ABSTRACT

The Global Financial Crisis (GFC) threatened to bring world financial markets to a halt. It is now coming to light that in the run-up to, and at the height of, the GFC, investment banks and other participants in the financial markets acted unethically as well as imprudently. This paper takes a closer look at this unethical behaviour and the way in which it constitutes a failure of trust. The paper defines trust and outlines why it is important in the regulation of financial markets and corporate law. It then looks at three examples of breakdowns or failures of trust in the run-up to the financial crisis. The paper concludes by arguing that trust is important in commercial relationships at both the intra-firm level (the relations between the different constituents of the firm) and the inter-firm level (the relations between the firm and other firms). An appreciation of the importance of trust in the corporate relationships calls for a review of narrow contractarian theories of corporate law.
BUILDING TRUST IN THE CORPORATE WORLD –Whither Corporate Law after the Global Financial Crisis

A. INTRODUCTION

This paper is concerned with the prevention and control of abuse and self-dealing in the financial sector. Our aim here is to examine the role that trust plays in financial markets, and in so doing, to consider some crucial background factors that could lay the foundation for effective counter-measures against abuse and self-dealing in the financial sector. There is already much academic literature on the role of trust in product markets, labour markets and intra-firm relations. This paper reviews this literature and aims to provide similar analysis and insight with relation to financial markets. It also looks at the role that trust (or lack of it) played in the global financial crisis that began in late 2007.

One of the most important elements of financial markets, which help to make those markets possible, is the existence of trust between those who operate in such markets. It has been argued by business leaders that trying to write good contracts with bad people simply does not work. The importance of trustworthiness applies especially to the major financial organisations and professionals that constitute the market. This includes the internal cultures of these organisations as well as the wider social context in which these organisations operate. To this extent, we will look at the role played by trust in intra-firm relationships (relationships between different members or stakeholders in a corporation) and inter-firm relationships (the relationships between a corporation and outsiders who transact with it).

In order to carry out a meaningful analysis of trust in the financial markets it is important to first try to understand what trust means. It has been defined as “a reasonable belief that trusted persons will tell the truth, and keep their promises”. It has also been defined as “the expectation that arises

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within a community of regular, honest and cooperative behaviour, based on commonly shared norms, on the part of other members of that community.” 6 One definition of trust that is particularly relevant to the discussion of trust in financial markets is as “faith or confidence in the loyalty, strength, veracity...of a person or thing...without examination”. 7 This definition is relevant to financial markets because it shows the link between trust and confidence. 8 The two words will not always be inter-changeable, but they are clearly linked, and references to collapses in confidence in financial markets are, to a large extent, akin to breakdowns of trust. A bank run may be seen as a stark illustration of a lack of trust in banks on the part of bank depositors.

B. THE IMPORTANCE OF TRUST IN COMMERCIAL RELATIONSHIPS AND FINANCIAL MARKETS

1. The role of ‘trust’ in commercial relationships

The relevance of trust in commercial relationships has generated a significant amount of debate in economic and corporate law circles. On the one hand, law and economics scholars and conservative contractarians place less emphasis on trust and more emphasis on the ‘rational economic man’ model that is associated with neo-classical economics, while on the other hand, socio-legal scholars place much greater emphasis on the role of trust.

Law and economics scholars generally view individuals as rational utility maximisers, that is, as autonomous individuals who make rational choices that maximise their satisfactions. 9 Economists like Williamson argue that if individuals are rational utility maximisers then they must take a calculative approach in their economic interactions or commercial transactions. 10 For them, trust is only used in personal relations. 11 They further argue that economic interactions are based on risk rather than trust, and that economic actors deal with risk using calculative approaches, such as contracts 12 and credible commitments, 13 to anticipate and allocate risk. It must be said here that rational utility maximising theory (or Rational Choice Theory, as it is popularly known) is not without its critics. 14

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8 For more on the link between trust and confidence see G A Akerlof and R J Shiller, Animal Spirits: How Human Psychology Drives the Economy and Why it Matters for Global Capitalism (Princeton, Princeton University Press, 2010), 12-13
11 Ibid, 469, 486
12 Ibid
13 Ibid
14 R Hardin, “Trustworthiness” (1996) 107 Ethics 26, 41-42
Socio-legal scholarship offers a contrasting view of trust to that of law and economics scholarship. Accounts of trust in terms of personal or social factors portray trust as having social, moral, ethical and cultural values rather than being based on rationality, self-interest or contract. According to them trust plays a significant role in shaping the firm’s inter-firm dealings, that is, its dealings with other firms. It has been argued, for example, that building trust between organisations is important because trust enhances business performance, and trust is an important component in the success of partnerships, strategic alliances and networks of small firms.

It has, however, been argued that this dichotomy is far too strongly drawn—the argument is that both calculative or self-interest accounts of trust, on the one hand, and the social notions of trust, on the other hand, neglect the role of institutional forms, including contract law, in sustaining and reproducing trust. This is because both accounts of trust marginalise explanations based on institutional form. Institutional trust (system trust) refers to the wider institutional and organisational framework within which inter-firm and personal relationships are formed. The benefit of having institutions is that they allow firms to form and extend relationships with greater confidence and effect.

It has also been argued that the building of trust through individual relationships and inter-organisational links cannot be seen in isolation from the institutional framework within which contracts are made and performed. Therefore the influence of the legal system needs to be understood in the context of other institutional factors, especially the activities of industry-level trade associations and standard-setting organisations. This is because these intermediate institutions, along with norms such as the norm of ‘good faith’, play an important role in the process through which the values, ethics or principles of the legal system come to be translated into the notions of business ethics or the more concrete terms of standard form agreements.

18 S Deakin, C Lane and F Wilkinson, “Contract Law, Trust Relations, and Incentives for Cooperation: A Comparative Study”, in Deakin and Michie supra n 15, 106
19 Ibid, 109-111
20 N Luhmann, Trust and Power (Chichester, Wiley, 1979); L Zucker, “Production of Trust: Institutional Sources of Economic Structure, 1840-1920” (1986) 8 Research in Organisational Behaviour S3
21 Deakin et al supra n 18, 134
22 Deakin et al supra n 18, 110-111
23 Deakin et al supra n 18, 105
24 S Deakin and F Wilkinson, “Contract Law and the Economics of Inter-organisational Trust”, in Lane And Bachmann supra n 16, 168
2. The role of ‘trust’ in the relationships within the firm

Some corporate law scholars hold similar views to the law and economics scholars, albeit in a more corporate law related context. Conservative contractarians view corporations as a ‘nexus of contracts’, that is, an aggregate of various inputs acting together to produce goods or services. To them the firm is a legal fiction because it is not really an entity, but is instead a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making the firm, namely, the shareholders, creditors, employees and management. They therefore view corporate law as consisting of default rules rather than mandatory ones. They view corporate rules as a substitute for private bargaining, that is, as contractual terms that have not yet been put into the contract. On this basis, they are unsympathetic to notions such as trust, ethics, morality or fiduciary duties.

Progressive corporate law scholars hold the opposite view to contractarians. They argue that human beings do not behave in the strictly individualistic and self-interested manner that economic models often imply, and that trust is central to relationships within firms. This is because a firm is not just an economic or a political institution, but also a social one as well. They argue that commercial or economic relationships are about more than just the pursuit of self-interest using calculative means-the fact that they are also social relationships means that they require trust in order to flourish, and that this trust gives them deeper human meaning. They even go as far as to argue that when human beings are trusted they become encouraged to behave in a more trustworthy manner.

Progressive corporate law scholars are supported by the literature in psychology and sociology which argues that economic motivation is much more complex and encompasses much broader social habits and mores. Fukuyama, for example, argues that commerce is about more than just

26 Bainbridge ibid, 858-860
31 Mitchell, ibid, 872, 887-900
33 Fukuyama supra n 6, 18
money and profit—economic life is deeply embedded in social life, and it cannot be understood apart from the customs, morals and habits (culture) of the society in which it occurs.\textsuperscript{34}

Having looked at the two sides of the debate regarding trust, we can now move on to examine trust in financial markets. The debate between contractarians and progressives is, in essence, about the difference between an economic environment where contracts prevail (calculativeness) and one where social responsibility, ethics and fiduciary duties prevail (trust). This dichotomy does not just apply to the relationships within a firm, but can also apply to the firm’s relationships with outsiders. It certainly applies to the relationships between trading entities in the financial markets, and raises questions such as whether we should see financial markets merely as contracts-based markets or whether markets have a social character, leading us to impose “other-regarding” duties, such as fiduciary duties on some financial market participants. This is however a debate that is beyond the scope of this paper.

3. The Importance of ‘trust’ in financial markets in particular

It has been argued that trust is important in commercial relationships because it is crucial to the health of the financial system and the economy.\textsuperscript{35} This is, in part, because it helps investors by providing a fairly easy and inexpensive way to help them decide whether or not to buy shares or other securities, and whether or not to enter into commercial relationships.\textsuperscript{36} Lynn Stout has argued that rather than being ‘rational expectations investors’, investors by and large tend to be ‘trusting investors’.\textsuperscript{37} This is because investors would find it far too difficult to be rational expectations investors—it would take up too much of their time and effort to act in this way, and would probably cost them too much money.\textsuperscript{38} This means that, in truth, investors use ‘trust’ as a sort of heuristic. This explains investors’ reliance on gatekeepers such as accountants (auditors), lawyers, credit rating agencies and investment analysts, to endorse what corporations and other securities issuers claim. Stout further argues that in order to maintain a large and thriving public securities market it is important that we pay attention to the needs of the ‘trusting investor’.\textsuperscript{39} It is therefore clear that we must pay attention to ‘trust’ issues if we want investors to continue investing in securities and other financial products and services.

Trust is relevant in both wholesale and retail financial markets. Some banking and finance scholars have highlighted the importance of trust and confidence with regard to decision-making by consumers of financial services, seeking to evaluate financial products as they seek to make sense of complex and uncertain financial product information. Gray and Hamilton, for example, argue that emotions such as trust and confidence are significant influences on decision-making, because consumers find it difficult to evaluate the risks associated with financial services products.\textsuperscript{40} They further argue that such reliance on trust and confidence parallels the shift, in contract theory, towards the recognition of relational contracting, where concepts such as trust and cooperation play

\begin{itemize}
  \item \textsuperscript{34} Fukuyama \textit{supra} n 6, 13
  \item \textsuperscript{35} Frankel \textit{supra} n 5, 87
  \item \textsuperscript{36} T Frankel, \textit{Trust and Honesty: America’s Business Culture at a Crossroad} (Oxford, Oxford University Press, 2006), 50-51
  \item \textsuperscript{37} L Stout, “The Investor Confidence Game” (2002) 68 \textit{Brooklyn Law Review} 407, 416, 422-430
  \item \textsuperscript{38} \textit{Ibid}, 418
  \item \textsuperscript{39} \textit{Ibid}, 431
  \item \textsuperscript{40} J Gray and J Hamilton, \textit{Implementing Financial Regulation: Theory and Practice} (Chichester, John Wiley, 2006), 209-210
\end{itemize}
an important role in characterising the relationship between the parties.\textsuperscript{41} Bank deposits are another area where trust is important- the Bank of England has argued that the relationships between banks and their depositors require a strong element of trust because bank deposits are supposed to be “unsecured, capital-certain” claims.\textsuperscript{42} Campbell and Cartwright argue that “the fragility of the financial system, built as it is on confidence, can mean that there is a real possibility of systemic risk spreading throughout the system”.\textsuperscript{43} Banks can therefore be regarded as special because they are part of a fragile system as evidenced by their susceptibility to bank runs and panics, their functions in regard to the money supply and their particular role in maintaining the payment system.\textsuperscript{44} This is what necessitates satisfactory depositor protection arrangements as part of any effective bank regulation regime.\textsuperscript{45}

C. THE DETRIMENTAL EFFECTS OF BREAKDOWNS OF TRUST IN THE FINANCIAL MARKETS

It is clear that trust plays an important role in relationships within the firm and in the firm’s commercial relationships with other firms and individuals. This section will look at three examples, from within the finance industry, which illustrate how important trust is in finance, and why breakdowns of trust are undesirable in financial markets. The GFC provides a good example of what can happen when there is a complete breakdown of trust in financial markets. The collapse of Lehman Brothers provides a strong example of how self-dealing and abuse can contribute to breakdowns of trust between the members of the firm. It also illustrates how such abuse and self-dealing can lead to breakdowns of trust between the firm and other firms. The recent scandal regarding Goldman Sachs’ role in the ABACUS 2007-AC1 (ABACUS) transaction also illustrates the detrimental effect that abuses of trust can have on a firm’s relationships with other firms in the market.

1. The Global Financial Crisis

Some accounts of the Global Financial Crisis (GFC) describe its origins as an asset price bubble in the US and UK housing markets, caused largely by deregulatory measures, benign macro-economic conditions, the reckless use of financial innovation, excessive liquidity and the easy availability of credit.\textsuperscript{46} Deregulatory measures have been highlighted as the catalyst in the build-up to the GFC.\textsuperscript{47}

\textsuperscript{41} Ibid, 209-210
\textsuperscript{42} T Latter, \textit{Causes and Management of Banking Crises} (Centre for Central Banking Studies, Bank of England, 1997), 3
\textsuperscript{43} A Campbell and P Cartwright, \textit{Banks in Crisis: The Legal Response} (Aldershot, Ashgate Publishing, 2002), 7
\textsuperscript{44} Ibid, 7
\textsuperscript{45} A Campbell, J R Labrosse, D Mayes and D Singh (eds.) \textit{Deposit Insurance} (Basingstoke, Palgrave Macmillan 2007)
Excessive liquidity and misuse of financial innovation led to a significant deterioration of risk controls for the extension of credit, and subsequently to excessive lowering of underwriting standards for sub-prime mortgages.\textsuperscript{48} This, along with market euphoria and irrational exuberance among investors, contributed to the real estate asset price bubble, which in large part triggered the financial crisis when it eventually burst.\textsuperscript{49}

The misuse of financial innovation was reflected in the adoption by banks of the originate-to-distribute business model, whereby banks re-package the loans they had advanced to customers into marketable securities, known as Asset-Backed Securities (ABS), that can be traded on global capital markets.\textsuperscript{50} The main forms of ABS used were Residential Mortgage-Backed Securities (RMBS) and Collateralised Debt Obligations (CDOs). These financial innovations (RMBS and CDOs) became a significant part of commercial and investment banking- they provided a source of finance for new loans as well as an avenue of investment for the banks themselves (who bought CDOS as well as selling them), hedge funds, pension funds and other financial institutions. The ABS were particularly attractive investments for these banks and investors because regulations, such as Basel II, compelled them to invest in only Triple A rated assets.\textsuperscript{51} Unknown to these institutional investors the sheer complexity of these financial innovations, coupled with conflicts of interest affecting the major credit rating agencies, led the credit rating agencies to erroneously grant Triple A ratings to securities (ABS) that were less than worthy of such ratings.\textsuperscript{52}

The asset price bubble that preceded the GFC has been described as “a supply-driven bubble, fuelled by the fact that mortgage loan originators came to realise that underwriters were willing to buy portfolios of mortgage loans for asset-backed securitisations without any serious investigation of the underlying collateral”.\textsuperscript{53} In effect, they ‘trusted’ the mortgage loan originators to only originate decent loans and therefore they did not bother to ‘verify’ the ‘decency’ of those loans. Such ‘trust’ is misplaced when the originators are not the ones who will bear the loss (costs) for not doing the proper screening of those to whom the mortgages have been granted, in effect generating a sort of moral hazard.\textsuperscript{54}

The bursting of the asset price bubble led to huge numbers of defaults of sub-prime mortgages. These sub-prime mortgages were part of the structured credit products that were developed under the originate-to-distribute model (RMBS and CDOs) and therefore the losses associated with the US

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Studies 1, 4; Testimony of SEC Chairman Christopher Cox before the Committee on Banking, Housing and Urban Affairs, US Senate, 23 September 2008
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51 Avgouleas supra n 48, 44-45; F Partnoy, Overdependence on Credit Ratings was a Primary Cause of the Crisis, University of San Diego Research Paper 09-015 (July 2009) at 9-12
53 Coffee supra n 47, 5
54 Coffee supra n 47, 5
sub-prime mortgage defaults spread to the banks, hedge funds and other capital market investors who were the main buyers of RMBS, CDOs and other such ABS.\textsuperscript{55} This wiped out the demand for these structured credit products in the capital markets, since the fear of hidden RMBS and CDO liabilities led to investors becoming wary of purchasing such products.\textsuperscript{56} One of the banks that were particularly badly affected by this was Northern Rock.

(a) Northern Rock

The fall in the demand for ABS and other Asset-Backed Commercial Paper (ABCP) contributed to the collapse of Northern Rock, a bank in the UK that funded its mortgage book largely through the sales of ABCP on the global capital markets. The failure of the interbank markets and the seizing up of interbank lending in August and September 2007 caused severe liquidity problems for Northern Rock, which had not foreseen the possibility of all of its funding markets closing simultaneously.\textsuperscript{57} Northern Rock was much more affected by the drying up of funds in the capital markets than other UK banks because it relied much more than the other UK banks on capital market funding rather than on retail deposit funding- its business strategy has been described as reckless and high-risk because it over-relied on short and medium-term wholesale funding from the capital markets and because it failed to take out adequate insurance for the problems that it faced.\textsuperscript{58} The bank suffered a run by its depositors and ultimately had to be nationalised.

The failure of Northern Rock illustrates what can happen when trading entities lose trust in each other. It suffered the run because the bank-customer relationship is based on trust, and this trust disappeared once it came to light that the bank’s business strategy was flawed. The failure of Northern Rock also shows how the inter-bank market and capital markets are also based on trust. Banks rely on the inter-bank market to fund day-to-day operations, and if this funding is withdrawn they can get into serious trouble.\textsuperscript{59} It is, therefore, important that banks and other financial institutions do everything within their power to maintain the trust reposed in them.

Banks and insurance companies that invested heavily in these structured credit products suffered huge losses, and subsequently saw their market capitalisations fall dramatically as their share prices tumbled. The investment banks most heavily involved in the structured credit business actually collapsed. The losses and falls in market capitalisations were so severe that three of the five large US investment banks had to be rescued\textsuperscript{60} or became insolvent,\textsuperscript{61} while the two Government-Sponsored Enterprises (GSEs) that specialised in structured finance,\textsuperscript{62} and the largest US insurance company,\textsuperscript{63}

\textsuperscript{55} President’s Working Group on Financial Markets, “Policy Statement on Financial Market Developments” (March 2008), 37-39
\textsuperscript{56} Ibid, 37-39
\textsuperscript{57} House of Commons, The Run on the Rock, Treasury Select Committee, Fifth Report of Session 2007-08, 24 January 2008, 16
\textsuperscript{58} Ibid, 19
\textsuperscript{60} Bear Sterns, the smallest of the five large US investment banks faced severe liquidity problems and eventually had to be taken over by JP Morgan, with financing support from the Federal Reserve Bank of New York, while Merrill Lynch, another of the big five US investment banks, was taken over by Bank of America
\textsuperscript{61} Lehman Brothers filed for corporate bankruptcy, while part of its investment banking business was eventually sold to Barclays Capital, the investment banking arm of Barclays Bank Plc
\textsuperscript{62} Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)
all had to be bailed out, at substantial cost to the US taxpayer. The most notable of these companies that suffered financial difficulties is Lehman Brothers (hereinafter, Lehman), which, at that time, was the fourth largest US investment bank.

Lehman, like other investment banks used a highly leveraged business strategy. The US Securities and Exchange Commission (SEC) had no authority to force investment banks to reduce their leverage, and as a result, debt financing rose greatly in comparison to equity financing. The reliance on leverage financing became so widespread as a result partly of competitive pressure and the desire to gain strong market share. Excessive leverage has been identified as one of a number of bank practices that contributed to the GFC. The use of leverage is problematic because of its inverse relationship with liquidity- during the process of credit expansion the financial system becomes progressively illiquid.

Increasing leverage therefore makes a firm less financially robust, and when a highly leveraged firm sustains losses beyond a certain level this will sharply reduce its ability to pay its debts. This is because it is more likely to be hit by a loss spiral, whereby a decline in the value of its assets erodes its net worth much faster than its gross worth because of its leverage and the limited amount that it can borrow falls. The upshot of this is that when a firm is highly leveraged a collapse of trust or confidence by its creditors or investors can quickly take it from being illiquid to being insolvent.

The collapse of Lehman was particularly significant for a number of reasons. The most significant of these is that it proved to be the tipping point, in which a credit crunch and loss of confidence in some financial firms, transformed into a full-blown systemic financial crisis. It is also significant because Lehman was the only financial firm that failed to secure privately or publicly funded financial assistance- it ultimately had to file for corporate bankruptcy. The decision by the US authorities to allow Lehman to fail represents the prioritising of concerns about moral hazard over and above concerns that troubled institutions that are too big to fail can trigger systemic crises if they are not rescued. This decision has, however, been criticised as incorrect because the collapse of Lehman had such a catastrophic effect on the global financial system.

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63 American International Group (AIG), the largest insurer in the world at the time, had been heavily involved in the Credit Default Swaps (CDS) market, and faced such heavy potential losses on these deals that it would have defaulted on its obligations if it did not receive substantial finance assistance from the US authorities.

64 See Coffee supra n 47, 16

65 See Coffee supra n 47, 16


67 A Nesvaitailova, Fragile Finance: Debt, Speculation and Crisis in the Age of Global Credit (Basingstoke, Palgrave Macmillan, 2007), 78


70 For more on tipping points see M Gladwell, The Tipping Point: How Little Things Can Make A Big Difference (London, Abacus, 2001), 7-9

(b) Lessons from the GFC

The GFC has shown how important liquidity is to the financial system. It has also shown that liquidity is largely dependent on trust. When confidence (trust) was eroded, liquidity disappeared. The erosion of confidence was signified by, for example, the collapse of confidence in RMBS and CDOs. The use, by investment banks such as Lehman, of a high-risk, high-leverage business model requires the maintenance of the trust of all the counterparties that they deal with-it has been said that with such a business model “confidence is critical”. This is because counterparties put themselves in a vulnerable position in relation to the investment bank, based on the understanding that they will be able to reclaim all funds due to them under their counterparty agreements. A bank or investment bank that knowingly and recklessly puts itself in a position where it could potentially be unable to fulfil its financial obligations to its counterparties will lose the trust of its counterparties.

Another lesson to draw from the GFC is the fallibility of reputational or trust intermediaries such as gatekeepers. Gatekeepers are reputational intermediaries who provide verification and certification services to investors, essentially doing what investors cannot easily do for themselves. They, in effect, assure investors of their trustworthiness and reliability by pledging the “reputational capital” that they have developed over many years so that investors recognise that no individual corporate client could pay the gatekeeper enough to compensate it fully for the loss of reputational capital that it would suffer from association with a major scandal. Typical examples of gatekeepers include auditors, securities analysts and credit rating agencies. Investors place their trust in the gatekeeper, thus putting the gatekeeper in a powerful position in relation to these investors.

The gatekeepers (in this case the credit rating agencies (CRAs)) failed in their gatekeeping duties because they suffered from conflicts of interest. The increased use of financial innovation (particularly structured finance) produced a change in the relationships between the ratings agencies and their clients- structured finance became the rating agencies’ leading source of revenue, since rating securitised offerings generated much higher fees and the increased competition in the CRA industry, when it changed from a duopoly (with Standard and Poors and Moodys) to one comprised of three CRAs (after the entrance of Fitch), made the competitors not more faithful to investors, but more dependent on their immediate clients, the issuers of the structured finance.


73 See Coffee supra n 47, 1; J C Coffee, Gatekeepers: The Professions and Corporate Governance (Oxford, Oxford University Press, 2006)

74 See Coffee supra n 47, 1


76 Partnoy, Credit Rating Agencies Are Not Like Other Gatekeepers, ibid; Tett supra n 52
products. In essence, the increased use of financial innovation, coupled with increased competition within the CRA industry, made the CRAs more beholden to the banks and other structured finance securities issuers.

The realisation that credit ratings were flawed led to the massive withdrawal of liquidity from the capital markets- investors were no longer willing to rely on ratings and, being unable to perform their own credit analyses, withdrew from a wide range of structured finance markets. This clearly illustrates how trust is crucial in order for capital markets to function properly. The pre-eminence of gatekeepers was a result of the fact that they were trusted. As a result of their failure to carry out their gate-keeping role effectively they were no longer respected, and the debate on how best to regulate them has intensified. It has, for example, been proposed that rather than merely relying on their reputations as a check on gatekeepers, such as CRAs, we might have to do this through either civil action or regulation. Regardless of which of these two approaches is adopted it is clear that something needs to be done about the CRAs as it is no longer enough to simply rely on their reputations to be an effective check on how they behave and manage the conflicts of interest that they face.

2. The collapse of Lehman Brothers

The collapse of Lehman was a very significant event in the GFC. Prior to its demise Lehman was the fourth largest investment bank in the US. It used a high-risk, high leverage business model that was based on maintaining the confidence of its counterparties- if these counterparties were to lose confidence in Lehman and decline to roll over its daily funding in the short term repo markets then Lehman would be unable to fund itself and unable to continue its operations. To this extent it operated a business model that relied on high levels of trust on the part of its counterparties.

In 2006 Lehman embarked on an aggressive growth strategy, taking on significantly greater risk and substantially increasing its leverage. In doing so, it repeatedly exceeded its own internal risk limits and controls. This reckless approach to leverage and risk management represents a failure by the firm’s senior management to run the firm appropriately and in the best, long-term interests of its investors, particularly its shareholders. Such failures can have a detrimental effect on trust in financial markets.

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77 See Coffee supra n 47, 9-10
78 See Avgouleas supra n 48, 41-42
80 See Partnoy, Rethinking Regulation of Credit Rating Agencies supra n 75
81 See Akinbami supra n 46
82 Bankruptcy Report, supra n 72, 3
83 Bankruptcy Report supra n 72, 4
84 Bankruptcy Report supra n 72, 4
Fraud and the issuing of Alt-A Loans

Lehman engaged in the business of non-prime loans; it was also heavily involved in the sub-prime loans business.\(^8^5\) In addition, it was heavily involved in the Alt-A loans business and even had a subsidiary, Aurora LLC, which specialised in such mortgages.\(^8^6\) Alt-A loans are not prime loans, but are supposed to be less risky than sub-prime loans.\(^8^7\) These loans have been referred to as liar’s loans.\(^8^8\) Such loans increase adverse selection\(^8^9\) and are allegedly ‘criminogenic’, because they encourage mortgage fraud by creating strong incentives to provide false information on loan applications.\(^9^0\) This combination of adverse selection and mortgage fraud gives Alt-A loans a highly negative expected value and can easily lead to significant losses for the lender or underwriter.\(^9^1\)

In the short-term, writing large quantities of Alt-A loans creates the misleading impression that the company or firm is making significant profits, but such profits turn out, in the long run, to be illusory, since the company suffers huge losses in the future when the Alt-A loans begin to default. The short-term appearance of profitability encourages the firms’ managers to take a short-termist view since their remuneration is based on short-term profits.\(^9^2\) It therefore becomes in the managers’ interest to make (and to conceal the potential future losses from) such loans, even though making such loans is totally contrary to shareholders’ long-term interests. In this way, Lehman activity in the Alt-A loan market illustrates the classic ‘agency’ problem, as illustrated by Berle and Means, whereby the separation of the ownership of the firm from its controllers leads to situations where the interests of the owners (shareholders) and the controllers (managers) diverge.\(^9^3\)

The so-called “agency problem” highlights the need for trust between the internal members of a firm. A large investment bank such as Lehman would have a diffused and diversified shareholder base, as well as several employees. This diverse body of shareholders entrust their property, the

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\(^8^5\) Sub-prime loans are loans that do not qualify for purchase by the GSEs because they have been made to borrowers with low credit scores, bad credit histories or other forms of credit impairment

\(^8^6\) W K Black, “Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner”, Statement to the US House of Representatives Committee on Financial Services, April 20 2010, 5, 9

\(^8^7\) Alt-A loans are loans to borrowers with decent credit scores and credit histories but little or no documentary proof of their income

\(^8^8\) Black supra n 86, 5

\(^8^9\) Adverse selection is a situation where one party enters into a business or transaction with a second party that it would be better off not doing business or transacting with, because information asymmetries exist which make the second party an undesirable or unprofitable party to do business with- see Akerlof supra n 1

\(^9^0\) Black supra n 86, 5

\(^9^1\) Black supra n 86, 5


firm, to the management of the firm. In turn, the management is expected to run the firm in the
best long term interests of the shareholders. The managers, as fiduciaries, must therefore put the
long-term business interest of the firm ahead of its short-term profitability, and ought to manage
the firm’s risk profile accordingly. To the extent that the Lehman management failed to do this, it
represents a failure of the trust placed in them by Lehman’s shareholders.

(b) Lehman’s Use of Repo 105 and Repo 108

Like many others in the banking and finance industry, Lehman required favourable ratings from the
principal rating agencies in order to maintain investor and counterparty confidence, and to do this it
had to report favourable net leverage numbers to maintain its ratings and confidence. It therefore
decided to paint a misleading picture of its financial condition - it used creative accounting to give
the impression that it had a strong and robust liquidity pool, when in fact it did not. This again
represents a significant failure of trust. In so doing Lehman’s senior management behaved in a way
that had the potential to reduce the trust placed in Lehman by the firm’s shareholders (intra-firm
trust) and other investors and counterparties (inter-firm trust).

In late 2007 and all through 2008 Lehman increasingly used accounting devices, known within
Lehman as Repo 105 and Repo 108, to temporarily remove billions of dollars of securities inventory
from its balance sheet. Repo 105 and 108 were similar to standard repurchase and resale (repo)
transactions used by investment banks to secure short-term financing but had one critical
difference: Lehman accounted for Repo 105 and 108 transactions as ‘sales’ rather than financing
transactions - a re-characterisation that removed such inventory from its balance sheet. Lehman
never publicly disclosed its use of Repo 105 and 108 transactions, its accounting treatment for these
transactions or the material impact these transactions had on its publicly reported net leverage
ratio. In fact, it categorically declared, in its financial statement, that it treated all repo transactions
as financing transactions (i.e. not sales) for financial reporting purposes. Lehman’s Bankruptcy
Examiner concluded that certain of Lehman’s officers breached their fiduciary duties by exposing
Lehman to potential liability for filing materially misleading periodic reports. It thus clearly
represents a situation where ‘trusted persons’ were seen to have abused the trust reposed in them.

The use of Repo 105 and 108 are problematic because they seem to have had no other purpose than
to deceive investors and regulators. It has been argued that accounting approaches used to achieve
GAAP accounting treatments that are contrary to the true nature (or the economic substance) of
the transaction are deceitful. Former insiders at Lehman have acknowledged that the only
purpose or motive for the transactions was reduction in the balance sheet and that there was no

94 Bankruptcy Report supra n 72, 5-6
95 Bankruptcy Report supra n 72, 5-6
96 Bankruptcy Report supra n 72, 732
97 A standard repo transaction is an agreement where one party transfers an asset or security to another party
as collateral for a short-term borrowing of cash, while at the same time agreeing to repay the cash, plus
interest, and take back the collateral at a future date
98 Bankruptcy Report supra n 72, 732
99 Bankruptcy Report supra n 72, 734
100 Bankruptcy Report supra n 72, 735
101 Bankruptcy Report supra n 72, 750
102 Black supra n 86
They referred to the transactions as “an accounting gimmick” and as “balance sheet window-dressing based on legal technicalities”. Repo 105 and 108 therefore amounted to what has been referred to as “non-disclosing disclosure”, whereby “all the relevant information is provided, but in such a way that it is almost impossible to realise it might raise questions for the accounting treatment used”. It has even been argued that regulators and law enforcement officials prefer to tackle out-and-out frauds (which are easier to prosecute) than creative accounting (which is harder to prosecute), and that this affected the enforcement response to the corporate governance failures at Enron so it focused only on fraud and criminal prosecutions (because they are easier to secure convictions) thereby failing to provide a definitive response to ‘gaming the system’ through the use of creative accounting.

The use of creative accounting, such as Repo 105 and 108, to conceal short-comings represents a failure of the trust that shareholders, employees (intra-firm trust) and creditors (inter-firm trust) placed in the firm’s management. Such esoteric accounting treatments bear similarities with the sort of creative accounting that was at the heart of breaches of trust by the managers of Enron, and ultimately contributed to its downfall. The problem with such creative accounting is that it helps management conceal short-comings in corporate performance, thus contributing to the downfall of companies. It also raises serious issues regarding the reliability of financial reporting - it has been pointed out, for instance, that part of the outrage felt after the Enron collapse was simply the result of the fact that Enron used creative accounting to fundamentally mislead the market. What this illustrates is that from the point of view of shareholders and investors, who place themselves in a vulnerable position by trusting the managers of the firm, the central concern is not whether the financial reports comply with the technical aspects of the law. It is, instead, whether or not the financial reports can be relied on, that is, the extent to which they can trust that such reports are an accurate portrayal of the firm’s true position.

3. Goldman Sachs, Paulson hedge fund, ACA, IKB and ABN transactions

This episode involved the structuring of a CDO transaction known as ABACUS by Goldman Sachs, and its marketing and sale to the German corporate finance bank IKB and the Belgian-Dutch bank ABN Amro. Paulson, a hedge fund, developed an investment strategy based on the bearish view that certain mid-and-sub-prime Residential Mortgage-Backed Securities (RMBS) would experience credit events, that is, would default. In essence, Paulson believed that synthetic CDOs whose reference assets consisted of certain Triple-B rated mid-and-subprime RMBS would experience significant losses and become worthless. Paulson then discussed the creation of a CDO with Goldman Sachs.
so as to allow Paulson to participate in selecting a portfolio of reference obligations and then effectively short selling the RMBS portfolio it helped to select.\footnote{ibid, 6}

Goldman Sachs knew it would be difficult to get investors to invest in a CDO that a short investor, such as Paulson, had played a significant role in creating. This is because the short investor would have the incentive and the opportunity to fill the CDO with RMBS that were likely to default. It is highly unlikely that anyone would buy something that someone else had designed to fail. Goldman Sachs also knew that the identification of an experienced and independent third party collateral manager as having selected the portfolio would facilitate the placement of the CDO (that is, encourage investors to invest in it). They knew that they needed to create the impression that an independent, neutral collateral manager had chosen the securities in the CDO, rather than someone who had effectively taken a bet against that very CDO.

Goldman Sachs therefore sought a collateral manager to play a role in the transaction proposed by Paulson.\footnote{ibid, 7} They approached the unit bond issuer, ACA Management LLC, to be the collateral manager, with the intention of using ACA’s strong brand name and credibility to market the transaction to investors, who would be more willing to buy the products if ACA was involved, because of the value of ACA’s brand - investors, in effect, trusted ACA’s brand. Goldman Sachs was keenly aware of, and wanted to take advantage of, the trust those investors placed in ACA.

Paulson’s selection criteria for what went into the CDOs favoured RMBS that included a high percentage of adjustable rate mortgages, relatively low borrower FICO scores, and a high concentration of mortgages in states like Arizona, California, Florida and Nevada that had recently experienced high rates of home price appreciation but were likely to suffer price declines in the near future. Paulson allegedly loaded the CDO with securities that were likely to fail.

According to the SEC, Goldman Sachs’ marketing materials for the synthetic CDO were false and misleading because they represented that ACA selected the reference portfolio while omitting any mention that Paulson, a party with economic interests adverse to CDO investors, played a significant role in the selection of the reference portfolio.\footnote{ibid, 11} The prospectus and other marketing materials contained no mention of Paulson, its economic interests in the transaction, or its role in selecting the reference portfolio.\footnote{ibid, 11-13} The investors were, in effect, misled into believing that the party selecting the portfolio had an “alignment of economic interest” with investors, when in actual fact the opposite was the case.

According to the SEC, Goldman Sachs also misled ACA into believing that Paulson was investing in the equity tranche of the synthetic CDO and therefore shared a ‘long’ interest\footnote{ibid, 13} with CDO investors.\footnote{supra n 109, 13} If ACA had been aware that Paulson was taking a ‘short’ position against the CDO, ACA would have been reluctant to allow Paulson to occupy an influential role in the selection of the

\footnote{ibid, 6}{\footnote{ibid, 7}{\footnote{ibid, 11}{\footnote{ibid, 11-13}{\footnote{ibid, 13}{\footnote{Long in the sense that it was investing in the equity tranche of the CDO and therefore had a favourable view of the prospects of the underlying assets that comprised the index that the CDO was based on}{\footnote{supra n 109, 13}}}}}}}}
reference portfolio, or ACA would probably not have agreed to take part in the transaction.\textsuperscript{117} ACA had sought clarification in regard to Paulson’s role in the transaction but Goldman Sachs and its employee Fabrice Tourre allegedly misrepresented the facts to ACA.\textsuperscript{118} It seems that ACA had not been careless or negligent- ACA’s belief that Paulson was ‘long’ on the deal was reasonable, given the information provided to them by Goldman Sachs and Tourre. Reference in ACA’s written approval memorandum to Paulson as “the hedge fund equity investor” confirms that ACA was under the misimpression that Paulson had a long position rather than a short position with respect to the CDO.\textsuperscript{119} This misimpression is wholly attributable to the fact that Goldman Sachs and its employee, Tourre, allegedly lied to and misled ACA.

\textbf{(a) The SEC Enforcement Action against Goldman Sachs and Fabrice Tourre}

The SEC has taken a successful enforcement action against Goldman Sachs and Fabrice Tourre. The first claim made by the SEC was that Goldman Sachs and Tourre knowingly, recklessly or negligently misrepresented, in the ABACUS marketing material, that the reference portfolio was selected by ACA without disclosing Paulson’s role in the selection and, in addition, misled ACA into believing that Paulson was investing in the equity tranche of the CDO when in reality it was not.\textsuperscript{120} This is contrary to section 17 of the Securities Act 1933.\textsuperscript{121} The second claim was almost identical to the first one, but was based on section 10(b) of the Securities and Exchange Act 1934\textsuperscript{122} and SEC Rule 10b-5.\textsuperscript{123} The distinction between the two claims is that the first claim merely requires the SEC to prove negligence on the part of the accused, a lower threshold for establishing culpability, while the second claim requires it to prove \textit{scienter}, that is, the intent to deceive, manipulate or defraud.\textsuperscript{124} Goldman Sachs agreed to settle the charges against it for $550 million. The settlement allowed Goldman Sachs to pay the fine without admitting or denying the allegations of fraud that had been levelled against it, nor did it compel the resignation of any Goldman Sachs officers or employees.\textsuperscript{125} Instead, Goldman Sachs admitted that the incomplete and inadequate disclosures in its marketing materials were a mistake.\textsuperscript{126} It has been argued that the SEC’s use of section 17 allowed Goldman Sachs to admit to negligence rather than fraud.\textsuperscript{127} Regardless of whether or not Goldman Sachs admitted to this, there is clearly a basis for an argument that its actions had a negative effect on trust in the financial markets.

\textbf{(b) The Issue of Disclosure and Information Asymmetry}

Disclosure is a key issue that underpinned the prosecution’s case in regard to the above transaction. The inadequate disclosure of information can sometimes constitute a significant market failure that

\begin{footnotesize}
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\item \textsuperscript{117} supra n 109, 13
\item \textsuperscript{118} supra n 109, 14-15
\item \textsuperscript{119} supra n 109, 14-15
\item \textsuperscript{120} supra n 109, 19-20
\item \textsuperscript{121} Securities Act 1933 section 17, 15 U.S.C s77q
\item \textsuperscript{122} Securities and Exchange Act 1934 section 10b, 15 U.S.C s78j(b)
\item \textsuperscript{123} SEC Rule 10b-5, C.F.R s240.10b-5
\item \textsuperscript{124} \textit{Ernst & Ernst v Hochfelder} 425 US 193, 197 (1976)
\item \textsuperscript{126} \textit{Ibid}, 33
\item \textsuperscript{127} \textit{Ibid}, 33
\end{itemize}
\end{footnotesize}
has often created a good justification for imposing enhanced regulation. Disclosure is a key weapon in the battle against fraud and market abuse, and is often the cornerstone of investor protection regimes in securities markets. The US New Deal securities statutes, for example, were enacted after the Great Depression largely to address the glaring need for adequate disclosure in the US securities markets. If the ABACUS transaction had been carried out on a registered Exchange, Goldman Sachs would have had to disclose information that ACA, IKB and ABN were not given. It has, however, been argued that although the ABACUS transaction was a specially structured deal, it nevertheless required a level of disclosure and transparency that was higher than what might be required in a simple bond sale or equity purchase.

The counter-argument that could be put forward by Goldman Sachs and its supporters is one based on libertarian free market ideology. The argument is that ACA and the investors, IKB and ABN, did not need disclosure or any other regulatory protection beyond their remedies for breach of contract since they were professional institutional investors or market counterparties, who ought to have properly examined the contents of ABACUS before investing in or becoming affiliated with ABACUS. Market counterparties are clients who are able to look after their own interests, thus not requiring the protection afforded by regulatory rules. There is some support for this view in UK law, where the courts are reluctant to interfere in transactions between commercial organisations dealing with each other as principals.

The argument, by Goldman Sachs and its supporters, that ACA, IKB and ABN were all professional institutional investors is, however, a weak one. US courts have held that the anti-fraud provisions of the Securities Acts do not distinguish between sophisticated and unsophisticated investors, since both are entitled to the protection afforded by disclosure and anti-fraud laws. Disclosure of relevant information to investors and potential investors is desirable for both economic and ethical reasons. The failure of Goldman Sachs to provide the requisite information for the ABACUS investors ultimately led to those investors being misled. Misleading investors in this way seriously undermines the possibility that cooperation and trust can enhance business performance or promote dynamic efficiency within markets.

(c) The Issue of Conflict of Interest

Goldman Sachs has been described as helping some clients to make huge bets against the very same mortgage-backed assets that it was selling to other clients, and as having failed to disclose this conflict of interest to investors. Conflicts of interest are problematic for both economic and ethical reasons. The Wall Street analyst case, where Merrill Lynch was punished for its use of implicit promises of favourable ratings from its research analysts in exchange for investment banking business such as IPO underwriting, provides a good example of disciplinary action taken against a firm for failing to properly manage conflicts of interest. The former Attorney-General of New York, Eliot Spitzer, took out a successful action against Merrill Lynch for its failure to properly manage conflicts of interest when its investment bank put pressure on its research analysts to publicly recommend stocks for investors to purchase even though privately the analysts knew that these stocks were of poor quality. In addition, a subsequent joint investigation by Spitzer, the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD) and North American Securities Administrators Administration (NASAA) into research analysts and their conflicts of interest, resulted in a settlement in which ten Wall Street firms and two individuals agreed to pay a total of approximately $1.4 billion and to improve their policies and procedures so as to avoid conflicts of interest in the future. The comment by Spitzer that Merrill Lynch’s behaviour was “a shocking betrayal of trust by one of Wall Street’s most trusted names” provides strong support for the argument that failing to properly manage conflicts of interest can have a detrimental effect on trust in the financial markets.

Goldman Sachs’ defence to the accusation that it failed to manage conflicts of interest properly is rooted in the libertarian free market view that there will inevitably be winners and losers in a free market. Goldman Sachs defiantly countered accusations of conflict of interest or betting against its clients, arguing that although it “went short” on the housing market while simultaneously continuing to trade mortgage-backed securities to its clients, this was not wrong, and was merely a case of various sophisticated investors simply taking different views. There is some support for this view—the arm of Goldman Sachs that sold mortgage-backed securities was not a financial advisory business, counselling clients on what might be in their best interests. Instead, it is arguably a market-making division where customers come forward with things they want to buy or sell and Goldman Sachs shops around to find a party willing to be on the other side of the deal. The whole

140 See Adams supra n 138
142 Ibid., 86
144 In re Spitzer v Merrill Lynch & Co., No. 02-401522 (N.Y Sup. Ct, April 8 2002)
145 SEC, Joint Press Release, Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking, April 28 2003, available at http://www.sec.gov/news/press/2003-54.htm; interestingly Goldman Sachs was one of these ten investment firms
147 Goldman Sachs, Letter to Shareholders, Annual Report for 2009, April 7 2010, 11-12
148 Clark supra n 132
point of markets is that buyers are taking the opposite view from sellers - there would not be any
sellers if everyone expected a security to only increase in value.\textsuperscript{149}

Although Goldman Sachs would take the view that it is not unlawful to bet against your clients, such
an action is arguably inherently unfair and unethical. Indeed, other industry insiders have
condemned such actions - it has been described as a “reputation issue” that should not have arisen
if Goldman Sachs held on to its “moral compass”.\textsuperscript{150} This contributes to the idea that failing to
behave morally or ethically is tantamount to a failure of trust, even where it is not technically a
breach of the law. A competitor of Goldman Sachs had actually declined to take part in such a
transaction because it did not think it should “sell deals that someone was shorting on the other
end”.\textsuperscript{151} The fact that even traders and industry professionals who knew and understood the nature
of the product acknowledged that such behaviour was immoral and unethical shows that such action
would be a failure of trust that would tarnish the reputations of those who acted in this way.

\textit{(d) Trust}

In many ways, the behaviour of Goldman Sachs with regard to the \textit{ABACUS} transaction constitutes a
breach of popular conceptions of trust. It has been observed that properly-functioning markets are
built on trust, transparency, confidence and certainty, and that these key foundations are severely
eroded when prominent financial institutions engage in abuses of trust or otherwise act immorally
or unethically.\textsuperscript{152} Macaulay has argued that it is acceptable for some to do better than others when
they play by the rules of the game, but unacceptable if those who come out on top achieve this by
tricking others and having their deceptions supported by the legal system.\textsuperscript{153} Such deceptions
undermine trust and, in so doing, reduce the instrumental role that trust plays in enhancing business
performance.

There is some evidence that the \textit{ABACUS} deal has had a negative impact on how Goldman Sachs is
regarded. A recent opinion poll, by CNBC, shows that a large percentage of Americans now have an
unfavourable opinion of Goldman Sachs in light of the \textit{ABACUS} controversy.\textsuperscript{154} Moreover, a recent
Bloomberg news survey also showed that the public no longer trusted Goldman Sachs and that its
reputation had been tarnished by the \textit{ABACUS} scandal.\textsuperscript{155} This loss in public trust may drive away
current and future clients, as has already been evidenced by the decision of some European nations
to stop doing business with Goldman Sachs in the light of its role in the recent Greek sovereign debt
crisis.\textsuperscript{156}

\textsuperscript{149} Clark supra n 132
\textsuperscript{150} G Zuckerman, \textit{The Greatest Trade Ever: How One Man Bet Against the Markets and Made $20 Billion}
\textsuperscript{151} Ibid
\textsuperscript{152} See Pekarek and Lufrano supra n 125, 45
\textsuperscript{153} S Macaulay, “Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian MacNeil
and Lisa Bernstein” (2000) 94 \textit{Northwestern University Law Review} 775, 804
\textsuperscript{154} “Did Goldman Sachs Do Something Wrong?” CNBC, 27 April 2010, available at
http://www.cnbc.com/id/36797597/Did_Goldman_Sachs_Do_Something_Wrong
\textsuperscript{155} C Harper and R Schmidt, “Goldman Deserves Regulatory Probe, Bloomberg Poll Says”, \textit{Bloomberg}, June 8
regulators-in-bloomberg-subscriber-poll.html
\textsuperscript{156} E Moya, Europe Freezes Out Goldman Sachs, \textit{The Observer}, 18 July 2010, 35
D. CONCLUSION

This paper has looked at trust and its significance in commercial relationships. In particular it has examined the important role that trust plays in intra-firm and inter-firm relationships, as well as why it is necessary to have trust in financial markets. It is clear that important components of financial markets, such as liquidity and investor confidence, are to a large extent based on trust. To this extent, financial markets will eventually be weakened if trust is eroded within them. The failure of Northern Rock, during the GFC, serves as a stark illustration of why trust is important in financial markets. The erosion of trust in the inter-bank and capital markets made it difficult for Northern Rock to raise finance through the sale of ABCP. In addition, the depositor run that Northern Rock suffered shows that trust is important in retail banking in much the same way as it is important in wholesale capital markets.

At the intra-firm level, agency problems and creative accounting remain fundamental issues that must be addressed in order to promote trust. The use of esoteric accounting treatments is problematic because it helps managements conceal important information from shareholders, such as shortcomings in corporate performance. Such accounting treatments therefore exacerbate the agency problem rather than reduce it. The collapse of Lehman highlighted the need to address these fundamental issues. Creative accounting reduces trust once it has been discovered. It is therefore important that adequate measures are taken to tackle it.

At the inter-firm level, the ABACUS transaction carried out by Goldman Sachs illustrates the need for market participants to act conscientiously. Although markets operate on the basis that market participants are free to take divergent views on the desirability of their investments the market has to guarantee that they will be able to make their decisions based on all of the relevant information. Commercial or business relationships are underpinned by contractual relationships which involve or ought to involve overarching obligations of good faith, solidarity, role integrity and mutuality. The integrity of markets therefore depends, to a large extent, on market participants being truthful, open and honest with each other. The deliberate withholding, or non-disclosure, of essential information that is required by market participants to make informed decisions, will be a failure of trust that undermines the integrity of markets.

Corporate law theory clearly needs to be enriched by resort to a greater range of concepts to help us to provide a more nuanced understanding of corporations and the financial markets in which they operate. The concept of trust is clearly a useful one in this regard. This paper has argued that the concept of trust provides us with essential insights into conduct and transactions that are to be found in financial markets. More applications of this concept and similarly important ideas which explain market conduct by individual investors and corporations are appropriate.