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REGULATING COMPLEX FINANCIAL PRODUCTS: LESSONS FROM LEGAL INNOVATION INTERNATIONALLY

This paper examines the legal and policy implications of the implosion of the securitisation market internationally and argues that comprehensive reform cannot be left to the courts. The paper highlights the limitations of the current legal framework by evaluating the US settlement reached by Goldman Sachs following SEC proceedings against it. Reforms based on proceedings such as this divert attention from the key normative values of permissibility, responsibility and legitimacy — critical features of liberal democracy on which contemporary capitalism rests.

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The global financial crisis (GFC) had its roots in three interconnected phenomena: flawed governance mechanisms; unsustainable models of financing; and defective regulatory structures. These deficiencies were particularly apparent in the design, marketing, sale and regulation of complex financial products. The myopia demonstrated conclusively the limits of disclosure, the principal regulatory tool for safeguarding the integrity of capital markets. Yet, in the United States, the United Kingdom and Australia the stated policy preference is to enhance disclosure requirements (e.g. FSA 2009; Securities Exchange Commission (SEC) 2010; Treasury 2011). At one level, this is puzzling. Most initial direct losses associated with investments in complex financial products (with the partial exception of Australia) accrued to the wholesale market.

The unresolved policy problem is that professional and/or sophisticated investors trading as individual or institutional actors were aware of, but transacted around, the risks. In summary, the search for yield trumped reason. If defective disclosure was not the cause of both the myopia and the primary problems that arose in the sophisticated sector, a more granular ex ante articulation of risk is unlikely, in itself, to be effective. Is the regulatory response, therefore, misguided? Alternatively, is a more subtle, complex re-calibration of what constitutes duty of care in finance being played out, one which could have potentially far-reaching consequences for capital market practice and governance?

Satisfactory answers require an evaluation of how the reform agenda addresses a range of issues, not just objective *efficiency* (i.e. lower transaction costs). Three additional distinct but overlapping subjective normative criteria 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 and who should determine it).

These normative considerations, central to the functioning of liberal democracies, underpin regulatory debates in the United States as well as the United Kingdom and here in Australia. The disclosure debate masks, therefore, a much more profound ideational dispute. Definitive resolution will determine whether the reforms herald substantive change or mark yet another exercise in the triumph of the politics of symbolism. There are grounds for cautious optimism that reforms will move more in the direction of the former.

Unlike previous crises, which started or were contained within specific countries or discrete regulatory systems, the dislocation caused by the implosion of the securitisation markets revealed the spurious nature of the *rules v principles* bifurcation as the primary distinguishing feature of regulatory design. Both systems of oversight were incapable of embedding the ethical restraint required for effective market integrity (O'Brien 2010). In a somewhat mischievous and sentient intervention, Hector Sants (2009) has 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. This was not simply a particularly memorable aside. As with pregnancy, it is impossible to be semi-ethical. This, in turn, suggests the need for the dynamic integration of rules, principles and social norms within an interlocking responsive framework. To be effective, this must be capable of application across all levels within individual markets and across national boundaries. To do otherwise risks the kind of regulatory arbitrage that has done so much to loosen reputational restraints. The critical question is whether this can be done? Here the evidence of an initial repositioning within regulatory practice in the United States as well as the United Kingdom and here in Australia is encouraging — but by no means confirmed.

The limits of disclosure

The changing contours of global regulatory ambition have been sketched by Lord Turner, the Chairman of the soon-to-be-abandoned Financial Services Authority (FSA) in the United Kingdom. In his influential 2009 review of the banking sector in the United Kingdom, Lord Turner publicly questioned the social utility of financial engineering. Just as significantly, Turner (FSA 2009, p. 39) argued 'the [global financial] crisis also raises important questions about the intellectual assumptions on which previous regulatory approaches have largely been built'. The Securities and Exchange Commission (2010b) has affirmed, implicitly, these flaws as part of its proposed rules to enhance the disclosure required for products offered to sophisticated investors. Now Australia too is questioning the efficacy of the regulatory architecture, through an exceptionally contested consultation process (Treasury 2010, pp. 8–10).

The Australian review has been prompted because 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). Crucially, those unable to manage risk included municipal authorities in metropolitan Sydney, rural New South Wales and Western Australia. In class action litigation now before the Australian Federal Court, the councils claim Lehman Brothers Australia (LBA) was guilty of deceptive, misleading and unconscionable conduct in the provision of financial advice. They also claim that the inclusion of complex risky financial products contravened management protocols to privilege conservative over aggressive portfolio selection. LBA has denied the claims. It argues that no duty of care was owed as the councils met the sophisticated investor criteria laid down in the *Corporations Act 2001*. LBA argues that the contractual wording of the individual agreements gave it considerable latitude. The matter is now before the Federal Court. It is not the place of the author to pre-determine the outcome. What is interesting, however, is the extent to which the defence used by LBA closely tracks that used in litigation in the United States, most notably in the case brought by the Securities and Exchange Commission against Goldman Sachs, which is detailed below.

Irrespective of the jurisdiction, therefore, the interlinked corporate, legal and broader political pressures highlight a single existential dispute. It is predicated on the potential incommensurability between the enabling basis of private law and the public law imperatives of securities regulation. Past reliance on bifurcation masked but did not resolve this core problem. The global financial crisis has made resolution a public policy imperative. I stress, therefore, that much greater emphasis needs to be placed on articulating and delineating more precisely where responsibility and accountability lies in financial product design. Unfortunately, legal action in the United States has delayed comprehensive resolution of this question, most notably in the Goldman Sachs case, the most notorious litigation yet seen in the securitisation crisis.

Taking on the street

When taking enforcement action, regulatory agencies need to balance the effect of conviction with the political costs associated with bringing complex and uncertain cases to trial. Beyond the merits of an individual action, achieving a wider demonstration effect requires changing both the content and context of the underpinning regulatory system. First, the preparation of the case and its subsequent staging — including the critical initial presentation of the evidential base — needs to reconfigure media representations of what constitutes acceptable conduct. This reality applies irrespective of the legal strength of the material claim. Irrespective of the domain, trial strategies tend to focus on competing (if partially understood) narratives, one of which gains media traction. It is, therefore, essential to 'own' the media agenda. Second, the litigation needs to be capable of recalibrating — without credible dissension — the broader policy agenda.

The very fact of prosecution can endorse, justify and legitimise agency interpretation of legal and regulatory authority. To be successful, therefore, prosecutorial strategies need to facilitate the positive framing of policy issues around not only the regulator's own interpretation of its appropriate purpose and accountability but also broader societal understandings, which are intermediated through media narratives. This coupling is essential to ensure that neither judicial failure nor premature settlement will translate into an incremental erosion of wider support for the legitimacy of the regulator's operational imperatives.

These interlinked factors were all too evident in the litigation brought by the Securities and Exchange Commission against Goldman Sachs. Moreover, there was a striking similarity between the media management of this case and those prosecuted by former New York State Attorney General Eliot Spitzer over conflicts of interest in analyst research in the aftermath of the Enron and WorldCom accounting scandals (see Macey 2004; O'Brien 2005). For Spitzer, the veracity of the legal claim was always less important than the staging of the litigation and its impact on broader policy goals, as well as his own political self-interest. Spitzer gambled correctly that the sweeping powers afforded to the New York Attorney General through the *New York Business Law of 1921* (sections 352–353), otherwise known as the 'Martin Act', shifted the risk calculus in favour of the state. The law gives the State Attorney General unparalleled investigative capacity to probe activities that could be detrimental to the well-being of the state. Until Spitzer's innovative application, the law was rarely used to investigate financial services (although his strategy was replicated by his successor as both State Attorney General and Governor, Andrew Cuomo).

Given the dominance of New York City as a financial centre, Spitzer — and, indeed, Cuomo — was able to use the state law to highlight the manner in which Wall Street actually operated. Embarrassed at the time by Spitzer's recurring efforts to set his own policies and by the political firestorm that accompanied revelations that Wall Street practices had not in fact changed in the intervening period (thus allowing Cuomo to enter into the enforcement arena), the SEC was determined to take a much more aggressive approach. Despite the risk that it could be accused of adventurism by taking the case against Goldman Sachs, the divided and wary federal commission opted to chance litigation failure (Goldfarb 2010).

The strategic calculation for both the SEC and Goldman Sachs lay in the reputational implications of proceeding to trial. For the SEC, the risk that a jury would find that Goldman Sachs was following accepted, albeit flawed, rules of the game needed to be balanced with rising public and political pressure to hold the banking sector to account. Along with other regulatory agencies, the SEC had been criticised by President Barack Obama (2009) for its prior failure to police Wall Street. Indeed, criticism of regulatory capture plays a central part in the narrative constructed by the Financial Crisis Inquiry Commission (2011). For Goldman Sachs, protesting innocence on technical grounds risked exacerbating reputational damage in the short-term.

The bank, like the rest of Wall Street, was also cognisant that protesting innocence on technical grounds provided succour to those legislators pressing for enhanced financial oversight (e.g. Levin 2010a). Neither party to the case had an interest in proceeding to trial or to a lengthy appeal process. The litigation is best seen, therefore, as part of a calculated bargaining process. Despite the apparent success of the SEC in forcing a $550 million settlement, it is far from clear that the SEC emerged as the winner. It may well, in time, be seen to have won the hand but lost the game.

The case against Goldman

What was, perhaps, most surprising about the SEC charges filed in the Southern District of New York was the failure of the bank to disclose that it had been served a Wells Notice several months earlier. A Wells Notice provides 'potential defendants of the general nature of its investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Commission for the commencement of an administrative or injunctive proceeding' (Atkins and Bondi 2008, pp. 381–82). Although the process is designed to be confidential, there can be no doubting its materiality. Yet Goldman Sachs made the calculated decision not to disclose its existence nor provide a substantive response before the Enforcement Division sought and gained permission to proceed from a divided commission (see Goldfarb 2010).

Given the exceptional market volatility, the bank's approach to investor and public relations management was uncharacteristically myopic. As a result, neither the bank nor the market was prepared for the media backlash. Having lost the public relations advantage, the bank remained on the defensive. It failed to submit a substantive response (Goldman Sachs 2010a; 2010b; 2010c; Gallu 2010). Despite its protestations of innocence, proffering a legal defence that could change the media dynamic was problematic to say the least. The danger associated with an inability to control the agenda became acutely apparent as news leaked of a potential investigation into a second CDO transaction, disclosed at an exceptionally combative hearing of the Senate Permanent Committee on Investigations 11 days after the ABACUS suit was filed (Gallu and Harper 2010).

The tone of the broader debate, which encapsulated the difficulties faced by the banking sector, was set by Senator Carl Levin's opening statement. He claimed that Goldman Sachs had corrupted the industry and despoiled the Republic.

> 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 (Levin 2010b).

Levin was incredulous at the public stance adopted by Goldman Sachs. For the bank 'to go out and sell these securities to people and then bet against those same securities, it seems to me, is a fundamental conflict of interest and … raises a real ethical issue' (Levin 2010a). As a consequence, he advocated a more aggressive policing of the securitisation market than the Obama Administration had previously considered. Goldman Sachs attempted to steer the debate away from ethical considerations. Goldman Sachs (2010b) 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 was a further example of a 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' (Goldman Sachs 2010b).

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' (Goldman Sachs 2010b). Therefore, according to Goldman Sachs, if ACA placed inappropriate referent securities in the offering, it had not only failed in its obligation, it had also acted irresponsibly on its own account. This transference of responsibility underpinned Goldman executives' testimony to the congressional inquiry, which had so angered Senator Levin. Moreover, the argument by the Goldman Chief Executive Officer that the firm was

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merely facilitating 'God's work' proved unhelpful (Arlidge 2009, p. 4). Subsequently, Goldman Sachs announced the creation of a Business Standards Committee. It announced that the results of its review would be made publicly available, a promise delivered the following year (Goldman Sachs 2011). The SEC commended both initiatives as sincere attempts by the firm to address the perceived ethical deficit (SEC 2010a). A more realistic assessment, however, is that Goldman Sachs concluded that neither the case nor its prior approach was remotely winnable in the court of public opinion.

Closure necessitated accepting that past practice had severely damaged the firm's self-proclaimed reputation for integrity and probity. It was insufficient for the bank to merely state that practice had changed; it had to at least attempt to demonstrate that confidence was warranted. The creation of the Business Standards Committee is designed to provide a benchmark against which it is at least theoretically possible to judge ongoing if not past corporate behaviour (Goldman Sachs 2011, p. 62).

Despite the firm's capitulation, however, the strength of the SEC's legal case is questionable. The extraction of an admission from the bank that it was 'mistaken' in its management of the conflicts of interest further raises the risk that private litigation will benefit from what amounted to retrospective prosecution. Although there are circumstances in which retrospective prosecutions can and have been defended (e.g. Woozley 1968), the danger for regulators is that when the pendulum swings back, as it inevitably will, from enforcement to a focus on facilitating the growth of financial markets, accusations of regulatory adventurism will inevitably also return (see O'Brien 2007).

The very fact that the SEC has implicitly accepted the retrospective nature of its litigation against Goldman therefore poses long-term risks for the authority and legitimacy of the regulator. As noted above, the central policy issue is whether individual investors can contract out of the general anti-fraud provisions of the *Securities Act of 1933* and the *Securities and Exchange Act of 1934*. If so, then the remit of the SEC is reduced as the investors are deemed to be knowledgeable enough to look after their own interests. The scale of investor losses has made this unpalatable. Indeed, there is a growing international consensus that the sophisticated–unsophisticated bifurcation is both unhelpful and dangerous (FSA 2009). Changing this framework, however, raises profound

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questions about the limits of the freedom to contract, which remains the underpinning rationale of corporate law in the United States and of securities market regulation throughout the common-law world. It is central to the Department of Treasury consultations here in Australia. The settlement of the Goldman Sachs case defers for the moment a definitive judicial ruling. How the courts and legislature eventually determine this issue will have profound consequences for the future global governance of investment banking activity.

It is in this regard that the SEC's own presentation of revised rules for the governance of asset-backed securities creates future problems for the agency. The proposed rules, released while the Goldman Sachs litigation remained alive, undermined the legitimacy of its own case against the bank. They also ignited a broader normative debate about the purpose of the capital markets. In outlining the case for change, the SEC argued:

> Investors have complained that the mechanisms for enforcing the representations and warranties in securitization transaction documents are weak, and thus are not confident that even strong representations and warranties provide them with adequate protection. In the private market we believe that, in many cases, investors did not have the information necessary to understand and properly analyse structured products, such as CDOs, that were sold in transactions in reliance on exemptions from registration (SEC 2010b, p. 12).

Such a failure to assess risk lies at the heart of the ABACUS transaction, and, of course, Goldman Sachs' own defence. The ABACUS marketing materials, including the Flipbook — essentially a Powerpoint presentation — was exceptionally detailed. The contents prompted an influential *New Yorker* financial columnist to remark that they may well have said 'Don't trust us' (Surowiecki 2010, p. 25). The ABACUS transaction provides a salutary lesson in how incompetence and greed guided investor decision-making. It also demonstrates an amoral imperative on the part of the former investment bank, which has now lost its independent status by submitting itself to federal oversight. These dual failures provide a justification for future reform, but not necessarily retrospective prosecution, a point implicitly conceded by the SEC. As the agency (SEC 2010b, p. 22) correctly argues:

> 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. However, 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.

These proposed rule changes also include the need to provide 'basic material 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' (SEC 2010b, p. 273). The rule changes are, however, of limited value to investors who fail to conduct their own due diligence. It is this concern about regulatory adventurism that underpinned the criticism that did so much to weaken prosecutorial authority in the lead-up to the boom.

Conclusion

It is, perhaps, unfortunate that it takes the threat of strengthened private and public enforcement action for influential banks to take seriously their responsibility for protecting market integrity. The sad reality, however, is that without such strengthened enforcement, combined with articulation of professional commitment to market integrity, meaningful change is unlikely to occur. If fealty to market integrity is to mean anything more than narrowly defined and easily transacted-around legal obligation, the reform agenda must address, comprehensively and directly, the ethical deficit at the heart of global finance. The central argument advanced here is that we cannot leave this to the court. It must and should be legislatively determined. ■

Note

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