HOW THE AMERICAN DREAM BECAME A GLOBAL NIGHTMARE: AN ANALYSIS OF THE CAUSES OF THE GLOBAL FINANCIAL CRISIS

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I INTRODUCTION

The International Monetary Fund ('IMF') opined in April 2008 that:

> The financial market crisis that erupted in August 2007 has developed into the largest financial shock since the Great Depression, inflicting heavy damage on markets and institutions at the core of the financial system.[1]

The financial market crisis has since infected the rest of the world economy resulting in a crisis of confidence, credit rationing and widespread de-leveraging that has had major impacts on wealth, output, trade, employment and standards of living across the globe.

In April 2009, the IMF reported that '[t]he global financial system remains under severe stress as the crisis broadens to include households, corporations, and the banking sectors in both advanced and emerging market countries.'[2] The crisis has also impacted pension and superannuation funds and insurance companies. The IMF estimates that losses from the financial crisis could reach US$4 trillion.

In Australia, superannuation assets decreased to A$1.05 trillion in the 12 months ending December 2008 – a decrease of nearly 15 per cent.[3] The aggregate-listed share price of Australian banks from July 2007 to March 2009

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1 IMF, *World Economic Outlook: Housing and the Business Cycle* (April 2008) 4. At that time several major bankruptcies, including Lehman Brothers, Circuit City and Chrysler and bailouts for large financial institutions such as AIG and Citigroup, had yet to occur.

2 IMF, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks* (April 2009) xi-xii. See also 'The global financial system is facing a once-in-a-century event, where credit risks have risen to extremely high levels': at 3.

3 Australian Prudential Regulatory Authority ('APRA'), *Quarterly Superannuation Performance* (December 2008) APRA <http://www.apra.gov.au/media-releases/09_06.cfm> at 25 May 2009.

fell approximately 40 per cent.[4] In the six months ending December 2008, the value of equities held by Australian superannuation funds fell 38 per cent.[5]

The ramifications of the global financial crisis ('GFC'), perhaps to be known in history as the Great Recession or the Second Great Depression, has led to questions about its causes.[6] The search for a single cause is likely to be in vain; rather, the focus should be on issues of initial drivers, forces that exacerbated these drivers and factors that have operated to prolong the crisis.

This article seeks to examine the issue of causes in three parts. Part II provides a factual account of what has occurred up to June 2009. Part III examines the crisis by highlighting a number of key underlying themes that arise from the factual account. An appreciation of these themes assists in understanding the legal and regulatory problems that the crisis has brought to light, which are discussed in Part IV.

This article takes the approach that those that fail to learn from history are doomed to repeat it.[7] A causal analysis thus has merit in terms of preventing a recurrence of those events that led to the GFC. However, caution must accompany a discussion of causes. Any causal analysis, especially of socioeconomic phenomena such as economics and financial markets, is likely to simplify what is a complex matter. We are still very close to the events under study and developments continue to arise on a daily basis with revised stimulus packages and recriminations over corporate collapses. Perfect vision is possible only with hindsight, and the causes and contributors to the financial crisis will reveal themselves in a more complete form over time. Nonetheless, the dramatic effect of the GFC on the world's financial system and implications for Australia's corporate and financial services regulatory regime makes analysis necessary.

II BACKGROUND

To understand the causes of the credit crunch and GFC, it is necessary to start with the events that led to the housing market bubble and subprime lending in the United States and how the bursting of that bubble spread to other sectors of the US economy – most notably the financial services sector – and then to the rest of the world. It is a story of contagion, interdependence, interconnection and co-variance: how the American Dream became the global nightmare.

The GFC has its roots in the US subprime mortgage market. Subprime mortgages are loans to borrowers who have a poor credit history and so are likely

4 Reserve Bank of Australia ('RBA'), *Financial Stability Review* (March 2009) Graph 2.

5 Ibid Table 6.

6 For a comparison of the Great Depression and the GFC see Kevin Rudd, 'A Strategy for Sustainable Economic Recovery – the Role of the G20', (Speech delivered at the Hotel Adlon Kempinski, Berlin, 7 July 2009).

7 'Those who cannot remember the past are condemned to repeat it': George Santayana, *The Life of Reason; or, The Phases of Human Progress: Reason in Common Sense* (2nd ed, 1924) 284.

to default such that a higher interest rate is usually applied to the loan. After the dotcom bust and the terrorist attacks of 11 September 2001, interest rates in the United States were lowered in an attempt to stimulate the economy.[8] This promoted investment in housing. Much of that investment took place through subprime mortgages that went from comprising less than 15 per cent of US mortgages in 2001 to around 50 per cent by 2006.[9]

By comparison, during the same period, Australian non-conforming home mortgages for people with a poor credit history did not exceed one per cent of either total outstanding mortgages or new home mortgages.[10] While Australia has no exact equivalent to the US market for subprime mortgages, 'low doc' and loans for up to 100 per cent of the purchase price were issued in Australia.[11]

A number of incentives beyond low interest rates promoted US subprime lending and borrowing. These include a then widespread belief that property prices would continue to rise so that bad loans were not a concern as the house could, it was thought, be resold for a profit. This led to lax lending standards, as both borrowers and lenders sought to benefit from the increase in housing prices. Further, lenders operated on an 'originate to distribute' business model where mortgages were onsold shortly after being written, so that the risk of the mortgage was passed to another financial institution. In this way, lenders' focus switched from maintaining high credit standards to generating maximum volume.[12] The housing boom was a classic asset price 'bubble'.[13] The ability to easily transfer mortgage debts from the originator's balance sheet by packaging

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8 The US Federal Reserve lowered interest rates from 6.5 per cent to 3.5 per cent in late 2000 and to one per cent in 2003: Charles Morris, *The Trillion Dollar Meltdown* (2008) 59.

9 See generally Martin Neil Baily, Robert E Litan and Matthew S Johnson, *The Origins of the Financial Crisis* (November 2008) 14–5; Eamonn Butler, 'The Financial Crisis: Blame Governments Not Bankers' in Philip Booth (ed), *Verdict on the Crash: Causes and Policy Implications* (2009) 51; Morris, above n 8, 62–7.

10 Guy Debelle, 'A Comparison of the US and Australian Housing Markets' (Speech delivered at the Subprime Mortgage Meltdown Symposium, Adelaide, 16 May 2008).

11 Luci Ellis, 'The Global Financial Crisis: Causes, Consequences and Countermeasures' (Speech delivered at Australia in the Global Storm: A Conference on the Implications of the Global Financial Crisis for Australia and its Region, Victoria University, Melbourne, 15 April 2009); RBA, *Financial Stability Review* (September 2005) 39–40.

12 John Cassidy, 'Subprime Suspect' (2008) 84(7) *The New Yorker* 78, 85; Baily et al, above n 9, 20–1. Other incentives included: loans in some US states were non-recourse so that borrowers' other assets could not be accessed in the event of default; the use of adjustable rate mortgages that had low initial payments and then reset to a higher rate after two to three years; and interest only or negative amortisation (less than full interest is paid) loans that have low repayments at the beginning of the loan but increase over time: see generally Allen J Fishbein and Patrick Woodall, 'Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders' (May 2006) Consumer Federation of America <http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf> at 25 September 2009.

13 See generally Sushil Bikhchandani, David Hirshleifer and Ivo Welch, 'A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades' (1992) 100(5) *Journal of Political Economy* 992; Hyman P Minsky, 'The Financial Instability Hypothesis' (Working Paper No 74, Jerome Levy Economic Institute, Bard College, 1992); Robert J Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do About It* (2008).

loans into securities allowed the risk of mortgage defaults to spread well beyond traditional mortgage lenders.

The risk of the subprime mortgage found its way into the global financial system through the process of financial innovation that gave rise to 'securitisation' and 'credit derivatives'.[14] Securitisation is the pooling and repackaging of cash-flow-producing, but generally illiquid, financial assets into securities that are then sold to investors.[15] Mortgages, including subprime mortgages, were 'securitised' in this way, and known as mortgage-backed securities ('MBS').[16] The securitisation process involves pooling the mortgages and then separating them into tranches that have different levels of risk, return, order of payment and degree of credit support.[17] The senior tranche, which is rated AAA by a credit rating agency ('CRA') such as Moody's or Standard and Poor's, has the first claim on returns, thus reducing risk but also returning a lower yield.[18] The bottom tranche is the first to absorb any losses in the MBS but enjoys the highest rate of return. The importance of the AAA rating lies in the fact that many institutional investors, including municipal authorities, hospitals and universities, are required to hold only highly rated securities. The alchemy of securitisation allows risky mortgage assets to be turned into highly rated investment grade assets available to a wide range of investors.

Although MBS are often purchased by institutional investors, securitisation allowed these assets to be further carved up into yet more specialised and complex securities: the 'collateralised' debt obligation ('CDO'). CDOs are made up of a pool of various tranches of MBS and other asset backed securities and are then separated into further tranches that are sold to investors. The CDO is thus another step removed from the actual mortgage as it is composed of the securities that were issued as part of the MBS process.[19] Ideally, this diversification of risk makes investors in the CDO less vulnerable to the problems of a single borrower or security. However, the tranching described above allowed the most senior tranche in the CDO to have a AAA credit rating even when the ratings of the

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14 Morris, above n 8, 73–9.

15 Paul Ali, *The Law of Secured Finance: An International Survey of Security Interests Over Property* (2002) 7.

16 The MBS is a subset of asset-backed securities ('ABS'). MBS may be further classified into residential mortgage backed securities ('RMBS') and commercial mortgage backed securities ('CMBS'). The process was originally developed in 1983 by US Government-sponsored agencies Freddie Mac and Fannie Mae to alleviate constraints on lenders' balance sheets so that they could disperse risk, which would reduce the costs of borrowing and make more home loans: ibid.

17 Adam B Ashcraft and Til Schuermann, 'Understanding the Securitization of Subprime Mortgage Credit', *Federal Reserve Bank of New York Staff Report No 318* (March 2008) 29–36.

18 The safety of the senior tranche depends on the risk of the underlying asset, but this is reduced through the degree of subordination and the level of credit enhancement. Subordination refers to how much of the MBS ranks lower than those holding the senior tranche and is thus able to absorb any losses. Credit enhancement includes: 'over-collateralisation', in which the face value of the mortgage assets is greater than the face value of the repackaged securities; and excess spread, whereby the total incoming interest received from the mortgage payments exceeds the payments made to securities holders, fees to the issuer and any other expenses: Baily et al, above n 9, 24–5.

19 Baily et al, above n 9, 27.

underlying assets were less than AAA – a process described by one analyst as 'turning garbage into gold'.[20]

To further bolster a CDO's tranches' ratings the issuer would purchase a Credit Default Swap ('CDS') or insurance from monoline insurers, banks, hedge funds or even traditional insurers such as AIG.[21] The CDS and credit insurance allow the insurer to assume, in exchange for payment, the risk of default. If there is a default then the party assuming the risk is required to make an agreed payment to the other party, thus offsetting their exposure to that risk.[22] The growth of the market for trading in CDS instruments has led to the total value of CDS far exceeding the total value of global corporate debt.[23] This creates the problem of spreading the losses caused by defaults on loans such as those that occurred following the collapse of Lehman Brothers and the 'conservatorship' of Fannie Mae and Freddie Mac in the United States.

The effectiveness of the tranching in MBS and CDOs and structuring of the CDS and insurance depends on a proper understanding of the risk of the underlying assets, as the tranching rearranges but does not eliminate that risk.[24] Instead of risk being determined by due diligence on the underlying asset it was calculated through highly complicated mathematical formulae called quantitative analysis that contributed to greater complexity in financial products and provided unwarranted security.[25]

As commercial banks were subject to capital requirements in relation to their balance sheets,[26] but wanted to take on more debt to be able to make the investment returns that MBS and CDOs offered, these investments were made through Structured Investment Vehicles ('SIV') or off-balance-sheet special-purpose vehicles. When SIV got into financial difficulties the banks would bring them onto their balance sheet to preserve the bank's reputation.[27] Investment Banks and SIVs funded their investment in MBS and CDOs through short-term

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20 Michael Lewis, 'The End' *Condé Nast Portfolio* (New York), December 2008, 122.

21 'Caveat Counterparty', *The Economist* (London), 22 March 2008, 100.

22 Satyajit Das, *Credit Derivatives and Credit Linked Notes* (2nd ed, 2000) 27 – 8.

23 The Bank for International Settlements ('BIS') estimates that the total notional value for credit default swaps worldwide in December 2008 was in excess of US$41 trillion. This may be compared with the estimated total value of international debt securities during the same period at US$4.5 trillion: Joint BIS-IMF-OECD-World Bank, *Joint External Debt Hub: Creditor/Markets Tables* (2009) JEDH <http://www.jedh.org/jedh_metadata-line per cent20items.html> at 2 August 2009; BIS, 'Table 19: Amounts Outstanding of Over-the-Counter (OTC) Derivatives by Risk Category and Instrument' <http://www.bis.org/statistics/otcder/dt1920a.pdf> at 11 June 2009.

24 Baily et al, above n 9, 24–5.

25 Satyajit Das, *Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives* (2006) 182–210; 'In Plato's Cave', *The Economist* (London), 24 January 2009, 12.

26 APRA, *Australian Prudential Standard 112: Capital Adequacy: A Standardised Approach to Credit Risk* (January 2008); Basel Committee on Banking Supervision, *International Convergence of Capital Measurements and Capital Standards: A Revised Framework* ('Basel II Accord') (June 2004).

27 Baily et al, above n 9, 29.

borrowing by way of Asset-Backed Commercial Paper ('ABCP') and repurchase agreements that had to be rolled over regularly, often within a matter of days.[28]

The above financial products – MBS, CDOs and CDS – were attractive to both investment banks, who could make large fees through the creation, sale and underwriting of the product, and also to investment bankers, who could earn large bonuses. The products were equally attractive to investors, who believed they were able to earn secure higher returns on products with AAA credit ratings compared with government bonds that attracted similar ratings but that, because interest rates were at historic lows, offered much lower yields. The credit rating became a crucial indicator of risk as investors were not in a position to evaluate the quality of the underlying asset.[29] Indeed, the investment mandate for many institutional investors often prohibited investments in creditor products that had not been rated by at least two out of the three large international CRAs (Moody's, Standard and Poor's, and Fitch Ratings). Investors also took advantage of low interest rates by using debt to leverage their investments.[30] In Australia, this coincided with the growth of margin lending and the spectacular rise (and fall) of financial firms that promoted the practice, such as Opes Prime and Storm Financial.[31]

In the United States, interest rates were raised by the Federal Reserve as concerns about inflation arose. The housing market also began to cool while, at the same time, 'teaser rates' expired and interest rates on many mortgages began to reset at much higher levels.

In the beginning of 2007 a number of subprime lenders in the United States began filing for bankruptcy including the largest subprime lender, New Century Financial.[32] In July 2007, the links between the property market and the financial system started to become apparent when two Bear Stearns hedge funds specialising in subprime debt announced significant losses resulting in them filing for bankruptcy.[33] A number of private equity deals were unable to access financing at an acceptable rate and were terminated.[34] In the United Kingdom, the Bank of England was forced to extend emergency funding to Northern Rock,

28 Ibid 30–1. Goldman Sachs supported US$1.1 trillion of assets with US$40 billion of equity and Merrill Lynch supported US$1 trillion of assets with US$30 billion of equity: 'What Went Wrong', *The Economist* (London) 22 March 2008, 92.

29 Steven L Schwarcz, 'Protecting Financial Markets: Lessons From the Subprime Mortgage Meltdown' (2008) 93(2) *Minnesota Law Review* 373, 404.

30 Baily et al, above n 9, 27.

31 See, eg, *Storm Financial Ltd v Commonwealth Bank of Australia* [2008] FCA 1991; *Beconwood Securities Pty Ltd & Anor v Australia and New Zealand Banking Group Ltd & Ors* (2008) 246 ALR 361.

32 Julie Creswell, 'Mortgage Lender New Century Financial Files for Bankruptcy', *New York Times* (New York), 2 April 2007 <http://www.nytimes.com/2007/04/02/business/worldbusiness/02iht-loans.5.5118838.html> at 25 May 2009.

33 Morris, above n 8. 80.

34 Ibid 81.

a large British mortgage lender. Northern Rock was subsequently nationalised in early 2008.[35]

From July to August 2007 in Australia, Basis Capital's investment vehicle Basis Yield Alpha Fund (Master), which invested A$1 billion in asset-backed and credit securities exposed to subprime mortgages, suspended redemptions and was then placed into liquidation after defaulting on margin calls from its financiers.[36] Similarly, Absolute Capital suspended two funds worth around A$200 million due to a lack of liquidity in global structured credit markets and later appointed a voluntary administrator.[37]

The impact of subprime on the debt markets is illustrated by RAMS Home Loans Group which listed on the Australian Stock Exchange ('ASX') on 27 July 2007 at A$2.50 a share. Despite having no exposure to subprime mortgages, the material increases in spreads and shortages of liquidity in the US debt capital markets, where RAMS obtained a large portion of its funding, resulted in a substantial decline in earnings and a share price of around 25 cents. The sale of its brand name and network of 97 franchise outlets ensued.[38]

In late 2007, Merrill Lynch and Citigroup wrote down US$7.9 billion and US$11 billion respectively in bad debts from losses related to subprime mortgages, resulting in the resignation of their CEOs. Citigroup obtained a capital injection from the Abu Dhabi government. In December 2007, Morgan Stanley announced US$9.4 billion in write downs from subprime losses and received a capital injection from a Chinese sovereign wealth fund of US$5 billion. Centro Properties Group, the second largest shopping centre owner in Australia and the fifth largest in the United States, announced that it was having difficulty rolling over A$3.9 billion in debt that was followed by its share price declining by 90 per cent in the 12 months to mid-January 2008.[39]

The decline in Centro's share price was emblematic of a significant reduction in the performance of many highly leveraged Australian managed investment

35 Tripartite Statement by HM Treasury, Bank of England and Financial Services Authority, 'News Release Liquidity Support Facility for Northern Rock plc' (Press Release, 14 September 2007); Alistair Darling, 'Statement on the Nationalisation of the Northern Rock Bank', *BBC News* (London), 17 February 2008 <http://news.bbc.co.uk/2/hi/business/7249575.stm> at 25 May 2009.

36 *Basis Capital Funds Management Ltd v BT Portfolio Services Ltd & Ors* (2008) 219 FLR 157; Stuart Washington, 'Subprime Turmoil Claims Australia's Basis Fund', *The Sydney Morning Herald* (Sydney), 30 August 2007 <http://www.smh.com.au/news/business/subprime-turmoil-claims-australias-basis-fund/2007/08/30/1188067234101.html> at 25 May 2009.

37 Absolute Capital, 'Absolute Capital Temporarily Closes its Yield Strategies Funds to Protect Investors' (Press Release, 25 July 2007); Peter Ryan, 'US Subprime Mortgage Crisis Hits Aust Funds' *ABC News* (Sydney) 26 July 2007; McGrathNicol, 'Absolute Capital Group Limited Board Appoints Voluntary Administrator' (Press Release, 27 November 2007).

38 Bryan Frith, 'New RAMS Shareholders Left Bleating', *The Australian* (Sydney), 15 August 2007 <http://www.theaustralian.news.com.au/story/0,25197,22246684-16941,00.html> at 25 May 2009; Danny John, '$5.2B Deal Saves RHG Group', *The Sydney Morning Herald* (Sydney), 9 February 2008 <http://business.smh.com.au/business/52b-deal-saves-rhg-group-20080208-1r3o.html> at 25 May 2009.

39 Centro Properties Group, 'Centro Earnings Revision and Refinancing Update' (Press Release, 17 December 2007); Centro Retail Trust, 'Centro Retail Trust Announces Interim Extension of A$1.2 Billion in Maturing Facilities' (Press Release, 17 December 2007); Mathew Dunckley and Ben Wilmot, 'Centro Acts to Appease Banks', *The Australian Financial Review* (Melbourne) 16 January 2008, 1.

schemes, including listed property trusts, as refinancing of debt became more expensive.[40] During this time the price of corporate debt rose significantly as the supply of credit tightened, making it much more difficult for companies to raise new funds or roll over existing loans.[41]

In January 2008 Australia's main share indexes fell more than seven per cent – their biggest one-day falls since 1989 – cutting about A$100 billion from the value of shares.[42]

In March 2008 HSBC, the UK's largest bank, reported a US$17.2 billion loss on write downs of its US mortgage portfolio. At the same time, France's largest retail bank, Credit Agricole, announced an €857 million loss after write-downs of €3.3 billion on its exposure to the credit crisis.[43] Further write-downs and losses followed.

March 2008 also saw rumours begin to appear that Bear Stearns may have liquidity problems and by 16 March 2008, JP Morgan Chase announced that it would acquire Bear Stearns for US$2 per share, later raised to US$10 per share. Bear Stearns had traded at US$30 per share only two days earlier. The steep discount was an attempt to balance the need to maintain confidence in financial markets but without creating the risk of moral hazard – if people were protected from their own irresponsibility they will be more likely to be irresponsible in the future.[44]

In mid-2008 the terms 'subprime' and 'credit crunch' were recognised as new words in the English language by the Oxford English Dictionary and the Merriam-Webster Dictionary.[45]

That September the US government was forced to take control of Freddie Mac and Fannie Mae, government-sponsored entities that were created to

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40 See, eg, Peter Studley, 'Risk, Re-adjustment and Recovery' (2008) 1(8) *Australian and New Zealand Property Journal* 641, 643–4 (reporting on an unprecedented market sell-off of listed property trusts, listed property returns being negative 42 per cent and cutting of distributions).

41 The cost of issuing BBB rated corporate bonds (which is the lowest rating for investment grade securities) as calculated by the spread between the yields offered by these bonds over government bond yields (which offer a virtually risk free rate of return) almost doubled between 2007 and 2008, rising from 250 basis point (2.5 per cent) in April 2007 to 449 basis points in December 2008. This spread has since increased further to be as high as 582 basis points on 21 April 2009: RBA, 'Capital Market Yields and Spreads-Non-Government Instruments' (2009) RBA <http://www.rba.gov.au/statistics/bulletin/F03.pdf> at 26 May 2009.

42 Ruth Williams and Vanessa Burrow, 'Black Tuesday Wipes off $100 Billion', *The Age* (Melbourne), 23 January 2008 <http://www.theage.com.au/articles/2008/01/22/1200764265886.html> at 25 May 2009.

43 'HSBC in $17bn Credit Crisis Loss', *BBC News* (London), 3 March 2008 <http://news.bbc.co.uk/2/hi/business/7274385.stm> at 25 May 2009; 'Credit Agricole's $10b Call to Shareholders', *Sydney Morning Herald* (Sydney), 14 May 2008, <http://www.smh.com.au/business/credit-agricoles-10b-call-to-shareholders-20080514-2dzj.html> at 14 September, 2009.

44 James Surowiecki, 'Too Dumb to Fail' *The New Yorker* (New York), 31 March 2008, 46.

45 Peter Hutchison, 'Credit Crunch and Subprime Join the Oxford English Dictionary', *Telegraph* (London), 4 July 2008 <http://www.telegraph.co.uk/finance/markets/3053926/Credit-crunch-and-sub-prime-join-the-Oxford-English-Dictionary.html> at 25 May 2009; Stephanie Reitz, 'Merriam-Webster Unveils New Dictionary Words', *San Francisco Chronicle* (San Francisco), 7 July 2008 <http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2008/07/07/national/a114607D83.DTL&hw=webster&sn=001&sc=1000> at 25 May 2009.

generate funding for the US housing market through securitising home loans, and the US$5 trillion in home loans they back, in what may become the world's largest financial bailout.[46]

Concerns were voiced about the fate of American investment banks in mid-2008. On 15 September 2008, Lehman Brothers announced it would file for bankruptcy and the Bank of America announced that it would acquire Merrill Lynch for US$50 billion.[47] On 16 September 2008, the US Federal Reserve announced it would lend AIG, once the world's largest insurance company with a market value of US$239 billion, US$85 billion in emergency funds due to its insurance of various financial products resulting in substantial losses and impacts on its balance sheet.[48] On 17 September 2008, Lloyds announced it would take over HBOS, previously the UK's largest savings institution, for £12 billion.[49] On 22 September 2008, the remaining American investment banks, Goldman Sachs and Morgan Stanley were approved by the Federal Reserve to become bank holding companies that subjects them to regulation by the Federal Reserve.[50] The failure of Washington Mutual, the sixth largest US bank, on 25 September 2008 marks the largest bank failure in US history.[51] In the UK, the government nationalised Bradford & Bingley.[52]

On 12 October 2008, the Australian federal government announced that it would guarantee all deposits held by authorised deposit taking institutions regulated by the Australian Prudential Regulatory Authority ('APRA') including Australian banks, building societies and Australian subsidiaries of foreign banks. This measure also included a guarantee over debt securities offered by these institutions.[53] This was to allow financial institutions to raise capital more easily at a time when the liquidity of credit markets was very tight.

The fourth quarter of 2008 saw inter-bank markets, in which banks loan money to each other, almost halt as trust in contractual counterparties no longer

46 David Ellis, 'US Seizes Fannie and Freddie', *CNN Money* (New York), 7 September 2008 <http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm> at 25 May 2009.

47 Carrick Mollenkamp et al, 'Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash', *Wall Street Journal* (New York), 16 September 2008, <http://online.wsj.com/article/SB122145492097035549.html> at 14 September 2009.

48 'AIG's Rescue – Size Matters', *The Economist* (London), 20 September 2008, 85.

49 'Lloyds TSB Seals £12bn HBOS Deal', *BBC News* (London), 17 September 2008 <http://news.bbc.co.uk/2/hi/business/7622180.stm> at 26 May 2009. See also 'Lloyds HBOS Merger Gets Go-ahead', *BBC News* (London), 12 January 2009, <http://news.bbc.co.uk/2/hi/business/7823521.stm> at 14 September 2009.

50 'Federal Reserve Approves Goldman Sachs, Morgan Stanley Bank Applications', *Forbes: Thompson Financial News*, 22 September 2008, <http://www.forbes.com/feeds/afx/2008/09/22/afx5454896.html> at 14 September 2009; see also Lewis, above n 20, 157.

51 Elinor Comlay and Jonathan Stempel, 'WaMu Is Largest US Bank Failure', *Reuters* (London), 26 September 2008, <http://www.reuters.com/article/topNews/idUSTRE48P01R20080926> at 14 September 2009.

52 'B&B Nationalisation Is Confirmed', *BBC News* (London), 29 September 2008 <http://news.bbc.co.uk/2/hi/business/7641193.stm> at 26 May 2009.

53 Wayne Swan, 'Government Announces Details of Deposit and Wholesale Funding Guarantees' (Press Release No 117, 24 October 2008).

existed.[54] Short-term borrowings could not be rolled over at all or at the previously low interest rates, and concerns grew that insurance and CDS could become ineffective if the counter-party was insolvent.[55]

In November 2008 the US government agreed to rescue Citigroup, resulting in the government receiving warrants to buy shares. In early 2009, the US Treasury announced it would take a 36 per cent equity stake in Citigroup.[56]

In Australia the effect of leverage was graphically illustrated when two of the boom sharemarket darlings, ABC Learning and Allco, were placed into receivership and administration after months of share price declines and attempts to renegotiate debt.[57] Other companies have had to undertake large equity capital raisings to help repay high debt levels, particularly in the property and minerals sectors.[58]

By the end of 2008, litigation trends in the United States revealed a large increase in the filing of subprime cases, including securities class actions.[59] On a smaller scale in Australia, class actions were commenced or threatened against Centro, ABC Learning, Allco and National Australia Bank for alleged defective disclosure related to debt and leverage problems.[60]

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54 Claudio M Loser, *Global Financial Turmoil and Emerging Market Economies: Major Contagion and a Shocking Loss of Wealth* (2009) 7. The 'TED spread' – the difference between the three-month dollar LIBOR (London inter-bank offered rate) and the Treasury Bill rate – is a measure of the risk aversion shown by banks and went from 20 basis point or one-fifth of a percentage in early 2007 to 3.3 per cent in October 2008: 'Blocked Pipes', *The Economist* (London), 4 October 2008, 70–2.

55 'Wall Street's Bad Dream', *The Economist* (London), 20 September 2008, 81–2.

56 Federal Deposit Insurance Corporation, 'Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup' (Press Release, 23 November 2008); David Enrich and Deborah Soloman, 'Citi, US Reach Accord on a Third Bailout', *Wall Street Journal* (New York), 28 February 2009 <http://online.wsj.com/article/SB123573611480193881.html> at 26 May 2009.

57 McGrathNicol, 'ABC Childcare Centres to Remain Open' (Press Release, 6 November 2008); McGrathNicol, 'Allco Finance Group Limited: Creditor Information' (2008–09) McGrathNicol <http://www.mcgrathnicol.com/currentprojects/allco/Pages/creditorinformation.aspx> at 2 August 2009.

58 In the financial year to June 2009 a record A$90 billion of new capital was raised on the ASX comprising A$1.9billion in initial public offerings (down 83 per cent on the previous year) and secondary raisings of A$88.1 billion (up 74 per cent on the previous year). See 'ASX Group Monthly Activity Report – June 2009' (Market Announcement, 6 July 2009).

59 Stephanie Plancich and Svetlana Starykh, *2008 Trends in Securities Class Actions: Annual Filings are at the Highest Level in Six Years, Driven by the Credit Crisis, While Median Settlement Values Stay Steady* (December 2008); Cornerstone Research, *Securities Class Action Filings 2008: A Year in Review* (March 2009); as of 14 July 2009, 195 subprime and credit crisis-related securities lawsuits had been filed: D&O Diary Blog, *Subprime and Credit Crisis-Related Securities Class Action Lawsuits* (2009) <http://www.oakbridgeins.com/clients/blog/subprimelawsuitslist.doc> at 2 August 2009.

60 James Eyers and Alex Boxsell, 'Shareholders Queue to Sue', *The Australian Financial Review* (Melbourne), 30 January 2009, 56; Alex Boxsell, 'Mum and Dad Take to Class Action', *The Australian Financial Review* (Melbourne), 11 July 2009, 37–9; there has also been litigation against Lehman Brothers Australia in respect of alleged misleading conduct by one of its subsidiaries in relation to the marketing of complex CDO products to conservative institutional investors such as local government authorities, charities and universities: *Lehman Brothers Australia Limited v Wingecarribee Shire Council* [2009] FCAFC 63; PPB, *Section 439A Report to Creditors of Lehman Brothers Australia Ltd* (19 March 2009); Susannah Moran, 'Nothing for Creditors in Lehman Proposal', *The Australian* (Sydney), 27 May 2009 <http://www.theaustralian.news.com.au/business/story/0,,25553211-20501,00.html> at 8 August 2009.

Late 2008 and 2009 saw a concerted global response to the GFC with meetings of the G8 and G20 aimed at regulatory reform and national governments adopting a variety of mechanisms for economic stimulus.[61] The recently elected Obama administration, the government at the epicentre of the GFC, set out its response to the GFC in the US Department of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (June 2009).[62]

III UNDERLYING THEMES

This part will identify the underlying themes explaining the nature and scope of the financial crisis. The discussion will focus first on those factors that contributed to the germination of the crisis and then will expand to include those factors that operated to exacerbate and prolong its adverse effects.

A Transparency

Former US Supreme Court Justice Louis Brandeis famously said 'sunlight is said to be the best of disinfectants; electric light the most efficient policeman.'[63] This comment encapsulates the raison d'être of modern securities regulation. Securities laws around the world have followed the lead of the New Deal statutes the *Securities Act of 1933*, 15 USC §§ 77a–77aa (1933) and the *Securities Exchange Act of 1934,* 15 USC §§ 78a–78lll (1934) in focusing regulation on the disclosure of information deemed important to potential investors. The rise of the Efficient Capital Market Hypothesis ('ECMH')[64] in the late 1960s and its increasing popularity in the succeeding decades has placed transparency of securities in a central position within the regulatory framework.[65] The EMCH argues that efficient capital markets are able to rapidly incorporate information into the prices offered for securities traded over those markets. The central idea is that investors should be able to rely on securities prices as they reflect the collective market's valuation sentiment based on information that is publicly

61 See, eg, 'G20, Global Plan for Recovery and Reform: The Communiqué from the London Summit' (2 April 2009) G20 <www.g20.org/Documents/final-communique.pdf> at 26 May 2009; Douglas W Arner, 'The Global Credit Crisis of 2008: Causes and Consequences' (2009) 43 *International Lawyer* 91, 119–34; Wayne Swan, 'Extraordinary Times Demand Extraordinary Action' (Speech delivered at the London School of Economics, London, 13 March 2009).

62 Department of the Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (June 2009).

63 Louis D Brandeis, *Other People's Money and How the Bankers Use It* (1914) 92.

64 Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25(2) *Journal of Finance* 383; Razeen Sappideen, 'Securities Market Efficiency Reconsidered' (1988) 9 *University of Tasmania Law Review* 132; Entcho Raykovski, 'Continuous Disclosure: Has Regulation Enhanced the Australian Securities Market?' (2004) 30 *Monash University Law Review* 269.

65 There are, however, numerous criticisms of the underlying theory, particularly from the field of behavioural finance: see, Raykovski, above n 64; Angie Zandstra, Jason Harris and Anil Hargovan, 'Widening the Net: Accessorial Liability for Continuous Disclosure Contraventions' (2008) 22 *Australian Journal of Corporate Law* 51.

available. In Australia this has included regulatory measures covering both periodic and continuous disclosure obligations that aim to ensure material information is disclosed to the market in a timely manner.[66]

Perhaps the key theme underpinning the genesis of the GFC has been the lack of *effective* transparency concerning the underling products noted above, including MBS, CDOs, CDS and a range of other 'alphabet soup' derivative products.[67] The levels of disclosure concerning the risks of these products were not always sufficient to allow end users to understand the risks involved, even in circumstances where the disclosures that were made satisfied existing legal obligations.[68] The role of credit ratings over these products is also important here and will be discussed further below.

Why were these products not transparent? There are several reasons that contributed to the lack of understanding about these products – dubbed 'financial weapons of mass destruction' by investment manager Warren Buffett.[69] First, the complexity of the arrangements made understanding these products difficult even for sophisticated investors.[70] That complexity was driven by a range of factors including the lack of a central trading platform, such as that which exists for traditional securities like shares and options. This meant that each CDO or CDS was created individually, with idiosyncratic features and disclosures, making comparisons between products difficult for investors. Each product originator marketed their special expertise in financial engineering and their individual capacity to design the next useful instrument for securing high yields and favourable tax treatment. Second, products based on derivatives have traditionally been exempt from consumer protection disclosure laws on the assumption that they are only traded between sophisticated investors. Third, these particular products were typically designed with a view to avoid adverse regulatory consequences (particularly tax laws) that would turn a simple MBS into a complex structure. This would secure favourable regulatory characterisation, even if only by obfuscation. As the head of the UK Financial Services Authority said in January 2009:

> Not all innovation is equally useful. If by some terrible accident the world lost the knowledge required to manufacture one of our major drugs or vaccines, human welfare would be seriously harmed. If the instructions for creating a CDO squared have now been mislaid, we will I think get along quite well without. And in the years running up to 2007, too much of the developed world's intellectual talent was devoted to ever more complex financial innovations, whose maximum

66 *Corporations Act 2001* (Cth) ch 2M, ss 674, 675.

67 Adair Turner, 'The Financial Crisis and the Future of Financial Regulation' (Speech delivered at *The Economist's Inaugural City Lecture*, London, 21 January 2009).

68 'An investor would need to read in excess of one billion pages to understand a CDO': Andrew Haldane, 'Rethinking the Financial Network' (Speech delivered at the *Financial Student Association*, Amsterdam, April 2009) 17; see also Table 2, 37; see also APRA, ASIC and RBA, *Survey of the OTC Derivatives Market in Australia* (May 2009).

69 Warren Buffett, *2002 Letter to Berkshire Hathaway Shareholders* (2002) Berkshire Hathaway <http://www.berkshirehathaway.com/letters/2002pdf.pdf > at 2 August 2009, 15.

70 See generally, Frank Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* (2003).

> possible benefit in terms of allocative efficiency was at best marginal, and which in their complexity and opacity created large financial stability risks.[71]

The triumph of complexity over substance has also been driven by an increasing reliance on complex financial mathematics. Since the early days of the Capital Asset Pricing Model[72] and the Black/Scholes option pricing model[73] in the 1970s, investment firms have recruited analysts and traders with skills in quantitative analysis.[74] Over time, quantitative analysis and its complex models (such as the many variations of the *value at risk* models or 'VAR') moved from a measure used to verify prudential investment standards to becoming a major prudential and risk management tool for many investment firms.[75] This fed back into financial product design with many investment products designed primarily on complex financial models that hinged on their predictive capabilities.[76] The concept of tranching discussed above, central to the marketability of CDOs, depends on assuring investors (and CRAs) that the originator's financial modelling can accurately predict potential adverse events such as default rates.

The use of financial modelling as the main tool for modern risk management has contributed significantly to the growing complexity of financial products and the consequential lack of transparency about the risks associated with those products. However, the utility of a model is determined by the strength of its underlying assumptions, the accuracy of the data included in using the model and the ability of the model to predict previously unforeseen potentialities (the so called 'black swan event').[77] As the *Turner Review* noted in its final report on international banking regulation: 'It is clear in retrospect that the VAR measures of risk were faulty and that required trading book capital was inadequate'.[78]

The size of the market and its high degree of risk concentration, itself generating systemic risk, compound these problems of complexity.[79] For example, the high credit ratings given to many complex structured instruments were based partly on the existence of bond insurance conferred by companies such as Ambac and MBIA. These institutions (known as 'monoline insurers') had traditionally been involved in insuring municipal bonds that are relatively conservative, low yield financial products. Monoline insurers sought increasing profits by providing insurance over structured financial instruments such as

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71 Turner, above n 67.

72 William F Sharpe, 'Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk' (1964) 19(3) *Journal of Finance* 425.

73 Fischer Black and Myron Scholes, 'The Pricing of Options and Corporate Liabilities (1973) 81(3) *Journal of Political Economy* 637.

74 See generally, Partnoy, above n 70.

75 Joe Nocera, 'Risk Management', *New York Times Magazine* (New York) 2 January 2009, 24.

76 For example, a basic CDO could be used as collateral for another CDO thereby creating a CDO squared. This in turn could be used as collateral for another CDO called a CDO cubed.

77 Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (2007).

78 Financial Services Authority ('FSA'), *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) 19.

79 Systemic risk is an event such as an economic shock or institutional failure that causes a chain of detrimental effects to the financial system and real economy such as market failure, financial losses and volatility: see Steven L Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal* 193, 197–8.

CDOs, which in turn provided partial justification for AAA credit ratings over senior tranches of the CDOs. However, the value of the insurance depends on the reliability of the insurer. If a monoline insurer's corporate credit rating decreased, the value of its insurance over CDOs and other products would also decrease, causing widespread credit downgrades as structured instruments and investment managers could no longer hold the instrument due to investment mandates.

The large US monoline insurer MBIA provides a stark illustration of the potential for systemic risk posed by CDOs. At the end of December 2008 MBIA had provided insurance over approximately US$127 billion of CDOs. At the same time, MBIA had under US$1 billion in equity.[80] If MBIA were unable to pay the insurance covered by these amounts, the CDOs would be sold off on a massive scale as widespread credit downgrades forced asset sales, thereby flooding the market with already unpopular products and crushing the market price of the assets.

B Valuation

One important consequence of the lack of transparency regarding the risks associated with financial products has been the increasing difficulty of valuing these products, both as assets of the end purchasers, and as liabilities of the product issuers. For example, rising default rates in the US subprime market created uncertainty about the reliability of the financial modelling used to rate the risks associated with CDO products based on these mortgages. There is a well known behavioural trait that leads investors to assume the worst in the absence of complete information.[81] This is because firms have an incentive to release positive information (as share prices may rise as a result) and an incentive to conceal negative information (as share prices may fall as a result). Thus, investors who were unsure of the quality of the valuations of the underlying assets likely assumed the worst – ie that the assets were worthless. As buyers for these products disappeared, the securitisation market virtually closed. This was a significant contributing factor in driving up the cost of corporate finance.[82] Rising corporate finance costs were also caused by increasing demand for traditional bank debt when the securitisation and short-term commercial paper market closed down. Another cause was the failure or contraction of lending by hedge funds and other institutional investors (the so called 'shadow banking sector' discussed below). Bank lenders engaged in credit rationing both because of uncertainty about the valuations of their own assets and because of concern

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80 MBIA Inc, 'Form 10K Filing with SEC', 2 March 2009, Pt II item 6 (2009) MBIA <www.mbia.com> at 11 June 2009.

81 Frank H Easterbrook and Daniel R Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70(4) *Virginia Law Review* 669; George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84(3) *Quarterly Journal of Economics* 488; Stephen A Ross, 'The Determination of Financial Structure: The Incentive-Signalling Approach' (1977) 8 *The Bell Journal of Economics* 23.

82 'Blocked Pipes', above n 54, 70.

regarding the asset valuations maintained by borrowers, even in the inter-bank lending market.

These problems have also highlighted tensions with current international accounting standards, particularly the 'fair value' system that requires companies to regularly mark the value of their assets to market price.[83] In the extraordinary times of the financial crisis this has meant marking values to a virtually nonexistent market. When market value is the price that a fair-minded buyer is prepared to pay from a not-impatient seller how does one value assets that cannot be sold at any price because the market for that class of assets (such as CDOs) has closed down? The answer for many companies was $0. This seems unreasonable given that even a pool of high risk subprime mortgages is likely to have some borrowers who repay their loans on time, which means the underlying assets in many cases have value, albeit a value that will take 20–40 years to be realised.[84] The problems associated with fair value accounting for illiquid markets have been recently recognised by the Basel Committee, which has issued guidelines to banks that allow greater judgment in marking asset values to illiquid market valuations, particularly where one or more transactions (ie asset sales) have occurred at less than expected value due to illiquid market conditions.[85]

C Incentive Misalignment

Much of corporate law regulation is concerned with the problem of agency costs, which arise whenever there is a separation between ownership and control.[86] The common response to the problem of agency costs is to seek to align the interests of management with the perceived interests of investors[87] through the use of executive share schemes and other bonding devices. Similarly, it is common for major corporations to offer employees bonuses pegged to performance hurdles linked with corporate success. In investment banking, individual bonuses could reach astonishing levels – in the tens of millions of dollars each year for 'rainmaker' employees who brought in deals worth billions of dollars.

As noted above, over-the-counter derivatives are idiosyncratic products, creating the potential for high profit margins because of the lack of competition or comparison. On the other hand, competing firms could easily replicate highly successful products, which meant first that there was a constant imperative to

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83 Australian Accounting Standards Board ('AASB') *AASB 7: Financial Instruments: Disclosures* (2008); AASB, *AASB 139: Financial Instruments: Recognition and Measurement* (2008).

84 See generally David Roderic Myddelton, 'Accounting Aspects of the Financial Crisis' in Booth, above n 9, 101.

85 Basel Committee on Banking Supervision, *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices* (April 2009).

86 Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.

87 The alignment of interests does not focus on the actual demands of real shareholders as they are not a homogenous group.

innovate, and second that the profits from particular products would not remain high in the long or even medium term. This created a high-pressure environment to make fast profits by designing and selling new complex products to corporate and institutional investors. The incentives created by this environment were, in hindsight, overly weighted towards rewarding short-term behaviour that favoured large deals over sustainable future profits. This has been recognised by several major institutions changing their remuneration practices to reward longer term benefits.[88]

It should also be noted that salaries in investment banking are not driven solely by the hubris or greed of investment bankers but were substantially influenced by the competition for high quality employees across the finance industry, including lucrative packages offered by the funds management and hedge fund industry in recent years.[89] Another way of looking at individual incentives is through the lens of conflicts of interest, which are discussed below in Part IV.

The problem of incentive misalignment contributes to the 'procyclicality' of the banking system. It is generally accepted that banks tend to operate in tandem with macroeconomic cycles by engaging in higher risk activities during boom times and thereby suffering substantial losses during recessions. Incentive misalignment through huge short-term bonus payments encouraged traders to 'bet the house' during boom times. The near collapse of the US insurance giant AIG is ample evidence of the problems that can be caused for financial stability when 'casino capitalism'[90] takes hold.

Some have argued that the Basel II banking capital requirements further entrench the 'procyclicality' of the banking system.[91] The Basel II Accord is based on risk-weighted assets, with the risk weighting given to certain assets based on ratings given by CRAs. The lower the credit rating the greater the risk weighting given to the asset.[92] Unfortunately, the Basel II requirements, which have been widely adopted, resulted in financial institutions across the globe seeking out similar asset classes and similar highly rated securities that would carry lower risk weighting. Therefore, falls in the market value of these highly

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88 See, eg, changes made to the remuneration structures adopted by Swiss bank UBS, which provide cash bonuses spread over three years depending on a range of conditions, including no government bailouts and overall enterprise profitability: Swiss Financial Market Supervisory Authority ('FINMA'), *UBS – Variable Remuneration 2008* (10 February 2009) FINMA <www.finma.ch/d/aktuell/Documents/kurzbericht-ubs-variable-verguetungen-20090210-e.pdf> at 26 May 2009.

89 In May 2008, Australian hedge fund manager Greg Coffey made headlines worldwide when he turned down a A$250 million bonus to set up his own hedge fund in London. Mr Coffey's manager was quoted as saying he 'would never have imagined that a few hundred million dollars was an insufficient amount to retain somebody': Peter Wilson, 'Star Trader Coffey Takes $4bn with Him', *The Australian* (Sydney), 8 May 2008 Peter Wilson, 'Star Trader Coffey Takes $4bn with Him', *The Australian* (Sydney), 8 May 2008, < http://www.theaustralian.news.com.au/story/0,25197,23663981-601,00.html> at 17 September 2009.

90 Susan Strange, *Casino Capitalism* (1986).

91 FSA, above n 78.

92 APRA, above n 26.

rated securities has been felt throughout the financial sector. Capital adequacy rules that were designed to improve the stability of individual banks, have instead increased the level of systemic instability. There is also the problem of Basel II focusing on capital adequacy rather than adequate levels of liquidity.[93] The problems of similar assets being held by most financial institutions can generate significant market-wide problems when ratings downgrades occur and large volumes of similar assets need to be sold. This can render previously highly rated assets almost illiquid because market values may substantially decline as volume forced sales occur.[94]

Apart from the inadequacies of the Basel II Accord, it is clear that the short-term mentality of some finance executives and traders worked in tandem with the 'procyclical' nature of the banking system to create a bigger problem than the root cause of subprime mortgage defaults. However, short-termism could not have caused the damage it did without the ready supply of capital provided by the largely unregulated shadow banking system.

D New Pools of Capital

Another major factor in the depth of the financial crisis has been the increasingly important roles in credit provision played by non-traditional lenders such as hedge funds and money-market funds as well as credit provided by the securitisation process. It is estimated that this 'shadow banking system' comprised in excess of 80 per cent of the total credit provided in the US economy prior to the financial crisis.[95] Much of this lending capacity was provided by leverage and securitisation (discussed above), which depended on the low official interest rates. Low interest rates were driven by a range of factors, including the increasing role played by sovereign bodies with large trade surpluses generated by rising commodities prices and an export boom. These surplus funds were often used to purchase safe US treasury bonds, which put downward pressure on bond yields.[96]

Low bond yields caused investors to seek out the higher yields offered by so-called 'alternative investment classes', such as hedge funds and private equity funds. The money provided to these funds came from diverse sources including wealthy investors, pension funds, other alternative investment bodies (so-called 'fund of funds') and of course through the purchase and sale of CDOs.

Once the short term money markets and securitisation markets tightened up in 2007–8, the shadow banking system shrank dramatically. This had several

93 FSA, above n 78; Arner, above n 61.

94 FSA, above n 78.

95 'Too Big to Swallow', *The Economist* (London), 16 May 2009 <http://www.economist.com/specialreports/displaystory.cfm?story_id=13604641> at 14 September 2009. See also Garry Schinasi, *Safeguarding Financial Stability: Theory and Practice* (2006) 167.

96 Loser, above n 54, 6; Ravi Balakrishnan, Tamim Bayoumi and Volodymyr Tulin, 'Globalization, Gluts, Innovation or Irrationality: What Explains the Easy Financing of the US Current Account Deficit?' (Working Paper No 07/160, IMF, 2007); William Devlin and Bill Brummitt, 'A Few Sovereigns More: The Rise of Sovereign Wealth Funds' (2007) Spring, *Economic Roundup*, 119.

important consequences. In particular, the declining profitability of these funds (particularly hedge funds) caused in some cases a dramatic rise in redemption requests from investors. Numerous funds have closed down, many more have limited or even frozen redemptions by investors.

The growing number of redemption requests has caused some funds to liquidate large portions of their asset portfolios, in many cases through forced sales at well below book value for the assets. This has had flow-on effects on the broader economy by contributing to a general decline in asset prices, particularly with respect to securities and real property. This can create a negative feedback loop where declining asset prices lower the profitability of funds and sap investor confidence, resulting in further redemptions and asset sales.

One thing is clear: low interest rates and (comparatively) easy access to credit set the foundation for the initial asset price bubble to develop and expand. Failures by central banks to reign in 'irrational exuberance'[97] by tightening monetary policy, and by federal governments to maintain conservative fiscal policy, allowed the asset bubble to become unsustainable.

E Regulatory Gaps

Financial regulation takes both direct and indirect forms. Direct financial regulation occurs through the role and powers of government regulators, such as the Australian Securities and Investments Commission ('ASIC'). Regulators may be responsible for specific issues – for example APRA which regulates prudential capital requirements – or have a broader brief, for example ASIC, which includes primary supervision of financial services licensing, consumer protection as well as corporate governance and corporate disclosure. Indirect regulation can occur through the use of particular non-government bodies who act as gatekeepers, such as auditors, lawyers and credit ratings agencies. The role of gatekeepers is discussed below in Part IV.

Many of the problems associated with the financial crisis have involved banks and bank lending practices.[98] Banks were able to lend to borrowers who could not repay the loans, to sell the risky loans through complex financial products and to invest in opaque securities because of the lack of effective and clear regulatory oversight. This was particularly so in the United States, although banking regulators in other countries such as England, Germany and Switzerland have also been heavily criticised,[99] and particularly with regard to investment

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97 Alan Greenspan, 'The Challenge of Central Banking in a Democratic Society' (Speech delivered at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, DC, 5 December 1996).

98 Alex Brummer, 'A Failure of Regulation', *New Statesman* (London), 20 September 2007 <www.newstatesman.com/business/2007/09/northern-rock-bank-crisis> at 26 May 2009; FSA, above n 78.

99 FSA, above n 78; Department of Treasury, above n 62; Booth, above n 9.

banking and derivatives.[100] With the exception of AIG, General Motors and Chrysler in the United States, the majority of large-scale bailouts and bankruptcies caused by the crisis have involved banks.[101]

It is clear that bank supervision has contributed to the size, severity and duration of the credit crisis.[102] Aside from the role of the Basel II Accord, discussed above, two issues stand out in particular. First, the failure of banking regulators, particularly in the United States, to limit or seemingly to curtail in any way the extraordinary risks taken by banks (both investment and commercial) or to minimise the large concentration of risk being held in a small number of institutions. For example, after taking over Bear Stearns in 2008, it was estimated that JP Morgan Chase held over 25 per cent of all of the world's CDS. Given the destruction of value generated by CDS trading at AIG, it seems extraordinary that so much risk, both before and after the takeover, could be concentrated in one institution without banking regulators taking action.

Furthermore, the patchwork of regulation in the US banking system seems to have facilitated the banks' high risks. Unlike Australia, the US has a fragmented system of banking regulation, involving both state and federal banking regulators.[103] Australian banks and other authorised deposit taking institutions are regulated by APRA within the framework of the *Banking Act 1959* (Cth). The Reserve Bank of Australia provides regulatory supervision of the overall payment system and regulates the cost of credit through its responsibilities for setting monetary policy. US banks, on the other hand, have a range of state regulatory bodies (such as the New York State Banking Board) as well as national bodies under the overarching jurisdiction of the Federal Reserve System that has 12 separate banks and 24 individual branches, under the overall chairmanship of Ben Bernanke and the other board of governors.[104]

The Federal Reserve has responsibility for the overall supply and pricing of money for federal banks, and also sets capital adequacy requirements. Of course, not all banks are federal, which means that state banking regulators also have this responsibility. Other federal bodies, such as the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and the Office of Thrift

100 See Lawrence A Cunningham and David T Zaring, 'The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response' (2009) forthcoming *George Washington Law Review*.

101 For a list of institutions receiving financial assistance from the US Troubled Asset Relief Program ('TARP') see <http://www.financialstability.gov/impact/contracts_list.htm> at 20 June 2009; *The New York Times* also maintains an up to date list of relief recipients according to industry type with almost all of the recipients in the banking industry: Matthew Ericson, Elaine He and Amy Schoenfeld 'Tracking the $700 Billion Bail Out' (2009) *New York Times*, <http://projects.nytimes.com/creditcrisis/recipients/table> at 2 August 2009.

102 See generally FSA, above n 78; Booth, above n 9.

103 Mark Jickling and Edward V Murphy, *R40249 Who Regulates Whom? An Overview of US Financial Supervision* (24 February 2009); Heidi Mandanis Schooner and Michael Taylor, 'Convergence and Competition: The Case of Bank Regulation in Britain and the United States' (1999) 20(4) *Michigan Journal of International Law* 595; Andreas Busch, *Banking Regulation and Globalization* (2009) ch 3.

104 See generally Board of Governors of the Federal Reserve System, <www.federalreserve.gov> at 3 August 2009.

Supervision, also have a role in setting capital adequacy requirements for banks and other deposit taking and lending institutions. The complex web of federal and state regulators, each with their own requirements and supervisory powers, generates considerable regulatory gaps that appear to have been exploited with banks in the US taking huge risks on structured finance instruments. These problems were exacerbated by the systemic risk posed by the increasingly important shadow banking sector.[105] The banking regulatory gaps that existed in the US allowed non-bank firms to take an important role in providing liquidity to the market. The failure to adequately regulate hedge funds and private equity funds by focussing on institutional characteristics rather than functional characteristics has allowed high concentrations of systemic and contagion risk to develop, with AIG being a clear example of this.[106]

This has been recognised by the recent US Treasury Reform Proposal to provide the Federal Reserve with further powers and responsibility to oversee 'systemic risk'.[107] The regulatory gaps in the US banking system also allowed non-bank lenders such as hedge funds to take an increasingly important role in providing liquidity by purchasing derivatives and other structured finance products. The significance of hedge funds and other participants in the so-called 'shadow banking system' and the systemic risks they pose, has been recognised by the recent US Treasury reform proposals to increase oversight of systemic risks.[108]

Another regulatory gap has been the perceived inconsistency of approach applied by regulators, central banks and government treasury departments in responding to the crisis. The best example is the differing treatment of Bear Stearns on the one hand, which the US government engineered a takeover as a bailout, and Lehman Brothers on the other, which the US government refused to rescue and that eventually entered bankruptcy.[109]

F Globalisation of Capital Flows

The globalisation of capital has been an integral part of the scale of the financial crisis.[110] The globalisation or internationalisation of finance has both benefits and disadvantages for individual countries and their citizens. It can provide for access to global markets, thus reducing financing costs and allowing for business cycles to be smoothed, but it can also allow for the rapid

105 Emilios Avgouleas, 'The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy' (2009) 9 *Journal of Corporate Law Studies* 23.

106 Aaron Unterman, 'Innovative Destruction – Structured Finance and Credit Market Reform in the Bubble Era' (2009) 5 *Hastings Business Law Journal* 53.

107 Department of Treasury, above n 62.

108 These will include increasing the responsibility and powers of the Federal Reserve, the creation of a new Financial Services Oversight Council and increasing capital adequacy requirements for financial firms: ibid.

109 Arner, above n 61, 113–5.

110 See Garry Schinasi, *Safeguarding Financial Stability – Theory and Practice* (2006) 155–65 for an overview of the globalisation of finance process.

transmission of economic shocks between economies.[111] Investors are able to purchase a wide variety of securities offered on various international markets, which has allowed the impact of the subprime crisis to spread around the world. It also allows for regulatory competition as financial institutions or investors move their operations and investments to jurisdictions they find favourable – whether that be because of the presence of the rule of law, the existence of transparency and good corporate governance or because regulation and its associated costs are minimised. Regulatory competition that results in jurisdictions with inadequate regulation can then create risks for other jurisdictions due to the interconnection of economies and markets.[112] On the other hand, there is the incentive for jurisdictions having low levels of investor protection to increase their levels of regulation in order to encourage increasing capital inflows.

The globalisation of capital flows also poses considerable regulatory challenges. The financial institutions at the centre of the financial crisis, such as AIG, UBS and Lehman Brothers all operate(d) across borders with each foreign subsidiary subject to different regulatory supervision. AIG, for example, undertook most of its controversial CDS transactions via its London office, but it was regulated as an insurance company in the US. The move to harmonise international financial laws has been discussed in various forums, including the G20. However, aside from supervisory cooperation through bodies such as International Organization of Securities Commissions ('IOSCO') and model law initiatives through United Nations Commission on International Trade Law ('UNCITRAL'), it is difficult to achieve international consistency. The competitiveness of capital markets depends in part on the attractiveness of the legal regime for capital market regulation and investor protection. Proposed regulatory changes to US, UK or other capital markets are outside of the scope of this article.

The factors discussed above did not individually cause the global financial crisis that has seen asset values and stock markets plummet, millions of jobs lost and large numbers of corporations collapse, even those once thought too big to fail. However, each of these factors played a part in turning rising US mortgage defaults into the worst financial crisis since the Great Depression. Having discussed the key events that have unfolded during the crisis so far and elucidated the underlying themes that generated, spread and prolonged the financial crisis, it is now important to understand what role the law has in the debate about the GFC's causes and consequences.

111 Hal Scott, *International Finance: Law and Regulation* (2008) 14–5. Globalisation's benefits are also not evenly spread across nations: see Ross Buckley, *International Financial System – Policy and Regulation* (2008) ch 2.

112 '[The US] had a number of firms that took wild and unjustified risks, we had regulators that were asleep at the switch, and it has taken an enormous toll on the US economy and has spread to the world economy.': Barack Obama, 'News Conference by President Obama' (Speech delivered at the ExCel Center, London, 2 April 2009).

IV LEGAL ASPECTS OF THE CRISIS FOR AUSTRALIA

Governments, regulators, advisers and researchers have debated the roles of the market, the political economy and the legal system in relation to what factors contribute to financial development and economic growth. The debate has included analysis of lack of regulation and over-regulation, legal rules compared to actual enforcement, and of public verses private enforcement.[113] Findings have included that countries with poorer investor protection, measured by both the character of legal rules and the quality of legal enforcement, have smaller and narrower capital markets.[114] However, law, markets and politics are continually evolving and impacting upon each other. Laws create incentives for particular types of behaviour; markets develop new financial products or services that are not subject to regulation and political views about how best to regulate can affect what laws are created and applied. The financial industry has argued that over-regulation can lead to costs and a lack of international competitiveness.[115] Indeed much of the past 25 years has been aimed at securing deregulation because of the efficiency of markets and meant that regulation could distort the market's ability to allocate resources.[116]

The GFC has seen a shift in the role envisaged for law as there has been a lack of regulatory oversight and a miscalculation of the costs of too little regulation. The prime examples are investment banks and derivatives,[117] but banking and investor protection generally have also been criticised.[118]

The GFC therefore calls for a fundamental rethinking about the appropriate levels and methods of regulation. Indeed, the last catalyst for large scale government regulation in the area of markets and securities was the Great Depression, suggesting that a similar opportunity exists now.[119] Even one of the doyens of the Chicago School of Economics, Richard Posner, has stated: 'The

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113 See, eg, Rafael La Porta et al, 'Legal Determinants of External Finance', (1997) 52(3) *Journal of Finance* 1131, 1149; John C Coffee Jr, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control' (2001–2) 111 *Yale Law Journal* 1, 8–9; Bernard Black, 'The Legal and Institutional Preconditions for Strong Securities Markets' (2000–1) 48 *University of California at Los Angeles Law Review* 781, 782–3; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'What Works in Securities Laws?', (2006) 61 *Journal of Finance* 1, 14, 20; John C Coffee Jr, 'Law and the Market: The Impact of Enforcement' (2007) 156(2) *University of Pennsylvania Law Review* 229.

114 La Porta et al, 'Legal Determinants', above n 113, 1149; Rafael La Porta et al, 'Law and Finance', (1998) 106(6) *Journal of Political Economy* 1113; World Bank, *World Development Report 2002 – Building Institutions for Markets* (September 2001).

115 John C Coffee Jr, 'Financial Crises 101: What can we learn from Scandals and Meltdowns – From Enron to Subprime?' in R P Austin, *The Credit Crunch and the Law* (2008) 37; see also Robert C Ellickson, 'Taming Leviathan: Will the Centralizing Tide of the Twentieth Century Continue Into the Twenty-First?' (2000) 74 *Southern California Law Review* 101.

116 Peter Cartwright, *Banks, Consumers and Regulation* (2004) 14–8.

117 Cunningham and Zaring, above n 100.

118 Brummer, above n 98.

119 See, eg, *Securities Act*, 15 USC §§ 77a–77aa (1933); *Securities Exchange Act*, 15 USC §§ 78a–78lll (1934); Lawrence Friedman, *A History of American Law* (2nd ed, 1985) 658.

movement to deregulate the financial industry went too far by exaggerating the resilience – the self-healing powers – of laissez faire capitalism.'[120]

Part IV of the article seeks to focus on key legal issues that the GFC has raised and to suggest reforms for better protecting the financial system and its investors.

A Disclosure and Information Asymmetry

The investment problems relating to information asymmetries, particularly with regard to complex derivative instruments, are discussed above. The legal dimension that is concerned with this issue is the adequacy of disclosure requirements in regulating these instruments. In Australian securities law, derivatives are generally classified as financial products for the purposes of the *Corporations Act 2001* (Cth) Chapter 7.[121] However, the primary disclosure obligations of this classification do not necessarily resolve the problem of information asymmetries. This is because the products discussed above are often traded only between institutional investors and professional brokers and dealers, which means that the obligation to provide a product disclosure statement and statement of advice under Chapter 7 of the Act does not apply.[122] In this situation it is more likely that general provisions prohibiting misleading or deceptive conduct in relation to financial services or to a financial product will apply.[123]

While it seems clear that the disclosure obligations imposed on issuers and distributors of derivative instruments did not provide sufficient information to properly judge the risks associated with investing in these instruments, the problems of information asymmetry relate more to the complexity of the underlying instruments rather than defects in disclosed information. All investors, including large sophisticated institutions, should press the issuers of complex financial products to provide more comprehensible disclosure rather than wholly delegate this responsibility to gatekeepers such as CRAs (considered below). It could also be argued that government regulators could have done more to monitor information provided by product issuers, but with OTC markets it is exceedingly difficult to see how regulators such as ASIC or APRA could monitor the trading of private agreements. Regulatory gaps are bound to appear, particularly when those who are regulated have a vested interest in minimising transaction costs associated with regulatory burdens.

120 Richard Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009) xii.

121 It should be noted that the extensive regulatory gaps that exist for derivatives in the United States with no single regulator (neither the Commodity and Futures Trading Commission nor the Securities and Exchange Commission) having comprehensive responsibility has been addressed by US Treasury Department recommendations to harmonise the relationship between these two regulators to ensure comprehensive regulation of OTC derivatives: Department of Treasury, above n 62, ch II.

122 There are some limited exceptions however, such as contracts for difference, which are a type of equity based derivative marketed heavily to retail investors and therefore require disclosure. See generally: Sally Palmer, 'Contracts for Difference, Spread Bets and Over the Counter Derivatives: Through a Lawyer's Looking Glass' (2007) 25(4) *Company and Securities Law Journal* 246.

123 *Corporations Act 2001* (Cth) s 1041H.

Thus the legal response to information asymmetries is not to simply mandate further disclosure, or to extend standard form disclosure documents to complex derivatives. Rather the legal responsibility rests on more effective enforcement of existing rules, minimising regulatory gaps, addressing pervasive conflicts of interest and promoting a more responsible approach by individual investors to understand the products they are investing in. One measure that has been suggested by a joint report from APRA, ASIC and the RBA is to increase industry standard form contracts for different types of commonly traded derivatives.[124] The United States has also recently proposed that participants in derivatives trading should be required to maintain more extensive books and records and will be required to maintain stronger capital adequacy thresholds.[125]

B Gatekeepers

A gatekeeper is an outside or independent professional that is placed in a position whereby it can monitor or prevent wrongdoing.[126] In the corporate context gatekeepers are seen as performing two related roles. First is the certification role. This definition views gatekeepers as reputational intermediaries who provide verification and certification services to investors.[127] The gatekeeper fulfils its role because its reputational capital is at stake. The gatekeeper relies on repeat work that will only be forthcoming if its reputation remains intact and is seen as a reflection of quality and veracity. The second definition sees gatekeepers as restricting access to the market by securities issuers who do not conform to legal (and market) standards by withholding cooperation or consent.[128]

Gatekeepers are desirable first because they overcome an investor's inability to individually be able to afford the cost of monitoring an investment, second because they reduce agency costs and third because they can act as a form of investor protection.[129] Corporations also benefit from gatekeepers because in reducing the risk to investors they also reduce the issuers' cost of capital.[130] In the context of the GFC gatekeepers became very important because disclosure alone was insufficient to deal with the complexity of financial instruments. When the gatekeeping function failed, investors who did not understand the underlying investment themselves were left unprotected.

124 APRA et al, above n 68; similar measures have been proposed in the US: Department of Treasury, above n 62, ch II.

125 Department of Treasury, above n 62.

126 John C Coffee Jr, *Gatekeepers: The Professions and Corporate Governance* (2006) 1–2.

127 Stephen Choi, 'Market Lessons for Gatekeepers' (1998) 92 *Northwestern University Law Review*, 916, 918; ibid 2.

128 Reinier H Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (1986) 2 *Journal of Law Economic and Organization* 53.

129 Stephen J Choi and Jill E Fisch, 'How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries' (2003–4) 113 *Yale Law Journal* 269, 271–2.

130 See, eg, Jensen and Meckling, above n 86, 305–7.

1 *Auditors*

The auditor is the classic example of a gatekeeper as it provides an audit report in relation to financial accounts that verifies their compliance with the law.[131] A qualified audit report will alert shareholders to noncompliance and attract the attention of regulators.[132] In Australia, an auditor is required to form an opinion and report to members concerning whether the financial report is in accordance with the *Corporations Act 2001* (Cth), including compliance with accounting standards and presenting a 'true and fair view'.[133] Auditors also have an ongoing duty to disclose to ASIC any contraventions of the Act.[134]

The gatekeeper's integrity was reinforced through the *Corporate Law Economic Reform Act (Audit Reform and Corporate Disclosure) Act 2004* (Cth) ('CLERP 9') that was enacted in the wake of the Enron and HIH collapses to bolster independence. Division 3 of Part 2M.4 of the *Corporations Act 2001* (Cth) sets out general requirements for auditor independence and specific relationships that will compromise auditor independence. The Act creates offences to promote the avoidance of a 'conflict of interest situation' between an auditor and the 'audited body'. A conflict of interest situation is defined as existing when circumstances mean that:

- the auditor is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body; or
- a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.

The specific independence requirements create offences aimed at prohibiting certain relationships between the auditor and audited body that are set out in section 324CH(1). Those relationships may be described as nine employment and ten financial relationships that compromise an auditor's independence.[135]

Despite the above requirements audit failure has been implicated in the GFC. The allegations have focused on incorrect classification of debt, valuation of financial instruments such as CDOs and MBS and valuation of loans. Indeed the auditor has been referred to as a potential defendant in relation to most corporate

131 Coffee, above n 126, 2; Black, above n 113, 784.

132 Elizabeth Carson, Andrew Ferguson and Roger Simnett, 'Australian Audit Reports' (2006) 16(3) *Australian Accounting Review* 89, 92, 95.

133 *Corporations Act 2001* (Cth) ss 307–8; see also *Corporations Act 2001* (Cth) ss 296–7, 304–5.

134 *Corporations Act 2001* (Cth) ss 311, 601HG; Michael Legg, 'An Auditor's Obligations to Report to ASIC – Between the Hammer and the Anvil' (2005) 23 *Company and Securities Law Journal* 264.

135 Michael Legg, 'Auditor Independence and Criminal Liability Under CLERP' 9 (2006) 34 *Australian Business Law Review* 156; see also *Corporations Act 2001* (Cth) Div 5 of Pt 2M.4, which provides for auditor rotation; see also *Corporations Act 2001* (Cth) s 307C, which requires an auditor to provide a declaration of independence to the audited body.

collapses or major share price declines such as Centro and ABC Learning.[136] The continuation of audit litigation raises two issues for consideration: whether further reforms are needed to enhance the gatekeeper role, and the ramifications of the litigation for society.

A lack of independence in the above statutory terms has not yet been raised as a source of GFC-related litigation. However, independence in the broader sense of the auditor not viewing themselves as performing a public duty but rather seeing themselves as corporate advisers who can assist management so as to continue to earn audit fees may need further examination.[137] Further liability of auditors is an oft-raised suggestion that is a double-edged sword, as discussed below.

It remains to be seen whether the above allegations translate into findings of negligence or a search for a deep pocket. Legislation has been enacted to deter litigation aimed at deep pockets through the introduction of caps on liability and proportionate liability.[138] The legislative reforms still allow for the continuation of litigation against auditors and so reflect a balance between:

(a) reducing the extent of liability so as to ensure audit firm continuity that is essential to the functioning of corporate reporting and the capital markets; and

(b) preserving the ability of private litigation to deliver compensation, provide deterrence and encourage audit quality as part of promoting investor confidence in corporate reporting and the capital markets.

The problem with this domestic balance is that auditing is part of the global financial system so that the effectiveness of the balance may depend on how other countries deal with auditor liability.[139] The GFC has highlighted this global connection with substantial lawsuits pending against auditors. In the United

136 Patrick Durkin and James Eyers, 'Regulator to Crack Down on Auditors', *The Australian Financial Review* (Melbourne) 2 June 2009 1, 6–7; Adam Schwab, 'Billion-dollar Errors: Lawyers Shape Up to Big Audit Firms', *Sydney Morning Herald* (Sydney) 9 June 2009, 17–8.

137 Rebecca Roiphe, 'The Most Dangerous Profession' (2006) 39 *Connecticut Law Review* 603, 660–1; *contra* Coffee Jr, above n 126, 342 arguing that the auditor reporting to an audit committee comprised of independent directors may be the best available option.

138 *Professional Standards Act 1994* (NSW); *Professional Standards Act 1997* (WA); *Professional Standards Act 2003* (Vic); *Professional Standards Act 2004* (Qld); *Professional Standards Act 2004* (SA); *Professional Standards Act 2005* (Tas); *Professional Standards Act 2004* (NT); State or territorial laws limiting professional liability is extended to s 52 of the *Trade Practices Act 1974* (Cth) by ss 87AB, 1041H of the *Corporations Act 2001* (Cth) by ss 1044B, 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth) s 12GNA; *Civil Law (Wrongs) Act 2002* (ACT), ch 7A; *Civil Liability Act 2002* (NSW), pt 4; *Proportionate Liability Act 2005* (NT), pt 2; *Civil Liability Act 2003* (Qld), ch 2 pt 2; *Law Reform (Contributory Negligence and Apportionment of Liability) Act 2001* (SA), pt 3; *Civil Liability Act 2002* (Tas), pt 9A; *Wrongs Act 1958* (Vic), pt IVAA; *Civil Liability Act 2002* (WA), pt 1F; *Trade Practices Act 1974* (Cth), pt VIA; *Australian Securities and Investments Commission Act 2001* (Cth), pt 2 div 2 Subdiv GA; *Corporations Act 2001* (Cth), pt 7.10 div 2A; there is no proportionate liability in areas such as continuous disclosure, prospectuses and takeovers: see Michael Legg, 'Advisers Can Still End Up Out-of-pocket', *The Australian Financial Review* (Melbourne) 31 July 2006, 63.

139 Michael Legg, 'The Global Financial Crisis and Auditor Litigation' (2009) 61 *Keeping Good Companies* 55, 58.

States, the six largest auditing firms disclosed that prior to the GFC they were defendants in 90 actions with damage claims against the auditors in each case in excess of US$100 million.[140] To these suits may be added claims against auditors in relation to the buy-out of Bear Stearns, the demise of AIG and failure of Lehman Brothers, Washington Mutual, and subprime lenders Countrywide and New Century.[141]

The damages award that could flow from these cases could be of such a size as to exceed the total capital of an auditing firm. If a US law suit causes an audit firm to fail then Australia's capital markets, corporations and investors may be impacted regardless of Australia's liability regime. Auditor regulation is yet another area where a global response is required.

2 *Credit Rating Agency ('CRA')*

The CRA is also able to be viewed as a gatekeeper as the rating placed on a debt issue, MBS or CDO certifies the risk associated with that financial product to investors and without a rating the product could not be sold in the marketplace or only for a much reduced amount. In particular, securitisation would not have been as popular and could not have spread as easily throughout the global financial system without the imprimatur of CRAs. The world of structured finance involves complex products whose risks and cash flows are not easily ascertained because of the number of intermediaries involved and the detailed web of contractual rights and subordinated rights. Indeed, the more complex the product, the greater the reliance by both issuers and investors on the rating given because of the increased information asymmetries generated by opaque complex structures.

It seems clear in hindsight that the rating agencies were unable to perform their gatekeeper role because they could not provide ratings that accurately predicted the risk of default. This may be explained by reference to several factors.[142] First, the number of applications for ratings has increased exponentially in the last 20 years but the ratings agencies did not devote sufficient resources to assessing the quality of those applications.[143] Second, ratings agencies are paid by the product issuers and other companies that seek ratings. This became problematic because a small number of investment banks produced the majority of structured finance issues so that the CRA became

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140 Forty-one of the 90 cases seek damages in excess of US$500 million, 27 cases seek damages in excess of US$1 billion, and 7 cases seek damages over US$10 billion: Department of the Treasury, *Advisory Committee on the Auditing Profession: Final Report* (6 October 2008) VII: 24–6.

141 Matt Kelly, 'More Who-Gets-Screwed Bailout News', *Compliance Week* (Washington) 2 October 2008 <http://www.complianceweek.com/blog/kelly/2008/10/02/more-who-gets-screwed-bailout-news/> at 26 May 2009; Stuart Alix, 'Subprime Suspects', *CFO Magazine* (London) 1 December 2008 <http://www.cfo.com/article.cfm/12668112/c_12749395> at 14 September 2009.

142 Coffee Jr, above n 115.

143 Jeffrey Manns, 'Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability' (2009) 87 *North Carolina Law Review* 1011, 1043–7.

beholden to these banks for a comparatively large portion of the profits earned by the ratings agencies.[144]

The legal issues raised by CRAs centre on their relatively low levels of regulation and oversight and the perceptions of conflicts of interest and overall poor quality control with respect to rating complex products. CRAs have always had an important role in the US legal system with a wide range of statutes referring to ratings provided by a Nationally Recognized Statistical Rating Organization ('NRSRO').[145] The US Securities and Exchange Commission ('SEC') had traditionally recognised NRSROs by issuing no-action letters after investigating particular CRAs. However, the passage of the *Credit Rating Agency Reform Act 2006* (US) imposed stricter requirements on the SEC to provide formal rules relating to the recognition of NRSRO status that has now been completed with the release of final rules.[146] The Obama administration has indicated that it requires greater disclosure of conflicts of interest and ratings methodologies to enable investors to reach their own conclusions about the efficacy of a rating. Further, regulatory reliance on credit ratings is to be reduced.[147] These reforms have been labelled as a 'missed opportunity',[148] and are critiqued further below in relation to conflicts of interest.

In Australia, CRAs require an Australian Financial Services License ('AFSL') under Chapter 7 of the *Corporations Act 2001* (Cth), as their ratings advice would fall within the definition of providing a financial service. Holding an AFSL comes with a multitude of regulatory obligations, including conditions imposed on the license itself and ongoing burdens to maintain the license. However, ASIC has traditionally granted class order relief from these requirements for the three main global rating agencies (Moodys, Standard and Poor's and Fitch Ratings), with the result that these agencies are not required to hold an AFSL.[149] The class order relief from licensing is conditional on the ratings agencies complying with the IOSCO Code of Conduct for Credit Rating Agencies, which was introduced in 2003.[150] The Code deals with issues such as quality assurance of credit ratings, maintaining independence and dealing with conflicts of interest. IOSCO released additional guidance on the code of conduct in 2004, which promotes public disclosure by ratings agencies of their internal codes of conduct. Failure to disclose the code of conduct would remove the class order relief granted by ASIC.

On 11 November 2008, the then Minister for Superannuation and Corporate Law announced that the class order relief would be removed, bringing CRAs

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144 Jerome S Fons 'Testimony of Jerome S Fons Before the Committee on Oversight and Government Reform' (Opening Statement delivered at the *US House of Representatives*, 22 October 2008) 3.

145 See generally, SEC <www.sec.gov/divisions/marketreg/ratingagency.htm> at 3 August 2009.

146 Securities and Exchange Commission, 'Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations' (5 June 2007) 2.

147 Department of the Treasury, above n 62, 46.

148 Eric Dash, 'Critics Lament a Missed Opportunity', *The Australian Financial Review* (Melbourne) 19 June 2009, 19.

149 ASIC Class Order 05/1230.

150 Available at <www.iosco.org>.

within Chapter 7 of the Act.[151] This will therefore require CRAs to maintain an AFSL with conditions imposed by ASIC. CRAs will also be required to provide a compliance report with the IOSCO Code as a condition of their license. Requiring CRAs to maintain and AFSL will also impose the general obligations that apply to all AFSL holders including the obligation to:[152]

- maintain adequate measures to deal with conflicts of interest[153]
- maintain adequate resources to provide financial services; and
- ensure that its representatives are adequately trained, and are competent, to provide the financial services specified in its license.

Similar to the US reforms, there are questions as to whether the above changes go far enough in relation to a gatekeeper that was central to the GFC.

3 *Lawyers*

The lawyer is usually seen as owing professional, contractual, tortious and fiduciary duties to the client.[154] Those duties involve all legal practitioners maintaining confidentiality and acting with loyalty and fidelity to their client's interests within the bounds of the law.[155] The lawyer must also maintain their independence.[156] However, the lawyer has also been put forward as a potential gatekeeper that culminated in the United States with the *Sarbanes Oxley Act of 2002* that required that a lawyer must engage in 'up-the-ladder' reporting, whereby an attorney must inform senior management of material violations and if management does not adequately respond, the lawyer must go up the corporate chain of command and inform the board of directors or one of its committees.[157]

In the wake of the GFC the concept of lawyers as gatekeepers may need to be revisited. The role of lawyers in the GFC has arisen due to their documenting and advising on many of the financial instruments that allowed the risk of subprime mortgages to be disseminated amongst investors and in relation to misleading corporate disclosures about debt obligations. Whilst the criticism of lawyers in relation to the GFC has been primarily occurring in the US, recent developments in Australia suggest that Australian lawyers are not immune from having difficulty in identifying the client so that they seek to please management rather

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151 Nick Sherry, 'Improved Australian Controls for Credit Rating Agencies and Research Houses' (Press Release, 13 November 2008).

152 *Corporations Act 2001* (Cth) s 912A(1).

153 See also, ASIC, *Regulatory Guide 181, Licensing: Managing Conflicts of Interest* (30 August 2004); concerns about the adequacy of these measures are discussed further below.

154 *Maguire v Makaronis* (1997) 188 CLR 449, 463; Ysaiah Ross, *Ethics in Law: Lawyers' Responsibility and Accountabilty in Australia* (4th ed, 2005) 46, 65.

155 Ross, above n 154, 217, 481, G E Dal Pont, *Lawyers' Professional Responsibility in Australia and New Zealand* (3rd ed, 2005) 71, 75–8; Geoffrey C Hazard Jr and Angelo Dondi, *Legal Ethics: A Comparative Study* (2004) 170–2, 204–9.

156 G E Dal Pont, above n 155, 375–81; 'Clients seek a lawyer's guidance precisely because it is independent of the client's interests and objective in its legal content': Justice Gerard Brennan, 'Pillars of Professional Practice: Functions and Standards' (1987) 61(3) *Australian Law Journal* 112, 117.

157 'Developments in the Law: Corporations and Society' (2003–2004) 117 *Harvard Law Review* 2169.

than act in the best interests of the corporation and compromise their independence.

In the long-running dispute over pay television, *Seven Network News Ltd v News Ltd* (also known as the C7 litigation) the actions of the General Counsel of News Ltd came under close scrutiny. The Court found that News Ltd's General Counsel 'gave the impression of a man who quite willingly subordinated his sense of ethics and propriety to a single-minded determination to advance the commercial interests of his employer.'[158]

Similarly in the James Hardie case in which ASIC sought civil penalties against directors and officers, ASIC alleged that the General Counsel had breached his duty to exercise due care and diligence in failing to advise the board of directors that the draft ASX announcement that was prepared to comply with the company's continuous disclosure requirements was false and misleading.[159] The Court held that the General Counsel had breached his duty of due care and diligence as an 'officer' of the corporation.[160] Further, the Court opined that '[g]uarding against legal risks to [the corporate entity] was at the core of ... responsibilities as general counsel.'[161]

On one view the lawyer is merely the tradesman creating documents at their client's behest and cannot be held responsible for misconceived views about risk or the conflicts of interest that drove the deals that handsomely rewarded executives and bankers but were harmful to investors and shareholders. Further, lawyers may not have the knowledge to be able to comprehend the full effect of certain accounting treatments or intricacies of a financial product. Another perspective is that lawyers exercising their duty of independence should tell would-be clients 'they are damned fools and should stop'.[162] The latter position may assume a prescience that many politicians and regulators did not have. Nonetheless the gravity of the GFC means that potential reforms should be examined.

The first approach to reform would be to simply mirror the *Sarbanes-Oxley* reforms and create 'up-the-ladder' reporting obligations. This would reinforce to lawyers that their obligations are owed to the corporate entity and would empower the board of directors as they could expect improprieties known or suspected by the corporation's lawyers to be brought to their attention. A board of directors may still not act but it would be at their own peril.

The 'up-the-ladder' reporting obligations could be strengthened or weakened. A stronger reform would be to require lawyers to resign or terminate their representation if there was an inadequate response from the board of directors. An even more potent reform would be to impose specific external reporting

158 *Seven Network News Ltd v News Ltd* (2007) ATPR (Digest) 42–274, [422]. The Court's finding was based on admitted dishonesty and the destruction of documents so as to hinder any potential suit for breach of confidentiality.

159 *ASIC v Macdonald (No 11)* (2009) 256 ALR 199.

160 Ibid [406], [413].

161 Ibid [394].

162 Elihu Root in Hazard Jr and Dondi, above n 155, 158.

obligations. This could include a duty to disclose to ASIC any contraventions of the *Corporations Act 2001* (Cth) that a lawyer has reasonable grounds to suspect. This would be similar to sections 311 and 601HG in relation to auditors.[163] Similar requirements have been adopted in relation to suspicious money transfers in Australia, Europe and Canada.[164] A less strict approach would be to simply educate lawyers as to existing whistleblower legislation such as Part 9.4AAA of the Act.

Reporting to an outside entity may serve to bring possible contraventions to light more quickly and thus act to dissuade illegal activities. However, external reporting runs contrary to the lawyers' duties of confidentiality, loyalty and independence.[165] There may also be a loss of legal professional privilege although privilege cannot be maintained in relation to illegal activities.[166] There is therefore a question as to whether imposing external reporting obligations on lawyers would have a chilling effect on communications from a corporation's managers to lawyers. However, in a highly regulated world it would be very difficult for a corporation to function without legal advice.[167]

Alternatively, there could be the adoption of 'demand side' reforms, whereby there is a greater opportunity and incentive for the board of directors to obtain independent legal advice.[168] A listed corporation could be required to have any corporate disclosures verified by external counsel, thus imposing an obligation on the lawyer to monitor corporate disclosures.[169] This may be feasible in relation to annual or half-yearly reports, or a prospectus or product disclosure statement. However it may be too cumbersome for the continuous disclosure regime where legal advice is probably most needed, but difficult to obtain, when disclosure must be made 'immediately'.[170]

The lawyer as gatekeeper is a developing approach to corporate and securities regulation. The discussion above illustrates how it may be a practical response to the growth of corporations and the work of lawyers in relation to protecting the

163 See Michael Legg, 'An Auditor's Obligations to Report to ASIC – Between the Hammer and the Anvil' (2005) 23 *Company and Securities Law Journal* 264.

164 Andrew Galvin, 'AML Legislation: Implications for Lawyers' (2007) 22(10) *Banking Law Bulletin* 130; Hazard Jr and Dondi, above n 155, 201.

165 'The Law Council is fundamentally opposed to the imposition of reporting obligations on legal practitioners which undermine the independence of the profession and which are at odds with legal practitioners' well established duties to their clients, the court and the public.': Law Council of Australia Senate Legal and Constitutional Affairs Committee, *Anti-Money Laundering and Counter-Terrorism Financing Bill 2006* (17 November 2006) [5].

166 *Evidence Act 1995* (Cth) s 125; J D Heydon, *Cross on Evidence* (Online 2009) [25290].

167 Michael Legg, 'Conflict Vests in Gatekeeper's Role, *The Australian Financial Review* (Melbourne) 1 May 2009, 20.

168 Jill E Fisch and Kenneth M Rosen, 'Is There a Role for Lawyers in Preventing Future Enrons?' (2003) 48 *Villanova Law Review* 1097, 1131–7.

169 Coffee Jr, above n 126, 347–52.

170 'Consideration of continuous disclosure issues generally takes place in a market context, in "real time", and as a result is intensely time critical. This means that the window for consultation is very limited and in the absence of a trading halt or suspension, it is not possible to engage in detailed legal argument and protracted negotiation with a listed entity and its advisers': Australian Securities Exchange Listing Rule 3.1; ASX Guidance Note 8 (June 2005) [5].

corporate entity and shareholders. However, it also has drawbacks such as fundamentally altering the role of the lawyer and potentially comprising the ability of a client to obtain much needed legal guidance.

C Conflicts of Interest

1 *Defining Conflicts of Interest*

Conflict of interest may be defined broadly: (a) an incompatibility between the concerns or aims of different parties; (b) a situation whereby two or more of the interests held by, or entrusted to, a single person or party are considered incompatible.[171]

A conflict of interest may also be defined more narrowly, by reference to a particular category of legal relationship.[172] In the context of fiduciary relationships a conflict of interest may arise where, except with the informed consent of the principal, a fiduciary places himself or herself in a position where there is a real and sensible possibility of (a) a conflict between the duty as a fiduciary and his or her own interest ('duty-interest conflict') or (b) between the duty as a fiduciary to two or more persons ('duty-duty conflict').[173]

This article employs the broader definition, but with the qualification that the main concern is where the incompatibility of aims or interests arises in a context where one party is holding itself out as being independent, or able to be relied on, or acting 'for' the other party.

2 *Conflicts of Interest Before the GFC*

Conflicts of interest in the business and financial sector have attracted significant attention prior to the GFC. The issue of conflicts first attracted substantial attention in 2001–2 when New York Attorney-General Eliot Spitzer commenced an investigation into the conflicts of interest facing research analysts at a number of investment banks. Enforcement actions resulted in the banks paying US$1.4 billion in penalties and disgorgement.[174] The conflicts arose first because analysts recommended the purchase of securities to the public and to customers of their own firms without disclosing the fact that they owned those securities, second that their compensation was tied to their recommendations,

171 *Oxford English Dictionary* (Online Edition).

172 See generally, Charles Hollander QC and Simon Salzedo, *Conflicts of Interest* (3rd ed, 2008).

173 G E Dal Pont and D R C Chalmers, *Equity and Trusts in Australia* (4th ed, 2007) [4.15].

174 US Securities and Exchange Commission, 'Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking' (Press Release, 28 April 2003). *In re New York ex rel Spitzer v Merrill Lynch & Co. Inc* No. 02/401522 (N.Y. Sup. Ct. 21 May 2002) (stipulation and order of discontinuance of investigation and proceeding against Merrill Lynch) <http://www.oag.state.ny.us/investors/merrill_agreement.pdf> at 8 August 2009.

and, third and most significantly, that their firms received compensation in the form of investment banking business from the issuer.[175]

In Australia, the concern about conflicts of interest resulted in amendments to the *Corporations Act 2001* (Cth), with the insertion of section 912A(1)(aa), imposing an obligation to 'have in place adequate arrangements for the management of conflicts of interest' on all AFSL holders. ASIC issued *Policy Statement 181 – Licensing: Managing Conflicts of Interest* on 30 August 2004 ('PS 181') that indicated that to comply with section 912A(1)(aa), arrangements to manage conflicts of interest must include arrangements to control, avoid and disclose conflicts of interest, as appropriate.[176]

The issue of conflicts of interest and investment banks was brought to the fore in *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35 ('*ASIC v Citigroup*').[177] In *ASIC v Citigroup*, a case that turned on the exclusion of any fiduciary duty between an investment bank and a client, Justice Jacobson in obiter rejected ASIC's approach to the interpretation of section 912A(1)(aa) that some conflicts must be avoided as it was inconsistent with the plain meaning of the text.[178] Justice Jacobson reasoned that the section uses the word 'management', which does not require the elimination of a possible conflict, although one way of managing conflicts would be to eliminate them if a licensee chose to do so.[179] Further, 'the phrase "management of conflicts of interest" assumes that there will be potential conflicts which must be managed by adequate arrangements rather than totally eliminated.'[180]

The section 912A(1)(aa) approach can be contrasted with the regulatory approach adopted in relation to auditors where the conflict of interest from receiving substantial income through consulting and other services resulted in independence requirements that effectively banned such conflicts.

3 *The GFC and the Continuing Problem of Conflicts of Interest*

Conflicts of interest have been a major part of the behaviour that fuelled the GFC. In the subprime market the mortgage origination and distribution model meant that mortgage brokers were paid for originating a mortgage but did not bear the risk of the non-performance of that mortgage due to it being onsold. The mortgage broker had an incentive to maximise the number of loans that they

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175 See Affidavit of Eric Dinallo in Support of Application for an Order Pursuant to General Business Law § 354 (8 April 2002) <http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf> at 8 August 2009; Jill I Gross, 'Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?' (2002) 3 *Columbia Business Law Review* 631, 632.

176 ASIC, above n 153, [20]–[21].

177 See Michael Legg and Nicholas Mavrakis, '*ASIC v Citigroup*: Fiduciary Duties, Managing Conflicts and Chinese Walls' (2009) (forthcoming) *Macquarie Journal of Business Law*.

178 *ASIC v Citigroup* (2007) 160 FCR 35, [443].

179 Ibid [311], [444].

180 Ibid [445].

wrote which conflicted with the need to assure the quality of the mortgages which was in the best interests of the investor that purchased the MBS.[181]

A further conflict was between individual bankers and the investment banks that they worked for in that their remuneration or bonuses were based on their being able to be rewarded for continuing to create, sell and underwrite financial products such as CDOs although the risk inherent in the CDO was borne by their employer or the shareholders in the investment bank.[182]

The conflict created in investment banks may also be seen as a specific example of the more general situation in which executive remuneration is directed to short-term profitability rather than to long term success, with the result that CEOs are 'incentivised' to take steps to maximise their wealth in the short term by maximising the corporate performance short-term even though that may involve significant risks that ultimately reduce or destroy shareholder wealth in the long term. There is therefore a conflict of interest created between the CEO's interests and the shareholders' or corporations' interests.[183]

These conflicts have seen a number of proposals for reform put forward with the common thread of aligning interests. Mortgage brokers would retain an interest in the mortgages they wrote, investment bankers and executives would receive bonus payments over time so as to encourage long term performance.[184]

The issue of conflicts also permeates the problems experienced with gatekeepers. Most notably in relation to CRAs. A conflict of interest arose as the rating agency was paid by the issuer of the CDO or MBS who then used the rating to be able to market the financial product to investors. The CRAs remuneration and continued utilisation depended upon them providing sufficiently high ratings and thereby creating a conflict between their financial interest and the interest of investors who relied on the ratings.[185] The CRA conflict has been addressed in Australia through bringing CRAs under the coverage of Chapter 7 of the *Corporations Act 2001* (Cth) as discussed above.

In Australia the most prominent conflict of interest has related to financial advisers and consumers where the advisers is paid a commission by the provider of the financial product that they sell to the consumer. Examples include consumers who were advised to invest in Westpoint, Fincorp, Storm Financial,

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181 Schwarcz, above n 29; Securities and Exchange Commission, 'Proposed Rules for Nationally Recognised Statistical Rating Organisations' (Press Release, 16 June 2008) 9.

182 Stephanie Tsao, 'Managing Investment Banks During the Mortgage Crisis' (2007–8) *Developments in Banking and Financial Law* 50; 'No investment bank owned by its employees would have levered itself 35 to 1 or bought and held \$50 billion in mezzanine CDOs. ... The hope for short term gain would not have justified the long term hit.': Lewis, above n 20, 158–9.

183 Paul Krugman, 'Banks Gone Wild', *New York Times* (New York), 23 November 2007 <http://www.nytimes.com/2007/11/23/opinion/23krugman.html> at 8 August 2009.

184 Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009); Department of the Treasury, above n 62, 44–5.

185 David Matthews, 'Ruined in a Conventional Way: Responses to Credit Ratings Role in Credit Crisis' (2009) 29 *Northwestern Journal of International Law and Business* 245, 257; Securities and Exchange Commission, 'Proposed Rules for Nationally Recognised Statistical Rating Organisations' (Press Release, 16 June 2008) 12.

Great Southern, Timbercorp and Opes Prime products – all of which failed.[186] The commission-based remuneration creates an incentive for the adviser to put consumers into products paying the best commissions rather than the products most suitable for the consumer.

A particularly egregious example of potential conflicts of interest lay with Great Southern, which used a network of 1100 financial planners and accountants who were paid up-front fees of 10 cents for every dollar invested in Great Southern financial products. In relation to 337 of Great Southern's authorised representatives it has been alleged that they were only authorised to sell Great Southern products so that there could not have been any assessment of whether a different product would have better suited an investor's needs. Through this scheme Great Southern raised A$1.8 billion from 47,000 investors in five years.[187] Great Southern was placed into administration on 18 May 2009.[188]

Conflicts of interest in the financial sector have traditionally been addressed through disclosure[189] and more recently through section 912A(1)(aa). The GFC suggests that both need to be revisited.

The aim of disclosure is to allow the recipient of the advice to discount the advice to the extent it is influenced by the conflict.[190] The act of disclosure may also reinforce the existence of the conflict and the need to counteract it, leading to greater honesty on the part of the advisor.[191] Disclosure is favoured as a regulatory policy as it is the least intrusive way of addressing the conflict and it informs the recipient of the advice so that they can take the action appropriate to their situation.[192] It is also acceptable to the individual or entity facing the conflict as they are not forbidden from acting and can reap the benefits that flow from the conflict – usually financial rewards.[193] The disclosure solution also allows advisers to offer free or at least affordable advice to investors as the advisor is remunerated by the financial product provider.[194]

The problems with disclosure are: (1) recipients of disclosure cannot utilise the disclosure effectively; and (2) the disclosure becomes routine or a

186 Nicola Berkovic, 'Probe into Conflicts of Interest that Cost Small Investors Billions', *The Australian* (Sydney), 27 February 2009, <http://www.theaustralian.news.com.au/story/0,25197,25112829-601,00.html> at September 14 2009; Patrick Durkin, 'Corbett Says Commissions Flawed', *The Australian Financial Review* (Melbourne), 29 May 2009, 5.

187 Anthony Klan, 'Agribusiness Scheme Pay-offs Cost 40c in Dollar', *The Australian* (Sydney), 20 May 2009, 20; Anthony Klan, '"Sales professionals" Pushed Great Southern Products', *The Australian* (Sydney), 21 May 2009, 7.

188 McGrathNicol, 'Receivers and Managers Appointed to Great Southern', 19 May 2009.

189 *Corporations Act 2001* (Cth) ch 7; Peter Kell, 'Sins of Commission', *Sydney Morning Herald* (Sydney), 17 August 2005 <http://www.smh.com.au/news/money/sins-of-commission/2005/08/15/1123957999313.html> at 8 August 2009.

190 Daylian Cain, George Loewenstein and Dan Moore, 'Coming Clean but Playing Dirtier – The Shortcomings of Disclosure as a Solution to Conflicts of Interest' in Don Moore et al (eds), *Conflicts of Interest: Challenges and Solutions in Business, Law, Medicine and Public Policy* (2005) 105.

191 Cain et al, above n 190, 114.

192 Ibid 107.

193 Ibid.

194 Cartwright, above n 116, 75.

'boilerplate' clause in documentation that ceases to reinforce, or even undermines, the advisor's obligations to the recipient.[195]

A substantial body of cognitive psychology research has found that recipients do not correctly discount advice from biased sources. The recipient does not know if or how the conflict may affect the advice they receive. They only know that it might have an effect that they are not in the position to quantify. However, disclosure can also have a counterproductive result. A recipient having been warned of a conflict of interest may then put greater trust in the adviser because of their honesty. The advisor having disclosed the conflict may then feel that they have satisfied their obligation to the recipient and if the recipient relies on the conflicted advice they do so from an informed position.[196] Significantly, these findings do not suggest that the recipient is uneducated or gullible, nor that the advisor is corrupt or fraudulent, only that both are human.

Disclosure also allows conflicts to continue and does not effectively alleviate the underlying problem of tainted advice or actions.[197] Some conflicts are so harmful that the conflict should be removed or banned. The independence requirements imposed on auditors after the Enron and HIH collapses are examples of certain identified conflicts of interest not being permitted through structuring relationships so that a conflict cannot arise.[198] It should be noted that after *ASIC v Citigroup*, section 912(1)(aa) does not require the elimination of conflicts of interest, only that they be managed, presumably with disclosure playing a prominent role.

The ramifications of the GFC suggest that some conflicts of interest may need to be structurally prevented. This is because in some cases they create such a mismatch of incentives and are so widespread that they create a systemic risk. The CRAs would be a prime example. Alternatively, in the Australian context the conflict that exists in relation to investment advice for superannuation may be too great a risk for a system of privately funded retirement. The need for affordable advice may mean that it needs to be provided by government or form part of a person's superannuation benefits.[199]

D Private Enforcement

Traditionally the response to 'mass wrongs' is to rely on government regulation that may encompass both preventive measures and enforcement

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195 See generally William C Whitford, 'The Functions of Disclosure Regulation in Consumer Transactions' (1973) 2 *Wisconsin Law Review* 400, 403; Ross Cranston, *Consumers and the Law* (2nd ed, 1984) 304–6.

196 Cain et al, above n 190, 114–6; see also Susanna Ripkin, 'The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation' (2006) 58 *Baylor Law Review* 139, 160–76.

197 James Surowiecki, 'The Talking Cure', *The New Yorker* (New York), 9 December 2002, 54.

198 Samuel Issacharoff, 'Legal Responses to Conflicts of Interest' in Moore et al (eds) above n 190, 198–9.

199 Cartwright, above n 116, 76.

measures.[200] An alternative response to mass wrongs or group injuries, including securities fraud, misleading or deceptive conduct or nondisclosure is private enforcement, typically through the class action. [201]

Class actions (also known as group proceedings, collective actions or representative actions) can take many forms, however they may be generally defined as a legal procedure that enable the claims of a number of persons against the same defendant to be determined in the one suit.[202] The grouping of claims allows for the costs of litigation to be shared and provides an incentive for a third party to fund the litigation. Shareholder class actions have been steadily increasing in Australia in response to a favourable legal framework.[203] However the GFC, its spate of corporate collapses and share price declines have seen class action activity increase even further.[204] The GFC's stoking of class action activity in the highly regulated area of securities and financial products suggests that an assessment of public verses private enforcement is warranted.[205]

Private enforcement through class actions is advocated on the basis that it promotes corporate governance and the efficiency of the market by allowing for the enforcement of statutory requirements such as continuous disclosure and prohibitions on misleading conduct.[206] As contraventions are more likely to result in litigation and its related costs, corporations will take greater care not to contravene the law and will provide more reliable information to market participants.[207] This in turn promotes investor confidence. Further, being able to

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200 Public enforcement has been criticised for being selective and late: Michael Pascoe, 'How to Spread Rumours', *Sydney Morning Herald* (Sydney), 25 March 2009, <http://www.smh.com.au/business/how-to-spread-rumours-20090325-99ub.html> at 14 September 2009; Michael West, 'The Corporate Watchdog That Just Won't Bite', *Sydney Morning Herald* (Sydney), 29 June 2009 <http://business.smh.com.au/business/the-corporate-watchdog-that-just-wont-bite-20090628-d18h.html> at 8 August 2009.

201 'The aggregation of individual claims in a classwide suit is an evolutionary response to the existence of injuries unremedied by the regulatory action of the government. Where it is not economically feasible to obtain relief within the traditional framework of a multiplicity of small individual suits for damages, aggrieved persons may be without any effective redress unless they may employ the class-action device': *Deposit Guaranty Bank v Roper* 445 US 326, 339 (1980).

202 Rachael Mulheron, *The Class Action in Common Law Legal Systems: A Comparative Perspective* (2004) 3.

203 Michael Legg, 'Shareholder Class Actions in Australia – The Perfect Storm?' (2008) 31(3) *University of New South Wales Law Journal* 669.

204 Tony Featherstone, 'Perfectly Legal', *Business Review Weekly* (Sydney), 12–18 February 2009, 62–3; Elisabeth Sexton, 'IMF Benefit from Disasters', *Sydney Morning Herald* (Sydney), 21 February 2009, 3.

205 Large-scale litigation is the consequence of socio-economic trends, not the cause of these trends – government needs to determine how to best address those socio-economic issues: Deborah Hensler, 'Revisiting the Monster: New Myths and Realities of Class Action and Other Large Scale Litigation' (2001) 11 *Duke Journal of Comparative & International Law* 179, 212.

206 Peta Spender, 'Securities Class Actions: A View from the Land of the Great White Shareholder' (2002) 31 *Common Law World Review* 123, 127; Bernard Murphy and Camille Cameron, 'Access to Justice and the Evolution of Class Action Litigation in Australia' (2006) 30 *Melbourne University Law Review* 399, 404–5.

207 Robert Thompson and Hillary Sale, 'Securities Fraud as Corporate Governance: Reflections Upon Federalism' (2003) 56 *Vanderbilt Law Review* 859, 861.

commence legal proceedings allows for compensation to those who have suffered loss or damage as a result of misconduct.[208]

Private enforcement is not without its detractions. The advocacy of private enforcement necessarily assumes that public enforcement is not at an optimal level and that private enforcement does not result in over-regulation or over-enforcement – matters that are hotly contested.[209] The private litigant may also directly interfere with public enforcement. This is most clearly present in the case of the regulators attempts to encourage and protect the identity of whistleblowers. The class action promoters in seeking access to the fruits of a regulator's investigation or enforcement action can dissuade potential whistleblowers from coming forward as their identity may be revealed or they may become the target of litigation.[210] Equally, the regulator may find it more difficult to obtain cooperation or agreement to some form of settlement or fine when a much more expensive class action claim could follow.

The private enforcer may also be unaccountable to the public, as argued by Callinan and Heydon JJ in *Campbells Cash and Carry Pty Limited v Fostif Pty Ltd*, in which they observed that a litigation funder is not '"a generous spirited company who are trying to bring people to justice". It has no public duties, nor is it held to public account, in the same way as an Attorney-General or other public servant.'[211] Similarly, the analogy with the state or an administrative agency neglects the fact that the state provides disinterested administrative expertise as compared to the existence of self-interested class action promoters who often create the class action and have the most to gain from its prosecution or settlement.[212] The management of conflicts of interest between class action promoters and the group members becomes an important issue in the efficacy of any class action.[213]

The public verses private enforcement debate, while relevant to many areas of regulation, is particularly significant for both securities regulation and investor protection in light of the GFC, where government regulation failed.

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208 James Cox, 'The Social Meaning of Shareholder Suits' (1999) 65 *Brooklyn Law Review* 3, 8–9. However the utility of compensation has not gone unchallenged: see Legg, above n 203, 709.

209 'Public enforcement plays a modest role at best in the development of stock markets': La Porta et al, 'What Works', above n 113, 20; *contra* 'public enforcement typically dominates private enforcement': Howell E Jackson and Mark J Roe, 'Public Enforcement of Securities Laws: Preliminary Evidence', *2nd Annual Conference on Empirical Legal Studies Paper*, 8 August 2007, 37; John C Coffee Jr, 'Law and the Market: The Impact of Enforcement' (2007–8) 156 *University of Pennsylvania Law Review* 229, 302.

210 See *ASIC v P Dawson Nominees Pty Ltd* (2008) 169 FCR 227; James Eyers, 'Class Actions Pressure Regulators', *The Australian Financial Review* (Melbourne), 17 May 2009 22–3.

211 *Campbells Cash and Carry Pty Limited v Fostif Pty Ltd* (2006) 229 CLR 386, [269].

212 Samuel Issacharoff, 'Governance and Legitimacy in the Law of Class Actions' (1999) *Supreme Court Review* 337, 351.

213 Michael Legg, 'Judge's Role Is Settlement of Representative Proceedings: Lessons from United States Class Actions' (2004) 78 *Australian Law Journal* 58, 70–1.

E Global Regulatory Issues

The GFC has provoked much soul searching and recommendations for reform in the United States.[214] Australia, having not had its major financial institutions harmed to the same extent, has not sought to fundamentally re-work its 'twin-peaks' regulatory system – one regulator responsible for prudential regulation of relevant financial institutions (APRA), and another regulator responsible for business conduct and consumer protection (ASIC).[215] However, markets are global so that national regulatory systems impact upon other nations. For example, the derivatives created by US investment banks found their way into the investment portfolios of local councils in Australia.[216]

The US President Barack Obama, in seeking financial regulatory reform, commented:

> Finally, we must recognize that the challenges we face are not just American challenges, they are global challenges. So as we work to set high regulatory standards here in the United States, we have to challenge other countries around the world to do the same. That's how we will stop financial crises from spilling across borders and prevent global crises of the sort that we now face.[217]

The Obama Administration has accepted that financial stress can spread easily and quickly across national boundaries but that regulation takes place largely in a national context.[218] Consequently, in addition to reforming its domestic structures, the US is seeking to improve international cooperation through supporting 'supervisory colleges' for significant cross-border firms, cross-border crisis management for dealing with failing firms and strengthening of international financial and banking organisations.[219] These views were echoed by the Turner Report, issued by the Financial Services Authority in the UK.[220]

For Australia, an active participation in global reform is essential as a means to protect the domestic financial system and domestic investors.

V CONCLUSION

The GFC has had a widespread impact on the world economy. Australia has not been spared the effect of the GFC although Australia has (so far) fared better

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214 See, eg, Cunningham et al, above n 100; Department of the Treasury, 'A Blueprint for a Modernized Financial Regulatory Structure' (March 2008); Group of Thirty, 'The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace' (October 2008); Group of Thirty, 'Financial Reform: A Framework for Financial Stability' (January 2009).

215 Ian Macfarlane, 'The Crisis: Causes, Consequences and Lessons for the Future. The Australian Perspective' in ASIC, *ASIC Summer School – The Big Issues for our Financial Markets* (2–3 March 2009) 43–4.

216 See also, Michael Cole, *Review of NSW Local Government Investments: Final Report* (April 2008).

217 Barack Obama, 'Remarks by the President after Regulatory Reform Meeting' (Speech delivered at Diplomatic Reception Room, Washington DC, 25 February 2009).

218 Department of the Treasury, above n 62, 80. See also Jan Aart Scholte, Governing Global Finance in David Held and Anthony McGrew (eds), *Governing Globalization* (2002) 193.

219 US Department of the Treasury, above n 62, 80–8.

220 FSA, above n 78.

than most countries.[221] Nonetheless the GFC has demonstrated that both global and domestic regulatory structures should be revisited. This article has sought to take the first steps in identifying the sources of the GFC through identifying the themes that gave rise to the nature and scope of the financial crisis. It also puts forward some suggested reforms for consideration from an Australian perspective in the area of disclosure, gatekeepers, conflicts of interest, private enforcement and global regulatory cooperation. Other areas such as corporate governance, executive remuneration, margin-lending, securities lending, short selling, insider trading and market manipulation which could not be addressed due to limits on space also require attention.[222]

While this article necessarily focuses on the shortfalls of existing regulation and excesses of the marketplace, a balance must be struck between regulatory reform and efficient markets. Markets are essential to human development, including in countries such as Australia, as they afford not just economic advancement but the opportunity for personal well-being.[223] Equally, the GFC demonstrates that regulation is needed to ensure that economic advancement and well-being are facilitated. The zeal to reform must be accompanied by caution so as to ensure that the marketplace is not suffocated, innovation impeded, recovery retarded nor that unintended incentives are created that sow the seeds of future crises. Regulation is back in vogue and people again appreciate the need for government. The opportunity to address the excesses must not be lost. However, as with all good things – moderation is required.

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221 Tony D'Aloisio, 'Regulatory Issues Arising from the Financial Crisis for ASIC and for Market Participants', (Speech delivered at the Securities and Derivatives Industry Association 12 Annual Conference, Sydney, 29 May 2009). Australian banks still make up 25 per cent of AA rated financial institutions worldwide. There are signs that investor confidence is still relatively strong, with major corporations being able to raise over A$100 billion in capital from October 2008 to April 2009.

222 See, eg, Corporations and Markets Advisory Committee, *Aspects of Market Integrity – Report* (June 2009) and Productivity Commission, *Regulation of Director and Executive Remuneration in Australia* (April 2009).

223 See Amartya Sen, *Development as Freedom* (1999) 142–5.