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Shooting Fish in a Barrel: Sophisticated Investor Protection in the Aftermath of the Global Financial Crisis

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ABSTRACT

In a landmark ruling, the Australian Federal Court has found that monetary capacity alone cannot serve as a proxy for the sophistication of investors transacting in complex financial instruments. The judicial determination in *Wingecarribee Shire Council v Lehman Brothers Australia* that the investment bank had engaged in deceptive and misleading practice in both individual transactions and through investment management protocols by placing derivative contracts in portfolios managed by local councils has implications far beyond Australian shores. It follows considerable controversy in the United States over the decision to settle rather than to prosecute similar types of cases. The paper assesses the national and international implications of the Australian Federal Court ruling. The paper argues that the judicial reasoning has not only clarified legal obligation; it also demonstrates significant failings in regulatory policy settings, both here in Australia and in the United States.

A Introduction

'How was it that relatively unsophisticated Council officers came to invest many millions of ratepayers' funds in these specialised financial instruments? That is the fundamental question at the heart of these proceedings,' reflected Rares J, before pronouncing judgment in a case that has far-reaching implications for the regulation of financial services.[1] *Wingecarribee Shire Council v Lehman Brothers Australia* addresses directly a critical issue: what specific duty of care does an investment bank owe to its clients and can these be voided by contractual terms or legislative exceptions? The Rares judgment provides the first definitive affirmative answer to the former and a negative to the latter. It holds that a critical bifurcation in the Australian securities legislation between sophisticated and unsophisticated investors cannot be used to evade responsibility to act in the best interest of clients. It finds that Grange Securities, a wholly owned subsidiary of Lehman Brothers, had breached its fiduciary duty in facilitating individual transactions for complex products without explaining the risks. Of potentially greater significance, in what is a damning indictment of financial engineering and the methods used by its leading practitioners, it holds that the placing of highly complex collateralized debt obligations in the investment portfolios of councils occurred because of misleading and deceptive conduct.

The litigation's significance focuses on the interplay between three inter-connected factors. First, the judgment reveals a serious and unresolved conflict over policy implementation of legislative intention in determining how complex securities instruments can and should be marketed. Second, it derives from rather than spawns a class action. That the testing of obligation was left to commercial funders, listed on the Australian Stock Exchange for profit, rather than the regulator funded by the taxpayer to uphold the public interest is even more surprising given that the entities representing that action are themselves an arm of government. Third, precisely because Lehman Brothers Australia is in administration it is unlikely to appeal. The legal advisors to the litigation funders, IMF, have already signaled intention to file against other solvent providers of complex financial products. The ruling is, therefore, likely to herald a wave of litigation.

The United States investment bank Lehman Brothers had entered the Australian market through its acquisition of Grange Securities and Grange Asset Management in March 2007.[2] In so doing, it took responsibility for the management of ongoing and prior relationships. These included the provision of transactional services and asset management for a number of local councils, each governed by a specific

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[1] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 14.

[2] In December 2007, four months after the problems in the US securitisation market became apparent, the business was rebranded as Lehman Brothers Australia and Lehman Brothers Asset Management, respectively.

Individual Management Protocol (IMP). The Federal Court found that 'the improvidence, and commercial naivety, of Grange's Council clients in entering into these transactions that were highly advantageous to Grange'[3] could only have occurred because the financial services firm was dealing with officials variously described as 'financially quite unsophisticated and completely out of his depth,'[4] 'uninformed,'[5] and 'careless.'[6] Notwithstanding the carelessness, the Federal Court did not find grounds to reduce liability through contributory negligence precisely because the financial services firm had used a deliberate strategy to take advantage of its asymmetrical knowledge of product and regulatory complexity.[7]

'The contrast between the actual, and patent, lack of financial acumen of the various Council officers at each of Swan, Parkes and Wingecarribee [each of which are local councils representing the class action] and the intelligent, shrewd and financially astute persons at Grange was striking,' noted Rares J.[8] 'Generally, risk-averse people do not take bets with substantial assets held for public purposes,' he concluded.[9] That they did so could, the court found, be rendered explainable by the fact that they were victims of an elaborate deception. 'Grange financed itself when it required cash by borrowing from its Council clients at a rate of interest or on terms as to security that Grange was not likely to achieve in an informed, arms length transaction with a commercial financier.'[10] The clients had no 'real appreciation of the true risks of SCDOS [Synthetic Collateralized Debt Obligations] or the financial wisdom of its [i.e. Grange's recommendation.'[11] Rares J is, disarmingly, forthright as to how and why this could happen:

> The nature and risks of a SCDO are concepts that are beyond the grasp of most people. Indeed, after the benefit of expert reports, concurrent expert evidence and the addresses of counsel, I am not sure that I understand fully how SCDOs work or their risks. Nonetheless, Grange portrayed itself as an expert in these investments. Most certainly, none of the seven Council officers who gave evidence had any expertise in these financial products. And, Grange knew and preyed on that lack of expertise and the trust the Councils placed in its expert advice.[12]

The 445-page judgment highlights again and again how Grange actively circumvented the stated objection of its clients to investing in illiquid complex instruments through a combination of deception and obfuscation. This is made manifest in the evaluation of specific dealings with Wingecarribee Council, a rural cantonment in New South Wales. 'Grange tested the water' and when the official 'bit' he was 'reeled in' by 'words of comfort.'[13] According to the Court, the council believed that it 'had the best of both worlds: principal protection and increased interest. For Grange, this manner of allaying risk averse, financially unsophisticated council officers' fears of CDOs, was as easy as shooting fish in a barrel.'[14]

There can be no doubting the level of judicial disquiet at corporate interpretation of the bifurcation between sophisticated and unsophisticated investors 'given the subject matter involved, the prudent investment of public money.'[15] The severity of the offence and the robustness of the judgment calls into question the sufficiency of a range of options currently canvassed by the Australian Department of Treasury on how complex financial products were systematically sold to mid-market participants (i.e. those that were deemed sophisticated or professional in legal terms but were, arguably, nothing of the sort).[16] The unresolved policy question focuses on whether the conduct complained of in relation to Grange–for which Lehman Brothers was ultimately held liable–derived from a suboptimal culture within an individual firm or extended to the broader financial services community. Although a significant actor in the Australian marketplace, Grange was not the sole facilitator of the placing of complex instruments in investor portfolios. In this crucial respect the judgment in *Wingecarribee Shire Council v Lehman Brothers Australia* raises more questions than it answers.

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3 *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 266.
4 Ibid, 483.
5 Ibid, 491.
6 Ibid, 462.
7 *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 ("Grange was a person who, unlike each of the Council officers had the necessary financial acumen and expertise to be categorized as a "sophisticated investor" in the English ordinary usage of that expression. That is the capacity in which each Council engaged Grange to act on its behalf:' at 913.)
8 Ibid, 752.
9 Ibid, 895.
10 Ibid, 264.
11 Ibid, 265.
12 Ibid, 410.
13 Ibid, 662.
14 Ibid.
15 Ibid, 790.
16 Department of Treasury, *Wholesale and Retail Clients: The Future of Financial Advice* (Canberra: January 2011) 8-10.

The paper examines the legal and policy implications of the case. Section B outlines the rationale for the bifurcation between investor classes and the impact of the collapse of the securitisation market on investor confidence. Section C highlights how these issues have subsequently played out in litigation in the United States, most notably in a case taken by the Securities and Exchange Commission (SEC) and subsequently settled with Goldman Sachs.[17] Section D conducts a detailed review of the Lehman Brothers case and its likely impact on the dynamics of what constitutes a duty of care in finance. In Section E, drawing on and synthesizing the political economy and regulatory theory literatures, the paper stresses that much greater emphasis needs to be placed on articulating and delineating more precisely where responsibility and accountability lies in financial product design. Section F concludes that if fealty to market integrity is to mean anything more than a narrowly defined and until now transacted around obligation, the reform agenda must address, comprehensively and directly, the ethical deficit at the heart of global finance.

B Caveat Emptor and the Professional Investor

The ability to contract out of investor protection mechanisms is central to the rationale behind the bifurcation between sophisticated (i.e. wholesale or professional) and unsophisticated (i.e. retail) investors. In most developed markets much greater disclosure is required when products or financial advice are offered to retail clients. These restraints are designed to protect the naïve and the unwary from unscrupulous action by those with asymmetrical advantage. Sophisticated investors, by contrast, have traditionally been assumed to have the resources to make informed decisions.[18] The bifurcation has been justified, in part, on the need to facilitate financial services innovation and generate economic prosperity. These objectives can and often have had positive effects on the broader economy. Securitisation, for example, was once lauded as the primary mechanism for expanding home ownership. The dispersal of risk did, in fact, facilitate the advancement of credit to those imperfect credit histories.[19] The claim by the Goldman Sachs chief executive, however, that the bank was doing 'God's work' is a carefully circumscribed one.[20]

The apparent success of securitisation was measured by short-term *efficiency* criteria. These retrospectively justified and legitimated the innovation. The potential negative externalities were traditionally glossed over or ignored.[21] Following the implosion of the securitisation market, the individual corporate and societal consequences of this myopia became clear. The fallout impacted negatively the *responsibility* and *legitimacy* as well as long-term *efficiency* dimensions. Investment losses triggered an enormous erosion of private wealth. Housing and capital markets went into a downward spiral and credit stopped flowing. Emergency funding to the banking and financial services sector solved neither the underlying liquidity nor solvency problems. It merely transferred the risk. Sloganeering about the inherent unfairness of 'privatized profits and socialized losses' became more than a worn-out cliché.

Throughout the crisis and beyond, as we moved from the great moderation to the institutionalisation of the politics of austerity, senior bankers expressed carefully couched regret. At no

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[17] *Securities and Exchange Commission v Goldman Sachs & Co and Fabrice Tourre* 10 Civ. 3329 (SDNY, 15 April 2010).

[18] See *Securities and Exchange Commission v Capital Gains Research Bureau* 375 US 180 (Goldberg J) (1963) ('A fundamental purpose common to these statues, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry': at 186). This necessitates, however, balancing valid and spurious claims, see Justin O'Brien, *Redesigning Financial Regulation* (2007) 66-67 (citing Judge Milton Pollack's argument that the federal securities laws are not meant 'to underwrite, subsidize and encourage…rash speculation in joining a free-wheeling casino that lured thousands obsessed with the fantasy of Olympian riches but which delivered such riches to only a scant handful of lucky winners'). See generally, C. Edward Fletcher, 'Sophisticated Investors Under the Federal Securities Laws' (1998) 1998 *Duke Law Journal* 1081 at 1100 (noting US Eighth Circuit precedent that 'there is no duty to disclose information to one who reasonably should already be aware of it' beyond the basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions').

[19] See Stephen Schwartz, 'The Alchemy of Securitisation' (1994) 1 *Stanford Journal of Law, Business and Finance* 133.

[20] John Arlidge, '"I'm Doing God's Work." Meet Mr. Goldman Sachs,' *The Sunday Times*, 8 November 2009, 4.

[21] Claudio Borio, 'The Financial Crisis of 2007-? Macroeconomic and Policy Lessons' (G20 Workshop on the Global Economy, Mumbai, 24-26 May 2009) 13 ('to varying degrees, policymakers, just like everyone else, underestimated the threat. They were caught up in what, in retrospect, has partly turned out to be a Great Illusion. And even had the threat been fully recognized – and some no doubt did – the political economy pressures not to change policies would have been enormous. On the face of it, the regimes in place had proved to be extremely successful. A lot of reputational capital was at stake') <http://www.g20.org/Documents/g20_workshop_causes_of_the_crisis.pdf>; see also Raghuram Rajan, *Faultines: How Hidden Fractures Still Threaten the World Economy* (2010) 1 ('The problem was not that no one warned about the dangers; it was that those who benefited from an over- heated economy—which included a lot of people—had little incentive to listen').

stage did they accept responsibility.[22] Instead a narrow technical defence was proffered. As the immediate crisis facing the banks receded, the strategies were framed even more aggressively. To preserve the sanctity of contract, there was a stated need to uphold terms entered into freely (if misguidedly). Second, the privileging of *caveat emptor* facilitated the transference of responsibility. Equally understandably, both sets of strategies fuelled public resentment. This prompted, in turn, political recognition of the need for substantive reform to safeguard legitimacy.

The moral tone of this broader debate was particularly apparent in the United States. It was set from Senator Carl Levin's opening statement to the Senate Permanent Committee on Investigations in April 2010. Senator Levin claimed that documents subpeoned by the committee demonstrated that accepted practice had corrupted the industry and despoiled the Republic.[23] According to Senator Levin,

> investment banks such as Goldman Sachs helped feed the conveyor belt of toxic assets that nearly brought economic ruin. Goldman Sachs 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.[24]

Even more problematically for the securities industry, Congress renewed its periodic interest in the desirability of imposing fiduciary standards.[25] For Wall Street the stakes could not have been higher. It faced a perfect storm of public disgust and initial political will and regulatory determination to change the conceptual framework.[26] Despite initial apparent success, most notably in the SEC's securement of a major settlement from Goldman Sachs, a very real danger was also exposed. The rush to settle demonstrated not the underlying strength of the regulatory system but its profound weakness. As the influential New York judge Jed Rakoff put it, settlements create the 'façade of enforcement.'[27] Nowhere was this more apparent that in the prosecution of Goldman Sachs and its defence that no liability should accrue precisely because the investors were sophisticated, who should have known what they were doing and if not should be dismissed as reckless.

C Prosecuting Ethical Lapses: The Case Against Goldman

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[22] See, for example, Andrew Hornby and Lord Stevenson, 'Memo to Treasury Select Committee' Westminster, 10 February 2009, 38 (in a joint statement the CEO and Chairman of HBOS stated they were 'profoundly sorry' but claimed unprecedented global circumstances affected virtually all the top banks in the world but HBOS specifically').

[23] Evidence to U.S. Senate Permanent Subcommittee on Investigations, *Wall Street and the Financial Crisis: The Role of Investment Banks*, US Congress, Washington DC, 27 April 2010 (C. Levin) ('Goldman's actions demonstrate that it often saw its clients not as valuable customers, but as objects for its own profit. This matters because instead of doing well when its clients did well, Goldman Sachs did well when its clients lost money. Its conduct brings into question the whole function of Wall Street, which traditionally has been seen as an engine of growth, betting on America's successes and not its failures').

[24] Carl Levin, 'Senate Floor Statement on Passage of the *Restoring American Financial Stability Act* (2010)' (Press Release, Washington D.C., 25 May 2010).

[25] See Senate Committee on the Judiciary Hearing, *Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations* (U.S. Congress, Washington DC, 4 May 2010).

[26] See Barack Obama, 'Remarks on Financial Regulatory Reform' (Press Conference, White House, Washington DC, 17 June 2009). 'In many ways, our financial system reflects us. In the aggregate of countless independent decisions, we see the potential for creativity — and the potential for abuse. We see the capacity for innovations that make our economy stronger — and for innovations that exploit our economy's weaknesses. We are called upon to put in place those reforms that allow our best qualities to flourish — while keeping those worst traits in check. We're called upon to recognize that the free market is the most powerful generative force for our prosperity — but it is not a free license to ignore the consequences of our actions.'

[27] *SEC v Bank of America* 09 Civ. 6829 (SDNY, 14 September 2009) 8 (Judge Jed Rakoff held 'the proposed settlement in relation to the claim that Bank of America had misled investors over the payment of bonuses to executives within Merrill Lynch is described as 'a contrivance designed to provide the SEC with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry'). Judge Rakoff reluctantly signed off on the settlement, citing judicial restraint but stating that the settlement was 'half baked justice at best,' see *SEC v Bank of America* 09 Civ. 6829 (SDNY, 22 February 2010) 14. In September 2012, Bank of America settled a related class action for $2.6billion, see Peter Henning and Steven Davidoff, 'For Bank of America More Trouble From Merrill Lynch Merger, New York Times, 28 September 2012 http://dealbook.nytimes.com/2012/09/28/the-cost-of-putting-the-merrill-lynch-merger-behind-it/. Similar frustration has been voiced by Judge Ellen Segal Huvelle, who refused to endorse a $75million fine agreed by Citigroup to settle charges that the bank had misled investors over its sub-prime exposure, see Kara Scannell, 'Judge Won't Approve Citi-SEC Pact', *Wall Street Journal*, 17 August 2010, B1 ('I look at this and say, "Why would I find this fair and reasonable"…You expect the court to rubber stamp, but we can't'). See generally, Binyamin Appelbaum, 'US Judges Sound Off on Bank Settlements', *New York Times*, 23 August 2010, B1 (noting broader opposition to recent settlements proposed with Barclays, Citigroup and Bank of America). For discussion of wider risks, see Justin O'Brien, The Façade of Enforcement: Goldman Sachs, Negotiated Prosecutions and the Politics of Blame,' in S. Handelman, S. Will and D. Brotherton (eds.), *How They Got Away With It: Lessons from the Financial Crisis* (2012)

In the United States, each epoch of scandal brings with it a landmark case. This one is no different. Not surprisingly, it was taken against Goldman Sachs. The extraordinarily well-connected bank had become a popular symbol of societal irresponsbility. The stilted performance of its executives at congressional hearings made it exceptionally vulnerable to public disdain. The pretensions of the bank were mocked in the influential reporting of *Rolling Stone*,[28] *Inside Job*, a Hollywood-financed documentary that became a box-office hit and in the corsucating commentary on the crisis provided by *The Daily Show*. Given the centrality of Goldman Sachs to the operation of the CDO market (and its profiting from the collapse), it was inevitable that it found find itself under investigation by the SEC.

The SEC complaint accused the firm of perpetrating a fraud on the market in failing to disclose that an investor with an interest in the collapse of ABACUS, a synthetic collateralised debt obligation (SCDO), was involved in choosing the referent securities.[29] Goldman Sachs paid a record $550m fine to settle, without admitting liability. It committed to remedial corporate governance reform. This included redefining 'the role and responsibilities of internal legal counsel, compliance personnel, and outside counsel in the review of written marketing materials for such offerings. The settlement also required additional [but undefined] education and training of Goldman employees in this area of the firm's business.'[30] The SEC's Director of Enforcement, Robert Khuzami, claimed that the settlement sent 'a stark lesson to Wall Street firms that no product is too complex, and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing.'[31]

The settlement came as Goldman Sachs and other banks were facing a torrent of private litigation.[32] Basis Capital, a Caymen Island-registered hedge fund, accused the firm of misrepresenting the risk associated with Timberwolf, a CDO described by a Goldman Sachs executive as 'one shitty deal.'[33] In a separate case, the Boston-based insurer Liberty Mutual alleged that Goldman Sachs deliberately underplayed the risks associated with underwriting Fannie Mae, the government-sponsored enterprise charged with providing liquidity to the US housing and mortgage market.[34] The defence proferred by Goldman Sachs in each case was illuminating. It emphasised the sophisticated nature of the investors. A

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[28] See Matt Taibbi, 'The Great American Bubble Machine', *Rolling Stone*, 9 July 2009, 52 <http://www.rollingstone.com/politics/news/12697/64796> (Goldman Sachs is memorably described as a 'great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money'). The pre-released article was widely cited and (in places endorsed), see Stephen Gandel, 'Goldman Sachs v Rolling Stone: A Wall Street Smackdown,' *Time*, 3 July 2009 (citing Nell Minow, Co-founder of the Corporate Library: "The [*Rolling Stone*] article makes a very compelling case against Goldman Sachs, but I think the problems it identifies are pervasive in financial firms and corporate America in general"); see also Arlidge, above n 20.

[29] *Securities and Exchange Commission v Goldman Sachs & Co and Fabrice Tourre* 10 Civ. 3329 (SDNY, 15 April 2010). For full discussion from which this summary draws, see O'Brien, above n 27.

[30] Securities and Exchange Commission, 'Goldman Sachs to Pay Record $550 million to Settle SEC Charges Related to Subprime Mortgage CDO' (Litigation Release 21592, Washington D.C., 15 July 2010).

[31] Securities and Exchange Commission, 'Goldman Sachs to Pay Record $550 million to Settle SEC Charges Related to Subprime Mortgage CDO' (Press Release, Washington D.C., 15 July 2010).

[32] Cases filed on the West Coast point to significant ethical shortcomings and potential illegalities in the management of conflicts of interest across the entire industry. The defendants include Credit Suisse, Merrill Lynch UBS and Deutsche Bank, whose General Counsel for the Americas at the time is now director of enforcement at the SEC, see Gretchen Morgenson, 'The Inflatable Loan Pool', *New York Times*, 20 June 2010, BU1; for detail of the complaint, seeking to rescind the purchase of 136 securities in 116 securitization trusts, for which the Bank originally paid more than $19.5billion, see Federal Home Loan Bank of San Francisco, 'Statement Regarding PLRMBS Litigation (Updated)' (Press Release, San Francisco, 10 June 2010) <http://www.fhlbsf.com/about/investor/satellite/MBSlitigation.asp> (amended complaints allege, on a trust-by-trust basis, that 'the defendant dealers made untrue or misleading statements about the loan-to-value ratios of the mortgage loans in the trusts, the percentage of those loans that were secured by the primary residence of the borrower, and the extent to which the originators of those loans departed from their disclosed underwriting standards in making the loans'). The San Francisco Federal Home Loan Bank has announced gross unrealized loss of $5.5billion, see Federal Home Loan Bank of San Francisco, '10-K Filing to the Securities and Exchange Commission,' <http://www.fhlbsf.com/about/investor/ar/pdf/2009/10-K.pdf>; See *Federal Home Loan Bank of San Francisco v Credit Suisse Securities; Credit Suisse First Boston Mortgage Securities; Deutsche Bank Securities; JP Morgan Securities F/K/A Bear Stearns et al* 10 Civ. 497840 (Supreme Court, Cal, 15 March 2010).

[33] *Basis Yield Alpha Fund v Goldman Sachs* 10 Civ 04537 (SDNY, 9 June 2010) 1. The complaint alleges Goldman Sachs materially misrepresented the value of $38 million of AA-rated and $42.1 million of AAA-rated securities within the CDO.

[34] *Liberty Mutual v Goldman Sachs* 10 Civ 11150 (D Mass, 9 July 2010). The suit alleges that Goldman acted fraudulently by offering preferred shares in Fannie Mae in late 2007. It claims 'Goldman Sachs not only knew about the serious risks in the mortgage market but it was urgently moving to short the mortgage market…As a knowledgeable and sophisticated investor in the U.S. real estate financial markets and with access to Fannie Mae's financial records, Goldman Sachs knew or recklessly disregarded the actual status of Fannie Mae's capital structure.' Liberty lost $62.5m in its investment. For Goldman Sachs response, see Jonathan Stempel, 'Goldman Sued by Liberty Mutual Over Fannie Stock,' *Reuters*, 9 July 2010 <http://www.reuters.com/article/idUSN0915845220100709>.

spokesman for the bank claimed, for example, that the Liberty case was entirely without merit, while the litigation brought by Basis was 'a misguided attempt by…one of the world's most experienced CDO investors, to shift its investment losses to Goldman Sachs.'[35] A similar defence was initially advanced to counter the SEC charges.[36]

Goldman Sachs noted that the 'SEC's complaint accuses the firm of fraud because it didn't disclose to one party of the transaction who was on the other side of that transaction.' This is deemed to be a further example of an entire case that the bank claimed was 'wrong in law and fact…As normal business practice, market makers do not disclose the identities of a buyer to a seller and vice versa.'[37] Goldman placed responsibility for picking the referent stocks on the independent rating specialist, ACA. Precisely because it 'had the largest exposure to the transaction, investing $951 million…[it] had an obligation and every incentive to select appropriate securities.'[38] If ACA had placed inappropriate referent securities in the offering then it had not only failed in its obligation but had also acted irresponsibly on its own account. This transference of responsibility also underpinned the testimony provided by Goldman executives to the congressional inquiry, which had so angered Senator Levin.[39]

Notwithstanding the qualified support offered by Warren Buffet,[40] a key Goldman Sachs investor and one of the few to question publicly the SEC's case, the bank entered into settlement talks. It created a web-based micro-site and announced the creation of a Business Standards Committee. The SEC subsequently commended both initiatives as evidence of Goldman Sachs sincerity in addressing the perceived ethical deficit.[41] More significantly, Goldman Sachs, without admitting liability, acknowledged in the final consent decree 'that the marketing materials for the ABACUS 2007-ACI 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.'[42]

It was most unfortunate that the Goldman Sachs settlement has precluded definitive ruling on the degree of responsibility that is required to sophisticated investors. On the other hand the decision to settle was curious on the part of Goldman Sachs, not least because the SEC had earlier released new draft rules governing the sale of asset-backed securities. These suggested that the case itself amounted to retrospective prosecution.[43] The SEC explicitly stated that 'the financial crisis has called into question the ability of our rules, as they relate to the private market for asset-backed securities, to ensure that investors had access to, and had sufficient time and incentives to adequately consider appropriate information regarding these securities.'[44] The proposed changes include the need to provide 'basic material

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[35] Joshua Gallu and Christine Harper, 'Goldman Sachs Hudson CDO Said to be Target of Second SEC Probe,' *Bloomberg*, 10 June 2010 <http://www.businessweek.com/news/2010-06-10/goldman-sachs-hudson-cdo-said-to-be-target-of-second-sec-probe.html>.

[36] 'Goldman Sachs Makes Further Comments on SEC Complaint' (Press Release, New York City, 16 April 2010) ('IKB, a large German Bank and sophisticated CDO market participant and ACA Capital Management, the two investors, were provided extensive information about the underlying mortgage securities. The risk associated with the securities was known to these investors, who were among the most sophisticated mortgage investors in the world. These investors also understood that a synthetic CDO transaction necessarily included both a long and short side').

[37] Ibid.

[38] Ibid.

[39] The Goldman Sachs chief executive officer, Lloyd Blankfein, reiterated this message in testimony to Congress, see Evidence to U.S. Senate Permanent Subcommittee on Investigations Hearing, *Wall Street and the Financial Crisis: The Role of Investment Banks,* US Congress, Washington DC, 27 April 2010 (L. Blankfein) ('We are one of the largest client franchises in market-making in these kinds of activities we're talking about…. They [sophisticated investors] know our activities, and they understand what market making is').

[40] Andrew Clark, 'Warren Buffet Defends Goldman Sachs,' *The Guardian*, 1 May 2010 ('There's no question the allegation alone causes the company to lose reputation. Obviously, the past few weeks have hurt the company and hurt morale…[However] it's a little hard for me to get terribly sympathetic with the fact that a bank made a dumb credit deal') <http://www.guardian.co.uk/business/2010/may/01/warren-buffett-defends-goldman-sachs>. Without questioning Buffet's integrity it should also be noted that the famed investor had a vested interest in minimizing the reputational damage as Berkshire Hathaway invested heavily in the bank at the height of the crisis, see Suzanne Craig, 'Buffet to Invest $5 billion in Goldman,' *Wall Street Journal*, 24 September 2008, A1.

[41] SEC, above n 31.

[42] *SEC v Goldman Sachs and Fabrice Tourre* 10 Civ 3229 (SDNY, Consent Decree. 15 July 2010), 2 <http://www.sec.gov/litigation/litreleases/2010/consent-pr2010-123.pdf>.

[43] SEC, 'Proposed Rule: Asset Backed Securities' http://www.sec.gov/rules/proposed/2010/339117.pdf.

[44] Ibid, 22.

information concerning the structure of the securities thereon, the nature, performance and servicing of the assets supporting the securities and any credit mechanism associated with the securities.'[45]

The SEC noted, however, that 'all our proposals, if adopted, would apply to new issuances of asset-backed securities. Therefore, the proposed rules, if adopted, would not impose new requirements on outstanding asset-backed securities.'[46] This points to the danger that the current system of regulation facilitates unethical conduct. It also suggests that from the SEC's perspective there was recognition that its illegality was in itself questionable, (i.e. that defendants could use a sophisticated investor defence). Elizabeth Warren, a law professor at Harvard, has neatly summarised the problem. She maintains that while toasters are routinely tested, 'financial products go unmonitored for basic safety. When shopping in the complex and constantly evolving financial market, where actual costs and unfavorable terms are regularly concealed, consumers are on their own.'[47] More significantly, perhaps, Warren, who served as chair of the Congressional Oversight Panel, responsible for monitoring the US Department of Treasury's management of the Troubled Asset Relief Program, proposed the establishment of a Financial Product Safety Commission. Her proposals received limited traction with (sections of) Congress and the Obama administration. The *Wall Street Reform and Investor Protection Act* (2010) established a Consumer Financial Protection Agency. President Obama selected Professor Warren as interim chairman. The distinction in remit and title is not merely a question of semantics. The new agency's remit is circumscribed. It deals with the question of whether or not consumers should be allowed access to complex financial instruments. The financial services industry remains sanguine about attempts to limit the exposure of ordinary consumers. There has been considerable opposition to any proposal to limit the access of sophisticated investors to these products.[48] Whether such a distinction is warranted given institutional investor losses across the globe is another matter entirely.

The limits of enforcement in the United States reinforce the practical and conceptual problems associated with the bifurcation paradigm. There are strong parallels between the legal disputes in the United States and the claims brought by local councils in Australia, namely that a technical legal defence could evade a general legal obligation to uphold market integrity. As with the United States, the legal framework in Australia privileges a compartmentalisation of authority and responsbility. It objectively allows for conflicts of interest as long as they are subjectively effectively managed.[49] This privileging can have and has had the effect of reducing the integrity of the market in the United States.[50] The emphasis on settlements has, however, reduced the judicial capacity to ascertain whether they serve the public interest. It is preceisely for this reason that the class action brought against the administrators of Lehman Brothers Australia has such potential paradigmatic implications.

D The Australian Legal and Policy Framework

In entering the market, Lehman Brothers Australia, like its predecessor, Grange Securities, was signalling a commitment to abide by and uphold legal and regulatory requirements. This integrates hard law with

[45] Ibid, 284.

[46] Ibid, 22. Final rules were introduced in January 2011; see 'Disclosure for Asset Backed Securities,' (SEC, Washington, 20 January 2011) <http://www.sec.gov/rules/final/2011/33-9175.pdf>. Proposed rules to prohibit conflicts of interest between those who package and sell asset-backed securities and those who invest in them were released in September 2011, see 'SEC Proposes Rule to Prohibit Conflicts of Interest in Certain Asset-Backed Securities Transactions' (Press Release, Washington, D.C., 21 January 2011) <http://www.sec.gov/news/press/2011/2011-185.htm>. There is no indication of when this final rule will be introduced.

[47] Elizabeth Warren and Amelia Warren Tyagi, 'Protect Financial Consumers,' *Harpers*, November 2008 <http://www.harpers.org/archive/2008/11/0082252>.

[48] See Bob Herbert, 'Chutzpah on Steroids,' *New York Times*, 14 July 2009, A25.

[49] Alasdair MacIntyre, 'Why Are the Problems of Business Ethics Insoluble,' in Bernard Baumin and Benjamin Friedman (eds.), *Moral Responsibility and the Professions* (1982) 358 ('Effectiveness in organizations is often both the product and the producer of an intense focus on a narrow range of specialised tasks which has as its counterpart blindness to other aspects of one's activity'); see also Alasdair MacIntyre, 'Social Structures and their Threats to Moral Agency' (1999) 74 *Philosophy* 311 (Compartmentalisation occurs when a 'distinct sphere of social activity comes to have its own role structure governed by its own specific norms in relative independence of other such spheres. Within each sphere those norms dictate which kinds of consideration are to be treated as relevant to decision-making and which are to be excluded': at 322).

[50] See David Brooks, 'The Responsibility Deficit,' *New York Times*, 23 September 2010, A29; see also Joseph Stiglitz, 'Moral Bankruptcy,' *Mother Jones*, January 2010 <http://motherjones.com/politics/2010/01/joseph-stiglitz-wall-street-morals>; According to Stiglitz, 'part of moral behavior and individual responsibility is to accept blame when it is due. Yet bankers have repeatedly worked hard to shift blame to others, including to those they victimized. In today's financial markets, almost everyone claims innocence. They were all just doing their jobs. There was individualism, but no individual responsibility.'

governance principles (i.e. the legislative framework provided by the *Corporations Act 2001* (Corporations Act) and the *Australian Securities and Investments Commission Act 2001* (ASIC Act), the specific provisions attached to holding an Australian Financial Services Licence (AFSL) as well as Australian Stock Exchange listing rules and corporate governance principles). This interlocking system is designed to ensure market integrity. A financial services licence is granted if the application is made in accordance with procedures outlined in s. 913A of the Corporations Act and the Australian Securities and Investments Commission (ASIC) has no reason to believe that the applicant will not comply. These require the holder to 'do all things necessary to ensure that the financial services covered by the licence are provided efficiently, fairly and honestly.'[51] In addition, the entity is required to 'have in place adequate arrangements for the management of conflicts of interest that may arise wholly or partially in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative.'[52]

Regulatory guidance provides a more granular determination of what constitutes generic compliance obligations.[53] Conduct and disclosure obligations for financial product advisers are specified,[54] as well as what constitutes adequate procedures in managing conflicts.[55] In the Australian context, effective conflicts management is seen as a critical precondition for market integrity.[56] Moreover, ASIC takes, what is on paper, an expansive definitional view. They 'emerge where some or all of the interests of people (clients) to whom a licensee (or its representative) provides financial services are inconsistent with, or diverge from, some or all of the interests of the licensee or its representatives. This includes actual, apparent and potential conflicts of interest.'[57] In addition, for ASIC a 'licensee's obligation to manage conflicts of interest does not depend on whether its clients are retail or wholesale. Licensees must have adequate arrangements to identify and manage *all* conflicts of interest (other that those that occur wholly outside a licensee's financial services business), whether they relate to retail clients or wholesale clients. Licensees are also obliged to operate efficiently, honestly and fairly in relation to all clients.[58]

The management of conflicts of interest has three components: *control*, *avoidance* and *disclosure*. Best practice necessitates identifying the conflict, assessing the risks associated with it and deciding upon and implementing procedures to deal with or avoiding it.[59] As ASIC points out, 'to be adequate, conflicts management arrangements must successfully identify conflicts of interest and *control* the effects of those conflicts on the provision of financial services so that the quality of those financial services is not significantly compromised. Licensees should monitor whether their conflict management arrangements successfully do this.'[60] In ascertaining whether the holder of an AFSL has effective mechanisms in place, ASIC notes the following criteria:

> Licensees must ensure that they treat their clients fairly. In considering their obligations, we would generally expect licensees to consider the following questions:
> (a) Are they providing financial services in a manner that unfairly puts the interests of the licensee (or its representatives) ahead of their clients?
> (b) Are they providing financial services in a way that unfairly puts the interests of one client ahead of the interests of other clients?
> (c) Are they using knowledge about their clients in a way that is likely to advance their own interests without sufficient disclosure to affected clients?[61]

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[51] *Corporations Act 2001* (Cth) s 912A(1) (a).
[52] *Corporations Act 2001* (Cth) s 912A(1) (aa).
[53] ASIC, *Licensing: Meeting the General Obligations* (Regulatory Guide 104, October 2007); ASIC, *Licensing: Organisational Competence* (Regulatory Guide 105, October 2007).
[54] ASIC, *Licensing: Financial Product Advisers – Conduct and Disclosure* (Regulatory Guide 175, May 2009) (superseding PS175A (26 June 2003); PS175B (13 May 2005); PS175C, 28 May 2007).
[55] ASIC, *Licensing: Managing Conflicts* (Regulatory Guide 181).
[56] Ibid RG 181.13 ('Adequate conflicts management arrangements help minimise the potential adverse impact of conflicts of interest on clients. Conflicts management arrangements thereby help promote consumer protection and maintain market integrity. Without adequate conflicts management arrangements, licensees whose interests conflict with those of the client are more likely to take advantage of that client in a way that may harm that client and may diminish confidence in the licensee or the market').
[57] Ibid RG 181.15 (noting in an example 'Licensee A has an interest in encouraging client B to invest in higher risk products that result in high commissions, which is inconsistent with client B's personal desire to obtain a lower risk product').
[58] Ibid RG181.22
[59] Ibid RG181.28.
[60] Ibid RG 181.30.
[61] RG181.40.

Furthermore, ASIC argues that disclosure of these actual or perceived conflicts is an essential component of effective management. For ASIC, 'adequate disclosure means providing enough detail in a clear, concise and effective form to allow clients to make an informed decision about how the conflict may affect the service being provided to them. We expect disclosure by licensees to focus on material conflicts.'[62] The extent and detail of the disclosure varies on the sophistication of the client, the complexity of the service and how much the client knows about the specific conflict. Underpinning this regime are the statutory provisions of the Corporations Act particularly s. 1041H, regarding misleading or deceptive conduct and the ASIC Act (s. 12DA), which replicate the provisions found in the *Trade Practices Act 1974*.

In Australia, when offered to retail clients, all advice must comply with a suitability test. The providing entity must make reasonable inquiries about the clients relevant status, reasonably consider and investigate the subject matter and ensure that the advice is appropriate.[63] There is a requirement to warn the client if the advice is based on incomplete or inaccurate information.[64] A Statement of Advice is required in cases where the individual value of the transaction exceeds $15,000.[65] A recommendation is considered a statement of advice if it is, or could reasonably be considered as being, intended to influence a person or persons in making a decision about as particular financial product or class of financial products, or an interest in a particular financial product or class of financial products.[66] Disclosure is not required, for example, if the minimum amount payable for the securities on acceptance of the offer by the person to whom the offer is made is at least $500,000 or the amount payable for the securities on acceptance by the person to whom the offer is made and the amounts previously paid by the person for the body's securities of the same class that are held by the person add up to at least $500,000; the issuer is in receipt of a certificate from a certified accountant that the investor has net assets or the offer is made to a company or trust that meets the requirements.[67]

In dealing in financial products there is a general obligation for the licensee to be satisfied on reasonable grounds that the client has previous experience in using financial services and investing in financial products that allows the client to assess the products and services; that the licensee provides a written statement to the client explaining why the licensee is so satisfied; and the client signs a written acknowledgement that the licensee will not be treating the client as a retail client.[68] Moreover, in providing advice, the entity must determine the relevant personal circumstances in relation to giving the advice and make reasonable inquiries in relation to those personal circumstances.[69] Having regard to that information, s 945A (1) (iii) further specifies that 'the providing entity has given such consideration to, and conducted such investigation of, the subject matter of the advice as is reasonable in all of the circumstances; and (iv) the advice is appropriate to the client, having regard to that consideration and investigation.'[70]

As will be explored below the operation of the CDO market as practiced by Grange Securities and for which Lehman Brothers Australia was held liable has demonstrated major problems with the framework. The profusion of statutory statutes and regulatory exceptions in particular was to seriously aggravate Justice Rares, who claimed the search for regulatory certainty had instead created a regime of labyrinthine complexity.[71]

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[62] Ibid RG181.50 (moreover, this disclosure should be 'timely, prominent, specific and meaningful to the client, see RG 181.52).
[63] *Corporations Act 2001* (Cth) s. 945A; ASIC, RG 175.114-175.137.
[64] *Corporations Act 2001* (Cth), s. 945B.
[65] *Corporations Act 2001* (Cth) s. 946A.
[66] *Corporations Act 2001* (Cth) s. 766B; ASIC RG 175.21.
[67] *Corporations Act 2001* (Cth) s. 761G(7); by way of comparison for rights issues, see s 708 (10) (b) 'licensee is satisfied on reasonable grounds that the person to whom the offer is made has previous experience in investing in securities that allows them to assess (i) the merits of the offer; (ii) the value of the securities; and (iii) the risks involved in accepting the offer; and (iv) the adequacy of the information given by the person making the offer.'
[68] *Corporations Act 2001* (Cth) s 761GA.
[69] *Corporations Act 2001* (Cth) s 945A (1) (a) (i) (ii).
[70] *Corporations Act 2001* (Cth) s 945A (1) (a) (iii)-(iv).
[71] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 ('The Councils relied on the various statutory provisions prohibiting corporations from engaging in misleading or deceptive conduct. For many years all one had to know was that the elegantly simple s 52(1) of the Trade Practices Act 1974 (Cth) prohibited a corporation from engaging in conduct, in trade or commerce, that was misleading or deceptive or likely to mislead or deceive. For some purpose that is not evident the Parliament decided to remove elegant simplicity in its statutory drafting some years ago. Now the community and the Courts must grapple with a labyrinth of statutes:' at 947).

D Banking on the Council: Lehman's Australian Adventure

The United States investment bank Lehman Brothers entered the Australian market through its acquistion of Grange Securities and Grange Asset Management in March 2007. In December 2007, four months after the problems in the US securitisation market became apparent, the business was rebranded as Lehman Brothers Australia and Lehman Brothers Asset Management, respectively. The incoming chief executive was Jim Ballentine, formerly head of Risk Strategy at the Fixed Income Division in New York, who was described as 'a very senior credentialled Lehman resource' whose appointment was designed to 'provide connectivity to the Australian business and the global business.'[72] The new CEO was acutely aware of the risks associated with complex derivatives (as indeed would the firm have been of Grange Securities role in developing this lucrative business through the due diligence process prior to its acquisition). He was interviewed, for example, for a *BusinessWeek* article as early as 2005 on the risk associated with credit defaults and defective modelling in credit derivatives.[73] In 2005 Ballentine, as Head of Structured Credit was partly responsible for Lehman receiving the *Euromoney Award for Excellence* as 'best derivatives house', an award that the magazine claimed was based on the fact that 'Lehman Brothers has been one of the more conservative credit derivatives houses. It has focused on doing the right thing for its credit derivatives clients. If that has meant missing out on a few extra cents per share over the years, so be it. And it has protected the bank from the reputational risk that the likes of Barclays Capital and Bank of America have run selling structured credit products.'[74] It was a reputation that was not to last in either the United States or in Australia.

The CDO market in Australia had experienced enormous growth in the early years of the millennium. In a survey conducted in 2007, updating previous research, the Reserve Bank of Australia noted demand was driven by what it described as middle-level rather than institutional investors, particularly local councils.[75] It also noted that that quality of the collateral shifted progressively downward as the rise of SCDOs offered investors capacity to include international credit exposure, particularly the United States. As early as 2004, the risk associated with SCDOs had been modeled by the Federal Reserve in Washington, D.C., with particular reference to potential time lags between a credit event happening and a ratings downgrade.[76] The Reserve Bank of Australia was much more sanguine. It did, however, highlight that the increasing complexity of some deals has made it difficult for issuers and investors to properly price risk.[77] It also noted that the 'secondary market trading of CDOs is much less developed in

72 Vishal Teckchandani, 'Lehman Rebrands Australian Business,' *Investor Daily*, 4 December 2007 <http://www.investordaily.com/cps/rde/xchg/id/style/3511.htm?rdeCOQ=SID-0A3D9633-D01480BA>.

73 See Mara Der Hovanesian, 'Taking Risk to Extremes,' *Businessweek*, 23 May 2005 <http://www.businessweek.com/magazine/content/05_21/b3934099_mz020.htm>. Moreover, the article cited an International Monetary Fund annual report, see International Monetary Fund, *Global Stability Report* (Washington, D.C. April 2005) 1 ('If history is any guide, the single most important risk factor for financial markets in good times is complacency….The combination of low risk premiums, complacency, and untested elements of risk management systems dealing with complex financial instruments could ultimately become hazardous to financial markets'). The report is prescient. It further warns, 'An increasingly relevant contributor to this liquidity risk is the recent proliferation of complex and leveraged financial instruments, including credit derivatives and structured products such as collateralized debt obligations (CDOs). While secondary trading for these products exists, these instruments still rely on quantitative models for relative value assessment, investment decisions, and pricing. Therefore, there is a risk that models that are overly similar in their construction could cause investors to rush to exit at the same time, leading to market liquidity shortages. While risk management at many financial institutions has been strengthened and become more sophisticated in recent years, the risk management process still hinges, to a crucial extent, on the ability of market participants, in times of market stresses, to execute trades quickly without having prices move too much against them. However, most recent risk management models dealing with the new and complex credit instruments have not yet been put to a live test, that is, whether in time of need, the anticipated counterparties will stand ready to absorb the additional market and credit risks from those who would like to shed it': at 3).

74 Euromoney Awards For Excellence 2005 <http://www.euromoney.com/Article/1000868/Awards-for-excellence-Best-credit-derivatives-house.html>.

75 Reserve Bank of Australia, 'Recent Developments in Collateralised Debt Obligations in Australia,' Bulletin, November 2007 <http://www.rba.gov.au/publications/bulletin/2007/nov/pdf/bu-1107-1.pdf> ('Just over a third of NSW local governments had an investment in CDOS. Of those identified as holding CDOs, the average holding was 15 per cent of their investment portfolio, although the dispersion around this number is wide': at 7).

76 See Michael Gibson, 'Understanding the Risk of Synthetic CDOS,' Federal Reserve Board, Finance and Economics Discussion Series (2004-36, Washington D.C. November 2004) <http://www.federalreserve.gov/pubs/feds/2004/200436/200436pap.pdf> 1 ('Even though mezzanine tranches are typically rated investment-grade, the leverage they possess implies their risk (and expected return) can be many times that of an investment-grade corporate bond').

77 Reserve Bank of Australia, above n 75, 1.

Australia than in other markets. At present there are very few market-makers for these securities, though a number of institutions are prepared to transact on a best-endeavour basis.'[78]

Given the legislative and regulatory requirements outlined above, it would have been prudent for a manufacturer or supplier of these products to document both these trends and incorporate them into internal risk management and compliance procedures (i.e. it would have been prudent to ensure that the potential conflicts of interest in cases where the supplier was also underwriting the issue were identified, controlled, managed or avoided). It would also have been prudent to ensure that these risks were communicated to the client so that informed consent could be provided. In the provision of execution services, the presentation of material would need to ensure that there could be no suggestion that the relationship was advisory and that (with cause) the client was not considered a retail investor. A prudent supplier, mindful of its obligations to provide financial services 'efficiently, fairly and honestly,'[79] would not engage in a deliberate strategy to obfuscate risk. While this would ensure flexibility to provide tailored services to those deemed capable of investing in complex products, at a purposive level, the sophisticated investor provisions of the *Corporations Act* are not designed to trap the unwary.[80] But that is precisely what Rares J argued had occurred in this case as a consequence of how Grange marketed its services and executed transactions.[81]

"Grange knew that its business depended on winning and maintaining the trust and confidence of the financially unsophisticated and uninformed local government officers…with whom it dealt in order to effect transactions that would have been unachievable were the other party an informed investor.'[82] The majority of the CDOs offered by Grange to Parkes Council, for example, were designed largely to exceed the minimum $500,000 threshold. The contract notes offered in evidence gave no indication of the true risks associated with the SCDO market, as highlighted in Reserve Bank of Australia research. According to the council officials they were transacted on the basis of misplaced confidence and trust and disconnect between standard disclaimers and the text in the body of an email.[83] Grange ensured emails offering particular products carried a standard disclaimer:

> In preparing this document the licencee did not take into account the investment objectives, financial situation and particular needs of any particular person. Before making an investment decision on the basis of this document the investor needs to consider, with or without the assistance of an advisor, whether the advice is appropriate in light of the particular needs, objectives and financial circumstances of the investor.[84]

According to Rares J the fact that Parkes council continued to invest in these instruments from 2005 until 2007, 'it follows that they continued to lack, and Grange continued to be aware that they lacked, any appreciation of the nature or risks of investing in each of the claim SCDOs. Had [they] become aware of the risks of capital loss that might be substantive, illiquidity, price volatility, the lack of a secondary market and the lack of Parkes' investor suitability at any stage before the commencement of the global financial crisis in 2007 they would not have continued with investment of Council funds in SCDOs.'[85] In a withering rebuke, Rares J noted that the disclaimers could not evade a prior fiduciary duty as a consequence of Grange assuming the position of trusted financial advisor.[86] 'Its disclaimers told their readers not to act on a recommendation or opinion without first consulting the reader's financial adviser.

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[78] Ibid, 4.
[79] *Corporations Act 2001* (Cth) s. 912A(1)(a).
[80] *Corporations Act 2001* (Cth), s. 708 (8) in relation to rights issues; s. 761G in relation to sale of financial products.
[81] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 (noting presentation materials in which Grange presented itself as a an 'unique advisor to Councils,' that 'always advocates prudent investments' on the basis of rigorous research and due diligence' and claimed that 'Councils who have invested directly on Grange's advice have consistently outperformed those that invested in managed funds:' at 469).
[82] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 736.
[83] Sue Lanin, 'Lehman Hits Back at Council Claims,' *ABC Online* (Sydney), 7 March 2011.
[84] Email from Grange Securities to Parkes Council (Second Amended Statement of Claim, PRK.500.001.0049).
[85] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 492. Although the court found that 'this is not to diminish the significance of [Parkes Council investment manager] Mr Bokeyar's inattention to even the simplest written material dealing with each proposed investment of large amounts of public money. However, this trait must have become obvious over a short time to [Grange officials] Ms May and Mr Clout as they dealt with Mr Bokeyar and certainly, no later than February 2005:' at 493.
[86] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 (Grange was, and held itself out as, an expert on financial products and in the giving of financial advice to local government councils. The Council officers were, in contrast, not expert in either field. Rather they were reliant on Grange for information and advice about the SCDO products it was seeking to sell or buy. Grange chose to give an explanation of FRNs and each SCDO product to Swan. Each occasion was a serious one involving the possible investment of significant sums of public money by a person that Grange appreciated, or ought to have realised, was financially uninformed or, at the very least, far less informed than it about the nature of those products': at 786).

There is no doubt that the Council officers did exactly this….A reasonable person in the circumstances of each Council would have understood that Grange was acting as its financial adviser and that the disclaimers did not apply to Grange's advice and recommendations.'[87]

The accountability deficit was heightened precisely because the clients were representatives of elected government. Two of the applicants were local councils in New South Wales with authority to invest surplus funds through the operation of the *Local Government Act 1993* (NSW). The legislation specifies that investments can only be made in a form approved by the Minister for Local Government.[88] These two councils, Wingecarribbee and Parkes Shire, also had a responsibility to ensure that at all times investments were monitored in compliance with the *Trustee Amendment (Discretionary Investments) Act 1997* (NSW) (TA Act). The third council, the City of Swan, a local council in Western Australia, was mandated to ensure its investment portfolio was administered in compliance with the *Local Government Act 1995* (WA).[89] Throughout the period in which the New South Wales councils transacted with Grange Securities, the extant ministerial order allowed acquisition of securities that had been designated investment grade by Moody's Investor Services or Standard & Poors.[90] The accompanying guidelines specified the need to at 'a minimum consider the desirability of diversifying investments and the nature and risks associated with the investments.'[91] These were further updated in July 2005, without restriction on the range of instruments chosen.[92] The TA Act mandates 'a council or entity acting on its behalf should exercise the care, diligence and skill that a prudent person would exercise in investing council funds. A prudent person is expected to act with considerable duty of care, not as an average person would act, but as a wise, cautious and judicious person would.'[93] This standard, therefore, applies to the Parkes transactions and the Federal Court found they had acted prudently in taking the advice provided by Grange.

In the event that that responsibility is transferred to an external manager then the trustee must, in exercising a power of investment if the trustee's profession, business or employment is or includes acting as a trustee or investing money on behalf of other persons, exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing the affairs of other persons.[94] It is, therefore, appropriate that the provision of portfolio management services, be consistent with all of the terms of the relevant ministerial order and the TA Act. The TA Act states, in s 14C (1) 'Without limiting the matters that a trustee may take into account when exercising a power of investment, a trustee must, so far as they are appropriate to the circumstances of the trust, if any, have regard to the following matters:

(1) the purposes of the trust and the needs and circumstances of the beneficiaries.
(2) the desirability of diversifying trust investments.
(3) the nature of, and the risk associated with, existing trust investments and other trust property.
(4) the need to maintain the real value of the capital or income of the trust.
(5) the risk of capital or income loss or depreciation, the potential for capital appreciation.

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[87] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 788. This built from previous argument that 'the reason that the Grange representatives never mentioned the disclaimers in any oral dealings they had with Councils was patent. It had offered its services as, and acted as, a financial adviser to each of the Councils in respect of, among others, the particular transaction or dealing it was recommending to the Council and advising the Council to effect. As I explained in [585] the last thing Grange wanted was for the Councils to seek someone else's advice, given that it had positioned itself as a trusted financial adviser on investments for them': at 726.

[88] *Local Government Act 1993* (NSW), s. 625 (2).

[89] *Local Government Act 1995* (WA), s. 614.

[90] See Harry Woods, Local Government Act 1993 – Order (16 November 2000) (l); David Campbell MP, Local Government Act 1993 – Order (15 July 2005). The capacity to hold products that held investment grade ratings was rescinded in July 2008, see Paul Lynch, Local Government Act 1993 – Order (31 July 2008).

[91] NSW Department of Local Government Circular to Councils, 'Forms of Investment – Ministers Order' (29 November 2000) and accompanying *Investment Guidelines* 1; these were amended in 2005 (noting also that 'Ratings in no way guarantee the investment or protect an investor against loss. Prescribed ratings should not be misinterpreted by councils as an implicit guarantee of investments or entities that have such ratings. Even given this challenge, ratings provide the best independent information available': at 2.). The Guidelines further note that in the event that a security falls below the required minimum, 'a council must make all the necessary arrangements to withdraw the deposit as soon as practicable': at 2. Moreover, although the guidance states that 'funds required in the short-term must be invested with a short-term profile rather than with exposure to more volatile asset classes' there is no further explicit restriction placed on asset class or concentration.

[92] See Campbell, above n 90.

[93] *Trustee Amendment (Discretionary Investments) Act 1997*, s. 14A (2) (b)).

[94] Ibid, s. 14A (2) (a).

(6) the likely income return and the timing of income return.
(7) the length of the term of the proposed investment.
(8) the probable duration of the trust.
(9) the liquidity and marketability of the proposed investment during, and on the determination of, the term of the proposed investment.
(10) the aggregate value of the trust estate.
(11) the effect of the proposed investment in relation to the tax liability of the trust.
(12) the likelihood of inflation affecting the value of the proposed investment or other trust property.
(13) the costs (including commissions, fees, charges and duties payable) of making the proposed investment.

The responsible officers had a duty to ensure that the portfolio was managed according to these objectives.[95] Counsel for Lehman Brothers Australia disavowed responsibility in favor of the technical issue of whether the inclusion of specific investments was consistent with the relevant order (i.e. were they permissible).[96] It was a claim comprehensively rejected by Rares J, who deemed the insertion of SCDOs into the portfolios egregious in the extreme.[97]

Apart from the question of *permissibility* a second issue pivoted on who benefited most from the risk-benefit calculus (i.e. the extent to which these securities represented an appropriate investment strategy for the local councils given the relatively modest returns over the bank rate set against the downside risk in the event of default). Given the glaring conflicts of interest involved in Grange's vested interest in growing the CDO market, it would have been necessary to document how these were addressed if the company was to remain in compliance with regulatory guidance.[98] No evidence was provided to court that this was done. Instead counsel for Lehman Brothers Australia stressed the sanctity of contract and the transference of responsibility to the council. In so doing it was replicating the legal strategies used in the United States.

The Wingecarribbee IMP outlines the scope of the contract and outlines the scope of Grange's discretion.[99] The agreement provided Grange with wide discretion to deal, exercise any rights, establish operate or access any accounts, reinvest distribution and 'do anything else in connection with the Portfolio which Grange considers proper or necessary.'[100] The client was permitted to vary the Guidelines and request disinvestment of specific assets if requests were made in writing. Critically, however, the agreement specifies that notwithstanding the commitment to provide the services in accordance with the Guidelines, 'the Client acknowledges that the Portfolio may, for whatever reason, depart in a way which is not material from the Guidelines from time to time (but shall not be inconsistent with the *Local Government Act* (NSW) as amended.'[101] Moreover, Grange was provided authority to act on the instructions of any named authorised representative 'without the need to check authority.'[102] The City of Swan IMP allowed for similar discretion both in terms of the scope of the agreement and authority to act on the instructions of any authorised individual without checking further authority.[103]

The contractual wording reinforced the asymmetrical disadvantage the councils voluntarily conceded. The critical issue for the court related to contractual wording.[104] The Federal Court makes

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[95] For discussion of the prudent person test, see W. A. Lee, 'Trustee Investing: Homes and Hedges' (2001) 1 *Queensland University of Technology Law and Justice Journal* 3.
[96] Lanin, above n 83.
[97] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 891.
[98] See ASIC RG181.54 (Disclosure should also specify 'the extent (if any) to which the licensee (or any associated person) has a legal or beneficial interest in the financial products that are the subject of the financial product advice; the extent (if any) to which the licensee (or any associated person) is related to or associated with the issuer or provider of the financial products that are the subject of the financial product advice; and the extent (if any) to which the licensee (or any associated person) is likely to receive financial or other benefits depending on whether the advice is followed').
[99] Wingecarribee Council IMP (Second Amended Statement of Claim, document in evidence: WNG.004.001.0045, section 2.1).
[100] Ibid, s. 2.2(e).
[101] Ibid, s. 2.3(d).
[102] Ibid, s. 4.3(c).
[103] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 (noting, 'There was no evidence that Grange ever suggested to any of the three Councils that they should seek "professional advice". That is because Grange had assumed the role of being the Councils' financial adviser and provided the very advice to them that the disclaimers exhorted them to seek': at 585).
[104] See Lee above n 95 ('It is the contract that governs the relationship. It is unwise, particularly in Australia, to assume that financial advisers undertake fiduciary duties unless they are prescribed within the context of an enforceable relationship….So in

clear its belief that the results of such limited reasoning have been debilitating for corporate morality, corporate purpose and public order. 'The last thing Grange wanted the Councils to think was that the investment in SCDOs had higher risk than the classes of investments with which the Councils were familiar and comfortable.'[105] Of equal importance, Rares J suggested that this was systematic.[106] 'One thing is certain. Grange did not draw the disclaimers to the attention of any of the Councils. Nor did it tell any of them that it was not acting as the Council's financial adviser. Importantly, Grange never suggested that it might be in a position of conflict, as the Council's financial adviser for the transaction it was proposing and that the Council should obtain independent financial advice about what Grange was proposing, so that Grange could be released from any fiduciary obligation it owed,' he argued.[107] As a direct consequence he found it only fair and reasonable that "Grange is liable to the Councils for their claims in contract, in negligence, for misleading and deceptive conduct, as well as for breach of fiduciary duty.'[108]

The successful prosecution of Lehman Brothers Australia marks a significant departure. Courts in Australia and the United Kingdom have held these cannot be assumed to apply and indeed can be transacted around through explicit contractual terms.[109] The question of what constitutes obligation to the client, for example, lay at the centre of landmark proceedings taken by the ASIC against Citigroup in 2007. The proceedings, which were keenly watched across the globe, ultimately failed because of the court's ruling that investment banks had the capacity to contract out of obligations.[110] ASIC had claimed that Citigroup had breached fiduciary duties to its client, Toll Holdings, by proprietary trading in a takeover target without securing prior informed consent. Although strongly sympathetic to the argument that the relationship between an investment bank and its client was implicitly fiduciary in nature,[111] Jacobson J held that the precise relationship was determined by contractual terms.[112] According to Jacobson J, 'but for the express terms of the mandate letter, the pre-contract dealings between Citigroup and Toll would have pointed strongly toward the existence of a fiduciary relationship in Citigroup's role as an adviser.'[113] The decision was instructive. It reaffirmed the capacity of investment banks to define the nature of their relationship with clients outside of fiduciary obligation.[114] Whether this can or should be allowed to remain in the aftermath of the Rares J judgment is very much an open question. He argues that 'Grange acted as a financial adviser to each Council. It portrayed itself to them as having that role. By doing so, Grange voluntarily assumed the well-established obligations such a person owes to its clients to the extent that it did not exclude those obligations contractually.'[115]

This explicit 'duty to protect' inexorably raises significant policy questions, not least the legal and policy uncertainty associated with the exercise of subjective judgment (i.e. not simply how to regulate but why, for what ultimate purpose). Equally unsurprisingly, the financial services industry continues to privilege the efficiency arguments embedded in the freedom to contract model. Lest we forget, this too has an explicit (if restricted) normative dimension. It compartmentalises and, in so doing, limits debates on what constitutes or should constitute broader responsibility to maintain the social fabric. The interlinked corporate, legal and broader political pressures highlight an existential dispute. It is predicated on the potential incommensurability between the enabling basis of private law and the public law

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employing financial advisers to advise them or financial services providers to invest for them trustees must take great care in framing the terms of the contract between them:' at 16). It is a formulation that Rares J rejects, see *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 727.

[105] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 975.

[106] Ibid, There was no evidence that Grange ever suggested to any of the three Councils that they should seek "professional advice". That is because Grange had assumed the role of being the Councils' financial adviser and provided the very advice to them that the disclaimers exhorted them to seek': at 585.

[107] Ibid, 727.

[108] Ibid, 984.

[109] See, for example, *JP Morgan Chase Bank v Springwell Navigation Corporation* [2008] EWHC1186 (Comm); for synthesis of Australian case law, see Andrew Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest' (2005) 29 *Melbourne University Law Review* 478 at 497-503.

[110] *ASIC v Citigroup* (2007) FCA 963.

[111] Tuch, above n 109 at 509 (noting the public utility of requiring fiduciary relationship but accepting capacity to void same in contractual terms).

[112] *ASIC v Citigroup* (2007) FCA 963, 263-267.

[113] Ibid, 325.

[114] See also *Titan Steel Wheels v Royal Bank of Scotland* [2010] EWHC 211 (Contractual disclaimers, exclusion clauses and non-reliance clauses preclude an advisory duty of care from being owed to sophisticated investors).

[115] *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 733.

imperatives of securities market regulation. Past reliance on bifurcation masked but did not resolve this core problem. The sophisticated/unsophisticated debate masks, therefore, a much more profound ideational dispute.[116] The global financial crisis and its aftermath have made resolution a public policy imperative. It is to the policy implications of the case we now turn.

E The Policy Implications

Most initial direct losses associated with investments in complex financial products (with the partial exception of Australia) accrued to the wholesale market, where the search for yield trumped reason.[117] Even before the Rares J judgment there were indications that the *status quo* could no longer be defended.[118] As a consequence of public disquiet, the Australian Department of Treasury had prepared a consultation paper, which outlined four primary options: (a) retain and update the current system, including the introduction of extra requirements for specific complex financial products;[119] (b) remove the distinction between wholesale and retail clients, making disclosure obligations consistent across the investment universe;[120] (c) introduce a new sophisticated investor test based on the actual financial literacy of the specific investor;[121] or (d) no nothing. The final option, which despite having the advantage of not increasing compliance costs is effectively ruled out. The review notes inaction does not 'address the problems with the current system…and would be inconsistent with what comparable jurisdictions are doing.'[122] The ruling in *Wingecaribee Shire Council v Lehman Brothers Australia* casts significant doubt on the sustainability of all but option B. It is now incoherent from a legal perspective to limit the demand for greater integrity to one component of the marketplace. Can we seriously suggest that *product a, when offered to customer b is ethical, unethical when offered to customer c but that entity d, if offering both simultaneously, has a cohesive integrated operating framework and a warranted (as opposed to stated) reputation for integrity*? As with pregnancy, it is impossible to be semi-ethical. Removing the distinction and reliance on disclosure alone is not, however, going to change practice unless cultural change is also effected, a pointed recently underscored by the chairman of the Australian Securities and Investments Commission.[123]

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[116] See Jonathan Nash, 'Framing Effects and Regulatory Choice (2006) 82 *Notre Dame Law Review* 314; see more generally, Tony Porter and Karsten Ronit, 'Self-Regulation as Policy Process: The Multiple and Cris-crossing Stages of Private Rule Making' (2006) 39 *Policy Sciences* 41; Tony Prosser, 'Regulation and Social Solidarity' (2006) 33 *Journal of Law and Society* 364 (noting that most conflicts in regulation are about fundamental values: at 372).

[117] See Joe Carroll, 'Synthetic CDOS Were Good For Everybody,' *CreditFlux*, 10 June 2010 <http://www.creditflux.com/Newsletter/2010-06-02/Guest-comment-Synthetic-CDOs-were-good-for-everybody/> 1 (Structured credit has long claimed the ability to put risk into appropriate hands. It has never claimed the ability to turn lead into gold. Managing the risk might be complicated, but to an investor these instruments are pretty simple and completely transparent. Investors are paid to take exposure to the debt of a fully disclosed list of corporations. Viewed as a stand-alone business, a synthetic CDO is like a rust belt manufacturer: the CDO buys something; modifies it to increase its value; and sells it for more than it cost').

[118] The robustness of the language used raises the uncomfortable question of whether Grange was not a rogue operator but operating according to generally accepted principles. Legal advisors to IMF have already signaled the possibility of further litigation, see Leo Shanahan, 'Lehman Brothers Found to be Liable for Losses,' *The Australian*, 22 September 2013, 1.

[119] Department of Treasury, above n 16 ('It may also need to be recognized that certain products or classes of products [such as CDOs and CFDs] are, by their nature, inherently risky. It is therefore worth considering whether the products that are offered themselves should have any bearing on a client's status as a retail or wholesale client…This option would ensure that greater risk to the client should be accompanied by greater responsibility on the part of the intermediary. This would directly recognize that many large-scale losses by wholesale clients during the GFC were related to complex and risky products…A major disadvantage would be increased complexity and regulation due to different thresholds. There may also be difficulty in determining which specific products are deemed complex or risky enough that separate threshold limits should apply': at 7.9).

[120] Ibid ('This test ensures high levels of investor protection and recognizes the importance of information and disclosure. The complexities associated with administering objective wealth tests and subjective financial literacy tests are eliminated…Despite its apparent simplicity, there are several drawbacks, including a lack of certainty for intermediaries…There may be increased difficulty in acting as an intermediary for large-scale product offerings to investors who have significant financial means and investment experience, as well as a loss in efficiency due to the protections and disclosure mechanisms that would need to be extended': at 7.11).

[121] Ibid ('If administered accurately by industry, this option would ensure that investors are given the protections and disclosures that are commensurate with their experiences, as well as giving investors with high financial literacy broader access to complex products…[However] due to the difficulty and potential liability associated with administering a subjective test many intermediaries may take a cautious approach resulting in inefficiencies and very few investors being classified as wholesale clients. Additionally, a subjective test requires more work by intermediaries': at 7.12).

[122] Ibid at 7.13. It is indicative that the overwhelming majority of the 57 submissions to the consultation are hostile to even its staging.

[123] See Greg Medcraft, 'Fresh Thinking Needed to Tackle Hi-Tech Challenges,' *The Australian*, 9 October 2012, 28.

Any successful proposal to extend responsibility and accountability to those involved in product design rather than clarifying the enabling conditions governing marketing and sale would, however, constitute a seismic shift in the structure of the financial services industry. The integration of more interventionist normative objectives with enabling ones may also significantly change the ethical boundaries of global finance. What consitutes or should constitute optimal cultural traits necessitates extending beyond *efficiency* criteria (i.e. lower transaction costs) and a reliance on disclosure. Three additional distinct but overlapping subjective normative dimensions must be applied. First, *permissibility* (i.e. whether a particular product can be sold and if so to whom and on what basis); second, *responsibility* (i.e. who carries the risk if the investment sours and on what terms); and third, *legitimacy* (i.e. does the product serve a legitimate purpose). This, in turn, suggests the need for the dynamic integration of rules, principles and social norms within an interlocking responsive framework. As John Kay has persuasively argued, sustainable reform must be predicated on capability to 'restore relationships of trust and confidence in the investment chain, underpinned by the application of fiduciary standards of care by all those who manage or advise on the investments of others.'[124]

The Kay formulation builds on an insight first advanced by the recently retired managing director of the Financial Services Authority, Hector Sants. Sants had famously complained that it was impossible for principles-based regulation to work when those charged with informal authority to maintain the integrity of the system had no principles.[125] This was not simply a particularly memorable aside. It reflected belated cognisance of the importance of what Oliver Williamson has termed the 'non-calculative social contract.'[126] Sustainable reform must also be consistent with principles of good regulation. It must be proportionate, consistent in application, transparent and targeted. The danger is that an ill thought out structure will exacerbate rather than resolve conflicts within the industry.[127] It risks creating another layer of formal restraint that does little to change either corporate practice or facilitate voluntary progression towards higher ethical standards. It is also clear, however, that the construction of accountability mechanisms cannot rely on self-certification alone. It demands external validation. The recent history of financial regulation has demonstrated conclusively the dangers of past self-referential framing.[128] Not for the first time, credible solutions necessitate going back to the future.

Writers as diverse as Hayek,[129] Schumpeter,[130] Polanyi[131] and, more recently, Granovetter,[132] have noted the political calculation required to construct the economically rational. The interaction between

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[124] See John Kay, *The Kay Review of Equity Markets* (HM Government, London, July 2012) 9. According to Professor Kay, this necessitates a move away from short-termism, as 'trust and confidence are the product of long-term commercial and personal relationships: trust and confidence are not generally created by trading between anonymous agents attempting to make short term gains at each other's expense': at 5. <http://bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf>.

[125] Hector Sants, 'Delivering Intensive Supervision and Credible Deterrence' (Speech delivered at the Reuters Newsmaker Event, London, 12 March 2009) 2 ('The limitation of a pure principles-based regime have to be recognized. I continue to believe the majority of market participants are decent people; however a principles-based approach does not work with people who have no principles').

[126] Oliver Williamson, 'The New Institutional Economics: Taking Stock, Looking Ahead' (2000) 38 *Journal of Economic Literature* 595 at 597. Williamson notes that analysis of this 'level one' component of social theory is conspicuous by its absence with regulatory studies. The other three levels comprise institutional arrangements viewed primarily through property rights and positive political theory, governance mechanisms through transaction cost economics and resource allocation frameworks generally examined through agency theory.

[127] Critically, it must also be based on a re-conceptualization of the regulatory architecture, see Kay, above n 122 ('Bad policy and bad decisions often have their origins in bad ideas…Regulatory philosophy influenced by the efficient market hypothesis has placed undue reliance on information disclosure as a response to divergences in knowledge and incentives across the equity investment chain. This approach has led to the provision of large quantities of data, much of which is of little value to users': at 10).

[128] See Justin O'Brien, *Redesigning Financial Regulation: The Politics of Enforcement* (2007).

[129] Fredrich Hayek, *The Road to Serfdom* (1944) 29 ('To create conditions in which competition will be as effective as possible, to supplement it where it cannot be made effective....provide indeed a wide and unquestioning field for state activity. In no system that could be rationally defended would the state just do nothing. An effective competitive system needs an intelligently designed and continuously adjusted legal framework as much as any other').

[130] Joseph Schumpeter, *Capitalism, Socialism and Democracy* (1942) 137 ('No social system can work in which everyone is supposed to be guided by nothing except his short-term utilitarian ends...the stock market is a poor substitute for the Holy Grail').

[131] Karl Polanyi, *The Great Transformation* (1944) 171 ('The principle of freedom to contract…is…merely the expression of an ingrained prejudice in favour of a definite kind of interference, namely such as would destroy non-contractual relations').

[132] Mark Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness' (1985) 91 *American Journal of Sociology* 481 ('Idealized markets of perfect competition have survived intellectual attack in part because self-regulating economic structures are politically attractive to many. Another reason for survival, less clearly understood, is that the elimination of social

market norms and economic and regulatory policy has served an essential legitimating purpose.[133] The duality of agency and structure helped to create and sustain the parameters of the rational within a 'strategic action field.'[134] The strength of such a field is determined by its ideational terms of reference (i.e. the coherence of the underpinning vision, values and norms).[135] In the absence of crisis, power to effect change is largely determined by the creation and maintenance of barriers to entry, for example, the possession of specific technical competencies, prestige, access to key opinion-formers.[136] These networks define goals and determine how rules governing conduct are constructed, interpreted, evaluated and ultimately, legitimated.[137] This is an inherently social exercise, in which interlocking networks seek and receive validation.[138] As we have seen, within the capital markets context efficiency and effectiveness are predominantly privileged. Ostensible improvements to both, measured largely through short-term financial performance, provided a proxy for societal progress and, as a consequence, political legitimacy.[139] Ineffective or inefficient markets do not necessarily result in a crisis of legitimacy. The structure of the field can be and often is remarkably resilient. Past inefficiencies can be–and often are–redressed by the passage of further ostensibly more stringent rules or more granular articulation of overarching principles. This dynamic is particularly apparent in corporate governance and financial regulation reform, where these initiatives are often presented as evidence of increased accountability.[140] More often that not, however, these same initiatives tend to privilege the politics of symbolism.[141] Indeed, the structural separation of economic and political spheres can continue largely unchallenged, notwithstanding sweeping rhetorical statements to the contrary. This is no longer sustainable, a fact recognised by regulatory agencies and, more recently, in John Kay's independent review of the operation of the United Kingdom equity market.

On 12 March 2010, the then chief executive of the Financial Services Authority, Hector Sants, used an address at the University of Oxford to outline a new consumer protection strategy.[142] As with his speech the previous year on the failure of principles-based regulation,[143] Sants emphasised that changed societal preferences had fundamentally altered the risk-security calculation. The preference for security over innovation, he argued, required a radical shift from principles-based regulation towards an outcomes-based approach. Crucially, he accepted that past reliance on disclosure and financial literacy

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relations from economic analysis removes the problem of order for the intellectual agenda, at least in the economic sphere': at 484).

133 Anthony Giddens, *The Constitution of Society: Outline of the Theory of Structuration* (1985) 25 ('The constitution of agents and structures are not two independent given sets of phenomena, a dualism but represent a duality…the structural properties of social systems are both the medium and the outcome of the practices they recursively organize').

134 Neil Fligstein, 'Theory and Methods for the Study of Strategic Action Fields' (Paper presented at Institutional Development and Change Conference, Northwestern University, 16-19 July 1998). For Fligstein, 'the critical problem in any strategic action field revolves around what the rules are and how they are enforced. Hence all forms of strategic action oriented towards the creation and maintenance of rule are by nature political in that they involve both contestation and alliances': at 8).

135 John Ruggie, 'What Makes the World Hang Together? Neo-Utilitarianism and the Social Constructivist Challenge' (1998) 52 *International Organization* 855 ('The building blocks of international reality are ideational as well as material' at 879);

136 See Ricardo Gutierrez, 'When Experts Do Politics: Introducing Water Policy Reform in Brazil' (2010) 23 *Governance* 59 (noting how in 'highly specialized areas, such as water resources, experts "do politics" when they use expertise as a political resource and broker political, bureaucratic, and social relationships in order to get their proposals approved and implemented': at 60); see, more generally, Martha Finnemore and Kathryn Sikkink, 'International Norm Dynamics and Political Change' (1998) 52 *International Organization* 887 (referring to actors capacity to effect 'strategic social construction': at 888).

137 Christopher Hood, Henry Rothstein and Robert Baldwin, *The Government of Risk* (2001) 8 (describing a regulatory regime as a 'complex of institutional [physical and social] geography, rules, practice and animating ideas that are associated with the regulation of a particular risk or hazard').

138 For application to corporate law, see Curtis Milhaupt and Katharina Pistor, *Law and Capitalism* (2008) 6 (the production of law is a 'highly iterative process of action and strategic reaction'); see also Lauren Edelman, 'Overlapping Fields and Constructed Legalities: The Endogeneity of Law' in J. O'Brien (ed.) *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (2007) 55.

139 Such an approach conflates proximate with ultimate goals and objectives, see Seumas Miller, 'Institutions, Integrity Systems and Market Actors' in J. O'Brien (ed.), *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (2007) 339, 347. Moreover, as Miller points out, 'even the most staunch free marketeers have normative or ethical commitments: they are committed, in particular, to the ethical value of the social institution of private property, the moral force of contractual obligations, and the human right of individual freedom:' at 342.

140 For application to the politics of corporate governance, see Peter Gourevitch and James Shinn, *Political Power and Corporate Control* (2005) 57-94.

141 See Murray Edelman, 'Symbols and Political Quiescence' (1960) 54 *American Political Science Review* 695.

142 Hector Sants, Annual Lubbock Lecture in Management Studies, (Speech delivered at the Said Business School, 12 March 2010).

143 Sants, above n 125.

was not only insufficient. It was deleterious to consumer welfare. The regulator went on to emphasise the importance of 'culture, behaviour – dare I say it, ethics?'

> We need to answer the question of whether a regulator has a legitimate focus to intervene on the question of culture. This arguably requires both a view on the right culture and a mechanism for intervention. Answering yes to this question would undoubtedly significantly extend the FSA's engagement with industry.
>
> My personal view is that if we really do wish to learn lessons from the past, we need to change not just the regulatory rules and supervisory approach, but also the culture and attitudes of both society as a whole, and the management of major financial firms. This will not be easy. A cultural trend can be very widespread and resilient – as has been seen by a return to a 'business as usual' mentality.
>
> Nevertheless, no culture is inevitable. But changing it is a task that cannot be achieved by policymakers alone - we need to collectively address these issues. From the regulators' perspective it is probably the case that seeking to set ourselves up as a judge of ethics and culture would not be feasible or acceptable. More realistic would be to relate the consequences of culture to regulatory outcomes. However, developing this line of thinking requires much further debate, which I would welcome.[144]

This emphasis on culture is a critical point of departure. It suggests that a reduction in risk can only occur if compliance and ethics are explicitly linked to deterrence and accountability agendas within the firm and across the regulatory regime.[145] The outreach to industry suggested that creating or sustaining structures that facilitate the weakening of ethical obligation (or provide opportunities for gaming) are, by definition, self-defeating. The approach advocated by Sants is built on a synthesis between an appreciation of context, the need for virtuous behaviour and the importance of prescriptive rules and consequential principles of best practice within an overarching framework that is not subverted by compartmentalized responsibilities.[146] This offers the opportunity to build organically from principles of self-regulation and embed them within a much more clearly defined conception of business integrity.[147] The need for such an approach is amplified by the failure of private litigation in both the United States and the United Kingdom in cases concerning alleged deceptive and misleading conduct in the operation of the CDO market. Contractual restrictions had precluded sophisticated investors from gaining relief.[148] The Kay review suggests the need for legislative action to end any doubt of the obligations the financial services industry should owe.

> All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.[149]

The policy problem is how to render this framework operational in a systematic, dynamic and responsive way. To be successful, it needs to balance specific economic efficiency (i.e. benefits to business) and professional rights to self-governance with explicit requirements that society should not be held

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144 Ibid. See also Kay, above n 124 ('Regulation should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives. We look forward to a future of less intrusive and more effective regulation, the product of a new emphasis on the incentives market participants face, and to the creation of trust relationships which can give savers and companies confidence that the equity investment chain meets their needs and serves their interests': 11).

145 For application of integrated application of an approach that links compliance, ethics, deterrence, accountability and risk as both a diagnostic and evaluative tool, see Justin O'Brien and Olivia Dixon, 'The Common Link in Failures and Scandals at the World's Leading Banks,' (2013) 36 *Seattle University Law Journal*, forthcoming.

146 Micro social contract norms must be compatible with hyper norms (i.e. norms sufficiently fundamental that they can serve as a guide for evaluating authentic but less fundamental norms), see Thomas Donaldson and Thomas Dunfee, *Ties that Bind: a Social Contracts Approach to Business Ethics* (1999).

147 Lynn Stout, 'Social Norms and Other-Regarding Preferences' in J. Drobak (ed.), *Norms and the Law* (2006) 13 (reviewing results from social dilemma, ultimatum games and dictator games and postulating 'taken as a whole, the evidence strongly supports the following proposition: *whether or not people behave in an other-regarding fashion is determined largely by social context tempered-but only tempered by considerations of personal cost* [emphasis in original]': at 22); see also Lynn Stout, *Cultivating Conscience* (2011).

148 *SNS Bank, N.V. v Citigroup, N.A. et al* (SDNY) holding no breach of contract and no breach of fiduciary duty, with limitations on liability in the portfolio management agreement enforceable; *Banco Espirito Santo de Investimento S.A. v Citibank, Na* (SDNY) limitations imposed by contract upheld; *Daniel Boone School District v Lehman Brothers* (W.D., Pa) holding that Lehman may be liable only if it knew that product was explicitly prohibited and still sold to school district. In the United Kingdom, plaintiffs had similar problems attaching liability if deemed sophisticated, see *IFE v Goldman Sachs* (2007) ALL ER (D) 476 (July) holding no duty of care in cases in which the arranger adequately disclaims responsibility; see also *Titan Steel Wheels v Royal Bank of Scotland* [2010] EWHC 211 (Contractual disclaimers, exclusion clauses and non-reliance clauses preclude an advisory duty of care from being owed to sophisticated investors).

149 Kay, above n 124, 11.

responsible (or liable) for the failures of the former.[150] At corporate, professional and regulatory levels the framework needs to be mutually reinforcing. It needs to be capable of evaluating the calculative, social and normative reasons for behaving in a more (or less) ethically responsible manner.[151] It also requires reciprocal obligation from each institutional actor to maintaining (and certainly not contributing through omission or commission to the erosion of) the integrity of the governance arrangements. These must articulate common understandings of what constitutes the ethical problem. Moreover, it must generate a framework in which disputes over interpretation can and should be resolved in a manner that is proportionate, targeted, and, ultimately, conducive to the building of warranted trust in the operation of the financial sector. As John Kay has astutely noted, 'the most powerful mechanism for establishing a culture of trust and respect is for intermediaries and market participants to impose it on each other. Conversely, the contagious effect of failure to observe these standards at any point in the investment chain undermines them at every point in the market chain.'[152]

What is also apparent, however, is that those rules and procedures cannot be vouchsafed by allowing the communities of practice themselves to set what constitutes best-practice and monitor effectiveness; a point critical in Adam Smith's (lost) essential reasoning.[153] Much more granular assessment of the efficacy of existing trust boundaries is required as is evaluation of how codes of practice police deviance from agreed institutional commitments and reinforce stated adherence to integrity. In the aftermath of the GFC public trust in technical expertise is understandably unforthcoming. What is, therefore, required is an articulation of a renewed non-calculative social contract. It is an opportunity that cannot be wasted. Unless reform of this magnitude is bedded down, there is a risk that the ideational terms of reference inferred in Hector Sants' Oxford address will remain undeterred. This may represent a triumph for social science research into structured fields. It would a tragedy for the capital market, its participants and the communities they allegedly serve.

F Conclusion

The enormity of the global financial crisis has demonstrated just how misplaced confidence in market ordering was. As such, it represents a fin de siècle moment. The material and ideational certainties associated with the privileging of financial capitalism have evaporated. The *Wingecarribee Shire Council v Lehman Brothers Australia* decision highlights the sub-optimal effect of a retreat to technicalities in dealing with substantive ethical considerations. The critical issue is how to respond. As we have seen, rules are too easily transacted around and principles without external validation and oversight lack the granularity to be enforceable. Tackling ethical deficiencies requires we pay much more attention to the moral dimension of market conduct. It is essential to stress the ethical component of corporate and professional obligation. For the product manufacturer it demonstrates corporate responsibility, which can then be evaluated. For the regulator it offers an opportunity to engage in pro-active strategies that prevent systemic risk from developing. Ultimately, for the consumer and the sophisticated investor alike it provides a basis to trust.

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[150] For application to business as an intangible asset, see Joseph Petrick and John Quinn, 'The Challenge of Leadership Accountability for Integrity Capacity as a Strategic Asset' (2001) 34 *Journal of Business Ethics* 331; for original formulation of the model, see Joseph Petrick and John Quinn, 'The Integrity Capacity Construct and Moral Progress in Business' (2000) 23 *Journal of Business Ethics* 3.

[151] Soren Winter and Peter May, 'Motivation for Compliance with Environmental Regulations' (2001) 20 *Journal of Policy Analysis and Management* 675; see more generally Ian Ayres and John Braithwaite, *Responsive Regulation* (1992); for study suggesting the power of outsiders to frame the emphasis on effective internal controls only if there is a perception within the company that performance is being monitored, see Christine Parker and Vibeke Nielsen, 'To What Extent Do Third Parties Influence Business Behaviour' (2008) 35 *Journal of Law and Society* 309 (reporting survey evidence from 999 large Australian companies); for broader theoretical issues, see Melvin Dubnick and Justin O'Brien, 'Retrieving the Meaning of Accountability in Capital Market Regulation' in M. Dubnick and G. Fredrickson, *Accountable Governance* (2011), 282-301.

[152] Kay, above n 124, 47.

[153] Adam Smith, *The Theory of Moral Sentiments* (1759, 2009 edition), 133 (arguing that 'we can never survey our own motives, we can never form any judgment concerning them, unless we remove ourselves, as it were, from our own natural station, and endeavour to view them as at a certain distance from us').