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CONFLICTED GATEKEEPERS: THE VOLCKER RULE AND GOLDMAN SACHS

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In many areas of regulation, rules require one person to act with loyalty to another person, or at least constrain one person's pursuit of self-interest by restricting the extent to which that person may act in conflict with the interests of another person. These rules are typically justified on the basis of reducing (economic) agency costs. However, recently-adopted provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which include the so-called Volcker Rule, impose such conflict of interest rules on underwriters selling securities to investors, including sophisticated investors—a context in which agency costs do not arise. This article draws on the extensive literature on gatekeeper liability theory to develop a justification for imposing conflict of interest rules in these arm's length relationships between underwriters and investors. The article argues that conflict of interest rules provide incentives to underwriters (as gatekeepers) to take greater precautions to deter disclosure errors by their clients, the issuers of the securities sold by underwriters, than underwriters would take otherwise and that these rules thus supplement, or serve as an alternative to, rules of gatekeeper liability. The article assesses whether this justification applies to the Volcker Rule.

The article also uses as a case study a deal involving alleged conflicts of interest by Goldman Sachs in marketing the ABACUS 2007-AC1 collateralized debt obligation. That deal became the subject of highly publicized enforcement action by the SEC in 2010 and provided significant impetus in the adoption of the Volcker Rule. The article shows how the justification developed in this article for imposing conflict of interest rules informs our understanding of the propriety of Goldman Sachs' conduct in the ABACUS deal and assists in applying and interpreting the Volcker Rule.

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Andrew F. Tuch*

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I. Introduction

In many areas of regulation, rules require one person to act with loyalty to another person, or at least constrain one person's pursuit of self-interest by restricting the extent to which that person may act in conflict with the interests of another person. Fiduciary duties are the most common example. From an economic perspective, such rules—referred to in this article as "conflict of interest rules"—are typically justified on the basis of reducing (economic) agency costs.[1] These costs arise in a relationship in which one person engages and delegates authority to another person to perform some service on the first person's behalf.[2] In a recent development, U.S. financial regulation has imposed conflict of interest rules in the context of parties contracting at arm's length or, more specifically, where parties in non-agency relationships transact to buy and sell securities, with each party acting in its own self-interest. This regulatory development may be regarded as surprising given that agency costs do not arise between parties contracting at arm's length. Indeed, a longstanding premise of the common law is that contracting parties act in a self-interested manner.[3] Moreover, it is almost inevitable that the

[1] *See, e.g.*, Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1041 (2011).

[2] The relationship described is an agency relationship in economic theory, rather than in legal doctrine. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (defining an agency relationship as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent"); Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 39 (John W. Pratt & Richard J. Zeckhauser, eds., 1991) ("The economics literature has focused primarily . . . on the case in which (1) the agent's action is not directly observable by the principal; and (2) the outcome is affected but not completely determined by the agent's action.").

[3] *See, e.g.*, Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 630 (1943) (asserting that contract law "reflects a proud spirit of individualism and of *laissez faire*," and that "a contract is the result of the free bargaining of parties who are brought together by the play of the market . . ."). *See also* Richard A. Epstein, *All Quiet on the Eastern Front*, 58 U. CHI. L. REV. 555, 561 (1991) (asserting that the rules of contract law rest on the "twin assumptions of scarcity and self-interest"); Larry A. DiMatteo, *The History of Natural Law Theory: Transforming Embedded Influences into A Fuller Understanding of Modern Contract Law*, 60 U. PITT. L. REV. 839, 909 (1999) ("The basis of Anglo-American law's contract regime remains self-interested behavior.").

interests of parties contracting at arm's length will conflict, especially where they are parties to an agreement to buy and sell. Accordingly, the notion that conflict of interest rules should operate in the realm of such relationships has attracted opposition.[4]

The financial regulation in question is the Dodd-Frank Reform and Consumer Protection Act ("Dodd-Frank Act"), the Congressional response to the financial crisis of 2007-09, which includes provisions that impose conflict of interest rules on underwriters selling securities to investors. Long regarded as the hallmark of the investment banking industry, and now engaged in by major banking institutions,[5] underwriting securities is an activity involving the underwriter purchasing securities from an issuer for resale to investors. These provisions in the Dodd-Frank Act were intended, in part, to address alleged misconduct by Goldman Sachs in a deal that became the subject of highly publicized enforcement action by the Securities and Exchange Commission ("SEC").[6] That deal, given the moniker ABACUS 2007-AC1 by the bank, involved

[4] *See, e.g.*, Steven M. Davidoff, Alan D. Morrison & William J. Wilhelm, Jr., *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. CORP. L. 529, 540, 549 (2012) (arguing that fiduciary duties are "inappropriate" in arm's length transactions); Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 ALA. L. REV. 1083, 1093 (2007) (arguing that conflict of interest rules should not be imposed outside fiduciary relationships).

[5] *See, e.g.*, CHARLES R. GEISST, INVESTMENT BANKING IN THE FINANCIAL SYSTEM 3 (1995) ("Investment banking means first and foremost the underwriting of securities. Other activities are certainly important . . . , but prowess in underwriting and syndication are nevertheless the hallmark of the industry."). As to major financial institutions engaging in underwriting, *see, e.g.*, J.P. MORGAN CHASE & CO, 2011 ANNUAL REPORT, at 79 (graphically depicting business segments); BANK OF AMERICA, 2011 ANNUAL REPORT, at 263 (describing business segments).

[6] *See* Complaint, Securities and Exchange Commission v. Goldman Sachs & Co. and Fabrice Tourre (S.D.N.Y. 2010), dated April 16, 2010, *available at* http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf [hereinafter SEC Complaint].

The SEC action against Goldman Sachs provided significant impetus in the adoption of the Volcker Rule provisions, which are core provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act 12 U.S.C. § 1851 *et. seq.* (2010) [hereinafter *Dodd-Frank Act*]. Prior to the announcement of the SEC's enforcement action against Goldman Sachs, the Volcker Rule was considered unlikely to be included in the Dodd-Frank Act. *See* Randall D. Guynn, *United States* 25, 47–48, *in* INTERNATIONAL BAR ASSOCIATION'S TASK FORCE ON THE FINANCIAL CRISIS: A SURVEY OF CURRENT REGULATORY TRENDS (2010) (discussing the passage of the Volcker Rule and asserting that even after the Obama administration issued the legislative text of the Volcker rule it was considered "dead on arrival"), *available at* http://www.ibanet.org/Article/Detail.aspx?ArticleUid=2C72F588-7222-47C9-83E4-7DB0A0A8BF1C. The action against Goldman "transformed the political landscape," according to Professor David Skeel. David A. Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences,* (University of Pennsylvania Inst. for Law & Econ. Research Paper No. 10-21) ("The securities fraud allegations that the bank's broker-dealer subsidiary had conflicts of interest due to certain undisclosed transactions from which the bank would profit if the securities it sold as an underwriter to investors lost value.[7] The ABACUS transactions fueled intense criticism of the bank for having conflicts of interest.[8]

The article focuses on two particular provisions of the Dodd-Frank Act. The most controversial is Section 619, the so-called Volcker Rule,[9] the effect of which for present purposes is to permit banks to engage in underwriting only if that activity does not involve or result in a "material conflict of interest" between the underwriting bank and its "clients, customers or counterparties."[10] A companion provision of the Volcker Rule, Section 621 of the Dodd-Frank Act, focuses on the underwriting of asset-backed securities ("ABS"); it bans any

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allegations [against Goldman Sachs] transformed the political landscape, shifting the momentum decisively in favor of the legislation"), *available at* http://ssrn.com/abstract=1690979. The Volcker Rule was rejuvenated in this new climate and was included in the Dodd-Frank Act, together with its companion provision, Section 621.

[7] *See infra* text accompanying notes 117–25.

[8] *See Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security & Governmental Affairs*, 111th Cong. 2 (2010), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57322.pdf [hereinafter *Senate Committee Hearing*]; Press Release, Securities and Exchange Commission, SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages (Apr. 16, 2010) *available at* http://www.sec.gov/news/press/2010/2010-59.htm; John D. McKinnon, *Lawmakers Target Investment Banks*, WALL ST. J. ONLINE (May 5, 2010), http://online.wsj.com/article/SB10001424052748704866204575224653696310876.html ("Lawmakers are weighing tough new legal standards for investment banks' dealings with customers, after allegations that Goldman Sachs Group Inc. took advantage of clients in the mortgage-market collapse. . . . A broader effort in the wake of the Goldman revelations would impose a fiduciary obligation on bankers to watch out for their clients' best interests."). *See also infra* text accompanying notes 117–25.

[9] Dodd-Frank Act § 619, 12 U.S.C. § 1851 (2010). Under Section 619, various regulatory agencies, including the Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Securities and Exchange Commission ("SEC"), are required to issue regulations to implement the provision. In October 2011, these agencies proposed such regulations for comment. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, Exchange Act Release No. 65,545, 76 Fed. Reg. 68,846 (proposed Oct. 12, 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-65545.pdf [hereinafter Volcker Rule Implementing Regulations (Proposed)]. As of November 20, 2012, the date of writing, the regulations are yet to be finalized.

[10] *See* Dodd-Frank Act § 619, 12 U.S.C. § 1851(d) (2010).

"material conflict of interest" between an underwriter and the buyers of those securities,[11] many of whom in the ABS context are sophisticated investors.[12] Both Dodd-Frank Act provisions thus impose conflict of interest rules on underwriters in selling securities to investors. Although Sections 619 and 621 are distinct provisions, the latter provision has been considered part of the former,[13] and for convenience they are referred to collectively in this article as the "Volcker Rule provisions."

This article develops a justification for imposing conflict of interest rules on underwriters in their relationships with buyers of securities. Unlike previous scholarly contributions,[14] this article does so by recognizing that underwriters of securities offerings are gatekeepers—actors that possess the capacity to monitor and control, or at least to influence, the conduct of the corporations issuing securities (underwriters' clients) and thereby to deter disclosure wrongs by those corporations. In acting as gatekeepers, underwriters provide assurance to investors as to the accuracy of issuers' disclosures, thus serving to economize on the information costs investors face in verifying the accuracy of issuers' disclosures and reducing the information asymmetry between issuers and investors. According to the extensive literature on gatekeeper liability

[11] Dodd-Frank Act § 621, 15 U.S.C. § 77z-2a (2010). Under Section 621, the SEC is required to issue regulations to implement the provision. It issued proposed rules in November 2011. *See* Prohibition against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 34-65355, *available at* http://www.sec.gov/rules/proposed/2011/34-65355.pdf [hereinafter Section 27B Implementing Regulations (Proposed)]. As of November 20, 2012, the date of writing, the regulations are yet to be finalized. Sections 619 and 621 have been regarded as "companion" provisions. 156 CONG. REC. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley, referring to the Volcker Rule and Section 27B as companion provisions), *available at* http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf.

[12] *See* SEC et al., Proposed Rule on Asset-Backed Securities, Exchange Act Release Nos. 33-9117, 34-61858, at 20 (2010), *available at* http://www.sec.gov/rules/proposed/2010/33-9117.pdf ("A significant portion of securities transactions, including the offer and sale of all [Collateralized Debt Obligations] and [Asset-Backed Commercial Paper], is conducted in the exempt private placement market, which includes both offerings eligible for Rule 144A resales and other private placements."). Private placements are made to major institutional investors.

[13] *See infra* note 34.

[14] *See infra* note 60.

theory,[15] imposing liability on gatekeepers for the disclosure wrongs of their clients provides incentives for gatekeepers to deter disclosure errors by their clients. This article argues that conflict of interest rules may also shape the incentives of gatekeepers to deter disclosure errors. In the securities underwriting context, conflict of interest rules serve to prevent an underwriter from having interests (other than those naturally arising from selling securities) that might impede it from performing its gatekeeping role of exercising its capacity to verify issuers' disclosures. Otherwise put, conflict of interest rules in the underwriting context require the independence of underwriters from extraneous or countervailing interests that create incentives for underwriters to police client disclosures less vigilantly than they would otherwise. Conflict of interest rules can thus be understood as mandating the independence of underwriters in securities transactions and as promoting the gatekeeping role underwriters perform. Conflict of interest rules supplement, or serve as alternatives to, gatekeeper liability rules. The articles goes further to consider whether the Volcker Rule provisions in particular can be justified on this basis—as rules promoting the gatekeeping role of underwriters and as supplementing existing underwriter liability rules.

This article uses the ABACUS 2007-AC1 deal as a case study for applying and interpreting conflict of interest rules in a securities underwriting transaction. It shows how the justification developed in this article for imposing conflict of interest rules on underwriters helps to advance our understanding of the propriety of Goldman Sachs' conduct in the ABACUS transactions. The justification aids in understanding the basis for expecting Goldman to avoid conflicts with the

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[15] *See generally* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004); John C. Coffee, Jr., *Partnoy's Complaint: A Response*, 84 B.U. L. REV. 377 (2004); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986); Frank Partnoy, *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491 (2001); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365 (2004).

interests of investors to whom it sold securities. Rather than focusing on whether Goldman owed fiduciary duties to investors as a broker-dealer in the transactions (an issue that attracted the intense interest of Congress), this article highlights Goldman's role as underwriter in and its structuring of the deal, which involved it forming a special purpose vehicle ("SPV") and preparing the relevant disclosure materials for investors.[16] As an underwriter of ABS, especially of securities issued by an SPV created by the bank itself, Goldman was acting as a gatekeeper and faced a conflict of interest by engaging in undisclosed transactions that risked skewing—and arguably did skew—its incentives to assure the accuracy of disclosures to investors. In underwriting securities, Goldman should have eschewed conflicts with the interests of the buyers of those securities (other than the conflict of interest with buyers naturally arising from the sale of those securities), not because doing so would have reduced agency costs, but because as a gatekeeper it had power to influence the disclosure about those securities and thus to economize on the information costs facing investors.

The article then analyzes how the Volcker Rule provisions would have applied to the ABACUS 2007-AC1 deal had the provisions been in force at the time of the deal. It argues that Goldman had a conflict of interest with investors, even though Goldman also lost money from its involvement in ABACUS. Taking into account the staggered nature of the transactions comprising ABACUS, it is evident that the bank's loss arose from a transaction occurring after it had underwritten the securities in question. Even if that transaction had occurred earlier, the bank's incentives were nevertheless shaped by its anticipation of neutralizing its exposure under that transaction and expectation of ultimately profiting from the deal. The article thus concludes

[16] The SPV is further described in text accompanying notes 35–37 and in more detail in Part IV.A.

that Goldman's conduct would have violated the Volcker Rule provisions had they been in force at the time.

The case study also provides guidance on how conflict of interest rules in the Volcker Rule provisions should be interpreted. In particular, this article grapples with how to identify the interests of an underwriter (for purposes of determining whether a conflict of interest exists), where the underwriter is part of financial conglomerate—a complex, large-scale financial institution providing multiple financial products and services (in addition to underwriting) through affiliated entities in the United States and abroad. This article also considers how to interpret conflict of interest rules in an environment characterized by the proliferation of financial products, in which banks use innovative trading strategies and financial instruments to instantaneously transform short positions into long ones, and vice versa, quickly reversing the determination of whether a conflict of interest arises. This article urges caution in allowing underwriters to rely on information barriers, or so-called Chinese walls, to avoid or cleanse conduct that would otherwise amount to a conflict of interest in breach of the Volcker Rule provisions and recommends that the Volcker Rule provisions be interpreted to capture "actual and reasonably anticipated" conflicts of interest.

The article makes several contributions. It develops a novel justification for imposing conflict of interest rules on underwriters selling securities to investors and argues why the justification provides support for the conflict of interest rules in the Volcker Rule provisions. Using the ABACUS deal as a case study, the article shows how this justification advances our understanding of the propriety of Goldman's alleged misconduct. The article also uses the case study to analyze how the Volcker Rule provisions should be applied and interpreted and in doing so provides guidance to regulators as they stand tasked with implementing the provisions.

The article proceeds as follows. The Volcker Rule provisions are outlined in Part II. Part III considers the traditional justification for conflict of interest rules, surveys recent scholarship, and develops a new justification for imposing conflict of interest rules in arm's length relationships, such as those between underwriters and investors. Part IV applies the Volcker Rule provisions to the ABACUS transactions and, in light of the justification developed in Part III, evaluates the propriety of Goldman's conduct and offers guidance on applying and interpreting the Volcker Rule provisions. A brief conclusion follows.

II. The Volcker Rule Provisions

A. The Volcker Rule

Widely-known as the Volcker Rule,[17] Section 619 of the Dodd-Frank Act introduces a new Section 13 to the Bank Holding Company Act of 1956.[18] The Volcker Rule is intended to promote the safety and soundness of banking entities (and thereby to reduce the risk of taxpayers facing the financial burden of bank failures), as well as to reduce the conflicts of interest that may arise from the activities of these institutions.[19] While the regulations implementing the Volcker Rule are yet to be finalized, the parameters of the Volcker Rule are relatively clear for present purposes.[20] The Volcker Rule severely restricts how banks may invest their own funds, and thus focuses on a bank's activities as principal, rather than on its activities on behalf of

[17] The provision is named for the former Chairman of the Federal Reserve Board, Paul A. Volcker, who was an early advocate of the core prohibitions in the Volcker Rule.

[18] Dodd-Frank Act § 619, 12 U.S.C. § 1851 (2010).

[19] *See* Dodd-Frank Act § 619 12 U.S.C. § 1851(b)(1) (2010) (requiring the newly-created Federal Stability Oversight Council to study and make recommendations on implementing the provisions of the Volcker Rule, namely, Section 619, "so as to" achieve various objectives that are expressed compendiously in the text above).

[20] According to the Volcker Rule, its provisions become effective twelve months after the issuance of final regulations by the relevant agencies, or July 21, 2012, whichever is earlier, and banking entities will then have the benefit of a transition period in which to comply. Dodd-Frank Act, § 619, 12 U.S.C. § 1851(c) (2010). Although regulations have been proposed, they are yet to be finalized. *See* Volcker Rule Implementing Regulations (Proposed), *supra* note 9.

clients or customers. More specifically, the Volcker Rule generally prohibits any "banking entity" (defined broadly to capture all banks and their affiliates)[21] from engaging in proprietary trading and from having certain affiliations with private equity funds and hedge funds, subject to certain important exemptions.[22] The ban on "proprietary trading" encompasses a banking entity buying or selling any financial instrument, including any security or derivative instrument, on its own account for a particular stated purpose, namely, "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)."[23] Put differently, the Volcker Rule prevents any banking entity from trading in financial instruments on its own account where, generally speaking, its intended trading horizon is short-term.

The exemptions *conditionally* carve out numerous financial activities from the general prohibition.[24] These financial activities are permitted as exemptions to the general prohibition only if they satisfy a critical proviso that they not involve or result in a "material conflict of

[21] More specifically, the term captures any entity that is, or is affiliated with, a federally-insured depository institution (such as a bank or thrift). *See* Dodd-Frank Act § 619, 12 USC § 1851(h)(1) (2010). The Volcker Rule thus applies to Goldman Sachs and Morgan Stanley, firms that converted to bank holding companies during the financial crisis, but excludes so-called boutique investment banks or private equity firms, which are unaffiliated with federally-insured depository institutions. Note that the Dodd-Frank Act includes a so-called "Hotel California" rule designed to prevent major bank holding companies that received federal assistance during the financial crisis from avoiding the strictures of the Volcker Rule by "de-banking." *See also* DAVIS POLK & WARDWELL LLP, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, at 15 (July 21, 2010), *available at* http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.

[22] The centerpiece of the Volcker Rule is this general prohibition. It provides that "a banking entity shall not (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund." Dodd-Frank Act, § 619., 12 U.S.C. § 1851(a) (2010).

[23] The Volcker Rule achieves this result by defining proprietary trading as "engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any [security or financial instrument]" and then defining "trading account" as "any account used for acquiring or taking positions" in such securities and instruments for the purpose expressed in the text above. *See* Dodd-Frank Act, § 619, 12 U.S.C. § 1851(h)(4), (6) (2010).

[24] *See* Dodd-Frank Act § 619, 12 U.S.C. § 1851(d)(1) (2010). In addition to underwriting, the exemptions include market-making related activities, risk-mitigating hedging activities, and trading in U.S. government securities.

interest" between a banking entity and its "clients, customers, or counterparties."[25] Because of the breadth of both the general prohibition and the exemptions to it, large swathes of financial activity are subject to this conflict of interest proviso. One of the financial activities exempted, and the activity of concern in this article, is underwriting.[26] Accordingly, the Volcker Rule permits a bank to engage in underwriting only if that activity does not involve or result in a material conflict of interest between the bank and its "clients, customers, or counterparties," an expression that clearly captures the buyers of securities.[27]

Although the Volcker Rule does not define underwriting, that activity is well-understood as a standardized process to facilitate offerings of securities by corporations or other entities.[28] In its

[25] The exemptions, which the statute refers to as "permitted activities," are subject to the proviso that, among other things, "[n]o transaction, class of transactions, or activity may be deemed a permitted activity . . . if the transaction, class of transactions, or activity . . . would involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties." *See* Dodd-Frank Act § 619, 12 U.S.C. § 1851(d)(2) (2010). Other requirements to which the permitted activities are subject include that the transaction, class of transactions or activity not result in "a material exposure by the banking entity to high-risk assets or high-risk trading strategies" or pose a threat to the safety and soundness of the banking entity or to US financial stability. *See* Dodd-Frank Act, § 619, 12 U.S.C. §1851(d)(2)(A)(ii)–(iv) (2010).

[26] *Id*.

[27] Since banks are often in fiduciary or agency relationships with their clients and customers, it is no surprise that the Volcker Rule's proviso should purport to ban conflicts of interest between banks and these actors. However, it is initially puzzling why the proviso should also ban conflicts of interest between banks and their counterparties. Although clients and customers are typically in contractual relationships with banking entities and may thus be regarded as counterparties, the express additional reference in the proviso to counterparties suggests that this term encompasses actors that are neither clients nor customers. The inclusion of this term suggests the Congressional intent to regulate conflicts of interest between banks and parties with which they are in arm's length relationships.

The legislative history of the Dodd-Frank Act sheds no light on the interpretation of "counterparties" in the Volcker Rule's conflict of interest proviso. Early versions of the Volcker Rule did not refer to "counterparties." The version introduced in the House of Representatives on December 2, 2009, banned proprietary trading on safety and soundness grounds, without referring to concerns about conflicts of interest. *See* WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2009, H.R. 4173, 111th Cong. § 1116 (2009). The version placed on the calendar in the Senate on April 15, 2010, prohibited proprietary trading subject to recommendation of the Financial Stability Oversight Council, which was required to study the extent to which the provision reduced "inappropriate conflicts of interest" between a banking entity and "the interests of the customers of such [entity]." *See* RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, S. 3217, 111th Cong. § 619 (2010). The current language referring to "counterparties" was introduced in the so-called Merkley-Levin Amendment in the House-Senate Conference Committee.

[28] In addition, the Volcker Rule Implementing Regulations (Proposed) describe "underwriting" by listing seven criteria an activity must satisfy to fall within the underwriting exemption. *See* Volcker Rule Implementing Regulations (Proposed), *supra* note 9, at 80–85.

most common form, which is known as firm commitment underwriting, underwriting involves a registered broker-dealer,[29] typically the subsidiary of a banking entity, purchasing securities as principal from the issuer of the securities at an agreed price for resale to investors.[30] In re-selling the securities, an underwriter also acts as a principal and is in an arm's length relationship with investors. Because the resale occurs within a matter of days of the purchase from the issuer, underwriting falls within the Volcker Rule's ban on proprietary trading and must be specifically exempted if it is to be permissible under the Volcker Rule.

While the principal capacity in which an underwriter acts is an important aspect of the underwriting function, the underwriter's role involves more than simply the purchase and resale of securities. An underwriter will also provide financial advice to the issuer (its client), including on such matters as the design of the securities to be offered and the timing of the proposed

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[29] In underwriting securities offerings, financial institutions act as registered broker-dealers. *See*, *e.g.*, MORRISON FOERSTER, A FIDUCIARY DUTY FOR BROKER-DEALERS? HOW DODD-FRANK MAY CHANGE THE WAY BROKER-DEALERS CONDUCT BUSINESS 3 (July 19, 2010) (discussing the implications of imposing fiduciary duties on underwriters under the heading "Potential Impact on Broker-Dealer Business Practices"), *available at* http://www.mofo.com/files/Uploads/Images/100719DoddFrank.pdf.

In such roles, however, broker-dealers are rarely subject to conflict of interest restraints: courts and regulators have resisted imposing fiduciary duties on broker-dealers, especially in their dealings with sophisticated counterparties. *See* SECURITIES AND EXCHANGE COMMISSION, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS, AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, at iv, 54–55, 59–66, *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf. Under Federal securities laws, broker-dealers must deal fairly with their customers and owe a suitability obligation to their customers, but generally are not subject to fiduciary duties. *See id*. The suitability obligation has little application to sophisticated investors. *See Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations*: *Hearing on S. 3217 Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. 2 (2010) (statement of John C. Coffee), *available at* http://judiciary.senate.gov/pdf/10-05-04CoffeesTestimony.pdf; Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 399 (2010) ("When acting as . . . underwriters, broker-dealer firms are in an adversarial posture vis-à-vis their customers; this posture competes with the fiduciary norm of putting one's customer's interests before one's own."). The position of broker-dealers thus contrasts with that of investment advisers, which are subject to fiduciary duties under the Investment Advisers Act of 1940. 15 U.S.C § 80b(1)–(21) (2000).

[30] This is a description of firm commitment underwriting. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 2.1[2][B] (rev. 5th ed. 2006); JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 116 (6th ed. 2009) (citing In re National Association of Securities Dealers, Inc., Exchange Act Release No. 17,371 (Dec. 1980)); Andrew F. Tuch, *Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts*, 7 J. CORP. L. STUD. 51, 54–61 (2007) (describing forms of and the process of underwriting securities offerings).

offering.[31] An underwriter will also assist in preparing the offering document, or prospectus, as well marketing the offering, such as by meeting potential investors in so-called "roadshow" presentations. The underwriter's role in assisting to prepare the offering document is particularly important and occurs against the backdrop of an elaborate regulatory regime that imposes potential liability on both issuers and underwriters for material misstatements and omissions in the offering materials. The underwriter will perform due diligence, a process in which the underwriter "[studies] the business from every angle, becoming familiar with the industry in which it functions, its future prospects, the character and efficiency of its operating policies and similar matters."[32] The object of due diligence is to ensure the accuracy and completeness of the offering document.[33] An underwriter thus performs multifarious functions for an issuer, acts as a principal—in an arm's length relationship—in selling securities to investors, and faces potential liability for disclosure errors in materials provided to investors.

B. Companion Provision

Section 621 of the Dodd-Frank Act, which is sometimes referred to as part of the Volcker Rule,[34] introduces a new Section 27B to the Securities Act of 1933. While Section 27B applies

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[31] *See* GEISST, *supra* note 5, at 3 (describing the role of underwriters); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613–21 (1984) (describing the functions of underwriters in achieving capital market efficiency).

[32] United States v. Morgan, 118 F. Supp. 621, 653 (S.D.N.Y. 1953).

[33] GEISST, *supra* note 5, at 7 (describing due diligence as the "process by which [underwriters] . . . assure that their client company has provided adequate and relevant information").

[34] *See, e.g.*, Margaret E. Tahyar, *Senate-House Conference Agrees on Final Volcker Rule*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (27 June 2010), http://blogs.law.harvard.edu/corpgov/2010/06/27/senate-house-conference-agrees-on-final-volcker-rule/ (on file with the Virginia Law & Business Review Association) (describing Section 27B of the Securities Act as part of the Volcker Rule); Bradley Sabel, *Volcker Rule Continues to Garner Outsized Attention*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (31 Oct. 2010), http://blogs.law.harvard.edu/corpgov/2010/10/31/volcker-rule-continues-to-garner-outsized-attention/#10b (on file with the Virginia Law & Business Review Association) (including Section 27B in its discussion of the Volcker Rule); 156 CONG. REC. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley, referring to the Volcker Rule

only to a specific type of security, it mirrors the Volcker Rule in imposing conflict of interest rules on underwriters in their relationships with the buyers of securities. The provision prohibits an underwriter, a placement agent, initial purchaser, or sponsor, or any of its affiliates of ABS, including a synthetic ABS, "from engaging in any transaction for one year after the first closing of the sale of the security that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity."[35]

Asset-backed securities are the outcome of a financing technique known as securitization, which involves the conversion of pools of financial assets into securities.[36] More specifically, the provision involves an SPV issuing securities to investors, giving such investors rights to the returns generated by pools of assets held by the SPV. The assets are generally illiquid, such as mortgages, credit card receivables and, in more creative cases (as in the ABACUS 2007-AC1 transactions described in Part IV), financial instruments designed to mimic the financial performance of other, specific assets. The securities offerings are typically underwritten, with underwriters purchasing the securities from SPVs for resale to investors. Investors in offerings of ABS are often sophisticated.[37]

The prohibition in Section 621 does not apply to certain risk-mitigating hedging activities or to purchases or sales of ABS made under commitments to provide liquidity for ABS or bona-fide

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and Section 27B as companion provisions), *available at* http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

[35] Dodd-Frank Act, § 621, 15 U.S.C. § 77z-2a (Supp. IV 2010). Initial purchasers also act in a principal capacity, buying (typically unregistered) securities from issuers for resale to investors. To the extent placement agents and sponsors are agents, rather than principals, the conflict of interest rules in Section 27B may be justified on the basis of reducing (economic) agent costs.

[36] *See* SEC, *supra* note 12, at 9 ("Securitization generally is a financing technique in which financial assets . . . are pooled and converted into instruments that are offered and sold in the capital markets as securities.").

[37] *See* SEC, *supra* note 12, at 20.

market-making in ABS. As with the Volcker Rule, regulators stand tasked with finalizing regulations to implement Section 27B.[38]

III. Justifying Conflict of Interest Rules

This Part now turns to developing a justification for conflict of interest rules on underwriters in their relations with investors and to considering the application of that justification to the Volcker Rule provisions. It begins by describing the common law approach to imposing conflict of interest rules and the economic justification offered in support of these rules.

A. Traditional Justification

The longstanding approach of the common law has been to assume that persons, especially as parties to contracts, will act in a self-interested manner.[39] Accordingly, in a relationship between two parties, the law rarely intervenes to constrain one party's pursuit of self-interest by restraining her freedom to act in a way that is contrary to—or in conflict with—the interests of the other party. This is especially so in contractual relationships involving the purchase and sale of an item since the parties' interests are in conflict (at least in terms of the sale price). The law does intervene, however, by imposing conflict of interest rules where special attributes in a relationship imbue that relationship with fiduciary character.

Generally speaking, a fiduciary relationship is one in which one person has power or influence over the interests of another person who is therefore vulnerable to the former person's exercise of discretion.[40] As is well-known, the law restricts the self-interested conduct of a

[38] *Id.* at 1.

[39] See *supra* note 3.

[40] *See, e.g.*, Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 37 DUKE L. J. 879, 902 (1988) ("In many relationships in which one party is bound by a fiduciary obligation, the other party's vulnerability to the fiduciary's abuse of power or influence conventionally justifies the imposition of fiduciary obligation.");

fiduciary by demanding behavior by the fiduciary that is other-regarding and meets a standard that is "stricter than the morals of the marketplace."[41]

Although no single unifying theory determines the existence of a fiduciary relationship,[42] some categories of relationship are established in case law as having fiduciary character. These include relationships between a trustee and beneficiary, an agent and principal, a lawyer and client, and a corporate director and corporation.[43] Beyond the range of established categories of fiduciary relationship, the identification of a fiduciary relationship is more vexed, and courts apply analogical reasoning—a process of identifying connections with established fiduciary relationships as well as identifying particular indicia of fiduciary character.[44] These indicia are context-specific and may include the delegation of authority and the giving of advice.[45]

Fiduciary relationships are not considered arm's length relationships, despite their frequent existence in commercial contexts. An arm's length relationship is one between parties transacting in an adversarial manner, that is, with each party acting in its self-interest to secure

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Robert C. Clark, *Agency Costs Versus Fiduciary Duties, in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 71–76 (John W. Pratt & Richard J. Zeckhauser eds., 1991) (discussing the indicia of fiduciary relationships).

[41] Meinhard v. Salmon, 249 N.Y. 458, 464 (1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

[42] *See* DeMott, *supra* note 40, at 879 (describing the fiduciary concept as elusive); Cooter & Freedman, *supra* note 1, at 1045 ("[T]he precise nature of the fiduciary relationship remains a source of confusion and dispute.").

[43] *See* ROBERT C. CLARK, CORPORATE LAW 141 (1986) ("[D]irectors . . . owe their corporations, and sometimes other shareholders and investors, a fiduciary duty of loyalty.").

[44] *See* Andrew F. Tuch, *Investment Banks as Fiduciaries: Implications for Conflicts of Interest*, 29 MELB. U. L. REV. 478, 481-84 (2005) (describing the common law approach of determining the existence of fiduciary relationships).

[45] *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) (defining a fiduciary relationship as existing "between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation."); John Y. Campbell, Howell E. Jackson, Brigitte Madrian & Peter Tufano, *The Regulation of Consumer Financial Products: An Introductory Essay with a Case Study on Payday Lending, in* MOVING FORWARD: THE FUTURE OF CONSUMER CREDIT AND MORTGAGE FINANCE 206, 224 (Nicholas P. Retsinas & Eric Belsky eds., 2010) ("[Fiduciary duties are] [t]ypically imposed in situations where firms or individuals have discretionary control over the financial decisions of their customers.").

the best deal it can for itself.[46] Courts have consistently refused to characterize relationships between parties bargaining at arm's length as fiduciary, particularly if the parties are sophisticated and well-counseled.[47] In *Meinhard v. Salmon*,[48] Chief Judge Cardozo asserted that "[m]any forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties." More recently, the New York Supreme Court, Appellate Division explained that "[a] conventional business relationship between parties dealing at arm's length does not give rise to fiduciary duties . . . ."[49] The point for present purposes is the sparing approach the common law takes to imposing conflict of interest rules; in arm's length relationships, that is, absent the existence of a fiduciary relationship, the common law does not constrain one person's pursuit of self-interest by restricting the extent to which she may act in conflict with the interests of another person.

From an economic perspective, conflict of interest rules are justified on the basis of reducing agency costs.[50] These are the costs arising from an agency relationship (in the economic sense)—a relationship between two persons, in which one (the principal) engages and delegates authority to the other (the agent) to perform some service on the principal's behalf.[51]

[46] *See, e.g.*, Rosenblatt v. Getty Oil Company, 493 A.2d 929, 937–38 (Del. 1985) ("[T]he adversarial nature of the negotiations completely supports a conclusion that they were conducted at arm's length."); Legatski v. Bethany Forest Assoc., Inc., C.A. No. 03C-10-011-RFS, 2006 WL 1229689, at *4 (Del. Super. Ct. Apr. 28, 2006) (defining an arm's length transaction as "involv[ing] unrelated parties, each acting in their own self interest").

[47] *See, e.g.*, Meinhard v. Salmon, 249 N.Y. 458, 464 (1928); EBC I, Inc. v. Goldman Sachs & Co., 5 N.Y.3d 11, 22 (2005) (commenting on the "general rule that fiduciary obligations do not exist between commercial parties operating at arm's length"). *See also* George Bundy Smith & Thomas J. Hall, *The Hurdle to Pleading Fiduciary Duty Claims in Arm's Length Relations*, N.Y. L.J., at 3 (Feb. 19, 2010) (discussing recent cases and asserting: "[t]o plead a fiduciary duty claim, more is generally required than an arm's length business transaction or conclusory allegations that the defendant owed a fiduciary duty to, or had a special relationship with, the plaintiff.").

[48] Meinhard v. Salmon, 249 N.Y. at 464.

[49] Roni LLC v. Arfa, 74 A.D.3d 442, 444 (2010), aff'd, 18 N.Y.3d 846, 846 (2011) ("A conventional business relationship between parties dealing at arm's length does not give rise to fiduciary duties . . . .").

[50] *See supra* note 1.

[51] *See* Jensen & Meckling, *supra* note 2, at 308–09. *See also* Cooter & Freedman, *supra* note 1, at 1045 (applying the economic "principal-agent" model to study the economic character of the fiduciary relationship).

Characteristically, the information asymmetry between the parties effectively prevents the principal from observing or verifying the agent's exercise of discretion.[52] Agency costs arise because the interests of the agent will diverge from those of the principal, despite the desirability of the agent's interests being aligned with those of the principal. The central challenge of (economic) principal-agency theory has been expressed as one of inducing an agent to behave as if she were maximizing the principal's welfare or of motivating the agent to act consistently with the best interests of the principal.[53] Accordingly, principal-agent theory focuses on those mechanisms—contractual and regulatory—that reduce agency costs and thus promote an agent's loyalty to her principal.[54] Nevertheless, incongruity may exist in the extent to which (economic) agency theory may justify fiduciary duties, due to the differing conceptions underlying the legal and economic notions for analyzing conflicts of interest.[55]

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[52] Arrow, *supra* note 2. Professor Arrow also observed that "[t]he economics literature has focused primarily . . . on the case in which (1) the agent's action is not directly observable by the principal; and (2) the outcome is affected but not completely determined by the agent's action." *Id. See also* Sitkoff, note 1, at 1042 (referring to the principal's inability to "effectively observe or verify" the agent's exercise of discretion).

[53] *See, e.g.*, Jensen & Meckling, *supra* note 2, at 309 ("[I]t is worthwhile to point out the generality of the agency problem. The problem of inducing an "agent" to behave as if he were maximizing the "principal's" welfare is quite general."); LOUIS H.G. SLANGEN ET AL., INSTITUTIONAL ECONOMICS AND ECONOMIC ORGANIZATION THEORY: AN INTEGRATED APPROACH 209 (2008) ("The central problem in principal-agent relationship is how the contract should be designed to motivate the agent to act in a way that serves the interests of the principal best.").

[54] SLANGEN, *supra* note 53. The most commonly discussed contractual mechanisms are monitoring of the agent's conduct by the principal, and bonding by the agent to the principal.

[55] Several possible incongruities exist. First, the indicia of fiduciary relationships are context-specific in law, making it difficult to generalize about the circumstances when fiduciary duties will arise. *See* DEBORAH A. DEMOTT, FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP: DUTIES IN ONGOING BUSINESS RELATIONSHIPS 2 (1991) ("Fiduciary obligation is . . . notably elusive as a concept; the particular duties it imposes vary in different contexts, as does the justification for imposing the obligation itself."). It follows that fiduciary doctrine may require loyalty other than in principal-agent relationships in the economic sense.

Second, the degree of loyalty required and how it is to be achieved differs between the legal and economic approaches. Although the content and scope of fiduciary duties vary by context, the law generally demands undivided loyalty from a fiduciary, and it attempts to achieve that by limiting the fiduciary's range of conduct, requiring the fiduciary to avoid circumstances that might tempt her to act contrary to the principal's interests, subject to the principal's consent. Accordingly, in representing a principal, an agent is forbidden from acquiring a material benefit from a third party in connection with transactions involving the agent's use of the agent's position; from acting as or on behalf of an adverse party to the principal; from competing with the principal or from taking action on behalf of or otherwise assisting the principal's competitors; and from using the principal's property—including confidential information—for the agent's own purposes or those of a third party. *See* RESTATEMENT (THIRD) OF

The prevailing economic justification for imposing conflict of interest rules is perhaps best illustrated in the context of imposing conflict of interest rules on research analysts for the benefit of outside investors, a relationship clearly outside the traditional agency context. The issue of imposing conflict of interest rules in this context arose following the dot.com bubble bursting at the turn of this century, when research analysts employed by large financial institutions were accused of skewing their research report recommendations to secure lucrative investment banking work for their institutions. Regulators then subjected research analysts to conflict of interest rules designed to secure their independence from the influence of other units in their institutions.[56] In her criticism of these conflict of interest rules, Professor Jill Fisch observed that the rules were "premised on the conception of [research] analysts as fiduciaries";[57] after all,

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AGENCY, §§ 8.02–.05. The principal may consent to agent conduct that would otherwise amount to a breach of any of these duties. *See* THE RESTATEMENT (THIRD) OF AGENCY, § 8.06.

In contrast, the economic approach accepts the inevitability of a divergence of interests—and thus of some disloyalty—and adopts a more nuanced approach to determining the optimal level of agency costs (and thus the desired level of loyalty), taking into account, among other factors, the costs of reducing them. *See e.g.*, Jensen & Meckling, *supra* note 2, at 326–30 (discussing the comparison of the marginal benefits and marginal costs required to determine the level of monitoring and bonding activities); Cooter & Freedman, *supra* note 1, at 1064–67 (asserting that the optimal scope of fiduciary duties depends on a comparison of the fiduciary's (or agent's) marginal cost with the beneficiary's (or principal's) marginal benefit). *See also* Clark, *supra* note 40, at 71–77 (asking "how well do the attributes of the fiduciary relationship succeed in mitigating the problem of managerial discretion ('agency costs')?").

Still, both the legal and economic approaches are alert to differences between the parties to fiduciary or (economic) agency relationships and recognize the role of economic incentives in promoting loyalty. The legal approach may be seen to focus on the differences between the parties in terms of the fiduciary's power, influence and expertise and the resulting vulnerability of the beneficiary. The economic approach focuses on the information asymmetry between the actors, which prevents the beneficiary from adequately protecting itself against disloyalty, either by contractually specifying the required conduct of the fiduciary or by closely monitoring the fiduciary's behavior. *See* Cooter & Freedman, *supra* note 1, at 1048–51 (discussing obstacles to the parties to a fiduciary relationship in articulating an agent's conduct in advance and difficulties of the beneficiary in monitoring the fiduciary's conduct); Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738, 749–50 (1978) (discussing the barriers to contractual self-protection, including cost and loss of benefits of the fiduciary's expertise).

[56] Joint News Release: *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (Apr. 28, 2003), https://www.finra.org/Newsroom/NewsReleases/2003/p002909 (on file with the Virginia Law & Business Review Association) (describing the terms of the so-called Global Settlement between regulatory agencies and ten major financial institutions concerning research analyst conflicts of interest).

[57] Fisch, *supra* note 4, at 1092–93.

"[o]nly fiduciaries have an obligation of unselfishness, an obligation which turns self-interest into a conflict of interest."[58] Because research analysts were not fiduciaries of investors, they should not have been subjected to conflict of interest rules, Professor Fisch argued.[59] Recent scholarship has been more accepting of the possible justifications for imposing conflict of interest rules in non-agency relationships. However, that scholarship either considers the position of actors other than securities underwriters or fails to articulate in detail a justification for imposing conflict of interest rules on underwriters in their arm's length relationships with the buyers of securities.[60]

[58] *Id.* at 1093.

[59] *Id.* at 1093–97 (arguing that the imposition of conflict of interest rules on research analysts is undesirable).

[60] Professor Patrick Leyens develops a theory for imposing conflict of interest rules on auditors, credit rating agencies and research analysts, and does so by drawing on concepts in the civil law tradition that are less familiar to common law scholars and apparently less applicable to underwriters. See Patrick C. Leyens, *Intermediary Independence: Auditors, Financial Analysts and Ratings Agencies*, 11 J. CORP. L. STUDIES 33 (2011). Professor Leyens argues that such actors should be subject to conflict of interest rules in return for their being granted entry to the markets in which they operate. *Id.* at 46. In contract law in the tradition in which Professor Leyens writes, an agent is required to be loyal to its principal in return for—or "as a correlative to"—being given control over the principal's interests. *Id.* at 38. Professor Leyens argues that this notion of reciprocity can be applied to auditors, credit rating agencies and research analysts and that these actors can be subject to conflict of interest rules "as a correlative to market access." *Id.* at 39–40, 46–48.

Professors Steven Davidoff, Alan Morrison and William Wilhelm argue that conflict of interest rules are not appropriate in arm's length relationship, but may be appropriate in what they call "trust based" relationships. *See* Davidoff et al., *supra* note 4 (asserting, in the context of trust-based transactions, that "[a] more tacit, relationship-based legal standard like fiduciary duty may be more appropriate"). However, it is not apparent whether securities underwriting relationships would generally be regarded as arm's length or "trust based," although—as discussed in Part IV below—the professors argue that conflict of interest rules were inapplicable to Goldman Sachs as underwriter in the ABACUS transactions.

Professor Robert Thompson suggests that conflict of interest rules may be appropriate in non-agency relationships. *See* Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown*, 89 WASH. U. L. REV. 323, 331–32 (2011). In the banking context, Professor Thompson argues that conflict of interest rules may be desirable outside agency relationships when a bank uses "its reputation to backstop risks about information or nonperformance." *See id.* at 333, 342. The justification offered is that the bank is then performing a role that is "more like that of an advisor with fiduciary duties and not of a pure dealer." *Id.* at 344. This justification suggests an agency cost-like justification, which would seem to conform with the traditional justification for conflict of interest rules outlined in Part IIIA.

B. A New Justification

Although conflict of interest rules are traditionally justified on the basis of reducing agency costs, the Volcker Rule provisions and the criticism of Goldman Sachs for its conduct in the ABACUS transactions invites a reconsideration of this view. The Volcker Rule was imposed against the backdrop of existing federal securities regulations, which conform to the regulatory principle that investors are best protected by banning fraud and ensuring full disclosure.[61] Under this regime, underwriters face liability where they mislead or deceive the buyers of securities and in some cases where they fail to prevent an issuer from doing so. As broker-dealers, underwriters must deal fairly with, and owe a suitability obligation to, investors, but underwriters are generally not subject to fiduciary obligations for the benefit of investors or otherwise obliged to avoid conflicts with the interests of investors.[62] Indeed, underwriters are in arm's length relationships with the buyers of securities, and securities regulations do not alter the arm's length character of that relationship.

Investors in securities transactions face high costs associated with acquiring information to verify the accuracy of an issuer's disclosures concerning a security.[63] These costs inhibit investors' capacity to accurately value the securities offered for sale. However, gatekeepers have

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[61] Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669 (1984) ("[The Securities Act of 1933 and the Securities Exchange Act of 1934] . . . have two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued and periodically thereafter."); STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 1 (2d ed. 2008) ("The securities laws seek to protect investors by encouraging full disclosure and deterring fraud."). For a defense of the mandatory disclosure system, see John C. Coffee, Jr., *Market Failure and the Economic Case for A Mandatory Disclosure System*, 70 VA. L. REV. 717, 722–23 (1984).

[62] *See* MORRISON FOERSTER, *supra* note 29, at 3. Note, however, that in the Dodd-Frank Act, Congress granted regulators power to impose fiduciary protections for retail investors. *See* Dodd-Frank Act, § 913(b), 15 U.S.C. § 780 (Supp. IV 2010). The provision amends the Securities Exchange Act of 1934 to provide the Securities and Exchange Commission with authority to promulgate rules establishing standards of conduct for all broker-dealers when providing personalized investment advice about securities to retail customers.

[63] *See* Gilson & Kraakman, *supra* note 31, at 554. As to gatekeepers generally, see JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006).

been conceived of as actors that can deter client misconduct through monitoring and controlling (or at least influencing) their corporate clients (the issuers of securities), particularly their clients' conduct concerning disclosure.[64] By associating itself with a corporate transaction involving a corporate client, a gatekeeper certifies the corporation's disclosures, and gatekeepers thus represent a response to the problem of information asymmetry between an issuer and investors.

Underwriters, in particular, can perform a gatekeeping role in securities offerings.[65] Underwriters have power to monitor the disclosures of their clients and thereby to deter misconduct by them.[66] Issuers of securities have incentives to overstate the value of the securities they issue, even to the point of misleading investors. Investors will rationally greet issuers' disclosures with caution, applying some discount to reflect the possibility of being sold "lemons."[67] Underwriters typically exercise their power to deter issuers' misconduct by performing due diligence, a process of investigation designed to ensure the accuracy and completeness of the offering document.[68] Underwriters also effectively certify the accuracy of the disclosures made by their clients. According to the SEC, "[b]y associating [itself] with a

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[64] *See* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 890 (1984) [hereinafter Kraakman, *Corporate Liability Strategies*] (asserting that "[t]he first requisite for gatekeeper liability is, of course, an outsider who *can* influence controlling managers to forgo offenses"). As to the monitoring function of gatekeepers, see *id.* at 891; Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 62–66 (1986) [hereinafter Kraakman, *Gatekeepers*]. As to gatekeepers' power to monitor and control the accuracy of a corporation's disclosures, see Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1664–65 (2010).

[65] *See* CHOI & PRITCHARD, *supra* note 61, at 10 (observing that it is "rare" for issuers to sell securities directly to investors without the involvement of underwriters).

[66] *See id*. at 420 ("[I]nvestment banks play a gatekeeping role. Investors look to the investment bank to screen out poor or fraudulent offerings. With no investment bank to vouch for the offering, investors are likely to discount substantially the price they are willing to pay for the offered securities.").

[67] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489–90 (1970).

[68] For a description of the due diligence process, see text accompanying notes 28–33. Underwriters are regarded as being "in a uniquely advantageous position to thoroughly investigate and verify the facts concerning an issuer." Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case: Part I. Section 11 of the Securities Act of 1933,* 55 VA. L. REV. 1, 54 (1969).

proposed [securities] offering, an underwriter impliedly represents that [it] has made such an investigation [of due diligence] in accordance with professional standards."[69] By custom, an underwriter's name is prominently displayed on the cover of the offering document as well as in multiple places within, giving visible notice of the underwriter's association.[70] Accordingly, in selling the issuer's securities to investors, the underwriter represents to those investors that it has evaluated the issuer's disclosures and is prepared to stake its reputation on their accuracy.[71]

Because most issuers rarely undertake securities offerings, underwriters have greater opportunities and incentives to build and maintain reputations for ensuring the accuracy of disclosures to investors.[72] The importance of underwriters' reputations is an empirical phenomenon.[73] By monitoring and controlling the conduct of issuers, underwriters can acquire reputations for diligence and honesty, which they can effectively pledge for the benefit of an issuer of securities, thereby reducing information asymmetry between that issuer and investors. In metaphorical terms, underwriters are regarded as renting their reputations to corporations, a function that economizes on information costs[74] and creates value for the issuing corporations.[75]

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[69] In re The Richmond Corp., 41 S.E.C. 398, 406 (1963).

[70] *See* Edward F. Greene, *Investment Bankers: Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 NOTRE DAME L. REV. 755, 771 (1981) (referring to "the customary practice of prominently displaying the name of the managing underwriter on the cover of the prospectus").

[71] Gilson & Kraakman, *supra* note 31, at 620 ("[T]he investment banker rents the issuer its reputation. The investment banker represents to the market (to whom *it*, and not the issuer, sells the security) that it has evaluated the issuer's product and good faith and that it is prepared to stake its reputation on the value of the innovation.").

[72] Issuers also face limits on the extent to which they can self-certify the accuracy of their disclosures. *See, e.g.*, Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 288–89 (1984).

[73] *See, e.g.*, Lily H. Fang, *Investment Bank Reputation and the Price and Quality of Underwriting Services*, 60 J. FIN. 2729, 2729–32, 2756–59 (2005).

[74] Gilson & Kraakman, *supra* note 31, at 554 ("[W]e argue that . . . many familiar market institutions, such as investment banks, serve the function of reducing information costs, and thereby facilitate efficiency in the capital market."). As to the similar role performed by accountants and other professionals, see *id.* at 604–07.

Gatekeeper liability rules, or rules imposing liability on gatekeepers for the disclosure errors of their clients, provide incentives for gatekeepers to vigilantly monitor their clients' disclosures.[76] To achieve optimal deterrence of disclosure errors, a gatekeeper would take precautions to deter disclosure errors by its client up to the point where the marginal costs of doing so equals the marginal reduction in its client's expected wrongdoing, subject to the overall cost of precautions being less than the overall social benefit of reducing wrongdoing.[77] Since a gatekeeper's reputation provides incentives for it to take precautions to deter disclosure wrongs by its client, the use of gatekeeper liability is premised on the failure of reputational incentives to ensure gatekeepers take optimal precautions. The imposition of gatekeeper liability, in addition to the risk of reputational harm, is intended to provide incentives for gatekeepers to take optimal precautions to deter client misconduct.

The primary claim in this article is that conflict of interest rules can promote the gatekeeping role performed by underwriters and can serve to supplement, or even as an alternative to, gatekeeper liability rules—and thus can be justified on the same basis as gatekeeper liability rules. Conflict of interest rules can shape the incentives underwriters face to deter disclosure errors by their clients. These rules can do so not by increasing the expected penalties underwriters face in the event of a disclosure error, but by limiting extraneous financial interests

[75] Referring to verification techniques as "critical means of reducing total information costs," Ronald Gilson has explained how the reduction of information costs by lawyers can create value for corporations, their clients. *See* Gilson, *supra* note 72, at 90.

[76] Underwriters face liability for any misstatement or omission in a registration statement unless they can show that after reasonable investigation they had a reasonable ground to believe—and did believe—the statement was true. Since the provision does not require gatekeepers directly to make a statement or omission for liability to arise, conceptually it can be understood to impose gatekeeper liability—that is, liability on gatekeepers for failing to adequately deter wrongs committed by their clients. *See* Securities Act § 11(a), 15 U.S.C. § 77k(a) (2006). In addition, underwriters may face liability for the disclosure errors of their clients—or, more specifically, for aiding and abetting corporate wrongdoing. 17 C.F.R. § 240.10b-5 (2012).

[77] *See generally* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 103 (1st Harv. Univ. Press, paperback ed. 2007) (1987); David Rosenberg, *Joint and Several Liability for Toxic Torts*, 15 J. HAZARDOUS MATERIALS 219, 225 (1987). This principle reflects Judge Learned Hand's famous notion in *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947), for deciding questions of negligence.

underwriters may face to police client disclosures less vigilantly than they would otherwise. Such extraneous interests would typically arise from other, related functions being conducted within the banking entity (which is typically a financial conglomerate) acting as underwriter. Extraneous interests—those in tension with a gatekeeper's own reputation and the risk of gatekeeper liability—may arise if, for example, an underwriter expects to benefit from a fall in value of the securities offered for sale (due to having a short position in the securities) or expects to receive part of any offering proceeds raised (such as from the repayment by the issuer to the underwriter of a loan). In both instances, the underwriter may face increased incentives to induce investors to buy the securities, in the former example to profit from any subsequent price reduction and in the latter example to receive a portion of the offering proceeds (in addition to the underwriting commission). Both examples represent opportunities that might be lost if the securities were not sold. These interests are separate from the inevitably conflicting interests an underwriter has with an investor by virtue of being on the opposite side of the transaction to sell securities and, critically, they are in tension with those incentives created by reputation and gatekeeper liability to ensure the accuracy of disclosures concerning the securities for sale. By limiting the countervailing incentives facing underwriters, conflict of interest rules can serve to supplement, or even as an alternative to, gatekeeper liability rules. Like gatekeeper liability rules, such rules can be justified on the basis of reducing information costs in arm's length relationships, including between sophisticated counterparties.

It follows that conflict of interest rules on underwriters should be equated not with fiduciary duties, but with gatekeeper liability rules. Conflict of interest rules do not function to promote the complete loyalty of underwriters to investors (an impossibility given the basic adverse interests between underwriters and investors in the sale of securities), but to promote the gatekeeping role underwriters perform of taking precautions (often through undertaking due diligence) to ensure the accuracy of the statements made by underwriters' clients, the issuers of securities. Imposing conflict of interest rules on underwriters thus mandates the independence of underwriters.

Does this justification support the conflict of interest rules imposed on underwriters in the Volcker Rule provisions? Such rules would be desirable to supplement existing gatekeeper liability rules if the existing regime created inadequate incentives for underwriters to deter disclosure errors by their clients. The task of optimally calibrating the incentives facing underwriters to deter client wrongdoing is extraordinarily difficult and will require numerous empirical assessments and likely vary for different types of transactions. However, some considerations do suggest the inadequacy of the existing regime.

To begin, underwriters face a form of gatekeeper liability under Section 10(b) of the Securities Exchange Act and the associated Rule 10b-5.[78] However, the threat of such liability is far from assured. Under the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*,[79] gatekeepers are shielded from liability for aiding and abetting the wrongs of their clients under Rule 10b-5 in private actions. Moreover, under Rule 10b-5, a misstatement or omission must be made with *scienter*—that is, recklessly or with intent to

[78] 17 C.F.R. § 240.10b-5 (2012) (forbidding, among other things, the making of "any untrue statement of a material fact . . . in connection with the purchase or sale of any security").

[79] Central Bank v. First Interstate Bank, 511 U.S. 164, 185 (1994) (holding that in private actions nothing in § 10(b) of the Securities Exchange Act could give rise to liability for aiding and abetting a violation of the provision). Pursuant to Section 20(e) of the Securities Exchange Act, gatekeepers do face such liability in actions brought by the SEC. As § 20(e) made explicit after the Supreme Court's *Central Bank* decision, secondary actors face aiding and abetting liability in actions brought by the SEC. Securities Exchange Act of 1934 § 20(e), 15 U.S.C. § 78t(e) (2006).

deceive, manipulate, or defraud[80]—and this requirement is a blunt instrument for shaping the incentives of underwriters to take precautions to deter disclosure errors by underwriters.

Underwriters also benefit from generous judicial interpretations of the due diligence defense, which operates to relieve underwriters of strict liability in the case of primary securities offerings under Section 11 of the Securities Act.[81] The due diligence defense requires an underwriter to reasonably investigate matters disclosed in non-expertised portions of a registration statement and to form a reasonably grounded belief as to their veracity.[82] Section 11 imposes civil liability on underwriters, among other actors in securities offerings, for misstatements or omissions in registration statements.[83] In applying the due diligence defense, courts have relieved an underwriter of liability for misstatements or omissions in non-expertized portions of a registration statement where the underwriter has relied on other gatekeepers, such as lawyers and accountants. They have done so without any judicial inquiry into whether these other gatekeepers themselves took precautions to deter the misstatements or omissions in question.[84] This judicial approach produces incentives for underwriters to obtain written assurances in standard terms from the other gatekeepers on which they rely in the hope and expectation that doing so will constitute due diligence (and thus prevent liability under Section 11), while simultaneously producing incentives for the other gatekeepers to craft assurances that will minimize their

[80] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); 17 C.F.R. § 240.10b-5 (2012).

[81] The defense also operates to relieve an underwriter of *scienter*-based liability under Rule 10b-5. *See, e.g.*, In re Software Toolworks Inc. v. Dannenberg, 50 F.3d 615, 626–27 (9th Cir. 1994) ("Because we conclude that the Underwriters acted with due diligence in investigating [the company's business and revenues], we also hold that the Underwriters did not act with scienter [under § 10(b)] regarding those claims.").

[82] Securities Act of 1933 § 11(b)(3)(A), 15 U.S.C. § 77k(b)(3)(A) (2006).

[83] *See* Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2006).

[84] Tuch, *Multiple Gatekeepers*, *supra* note 64, at 1648–55.

liability if underwriters fail to establish due diligence. The due diligence defense will also tend to relieve underwriters of liability under Rule 10b-5 by negating the inference of *scienter*.[85]

Another relevant consideration in assessing the need for conflict of interest rules in addition to the existing underwriter liability regime is that, as financial conglomerates have grown in size and complexity, the opportunities for underwriters to face conflicts of interest have increased. Casual empiricism strongly suggests that the development of novel financial instruments and the massive incentives banks face to earn income from their trading operations ensure that banks will have potentially conflicting interests in transactions more so than in the past. Where remuneration structures produce outsized rewards for individual bankers, it is plausible to think that such extraneous incentives could skew the conduct of underwriters and thereby compromise the gatekeeping role. Conflict of interest rules would counter these developments.

A weak form of conflict of interest rules has already been imposed on underwriters in particular circumstances. The Financial Industry Regulatory Authority ("FINRA"), the self-regulatory body of the securities industry that operates under SEC supervision, regulates some conflicts of interest afflicting underwriters. Because these regulations apply only to public securities offerings, they do not apply to private transactions involving sophisticated investors and for this reason did not apply to the ABACUS deal. The relevant rules forbid an underwriter having a conflict of interest with investors (for example, from an affiliation with the issuer of the securities it is underwriting) from underwriting a public securities offering unless certain

[85] *Cf.* John C. Coffee, Jr., A Statutory and Case Law Primer on Due Diligence Under the Federal Securities Law, *in* P.L.I. Corporate Law and Practice Course Handbook Series, Conducting Due Diligence, 886 PLI/Corp 11, 13 (1995). For example, in In re Software Toolworks Inc. v. Dannenberg, *supra* note 81, at 626–27, the Court explained as follows: "Because we conclude that the Underwriters acted with due diligence in investigating [the company's business and revenues], we also hold that the Underwriters did not act with scienter [under § 10(b)] regarding those claims."

independence and disclosure conditions are satisfied.[86] The FINRA rules regulate conflicts of interest not by banning them outright, but by requiring additional "prominent disclosure" and the use of a "qualified independent underwriter to act with the conflicted underwriter."[87] The rules specifically require a qualified independent underwriter to "[exercise] the usual standards of 'due diligence'" in preparing the offering document.[88] While these FINRA rules implicitly recognize the gatekeeping role underwriters perform, they apply narrowly—only to public offerings. Moreover, the use of a qualified independent underwriter may fail to achieve its intended purpose of addressing underwriting deficiencies associated with having a conflicted underwriter. According to the Hong Kong Securities and Futures Commission, the use of an independent underwriter to act with a conflicted underwriter has created concern that the conflicted underwriter continues to lead the transaction,[89] thereby compromising the gatekeeping function.

[86] Financial Industry Regulatory Authority Rule 5121 forbids an underwriter from participating in a public offering if the underwriter has a "conflict of interest," unless, generally speaking, either the underwriters "primarily responsible for managing the public offering" do not have a conflict of interest and the securities are investment-grade rated and offered in a bona fide public market (FINRA Rule 5121(1)), or a "qualified independent underwriter" (generally speaking, an underwriter free of conflicts of interest) has participated in the offering and the nature of the conflict of interest afflicting the (other) underwriter is prominently disclosed to investors (FINRA Rule 5121(2)). Rule 5121 defines conflicts of interest in terms of an underwriter's affiliation with the issuer, such as through ownership, control or a lending relationship (FINRA Rule 5121(f)(5)). As to when an underwriter is considered to "participate in a public offering," see Regulatory Notice 09-49, "SEC Approves Amendments to Modernize and Simplify NASD Rule 3720 Relating to Public Offerings in Which a Member with a Conflict of Interest Participates."

[87] Qualified independent underwriters may nevertheless face temptations to avoid alienating conflicted underwriters in the desire of being included in future underwriter syndicates. *See* Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 434 (2010).

[88] FINRA Rule 5121(2)(A) (requiring that "[a] qualified independent underwriter has participated in the preparation of the registration statement and the prospectus, offering circular, or similar document and has exercised the usual standards of 'due diligence' in respect thereto"). *See also* FINRA 5121, *supra* note 86.

[89] The Hong Kong Securities and Futures Commission considers the position of sponsors, which in Hong Kong are analogous to the lead or managing underwriter in the U.S. *See* Hong Kong Securities and Futures Commission, *Consultation Paper on the Regulation of Sponsors*, 28 (2012) (discussing concerns about the existing independence requirements for underwriters and proposing that only independent sponsors be permitted to underwriter initial public offerings), *available at* http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CP1.

In consequence, the Securities and Futures Commission is considering imposing stricter rules that would ban conflicted underwriters, at least in initial public offerings.[90]

Finally, reasons of political economy deserve consideration in assessing the desirability of the Volcker Rule provisions. Provisions imposing liability for disclosure errors depend for their enforcement on the willingness of regulators to act, and they require regulatory determinations on issues such as *scienter*. In contrast, conflict of interest rules diminish the need for regulatory discretion, particularly in the case of such rules that impose outright bans on conflicts of interest. In view of concerns about regulatory capture and the "revolving-door" temptations facing regulators,[91] rules that operate ex ante and thus rely less on vigilant enforcement by regulators for their success—such as conflict of interest rules—may be preferable to those rules requiring ex post detection and imposition of liability by regulators.

Of course, these various factors merely suggest the inadequacy of the existing regulatory regime for underwriters and make a preliminary case for the imposition of conflict of interest rules to remove incentives currently shaping the conduct of underwriters in undesirable ways. The case for conflict of interest rules would seem strongest for the underwriting of equity securities, particularly in initial public offerings, where the due diligence performed by underwriters plays a critical role[92] and where other functions performed by a banking entity for the issuer would seem not to give rise to synergies that might offset any costs associated with acting as a conflicted underwriter. However, conflicts of interest have long handicapped the

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[90] *Id.*

[91] In the case of the SEC, see Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679, 724–26 (2012) (discussing the possibility of regulatory capture of SEC officials).

[92] *See, e.g.*, Hong Kong Securities and Futures Commission, *supra* note 89, at 2–3 (discussing the role of due diligence by underwriters in initial public offerings).

financial services industry and are a recurring theme in major corporate and economic crises.[93] The burden should rest on banking entities to shift the presumption, for particular transaction types only, that the conflict of interest rules in the Volcker Rule are justified.[94]

IV. A Case Study: SEC v. Goldman Sachs

This article now uses a case study to apply conflict of interest rules to a securities underwriting transaction. In doing so, it considers how the Volcker Rule provisions would have applied to the ABACUS 2007-AC1 deal had those provisions been in force at the time.

A. The Transactions and Issues

The SEC enforcement action against Goldman Sachs centered on the bank's disclosures to sophisticated investors in ABSs as part of a collateralized debt obligation ("CDO"). The CDO comprised several related transactions intended to be executed simultaneously to facilitate the investment strategy of the New York hedge fund Paulson & Co. Inc., which had sought Goldman's assistance in speculating that housing prices would fall.[95] To facilitate Paulson's investment strategy, Goldman would enter into a derivative contract known as a credit default swap ("CDS") with Paulson, under which Goldman would pay Paulson large sums, contingent

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[93] For a discussion of the conflicts of interest afflicting financial institutions, particularly in the wake of major financial events, see LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT at Chapter 4 (1914); NICHOLAS WOLFSON, CONFLICTS OF INTEREST: INVESTMENT BANKING: REPORT TO THE TWENTIETH CENTURY FUND STEERING COMMITTEE ON CONFLICTS OF INTEREST IN THE SECURITIES MARKET (1981); PHILIP AUGAR, THE GREED MERCHANTS: HOW THE INVESTMENT BANKERS PLAYED THE FREE MARKET GAME (2005); and Andrew F. Tuch, *The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife With Conflicts of Interest, in* THE REGULATION OF WEALTH MANAGEMENT 52 (Hans Tjio ed., 2008).

[94] *See infra* note 179–81.

[95] SEC Complaint, *supra* note 6, at 5 ("Paulson developed an investment strategy based upon the belief that . . . certain mid-and-subprime [residential mortgage-backed securities] . . . would experience credit events."). As to the general structure of the agreements, including the agreements with Paulson to execute the various transactions simultaneously, see generally Exhibits, *U.S. Senate Permanent Subcommittee on Investigations, Hearings on Wall Street and the Financial Crisis: The Role of Investment Banks* (Apr. 27, 2010), *available at* http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/042710Exhibits.pdf?attempt=2 [hereinafter Exhibits of *Senate Hearing on Investment Banks*]; Exhibits 117 (Draft Goldman Sachs Letter Agreement to Paulson Credit Opportunities Master Ltd., Feb. 3, 2007); Exhibit 121 (Goldman Sachs, ABACUS 2007-AC1, LTD, Offering Circular, Apr. 26, 2007 (excerpt)).

on the happening of events that would serve as rough proxies for the deterioration of mid-and-subprime housing loans. Under the CDS, Paulson would receive contingent payments—akin to insurance payouts—in the event that a specific reference portfolio of mortgage-backed securities incurred losses or other negative credit events.[96] This contract would enable Paulson to wager against housing prices: weakening prices would be expected to diminish the value of securities "backed" by mid- and sub-prime mortgages, creating losses or other negative credit events and triggering payments to Paulson under the CDS. For buying this "protection" from losses of value of the reference portfolio, Paulson would be obliged under the CDS to make periodic payments to Goldman in the nature of insurance premiums.

The other side of the deal would involve multiple transactions designed to offset Goldman's financial exposure under the CDS with Paulson.[97] In the first offsetting transaction, Goldman would structure and market a synthetic CDO,[98] a transaction involving the formation of an SPV that would enter into a CDS with Goldman.[99] Under the CDS, the SPV would sell Goldman protection (the reverse of Goldman's transaction with Paulson) in the event that a matching reference portfolio of mortgage-backed securities incurred losses or other negative credit events. The SPV would issue securities to investors; importantly, Goldman Sachs would underwrite this

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[96] *See* SEC Complaint, *supra* note 6, at 3 (regarding payment of approximately $1 billion to Paulson); Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 1.a (Memorandum from Permanent Subcommittee on Investigations Chairman Carl Levin and Ranking Minority Member Tom Coburn to the Members of the Subcommittee), at 4–12 (describing the structuring of synthetic CDO transactions and, in particular, the ABACUS 2007-AC1 CDO). For description of CDS, see SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 125–26 (2010).

[97] Goldman's letter agreement with Paulson provided that the CDS between Paulson and Goldman would be "matched" by one or more CDSs between Goldman and other counterparties. *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 117 (Draft Goldman Sachs Letter Agreement to Paulson Credit Opportunities Master Ltd., Feb. 3, 2007).

[98] SEC Complaint, *supra* note 6, at 6 ("Among the transactions considered were synthetic CDOs whose performance was tied to Triple B-rated RMBS.").

[99] As to the structure of the synthetic CDO, see Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 117 (Draft Goldman Sachs Letter Agreement to Paulson Credit Opportunities Master Ltd., Feb. 3, 2007); and Exhibit 118 (Goldman Sachs Internal Memorandum to Mortgage Capital Committee, Mar. 12, 2007).

securities offering. In the securities offering, investors would be entitled to a share in payments derived from the SPV's underlying assets;[100] since the payments would be derived from premiums received under the CDS,[101] rather than from a reference portfolio of actual securities, the CDO would be considered synthetic.

In the second offsetting transaction, Goldman would enter into a CDS with another counterparty, under which Goldman would buy protection (again, the reverse of the Paulson CDS) in the event that a matching reference portfolio of securities incurred losses or other negative credit events. Together with the first offsetting transaction, this transaction would offer Goldman the potential to neutralize its exposure under its CDS with Paulson.[102] By design, therefore, if Goldman were required to pay Paulson under that CDS, Goldman would receive payments from both the SPV and the other CDS counterparty. Goldman thus acted as an intermediary between Paulson, on the one hand, and the SPV and the other CDS counterparty, on

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[100] SEC Complaint, *supra* note 6, at 5 ("CDOs are debt securities collateralized by debt obligations including RMBS. These securities are packaged and generally held by a special purpose vehicle ("SPV") that issues notes entitling their holders to payments derived from the underlying assets.")

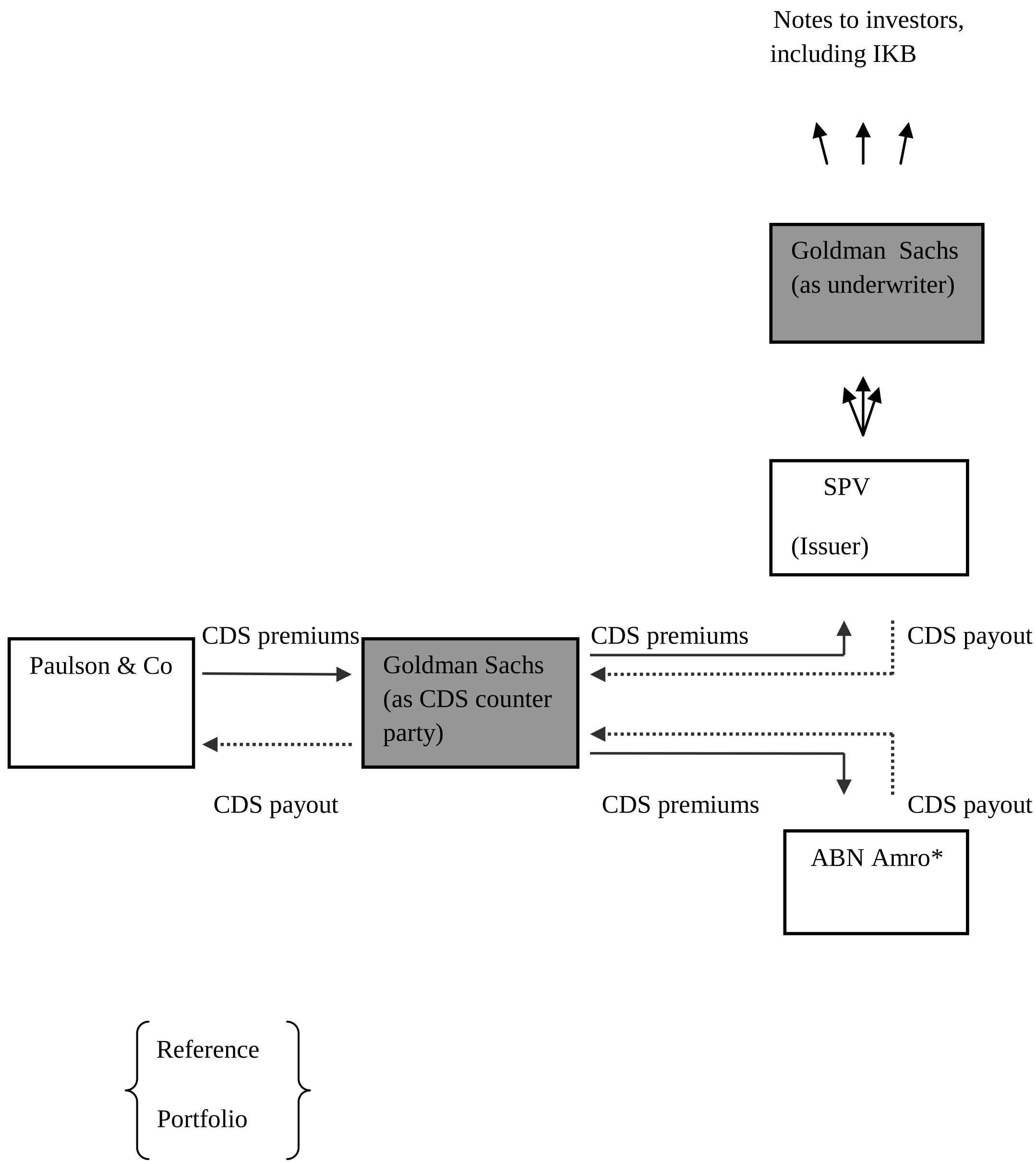
[101] The SPV would hold some securities as collateral which, together with the premium payments under the CDS, would be used to pay securities holders. *See* Submission on Behalf of Goldman Sachs, at 10 (2009), *available at* http://av.r.ftdata.co.uk/files/2010/04/Goldman-defence-doc-Part-I.pdf [hereinafter Goldman Sachs Submission].

[102] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit, 118 at 2 (Goldman Sachs Internal Memorandum to Mortgage Capital Committee, Mar. 12, 2007) ("Goldman is not taking any warehouse risk in this transaction. . . . Goldman is solely working as agent and but [sic] retains the option to underwrite the risk as principal . . . . [T]he [CDO] tranches that are distributed will be immediately crossed to Paulson, resulting in no retained unobservable tranches on the closing date."). *See also* Goldman Sachs Submission, *supra* note 101, at 14 (explaining that "[t]hrough CDSs with Paulson, Goldman Sachs sold all of the protection that it had purchased from the SPV and from ACA (through ABN)"). In fact, Goldman did not entirely offset its exposure to Paulson since it "purchased protection from ACA on a portion (50-100%) of the super senior tranche, but wrote protection to Paulson on the entire (45-100%) super senior tranche," thus leaving it bearing "the risk that poor performance of the Reference Portfolio would affect the 45-50% portion." *See* Goldman Sachs Submission, *supra* note 101, at 14–15.

the other hand. For structuring the transactions to facilitate the investment strategy of Paulson, Goldman expected to receive a fee from Paulson of between $15 million and $20 million.[103]

[103] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 118 at 6 (Goldman Sachs Internal Memorandum to Mortgage Capital Committee, Mar. 12. 2007) ("[T]his transaction is expected to generate, after fees and expenses, between $15 and $20 million in P&L.").

The ABACUS deal structure is summarily depicted below.



* For analytical convenience, this diagram conflates transactions involving ABN Amro and another counterparty, ACA. See *infra* note 106.

As events transpired, Goldman pursued these transactions, although neither logically nor simultaneously. Goldman first structured and marketed the synthetic CDO, entering into a CDS with an SPV, buying protection from it on a reference portfolio that would match the reference portfolio in the CDS (subsequently entered into) with Paulson. In an offering underwritten by

Goldman, the SPV issued privately-placed notes to investors, including the German bank Deutsche Industriebank AG ("IKB").[104] Conducted under Rule 144A of the Securities Act of 1933, the securities were accompanied by an offering document that set out relevant disclosures regarding the offering. In this securities offering, IKB bought from Goldman Sachs securities that had been issued by the SPV. In its enforcement action, the SEC did not allege that the relationship between Goldman and IKB was anything other than arm's length.[105]

Subsequently, Goldman entered into the CDS with Paulson. It also entered into a CDS with another counterparty, the Dutch bank ABN Amro, obliging it to pay Goldman if a matching reference portfolio incurred losses or other negative credit events.[106]

Famously, Paulson's investment strategy paid off. As the subprime market collapsed, the securities in the reference portfolio were severely affected, triggering a billion dollar gain for Paulson—and corresponding losses by both the SPV and ABN Amro.[107] The SEC commenced enforcement action against Goldman Sachs on April 16, 2010, accusing the bank of securities

[104] *See* Goldman Sachs Submission, *supra* note 101, at 2 (referring to Goldman's role "as the underwriter of privately-placed notes issued in a synthetic CDO transaction known as ABACUS 2007-AC1 . . ."). Goldman Sachs is described as the initial purchaser, a term used to describe the underwriter of a private offering.

[105] The ABACUS offering document, which describes Goldman as the initial purchaser of the securities, makes clear that the securities are being sold by Goldman as principal. *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 121 at i (Goldman Sachs, ABACUS 2007-AC1, LTD, Offering Circular, Apr. 26, 2007 (excerpt)) ("The [securities] are being offered hereby by Goldman, Sachs & Co. to Qualified Institutional Buyers . . . in reliance on Rule 144A under the Securities Act. . . . The Notes are offered by the Initial Purchaser . . . subject to its right to reject any order in whole or in part.").

[106] More specifically, Goldman Sachs entered into a CDS with ACA. This CDS was intermediated by ABN Amro, meaning that ABN Amro would be required to perform ACA's obligations under the CDS with Goldman Sachs if ACA failed (as it did). *See* Goldman Sachs Submission, *supra* note 101, at 5 ("ABN Amro . . . intermediated Goldman Sachs' swap with ACA . . . ."). For analytical convenience, the description in the text above conflates the roles of ABN Amro and ACA in respect of the CDS with Goldman Sachs.

[107] *See* Goldman Sachs Submission, *supra* note 101, at 15–16 (discussing the collapse of the subprime market and the consequences for the securities in the reference portfolio).

fraud for its role in marketing the CDO.[108] Later that month, the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security & Governmental Affairs conducted highly publicized hearings about the ABACUS transactions.[109]

The SEC's particular focus was Goldman's disclosure to investors in its marketing materials, including in the offering document, about the selection of the reference portfolio. The reference portfolio consisted of dozens of subprime mortgage-backed securities.[110] The SEC claimed that Paulson performed a "significant role" in selecting the reference portfolio that was not disclosed to investors.[111] According to the SEC, Goldman knew that the choice of an experienced and independent "portfolio selection agent" to select the portfolio would facilitate the marketing of the ABACUS CDO and even knew that IKB was unlikely to invest in a CDO without such an agent.[112] Goldman thus sought to have, and succeeded in having, ACA Management serve as portfolio selection agent for the CDO. According to the SEC, by claiming in marketing materials provided to IKB and ABN Amro that ACA Management had selected the reference portfolio without disclosing the role of the hedge fund (Paulson) with directly adverse interests, Goldman

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[108] *See* SEC Complaint, *supra* note 6. The enforcement action had been foreshadowed on Christmas Eve 2009, when a front page *New York Times* article reported on SEC unrest with Goldman Sachs' structuring of CDOs. *See* Gretchen Morgenson & Louise Story, *Banks Bundled Bad Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 24, 2009, at A1. *See also Goldman Sachs Responds to The New York Times on Synthetic Collateralized Debt Obligations*, Dec. 24 2009, *available at* http://www.goldmansachs.com/media-relations/comments-and-responses/archive/response-scdo.html.

[109] *Senate Committee Hearing*, *supra* note 8.

[110] Goldman Sachs Submission, *supra* note 101, at 2 ("[T]he synthetic [reference] portfolio consisted of dozens of Baa2-rated subprime residential mortgage-backed securities . . . .").

[111] SEC Complaint, *supra* note 6, at 21 (alleging securities fraud by Goldman for misrepresenting "in the term sheet, flip book and offering memorandum for ABACUS 2007-AC1 that the reference portfolio was selected by ACA without disclosing the significant role in the portfolio selection process played by Paulson, a hedge fund with financial interests in the transaction adverse to [investors]").

[112] *Id.* at 7 ("[Goldman Sachs] knew that the identification of an experienced and independent third-party collateral manager as having selected the [reference] portfolio would facilitate the placement of the CDO liabilities in a market that was beginning to show signs of distress . . . [and] also knew that at least one potential investor, [IKB] . . . , was unlikely to invest in the liabilities of a CDO that did not utilize a collateral manager to analyze and select the reference portfolio.").

committed securities fraud.[113] For SEC purposes, therefore, the primary issue concerned whether Goldman had misrepresented material facts relating to the role of Paulson in selecting the reference portfolio.[114]

Goldman Sachs settled the SEC enforcement action, and paid a $550 million fine, without either admitting or denying the SEC's allegations.[115] In the settlement, the bank acknowledged that its marketing materials "contained incomplete information" and that "it was a mistake for the . . . materials to state that the reference portfolio was 'selected by' ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors."[116]

The focus of Congressional hearings was explicitly on Goldman's alleged conflicts of interest with investors. The bank stood accused of having "bet against" the securities it sold investors.[117] Questioning focused on whether Goldman's other interests associated with

[113] The SEC alleged violation of Section 17(a) of the Securities Act and Section 10(b), and Rule 10b-5 thereunder, of the Securities Exchange Act. *See* SEC Complaint, *supra* note 6, at 19–21. Although the SEC also alleged fraud against Goldman in misleading ACA Management as to Paulson's role in the transaction, the settlement made no mention of this claim. *See* Sec. and Exch. Comm'n v. Goldman, Sachs & Co. and Fabrice Tourre, Consent of Defendant Goldman, Sachs & Co., at 1 (July 14, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/consent-pr2010-123.pdf [hereinafter Goldman Sachs Consent Order]. The SEC's allegations against Goldman in its dealings with ACA Management are not pursued in this article.

[114] Goldman Sachs Submission, *supra* note 101, at 2–3 ("Now . . . , the Staff proposed to charge Goldman Sachs with misrepresenting material facts relating to the [ABACUS] offering . . . . [T]he Staff's theory relates exclusively to the role of Paulson . . . in making suggestions to the [portfolio] selection agent . . . and taking a negative position on that portfolio through a swap with Goldman Sachs.").

[115] *See* Goldman Sachs Consent Order, *supra* note 113, at 1. The fine comprised a civil penalty of $535 million and disgorgement of profits of $15 million.

[116] *Id*. at 2.

[117] United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Government Affairs, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, Majority and Minority Staff Report, April 13, 2011 (*available at* http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf) [hereinafter Senate Report on Wall Street and the Financial Crisis] at 36 (alleging that Goldman "bet against" the mortgage market, and in some cases took positions that only "paid off" when its clients lost money on securities sold to them by Goldman).

transactions that may not have been identified in the SEC's allegations allowed it to profit if the securities it sold to investors lost value. The rhetoric surrounding the Congressional hearings included claims that Goldman "designed a product to fail"[118] and likened Goldman's conduct to "selling someone a car with faulty brakes and then taking out an insurance policy on the driver."[119] Congressional questioning of Goldman executives during the hearings repeatedly touched on Goldman's alleged conflicts of interest[120] and specifically on whether it owed

[118] *See, e.g.*, Louise Story & Gretchen Morgenson, *SEC Accuses Goldman of Fraud in Housing Deal*, N.Y. TIMES, Apr. 17, 2010, at A1 ("Goldman Sachs . . . was accused of securities fraud in a civil lawsuit filed Friday by the Securities and Exchange Commission, which claims the bank created and sold a mortgage investment that was secretly intended to fail."); Paul Krugman, Op-Ed., *Looters in Loafers*, N.Y. TIMES, Apr. 19, 2010, at A23 ("[N]ow the S.E.C. is charging that Goldman created and marketed securities that were deliberately designed to fail, so that an important client could make money off that failure."); Susan Pulliam & Evan Perez, *Criminal Probe Looks Into Goldman Trading*, WALL ST. J., (Apr. 30, 2010), http://online.wsj.com/article/SB10001424052748703572504575214652998348876.html ("On April 16, the SEC charged Goldman . . . with securities fraud in a civil suit relating to a mortgage transaction, known as ABACUS 2007-AC1, a deal the government said was designed to fail."); Kate Kelly, *SEC v. Goldman Sachs: Goldman's Take-No-Prisoners Attitude—Mortgage Division Casts Bet Boldly; Awaiting 'Big One,'* WALL ST. J.**,** Apr. 26, 2010, at C1 ("The financial world is riveted on the Securities and Exchange Commission lawsuit filed earlier this month against Goldman, which is accused with one of its traders in the mortgage group of creating a product secretly designed to fail for the benefit of a favored hedge-fund client."); Edward Jay Epstein, Op-Ed., *Goldman and Washington's Wall Street Takeover*, WALL ST. J., May 22, 2010, http://online.wsj.com/article/SB10001424052748704852004575258292274111802.html (commenting on the widely echoed "designed to fail" charge against Goldman Sachs).

[119] Mary Bottari, *Goldman Accused of Cutting the Breaks*, HUFFINGTON POST, Apr. 19, 2010, *available at* http://www.huffingtonpost.com/mary-bottari/goldman-accused-of-cuttin_b_542597.html (referring to Financial Crisis Inquiry Commission chair Phil Angelides likening Goldman's conduct to the practice of "selling someone a car with faulty brakes and then taking out an insurance policy on the driver" and suggesting that the SEC's action revealed that "Goldman had cut the brakes").

[120] *Opening Statement of Senator Carl Levin U.S. Senate Permanent Subcommittee on Investigations Hearing Wall Street and the Financial Crisis: The Role of Investment Banks*, 5 (Apr. 27, 2010), *available at* http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=f07ef2bf-914c-494c-aa66-27129f8e6282 ("Abacus may be the best-known example of conflicts of interest revealed in the Goldman documents, but it is far from the only example.").

Other subcommittee members also described Goldman's conduct in the ABACUS deal as involving a conflict of interest. *See Opening Statement of Senator Tom Coburn, U.S. Senate Permanent Subcommittee on Investigations Hearing Wall Street and the Financial Crisis: The Role of Investment Banks*, 1 (Apr. 27, 2010), *available at* http://www.hsgac.senate.gov/download/opening-coburn-tom-april-27-2010-financial-crisis-hrg ("Sorting out these potential conflicts is central to understanding how we move forward with financial reform. Several instances seemed to show bankers and traders were focused on *doing what was right for the firm*, rather than *what was in the best interests of clients*. In an exchange over the ABACUS deal, one employee remarked: 'The way I look at it, the easiest managers to work with should be used for our own [priorities]. Managers that are a bit more difficult should be used for trades like Paulson . . . . '").

fiduciary duties to the buyers of the securities it sold as underwriter.[121] Blanket media attention followed, focusing on the possibility of legislative reforms to impose conflict of interest rules on broker-dealers.[122]

Implicit in the debate concerning Goldman's conduct was the premise that the bank should avoid conflicts with the interests of the buyers of securities. The debate became one concerning whether Goldman owed—or should owe—fiduciary duties to investors. The fact that Goldman as underwriter had been in arm's length relationships with buyers of securities seemed lost on critics—but not on Goldman. Goldman responded by focusing on its role as a principal with interests opposed to those of its counterparties and sought to differentiate that principal role from an agency or advisory role. For example, when asked by Senator Levin whether he was troubled about his bank's conduct, Lloyd Blankfein, Goldman's Chief Executive Office, responded: "I am not troubled by the fact that we market make as principal and that we are the opposite—when

[121] *See Senate Committee Hearing*, *supra* note 8, at 10, 26, 57 (statement of Sen. Susan Collins referring to Goldman Sachs' conduct) ("While such conflicts of interest may not be illegal, they certainly seemed ethically questionable, and these conflicts of interest appeared to be rooted in the fact that broker-dealers do not have a fiduciary obligation to their clients. That is an issue we will be considering.") ("Mr. Sparks, when you were working at Goldman, did you consider yourself to have a duty to act in the best interests of your clients? . . . Mr. Birnbaum, . . . [d]o you have a duty to act in the best interests of your clients? . . . Mr. Tourre, [d]o you have a duty to act in the best interests of your clients? . . . Mr. Birnbaum, do you think that since there is apparently some confusion or some difference of opinion on this issue . . . that Congress should impose a clear fiduciary obligation to act in the best interests of your clients on broker-dealers?") (statement of Sen. Mark Pryor) ("[W]hether that is truly a conflict of interest or not, whether you truly have a fiduciary responsibility or not, I just think that we need to spend some time as the Senate . . . thinking about that.").

[122] *See, e.g.*, Francesco Guerrera & Tom Braithwaite, *Goldman Lobbies against Fiduciary Reform*, FIN**.** TIMES, (May 12, 2010), http://www.ft.com/intl/cms/s/0/bd3f9db4-5d5e-11df-8373-00144feab49a.html#axzz25jAaVwYY. ("The case [*SEC v. Goldman Sachs*] has fuelled attempts to introduce fiduciary duty rules into financial regulation legislation that is due to come to a final vote in the US Senate in the next two weeks."); Gillian Tett, *Sophisticated Investor Debate Takes On A New Dimension*, FIN**.** TIMES, (May 7, 2010) (discussing the debate on fiduciary duties for sophisticated investors after Goldman's Senate hearings); Len Canty, *Goldman and God's Work*, AM. BANKER, at 9 (May 7, 2010) (citing Goldman's Senate hearings as evidence for imposing fiduciary duties on bankers); Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient?—Principles, Rules and Fiduciary Duties*, 2010, COLUM. BUS. L. REV. 710, 712 (2010) ("Following the financial crisis and frauds . . . , there was considerable talk of creating explicit stock broker fiduciary duties . . . . These calls for heightened duties also arose in the context of the Goldman Sachs . . . investigation."); Skadden, *The Dodd-Frank Act: Commentary and Insights*, at 158 (July 12, 2010), http://www.skadden.com/sites/default/files/publications/Skadden_Insights_Special_Edition_Dodd-Frank_Act1_6.pdf ("One of the more contentious debates connected to Congress' financial reform effort concerns whether broker-dealers should be subject to a 'fiduciary duty.' The debate gained momentum in the wake of allegations by the SEC that Goldman Sachs committed securities fraud . . . .").

somebody sells, they sell to us, or when they buy, they buy from us."[123] When pressed further in a media interview, Mr. Blankfein explained, "We're like a machine, that lets people buy and sell what they want to buy and sell . . . . That's not the advisory business. That's just a facility for market making."[124] In making these statements, Mr. Blankfein was simply stating what Goldman itself had told investors in the ABACUS transactions: it was acting as a principal, not as their fiduciary.[125]

B. Analysis

Even though Goldman was acting in a principal capacity in selling securities to investors such as IKB, it does not follow that the bank was not, or should not have been, subject to conflict of interest rules—as Part III of this article sought to establish. At issue then is whether the bank was a gatekeeper in the ABACUS transactions and, if so, whether it was in a position of conflict with investor interests.

1. Goldman Sachs as Gatekeeper

The issue of whether Goldman acted as a gatekeeper should be unproblematic, given the bank's role as underwriter of securities issued to IKB. However, this question connects with an important fault line in the literature on gatekeeper liability.[126] In laying the theoretical foundation for gatekeeper liability, Professor Reinier Kraakman conceived of the gatekeeper as an actor with

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[123] Senate Report on Wall Street and the Financial Crisis, *supra* note 117, at 611–12.

[124] *Id.* at 612 (citing *Goldman Sachs' Lloyd Blankfein Defends 'Market Maker' Firm On 'Charlie Rose Show*,' HUFFINGTON POST, (last updated May 25, 2011) (video of Charlie Rose interview of Lloyd Blankfein embedded), http://www.huffingtonpost.com/2010/05/01/goldman%1esachs%1elloyd%1eblank_n_559606.html.

[125] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 120 at 8 (Goldman Sachs, ABACUS 2007-AC1, Indicative Terms Marketing Materials) ("Goldman Sachs does not provide investment, accounting, tax or legal advice and shall not have a fiduciary relationship with any investor.").

[126] For a discussion of this fault line, see Tuch, *Multiple Gatekeepers*, *supra* note 64, 1664–65.

the capacity to monitor and control, or at least to influence, the conduct of its corporate client and thereby to deter wrongdoing by it.[127] Referring to Professor Kraakman's definition, Professor John Coffee has offered an alternative definition of a gatekeeper that intentionally omits the requirement that gatekeepers have the capacity to monitor and control corporate conduct; instead, Professor Coffee conceives of a gatekeeper as "an agent who acts as a reputational intermediary to assure investors as to the quality of the 'signal' sent by the corporate issuer."[128] The distinction may well be overstated, since Professor Kraakman's conception necessarily incorporates the notion of the gatekeeper as a reputational intermediary; in fact, he claims that gatekeepers "increase the confidence—and reduce the information costs—of disaggregated investors by implicitly offering their market reputations as 'hostages' for the quality of their clients."[129]

While it seems clear that Goldman, in performing an underwriting role in the ABACUS transactions, possessed the capacity to monitor and control the disclosure decisions of the issuer (the SPV that it formed), it is less clear whether the bank acted as a reputational intermediary (to employ the term in Professor Coffee's definition). This article takes the position that Goldman did act as a reputational intermediary, staking its reputation to assure investors such as IKB about the quality of the issuer's disclosures. That view, however, is opposed in a recent article by Professors Steven Davidoff, Alan Morrison and William Wilhelm. The professors adopt what they call a "transaction-based" perspective of the ABACUS deal, which they argue is more

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[127] Professor Kraakman asserts that "[t]he first requisite for gatekeeper liability is, of course, an outsider who *can* influence controlling managers to forgo offenses." Kraakman, *Corporate Liability Strategies*, *supra* note 64, at 890. As to the monitoring function of gatekeepers, see *id.* at 891; and Kraakman, *Gatekeepers*, *supra* note 64, at 62–66.

[128] JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006).

[129] Kraakman, *Gatekeepers*, *supra* note 64, at 61 n.20 (internal citations omitted).

appropriate than the alternative—a “trust-based” approach.[130] In applying a transactional approach to the ABACUS deal, the professors analogize the deal to the short-sale of an exchange-traded stock, in which a bank stands between a party selling stock (borrowed, because it does not own the stock) and another customer buying that stock.[131] In applying the transactional approach, the professors reject the view that Goldman was putting its reputation at stake in the ABACUS deal and claim that, more generally, investment banks do not stake their reputations in similar types of transactions.[132]

The professors appear to have overlooked both the underwriting role Goldman performed as well as the bank’s role in structuring the CDO, which included forming the SPV. The professors’ short-sale analogy focuses attention only on Goldman’s role between Paulson as protection buyer, on the one hand, and both the SPV and ABN Amro as protection sellers, on the other hand. It was Goldman’s role as underwriter of the securities sold to IKB (for which the disclosures in question were prepared) on which the SEC focused its attention.[133] Even

[130] Davidoff et al., *supra* note 4, at 539 (“[C]an we adopt a purely *transactional* perspective of the ABACUS deal?”). *See id.* at 542 (“We are . . . skeptical that the norms and practices of the time justified anything but a transactional approach to the ABACUS transaction.”). *See also id.* at 547–49 (arguing in favor of the transaction-based perspective).

[131] *Id.* at 539 (“Can we think of the ABACUS deal as a more complicated version of the short-selling [of an exchange-traded stock]? That is, can we adopt a purely *transactional* perspective of the ABACUS deal?”); *see also id.* at 542 (“We are . . . skeptical that the norms and practices of the time justified anything but a transactional approach to the ABACUS transaction.”).

[132] *Id.* (“Did market players think that their investment bank counterparts were placing their reputation on the line when they traded, and did they make investment decisions accordingly . . . [and] did investment banks attempt to trade on their reputations? . . . [W]e are unaware of any convincing evidence that investment banks staked their reputations on statements about the likely performance of the securitized investments that they structured. We are thus skeptical that the norms and practices of the time justified anything but a transactional approach to the ABACUS transaction.”).

[133] The consent settlement between the SEC and Goldman Sachs focused only on Goldman’s disclosures in marketing materials for the ABACUS CDO. *See* Goldman Sachs Consent Order, *supra* note 113, at 2 (“Goldman acknowledges that the marketing materials for the ABACUS 2007-ACI transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was "selected by" ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors. Goldman regrets that the marketing materials did not contain that disclosure.”).

sophisticated investors would be expected to face collective action problems in verifying the accuracy of an issuer's disclosures and would therefore be reassured by the involvement of a reputable underwriter. Contracting by investors with underwriters to protect themselves might render conflict of interest rules unnecessary, but contracting is costly and time-consuming. Where time is short and an offering document has already been prepared, it is easy to envisage even sophisticated investors taking some assurance from the existence and identity of the underwriter. Investors would put greater store in the accuracy of disclosures in a deal underwritten by Goldman Sachs than in a deal involving an unknown issuer without an underwriter. Broad support for this view comes from Goldman itself. Its recent Business Standards Report, issued by the bank as part of the firm's settlement with the SEC, emphasizes the importance of the firm's reputation in *all* aspects of its business.[134]

One must also consider Goldman's role in structuring the CDO. This involved the bank forming an SPV and preparing the disclosure materials. The SPV was a shell company newly formed in the Cayman Islands for the specific purpose of the transaction and with no operating history.[135] In structuring the transaction, Goldman had considerable—perhaps even full—control over the issuer, heightening the bank's ability to prevent disclosure errors by the issuer. And

[134] *See Goldman Sachs Business Principles and Standards Committee Report*, http://www.goldmansachs.com/who-we-are/business-standards/committee-report/business-standards-committee-report.html ("We must renew our commitment . . . above all, to client service and a constant focus on the reputational consequences of every action we take . . . . We believe the recommendations contained in this report represent a fundamental re-commitment by Goldman Sachs . . . to reputational excellence associated with everything the firm does.").

[135] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 118 at 2 (Goldman Sachs Internal Memorandum to Mortgage Capital Committee, Mar. 12, 2007) ("A Cayman's special purpose vehicle will be established for the sole purpose of issuing . . . Notes . . . ."). *See also* Exhibit 121 at 2 (identifying two SPVs, one a "company incorporated under the laws of the Cayman Islands for the sole purpose of issuing the Notes" and the other, its co-issuer, as a "company incorporated under the laws of the State of Delaware . . . [which] will not have any assets (other than $10 of equity capital)"). For a detailed discussion of the role of SPVs in corporate transactions, see William J. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, U. of Penn., Inst. for Law & Econ. Research Paper No. 12-26, Georgetown Law and Economics Research Paper No. 12-034, Georgetown Public Law Research Paper No. 12-126 (Aug. 13, 2012), *available at* http://ssrn.com/abstract=2126778 or http://dx.doi.org/10.2139/ssrn.2126778.

what reason did investors have to trust the accuracy of the disclosures by this SPV? It is difficult to think that investors would not have been assured by the involvement of Goldman Sachs in deciding to buy securities, especially considering that Goldman formed a legal entity for the purpose of issuing those securities, marketed the securities as an underwriter of the deal, and emblazoned its name on the front cover of the sales document used to market them.[136] In a deal effectively structured by the underwriter involving an issuer formed by the underwriter itself, the case for the underwriter as reputational intermediary would seem stronger than in other transactions, particularly those involving an issuer with an established operating history that had been vetted by other market professionals. While a retrospective analysis of the parties' beliefs would be required to resolve whether Goldman in fact staked its reputation on the ABACUS deal and thereby acted as a gatekeeper (according to Professor Coffee's conception of the term),[137] the circumstances discussed strongly suggests that it did so. In the ABACUS deal, Goldman Sachs acted as a gatekeeper under either of the commonly accepted definitions of the term.[138]

None of this should be taken to suggest that the relationship between Goldman and investors was anything other than arm's length. Goldman was not acting on behalf of investors, gave no advice to them, and exercised no discretion over their decisions to buy. Both Goldman and the investor in each sale were pursuing their self-interest and were in an adverse relationship to one another. The bank was acting as a gatekeeper, a role that may justify the imposition of rules mandating the bank's independence.

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[136] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 121 (Goldman Sachs, ABACUS 2007-AC1, LTD, Offering Circular, dated Apr. 26, 2007 (excerpt)). As is customary in offerings of this type, the name "Goldman, Sachs & Co." is printed in bold type in font that is larger than for any other words on the cover page (apart from the issuer, Abacus 2007-AC1, Ltd).

[137] This approach—undertaking a retrospective analysis—is advocated by Professors Davidoff, Morrison and Willhelm. *See* Davidoff et al., *supra* note 4, at 542 ("To determine perfectly whether the ABACUS deal involved an element of trust-based trade, we would need to observe the beliefs of the parties to the deal.").

[138] *See supra* text accompanying notes 126–29.

2. Goldman Sachs as Conflicted Gatekeeper

Determining whether Goldman faced a conflict of interest in the ABACUS transactions is relevant to the incentives it faced as a gatekeeper and to how the Volcker Rule provisions would have applied. The bank's interests must be analyzed throughout these transactions.[139] This analysis is complicated by the staggered timing of events and the ease and speed with which a financial institution may transform a long position into a short one, or vice versa, instantly reversing the determination of whether a conflict of interest exists. Although a letter agreement between Paulson and Goldman contemplated the simultaneous execution of the various transactions described above,[140] it is clear that this did not occur. The notes sold to IKB were issued on or about April 26, 2007,[141] and the CDS between Goldman and the SPV must have been entered into at this time. The CDS with ABN Amro was not entered into until weeks later, in late May of 2007.[142] By that time, according to internal Goldman correspondence, Goldman still had not entered into the CDS with Paulson, and its bankers expressed concern that Paulson was getting "cold feet" and feared they would "loose [sic] their order."[143] Eventually, Goldman did enter into the CDSs with ABN Amro and with Paulson. However, despite the intention of Goldman bankers to completely neutralize the bank's exposure under the Paulson CDS,[144]

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[139] IKB interests will be assumed to be those arising only from its ownership of ABACUS 2007-AC1 notes. Nothing in the SEC's Complaint appears to suggest that IKB's interests were otherwise.

[140] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 117 (Draft Goldman Sachs Letter Agreement to Paulson Credit Opportunities Master Ltd., Feb. 3, 2007).

[141] *See* SEC Complaint, *supra* note 6, at 11, 17 (referring to the ABACUS 2007-AC1 transaction closing "on or about April 26, 2007").

[142] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 124 (Goldman Sachs internal e-mail, dated May 2007) (indicating that the CDS with ABN Amro was entered into on May 31, 2007). *See also* SEC Complaint, *supra* note 6, at 18 (referring to ABN Amro entering into the CDS "[o]n or about May 31, 2007").

[143] Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 125 (Goldman Sachs internal e-mail, dated May 2007, re: Paulson update) ("Paulson is starting to get "cold feet" on this supersenior trade, and I think we might loose [sic] their order if we wait too long. Would like to take down their supersenior risk tomorrow in order to avoid loosing [sic] their order.").

[144] Goldman's internal memorandum to its Mortgage Capital Committee states the firm's intention to neutralize its exposure to Paulson. It expresses its intention to obtain CDS protection from the SPV covering cumulative losses

Goldman retained some exposure because the bank's position under the CDSs with ABN Amro and the SPV failed to completely offset its exposure under the CDS with Paulson.

Viewing Goldman Sachs' interests from an ex ante perspective, and imputing to Goldman the current intention or anticipation of entering into the CDS with Paulson and neutralizing its exposure under that CDS, Goldman finds itself with interests in conflict with those of IKB. Even with an intention fully to neutralize it exposure under the various CDSs, Goldman's interests favored selling the notes to IKB to earn an expected $15 to $20 million from its arrangement with Paulson.[145] In addition, the Senate Permanent Subcommittee on Investigations identified another possible conflict arising from the Goldman Sachs' remuneration structure in its April 2011 report entitled "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse."[146]

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from 10% to 45% of the notional amount of the reference portfolio, and to obtain CDS protection from another counterparty for the remaining risk layer, from 45% to 100%. Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 118 at 2 (Goldman Sachs Internal Memorandum to Mortgage Capital Committee, Mar. 12, 2007) ("The Issuer will enter into a CDS with Goldman to write protection on the mezzanine layers of risk of the Reference Portfolio. Under the CDS, the Issuer will write protection to Goldman covering cumulative losses from 10.00% and 45.00% of the notional amount of the Reference Portfolio . . . . We intend to separately purchase credit default swap protection from one or more suitable counterparties approved by Credit on the super senior 45% to 100% risk layer. The Desk has been in discussions . . . to transact on this supersenior tranche . . . .").

Other statements in Goldman's internal memorandum also suggest an intention by Goldman's bankers to neutralize the bank's exposure to Paulson. *See id.* ("Goldman is not taking any warehouse risk in this transaction . . . . Goldman is solely working as agent and but [sic] retains the option to underwrite the risk as principal . . . . [T]he [CDO] tranches that are distributed will be immediately be crossed to Paulson, resulting in no retained unobservable tranches on the closing date.").

In the event, Goldman remained exposed on the 45-50 tranche, and internal correspondence suggests that, in view of this risk, Goldman contemplated "trading" that tranche. *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 123 (Goldman Sachs internal e-mail, dated May 2007) (referring to "Option 2: we offer them protection on 45-100 @ 80bps running, 1.50 pt upfront, $1.1bn notional. We would be at risk on $100mm of the 45-50 tranche, but assuming we can trade that tranche at approx 100 bps spread (which I am confident we can do), we would make $18mm."). *See also* Exhibit 125 (Goldman Sachs internal e-mail, dated May 2007, re: Paulson update) ("This would leave us net/net with $91mm of 45-50 tranche risk that we would work on over the next few weeks—we are showing this tranche to a few accounts . . . ."); Exhibit 126 (Goldman Sachs internal e-mail, dated June 5, 2007) (outlining offer to distribute the 45-100 tranche).

[145] Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 118 at 5–6 (Goldman Sachs Internal Memorandum to Mortgage Capital Committee, Mar. 12, 2007) ("Goldman's profits come directly from . . . a pre-negotiated premium that will be payable by Paulson . . . . [T]his transaction is expected to generate, after fees and expenses, between $15 and $20 million in P&L.").

[146] Senate Report on Wall Street and the Financial Crisis, *supra* note 117, at 397.

The report explains that Goldman would receive additional fees from Paulson for structuring the ABACUS CDO in a particular way that was favorable to Paulson, but contrary to the interests of CDO investors such as IKB.[147] These conflicts of interest are analogous to the conflict of interest targeted by the FINRA rules mentioned above[148]—that of the underwriter of an initial public offering that gains not simply from the underwriting commission, but also from the repayment of a loan by the issuer out of the proceeds of the offering. The underwriter's extraneous interests are separate from its interests as seller of securities as underwriter to investors. These extraneous interests are adverse to those of investors and diminish Goldman Sachs' incentives to exercise precautions as a gatekeeper to ensure the accuracy of the disclosures made to investors. Put simply, from an ex ante perspective Goldman faced extraneous interests that compromised the independence of its gatekeeping role.

Taking an ex post perspective, and considering only the bank's actual—rather than its intended or anticipated—position, presents a somewhat different picture. From this perspective, some scholars argue that Goldman did not face a conflict of interest with IKB or other investors because, as events transpired, Goldman did not neutralize its exposure under the transaction with Paulson[149] and actually lost money on the ABACUS deal when the reference portfolio was

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[147] *Id.* ("Goldman had entered into a side arrangement with the hedge fund in which it would receive additional fees from Paulson for arranging CDS contracts tied to the Abacus CDO that included low premium payments falling within a specified range. While those lower premium payments would benefit Paulson by lowering its costs, and benefit Goldman by providing it with additional fees, they would also reduce the amount of cash being paid into the CDO, disadvantaging the very investors to whom Goldman was marketing the Abacus securities.") (footnotes omitted).

[148] *See supra* text accompanying notes 85–90.

[149] Goldman Sachs did not entirely offset its exposure to Paulson since it "purchased protection from ACA [through ABN Amro] on a portion (50-100%) of the super senior tranche, but wrote protection to Paulson on the entire (45-100%) super senior tranche," thus leaving it bearing "the risk that poor performance of the Reference Portfolio would affect the 45-50% portion." *See* Goldman Sachs Submission, *supra* note 101, at 14–15. *See also supra* note 144.

adversely affected.[150] However, if Goldman's interests were in fact aligned with investors, as some scholars argue, this only occurred several weeks after securities were issued to IKB—when the bank entered the CDSs with Paulson and ABN Amro. Until that time, Goldman Sachs was a counterparty with the SPV and thus had interests adverse to those of IKB under the CDS. From an ex post perspective, Goldman faced a conflict of interest if it had (as alleged) undisclosed positions from which it benefited when the reference portfolio was adversely affected. Whether it did have such undisclosed positions remains contested.[151]

The ex post perspective seems artificial considering the objective of determining whether the bank faced financial interests that might skew its incentives to perform its gatekeeping role of ensuring the accuracy of the disclosures. It is apparent from internal e-mails that Goldman

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[150] *See*, *e.g.*, Bill Snyder, *Stanford Professors Assess Landmark SEC-Goldman Suit and Underscore Need for Better Regulation of Financial Sector*, STAN. BUS. MAG. ONLINE, 1 (Apr. 1, 2010), http://www.gsb.stanford.edu/news/headlines/duffie-SEC.html ("[Stanford Professor] Darrell Duffie, . . . , explained the intricacies of a deal known as Abacus 2007 AC-1, . . . , and concluded that Goldman's economic incentives for the performance of the deal were the same as those of the Abacus investors. Like those investors, Goldman ended up losing money, ..."); Joseph A. Grundfest, *SEC v. Goldman: Analyzing the SEC's Complaint, Stanford University Rock Center for Corporate Governance*, at 12 (Apr. 27, 2010), *available at* http://rockcenter.stanford.edu/2010/05/06/sec-v-goldman-analyzing-the-secs-complaint-materials-now-available/ (arguing that "Goldman held a long position in Abacus"; that representing the truth to investors "would here have disclosed that Goldman was long . . . "; and that "even if there was a misrepresentation or omission, disclosure of the full truth would have caused even greater interest among the longs [because of Goldman's long position and its "prestige"], thereby further negating any suggestion of materiality, negligence, or scienter"; and that "[t]he SEC can't have it both ways. It can't argue that Paulson's short had to be disclosed but that Goldman's long in the same transaction was irrelevant").

See also Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 129 (Goldman Sachs Press Release: Goldman Sachs Makes Further Comments on SEC Complaint) ("Goldman Sachs, itself, lost more than $90 million. Our fee was $15 million. We were subject to losses . . ."; and "Goldman Sachs retained a significant residual long risk position in the transaction . . . Goldman Sachs's substantial long position in the transaction lost money for the firm.").

[151] *See* Senate Report on Wall Street and the Financial Crisis, *supra* note 117, at 445–66 (alleging that Goldman faced conflict with the interests of its client by betting against the housing market). *Compare* Andrew Ross Sorkin, *The Fine Print of Goldman's Subprime Bet*, N.Y. TIMES DEALBOOK (June 6, 2011), http://dealbook.nytimes.com/2011/06/06/the-fine-print-of-goldmans-subprime-bet/ (contesting claims in the Senate report that Goldman bet against its clients' interests), *with* Matt Taibbi, *The Times' Andrew Ross Sorkin Gives Goldman a Rubdown*, ROLLING STONE BLOG (June 7, 2012), http://www.rollingstone.com/politics/blogs/taibblog/andrew-ross-sorkin-gives-goldman-a-rubdown-20110607.

bankers intended to neutralize the bank's interests and profit from Paulson's fees.[152] It is questionable whether the bank's exposure to the reference portfolio due to events occurring several weeks after the sale of securities would have altered the incentives operating within the bank. In view of this analysis, the focus of regulators concerned to detect material conflicts of interest in breach of the Volcker Rule provisions should be not exclusively on a bank's actual or ex post financial interests, but also on its reasonably anticipated financial interests, since those financial interests appear in fact to shape underwriters' conduct.

In the final analysis, Goldman's incentives to sell the securities to IKB seem to have been motivated by its interests in doing the deal with Paulson, giving it incentives that more than offset those created by the threat of liability and compromised its gatekeeping role—incentives that, according to its admissions of disclosure error in settling the matter,[153] it acted upon. Its role as gatekeeper in the transaction was thus compromised. Extraneous financial interests shaped how it performed its gatekeeping role, according to this author's reading of the internal correspondence among bankers.[154]

C. Applying the Volcker Rule Provisions

Turning now to the Volcker Rule provisions, what would the likely outcome have been if they had been in force at the time the ABACUS transactions occurred?[155] Applying the provisions carries significance in light of the claim in the recent report of the Senate Permanent Subcommittee on Investigations that the Volcker Rule provisions would have prevented

[152] *See, e.g., supra* note 144.

[153] *See* Goldman Sachs Submission, *supra* note 101, at 2.

[154] *See, e.g., supra* note 144.

[155] Although Goldman Sachs was not a "banking entity" at the time of the relevant conduct, it subsequently converted to a bank holding company and is thus now subject to the Volcker Rule. Section 27B is not similarly constrained in its application to banking entities, but applies to any actor functioning in any of the capacities identified in the provision.

Goldman's misconduct in the ABACUS transactions had the provisions been in force at the time.[156] Applying the provisions also presents an opportunity to identify and discuss interpretive questions associated with the imposition of conflict of interest rules on underwriters.

1. Would the Provisions Have Applied?

The SEC's allegations took aim at Goldman's dealings with both IKB, an investor in the ABACUS CDO, and ABN Amro, a CDS counterparty with Goldman. In underwriting securities as part of the CDO,[157] Goldman engaged in an activity that is within the Volcker Rule's prohibition on proprietary trading and an activity identified in the Volcker Rule as a permitted activity—underwriting.[158] Accordingly, the conflicts of interest proviso in the Volcker Rule would have applied to Goldman, banning the bank from performing its underwriting role if that activity would involve or result in a material conflict of interest between Goldman (including its affiliates) and its "clients, customers or counterparties."[159] Given the arm's length nature of Goldman's dealings with IKB, IKB would at least fall within the conception of "counterparties."

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[156] *See* Senate Report on Wall Street and the Financial Crisis, *supra* note 117, at 624. The report assessed the ABACUS 2007-AC1 deal, but only "in the context of the law prevailing in 2007." The report recommended that "[r]egulators implementing the conflict of interest prohibitions in [the Volcker Rule provisions] should consider the types of conflicts of interest in the [report's] Goldman Sachs case study," *Id*. at 638–39. The report asserts—without supporting analysis—that "[the Volcker Rule provisions], if well implemented, will protect market participants from the self-dealing that contributed to the financial crisis." *Id*. at 638.

[157] In its Submission to the SEC, Goldman's counsel refers to Goldman as an underwriter of the notes to IKB. *See* Goldman Sachs Submission, *supra* note 101, at 2 ("In early 2007, Goldman Sachs acted as the underwriter or privately-placed notes issued in a synthetic CDO transaction known as ABACUS 2007-AC1 . . . ."). The offering circular for the ABACUS 2007-AC1 offering refers to Goldman as initial purchaser (a function that is synonymous with an underwriter). *See* Exhibit 121 (Goldman Sachs, ABACUS 2007-AC1, LTD, Offering Circular, dated Apr. 26, 2007 (excerpt)).

[158] The transaction would have offended the general prohibition because, in underwriting the issue of securities by the SPV, Goldman did so "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)," as required by 619 (codified at 12 U.S.C. §1851(h)(6) (defining "trading account," a term used in the definition of proprietary trading in 12 U.S.C. §1851(h)(4)).

[159] Dodd-Frank Act § 619, 12 U.S.C. § 1851(d) (2010).

Consider next the application of Section 27B of the Securities Act to Goldman's alleged conduct. As outlined in Part II, this companion provision to the Volcker Rule prohibits an underwriter, placement agent, initial purchaser, and sponsor (or affiliate or subsidiary of any such actor) of an ABS from engaging within a prescribed period in any transaction "that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity."[160] The period during which the conflict of interest prohibition in Section 27B operates is one year from "the date of the first closing of the sale of the [ABS]."[161] The provision regulates material conflicts with "any investor in a transaction arising out of such activity."[162] The reference to "such activity" is an apparent reference to the activities of acting as underwriter, placement agent, initial purchaser, or sponsor of an ABS; presumably, therefore, "any investor" refers to the purchaser of an ABS in a transaction "arising out of" these activities. Section 27B would apply to Goldman's dealings with IKB, since Goldman was then acting as an underwriter of ABSs.[163]

Neither the Volcker Rule nor Section 27B would apply to Goldman's dealings with ABN Amro. To begin, the CDS between Goldman and ABN Amro would not seem to offend the Volcker Rule's general prohibition—a point foreclosing further analysis. As for proprietary

[160] *See* Dodd-Frank Act, § 621, 15 U.S.C. § 77z-2a (2010).

[161] *Id*.

[162] *Id*.

[163] For completeness, it is worth noting that the exceptions under Section 27B would have offered no relief to Goldman. Most relevant is the exception concerning "risk-mitigating hedging activities." Dodd-Frank Act, § 621, 15 U.S.C. § 77z–2a(c). The two other exceptions, which concern first, "commitments of the underwriter, placement agent, initial purchaser, or sponsor [or any affiliate or subsidiary thereof] . . . to provide liquidity for the asset-backed security and second, bona fide market-making in the asset-backed security, . . . " would clearly not have assisted Goldman. The hedging exception is tightly drawn to capture only hedging activities "in connection with positions or holdings arising out of the underwriting . . . of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, . . . associated with positions or holdings arising out of such underwriting . . . ." *Id*. Such "specific risks" could plausibly arise from securities not sold to investors but retained by the underwriter, but not from the underwriter performing the distinct role of acting as counterparty on a CDS.

trading, even if one regarded a CDS as a financial instrument (a term awaiting regulatory guidance),[164] Goldman's position in the CDS would not amount to proprietary trading unless, in taking that position, it did so "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)."[165] No evidence seems to suggest such an intention on the bank's part. As for Section 27B, Goldman was not acting in any of the capacities—including underwriter—listed in the provision.

In sum, the conflict of interest rules in the Volcker Rule provisions would have applied to the bank's underwriting activities and thus to its sale of securities to IKB, but would not have applied to Goldman's dealings with ABN Amro.

2. How Would the Provisions Have Been Applied?

The Volcker Rule provisions ban material conflicts of interest. The Volcker Rule's proviso operates, according to its terms, to ban any activity, transaction or class of transactions if it would involve or result in a material conflict of interest between the bank and its clients, customers, or counterparties.[166] Section 27B operates to ban an underwriter engaging in any transaction during a twelve-month period "after the first closing of the sale of the security that would involve or result in any material conflict of interest."[167]

Based on the analysis in Section B of Part IV, it is apparent that Goldman Sachs faced conflicts of interest arising from its dealings with Paulson. This conclusion is hard to escape,

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[164] *See* Dodd-Frank Act § 619, 12 U.S.C. § 1851(h)(4)(2010) (defining proprietary trading as "any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may . . . determine.").

[165] *See id.*, § 1851(h)(6) (defining "trading account," a term used in the definition of proprietary trading in 12 U.S.C. § 1851(h)(4)).

[166] Dodd-Frank Act § 619, 12 U.S.C. § 1851(d) (2010).

[167] Dodd-Frank Act, § 621, 15 U.S.C. § 77z-2a (2010).

particularly having regard to Goldman's intention to earn fees from Paulson for structuring the deal and otherwise neutralize its exposure to Paulson. Although what amounts to a "material" conflict of interest awaits regulatory guidance, these extraneous interests were likely material to the individual bankers acting on Goldman's behalf in the ABACUS deal.

The staggered timing of the transactions in the ABACUS deal gives rise to an interpretive conundrum concerning the Volcker Rule provisions. Section 27B only tackles conflicts of interest occurring after the "first closing of the sale of the security." This expression contemplates a primary securities transaction, in which an issuer offers and sells it own securities to investors and would be a reference to the ABACUS deal closing on or about April 26, 2007. On its terms, Section 27B bans transactions during a prescribed period, but does not purport to ban the primary offering itself. In contrast, the Volcker Rule purports to ban an offering if it would result in a material conflict of interest. How do these provisions treat conflicts occurring simultaneously with or prior to the first closing of the transaction? Section 27B bans transactions *after* the first closing, suggesting that the banned transactions are independent of the transaction closed. While this interpretation might seem unintended, it is also difficult to avoid. The Volcker Rule's ban on conflicts of interest is not similarly restrictive and would appear to plug any gaps in regulation created by such a literal interpretation of Section 27B.

D. Interpretive Questions

This section provides preliminary comments on some other important interpretive issues facing regulators in implementing the Volcker Rule provisions. One issue concerns how to determine a banking entity's interests for purposes of the provisions. This question precedes the determination of whether a conflict exists between the bank's interests and a counterparty's interests. The starting point of analysis requires determining the interests of the financial conglomerate (including its multiple affiliated entities, both in the US and abroad), of which the underwriter is part. In proceeding from this point, several factors should be considered. First, as sophisticated actors in financial markets, banks may employ trading strategies and myriad derivative and other financial instruments to shift their financial positions, potentially transforming a short position into a long one, or vice versa, and thus reversing any determination that a conflict of interest exists with the interests of another person. In such an environment, it may well be that a snapshot of a bank's immediate financial position is not a reliable indication of an underwriter's incentives with respect to investors. Expanding the conception of conflict of interest to capture both actual and "reasonably anticipated" conflicts of interest would offer stronger protections to investors from conflicted underwriters. It would focus regulatory attention on the incentives in fact shaping the conduct of underwriters, incentives that may sway their independence. The ABACUS case study illustrates how a party's anticipated interests—in that case arising from the bank's intention to earn fees from the Paulson transaction and otherwise neutralize is exposure to Paulson—led the bank to compromise its gatekeeping function even though its actual interests ultimately never matched the incentives apparently shaping its conduct.

Another factor concerns the application of information barriers, otherwise known as Chinese walls, which are measures employed within organizations to prevent flows of non-public information from individuals in one part of an organization to those in another part of the same organization.[168] As registered broker-dealers, underwriters are required to establish, maintain and

[168] *See* Norman S. Poser, *Chinese Wall or Emperor's New Clothes: Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 MICH. YBI LEGAL STUD. 91, 92–93 (1988). The Volcker Rule Implementing Regulations (Proposed) provide that information barriers may sanitize a "material conflict of interest" unless "in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the covered banking entity's establishment of information barriers, the

enforce barriers that are reasonably designed to prevent the misuse of material non-public information by bank employees and associated persons.[169] The question here is whether, in applying the Volcker Rule provisions, information barriers should be relevant for determining a bank's interests—and thus whether a conflict exists between its interests and those of a counterparty. The issue of the effectiveness of information barriers must inevitably be faced, considering the ubiquity with which these measures are employed in the financial services industry.[170]

Relying on the use of information barriers, one plausible line of argument would deny the existence of a conflict of interest under the Volcker Rule provisions even where the banking entity, taken as a single economic unit, has financial interests (or reasonably anticipated financial interests) conflicting with those of investors in a transaction being underwritten by the bank. This argument would hinge on information barriers preventing individuals involved in underwriting the relevant transaction from becoming aware of the firm's conflicting interests, a plausible scenario where those conflicting interests arise from activities conducted by a separate, "walled-off" unit of the banking entity. No conflict of interests would arise under the Volcker Rule provisions, according to this argument, because the independence (and the gatekeeping role) of those individual bankers dealing with investors is not compromised.

If information barriers are indeed effective to prevent information flows, the gatekeeping role performed by a banking entity would not be compromised; those individuals associated with

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conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty." Volcker Rule Implementing Regulations (Proposed), *supra* note 9, at §§ _.8(b)(2), _.17(b)(2).

[169] Securities Exchange Act of 1934, § 15(g) requires "[e]very registered broker or dealer . . . [to] establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information . . . ."). Banks also face regulation of insider trading by federal banking regulators. *See*, *e.g.*, 12 C.F.R. § 12.1 (Office of Comptroller of the Currency).

[170] *See* Poser, *supra* note 168, at 92.

ensuring the accuracy of the disclosure of the corporate issuer (namely, those responsible for structuring and marketing a product such as a CDO) would face no countervailing incentives created by the financial interests of other units of the bank. On this basis, the incentives created by the bank (through a separate, "walled-off" unit) entering into a transaction to, say, bet against the success of the proposed offering would not violate the Volcker Rule provisions' conflict of interest rules. Instead, determining compliance with the Volcker Rule provisions would require an inquiry into the incentives facing the individuals involved in the bank's underwriting unit.

The use of information barriers risks undermining the intended operation of the conflict of interest rules in the Volcker Rule provisions. To begin, information barriers have typically been effective as a defense against liability for insider trading, by preventing non-public information in possession of one individual from being attributed to another or to the firm generally, whereas they have not been effective as a defense in claims of breach of fiduciary duty.[171] This approach may be in recognition of the difficulty courts and regulators have in determining whether a conflict of interest was exploited and thus whether the appearance of a conflict of interest is manifested in reality. The conflict of interest rules in the Volcker Rule provisions show more concern for conflicts of interest than they do for the misuse of non-public information (although the latter may indeed produce conflict of interest concerns). It is also relevant that the FINRA rules referred to above make no concession for information barriers, a relevant consideration bearing in mind that the FINRA rules also promote the gatekeeping role of banks.[172]

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[171] *See id.* at 93, 144; RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b illus. 9 (2006) (discussing the effectiveness of information barriers on attribution of information within organizations).

[172] *See* FINRA Rule 5121(2)(A) (requiring that "[a] qualified independent underwriter has participated in the preparation of the registration statement and the prospectus, offering circular, or similar document and has exercised the usual standards of 'due diligence' in respect thereto . . . .").

The strongest argument against allowing banks to rely on information barriers to satisfy the Volcker Rule provisions' conflict of interest rules is that information barriers often prove ineffective. Numerous instances of their failure have been reported. For example, in 2011 the SEC fined Merrill Lynch for the conduct of bankers on its trading desk, who—in violation of the firm's information barriers—conveyed information about customers' orders to the firm's proprietary traders.[173] The research analyst scandals in the past decade involving bank research analysts issuing skewed research reports to win investment banking business led to the censure of banks for failing to respect information barriers.[174] Systematic empirical evidence raises similar concerns about the robustness of information barriers.[175] If banks are permitted by the use of information barriers to engage in conduct that would otherwise breach the conflict of interest rules in the Volcker Rule provisions, then greater regulatory attention would need to be paid to improving information barriers' effectiveness.

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[173] *See* Merrill Lynch, Pierce, Fenner & Smith Inc., Exchange Act Release No. 63760 2011 WL 231575, at *3 (Mar. 25, 2011) (instituting administrative and cease-and-desist proceedings, making findings, and imposing remedial sanctions). The firm's conduct occurred at the bank between 2003 and 2005. The firm was found to have violated Section 15(g) of the Securities Exchange Act of 1934, which requires firms to establish, maintain, and enforce information barriers.

[174] As part of a "global settlement" between federal regulators and ten of the nation's largest banks, the banks agreed to "create and enforce firewalls restricting interaction between investment banking and research except in specifically designated circumstances." *See* Press Release, Securities and Exchange Commission, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm.

[175] *See generally* Andriy Bodnaruk, Massimo Massa & Andrei Simonov, *Investment Banks as Insiders and the Market for Corporate Control*, 22 REV. FIN. STUD. 4989 (2009) (finding that large financial institutions make abnormal returns in trading in the stock of companies involved in merger and acquisition deals on which the banks themselves have performed an advisory role, suggesting that banks make use in trading of non-public information gained in their advisory roles); Narasimhan Jegadeesh & Yue Tang, *Institutional Trades Around Takeover Announcements: Skills vs. Inside Information* 1 (Dec. 2010) (Emory University Working Paper), *available at* http://ssrn.com/abstract=1568859 or http://dx.doi.org/10.2139/ssrn.1568859 (finding that large financial institutions misuse non-public information garnered from their M&A clients for the benefit of some of their brokerage clients); Massimo Massa & Zahid Rehman, *Information Flows within Financial Conglomerates: Evidence from the Banks-Mutual Funds Relationship*, 89 J. FIN. ECON. 288 (2008) (finding evidence that mutual funds affiliated with financial conglomerates invest more in the stock of companies to which their firm lends money (and thus possesses non-public information) than unaffiliated funds and that their performance is superior to their performance investing in the stock of other companies (about which they do not have non-public information) in the same industry at the same time; and concluding that financial conglomerates "exploit privileged inside information not available to other market participants").

Another, related issue concerns whether disclosure by a bank of its conflicts of interest might be sufficient to satisfy the Volcker Rule provisions' conflict of interest rules. This question goes to whether the provisions impose outright bans on conflicts of interest—as the terms of the provisions suggest. The Volcker Rule provides, in relevant part, that "[n]o transaction, class of transactions, or activity may be deemed a permitted activity . . . if [it] . . . would involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties."[176] In similarly categorical terms, Section 27B provides that an underwriter, or person performing a related function, "shall not [for a prescribed period] . . . engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction."[177] The provisions thus purport to prohibit outright certain activities resulting in a material conflict of interest, rather than taking the more lenient approach favored in some jurisdictions of requiring conflicts of interest to be "managed"[178] or of requiring simply the disclosure of conflicts of interest and thus transforming conflict of interest rules into open-ended disclosure requirements.[179]

Sound reasons may exist for permitting the disclosure of conflicts of interest to satisfy the conflict of interest rules in the Volcker Rule provisions. For instance, permitting the underwriting bank to perform multiple functions in a deal (rather than banning it from doing so) may result in benefits that would be lost if multiple distinct banks performed those functions instead. As argued above, banks should bear the burden of establishing those types of deals in

[176] *See* Dodd-Frank Act § 619, 12 U.S.C. § 1851(d)(2)(A)(i)–(iv) (2010).

[177] Dodd-Frank Act, § 621, 15 U.S.C. § 77z-2a (2010).

[178] *See, e.g.*, *Corporations Act 2001* (Cth) § 912A(1)(aa) (Austl.) (requiring holders of financial services licenses to "have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee . . . .").

[179] *See* Campbell et al., *supra* note 45, at 225 (describing fiduciary duties that can be satisfied through disclosure as potentially becoming "little more than an open-ended disclosure requirement where the disclosing party bears the burden of establishing that the counterparty knowingly assents to the disclosed terms").

which the full disclosure of conflicts of interest is likely to allay concerns about conflicts of interest.[180] These transactions are likely to be those in which the information asymmetry between the issuer and investors is diminished, resulting in a diminished role for the underwriter to verify the accuracy of the issuer's disclosures. Where banks meet the burden, regulators could respond through no-action, interpretive, and rulemaking processes to permit transactions that would otherwise infringe the Volcker Rule provisions' ban on conflicts of interest.

In considering the merits of disclosure of conflicts of interest as a remedial measure under the Volcker Rule provisions, it is worth observing that Goldman clearly disclosed the *possibility* that it faced conflicts of interest in the ABACUS deal. In the offering memorandum for investors, it warned that it "may hold long or short positions" with respect to the reference portfolio and "may enter into credit derivative or other derivative transactions with other parties pursuant to which it sells or buys credit protection with respect to [the reference portfolio]."[181]

Generalized disclosure rules of the type employed in ABACUS seem ineffective since they provide no firm basis for the counterparty to determine whether and how any conflict of interest may adversely affect its interests. Instead, where it is permitted to satisfy the Volcker Rule provisions' conflict of interest rules, disclosure should provide more than a discussion of hypothetical conflicts of interest; at a minimum, disclosure should refer to the underwriters' actual and reasonably anticipated conflicts of interest. Moreover, if disclosure by banks is to satisfy the conflict of interest rules in the Volcker Rule provisions, then it should not substitute for the existence of robust information barriers. Banks should be required to disclose material conflicts of interest the firm as a whole faces, even if information barriers are in place. Then

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[180] *See supra* text accompanying notes 92–94.

[181] *See* Exhibits of *Senate Hearing on Investment Banks*, *supra* note 95, Exhibit 121 at 33 (Goldman Sachs, ABACUS 2007-AC1, LTD, Offering Circular, Apr. 26, 2007 (excerpt)).

counterparties would be informed as to the conflicts of interest (actual and reasonably anticipated) afflicting the bank—conflicts that may be exploited in the event that information barriers prove ineffective.

V. Conclusion

This article considered the regulation of conflicts of interest and advanced a justification for imposing conflict of interest rules on underwriters in their arm's length transactions with investors. As gatekeepers, underwriters perform an information cost-economizing role, and conflict of interest rules supplement, or may serve as an alternative to, gatekeeper liability. Conflict of interest rules may thus promote the gatekeeping role underwriters perform in securities offerings. This article argued that conflict of interest rules imposed by the Volcker Rule provisions may be justified on this basis. On this view, the conflict of interest rules in the Volcker Rule provisions should be interpreted to mandate underwriter independence by limiting the effect of extraneous influences on underwriters as they verify the accuracy of issuers' disclosures.

The article also considered the propriety of Goldman Sachs' conduct in the highly publicized ABACUS 2007-AC1 transactions that became the subject of SEC enforcement action and provided impetus in Congress adopting the Volcker Rule provisions. Recognizing the conceptual foundation for imposing conflict of interest rules in arm's length transactions as well as Goldman's role as gatekeeper in the transactions informs an assessment of the propriety of Goldman's conduct. The article concludes that Goldman did act as a gatekeeper in the transactions and that its interests in securing a deal with Paulson compromised its gatekeeping function. Those conflicts of interests were manifested in the bank—as underwriter—failing to take adequate precautions in ensuring the accuracy and completeness of disclosure made to investors regarding the securities they were buying.

The article also applied the Volcker Rule provisions to the ABACUS transactions. Although the Volcker Rule provisions likely would have prevented the bank's misconduct (had the provisions been complied with), the article recommends that the conflict of interest rules in the Volcker Rule provisions be interpreted to capture "actual and reasonably anticipated" conflicts of interest to account for the most likely incentives shaping banks' conduct.

As gatekeepers, underwriters perform a vital role in financial markets. The Dodd-Frank Act expands the regulatory arsenal available for regulating the independence of underwriters. In addition to facing liability for the disclosure errors of their clients, underwriters now contend with conflict of interest rules that restrict the extent to which they may pursue their self-interest. Conflict of interest rules find sound justification in this context, despite the arm's length nature of underwriters' relationships with investors. Both the merits of the conflict of interest rules in the Volcker Rule provisions and the propriety of Goldman Sachs' conduct in ABACUS 2007-AC1 should be assessed in this light.

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