> *Ibid.*, para 36.

<sup>27</sup> *Ibid.*, para 44.

<sup>28</sup> *Ibid.*, para 47; on 12 February 2007, ACA internally approved its participation in ABACUS 2007–AC1 describing Paulson as investing in the equity tranche of the CDO.

<sup>29</sup> *Ibid.*, paras 52–54.

<sup>30</sup> *Ibid.*, para 54.

<sup>31</sup> *Ibid.*, para 58.

<sup>32</sup> *Ibid.*, para 40.

<sup>33</sup> *Ibid.*, para 60.

<sup>34</sup> *Ibid.*, paras 61–66.

<sup>35</sup> *Ibid.*, para 70.

<sup>36</sup> Subcommittee Memorandum, *supra* n 7.

<sup>37</sup> Opening Statement of Senator Carl Levin, US Senate Permanent Subcommittee on Investigations Hearing, Wall Street and the Financial Crisis: The Role of Investment Banks, 27 April 2010, [http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=f07ef2bf-914c-494c-aa66-27129f8e6282](http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=f07ef2bf-914c-494c-aa66-27129f8e6282) (accessed 18 February 2011) (Opening Statement of Senator Carl Levin).

<sup>38</sup> *Ibid.*, 4.

<sup>39</sup> "Senate Turns Up Heat on Goldman Sachs Executives", *CBS News*, 27 April 2010, [www.cbsnews.com/stories/2010/04/27/business/main6436469.shtml](http://www.cbsnews.com/stories/2010/04/27/business/main6436469.shtml) (accessed 19 February 2011); Goldman Sachs CEO, Lloyd Blankfein, further denied any inherent conflict of interest: "We do hundreds of thousands, if not millions of transactions a day, as a market maker . . . noting that behind every transaction there was a buyer and a seller, creating both winners and losers."

<sup>40</sup> Consent of Defendant Goldman, Sachs & Co., 14 July 2010, [www2.goldmansachs.com/our-firm/investors/financials/archived/8k/pdf-attachments/07-14-10-8k-doc.pdf](http://www2.goldmansachs.com/our-firm/investors/financials/archived/8k/pdf-attachments/07-14-10-8k-doc.pdf) (accessed 18 February 2011) ("Consent of Goldman Sachs").

<sup>41</sup> "SEC Settlement with Goldman Sachs for \$550 Million Approved by US Judge", *Bloomberg*, 21 July 2010, [www.bloomberg.com/news/2010-07-20/goldman-sachs-settlement-with-sec-for-550-million-approved-by-u-s-judge.html](http://www.bloomberg.com/news/2010-07-20/goldman-sachs-settlement-with-sec-for-550-million-approved-by-u-s-judge.html) (accessed on 18 February 2011).

- <sup>42</sup> Consent of Goldman Sachs, *supra* n 40, para 3.
- <sup>43</sup> Lehman Brothers Holdings Inc, Chapter 11 Proceedings Examiners Report, Executive Summary of the Examiner's Conclusions, Vol I, at 2, <http://lehmanreport.jenner.com> (accessed 22 February 2011) ("Valukas Report").
- <sup>44</sup> *Ibid*, 2–3.
- <sup>45</sup> *Ibid*, 4.
- <sup>46</sup> *Ibid*, 5.
- <sup>47</sup> *Ibid*, vol III.A.4, 836.
- <sup>48</sup> *Ibid*, vol I, 5.
- <sup>49</sup> The traditional sale and repurchase agreement (repo) is a mechanism used by investment banks to secure short-term financing. It involves an asset or security transfer from one party to another as collateral for short-term financing "while simultaneously agreeing to repay the cash and take back the collateral at a specific point in time. When the repo transaction matures, the borrower repays the funds plus an agreed upon interest rate and takes back its collateral." See Valukas Report, *supra* n 43, vol III.A.4, 732, n 2848. Repo 105 resembles this traditional repo in apart from the critical distinction that LBHI treated Repo 105 transactions as sales on the basis of the over-collateralization (either by 5% or 8%). This overcollateralization of 5% or 8% was termed the "haircut", this being "the difference between the value of the collateral used to secure a borrowing and the amount of cash that is borrowed". See Financial Accounting Standards Board's Statement of Financial Accounting Standards No 140, [www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820919404&blobheader=application%2Fpdf](http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820919404&blobheader=application%2Fpdf) (accessed on 22 February 2011).
- <sup>50</sup> Valukas Report, *supra* n 43, vol I, 9.
- <sup>51</sup> *Ibid*, 8.
- <sup>52</sup> *Ibid*, 8.
- <sup>53</sup> *Ibid*.
- <sup>54</sup> *Ibid*, vol III.A.4, 779.
- <sup>55</sup> *Ibid*, 780.
- <sup>56</sup> *Ibid*, 784. LBHI was unable to obtain a true sale opinion letter in the US. However, LBHI was able to obtain a legal opinion that these transactions were a true sale under English law.
- <sup>57</sup> *Ibid*, 786.
- <sup>58</sup> *Ibid*, 787.
- <sup>59</sup> *Ibid*, 756.
- <sup>60</sup> *Ibid*, 800.
- <sup>61</sup> *Ibid*, 823.
- <sup>62</sup> *Ibid*, 828.
- <sup>63</sup> *Ibid*, 832.
- <sup>64</sup> *Ibid*, 845.
- <sup>65</sup> *Ibid*, 962.
- <sup>66</sup> *Ibid*, 963.
- <sup>67</sup> *Ibid*, 964 (GAAP, Generally Accepted Accounting Principles).
- <sup>68</sup> *Ibid*, 965 (citing *In re Global Crossings Ltd Securities Litigation.*, 322 FSupp2d 319, 339 (SDNY 2004)).
- <sup>69</sup> 15 USC § 78a, *et seq.*
- <sup>70</sup> Valukas Report, *supra* n 43, vol III.A.4, 967.
- <sup>71</sup> *Management's Discussion and Analysis of Financial Condition and Results of Operations*, Item 303, Part 230, General Rules and Regulations, Securities Act 1933, <http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=20c66c74f60c4bb8392bfc9ad6fcca3&rgn=div5&view=text&node=17:2.0.1.1.11&dno=17#17:2.0.1.1.11.4.31.3> (accessed 25 February 2011).
- <sup>72</sup> Valukas Report, *supra* n 43, vol III.A.4, 973.
- <sup>73</sup> *Ibid*, 977.
- <sup>74</sup> *Ibid*.
- <sup>75</sup> *Ibid*, 985.
- <sup>76</sup> *Ibid*, 915.
- <sup>77</sup> A "colorable" claim is used within the Valukas Report to describe a claim for which "there is sufficient credible evidence to support a finding by a trier of fact" (Valukas Report, *supra* n 43, vol I, 17). This is a higher standard than that ordinarily used. The ordinary standard according to the Second Circuit is one "that on appropriate proof would support a recovery". See *In Re STN Enters*, 779 F2d 901, 905 (2d Cir 1985) (The Bankruptcy Courts Order Directing Appointment of an Examiner Pursuant to s 1104(c)(2) does not state what constitutes a "colorable" claim nor does the Bankruptcy Code. However, the phrase is used in such cases in order to establish "whether a creditors' committee has standing . . . to file suit on behalf of a debtor in possession or trustee" (see Valukas Report, *supra* n 43, vol VI, appendix 1, 5,6). But considering the extensive factual investigation conducted, this higher standard was preferred by the Examiner as otherwise, "'colorable' claims could be established wherever bare allegations might survive a motion to dismiss" (*ibid*, vol I, 17).
- <sup>78</sup> Valukas Report, *supra* n 43, vol III.A.4, 105, 990.
- <sup>79</sup> *Ibid*, 1027.
- <sup>80</sup> 15 USC § 7211.
- <sup>81</sup> Public Accounting Oversight Board, <http://pcaobus.org/About/Pages/default.aspx> (accessed 25 February 2011). The purpose of the PCAOB is to require "that auditors of US public companies be subject to external and independent oversight for the first time in history".
- <sup>82</sup> PCAOB Rule 3100, [http://pcaobus.org/Rules/PCAOBRules/Pages/Section\\_3.aspx#rule3100](http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx#rule3100) (accessed 25 February 2011).
- <sup>83</sup> Valukas Report, *supra* n 43, vol III.A.4, 1034. Members of Ernst & Young interviewed Matthew Lee on 12 June 2008 and during this meeting, "Lee raised an additional allegation not contained in his letter; specifically, he advised . . . that at the end of the second quarter 2008, Lehman moved \$50bn in assets off its balance sheet using Repo 105 transactions, only to move those assets back onto the balance sheet a few days later."
- <sup>84</sup> *Ibid*, 1037.
- <sup>85</sup> Presumably this is because "Securities Act claims are based on strict liability and negligence." Third Amended Consolidated Class Action Complaint for Violations of the Federal Securities Laws, para 23, [www.lehmansecuritieslitigation.com/pdf/2010-04-23%20Lehman%20Third%20Amended%20Complaint.pdf](http://www.lehmansecuritieslitigation.com/pdf/2010-04-23%20Lehman%20Third%20Amended%20Complaint.pdf) (accessed 26 February 2011).
- <sup>86</sup> Complaint, 2 December 2010, *Picard v JP Morgan Chase & Co*, US Bankruptcy Court Southern District of New York, Adv No 10-04932 (BRL), [http://msnbcmedia.msn.com/i/CNBC/Sections/News\\_And\\_Analysis/\\_Story\\_Inserts/graphics/\\_PDF/cnbc\\_jpmorgan.pdf](http://msnbcmedia.msn.com/i/CNBC/Sections/News_And_Analysis/_Story_Inserts/graphics/_PDF/cnbc_jpmorgan.pdf) (accessed 25 February 2011) ("JP Morgan Complaint"). The JP Morgan Complaint was originally filed under seal and was only made publicly available, with significant redactions, in February 2011.
- <sup>87</sup> *Ibid*, paras 3, 9 and 111; "JP Morgan Suspected Madoff Months Prior to Arrest, Kept Doing Business With Him", *ABC News*, 2 December 2010, <http://abcnews.go.com/Blotter/jp-morgan-suspected-madoff-months-prior-arrest/story?id=12294368> (accessed 19 February 2011).
- <sup>88</sup> Suspicious Activity Report submitted by JP Morgan to the Serious Organized Crime Agency, 29 October 2008, <http://abcnews.go.com/Blotter/page?id=12297036> (accessed 19 February 2011) ("Suspicious Activity Report").
- <sup>89</sup> JP Morgan Complaint, *supra* n 90.
- <sup>90</sup> *Ibid*, para 9.
- <sup>91</sup> Suspicious Activity Report, *supra* n 77.
- <sup>92</sup> *Ibid*; JP Morgan Complaint, *supra* n 90, paras 150–53.
- <sup>93</sup> "JP Morgan Suspected Madoff Months Prior to Arrest, Kept Doing Business With Him", *ABC News*, 2 December 2010,

- <http://abcnews.go.com/Blotter/jp-morgan-suspected-madoff-months-prior-arrest/story?id=12294368> (accessed 19 February 2011).
- <sup>94</sup> *Ibid.*
- <sup>95</sup> A similar lawsuit was filed by investors in Florida in April 2009. The suit claimed that JP Morgan Chase knew of the fraud but continued to generate fees through Madoff-related investments. In July 2010, a federal judge in New York dismissed the Florida action stating that “[w]hile it might have been possible for defendants to determine that Madoff was committing fraud from the ‘red flags’ that plaintiff points out, plaintiff alleges no facts to demonstrate that defendants actually did make such a discovery.”
- <sup>96</sup> G Shorter and M Seitzinger, “Credit Rating Agencies and Their Regulation. Congressional Research Service”, 3 September 2009, 7, [http://garrett.house.gov/UploadedFiles/Credit\\_Rating\\_Agencies.pdf](http://garrett.house.gov/UploadedFiles/Credit_Rating_Agencies.pdf) (accessed 16 March 2011).
- <sup>97</sup> J Katz, E Salinas and C Stephanou, “Credit Rating Agencies: No Easy Regulatory Solutions. Crisis Response”, *The World Bank Group*, October 2009, <http://rru.worldbank.org/documents/CrisisResponse/Note8.pdf> (accessed 26 February 2011).
- <sup>98</sup> *Ibid.*
- <sup>99</sup> B Balin, “Basel I, Basel II, and Emerging Markets: A Non-technical Analysis”, The Johns Hopkins University School of Advanced International Studies (SAIS), 10 May 2008, <https://jscholarship.library.jhu.edu/bitstream/handle/1774.2/32826/Basel%20I%2c%20Basel%20II%2c%20and%20Emerging%20Markets%20a%20Nontechnical%20Analysis052008.pdf?sequence=1> (accessed 16 March 2011). Basel II is a set of international standards that defines the minimum capital requirements for internationally active banks, among other general business practices. The required amount of capital is determined by the quality of loans distributed by a particular bank: the riskier the loans, the more capital a bank is required to provide. The difference in capital requirements for loans rated as AAA compared to those rated BBB– and below is exponential.
- <sup>100</sup> Katz *et al*, *supra* n 97.
- <sup>101</sup> *Ibid.*
- <sup>102</sup> F Partnoy, “Overdependence on Credit Ratings Was a Primary Cause of the Crisis”, Eleventh Annual International Banking Conference, The Federal Reserve Bank of Chicago and the European Central Bank Credit Market Turmoil of 2007–08: Implications for Public Policy, [www.law.yale.edu/documents/pdf/cbl/Partnoy\\_Overdependence\\_Credit.pdf](http://www.law.yale.edu/documents/pdf/cbl/Partnoy_Overdependence_Credit.pdf) (accessed 26 February 2011).
- <sup>103</sup> Davies, *supra* n 3, 123.
- <sup>104</sup> SEC Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, as Required by Section 702(b) of the Sarbanes–Oxley Act of 2002, January 2003, [www.sec.gov/news/studies/credratingreport0103.pdf](http://www.sec.gov/news/studies/credratingreport0103.pdf) (accessed 2 March 2011).
- <sup>105</sup> *Ibid.*, 44.
- <sup>106</sup> SEC Concept Release, “Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws”, 4 June 2003, [www.sec.gov/rules/concept/33-8236.htm](http://www.sec.gov/rules/concept/33-8236.htm) (accessed 2 March 2011).
- <sup>107</sup> 15 USC § 78o–7(c)(2).
- <sup>108</sup> House Report 109–546, n 22.
- <sup>109</sup> Congressional Record, 109th Congress, 12 July 2006.
- <sup>110</sup> 17 CFR Parts 240 and 249b.
- <sup>111</sup> Securities and Exchange Commission, “Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations”, Release No 34–55857, 82–83.
- <sup>112</sup> As one former director of Moody’s testified, “banks typically chose the agency with the lowest standards, engendering a race to the bottom in terms of rating quality”. See A Fitzgerald, “Fed Loans Guided by Raters Grading Subprime Debt AAA”, *Bloomberg*, 18 December 2008, [www.bloomberg.com/apps/news?pid=newsarchive&sid=af32G4ayfLQY](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=af32G4ayfLQY) (accessed 26 February 2011).
- <sup>113</sup> Criminal Law Revision Committee, “Eighth Report: Theft and Related Offences,” Cmnd 2977 (1966).
- <sup>114</sup> Which subsequently became the Theft Act 1968 (“the 1968 Act”).
- <sup>115</sup> [1982] QB 1053.
- <sup>116</sup> *Ibid.*, 1064.
- <sup>117</sup> D Omerod and DH Williams, *Smiths Law of Theft* (Oxford University Press, 2007), 204.
- <sup>118</sup> (1976) 64 CrAppR 29.
- <sup>119</sup> *Ibid.*, 30.
- <sup>120</sup> (1968) 52 CrAppR 618, [1968] 3 All ER 241.
- <sup>121</sup> (1968) 52 CrAppR 618, 619.
- <sup>122</sup> *Ibid.*, 620–21.
- <sup>123</sup> *Ibid.*, 621–22 (emphasis supplied).
- <sup>124</sup> *Baden v Société Générale pour Favoriser le Développement du Commerce et de l’Industrie en France*, [1993] 1 WLR 509, 575–76.
- <sup>125</sup> *Ibid.*, para 250 *per* Peter Gibson J.
- <sup>126</sup> [1990] Ch 265.
- <sup>127</sup> *Ibid.*, 293.
- <sup>128</sup> [1995] 2 AC 378.
- <sup>129</sup> [2002] 2 AC 164.
- <sup>130</sup> [2006] 1 WLR 1476.
- <sup>131</sup> [2006] EWCA Civ 1492.
- <sup>132</sup> *Ibid.*, para 66.
- <sup>133</sup> The UK’s regulatory response to the financial crisis, the Financial Services Act 2010, provides a minimal response to the crisis and fails to make any significant changes in the regulation of financial markets. The only noteworthy provision is the insertion of Part 8A, section 131C of the Financial Services and Markets Act 2000 which provides for the regulation of short selling.
- <sup>134</sup> The SEC is strictly prohibited from regulating or interfering with methodologies. US Securities and Exchange Commission: Credit Rating Agencies, [www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml](http://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml) (accessed 26 February 2011).
- <sup>135</sup> PubL 111–203, HR 4173.
- <sup>136</sup> US Securities and Exchange Commission: Credit Rating Agencies, [www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml](http://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml) (accessed 26 February 2011).
- <sup>137</sup> Dodd–Frank s 939D(b).
- <sup>138</sup> Dewey & Leboeuf, Client Alert, 22 July 2010, [www.deweyleboeuf.com/en/Ideas/ClientAlerts/2010/07/~/\\_/media/Files/clientalerts/2010/20100722\\_CopingwiththeRepealofRule436g.ashx](http://www.deweyleboeuf.com/en/Ideas/ClientAlerts/2010/07/~/_/media/Files/clientalerts/2010/20100722_CopingwiththeRepealofRule436g.ashx) (accessed 26 February 2011).
- <sup>139</sup> F Salmon, “Dodd Frank vs Basel III”, *Reuters*, 20 January 2011, <http://blogs.reuters.com/felix-salmon/2011/01/20/dodd-frank-vs-basel-iii/> (accessed 26 February 2011).
- <sup>140</sup> *Supra* n 138.
- <sup>141</sup> *Supra* n 139.
- <sup>142</sup> B Aboulian, “More Power for New EU Supervisor”, *Financial Times*, 26 September 2010. <http://cachef.ft.com/cms/s/0/79820bca-c802-11df-ae3a-00144feab49a.html#axzz1F4nSPHqq> (accessed 26 February 2011).
- <sup>143</sup> *Ibid.*
- <sup>144</sup> EU Commission Directive 2010/43/EU, Official Journal of European Union, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:176:0042:0061:EN:PDF> (accessed 26 February 2011). For an exhaustive list of on going European Commission’s financial services proposals see [www.lawnow.com/cmck/pdfs/nonsecured/ecfsproposals.pdf](http://www.lawnow.com/cmck/pdfs/nonsecured/ecfsproposals.pdf).

- <sup>145</sup> The US Supreme Court has similarly interpreted Rule 10b-5, promulgated under the Exchange Act, to only include fraud arising out of civil duty to speak. *Chiarella v United States*, 445 US 222, 234–36, 100 SCt 1108, 63 L Ed 2d 348 (1980) (“Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. . . . The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, nonpublic information to sellers from whom he bought the stock of target corporations. The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers.”).
- <sup>146</sup> The Law Commission, Report No 276, “Fraud: Report on a Reference under Section 3(1)(e) of the Law Commission Act 1965”, July 2002, para 7.28 (“Law Commission Report”).
- <sup>147</sup> *Ibid.*
- <sup>148</sup> C Band, “Conflicts of Interest in the Financial Services and Markets: The Regulatory Aspect” (2007) 22 *Journal of International Banking Law and Regulation* 88, 89.
- <sup>149</sup> *Ibid.*, 90 (emphasis added).
- <sup>150</sup> Securities and Futures Authority Limited, Board Notice 234, “Conduct of Business Rules Amendment to Rule 5-4 (Market Counterparties)”, 30 January 1995, [www.fsa.gov.uk/pubs/additional/234.pdf](http://www.fsa.gov.uk/pubs/additional/234.pdf) (accessed 18 February 2011); see also Financial Services Authority Discussion Paper, “Differentiated Regulatory Approaches: Future Regulation of Inter-Professional Business”, October 1998, [www.fsa.gov.uk/pubs/discussion/D01.pdf](http://www.fsa.gov.uk/pubs/discussion/D01.pdf) (accessed 18 February 2011) and also the definition of a “market counterparty” in the Glossary to the current Financial Services Authority Handbook, <http://fsa-handbook.info/FSA/html/handbook/Glossary/M> (accessed 24 May 2011).
- <sup>151</sup> An abstract of this paper was circulated to participants at a colloquium held on 30 March 2011 at the London School of Economics (Law and Financial Markets Project) and addressed by Richard Alderman, Director of the Serious Fraud Office. Differing views were expressed regarding the role of criminal prosecution in financial markets cases. Whilst some participants considered that criminal responsibility was necessary to record society’s moral condemnation of reckless risk-taking behaviour, other participants with experience of representing financial institutions strongly disagreed, arguing that corporate criminal liability would have a negligible effect on behaviour and that if our proposed changes were enacted, it would lead to increased “boilerplate” disclosures by financial institutions and credit-rating agencies which would have little or no value. We disagree and observe that if this analysis is correct, it begs a broader question as to whether, in addition to expanding the reach of criminal law, government needs to make greater effort to promote the application of sound ethical behaviour in the marketplace. In this connection, see R McCormick, “Towards a More Sustainable Financial System: The Regulators, The Banks and Civil Society” (2011) 5(2) *Law and Financial Markets Review* 129.