

# The Common Link in Failures and Scandals at the World's Leading Banks

*Justin O'Brien*\* & *Olivia Dixon*\*\*

## I. INTRODUCTION

While the roots of recent institutional failures run deep, this past northern summer has revealed substantial compliance, risk management, and governance failures at major international banks at an unprecedented level. The exposure of a new wave of scandals at JPMorgan Chase & Co., HSBC Holdings plc, and Standard Chartered Bank plc, and the panel-member banks under transatlantic investigation for the manipulation of the London Interbank Offered Rate (LIBOR) points to systemic governance failures that also call into doubt the structural integrity of current models of financial regulation. Taken together, they suggest that both regulated entities and their regulators face a profound legitimacy and authority crisis. The causes of the problems facing the banking industry and its regulators, while complex, share a common theme. They derive from a failure to integrate what we term the five core dimensions of internal and external oversight: compliance, ethics, deterrence, accountability and risk (CEDAR).

In the aftermath of the crisis, there are pressing reasons to revisit the fundamental purpose of corporate governance and financial regulation and to evaluate to what extent the reform agenda addresses the revealed limitations of current and proposed frameworks. It is in the interest of both the regulator and the regulated that one has substantive conceptions of compliance, rather than mechanical conceptions that are easily transacted around. It is in their common interest for there to be warranted commitment to ethical standards rather than a stated aspiration that lacks the granularity to be enforceable. Likewise, only effective de-

---

\* Professor of Law and Director, Centre for Law, Markets and Regulation, The Faculty of Law, The University of New South Wales. O'Brien acknowledges the financial support provided by an Australian Research Council Future Fellowship.

\*\* Lecturer, Faculty of Law, The University of Sydney.

terrence can assure public confidence, which necessitates demonstrable internal capacity and willingness to police and punish deviance. This, in turn, augments accountability, without which confidence cannot be assured. Ultimately, the goal of internal governance and external supervision through financial regulation is to reduce risk. This can only be vouchsafed, however, by evaluating the extent to which all five dimensions are integrated within an overarching design that encompasses mandate, corporate or bureaucratic process, and use of discretion. The CEDAR matrix serves, therefore, both a diagnostic and an evaluative function across mandate, process, and the use of discretion.

The first dimension of CEDAR is compliance, which includes the notion of compliance risk. Compliance risk is defined as “the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities.”<sup>1</sup> Parliamentary and congressional investigations into the recent banking scandals have shown that in each case compliance risk was exacerbated by globalized institutional structures that were too big to manage internally and too big to regulate externally. Against this rubric both the internal compliance paradigm and external deterrence strategies of enforcement are inherently unworkable. In the United States for example, where threats of criminal prosecution are hollow and breaches are routinely sanctioned by financial regulators through negotiated settlements,<sup>2</sup> there has been little incentive for such “systemically important financial institutions”<sup>3</sup> to implement a robust compliance program that extends beyond symbolism. Given the amount of repeat offenders, there is scant evidence to suggest that negotiated settlements encourage any meaningful behavioral change. Indeed, an influential New York district court judge, Jed Rakoff, argues that these agreements privilege the “facade of enforcement.”<sup>4</sup> In the United Kingdom, the situation is even more problematic given the failure to hold any

---

1. Basel Comm. on Banking Supervision, *Compliance and the Compliance Function in Banks*, BANK FOR INT’L SETTLEMENTS § 3 (Apr. 2005), <http://www.bis.org/publ/bcbs113.pdf>.

2. A negotiated settlement agreement is a voluntary alternative to adjudication in which the prosecuting agency agrees to grant amnesty in exchange for the defendant agreeing to fulfill certain requirements such as paying fines, implementing corporate reforms, and fully cooperating with the investigation.

3. Defined as “financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.” *Policy Measures to Address Systemically Important Financial Institutions*, FIN. STABILITY BD. 1 (Nov. 4, 2011), [http://www.financialstabilityboard.org/publications/r\\_111104bb.pdf](http://www.financialstabilityboard.org/publications/r_111104bb.pdf).

4. *SEC v. Bank of Am. Corp.*, 653 F. Supp. 2d 507, 510 (S.D.N.Y. 2009).

individual accountable.<sup>5</sup> Trust, which is the foundation of banking and its regulation, has in consequence and for good reason evaporated.

But ascertaining who or what is responsible for these banking scandals, who should be held accountable, and more fundamentally, how the oversight model could or should be redesigned remains exceptionally problematic. The core and unresolved issue pivots on purpose, both for the corporation and for the market in which it is nested. As Edward Mason famously noted in 1960, “[t]he fact seems to be that the rise of the large corporation and attending circumstances have confronted us with a long series of questions concerning rights and duties, privileges and immunities, responsibility and authority, that political and legal philosophy have not yet assimilated.”<sup>6</sup> The passage of time has demonstrated not only the sagacity of this insight, but also its particular relevance to the financial services industry.

Some have argued that the rapid expansion of financial services in recent years has disproportionately benefited the industry itself.<sup>7</sup> Proponents of this narrative advocate structural changes, such as reimposing the Banking Act of 1933,<sup>8</sup> also known as the Glass–Steagall Act,<sup>9</sup> or implementing a strict-form ban on proprietary trading under the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank).<sup>10</sup> Others blame weak regulators.<sup>11</sup> This privileges a familiar regulatory capture narrative.<sup>12</sup> It notes the failure of central bank officials and gov-

---

5. See FIN. SERVS. AUTH, THE FAILURE OF THE ROYAL BANK OF SCOTLAND (Dec. 2011), <http://www.fsa.gov.uk/static/pubs/other/rbs.pdf>. (“Quite reasonably . . . people want to know why RBS failed. And they want to understand whether failure resulted from a level of incompetence, a lack of integrity, or dishonesty which can be subject to legal sanction.”)

6. EDWARD MASON, THE CORPORATION IN MODERN SOCIETY 19 (1959).

7. See, e.g., Liam Halligan, ‘Liborgate’ Could Trigger Crucial Banking Reform, TELEGRAPH (July 7, 2012), <http://www.telegraph.co.uk/finance/comment/liamhalligan/9383982/Liborgate-could-trigger-crucial-banking-reform.html>.

8. 12 U.S.C. § 227 (1933).

9. The Glass–Steagall Act limited commercial bank securities activities and affiliations between commercial banks and securities firms. See A.J. Hebert III, *Requiem on the Glass–Steagall Act: Tracing the Evolution and Current Status of Bank Involvement in Brokerage Activities*, 63 TUL. L. REV. 157, 158 (1988).

10. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

11. See, e.g., Ben Protess & Mark Scott, *Bank Scandal Turns Spotlight to Regulators*, N.Y. TIMES DEALBOOK (July 9, 2012), <http://dealbook.nytimes.com/2012/07/09/libor-scandal-intensifies-spotlight-on-bank-regulators/>; Peter Gumbel, *LIBOR Rigging: What the Regulators Saw (But Didn't Shut Down)*, TIME (July 16, 2012), <http://business.time.com/2012/07/16/libor-rigging-what-the-regulators-saw-but-didnt-shut-down/>.

12. See, e.g., George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971), available at <http://www.rasmusen.org/zg601/readings/Stigler.1971.pdf>; James Freeman, *Regulators Captured*, WALL ST. J. (Aug. 23, 2012), <http://online.wsj.com/article/SB10000872396390444812704577607421541441692.html>.

ernment regulators to respond to patent misconduct that is, in some cases, exposed years prior to the commencement of official investigations.<sup>13</sup> As with all compelling narratives, each is plausible. What is lost, however, is perhaps an even more disturbing reality. While most of the scandals have excised the “rotten apples” deemed responsible, it could well be the case that it is actually the “barrel that is the cause of the problem.”<sup>14</sup> If so, then no amount of structural tinkering alone will be sufficient: one cannot solve normative problems with technical measures alone.

Should one rely on rules alone, there is the demonstrable danger that they will be transacted around; likewise, a reliance on principles lacks application in circumstances in which the actors have no conceptions—or very limited and emasculated conceptions—of what those principles are.<sup>15</sup> What needs to be mapped and tracked, therefore, is the extent to which rules and principles interact within specific epistemic communities of practice, whether they are professional, corporate, or regulatory. This in turn forces reflection on the question of culture, a recurring motif in the report of the United Kingdom Treasury Select Committee on the LIBOR price-manipulation scandal.<sup>16</sup> It is an issue initially raised but since then quietly buried by senior regulatory figures in the United Kingdom in the immediate aftermath of the Global Financial Crisis.<sup>17</sup> However, this Article argues that both the root cause of the

---

13. Freeman, *supra* note 12.

14. Jan Kregel, *The LIBOR Scandal: The Fix is in – The Bank of England Did It! Policy Note*, LEVY ECON. INST. BARD COLL. (Sept. 2012), [http://www.levyinstitute.org/pubs/pn\\_12\\_09.pdf](http://www.levyinstitute.org/pubs/pn_12_09.pdf).

15. *See, e.g.*, Hector Sants, Chief Exec., Fin. Servs. Auth., Speech at the Reuters Newsmaker Event: Delivering Intensive Supervision and Credible Deterrence (Mar. 12, 2009) (transcript available at [http://www.fsa.gov.uk/library/communication/speeches/2009/0312\\_hs.shtml](http://www.fsa.gov.uk/library/communication/speeches/2009/0312_hs.shtml)) (“I continue to believe the majority of market participants are decent people; however, a principles-based approach does not work with individuals who have no principles.”).

16. TREASURY COMMITTEE, *FIXING LIBOR: SOME PRELIMINARY FINDINGS, 2012-13*, H.C. 481-II (U.K.), available at <http://www.publications.parliament.uk/pa/cm201213/cmselect/cm/481/48102.htm>.

17. *See* Hector Sants, Chief Exec., Fin. Servs. Auth., Annual Lubbock Lecture in Management Studies: UK Financial Regulation: After the Crisis (Mar. 12, 2010) (transcript available at [http://www.fsa.gov.uk/library/communication/speeches/2010/0312\\_hs.shtml](http://www.fsa.gov.uk/library/communication/speeches/2010/0312_hs.shtml)). Sants states as follows:

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.

*Id.*

crisis and the route to restoring trust and confidence is to be found in ascertaining how to regulate culture across mandates, processes, and use of discretion.

Part II identifies the internal and external failings of four of the most recent global banking scandals within the CEDAR matrix. Part III discusses the regulatory challenges faced when compliance serves no practical function and the consequent material risk to market integrity. This Article concludes by suggesting that it is unsustainable for regulation to be decided, implemented, and monitored at a national level. Global oversight has become an imperative to reduce the conflicts of interest that may create profitable industries, but not socially beneficial ones.

## II. RECENT CASE STUDIES

### A. JPMorgan Chase & Co.

On May 10, 2012, JPMorgan disclosed a “surprise” trading loss of at least \$2 billion.<sup>18</sup> The loss was linked to a complex hedging strategy based on synthetic credit default swaps made by traders in London on behalf of the New York-based chief investment office (CIO).<sup>19</sup> According to the chief executive officer, Mr. Jamie Dimon, “the losses emerged after the firm tried to reduce that position and unwind the portfolio.”<sup>20</sup> In the immediate aftermath of the disclosure, JPMorgan shareholders saw about \$30 billion of market value obliterated.<sup>21</sup> The control failures at JPMorgan were not the consequence of rogue traders operating in a niche market far removed from the corridors of power (the “rotten apple theory”). The traders were executing a strategy on behalf of the CIO. Its function was to “hedge the bank’s exposure on loans and other credit risks to corporations, banks, and sovereign governments.”<sup>22</sup> Nothing could be more central to JPMorgan’s risk management, yet it appeared to be operating out of control. Unraveling how and why this occurred is instructive about the difficulties associated with conflating compliance with risk management. Moreover, it also highlights multiple ex post and

---

18. JPMorgan Chase & Co., Quarterly Report (Form 10-Q) (Aug. 9, 2012), available at <http://www.sec.gov/Archives/edgar/data/19617/000001961712000264/jpm-2012063010q.htm>.

19. *Id.*

20. Dawn Kopecki, Michael J. Moore & Christine Harper, *JPMorgan Loses \$2 Billion on Unit's 'Egregious Mistakes,'* BLOOMBERG (May 11, 2012), <http://www.bloomberg.com/news/2012-05-11/jpmorgan-loses-2-billion-as-mistakes-trounce-hedges.html>.

21. Erik Schatzker, Dawn Kopecki & Bradley Keoun, *House of Dimon Marred by CEP Complacency over Units Risk,* BLOOMBERG (June 12, 2012), <http://www.bloomberg.com/news/2012-06-12/house-of-dimon-marred-by-ceo-complacency-over-unit-s-risk.html>.

22. Kopecki, Moore & Harper, *supra* note 20.

ex ante accountability failures within the bank itself and with its regulators where confusion reigned over just who was responsible for monitoring risk and whether the global nature of the operations fatally undermined any meaningful capacity to regulate.

The first signs of problems had surfaced a month prior, on April 6, 2012. The *Wall Street Journal* reported that one bullish trader, nicknamed the “London Whale,” was taking such large positions that he was moving prices in the \$10 trillion market.<sup>23</sup> At the time, JPMorgan’s chief financial officer, Mr. Doug Braunstein, stated that the bank was “very comfortable” with the CIO’s positions.<sup>24</sup> In a conference call to analysts, Mr. Dimon, the chief executive officer, dismissed concerns about the trading activities, calling them a “complete tempest in a teapot.”<sup>25</sup> The public policy implications of the trading loss were examined when Mr. Dimon appeared before the Senate Banking Committee on June 13, 2012, and the House Financial Services Committee on June 19, 2012.<sup>26</sup> The latter hearing, entitled “Examining Bank Supervision and Risk Management in Light of JPMorgan Chase’s Trading Loss,” highlighted confusion and disagreement over which regulatory agency was in charge of monitoring risk.<sup>27</sup> By July 13, 2012, total losses were projected at close to \$7 billion.<sup>28</sup> Federal regulators, who were already examining the

---

23. Dawn Kopecki & Max Abelson, *Dimon Fortress Breached as Push from Hedges to Bets Blows Up*, BUSINESSWEEK (May 14, 2012), <http://www.businessweek.com/news/2012-05-14/dimon-fortress-breached-as-push-from-hedging-to-betting-blows-up>.

24. Dan Fitzpatrick, Jean Eaglesham, & Joann S. Lublin, *J.P. Morgan CFO to Exit Post*, WALL ST. J. (Oct. 10, 2012), <http://online.wsj.com/article/SB10000872396390444799904578048961507186872.html>.

25. Polya Lesova, *Dimon: London Whale Issues “Tempest in a Teapot,” Market Watch*, WALL ST. J. (Apr. 13, 2012), [http://articles.marketwatch.com/2012-04-13/industries/31335210\\_1\\_london-whale-tempest-jamie-dimon](http://articles.marketwatch.com/2012-04-13/industries/31335210_1_london-whale-tempest-jamie-dimon).

26. *A Breakdown in Risk Management: What Went Wrong with JPMorgan Chase: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 112th Cong. (2012) (testimony of Jamie Dimon, Chairman & CEO, JPMorgan Chase & Co.) [hereinafter *Breakdown in Risk Management Hearing*], available at <http://online.wsj.com/public/resources/documents/JPMCCIoTtestimony.pdf>; *Examining Bank Supervision and Risk Management in Light of JPMorgan Chase’s Trading Loss: Hearing Before the H. Fin. Servs. Comm.*, 112th Cong. (2012) (testimony of Jamie Dimon, Chairman & CEO, JPMorgan Chase & Co.) [hereinafter *Examining Bank Supervision Hearing*], available at <http://financialservices.house.gov/uploadedfiles/hhrg-112-ba00-wstate-jdimon-20120619.pdf>.

27. Referring to the Fed’s written testimony, Representative Pearce stated, “[W]e [congress] simply oversee! You are in charge of risk. That is what you say.” *Examining Bank Supervision Hearing*, *supra* note 26 (statement of Rep. Steven Pearce), available at <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=299359>. “[N]o, we are not the one in charge of the OCC. We are the consolidated supervisor.” *Id.* (statement of Scott Alvarez, Gen. Counsel, Fed. Reserve).

28. Jessica Silver-Greenberg, *New Fraud Inquiry as JPMorgan’s Loss Mounts*, N.Y. TIMES DEALBOOK (July 13, 2012), <http://dealbook.nytimes.com/2012/07/13/jpmorgan-says-traders-obscured-losses-in-first-quarter>.

trades, began examining whether the bank's traders may have intentionally tried to obscure the full extent of the losses to defraud investors.<sup>29</sup> JPMorgan senior management conceded that the hedging strategy was "flawed, complex, poorly reviewed, poorly executed and poorly monitored."<sup>30</sup> It was a far cry from Mr. Dimon's "tempest in a teapot" analogy.

The corporate and policy confusion over how to identify or deal with risk has implications far beyond the losses in this particular trade. As William Cohan has pointed out, JPMorgan's trading losses "played right into the hands of pundits."<sup>31</sup> In particular, they renewed vigor to the debate in Washington on the implementation of Dodd-Frank, the sweeping legislation designed to curb corporate excess and embed restraint, passed in response to the global financial crisis.<sup>32</sup> In regulation, all battles are won or lost at the implementation stage. The immediate impact of the JPMorgan trading losses will be seen in debates surrounding the still-stalled implementation of section 619 of Dodd-Frank, known as the Volcker Rule. The Volcker Rule was designed to prohibit proprietary trading by those institutions covered by an implicit government guarantee.<sup>33</sup> The most vocal critic of both the rule and its application is Mr. Dimon himself. He had famously described it as a misguided attempt to prohibit legitimate market-making activity that derived from the thinking of a man who "does not understand capital markets."<sup>34</sup> The failure of his bank's risk management-systems has significantly reduced the authority of its chairman and chief executive to advocate for a weakening of external oversight. Although regulators are aiming to finalize the Volcker Rule by the end of 2012, there is controversy as to whether it will be im-

---

29. *Id.*

30. Robert Lenzner, *JPM Trade "Flawed, Complex, Poorly Reviewed, Executed, Monitored,"* FORBES (May 12, 2012), <http://www.forbes.com/sites/robertlenzner/2012-/05/12/flawedcomplex-poorly-reviewed-executed-monitored/>.

31. William D. Cohen, *The One Thing Jamie Dimon Got Right This Week*, BLOOMBERG (May 12, 2012), <http://www.bloomberg.com/news/2012-05-11/the-one-thing-jamie-dimon-got-right-this-week.html>.

32. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

33. See, e.g., *Study & Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds & Private Equity Funds*, FIN. STABILITY OVERSIGHT COUNCIL (Jan. 2011), <http://www.treasury.gov/initiatives/documents/volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf>.

34. Peter Coy, *JPMorgan's Big Loss: Volcker's Not So Dumb After All*, BUSINESSWEEK (May 11, 2012), <http://www.businessweek.com/articles/2012-05-11/jpmorgans-big-loss-volckers-not-so-dumb-after-all>.

plemented.<sup>35</sup> It has transmogrified from a simple proposition to a gargantuan policy framework informed by a wave of exceptions.<sup>36</sup>

To date, JPMorgan has received no sanction from the New York Federal Reserve, which failed to monitor a trading strategy that had a material effect on international markets. Notwithstanding a campaign spearheaded by Elizabeth Warren, the former chair of the Congressional Oversight Panel, Mr. Dimon has not had to relinquish his position on the board of the New York Federal Reserve, where he sits on the pivotal strategy and compensation committees.<sup>37</sup> While Mr. Dimon admits that the London Whale “was the dumbest thing [he had] ever seen,”<sup>38</sup> he considers the matter closed. At a recent Q&A session with summer interns he stated: “I want you to know the London Whale issue is dead. The Whale has been harpooned. Desiccated. Cremated. I am going to bury its ashes all over.”<sup>39</sup> The hedging strategy may have been flawed, but so too were the compliance and risk-management systems.<sup>40</sup> It has also demonstrated accountability problems and a lack of credible capacity within the firm or beyond to police deviance. Indeed, for JPMorgan, once seen as a firm with bespoke capacity to manage risk, the regulatory problems are, if anything, mounting.

Unrelated to the London Whale incident, the U.S. Federal Energy Regulatory Commission (FERC) sued JPMorgan on July 2, 2012, to release twenty-five emails in an investigation of possible manipulation of

---

35. As we have seen from the Securities and Exchange Commission’s most recent pullback in relation to imposing restrictions on money market funds, the determination and capacity of industry remains exceptionally strong, especially in the context of an ideologically divided regulatory agency. See *Statement of SEC Chair Mary L. Shapiro on Money Market Reform*, SEC. & EXCH. COMM’N (Aug. 22, 2012), <http://www.sec.gov/news/press/2012/2012-166.htm>

36. *Id.*

37. *Elizabeth Warren After Jamie Dimon “Meet the Press” Interview Calls on JP Morgan CEO to Resign from NY Fed Board*, ELIZABETH WARREN FOR SENATE (May 13, 2012), <http://elizabethwarren.com/news/press-releases/elizabeth-warren-after-jamie-dimon-meet-the-press-interview-calls-on-jp-morgan-ceo-to-resign-from-ny-fed-board>. Of course, Professor Warren has her own agenda linked to her successful contest for the Senatorial seat in Massachusetts in the 2012 election.

38. Andrew Trotman, *Whale Has Been Harpooned: Dimon*, TELEGRAPH (Aug. 13, 2012), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9472835/JP-Morgan-chief-Jamie-Dimon-defends-banks-says-London-Whale-has-been-harpooned.html>.

39. *Id.*

40. See, e.g., Erik Schatzker, Dawn Kopecki & Bradley Keoun, *House of Dimon Marred by CEO Complacency over Unit’s Risk*, BLOOMBERG (June 13, 2010), <http://www.bloomberg.com/news/2012-06-12/house-of-dimon-marred-by-ceo-complacency-over-unit-s-risk.html>; Rachel Wolcott, *Analysis: JP Morgan Repeats Basic Mistakes Managing Traders*, REUTERS (May 15, 2012), <http://www.reuters.com/article/2012/05/15/us-jpmorgan-trading-management-idUSBRE84E0Y820120515>.



power markets in California and the Midwest.<sup>41</sup> FERC argues that JPMorgan's bidding techniques resulted in at least \$73 million in improper payments and that the bank improperly used attorney-client privilege to withhold or redact fifty-three emails subpoenaed in April 2012.<sup>42</sup> The bank has also been served with subpoenas from the New York State Attorney General relating to the manipulation of the LIBOR.<sup>43</sup> With JPMorgan now facing multiple investigations and significant ongoing litigation, its reputation as risk averse and well managed is now severely damaged.

### *B. Barclays et al.*

The corruption of core values stated in banking reached an inflection point with a multifaceted international investigation relating to revelations that Barclays officials and traders attempted to game LIBOR in June 2012.<sup>44</sup> They did so by manipulating submissions near the height of the global financial crisis, thereby portraying that they were more creditworthy than they were, in order to facilitate derivative contract positions.<sup>45</sup> LIBOR is tied to \$10 trillion in loans and \$350 trillion in interest-rate derivatives.<sup>46</sup> These revelations underscored the seriousness of the long-simmering scandal over how LIBOR is set and raised questions as to why regulators had not acted on behavior that was widely discussed in the media as far back as 2008.<sup>47</sup>

---

41. Fed. Energy Regulatory Comm'n v. J.P. Morgan Ventures Energy Corp., No. 12-MC352 (D.D.C. July 2, 2012).

42. Katarzyna Klimasinska & Dawn Kopecki, *Dimon Faces Image 'Nightmare' with Energy Probe at JPM*, BLOOMBERG (July 3, 2012), <http://www.bloomberg.com/news/2012-07-03/jpmorgan-probed-over-potential-power-market-manipulation-1-.html>.

43. See, e.g., David McLaughlin, *JP Morgan, UBS Said Among Banks Queried in Libor Probe*, BLOOMBERG (Aug. 16, 2012), <http://www.bloomberg.com/news/2012-08-15/jpmorgan-barclays-said-among-banks-to-get-libor-subpoenas.html>; Ben Protess, *State Regulators Widen Libor Investigation*, N.Y. TIMES DEALBOOK (Aug. 15, 2012), <http://dealbook.nytimes.com/2012/08/15/state-regulators-widen-libor-investigation/>.

44. Press Release, U.S. Dep't of Justice, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay \$160 Million Penalty (June 27, 2012), available at <http://www.justice.gov/opa/pr/2012/June/12-crm-815.html>.

45. *Id.*

46. David Enrich, Carrick Mollenkamp & Jean Eaglesham, *Libor Probe Includes BofA, Citi, UBS*, WALL ST. J. (Mar. 18, 2011), <http://online.wsj.com/article/SB1000142405274870381820457620599169854-8286.html>.

47. See, e.g., Carrick Mollenkamp & Mark Whitehouse, *Study Casts Doubt on Key Rate*, WALL ST. J. (May 29, 2008), <http://online.wsj.com/article/SB121200703762027135.html>.

The “honor system” method by which LIBOR is set renders it exceptionally vulnerable to manipulation.<sup>48</sup> This brings to the fore the ethics dimension of the CEDAR analytic framework. Each day the banks that contribute to the LIBOR-setting process send their interbank borrowing rates directly to Thomson Reuters.<sup>49</sup> The most important is the three-month dollar LIBOR.<sup>50</sup> The rates submitted are what the banks estimate they would pay other banks to borrow dollars for three months.<sup>51</sup> Thomson Reuters discards the top and bottom quartiles and then uses the middle two quartiles to calculate an average.<sup>52</sup> This methodology is followed 150 times to create the LIBOR rates for all of the ten currencies and fifteen maturities in which the LIBOR rate is set.<sup>53</sup> As the rates submitted by banks are estimates, not actual transactions, it is relatively easy to submit false figures.<sup>54</sup> Evidence provided in the belated regulatory investigation and subsequent parliamentary enquiries shows that traders at several banks conspired to influence LIBOR by getting colleagues to submit rates that were either higher or lower than their actual estimate.<sup>55</sup>

At Barclays, there were two types of motivations for rigging rates: individual and institutional. This distinction is important because Treasury Select Committee testimony suggests that management was ignorant of the former but had indications of the latter activity.<sup>56</sup> Individual traders were influencing the rates to profit on positions they had taken in particular trades and to benefit Barclays’ derivatives portfolio as a whole.<sup>57</sup>

---

48. Mark Gongloff, *Citigroup Manipulated Libor More Than Any Other U.S. Bank: Reports*, HUFFINGTON POST (July 20, 2012), [http://www.huffingtonpost.com/mark-gongloff/libor-scandal-citigroup\\_b\\_1689853.html](http://www.huffingtonpost.com/mark-gongloff/libor-scandal-citigroup_b_1689853.html).

49. *Frequently Asked Questions*, BRITISH BANKERS ASS’N, <http://www.bbalibor.com/bbalibor-explained/faqs> (last visited Oct. 16, 2012).

50. *Id.*; *Libor—What Is It and Why Does It Matter?*, BBC, <http://www.bbc.co.uk/news/business-19199683> (last visited Oct. 16, 2012).

51. *Frequently Asked Questions*, *supra* note 49.

52. *Id.*

53. *Id.*

54. *Id.*

55. TREASURY COMMITTEE, *supra* note 16. If anything, the release of recent email and instant messaging from traders working for the Royal Bank of Scotland raises even more questions of moral turpitude precisely because the infractions continued even after the bank was placed under de facto state stewardship as a consequence of a 82% bailout. See *RBS Securities Japan Limited Agrees to Plead Guilty in Connection with Long-Running Manipulation of Libor Benchmark Interest Rates*, DEP’T OF JUSTICE (Feb. 6, 2013), <http://www.justice.gov/opa/pr/2013/February/13-crm-161.html>.

56. TREASURY COMMITTEE, ORAL EVIDENCE TAKEN FROM BOB DIAMOND, 2012-13, H.C. 481-i (U.K.), [http://www.parliament.uk/documents/commons-committees/treasury/Treasury\\_Committee\\_04\\_July\\_12\\_Bob\\_Diamond.pdf](http://www.parliament.uk/documents/commons-committees/treasury/Treasury_Committee_04_July_12_Bob_Diamond.pdf).

57. Appendix A of Non-Prosecution Agreement Between the U.S. Dep’t of Justice and Barclays Bank PLC, at § 23 (June 26, 2012), available at <http://www.justice.gov/iso/opa/resources/9312012710173426365941.pdf> [hereinafter Appendix A of Non-Prosecution Agreement]; Media

Emails and other records show that this occurred frequently from 2005 to 2007 and occasionally until 2009.<sup>58</sup> The then-CEO Robert Diamond has called the traders' actions "reprehensible" and maintained in a statement prepared for a British parliamentary committee that no one "above desk supervisor level" knew about it until the settlement was reached.<sup>59</sup>

At the institutional level, Barclays wanted to boost market confidence in the bank's stability during the global financial crisis.<sup>60</sup> In 2007, Barclays became aware that they were submitting higher estimates for LIBOR than other panel banks.<sup>61</sup> Relative to other banks, which were still submitting lower rates, Barclays looked at risk,<sup>62</sup> a fact that the media emphasized.<sup>63</sup> On August 31, 2007, Barclays had notified the British Bankers Association that borrowing pounds for three months would cost it 6.8% more than any other bank on the panel and a full eleven basis points above the official August 31 fix.<sup>64</sup> On October 29, 2008, a telephone conversation occurred "between a senior individual at Barclays and the Bank of England during which the external perceptions of Barclays' LIBOR submissions were discussed."<sup>65</sup> These individuals were later disclosed to be Robert Diamond and Paul Tucker, the current deputy governor of the Bank of England who served as the executive director

---

Release, U.S. Dep't of Justice, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay \$160 Million Penalty (June 27, 2012), available at <http://www.justice.gov/opa/pr/2012/June/12-crm-815.html>.

58. Cora Currier, *Beyond Barclays: Laying out the Libor Investigation*, PROPUBLICA (July 6, 2012), <http://www.propublica.org/article/beyond-barclays-laying-out-the-libor-investigations>; Matt Scuffman, *Diamond Admits Reprehensible Behavior at Barclays*, REUTERS (July 5, 2012), <http://in.reuters.com/article/2012/07/04/barclays-bob-diamond-idINDEE8630CD20120704>; *Supplementary Information Regarding Barclays' Settlement with the Authorities in Respect of their Investigations into the Submission of Various Interbank Offered Rates*, WALL ST. J. (July 3, 2012), <http://online.wsj.com/public/resources/documents/3-July---Treasury-Select-Committee-Written-submission.pdf>.

59. Scuffman, *supra* note 58; see also Janet Paskin, 'Who's Going to Put My Low Fixings In?' – Highlights from the Barclays Emails, WALL ST. J. (June 27, 2012, 1:29 PM), <http://blogs.wsj.com/deals/2012/06/27/whos-going-to-put-my-low-fixings-in-highlights-from-the-barclays-emails>.

60. Appendix A of Non-Prosecution Agreement, *supra* note 57, at app. A, §§ 35–36.

61. *Id.* at §§ 37–40.

62. *Id.* at § 35.

63. See Mark Gilbert, *Barclays Takes a Money-Market Beating*, BLOOMBERG (Sept. 3, 2007), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8uEKKBY7As>.

64. *Id.*

65. TREASURY COMMITTEE, FIXING LIBOR: SOME PRELIMINARY FINDINGS, 2012-13, H.C. 481-I, 43 (U.K.), available at [http://www.parliament.uk/documents/commons-committees/treasury/Fixing%20LIBOR\\_%20some%20preliminary%20findings%20-%20VOL%20I.pdf](http://www.parliament.uk/documents/commons-committees/treasury/Fixing%20LIBOR_%20some%20preliminary%20findings%20-%20VOL%20I.pdf).

of markets at the time of the conversation.<sup>66</sup> In response, Barclays management issued a directive<sup>67</sup> that Barclays should not be an “outlier” and that submitters should lower their estimates to bring Barclays “within the pack.”<sup>68</sup> While this reaction strongly suggests that the idea of regulatory forbearance was at the heart of the misunderstanding between Barclays and the Bank of England, the Final Notice of the Financial Services Authority (FSA) stated that “no instruction for Barclays to lower its LIBOR submissions was given during this telephone conversation” and that “a misunderstanding or miscommunication occurred.”<sup>69</sup> A parliamentary investigation was more skeptical, noting in its report that “[i]t remains possible that the entire Tucker-Diamond dialogue may have been a smokescreen put up to distract our attention and that of outside commentators from the most serious issues underlying this scandal.”<sup>70</sup>

The LIBOR-rigging cartel was initially exposed on May 29, 2008. On that day, the *Wall Street Journal* reported that some banks might have understated borrowing costs in reports for LIBOR during the 2008 credit crunch, and this may have misrepresented their financial stability.<sup>71</sup> But the British Bankers Association claimed that LIBOR continued to be reliable, noting that “the financial crisis has caused many indicators to act in unusual ways.”<sup>72</sup> Similarly, the Bank for International Settlements stated that “available data do not support the hypothesis that contributor banks manipulated their quotes to profit from positions based on fixings.”<sup>73</sup> And the International Monetary Fund found that “[a]lthough the integrity of the U.S. dollar LIBOR fixing process has been questioned by some market participants and the financial press, it appears that U.S. dollar LIBOR remains an accurate measure of a typical creditworthy bank’s marginal cost of unsecured U.S. dollar term funding.”<sup>74</sup>

But documents released by the New York Federal Reserve and the Bank of England from 2008 show that they were acutely aware that banks were disingenuous at best about their borrowing costs when setting

---

66. *Id.* at 44–45.

67. *Id.*

68. *Id.* at 44.

69. *Id.* at 43.

70. *Id.* at 57.

71. Carrick Mollenkamp & Mark Whitehouse, *Study Casts Doubt on Key Rate*, WALL ST. J. (May 29, 2008), <http://online.wsj.com/article/SB121200703762027135.html>.

72. *Id.*

73. Jacob Gyntelberg & Philip Wooldridge, *Interbank Rate Fixings During the Recent Turmoil*, BIS Q. REV., Mar. 2008, at 70, [http://www.bis.org/publ/qtrpdf/r\\_qt0803g.pdf](http://www.bis.org/publ/qtrpdf/r_qt0803g.pdf).

74. *Global Financial Stability Report*, INT’L MONETARY FUND 76 (Oct. 2008), <http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf>.

LIBOR and chose to take no action against them.<sup>75</sup> In a telephone transcript, dated April 11, 2008, between a Barclays employee and an agent from the New York Federal Reserve, the Barclays employee stated, “[W]e know that we’re not posting . . . an honest LIBOR . . . and yet . . . we are doing it, because . . . if we didn’t do it . . . it draws . . . unwanted attention on ourselves.”<sup>76</sup> In response, the New York Federal Reserve agent acknowledged, “You have to accept it. I understand. . . . Despite it’s against what you would like to do. . . . I understand completely.”<sup>77</sup> Similarly, the Bank of England and its deputy governor, Paul Tucker, were aware as early as November 2007 of industry concerns that the LIBOR rate was being set below market rates.<sup>78</sup> Minutes to a meeting of the Bank of England Sterling Money Markets Liaison Group note that “[s]everal group members thought that Libor fixings had been lower than actual traded interbank rates through the period of stress.”<sup>79</sup>

In March 2011, the media reported that U.S. regulators, including the Department of Justice (DOJ), Securities Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC), were focusing on Bank of America, Citigroup, and UBS AG in their probe of LIBOR manipulation.<sup>80</sup> And by February 2012, the DOJ had commenced a criminal investigation.<sup>81</sup> On June 27, 2012, Barclays admitted and accepted responsibility for its misconduct set forth in a statement of facts incorporated into the agreement and paid a \$454 million regulatory fine to settle the case—\$200 million to the CFTC, \$160 million to the DOJ, and the remainder to the FSA.<sup>82</sup> As a nonprosecution agreement, the settlement did not pass through the federal court for approval of the terms, and DOJ has the power to enforce or proceed should it believe there is a

---

75. Mark Gongloff, *New York Fed's Libor Documents Reveal Cozy Relationship Between Regulators, Banks*, HUFFINGTON POST (July 13, 2012), [http://www.huffingtonpost.com/2012/07/13/new-york-fed-libor-documents-\\_n\\_1671524.html](http://www.huffingtonpost.com/2012/07/13/new-york-fed-libor-documents-_n_1671524.html).

76. Unofficial Transcript Between Barclays Bank and New York Federal Reserve Bank 6 (Apr. 11, 2008), [http://www.newyorkfed.org/newsevents/news/markets/2012/libor/April\\_11\\_2008\\_transcript.pdf](http://www.newyorkfed.org/newsevents/news/markets/2012/libor/April_11_2008_transcript.pdf).

77. *Id.* at 14.

78. Sterling Money Mkts. Liaison Grp., Bank of Eng., Minutes of Meeting 3–4 (Nov. 15, 2007), <http://www.bankofengland.co.uk/markets/Documents/money/mmlgnov07.pdf>.

79. *Id.* at 3.

80. David Enrich & Carrick Mollenkamp, *Banks Probed in Libor Manipulation Case*, WALL ST. J. (Mar. 16, 2011), <http://online.wsj.com/article/SB10001424052748704662604576202400722598060.html>; David Enrich, Carrick Mollenkamp & Jean Eaglesham, *U.S. Libor Probe Includes BofA, Citi, UBS*, WALL ST. J. (Mar. 18, 2011), <http://online.wsj.com/article/SB10001424052748703818204576205991698548286.html>.

81. Carrick Mollenkamp, *Exclusive: US Conducting Criminal Libor Probe*, REUTERS (Feb. 28, 2012), <http://www.reuters.com/article/2012/02/28/us-libor-probe-idUSTRE81R1ZG20120228>.

82. Press Release, U.S. Dep’t of Justice *supra* note 44.

violation of the agreement.<sup>83</sup> However, the “regulatory fine is just the beginning for Barclays, which is a defendant in some of the twenty-four interrelated Libor lawsuits aggregated” before a Manhattan federal court.<sup>84</sup> U.S. liabilities may be higher because U.S. plaintiffs are permitted to request punitive damages, while U.K. plaintiffs are limited to compensatory awards.<sup>85</sup> “Criminal liability could be added to those regulatory fines and civil lawsuits.”<sup>86</sup> Further, the Barclays settlement is just the first in the joint transatlantic investigation. On August 3, 2012, the Royal Bank of Scotland confirmed that it had retrenched staff in relation to the LIBOR scandal, with Chief Executive Stephen Hester stating that it “is a stark reminder of the damage that individual wrongdoing and inadequate systems and controls can have in terms of financial and reputational impact.”<sup>87</sup> On August 15, 2012, Bloomberg reported that subpoenas had been sent to JPMorgan, Deutsche Bank, Royal Bank of Scotland Group, HSBC, Citigroup, and UBS,<sup>88</sup> all of which are being investigated with respect to LIBOR manipulation. On December 19, 2012, UBS accepted a nonprosecution agreement and fines of \$1.5 billion to resolve its liability, while on February 6, 2013, RBS agreed to a deferred prosecution. In both cases, the banks accepted a criminal guilt plea from subsidiaries operating in Japan.

While the method by which LIBOR is set largely contributed to this widespread collusion, it could not have persisted without negligent oversight and regulators’ failure to enforce. In the aftermath of the scandal, the New York Federal Reserve has played defense, stating that although in 2008 it was aware of the structural flaws in setting LIBOR, it lacked the jurisdictional power<sup>89</sup> to effect any meaningful change other than providing written recommendations to the Bank of England.<sup>90</sup> But the limits of jurisdictional authority have rarely been an issue for U.S. regu-

---

83. Non-Prosecution Agreement Between the U.S. Dep’t of Justice and Barclays Bank PLC (June 26, 2012), available at <http://www.justice.gov/iso/opa/resources/337201271017335469822.pdf> [hereinafter Non-Prosecution Agreement]

84. Andrew Harris, Christine Harper & Lindsay Fortado, *Wall Street Bank Investors in Dark on Libor Liability*, BLOOMBERG (July 5, 2012), <http://www.bloomberg.com/news/2012-07-05/wall-street-bank-investors-in-dark-on-libor-liability.html>.

85. *Id.*

86. *Id.*

87. Steve Slater, *RBS Confirms It Sacked Staff over Libor Rigging Scandal*, REUTERS (Aug. 3, 2012), [http://www.banktech.com/regulation-compliance/240004922?itc=edit\\_in\\_body\\_cross\\_artend](http://www.banktech.com/regulation-compliance/240004922?itc=edit_in_body_cross_artend).

88. McLaughlin, *supra* note 43.

89. Shahien Nasiripour, *Fed ‘Lacked Jurisdiction’ on Libor*, FIN. TIMES (July 17, 2012), <http://www.ft.com/intl/cms/s/0/3245bb4c-cf91-11e1-a1d2-00144feabdc0.html#axzz23fCRg8F5>.

90. Timothy Geithner, *Libor Email from Timothy Geithner to Bank of England*, GUARDIAN (June 1, 2008), <http://www.guardian.co.uk/business/interactive/2012/jul/13/libor-email-timothy-geithner-bank-england>.

lators when national interest issues have been privileged in the past, and it is far from clear that this state of affairs has changed.<sup>91</sup> For its part, the Bank of England claimed that the recommendations lacked the granularity to either start an investigation or set off alarm bells.<sup>92</sup> The tortured justifications provided at corporate and regulatory levels, while self-serving and deeply problematic, could also equally apply to regulators in the United States who are faced with equally serious questions of competence.

In the United Kingdom alone, the LIBOR scandal has had a deep impact on regulatory authority. The Treasury Select Committee stated in its report that it was “concerned that the FSA was two years behind the U.S. regulatory authorities in initiating its formal LIBOR investigations and that this delay has contributed to the perceived weakness of London in regulating financial markets.”<sup>93</sup> The strongly worded report noted that “the standards and culture of Barclays, and banking more widely, are in a poor state. Urgent reform, by both regulators and banks, is needed to prevent such misconduct flourishing.”<sup>94</sup> The committee provided a devastating critique of past, current, and future trajectories. It accused the FSA of privileging a myopic approach that blinded it to the initial and ongoing systemic failure of compliance at Barclays<sup>95</sup>: “[T]he FSA has concentrated too much on ensuring narrow rule-based compliance, often leading to the collection of data of little value and to box ticking, and too little on making judgments about what will cause serious problems for consumers and the financial system.”<sup>96</sup>

In sharp contrast to the claims of sophistication and prudence that informed discussions of the risk-based approach of the British regulatory system prior to the Global Financial Crisis, the Treasury Select Committee now finds that “naivety” and inaction underscored “the dysfunctional

---

91. For example, U.S. regulators have continually pushed the jurisdictional limits of the Foreign Corrupt Practices Act. In the 2011 case of JGC Corporation, for example, unlike most corporate defendants in FCPA enforcement actions, JGC was neither a domestic concern nor an issuer, and was not alleged to have been the agent of a domestic concern or issuer. Instead, they based JGC’s FCPA liability upon two theories: (1) conspiring to execute the bribery scheme with other partners in TSKJ, who were either domestic concerns or issuers; and (2) aiding and abetting a domestic concern in the bribery scheme. See Press Release, U.S. Dep’t of Justice, JGC Corporation Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay a \$218.8 Million Criminal Penalty (Apr. 6, 2011), available at <http://www.justice.gov/opa/pr/2011/April/11-crm-431.html>.

92. See Ben Protess & Mark Scott, *British Libor Documents Show Timid Regulators*, N.Y. TIMES DEALBOOK (July 20, 2012), <http://dealbook.nytimes.com/2012/07/20/british-libor-documents-show-timid-regulators/>.

93. TREASURY COMMITTEE, *supra* note 65.

94. *Id.* at 19.

95. *Id.*

96. *Id.* at 87.

relationship between the Bank of England and the FSA which existed at that time to the detriment of the public interest.”<sup>97</sup> It would appear from the trenchant views expressed by the Treasury Select Committee that not much has changed. The erroneous calculation by the bank, the FSA, and the Bank of England was that early cooperation would pay dividends. The settlement did not place the blame on any individual executive, nor was there initially any expectation from the regulatory authorities in the United Kingdom or the United States that resignations were required or appropriate.<sup>98</sup> Each was taken aback by the ferocity of political criticism of the deal and the perceived lack of accountability for infractions that point to widespread collusion. The chairman of the FSA, Lord Adair Turner, belatedly acknowledged this lack of accountability and claimed that the activities of Barclays revealed “a degree of cynicism and greed which is really quite shocking . . . and that does suggest that there are some very wide cultural issues that need to be strongly addressed.”<sup>99</sup>

The media firestorm that followed led to the forced resignation of both the chairman and chief executive officer of Barclays. It also led regulatory authorities in the United Kingdom to release a discussion paper, the *Wheatley Review*, which outlined proposed changes to the governance of LIBOR in an effort to recapture lost authority.<sup>100</sup> Three conflating and conflicting dynamics informed the *Wheatley Review*.<sup>101</sup> The paper was diplomatic about past regulatory failure, blaming the lack of external supervision on an incomplete mandate. It was forceful in detailing the past and continuing risk of manipulation by market actors, and it was exceptionally defensive about the need to safeguard London’s centrality in establishing global benchmarks. But in none of these areas did the paper offer either tangible evidence of how the proposed reforms would provide warranted confidence in the integrity of the LIBOR benchmark or thought leadership in the design of a potential successor. Acknowledging that “at least some serious misconduct”<sup>102</sup> has occurred, the review bluntly stated that “[r]etaining LIBOR unchanged in its current state is not a viable option.”<sup>103</sup> It proposed two parallel strate-

---

97. *Id.* at 107.

98. See Non-Prosecution Agreement, *supra* note 83.

99. Patrick Jenkins, John Gapper & Brooke Masters, *The Gathering Storm: Flaws in Banking Fuel the Case for Structural and Cultural Reform*, FIN. TIMES (June 29, 2012), <http://www.ft.com/intl/cms/s/0/26d8a33c-c1e0-11e1-8e7c-00144feabdc0.html>.

100. *Wheatley Review of Libor: Initial Discussion Paper* (Aug. 16, 2012), [http://www.hm-treasury.gov.uk/d/condoc\\_wheatley\\_review.pdf](http://www.hm-treasury.gov.uk/d/condoc_wheatley_review.pdf).

101. *Id.*

102. *Id.* at 3.

103. *Id.*



gies: strengthening the structural weaknesses, and identifying and evaluating alternative benchmarks.<sup>104</sup> Both are unconvincing and unlikely to induce any practical effect.

The review limits intervention in the former while maintaining a veto on the implementation of the latter. Further, the review canvasses the merits of insulating the LIBOR submission process from trading desks by housing it within the risk-management function, enhancing accountability by making named individual staff with requisite seniority responsible for managing compliance, and establishing overarching codes of conduct.<sup>105</sup> At no stage does it address the structural weakness of risk management within the sector and the responsibility of the regulator to ensure in the exercise of its supervisory powers that these are addressed.

### C. HSBC Holdings PLC

The inability of HSBC to oversee how its affiliates were operating in critical markets became apparent on July 17, 2012, when the U.S. Senate Permanent Subcommittee on Investigations released a 340-page report<sup>106</sup> that showed how these failures had left the bank vulnerable to significant financial and reputational penalties. The report, which accuses HSBC of failing to prevent billions of dollars worth of money transfers linked to drug cartels and terrorist groups, dates back to 2001.<sup>107</sup> It suggests that the bank created an operation that was “a systemically flawed sham paper-product designed solely to make it appear that the Bank has complied”<sup>108</sup> with the Bank Secrecy Act<sup>109</sup> and other anti-money laundering (AML) laws, such as the Foreign Corrupt Practices Act.<sup>110</sup> In particu-

---

104. *Id.* at 4.

105. *Id.*

106. S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., U.S. VULNERABILITIES TO MONEY LAUNDERING, DRUGS AND TERRORIST FINANCING: HSBC CASE HISTORY (July 17, 2012), available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> (examining HSBC as a case study).

107. *Id.* at 1.

108. Carrick Mollenkamp, Brett Wolf & Brian Grow, *Special Report: Documents Allege HSBC Money-Laundering Lapses*, REUTERS (May 3, 2012), <http://www.reuters.com/article/2012/05/03/us-hsbcusa-probes-idUSBRE8420FX20120503>.

109. 31 U.S.C. § 5311 (2001).

110. 15 U.S.C. § 78dd-1 (1998).

lar, the report finds that between 2007 and 2008 HSBC's Mexican operations moved \$7 billion into the bank's U.S. operations.<sup>111</sup>

Both Mexican and U.S. authorities issued warnings to HSBC that such an amount of money could only be reached if linked to narcotics trades.<sup>112</sup> HSBC, it is claimed, also knowingly and willingly circumvented government safeguards designed to block terrorist funding, allowing, for example, affiliates to shield the fact that thousands of transactions involved links to Iran.<sup>113</sup> An independent audit paid for by HSBC found the bank facilitated 25,000 questionable transactions with Iran between 2001 and 2007.<sup>114</sup> The report also detailed that HSBC "worked extensively with Saudi Arabia's Al Rajhi Bank, some owners of which have been linked to terrorism financing."<sup>115</sup> HSBC's U.S. affiliate "supplied Al Rajhi with nearly \$1 billion worth of U.S. banknotes up to 2010," and "worked with two banks in Bangladesh . . . linked to terrorism financing."<sup>116</sup>

HSBC executives admitted as much at Senate hearings, where HSBC confessed to years of failure to comply with rules to prevent money laundering.<sup>117</sup> Mr. David Bagley, who had been HSBC head of group compliance since 2002, said that

despite the best efforts and intentions of many dedicated professionals, HSBC has fallen short of our own expectations and the expectations of our regulators. . . . I recommended to the group that now is the appropriate time for me and for the bank, for someone new to serve as the head of group compliance.<sup>118</sup>

As eloquently summarized by Mr. William J. Ihlenfeld II, U.S. Attorney for the Northern District of West Virginia, in a letter to officials at the DOJ, "HSBC is to Riggs, as a nuclear waste dump is to a municipal land fill."<sup>119</sup>

---

111. S. PERMANENT SUBCOMM. ON INVESTIGATIONS, *supra* note 106. For extended analysis of the HSBC scandal, see Justin O'Brien, *Who Controls HSBC in the Aftermath of its Deferred Prosecution Agreement with the United States Department of Justice*, 63 N. IR. LEGAL Q. 533 (2012).

112. *Id.*

113. Mollenkamp, Wolf & Grow, *supra* note 108.

114. S. PERMANENT SUBCOMM. ON INVESTIGATIONS, *supra* note 106.

115. James O'Toole, *HSBC Lax in Preventing Money Laundering by Cartels, Terrorists*, CNNMONEY (July 17, 2012), <http://money.cnn.com/2012/07/16/news/companies/hsbc-money-laundering/index.htm>.

116. *Id.*

117. Jon Li, *HSBC Money Laundering: David Bagley Resigns, Senator Grills Christopher Lok*, THE FIN. PAGES (July 18, 2012), <http://www.thefinancepages.co.uk/companies/hsbc-david-bagley-resigns/01713>.

118. *Id.*

119. Mollenkamp, Wolf & Grow, *supra* note 108.

Mexico's National Banking and Securities Commission (CNBV) levied a \$27.5 million fine against HSBC a week after the Senate report, the largest-ever handed out to a bank by the CNBV.<sup>120</sup> The CNBV "censured HSBC for noncompliance with anti-money laundering systems and controls as well as its late reporting of 1,729 unusual transactions, failing to report [thirty-nine] unusual transactions, and [twenty-one] administrative failures."<sup>121</sup> HSBC set aside \$700 million to cover the potential fines, settlements, and other expenses related to the AML inquiry in the United States, a gross underestimation of the final payout,<sup>122</sup> however, it has to date made no provision for potential fines or regulatory settlements related to the global investigation into the manipulation of LIBOR.<sup>123</sup>

The findings of the U.S. Senate Permanent Subcommittee on Investigations were foreshadowed in April 2003, when the Federal Reserve Bank of New York and New York state bank regulators issued warnings with regard to "suspicious money flows"<sup>124</sup> at the bank. A federal prosecutor was hired to oversee and install AML efforts at HSBC.<sup>125</sup> Nearly a decade later, the Senate Report suggests that HSBC's efforts failed.<sup>126</sup> The report lists how HSBC repeatedly put the pursuit of profit ahead of substantive compliance with AML provisions.<sup>127</sup> Critically, the report faults HSBC's regulator, the Office of the Comptroller of the Currency (OCC), for "systemic failures"<sup>128</sup> in the face of evidence of risky banking and accuses it of letting the problem "fester for years."<sup>129</sup>

The global failure of compliance and oversight suggests deep structural problems with HSBC's core business model. Providing local businesses with a global imprimatur has been shown to be an exceptionally

---

120. Dave Graham, *HSBC Mexico Chief Says Fine Concludes Money-Laundering Probe*, REUTERS (July 26, 2012), <http://www.reuters.com/article/2012/07/26/us-hsbc-mexico-idUSBR E86P0XM20120726>.

121. *Id.*

122. Neil Gough, *HSBC Sets Aside \$2 Billion for Legal Woes as Profit Falls*, N.Y. TIMES DEALBOOK (July 30, 2012), <http://dealbook.nytimes.com/2012/07/30/hsbc-sets-aside-2-billion-for-legal-woes-as-profit-falls/>. The Mexican operation alone cost HSBC \$1.92 billion. See O'Brien, *supra* note 111.

123. *Id.*

124. Mollenkamp, Wolf & Grow, *supra* note 108.

124. *Id.*

125. *Id.*

126. S. PERMANENT SUBCOMM. ON INVESTIGATIONS, *supra* note 106.

127. See generally, *id.*

128. Evan Perez & C.M. Matthews, *HSBC's Compliance Chief to Step Down*, WALL ST. J. (July 18, 2012), <http://online.wsj.com/article/SB10001424052702303754904577532633575159476.html>.

129. Mollenkamp, Wolf & Grow, *supra* note 108.

dangerous strategy for both the bank and, through a failure of enforcement, its regulator, the OCC, which is effectively accused of contributing to a national security failure.<sup>130</sup> Senator Carl Levin, Chairman of the Senate Permanent Subcommittee on Investigations, argued that “HSBC used its U.S. bank as a gateway into the U.S. financial system for some HSBC affiliates around the world to provide U.S. dollar services to clients while playing fast and loose with U.S. banking rules,” and the OCC tolerated this situation.<sup>131</sup>

Indeed, the OCC did not take a single enforcement action despite being aware of “multiple severe AML deficiencies, including a failure to monitor \$60 trillion in wire transfer and account activity; a backlog of 17,000 unreviewed account alerts regarding potentially suspicious activity; and a failure to conduct AML due diligence before opening accounts for HSBC affiliates.”<sup>132</sup> Senator Levin’s investigation was to provide cover for an investigation that has perhaps even more serious implications for the governance of financial markets.

#### *D. Standard Chartered PLC*

On August 6, 2012, the New York State Department of Financial Services (DFS) accused Standard Chartered, one of the few banks to come through the global financial crisis with its reputation intact, of leaving the U.S. financial system “vulnerable to terrorists, weapons dealers, drug kingpins and corrupt regimes,”<sup>133</sup> primarily through its dealings with Iranian banks. According to the DFS, from 2001 through to 2010, Standard Chartered helped facilitate U.S. dollar transactions worth \$250 billion on behalf of Iranian clients, “which generated hundreds of millions of dollars in fees”<sup>134</sup> for the bank.<sup>135</sup> Its investigation is based on what is claimed to be an examination of “more than 30,000 pages of documents, including internal SCB emails that describe willful and egregious violations of law.”<sup>136</sup> The phrasing raises a series of unanswered questions that call into question the manner in which the investigation

---

130. See, e.g., Media Release, S. Permanent Subcomm. on Investigations, HSBC Exposed U.S. Financial System to Money Laundering, Drug, Terrorist, Financing Risks (July 16, 2012), available at <http://www.hsgac.senate.gov/subcommittees/investigations/media/hsbc-exposed-us-financial-system-to-money-laundering-drug-terrorist-financing-risks>.

131. *Id.*

132. *Id.*

133. Order Pursuant to Banking Law § 39, Standard Chartered Bank 1 (N.Y. Dep’t of Fin. Servs. Aug. 6, 2012), available at <http://www.dfs.ny.gov/banking/ea120806.pdf>.

134. *Id.*

135. *Id.*

136. *Id.*

and its presentation has been handled. The order prompted a rigorous public response from Standard Chartered.<sup>137</sup> In a statement, the London-headquartered bank said it “strongly rejects the position or the portrayal of the facts as set out in the order issued by the DFS.”<sup>138</sup> Standard Chartered pointed to the historical nature of the claims and the fact that, at the time, none of the account holders was designated “a terrorist entity or organization.”<sup>139</sup>

This case presents a departure from regulatory strategy in earlier cases because the DFS in this case probed Standard Chartered on its own, drawing sharp criticism and accusations from other financial regulators that it had acted outside the scope of its authority.<sup>140</sup> The FSA claims that it was notified just ninety minutes before the DFS announced the allegations, breaching long-standing protocol among bank regulators.<sup>141</sup> Standard Chartered formed the same view. It asserted, “Resolution of such matters normally proceeds through a coordinated approach by such agencies. The Group was therefore surprised to receive the order from the DFS, given that discussions with the agencies were ongoing. We intend to discuss these matters with the DFS and to contest their position.”<sup>142</sup> The effect was to reduce the legitimacy of the claim and to imply that the DFS was an outlier. Left unstated but strongly implied was whether political gamesmanship colored both the nature of the narrative and the overarching claim.

This was a high-risk strategy given the capacity of the state government to revoke a license without reference to federal authorities. Eight days after the DFS threatened to revoke its New York state license, and one day before it was scheduled to appear at a hearing on the matter,

---

137. Press Release, Standard Chartered Bank PLC, Standard Chartered PLC Strongly Rejects the Position and Portrayal of Facts Made by the New York State Department of Financial Services (Aug. 6, 2012), available at <http://www.standardchartered.com/en/news-and-media/news/global/2012-08-06-response-to-NY-State-Department-comments.html>.

138. *Id.*

139. *Id.*

140. See, e.g., Mark Gongloff, ‘Rogue’ New York Regulator Benjamin Lawsky Sets Feds Scrambling in Standard Chartered Laundering Case, HUFFINGTON POST (Aug. 10, 2012), [http://www.huffingtonpost.com/mark-gongloff/benjamin-lawsky-standard-chartered-laundering\\_b\\_1765479.html](http://www.huffingtonpost.com/mark-gongloff/benjamin-lawsky-standard-chartered-laundering_b_1765479.html); Nils Pratley, Standard Chartered: Rogue Bank or Victim of Renegade Regulator?, GUARDIAN (Aug. 7, 2012) <http://www.guardian.co.uk/business/2012/aug/07/standard-chartered-rogue-bank-or-victim>.

141. Liz Rappaport, David Enrich, & Victoria McGrane, Bank Deal Rankles Regulators, WALL ST. J. (Aug. 15, 2012), [http://online.wsj.com/article/SB10000872396390444233104577591703856468-594.html?mod=WSJ\\_hpp\\_LEFTTopStories](http://online.wsj.com/article/SB10000872396390444233104577591703856468-594.html?mod=WSJ_hpp_LEFTTopStories).

142. Press Release, Standard Chartered Bank PLC, *supra* note 137.

Standard Chartered agreed to settle the matter.<sup>143</sup> While Standard Chartered initially responded that under \$14 million of the \$250 billion in transactions actually violated sanctions,<sup>144</sup> under the terms of the settlement it agreed that the “conduct at issue” involved \$250 billion.<sup>145</sup>

Under the terms of the agreement, Standard Chartered agreed to pay a fine of \$340 million, believed to be the largest ever for an individual regulator in an AML case.<sup>146</sup> It also acquiesced to the demand to permanently install appropriately credentialed staff to oversee and audit offshore money laundering due diligence and monitoring.<sup>147</sup> More significantly, the bank agreed to the appointment of an external monitor to be vetted by the DFS.<sup>148</sup> The monitor will have responsibility for ensuring ongoing compliance with AML controls and will report directly to the DFS.<sup>149</sup> In addition, the DFS has been given authority to place examiners on site within the bank.<sup>150</sup> Following the announcement, New York Governor Andrew Cuomo released a short statement that reignited questions of regulatory capacity.<sup>151</sup> The settlement, he proclaimed, demonstrated the value of a tough and fair regulator for the banking and insurance industries.<sup>152</sup> “This state and nation are still paying the price for a failed regulatory system and that must not happen again. This result demonstrates the effectiveness and leadership of the new Department of Financial Services, and I commend the state legislature for creating a modern regulator for today’s financial marketplace.”<sup>153</sup>

The settlement also received backing from Senator Carl Levin (D-Mich.), the influential chair of the Senate Subcommittee on Investigations who handed down the damning report relating details of HSBC’s

---

143. Press Release, N.Y. Dep’t of Fin. Servs., Statement from Benjamin M. Lawskey, Superintendent of Financial Services, Regarding Standard Chartered Bank (Aug. 14, 2012), available at <http://www.dfs.ny.gov/about/press/pr1208141.htm>.

144. Press Release, Standard Chartered Bank PLC, *supra* note 137.

145. See *supra* text accompanying note 143.

146. Liz Rappaport, *Bank Settles Iran Money Case*, WALL ST. J. (Aug. 15, 2012), <http://online.wsj.com/article/SB10000872396390444318104577589380427559426.html>.

147. Consent Order Under N.Y. Banking Law § 44, Standard Chartered Bank 1 (N.Y. State Dep’t of Fin. Servs. Aug. 6, 2012).

148. *Id.*

149. *Id.*

150. *Id.*

151. *Statement from Governor Andrew M. Cuomo on Settlement Between New York State and Standard Chartered*, GOVERNOR ANDREW M. CUOMO (Aug. 14, 2012), <http://www.governor.ny.gov/press/08142012-settlement-nys-standard-chartered>.

152. *Id.*

153. *Id.*

failure to install effective anti-money laundering controls.<sup>154</sup> Senator Levin argued that the Department of Financial Services

showed that holding a bank accountable for past misconduct doesn't need to take years of negotiation over the size of the penalty; it simply requires a regulator with backbone to act. New York's regulatory action sends a strong message that the United States will not tolerate foreign banks giving rogue nations like Iran hidden access to the U.S. financial system.<sup>155</sup>

The success of the DFS in pursuing a case without the assistance of the DOJ or the U.S. Treasury Department is likely to embolden other states' attorneys general, while adding pressure on federal regulators who have been criticized for a perceived lack of failure to confront large banks.<sup>156</sup>

### III. THE COMMON LINK

#### A. *The Failure to Act*

The JPMorgan and HSBC examples demonstrate the significant challenges that global reach poses to effective oversight. HSBC's problems were magnified precisely because it privileged an affiliate, essentially franchise-based model. It is a business model that HSBC has now begun to overhaul.<sup>157</sup> "While our old model served us well historically, it does not work in an interconnected world where transactions cross borders instantaneously and where weaknesses in one jurisdiction can be quickly exported to others,"<sup>158</sup> observed HSBC's Stuart Levey in testimony to Congress. He pointed out that

better global integration makes us better situated today to manage our risk on a global basis, better able to see where risk in one part of HSBC may impact another part, and better able for the first time to ensure that consistent compliance standards and practices are implemented across all of our affiliates.<sup>159</sup>

---

154. Senator Carl Levin, *Levin Statement on Standard Chartered Bank Settlement* (Aug. 15, 2012), <http://www.levin.senate.gov/newsroom/press/release/levin-statement-on-standard-chartered-bank-settlement>.

155. *Id.*

156. Rappaport, Enrich & McGrane, *supra* note 141.

157. *Hearing Before the S. Permanent Subcomm. on Investigations: U.S. Vulnerabilities to Money Laundering, Drugs and Terrorist Financing: HSBC Case History* (July 17, 2012) (written testimony of David Bagley, Head of Grp. Compliance at HSBC Holdings PLC); *id.* (written testimony of Stuart Levey, Chief Legal Officer of HSBC Holdings PLC).

158. *Id.* (written testimony of Stuart Levey, Chief Legal Officer of HSBC Holdings PLC).

159. *Id.*

It is a laudable vision but one that cannot be vouchsafed without external review and validation. All too often, banks have made empty promises at congressional hearings before going on to commit further violations, with monetary fines written off as the cost of doing business.<sup>160</sup> In part, HSBC's apparent conversion can be traced to narrow self-interest. Senator Levin warned that regulators must consider the ultimate sanction of bank charter revocation in the United States if banks fail to internally police deviance.<sup>161</sup> The HSBC response reflects an awareness of custodial and gatekeeping obligations, which offer a potential model to transform corporate practice if monitored effectively.

It is precisely for this reason that the intervention of the DFS has the potential to reshape the contours of financial regulation. Despite the lack of commentary from either the White House or federal executive agencies, the Standard Chartered investigation—and the manner in which it was handled—is certain to reignite the festering feud over how to regulate finance. Except for the physical bloodshed, the power struggle for control of banking regulation and the difficulty of changing its culture finds remarkable parallels in *Macbeth*, the classic Shakespearean tale of political infighting. Like Banquo's ghost, the specter of Eliot Spitzer and his battles with federal counterparts over the purpose of regulation looms large.

The conflict between state and federal authority over how to regulate finance has deep and complex roots. It traces back to the tenure of Spitzer as State Attorney General (SAG), where he prosecuted cases traditionally deferred to federal authorities, including civil actions and criminal prosecutions relating to white-collar crime, securities fraud, internet fraud, and environmental protection.<sup>162</sup> Spitzer's power derived from the Martin Act of 1921, which permits the New York Attorney General to subpoena witnesses and company documents pertaining to investigations of fraud or illegal activity by a corporation. Spitzer used this statute to allow his office to prosecute cases that have been described as within federal jurisdiction.<sup>163</sup>

The Supreme Court last adjudicated the issue of how to resolve this conflict in 2009 in a case that owes its origins to Spitzer's questionable

---

160. See, e.g., Mark Squillace, *Innovative Enforcement Mechanisms in the United States*, AUSTRALIAN INST. OF CRIMINOLOGY, [http://www.aic.gov.au/media\\_library/publications/proceedings/26/squill.pdf](http://www.aic.gov.au/media_library/publications/proceedings/26/squill.pdf) (last visited Oct. 16, 2012).

161. S. PERMANENT SUBCOMM. ON INVESTIGATIONS, *supra* note 106.

162. See, e.g., Rebecca Leung, *The Sheriff of Wall Street*, CBS (Feb. 11, 2009), <http://www.cbsnews.com/stories/2003/05/23/60minutes/main555310.shtml>.

163. *Id.*; see, e.g., Jake Zamansky, *Calling the Ghost of Eliot Spitzer*, FORBES (Oct. 12, 2012), <http://www.forbes.com/sites/jakezamansky/2012/10/12/calling-the-ghost-of-eliot-spitzer/>.



use of executive authority, *Cuomo v. Clearing House Ass'n*.<sup>164</sup> In *Clearing House*, the Supreme Court struck down attempts by the OCC to preclude any state enforcement action against national banks.<sup>165</sup> Simultaneously, it upheld the federal agency's sole "visitorial" or supervisory rights.<sup>166</sup> But the ruling left unresolved three critical policy questions.

First, would state-based authorities risk judicial questioning as to whether enforcement via subpoena power amounted to a "fishing expedition"? As Justice Scalia warned in *Clearing House*, discovery limitations are designed to limit "unreasonable annoyance, expense, embarrassment, disadvantage, or other prejudice."<sup>167</sup> Second, would the states limit resources to the prosecution of past violations of the law? Or would they seek to mold the substance of current and future corporate governance and risk-management systems, a key innovation associated with Spitzer's settlement strategies? Again, as Justice Scalia noted in the majority Supreme Court opinion, the state has authority as law enforcer, a formulation that limits capacity to effect regime change, which had famously underpinned Spitzer's strategy in forcing the resignation of the chief executive at Marsh & McLennan as a price of settlement in 2003.<sup>168</sup> Third, notwithstanding the position of New York as a global financial hub, would enforcement take into account the operations of international banks or the collateral consequences of attempting to hold them accountable? The investigation and settlement with Standard Chartered provide partial answers to each. Standard Chartered's status as an international bank adds a further complication. From the perspective of the New York authorities, Standard Chartered did not fall within the precedent set by the Supreme Court in *Clearing House*. This provided an opportunity for New York to again question the policy settings of the OCC. More fundamentally, it also reopens a series of questions over authority, mandate, bureaucratic processes, and use of discretion in financial services regulation at a time when the authority and legitimacy of the federal model has come under sustained criticism.

The publication of systemic AML compliance failures at HSBC in a Senate report and its damning assessment of the OCC provided perfect cover for the fledgling New York regulatory agency, led by Governor

---

164. 557 U.S. 519 (2009).

165. *Id.* at 556.

166. *Id.*

167. *Id.* at 531.

168. Complaint, Spitzer v. Marsh & McLennan Cos., Inc., No. 04403342 (N.Y. Sup. Ct. Oct. 14, 2004), available at [http://www.ag.ny.gov/sites/default/files/press-releases/archived/oct14a\\_04\\_attach1.pdf](http://www.ag.ny.gov/sites/default/files/press-releases/archived/oct14a_04_attach1.pdf).

Cuomo's former chief of staff, Benjamin Lawsky.<sup>169</sup> A lawyer with substantial experience prosecuting white-collar crime at state and federal level, Lawsky was appointed to the role of Superintendent of Financial Services.<sup>170</sup> He was tasked with guiding its creation and stewarding its agenda, which, ostensibly, concentrated on consumer protection and reduction of the regulatory burden.<sup>171</sup> The fact that its first major regulatory outcome was a reopening of the debate on how to embed restraint in global finance was as unexpected as it was inevitable, given the failure of federal oversight.

In the Manhattan staging of the Scottish play, the hybrid roots of the DFS as a consumer protection operation primarily based on licensing rather than enforcement make it a perfect cast for the role of Malcolm, whose existence was seen as unthreatening to Lord MacBeth and his allies until the moment of execution. First mooted in the 2011 State of the State Annual Address, the stated objective of merging the banking and insurance departments was to improve the efficiency and effectiveness of regulation.<sup>172</sup> A report issued to the Governor as late as December 30, 2011, noted the importance of creating a modern unified structure governed by "regulators who are more accessible, flexible and responsive than their federal counterparts due to a greater understanding of their home markets."<sup>173</sup> There is a passing reference to the fact that "given its position as the world financial capital, it is essential that New York be among the leaders in creating modern, effective and balanced regulation."<sup>174</sup> There was no indication, however, that the new regulatory agency would seek oversight beyond the narrow confines of consumer protection, notwithstanding the right to request information on the operation of a license embedded in the enabling legislative provisions.

It is precisely for this reason that the action taken against Standard Chartered caught the policy, academia, media communities so off guard. This included the advisors to Standard Chartered itself, who had voluntarily provided the information contained in a damning critique of its governance. This information resulted in a summons for the bank to at-

---

169. Press Release, N.Y. Dep't of Fin. Servs., *supra* note 143.

170. *Id.*

171. *Mission*, N.Y. STATE DEP'T OF FIN. SERVS., <http://www.dfs.ny.gov/about/mission.htm> (last visited Oct. 16, 2012).

172. Governor Andrew M. Cuomo, State of the State Address (Jan. 5, 2011) (transcript available at <http://www.governor.ny.gov/sl2/stateofthestate2011transcript>).

173. BENJAMIN LAWSKY, N.Y. STATE DEP'T OF FIN. SERVS., WORKING GROUP REPORT ON WAYS TO IMPROVE EFFICIENCY AND EFFECTIVENESS OF REGULATION 10 (2011), available at [http://www.dfs.ny.gov/reportpub/dfsprt\\_205a.pdf](http://www.dfs.ny.gov/reportpub/dfsprt_205a.pdf).

174. *Id.* at 15.

tend a meeting at which the Superintendent of Financial Services would determine whether or not to revoke its license to operate—the ultimate if rarely used form of industrial decapitation.<sup>175</sup> As noted above, the report of the Senate Subcommittee on Investigations regarding the OCC's catastrophic failure provided essential political cover for a strike that was executed with clinical precision.

Failure is not, however, limited to the Washington D.C.–New York City beltway. A similar problem afflicts the nexus between practitioners and regulators within the City of London. The inability to curtail the manipulation of the LIBOR has exposed similar failings. Crucially, it has opened a second line of attack from New York. Following the Treasury Select Committee hearings in London, the State Attorney General issued subpoenas to the contributing banks with operations in New York to release nonpublic compliance information relating to the operation of LIBOR.<sup>176</sup>

The leaking of the investigation served multiple interests. It can be used to infer internal jockeying for position within the state government, an agenda designed to raise concerns about New York's re-emergent muscularity. Or it can be used to force the banks under investigation to settle with the federal authorities. Since the initial leak, it emerged that both Britain's RBS and Italy's UniCredit were now under investigation.<sup>177</sup> What is clear, however, is that the subpoena process has itself become a complex negotiation game. By deferring to court adjudication, the SAG risks accusations of frivolous, if not capricious conduct. As noted above, a critical justification for the Supreme Court *Clearing House* compromise centered on judicial capacity to mediate mere “fishing expeditions” by dismissing claims advanced without evidence.<sup>178</sup> “In so doing the Supreme Court placed the reputation of the SAG on the docket, curtailing what had been viewed as the extortionist impulses of Spitzer at the turn of the millennium.”<sup>179</sup> The evidentiary base for just cause, however, has been strengthened by the investigation into the manipulation of LIBOR, which extends far beyond the territorial mandate of either state or federal government. The investigation saw Barclays admit to charges

---

175. Order Pursuant to N.Y. Banking Law § 39, Standard Chartered Bank (N.Y. State Dep't of Fin. Servs. Aug. 6, 2012), available at <http://www.dfs.ny.gov/banking/ea120806.pdf>.

176. See, e.g., McLaughlin, *supra* note 43; Proress, *supra* note 43.

177. See Kevin Voigt, *Scandals Hit Bank Recruiting*, CNN (Aug. 28, 2012), <http://business.blogs.cnn.com/2012/08/28/scandals-hit-bank-recruiting/>.

178. *Cuomo v. Clearing House Ass'n*, 557 U.S. 579 (2009).

179. Justin O'Brien, *Like Banquo's Ghost, Eliot Spitzer Haunts Standard Chartered Inquiry*, THE CONVERSATION (Aug. 31, 2012), <http://theconversation.edu.au/like-banquos-ghost-eliot-spitzer-haunts-standard-chartered-inquiry-9232>.

of manipulation and pledge ongoing cooperation.<sup>180</sup> Crucially, unlike Standard Chartered, neither the implicated banks nor the involved federal regulators—in this case, the Commodity and Futures Trading Commission and the Department of Justice—shared the information with the New York authorities. Evidence aired at a parliamentary inquiry conducted in London by the Treasury Select Committee provides additional information to justify the launch of a formal investigation.

It will be difficult for the banks involved to challenge the subpoena process, once again giving New York the power to set the terms of settlement. The fate of Standard Chartered provides an indication that its interests, if not necessarily those of the public, may be served by submitting to federal oversight immediately. It is far from clear, however, to what extent the muscularity is the first stage of an exercise to privilege substantive reform or a tired replaying of a derivative script. While the conflict has all of the ingredients of an epic Shakespearian play, it may also provide confirmatory evidence of the classic Marxian political epigram that history repeats first time as tragedy, the second time as farce.<sup>181</sup>

Compliance or cultural problems within a single bank, no matter how serious, can be contained either by adoption of a structural reform highlighted by HSBC's Levey, by external oversight as advanced by Lawsky, or if necessary, by closure as advanced by Senator Levin.<sup>182</sup> When the identified problems extend to allegations of collusion between banks, such as the manipulation of LIBOR, the entire social construction of the market itself comes under scrutiny. As noted by the chairman of the CFTC in testimony to Congress, "if these key benchmarks are not based on honest submissions, we all lose."<sup>183</sup> Lord Turner of the FSA has noted that it is now appropriate to adopt "a somewhat more interventionist course to wholesale conduct issues," aligned with warranted commitment by senior management to the fostering of better culture and values.<sup>184</sup> This can only be vouchsafed through the integrity and the robustness of the compliance function. This in turn necessitates disaggregating

---

180. Press Release, U.S. Dep't of Justice, *supra* note 44.

181. KARL MARX, THE EIGHTEENTH BRUMAIRE OF LOUIS BONAPARTE (1852), available at <http://www.marxists.org/archive/marx/works/1852/18th-brumaire/ch01.htm>. "Hegel remarks somewhere that all great world-historic facts and personages appear, so to speak, twice. He forgot to add: the first time as tragedy, the second time as farce." *Id.*

182. See *supra* notes 159–60, 162, 167 and accompanying text.

183. Gary Gensler, Chairman of the Commodity Futures Trading Comm'n, Statement Before the Fin. Stability Oversight Council (July 18, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement071812>).

184. Jill Treanor, Fin. Servs. Auth., *Chief in Attack on 'Cynical Greed' of City Traders*, GUARDIAN (July 24, 2012), <http://www.guardian.co.uk/business/2012/jul/24/financial-watchdog-criticises-free-banking>.

compliance from risk management and subsuming it within an integrated surveillance model capable of deployment by regulator and regulated alike. It is this critical function that the CEDAR model is designed to perform.

*B. Preemptive Regulation and the Design of Global Regulation*

The interaction of core conflicts exposed in the banking scandals raises a fundamental but often neglected question of regulatory design. What is the purpose of regulation? The appropriate first-order question is not how to regulate, but why. If new rules, principles, or standards, each altering the appropriate mix of regulatory strategies, are to be introduced, what should the benchmark be? Who should set it, and on what basis? When core values conflict, which approach or approaches should be preferred and why? Should interpretation of compliance and censure rest with the corporation itself, the market, the regulator, or wider society through legislative reinterpretation of the core responsibilities owed by the corporation? Can this be done in a piecemeal manner? Ultimate resolution of these issues requires the articulation of a common standard of what constitutes responsibility and concomitant clarification of requisite accountability structures. The CEDAR approach to measurement and evaluation provides this essential framework.

At the core of the design is the development of a capability model. Five key performance criteria are measured and evaluated: compliance, ethics, deterrence, accountability, and risk. The model differentiates between four levels of performance: world leading (setting new boundaries of excellence), exceeding sector best-practice, achieving best-practice, and lagging global standards. The proposed design involves scoping and applying thirty Key Performance Indicator (KPI) measurements for each dimension, giving 150 indicators in total. Critically, the framework has application for both the regulator and the regulated entity. This integrated approach to the evaluation of whether or how the regulatory regime enhances market integrity has the capacity to reduce contestation between institutional actors and align performance across each dimension to the furtherance of an overarching outcome—the demonstrable and verifiable commitment to integrity. For example, the deterrence KPI suite for a market-conduct regulator could include the number of enforcement actions, time lag between detection and prosecution, severity of offense, media management strategies, degree to which narrative is accepted or challenged, litigation success rate, emphasis on settlement and terms, scale of penalty, interaction with private enforcement actions (including class actions), degree of demonstration effect including evidence of impact, impact on other strategic imperatives of compliance, ethics, ac-

countability, and risk. It would also need to assess the extent to which enforcement action is itself aligned to overarching regulatory purpose. Overarching assessment depends on performance across each component of the CEDAR design.

Built into the design is the guidance from the Australian Government Productivity Commission and the Organisation for Economic Co-operation and Development (OECD) that regulator practice and performance must be evaluated against both the structural environment and the processes and practices within that environment.<sup>185</sup> Until now, there has been no systematic evaluation of performance, a lacuna recognized by the Productivity Commission.<sup>186</sup> As a consequence, the Productivity Commission “sees considerable value in further research being undertaken into regulator practices and performance.”<sup>187</sup> At a generic level, it notes that performance and the overall efficacy of a given system can be enabled or constrained by factors outside the control of regulators.<sup>188</sup> These factors include “the number of regulators and scope of the regulation for which each is responsible; extent of independence and policy-making responsibilities; and resources, enforcement tools, and discretion with which they are provided.”<sup>189</sup> The report notes that there is increasing agreement on principles for administering and enforcing regulation.<sup>190</sup> It also acknowledges that some principles may be difficult to render operational while maintaining consistency, coherence, and ongoing political, public, or corporate support.<sup>191</sup> Comprehensive mapping is, therefore, required to ascertain whether the obstacles have structural or managerial roots.

The CEDAR approach to regulatory effectiveness therefore assesses capacity and obstacles—structural and managerial—to achieving the objectives of substantive commitment to compliance, warranted commitment to higher ethical standards, effective deterrence, enhanced accountability and reduced risk. It does so in the context of a review of the overarching framework—legislative requirements, regulators powers, oversight arrangements—and the processes and practices the regulators themselves adopt within it. In so doing, it transcends the limitations of

---

185. See AUSTRALIAN GOV'T PRODUCTIVITY COMM'N, IDENTIFYING AND EVALUATING REGULATORY REFORM, at app. H (2011), available at <http://www.pc.gov.au/projects/study/regulation-reforms/report>.

186. *Id.* at 2.

187. *Id.* at 4.

188. *Id.* at 6.

189. *Id.* at 1.

190. *Id.*

191. *Id.* at 5.

equating compliance with ethical standards, effective deterrence, meaningful accountability, and enhanced risk management. The case studies highlighted above demonstrate that compliance served no real function beyond window dressing. Of equal importance, they have also demonstrated that accountability can only really be vouchsafed if the regulators themselves are held accountable, and it is questionable whether this can meaningfully be done in a national context. Given ongoing problems associated with implementing the global financial architecture, such as disputes over OTC derivative clearing and money market funds regulation, it is unsustainable for regulation to be decided, implemented, and monitored at a national level. Whether the control problems reflect a lack of resourcing, an erosion of restraint, or a lack of integrity remains unresolved. What is clear, however, is that the failure of compliance itself constitutes a material risk to market integrity, a core but to date uninvestigated dimension of financial stability.

#### IV. CONCLUSION

Globally, the practical and conceptual underpinnings of financial regulation are being questioned as never before. The legitimacy problem is serious, pressing, and structural. It is one we ignore at our peril. It is being played out in the sovereign debt crisis in Europe. The core systemic risk facing Europe, we are told from the markets, is concern that politicians will resile from failing and unworkable austerity agendas. An obverse risk comes from continued fealty to the framework governing financial regulation. We have become—or allowed ourselves to become—powerless.

The structural flaws inherent in the existing framework can be rectified through integrating the five core dimensions of the CEDAR framework: compliance, ethics, deterrence, accountability, and risk. Accountability can only be guaranteed if disputes over interpretation can be resolved in a manner that is proportionate, targeted, and ultimately, conducive to the building of warranted trust in the operation of the financial services sector. Regulatory effectiveness cannot be vouchsafed merely by reforming the institutional structure. As we have seen, these rules and principles can be transacted around. Articulating the parameters of what constitutes “smart regulation” does little to improve the conceptual underpinnings precisely because it lacks a normative dimension. Equally, enrolling actors into governance arrangements without articulating precisely what is meant by business integrity and accountability within specific contexts is unlikely to resolve the ongoing ethical questions.

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 (benefits to business) and professional rights to self-governance with explicit requirements that society should not be held responsible or liable for the failures of the former. 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. It also requires reciprocal obligation from each institutional actor to maintain, and certainly not contribute through omission or commission to the erosion of, the integrity of the governance arrangements. It must articulate common understandings of what constitutes the ethical problem.

Following the banking scandals of 2012, it is unsustainable for regulation to be decided, implemented, and monitored at a national level. As HSBC has acknowledged, global oversight has become an imperative to reduce the conflicts of interest that may create profitable industries but not socially beneficial ones. It is a lesson that the Federal Reserve Bank of New York and its British counterpart would do well to remember.