

# The Sword of Damocles: who controls HSBC in the aftermath of its deferred prosecution agreement with the United States Department of Justice?

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## Abstract

*HSBC has entered into a \$1.92bn deferred prosecution with the Department of Justice in the United States to settle charges that the bank's compliance systems and corporate governance controls had failed to prevent money laundering and sanctions violations on an industrial scale. The violations spanned the globe and demonstrated fundamental flaws with the bank's business model. The article evaluates the terms of the settlement and explores the national and extra-territorial implications. It argues that the settlement, the largest ever imposed on a financial institution, marks a significant turning point in the use of criminal prosecution precisely because it occurred just as the still burgeoning London Interbank Offered Rate (Libor) manipulation scandal reaches a denouement.*

## 1 Introduction

The US comprises the most significant export market for Mexican and Colombian drug cartels. Mexican democracy itself has been destabilised by cartel-sponsored corruption. Ongoing political violence, fuelled, in part, by the drug trade, has further weakened social and political capital. When the London-based global bank HSBC used advertising that claimed the importance of knowing when emerging markets have emerged it most certainly did not have the facilitation of the narcotics industry in mind. Yet this was precisely what occurred as a consequence of systemic compliance failures across the group. From the parent operation in London to affiliated entities in both the United States and Mexico, there was, according to an agreed Statement of Facts tabled in a New York federal court, a wanton disregard for the societal implications. When combined with identified inability to control money transfers to North Korea, Burma, Cuba and Sudan in violation of a United States-imposed sanctions regime, the global failure of compliance at the bank suggests deep structural problems with HSBC's core business model. Providing local businesses with a global imprimatur without strenuous checks to safeguard reputational capital has been shown to be an exceptionally dangerous strategy.

The \$1.92bn deferred prosecution agreement entered into by HSBC with US regulators contains the largest financial penalty ever imposed on a global bank by prosecutorial authorities in either a civil or criminal matter. The bank is required to disgorge \$1.256bn of profits. It will also pay a total of \$665m in civil penalties to regulatory agencies, including the Office of the Comptroller of the Currency (\$500m) and the Federal Reserve (\$165m). The

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payment to the Office of the Comptroller of the Currency is a partial, if not complete, vindication of the agency. Given the criticism of its oversight in an eviscerating report tabled to the United States Congress in July this year it is, at best, an equivocal endorsement of federal priorities.<sup>1</sup> Of even more significance, however, is the requirement that a corporate compliance monitor be appointed to a five-year term, in compliance with a template in operation since at least 2008.<sup>2</sup> Although ostensibly independent, the terms of engagement and accountability structures governing the design and implementation of the monitor's work plan make it abundantly clear that the holder is an agent of the Department of Justice, for which it makes no apology. 'HSBC is being held accountable for stunning failures of oversight – and worse – that led the bank to permit narcotics traffickers and others to launder hundreds of millions of dollars through HSBC subsidiaries, and to facilitate hundreds of millions more in transactions with sanctioned countries', noted the head of the Criminal Division of the Department, Lanny Breuer, in a broadly circulated circular.<sup>3</sup>

In a deferred prosecution, a corporation enters into an effective contract with the prosecutorial authority in which it accepts not to subsequently challenge an agreed narrative and engages in remedial action in exchange for a decision not to proceed with the charges. If there is no repetition of the complained of conduct within an agreed timeframe the charges are voided. Conversely, a violation allows for a filing of an indictment in which the statement of facts cannot be challenged. It is, therefore, an admission of guilt. It is closely allied to a non-prosecution agreement, which can also contain contractually agreed remedial action. In policy terms, the HSBC agreement is one of the most significant uses of the deferred prosecution mechanism since its application to deal with KPMG's development of abusive tax shelters in 2005.<sup>4</sup> The KPMG prosecution had ended with the Department of Justice castigated in the Manhattan Federal Court. Judge Louis Kaplan condemned what he termed its unconstitutional conduct. He voiced grave concern that the prosecutors had 'put a gun to KPMG's head' by forcing it to end legal support for partners whose defence centred on the fact that they were following corporate-sanctioned objectives.<sup>5</sup> The Department of Justice, stung by the criticism, retreated largely from forcing change on the financial sector, with the exception of active prosecution of sanctions violations and breaches of the Foreign Corrupt Practices Act of 1977. With the exception of the settlement with Lloyds Bank TSB, however, it had not imposed an external monitor on a major financial institution for

- 1 See Senate Permanent Sub-Committee on Investigations, *US Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History* (US Congress, Washington DC, 17 July 2012), 306 (noting a 2008 examination in which the OCC records 'As the U.S. dollar clearing bank for the Global HSBC network, HBUS maintains numerous relationships with institutions worldwide . . . The bank does business with numerous customers in both High Intensity Drug Trafficking Area and High Intensity Money Laundering and Related Financial Crime Area locations. HBUS provides pouch services through several business units. Historically, pouch services are vulnerable to money laundering risk').
- 2 Craig Morford, 'Memorandum on Selection and Use of Monitors in Deferred Prosecutions and Non Prosecution Agreements with Corporations' (Department of Justice, Washington DC, 8 March 2008).
- 3 Department of Justice, 'HSBC Holdings Plc and HSBC Bank USA NA Admit to Anti-Money Laundering and Sanctions Violations, Forfeit \$1.256 Billion in Deferred Prosecution Agreement', Press Release, Washington DC, 11 December 2012.
- 4 Justin O'Brien, *Redesigning Financial Regulation* (John Wiley & Sons 2007) 123–169; for assessment of the Department of Justice's usage, see Government Accountability Office, *Corporate Crime: Preliminary Observations on DOJ's Use and Oversight of Deferred Prosecution Agreements and Non-Prosecution Agreements* (Washington DC, 25 June 2009).
- 5 *United States of America v Jeffrey Stein et al* S1 05 Crim 0888 (LAK, 26 June 2006). Kaplan further noted: 'Those who commit crimes – regardless of whether they wear white or blue collars – must be brought to justice. The government, however, has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend': at 3. The decision was upheld on appeal in 2008, see *United States v Stein* No 07–3042 (2d Cir 28 August 2008).

sanctions violations. Instead it had relied on the stated intention of institutions to reform the compliance function.<sup>6</sup> This time, as they say, is different.

The success of the HSBC negotiations, significantly brought not in the Southern District of New York but in neighbouring Brooklyn, where HSBC Bank USA holds neither its head office nor conducts major business, served three core purposes. First, it expunged the debilitating error of judgment that informed the prosecution of the KPMG partners. Second, it signalled a determination by the Department to ensure that nascent state action, particularly in the sanctions violations space, did not usurp federal leadership in the setting of prosecutorial and regulatory priorities. The settlement came as Standard Chartered, another UK domiciled bank, agreed an overarching settlement of \$327m to draw to a conclusion litigation brought by a range of regulatory agencies, including the Criminal Division.<sup>7</sup> The timing is far from incidental. It follows the success by New York Department of Financial Services in securing a \$340m settlement with Standard Chartered in August 2012 on broadly similar charges,<sup>8</sup> which were dismissed at the time as the actions of a 'rogue regulator'.<sup>9</sup> The strategic approach adopted by the New York Department of Financial Services followed a playbook made famous by Eliot Spitzer, the former State Attorney General.<sup>10</sup> The decision not to require an independent monitor in the Standard Chartered case is, in part, linked to the fact that the violation amounted to a fraction of what was initially alleged by the New York Department of Financial Services.<sup>11</sup> Third – and most significantly – it repositioned the Department of Justice as a core moderator of regulatory priorities to use threatened prosecution as a catalyst for cultural change, not only

6 Similar settlements have been reached with a number of banks for sanctions violations involving Cuba and Iran, including – in descending monetary order – ING (\$619m), Credit Suisse (\$536m) Lloyds (\$350m) and Barclays (\$298m), see Carrick Mollencamp and Brett Wolf, 'HSBC to Pay Record \$1.9 US Billion Fine in Money Laundering Case', Reuters, 11 December 2012 <[www.complinet.com/global/news/news/article.html?ref=160723](http://www.complinet.com/global/news/news/article.html?ref=160723)>; see also Sharlene Goff, 'Barclays Fined \$298m Over Sanctions Breach', *Financial Times*, 17 August 2010 <[www.ft.com/intl/cms/s/0/6918f646-a96b-11df-a6f2-00144feabdc0.html#axzz2F4BqZ9tM](http://www.ft.com/intl/cms/s/0/6918f646-a96b-11df-a6f2-00144feabdc0.html#axzz2F4BqZ9tM)>. The settlements have prompted judicial scepticism, see, for example, Jean Eaglesham and Justin Baer, 'Barclays "Sweetheart Deal" Under Fire', *Financial Times*, 18 August 2010 <[www.ft.com/intl/cms/s/0/dece7c62-aa51-11df-9367-00144feabdc0.html#axzz2F4BqZ9tM](http://www.ft.com/intl/cms/s/0/dece7c62-aa51-11df-9367-00144feabdc0.html#axzz2F4BqZ9tM)>.

7 Department of Justice, 'Standard Chartered Bank Agrees to Forfeit \$227 Million for Illegal Transactions with Iran, Sudan, Libya, and Burma', Press Release, Washington DC, 10 December 2012.

8 Department of Financial Services, 'Statement from Benjamin M Lawskey, Superintendent of Financial Services, Regarding Standard Chartered Bank', Press Release, New York, 14 August 2012.

9 Kishore Mahbubani, 'A Lawskey Unto Himself, or Why New York Erred on StanChart', *Financial Times*, 12 August 2012 <[www.ft.com/intl/cms/s/0/f4c6b142-e2d5-11e1-bf02-00144feab49a.html#axzz24PyoHpnq](http://www.ft.com/intl/cms/s/0/f4c6b142-e2d5-11e1-bf02-00144feab49a.html#axzz24PyoHpnq)>.

10 For discussion of Spitzer's strategy (and the accountability deficit at its heart), see Justin O'Brien, 'The Politics of Enforcement, Eliot Spitzer, State-Federal Relations and the Redesign of Financial Regulation' (2005) 35 *Publius The Journal of Federalism* 439; see also Jonathan Macey, 'Wall Street in Turmoil: State-Federal Relations Post Eliot Spitzer' (2004) 70 *Brooklyn Law Review* 117, at 120–2; Kulbir Walha and Edward Filusch, 'Eliot Spitzer: A Crusader Against Corporate Malfeasance or a Politically Ambitions Spotlight Hound? A Case Study of Eliot Spitzer and Marsh & McLennan' (2005) 18 *Georgetown Journal of Legal Ethics* 1111, at 1114–15.

11 Standard Chartered, 'Standard Chartered Reaches Final Settlement With US Authorities', Press Release, 12 December 2012. The release notes that the investigation by the Office of Foreign Assets Control found 'that while SCB's omission of information affected approximately 60,000 payments related to Iran totaling \$250 billion, the vast majority of those transactions do not appear to have been violations of the Iranian Transactions Regulations'. Over the entire period from 2001 to the end of 2007, it found that approximately \$24m of transactions processed on behalf of Iranian parties and a total of \$109m on behalf other sanctioned entities from other countries (Burma, Sudan and Libya) appeared to be in violation of sanctions laws. Over the same period, SCB New York processed \$139trn in US dollar payments.

within individual entities but also across sectors, at both national and global level.<sup>12</sup> As such, it signals its return as a pivotal, if unpredictable, force in financial regulation.

The Standard Chartered and HSBC settlements reflect the growing centrality of deferred prosecutions as the preferred prosecutorial tool of choice.<sup>13</sup> The expansion of the measure reflects both its strengths and limitations.<sup>14</sup> On the one hand, it avoids the possibility of broader collateral damage. In the United States, a criminal conviction of a financial services firm would automatically trigger licence revocation. This could have devastating consequences for the individual institution indicted and the livelihoods of those who work for them.<sup>15</sup> Moreover, the licence revocation of a major bank or financial services firm deemed to be of regional or global significance could have an immediate effect on the stability of the global financial system. Indeed, these factors were explicitly noted by the Department of Justice in justifying the decision to delay prosecution. British regulators have gone further. Andrew Bailey, the designate head of the Prudential Regulation Authority, rather plaintively noted that to bring a criminal action against a bank would be a 'very destabilizing issue. It's another version of too big to fail.'<sup>16</sup> The limitation is that absent substantive requirements to change not only compliance practice but also

12 Lanny Breuer, 'Address to the New York City Bar Association', Speech delivered to the NYC Bar Association, New York, 13 September 2012.

13 The use of deferred prosecutions is also under consideration the UK, with particular references to violations of that jurisdiction's Bribery Act of 2010. A consultation process, now under review advocated its expansion, see Ministry of Justice, *Deferred Prosecution Agreements* Cm 8348 (2012).

14 For review, see Brandon Garrett, 'Globalized Corporate Prosecutions' (2011) 97 Virginia Law Review 1776. In the UK there has long been considerable interest in introducing the measure. The government had already signalled its strong support for the introduction of the measure, see Caroline Binham, 'Garnier Eyes US Style Fines and Bargains', *Financial Times*, 28 September 2011. A consultation process highlighted one critical difference from practice in the United States. There is to be judicial involvement in the initial decision as to deploy the mechanism and the parameters of the proposed terms, see Ministry of Justice (n 13). On 23 October 2012, the Ministry of Justice announced its introduction, see Ministry of Justice, 'New Tool to Fight Economic Crime', Press Release, London, 23 October 2012, quoting Justice Minister, Damian Green that: 'Deferred Prosecution Agreements will give prosecutors an effective new tool to tackle what has become an increasingly complex issue. This will ensure that more unacceptable corporate behaviour is dealt with including through substantial penalties, proper reparation to victims, and measures to prevent future wrongdoing.'

15 See Larry Thompson, 'Principles of Federal Prosecution of Business Organizations' (Washington DC, US Department of Justice, 20 January 2003). Following criticism of requirements that organizations under investigation should waive client-attorney privilege and withhold payment of legal fees to individuals prosecuted, most notably in the prosecution of KPMG, these components were subsequently dropped.

16 Harry Wilson, 'Banks are too Big to Prosecute Says FSA's Andrew Bailey', *Daily Telegraph*, 14 December 2012 <[www.telegraph.co.uk/finance/newsbysector/banksandfinance/9743839/Banks-are-too-big-to-prosecute-says-FSAs-Andrew-Bailey.html](http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9743839/Banks-are-too-big-to-prosecute-says-FSAs-Andrew-Bailey.html)>. Although the introduction of the Deferred Prosecution mechanism is designed primarily for the dealing with corruption, there is no doubt it could be applied by the Serious Fraud Office in relation to the Libor scandal in the event that a criminal prosecution eventuates. On 11 December 2012, British authorities announced that three people had been arrested, see Jill Traynor, 'Bleak Day for British Banking as Libor Arrests Follow Record HSBC Fine', *The Guardian*, 11 December 2012 <[www.guardian.co.uk/business/2012/dec/11/banking-libor-fine-hsbc](http://www.guardian.co.uk/business/2012/dec/11/banking-libor-fine-hsbc)>. On 19 December, the Department of Justice in the United States announced that two traders within UBS are to face criminal prosecution in relation to the manipulation of Libor, see Department of Justice, 'Attorney General Eric Holder Speaks at the UBS Press Conference', Press Release, Washington DC, 19 December 2012. The press conference revealed that UBS would face a combined fine of just over \$1.5bn, to be shared disproportionately between the Department of Justice (\$500m), the Commodity and Futures Trading Commission (\$700m), the UK's Financial Services Authority (\$260m) and the Swiss Financial Regulator, which while unable to levy a fine recouped \$69m in improper profits, see Kara Scanell et al, 'UBS in \$1.5bn Libor Settlement', *Financial Times*, 20 December 2012, at 1. For details of the scale of the deception, which spanned three continents see Financial Services Authority, 'Final Notice for UBS AG', London, 19 December 2012 <[www.fsa.gov.uk/static/pubs/final/ubs.pdf](http://www.fsa.gov.uk/static/pubs/final/ubs.pdf)>.

broader risk and corporate governance reporting frameworks, the financial penalties, while substantial, could be and often are written off as part of the cost of doing business.<sup>17</sup>

There is, therefore, a triangulated policy dilemma. If major banks are too big to fail, too big to prosecute and too big to manage, how does one secure substantive warranted commitment to ethical restraint and pro-social rather than anti-social behaviour from such entities? One way of offsetting that limitation is to ensure that cultural change is ongoing through the imposition of an external monitor.<sup>18</sup> It is the application of this component of the regulatory toolbox that differentiates the Department of Justice's approach to HSBC. In section 2 the article examines the charges themselves, which draw heavily from the damning Senate Permanent Sub-Committee on Investigations report.<sup>19</sup> Section 3 details the remedial action taken by HSBC to date and that mandated by the deferred prosecution agreement. Given this cooperation, section 4 then examines how and why the department did not accept remedial action at face value but instead imposed an external monitor with granular terms of reference. Section 5 of the article assesses the implications of that decision on regulatory design. It argues that the deal represents not the Department's weakness, as broadly reported. Instead it reflects its growing strength. This strength has far-reaching consequences, not just in the United States but internationally. Section 6 concludes.

## 2 A flawed business model

HSBC was found on 11 December 2012 in the Federal Court in Brooklyn of being responsible for systematic sanctions violations and the facilitation of money laundering on an industrial scale. It was held accountable for threatening national security by providing financing facilities to a Saudi Arabian bank with links to terrorist groups.<sup>20</sup> The four-count charge found that the bank had wilfully failed to develop, implement and maintain an effective anti-money laundering programme in contravention of the Bank Secrecy Act of

17 This is made manifest in two highly influential if disparate sources, Lex, 'HSBC/StanChart—Rap on the Knuckles', *Financial Times*, 11 December 2012 (noting 'transgressions normally only become public a long time after the fact. Markets seem happy to view these latest as one-off episodes of ancient history.').; see also Matt Taibbi, 'Outrageous HSBC Settlement Proves the Drug War is a Joke', *Rolling Stone*, 11 December 2012 <[www.rollingstone.com/politics/blogs/taibblog/outrageous-hsbc-settlement-proves-the-drug-war-is-a-joke-20121213](http://www.rollingstone.com/politics/blogs/taibblog/outrageous-hsbc-settlement-proves-the-drug-war-is-a-joke-20121213)>.

18 Christie Ford and David Hess, 'Can Corporate Monitorship's Improve Corporate Compliance' (2009) 34 *Journal of Corporation Law* 679 (noting the danger that these are exercises in symbolism with 'monitors not conducting deep dives into the corporation's culture': at 737); see also Vikramaditya Khanna and Timothy Dickinson, 'The Corporate Monitor: The New Corporate Czar' (2007) 105 *Michigan Law Review* 1713 (noting the de facto creation of a new professional class of advisors and advocating allocation of fiduciary duty to shareholders: at 1727). The critical issue, therefore, pivots on willingness to use nascent power and to whom accountability is owed. There can be no mistaking the potential to gain effective control of corporate strategy. In 2006, for example, the corporate monitor installed at Bristol-Meyer Squibb advocated the sacking of the chief executive officer and the general counsel, recommendations accepted by the board, see Brooke Masters, 'Bristol-Meyers Ousts its Chief at Monitor's Urging', *Washington Post*, 13 September 2006, D1.

19 *US Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History* (n 1); see also Carl Levin, 'Levin Statement on HSBC Settlement', Press Release, Washington DC, 11 December 2012, noting: 'In an age of international terrorism, drug violence, and organized crime, stopping illicit money flows is a national security imperative. Global banks have global responsibilities to prevent participation in illicit or suspect transactions. The HSBC settlement sends a powerful wakeup call to multinational banks about the consequences of disregarding their anti-money laundering obligations. It also shows the value of congressional oversight in exposing wrongdoing and the ongoing need to hold banks accountable.'

20 *United States of America v HSBC Bank USA NA and HSBC Holdings Inc* 12 Cr 763 (EDNY, 11 December 2012) <[http://lib.law.virginia.edu/Garrett/prosecution\\_agreements/pdf/HSBC.pdf](http://lib.law.virginia.edu/Garrett/prosecution_agreements/pdf/HSBC.pdf)>. The online resource contains the charges, the text of the deferred prosecution, an agreed statement of facts and the terms governing the appointment of an external monitor. Hereafter these are referenced as 'United States Charges', 'Deferred Prosecution Terms', 'Attachment A: Statement of Facts' and 'Attachment B: Corporate Compliance Monitor'.



1970.<sup>21</sup> The legislation, progressively extended in both granularity and geographic scope over the years to address an increase in criminal money-laundering activities utilising financial institutions, requires regulated entities to detect and report suspicious activity. Furthermore they are required to maintain records that could be used in criminal, tax or regulatory investigations or court proceedings. The bank's failure to comply with anti-money laundering legislation was not historical. Rather the deficiencies encompassed the period January 2006–December 2010; a period that straddled the global financial crisis. In the same period it was charged that HSBC wilfully failed to conduct due diligence on correspondent bank accounts for non-United-States persons. Correspondent accounts are set up to make or receive payments from individuals or organisations with which the US-based bank has no direct relationship. Under the terms of the Bank Secrecy Act, HSBC Bank USA was required to conduct extensive due diligence on the financial institutions for which it held these correspondent accounts. Inexplicably, HSBC Bank USA failed to do so in relation to accounts held by its affiliate in Mexico, notwithstanding the fact that there is no exception for foreign financial institutions within the same holding company. This, the count charged, inhibited the collection of material, which would have reasonably allowed for the detection and reporting of instances of money laundering and other suspicious activity.<sup>22</sup>

The risk posed by initial failure to conduct the due diligence on the establishment of the accounts was magnified by an ongoing failure to monitor wire transfers within and between them. It was further compounded by the absence of anti-money laundering protocols in the HSBC Mexico operation itself. The combination was rendered catastrophic for the parent company by its use of vertical reporting lines. This meant that HSBC Bank USA was not directly informed of growing unease of regulatory, diplomatic and law enforcement agencies on both sides of the Rio Grande about a rapid expansion of money laundering across the Mexican banking sector and in which HSBC Mexico played a pivotal if unwitting role. The money-laundering charges were conjoined with two counts dealing with sanctions violation. The third count charged violations of the International Emergency Economic Powers Act of 1977.<sup>23</sup> Between 2001 to 2006 HSBC 'knowingly, intentionally and willfully facilitated prohibited transactions for sanctioned entities in Iran, Libya, Sudan and Burma'. HSBC knowingly and willingly circumvented government safeguards designed to block terrorist funding, allowing, for example, affiliates to shield the fact that thousands of transactions involved links to Iran. The Senate investigation suggested the problem was even more widespread. An independent audit paid for by HSBC found the bank facilitated 25,000 questionable transactions with Iran between 2001 and 2007.<sup>24</sup> The report also detailed that HSBC worked extensively with Saudi Arabia's Al Rajhi Bank, some owners of which have been linked to terrorism financing. HSBC's US affiliate supplied Al Rajhi with nearly \$1bn-worth of US banknotes until 2010, and worked with two banks in Bangladesh linked to terrorism financing. The fourth count charged that HSBC had engaged in similar activity in relation to Cuba in violation of the Trading with the Enemy Act of 1917.<sup>25</sup>

The reputational damage to HSBC comes primarily, however, from the first two counts, not least because of the immediate cost of the drugs war on American society.<sup>26</sup> Astonishingly, the failure of the compliance policies and procedures is estimated to have caused at least \$881m in drug proceeds to filter through the United States financial

21 31 USC 5311–32.

22 The United States Charges (n 20) 11.

23 50 USC 1702.

24 *US Vulnerabilities to Money Laundering, Drugs and Terrorist Financing: HSBC Case Study* (n 1) 6.

25 12 USC §95aff.

26 It is this aspect of the case that has dominated media coverage, see, for example, Taibi (n 17).

system.<sup>27</sup> This was primarily achieved through the preference of drug cartels to use HSBC Mexico as a conduit for what was termed the 'Black Market Peso Exchange',<sup>28</sup> going as far as designing special containers that fit precisely under the teller windows installed across the bank's branch network. Building on an investigation launched in 2008 by the Department of Homeland Security into how HSBC Bank USA had been compromised, the litigation paints a dismal picture of wilful neglect at national and international levels within the bank.<sup>29</sup> When read in conjunction with the detailed congressional investigation, the Statement of Facts reveals how the cartels operated with apparent impunity.<sup>30</sup> Together, as highlighted above, they point to significant flaws in the entire HSBC business model.

The inability of HSBC, the London-headquartered self-styled world's local bank, to know how its affiliates were operating in critical markets does more than puncture a marketing myth. It also demonstrates the limited power that compliance departments at both national and broader group levels had to influence strategic direction. In operating on a franchise basis, rebranding foreign acquisitions without necessarily changing their culture or integrating them fully into global template, the bank institutionalised a silo approach to corporate governance and risk management. A senior London-based compliance officer noted the risk and likely result in discussions with a counterpart in Mexico as late as 2008,<sup>31</sup> six years after HSBC's acquisition of Grupo Financiero Bital in 2002, at the time the

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27 The United States Charges (n 20) 9–12.

28 Attachment A: Statement of Facts (n 20) para 49: 'In the BMPE, middlemen, often referred to as peso brokers, transform bulk cash from the sale of illegal drugs into revenue from the sale of legitimate goods. In this process, the peso brokers purchase bulk cash in United States dollars from drug cartels at a discounted rate, in return for Colombian pesos that belong to Colombian businessmen. The peso brokers then use the U.S. dollars to purchase legitimate goods from businesses in the United States and other foreign countries, on behalf of the Colombian businessmen. These goods are then sent to the Colombian businessmen, who sell the goods for Colombian pesos to recoup their original investment. In the end, the Colombian businessmen obtain U.S. dollars at a lower exchange rate than otherwise available in Colombia, the Colombian cartel leaders receive Colombian pesos while avoiding the costs associated with depositing U.S. dollars directly into Colombian financial institutions, and the peso brokers receive fees for their services as middlemen.'

29 Ibid, para. 50: 'The Department alleges, and HSBC Bank USA and HSBC Holdings do not contest, that, beginning in 2008, an investigation conducted by HSI's El Dorado Task Force, in conjunction with the U.S. Attorney's Office for the Eastern District of New York, identified multiple HSBC Mexico accounts associated with BMPE activity. The investigation further revealed that drug traffickers were depositing hundreds of thousands of dollars in bulk U.S. currency each day into HSBC Mexico accounts. In order to efficiently move this volume of cash through the teller windows at HSBC Mexico branches, drug traffickers designed specially shaped boxes that fit the precise dimensions of the teller windows. The drug traffickers would send numerous boxes filled with cash through the teller windows for deposit into HSBC Mexico accounts. After the cash was deposited in the accounts, peso brokers then wire transferred the U.S. dollars to various exporters located in New York City and other locations throughout the United States to purchase goods for Colombian businesses. The U.S. exporters then sent the goods directly to the businesses in Colombia . . . The investigation further revealed that, because of its lax AML controls, HSBC Mexico was the preferred financial institution for drug cartels and money launderers. The drug trafficking proceeds (in physical U.S. dollars) deposited at HSBC Mexico as part of the BMPE were sold to HSBC Bank USA through Banknotes. In addition, many of the BMPE wire transfers to exporters in the United States passed through HSBC Mexico's correspondent account with HSBC Bank USA.'

30 For analysis of the Congressional investigation and HSBC's response, see Justin O'Brien, 'Where the Buck Stops', *Australian Financial Review*, 27 July 2012, R1, 14–15.

31 Ibid para 34, noting that in July 2007, a senior compliance officer at HSBC Group told HSBC Mexico's Chief Compliance Officer that: '[t]he AML committee just can't keep rubber-stamping unacceptable risks merely because someone on the business side writes a nice letter. It needs to take a firmer stand. It needs some cojones. We have seen this movie before, and it ends badly.'

country's fifth biggest bank, with 1400 branches and 6m customers.<sup>32</sup> The catalogue of failure within and between the disparate components of HSBC as outlined in the agreed Statement of Facts is as extensive as it is shocking.

Specifically, HSBC Bank USA ignored the money laundering risks associated with doing business with certain Mexican customers and failed to implement a BSA/AML program that was adequate to monitor suspicious transactions from Mexico. At the same time, Grupo Financiero HSBC, S.A. de C.V. ('HSBC Mexico'), one of HSBC Bank USA's largest Mexican customers, had its own significant AML problems. As a result of these concurrent AML failures, at least \$881 million in drug trafficking proceeds, including proceeds of drug trafficking by the Sinaloa Cartel in Mexico and the Norte del Valle Cartel in Colombia, were laundered through HSBC Bank USA without being detected. HSBC Group was aware of the significant AML compliance problems at HSBC Mexico, yet did not inform HSBC Bank USA of these problems and their potential impact on HSBC Bank USA's AML program.<sup>33</sup>

The identified problems started within the Mexican operation. Despite the fact that the Mexican financial regulatory authority, the Comision Nacional Bancaria y Valores (the CNBV), had flagged its concerns in external reviews, which were, in turn, escalated to the chief executive officer of HSBC Holdings, no integrated approach on how to rank country risk was initiated.<sup>34</sup> Notwithstanding growing national and international concern about the rise of drug trafficking in and through Mexico, HSBC Bank USA maintained a risk ranking of 'standard'. This was the lowest rated risk. It meant that the accounts were given only cursory examination.<sup>35</sup>

Given the critical financial relationship between HSBC Mexico and its counterpart in the United States and awareness in both jurisdictions as well as headquarters in London of how the Mexican financial system was used as a global money-laundering gateway, this amounted to a reckless disregard towards risk management. Over \$200trn in wire transfers passed between HSBC Bank USA and its global affiliates, with \$659bn coming from Mexico alone. The risk was not confined, however, to the retail bank operation. The systemic risk was magnified by the fact that HSBC's global banknotes operation, headquartered in New York, is the largest volume trader of physical currency in the world, controlling 60 per cent of the market.<sup>36</sup> \$9.4bn in physical banknotes were purchased from accounts linked to the Mexican operation in the period July 2006–July 2009 alone. The bank derived its revenue from commissions on the sale or purchase of physical dollars and its transportation and storage at the Federal Reserve. The Statement of Facts notes, however, that the banknotes compliance operation was not only almost ludicrously understaffed. It also lacked an automated monitoring function.<sup>37</sup> Throughout this period the bank, while aware of the risk, failed to 'provide adequate staffing and other resources to maintain an effective anti-money laundering program'.

32 Ibid: 'At the time of the acquisition, HSBC Group's Head of Compliance acknowledged there was "no recognizable compliance or money laundering function in Bital at present." HSBC Group Compliance believed it would take one to four years to achieve its required AML standards at HSBC Mexico. However, until at least 2010, HSBC Mexico's AML programme was not fully up to HSBC Group's required AML standards for HSBC Group Affiliates.' para 30.

33 O'Brien (n 30) para 9.

34 Ibid para 31.

35 Ibid para 18. The Statement of Facts further notes that 'from 2006 until May 2009, when HSBC Bank USA raised Mexico's risk rating to high, over 316,000 transactions worth over \$670 billion from HSBC Mexico alone were excluded from monitoring in the CAMP system': at para 19.

36 O'Brien (n 30) para 20.

37 Ibid para 22.



The clear inference is that such were the profits deriving from the operation it was not in the interests of HSBC, at any level, to investigate much less close suspicious accounts. According to the Statement of Facts the problems were addressed only on receipt of a cease and desist order issued by the Federal Reserve and the Office of the Comptroller of the Currency in October 2010.<sup>38</sup> Although the filing of the criminal charges and their subsequent deferral relate only to anti-money laundering control violations in relation to Mexico, the statement of facts makes clear that the nature of HSBC and its geographic exposure constituted an inherent risk. It sets out that 'HSBC Group Affiliates conducted business in many high-risk international locations, including regions of the world presenting a high vulnerability to the laundering of drug trafficking proceeds'.<sup>39</sup> This speaks directly to the possibility of broader systemic risks. Unstated in the report but clearly inferred is that HSBC's failure in relation to Mexico may well be only the tip of the iceberg.

In this regard two factors in relation to the HSBC settlement warrant significant attention. First, the scale of the HSBC disgorgement and civil penalties fine sends an unambiguous message that materiality is increasing. As the *Financial Times* has noted, 'a billion here, a billion there and pretty soon you are talking about serious money'.<sup>40</sup> Second, the fine is the least of HSBC's concerns in relation to its ongoing corporate governance and risk evaluation. The imposition of an external monitor sends an unambiguous message that the bank's commitment to reform should not be taken at face value. Before exploring the rationale, terms and implications, it is essential to highlight the extent to which HSBC has already transformed the compliance function.

### 3 Remedial action

HSBC has done much to improve the quality of its internal governance, including recruiting former heavyweights from the Department of Justice, Treasury and the Department of Homeland Security to pivotal management positions. The newly appointed chief legal officer, Stuart Levey, in particular, was an inspired choice. He was recruited to the bank direct from the US Department of Treasury, where he had developed a formidable reputation as Under Secretary for Terrorism and Financial Intelligence. As HSBC's chief legal officer, Levey flagged many of the remedial actions taken by the bank in an assured performance to the Senate Sub-Committee on Investigations in July:

While our old model served us well historically, it does not work in an interconnected world where transactions cross borders instantaneously and where weaknesses in one jurisdiction can be quickly exported to others . . . We have learned that our approach to compliance – and AML in particular – was not adequate to address the risks we face as a global institution. And we have learned that we did not share information effectively enough across our affiliates, with

38 O'Brien (n 30) para 11. Although the OCC is the recipient of a \$500m fine it is important to note significant unease over its monitoring operations, see *US Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History* (n 1) 316. Specifically, the Senate report into the Mexican operation is as critical of the OCC as it is of HSBC itself: 'For more than six years, from July 2004 until April 2010, despite compiling a litany of AML deficiencies, the OCC never cited HBUS for a violation of law, never took a formal or informal enforcement action, and turned down recommendations to issue Cease and Desist Orders targeting particularly egregious AML problems, even though the same problems surfaced again and again. The OCC's failure to compel HBUS to remedy the AML deficiencies repeatedly identified by its examiners over a six-year period indicates that systemic weaknesses in the OCC's AML oversight model require correction.'

39 Attachment A: Statement of Facts (n 20) para 12.

40 Editorial, 'Paying the Price for the Banks' Mistakes', *Financial Times*, 11 December 2012 <[www.ft.com/intl/cms/s/0/7e97873a-43a1-11e2-a48c-00144feabdc0.html#axzz2F4BqZ9tM](http://www.ft.com/intl/cms/s/0/7e97873a-43a1-11e2-a48c-00144feabdc0.html#axzz2F4BqZ9tM)>.

serious consequences . . . We must implement a global strategy to tackle the root causes of our identified deficiencies.<sup>41</sup>

These deficiencies centred on the fact that at a global level compliance served an advisory rather than a control function, which had neither the resources or empowerment to provide a monitoring function. Responsibility for ensuring that standards were being implemented was delegated to country level. As the bank now acknowledges 'this led to inconsistency and in some cases confusion about ownership and escalation responsibility'. In candid testimony to Congress, Levy detailed how he negotiated the job parameters: 'In our conversations, the Chairman of the Board and the new CEO were candid with me about the problems HSBC faced, the reforms they wanted me to help them implement, and the empowerment that I would need and have', he said. It appears he has now that power.<sup>42</sup> Group Compliance is empowered to set standards across the organization and now has the necessary authority to reach down into affiliates and ensure that those standards are being met . . . The work we have undertaken is ambitious and complicated given our size and our global footprint, but we all recognize that it must be done', he told a receptive audience on Capitol Hill.<sup>43</sup> The work plan centres on the creation of four core business units – global markets and banking; commercial banking; private banking and retail banking; and wealth management.

We gave the heads of each business and function the authority over all personnel in their respective organizations all over the world, thus creating the ability to manage their business or function on a global basis, making it easier to implement consistent policies, standards, and processes [he said]. What that means is that the most senior people responsible for managing HSBC globally sit around a table every month, look at our risks, and make decisions . . . Better global integration makes us better situated today to manage our risk on a global basis, better able to see where risk in one part of HSBC may impact another part, and better able for the first time to ensure that consistent compliance standards and practices are implemented across all of our affiliates.<sup>44</sup>

It is a laudable vision but one that cannot be vouchsafed without external review and validation. The Department of Justice has itself praised the level of cooperation. Significantly, however, in sharp contrast to prior cases involving sanctions violations (or the approach taken by the Securities and Exchange Commission in its non-prosecution deal with Goldman Sachs to trust the bank to reform), the Department of Justice has not taken HSBC's word for it. It is the fear that symbolism will trump substance that underpins the decision to appoint an external monitor. The terms governing the appointment are exceptionally revealing of the level of distrust. It is abundantly clear that the Department of Justice is, at best, sceptical of self-regulation. That scepticism has an explicit extra-territorial dimension and extends beyond the governance of the bank to the global markets in which it operates.

#### 4 The imposition of an external monitor

In December 2012 two different approaches to embedding restraint began to take shape as London-headquartered banks reflect on the exceptional power of the United States Department of Justice to shift cultural mores through the flexing of its prosecutorial discretion. Both provide tangible evidence of the Department's renewed interest in the

41 Stuart Levy, 'Written Testimony for Senate Permanent Subcommittee on Investigations' (US Congress, Washington DC, 17 July, 2012).

42 Ibid.

43 Ibid.

44 Ibid.

financial sector. HSBC is in the process of submitting to the Department of Justice a pool of three suitably qualified candidates to the position of independent compliance monitor, a pool that the Department can unilaterally reject.<sup>45</sup> Meanwhile Barclays, which reached a financial settlement in relation to its role in the Libor scandal in August without the imposition of an external monitor is also ruminating over its future. In December 2012 Barclays announced that it had recruited Hector Sants, the former chief executive of the Financial Services Authority as group head of compliance and government and regulatory relations. Given Sants' previous stated interest in and support for the necessity of regulating culture, the appointment serves as a litmus test for both the bank and his own credibility.<sup>46</sup>

The critical but unresolved question for the banks and regulatory authorities on both sides of the Atlantic as well as here in Australia is to what extent the imposition of an external monitor who reports to the regulator rather than the board reflects 'the new normal' – the theme of the upcoming Australian Securities and Investments Commission Annual Forum on international regulatory developments.<sup>47</sup> At its core this involves an adjudication of what constitutes the appropriate level of external oversight over ongoing corporate practice. As such it extends far beyond narrow issues of capitalisation. It focuses attention instead on the critical questions of how to ensure warranted trust in the operation of free markets while balancing more intrusive supervision with requisite levels of both expertise and accountability.<sup>48</sup> It also underscores the critical importance of evaluating when and on what basis these decisions are made. Notwithstanding their prevalence, there is a remarkable lack of consistency in the application of the use of a deferred prosecution, the size of the fine and whether an external monitor is imposed. A database compiled by the University of Virginia Law School reveals that of 258 negotiated prosecutions, involving either a deferred or non-prosecution 79 have imposed an external monitor: 21 in the case of non-prosecution deals and 58 in which the prosecution is deferred.<sup>49</sup> Of the total, 56 have involved firms in

45 Attachment B: Corporate Compliance Monitor (n 20) para 1.

46 Barclays Bank, 'Barclays Appoints Sants As Head of Compliance and Government and Regulatory Relations', Press Release, London, 13 December 2012 <<http://group.barclays.com/news/news-article/1329927766649>>. In the period 2009–2010, Sants made three influential speeches on how to design, legitimate and implement regulatory initiatives surrounding the embedding of cultural restraint; see Hector Sants, 'Delivering Intensive Supervision and Credible Deterrence', Speech delivered at the Reuters Newsmaker Event, London, 12 March 2009, at 2, noting: 'The limitation of a pure principles-based regime have to be recognized. I continue to believe the majority of market participants are decent people; however a principles-based approach does not work with people who have no principles.'; Hector Sants, 'Annual Lubbock Lecture in Management Studies', Speech delivered at Said Business School, University of Oxford, 12 March 2010, noting: 'We need to answer the question of whether a regulator has a legitimate focus to intervene on the question of culture. This arguably requires both a view on the right culture and a mechanism for intervention . . . My personal view is that if we really do wish to learn lessons from the past, we need to change not just the regulatory rules and supervisory approach, but also the culture and attitudes of both society as a whole, and the management of major financial firms. This will not be easy. A cultural trend can be very widespread and resilient – as has been seen by a return to a "business as usual" mentality. Nevertheless, no culture is inevitable.'; and Hector Sants, 'Can Culture Be Regulated', Speech delivered at the Ethics and Values in the City Conference, London, 5 October 2010, noting: 'The regulator must focus on the actions a firm takes and whether the board has a compelling story to tell about how it ensures it has the right culture that rings true and is consistent with what the firm does.'

47 In the interests of full disclosure, this author is a keynote speaker (although his address centres on the historical underpinnings of the rationale for intervention).

48 See Morford (n 2) 5: the Department of Justice clearly differentiates the role of the monitor, arguing that the 'monitor is not responsible to the corporation's shareholders. Therefore, from a corporate governance standpoint, responsibility for designing an ethics and compliance program that will prevent misconduct should remain with the corporation, subject to the monitor's input, evaluation and recommendations.'

49 All data sourced from Brandon L Garrett and Jon Ashley, *Federal Organizational Prosecution Agreements*, University of Virginia School of Law <[http://lib.law.virginia.edu/Garrett/prosecution\\_agreements/home.suphp](http://lib.law.virginia.edu/Garrett/prosecution_agreements/home.suphp)>.

the financial sector.<sup>50</sup> Of these an independent monitor has been imposed 14 times, equally split between both non-prosecution<sup>51</sup> and deferred cases.<sup>52</sup> When the decision is made to impose a monitor, however, the terms and conditions follow a generic template.<sup>53</sup> The Department of Justice has also sought to impose consistency in how the monitors operate with the public release of guidance to individual prosecutorial units.<sup>54</sup> The HSBC requirement to subject itself to an external monitor flows precisely within those guidelines.

50 Salomon Brothers (jurisdiction not specified; 1/5/92; NPA); John Hancock Mutual Life (Massachusetts; 22/3/94; NPA); Prudential Securities (NY-Southern; 27/10/94; DPA); Lazard Freres (Massachusetts; 26/10/95; NPA); Arthur Andersen (Connecticut; 17/4/96; DPA); Coopers & Lybrand (jurisdiction not specified; 1/10/96; NPA); Credit Lyonnais (California—Central; 7/6/99; NPA); JB Oxford Holdings, Inc. (California—Central; 14/2/00; NPA); HSBC (NY—Southern; 1/12/01; NPA); BDO Seidman (Illinois—Southern & USDOJ Criminal; 12/4/02; DPA); Banco Popular de Puerto Rico (Puerto Rico; 16/1/03 DPA); Bank of New York (NY—Southern and Eastern; 27/5/03; NPA); PNC Financial (Pennsylvania—Western & USDOJ—Criminal; 1/6/03; DPA); Merrill Lynch (USDOJ—Enron; 17/10/03; NPA); Canadian Imperial Bank of Commerce (USDOJ—Enron; 22/12/03; DPA); AmSouth Bancorp (Mississippi—Southern; 12/10/04; DPA); American International Group (AIG-IP PAGIC Equity Holding Company & AIG Financial Products) (Pennsylvania—Western & USDOJ—Criminal; 1/11/04; DPA); Edward D Jones (Missouri—Eastern; 1/12/04; DPA); KPMG (NY-Southern; 26/10/05; DPA); HVB (NY-Southern; 1/2/06); American International Group (USDOJ—Criminal; 7/2/06; NPA); BankAtlantic (Florida—Southern; 25/4/06); BAWAG psk (NY-Southern; 2/6/06; NPA); Mellon Bank, NA (Pennsylvania—Western; 14/8/06; NPA); Prudential Equity Group (Massachusetts; 28/8/06; NPA); Electronic Clearing House (ECHO) Inc. (NY—Southern; 27/3/07; NPA); Omega Advisors (USDOJ—Criminal Division & NY Southern; 5/7/07; NPA); United Bank for Africa (NY-Southern; 6/7/07; NPA); NETeller plc (NY-Southern; 17/7/07; DPA); American Express Bank Intl (USDOJ—Criminal; 6/8/07; DPA); Union Bank of California (USDOJ—Criminal; 17/10/07; DPA); Sigue (USDOJ—Criminal; 23/1/08; DPA); Unum Group (California—Southern; 1/6/08; NPA); Lloyds TSB Bank plc (USDOJ—Criminal; 22/12/08; DPA); UBS AG (Florida—Southern; 18/2/09; DPA); Credit Suisse AG (USDOJ—Criminal; 16/12/09; DPA); General Reinsurance (USDOJ—Criminal; 18/1/10; NPA); Wachovia (Florida—Southern & USDOJ—Criminal; 16/3/10; DPA); Metropolitan Life Insurance Company (California—Southern; 15/4/10; NPA); AllianceOne (USDOJ—Criminal; 6/8/10; DPA); Barclays Bank (USDOJ—Criminal; 16/8/10; DPA); Deutsche Bank AG (NY-Southern and USDOJ—Tax; 21/12/10; NPA); Baystar Capital Management LLC (California—Northern; 1/3/11; DPA); Community One Bank (North Carolina—Western and USDOJ—Criminal; 1/5/11; NPA); UBS AG (USDOJ—Antitrust; 4/5/11; NPA); JPMorgan Chase & Co (USDOJ—Criminal; 6/7/11; NPA); Ocean Bank (Florida—Southern; 12/8/11; DPA); Islamic Investment Cos. Of the Gulf (Bahamas) Ltd (USDOJ—Tax; 12/8/11; NPA); Wachovia Bank NA (USDOJ—Antitrust; 6/12/11; NPA); Aon Corp (USDOJ—Criminal; 20/12/11; NPA); GE Funding Capital Markets Services Inc (USDOJ—Antitrust; 23/12/11; NPA); Diamondback Capital Management LLC (NY-Southern; 20/1/12; NPA); Imperial Holdings Inc. (New Hampshire; 30/4/12; NPA); BDO USA LLP (NY—Southern & USDOJ Tax; 6/6/12; DPA); ING Bank NV (USDOJ—National Security & Criminal Division; 12/6/12; DPA); Barclays Bank (USDOJ—Criminal; 26/6/12; NPA).

51 Coopers & Lybrand (obtaining confidential bid information and lying to grand jury); JB Oxford Holdings, Inc (securities fraud; failure to disclose activities and beneficial ownership); Bank of New York (money laundering; unlicensed money transfers; no anti-money laundering programme); Merrill Lynch (false statements; aided and abetted Enron); American International Group (misstatements in periodic financial reports; Bank Secrecy Act; failure to maintain effective anti-money laundering programme); Mellon Bank NA (theft of government property; theft of mail matter; conspiracy); Deutsche Bank AG (tax evasion).

52 The deferred prosecutions requiring an external monitor comprise Prudential Securities (fraud in sale of partnership interests – \$330m settlement with SEC; 3 years); Canadian Imperial Bank of Commerce (aided and abetted accounting fraud by Enron – \$80m settlement with SEC; 3 years); American International Group (violations of antifraud provisions and aiding and abetting violations of reporting and record keeping – \$80m settlement with Department of Justice); KPMG (tax fraud; conspiracy to defraud IRS; tax evasion – \$466m settlement with Department of Justice (\$128m disgorgement of fees; \$228m restitution to IRS; \$100m fines to IRS); 3 years); NETeller plc (conspiracy to conduct an illegal gambling business; failure to maintain an anti-money laundering programme – \$136m forfeiture: 2 Years); Lloyds TSB Bank plc (knowing and wilful violations of International Emergency Economic Powers Act – \$175m forfeiture to Department of Justice; 2 years); AllianceOne (violation of Foreign corrupt Practices Act – no fine; 3 years).

53 The requirements and language used to describe those requirements are almost identical to those used in cases against Bionet and Smith & Nephew.

54 See Morford (n 2).

'To the extent that HSBC Holdings' compliance with obligations as set forth below requires it, HSBC Holdings agrees to require that its wholly-owned subsidiaries comply with the requirements and obligations set forth below, to the extent permissible under locally applicable laws and regulations, and the instructions of local regulatory agencies', runs the opening paragraph of the job description for the position of corporate compliance monitor.<sup>55</sup> The position is a fixed term for five years, at the end of which HSBC must sever ties with the monitor for at least one year. The role is to evaluate the effectiveness of the internal controls, policies and procedures of the holding company and its subsidiaries in relation to both anti-money-laundering legislation and the remedial action taken in response to the identified failures. An initial report is required within 90 calendar days of the appointment, which itself is mandated within 60 days of the agreement. Four additional reviews are to be conducted on an annual basis, unless the agreement is either terminated or rendered moot because a further material breach triggers immediate indictment.

The reports are to be contemporaneously submitted to the Board of Directors of HSBC Holdings and the Chief of the Asset Forfeiture and Anti-Money Laundering Section of the Criminal Division, the address of which is helpfully provided, as well as to the Federal Reserve and the Financial Services Authority in London. Interestingly, however, the Financial Services Authority is not given any defined right to engage with the monitor, nor are any of the other parties to the agreement.<sup>56</sup> This is the Department of Justice's show. Although HSBC can identify and propose the candidate, the Department of Justice retains a veto over the appointment and the procedures governing the production of her reports. The arms-length terms as they relate to HSBC are explicit. The appointee cannot have had a material association with the bank. They are less clear-cut in relation to the Department of Justice itself. It does not have to justify its preference beyond ensuring that the appointee is regarded as having requisite if generically explained expertise.<sup>57</sup> Once appointed, the independent monitor has the capacity to utilise enormous leverage from the Department of Justice. At stake here, therefore, is not just the credibility of the monitor but also the Department.<sup>57a</sup>

55 Attachment B: Corporate Compliance Monitor (n 20) para 1.

56 The Financial Services Authority has separately agreed that HSBC should establish an anti-money-laundering/sanctions compliance board level committee, review policies and procedures and notes the employment of an independent monitor who is to communicate to the board and to regulators, see Financial Services Authority, 'FSA Requires Action of the HSBC Group', Press Release, London, 13 December 2012.

57 Deferred Prosecution Agreement (n 20) para 9: 'demonstrated expertise with regards to the Bank Secrecy Act; demonstrated expertise in the design and review of corporate compliance policies, procedures and internal controls; the ability to access and deploy resources as necessary to discharge duties and sufficient independence from HSNB Holdings to ensure effective and impartial performance'. For examination of how monitors carry out their roles, see Khanna and Dickinson (n 18) 1725–31 (noting that most tend to be former prosecutors); see also David Hess and Cristie Ford, 'Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem' (2008) 41 Cornell International Law Journal 307, at 341 (noting the importance of industry experience, the necessity of being 'structurally and psychologically independent from the corporation' and having 'own reputational capital at stake'); see also Cristie Ford, 'Towards a New Model for Securities Law Enforcement' (2005) 57 Administrative Law Review 757, at 797–802 (noting the emergence of the monitor as an agent of behavioural change).

57a In December 2012 the American Bar Association announced the formation of a working group to draw up a set of best-practice principles governing how monitorship should operate, see 'ABA Launches Taskforce on Corporate Monitors', *Corporate Crime Monitor*, 5 December 2012 <[www.corporatecrimereporter.com/news/200/abacorporatemonitortaskforce12052012/](http://www.corporatecrimereporter.com/news/200/abacorporatemonitortaskforce12052012/)>. The taskforce includes Larry Thompson, the former Deputy Attorney General, who rapidly expanded the use of deferred prosecution (see n 15) and Mary Jo White, the former District Attorney Southern District of New York, who pioneered the extension of the mechanism in the prosecution of Prudential Securities in 1994 (n 50).

The symbiotic nature of the relationship is explicitly spelt out in the terms of the negotiated settlement. The monitor has the right to report any difficulties associated with gaining access to sensitive material, with the Department having the right to make a final determination on what should be disclosed without reference to further external adjudication. The monitor, although ostensibly independent, is unquestionably, therefore, an agent of the Department. On an ongoing basis the work plan for conducting the evaluations of policies, procedures and remedial action, must be submitted to and approved in advance by the Department. Moreover, 'any disputes between HSBC Holdings and the Monitor with respect to the work plan shall be decided by the Department in its sole discretion'.

Although the monitor is encouraged to work closely with HSBC in the preparation of the reports, the bank itself lacks the discretion on whether to implement any recommendation unless considered 'unduly burdensome, inconsistent with local or other applicable law or regulation, impractical, costly or otherwise inadvisable'. In such an event the bank has to provide reasons for the objections 'and shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose'. The parties are then given 30 days to reach an agreement.

In the event HSBC Holdings and the Monitor are unable to agree on an acceptable alternative proposal, HSBC Holdings shall promptly consult with the Department, which will make a determination as to whether HSBC Holdings should adopt the Monitor's recommendation or an alternative proposal, and HSBC Holdings shall abide by that determination.<sup>58</sup>

Moreover, the Department is to be informed if in the course of the monitor's investigation of the efficacy of internal controls, policies and procedures improper conduct or a material violation of the law is uncovered as well as reporting such activity directly to the bank's chief legal officer. This can be bypassed if deemed appropriate by the monitor. The whistle-blowing protection is further embedded in the contractual terms as 'HSBC Holdings shall not take any action to retaliate against the Monitor for any such disclosures or any other reason'.<sup>59</sup> The Department of Justice recognising that the information contained in the compliance monitors reports may include 'proprietary, financial, confidential, and business information' has agreed, in principle, to keep the reports classified.<sup>60</sup> Public disclosure 'could discourage cooperation, impede impending or potential government investigations and thus undermine the objectives of the Monitorship'.<sup>61</sup> Even here, however, the Department can override the commitment to confidentiality if it 'determines in its sole discretion that disclosure would be in furtherance of the Department's discharge of its duties and responsibilities or is otherwise required by law'.<sup>62</sup>

Taken together the provisions governing the appointment and ongoing work of the monitor reflect an unparalleled extension of external oversight. As such they allay judicial

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58 Attachment B: Corporate Compliance Monitor (n 20) para 5.

59 Ibid para 8

60 Ibid.

61 Ibid.

62 Ibid para 9.



suspicion about limited exercise of discretion.<sup>63</sup> Just as significantly they transfer knowledge directly to the Criminal Division of the Department of Justice, whose remit is governed by very different imperatives than prudential or market conduct regulators. A new cop is on the beat and making its presence felt. Those drinking in the last chance saloon are on notice that anti-social behaviour orders have been written and will be applied in the event of further infractions. It is not before time. The challenge for the Department of Justice, however, is to exercise its enhanced power with restraint and within accountable boundaries. If not, the regulatory cycle will turn once more, with accusations of overreach and unconstitutionality replacing quiescence in the creation of robust external oversight.

## 5 The policy implications

The external monitor at HSBC holds what Lanny Breuer describes as a ‘Sword of Damocles’ over the bank. It also applies to the Department of Justice itself. Future violations will automatically trigger the criminal conviction and could produce the very outcome the settlement is designed to avoid.<sup>64</sup> Equally, the application of external stewardship can have far-reaching consequences. In the aftermath of the settlement, the HSBC share price rose marginally, reflecting a degree of closure. If anything, however, the sword is even more delicately poised. As with the global media industry in the aftermath of the Leveson Inquiry in the UK<sup>65</sup> and its facsimile in Australia,<sup>66</sup> however, the banking sector is drinking in the last chance saloon as a consequence of the burgeoning Libor scandal.

Compliance or cultural problems within a single bank, no matter how serious, can be contained by one of three methods. First, the company can adopt voluntary structural reform, an approach initially favoured by HSBC’s Stuart Levey but ultimately rejected by the

63 *SEC v Bank of America* 09 Civ. 6829 (SDNY, 14 September 2009) 8. Judge Jed Rakoff held ‘the proposed settlement in relation to claim that Bank of America had misled investors over the payment of bonuses to executives within Merrill Lynch is described as “a contrivance designed to provide the SEC with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry”’. Judge Rakoff reluctantly signed off on the settlement, citing judicial restraint but stating that the settlement was ‘half baked justice at best’, see *SEC v Bank of America* 09 Civ 6829 (SDNY, 22 February 2010) 14. Similar frustration has been voiced by Judge Ellen Segal Huvelle, who refused to endorse a \$75m fine agreed by Citigroup to settle charges that the bank had misled investors over its sub-prime exposure, see Kara Scannell, ‘Judge Won’t Approve Citi-SEC Pact’, *Wall Street Journal*, 17 August 2010, B1: ‘I look at this and say, “Why would I find this fair and reasonable” . . . You expect the court to rubber stamp, but we can’t.’ See generally, Binyamin Appelbaum, ‘US Judges Sound Off on Bank Settlements’, *New York Times*, 23 August 2010, B1 (noting broader opposition to recent settlements proposed with Barclays, Citigroup and Bank of America). In a subsequent case taken against Citigroup, a firm Judge Rakoff described as a ‘recidivist’ offender, the District Court Judge refused to endorse the agreement. The judgment is currently under appeal, with the Securities and Exchange Commission describing it as unwarranted judicial interference on its discretion, see Securities and Exchange Commission, ‘Enforcement Director Statement on Citigroup Case’, Press Release, Washington DC, 15 December 2011. The UK intends to ensure that ‘a prosecutor is not entering into a “cosy deal” with a commercial organization behind “closed doors” by ensuring judicial oversight of the entire process’, Ministry of Justice (n 13) 21.

64 See Masters (n 18). For review of how individual corporations have fared post corporate prosecution, see Gabriel Markoff, ‘Arthur Andersen and the Myth of the Corporate Death Penalty: Corporate Criminal Prosecution in the Twenty First Century’ (2013 forthcoming) University of Pennsylvania Journal of Business Law, working paper available at <http://ssrn.com/abstract=2132242>. The paper notes that no publicly traded corporation convicted in the period 2001–2010 has failed, which suggests that corporate prosecutions should be privileged because of its inherently stronger demonstration effect: at 7. He does accept, however, that the deferred prosecution should be used in situations where ‘a prosecution might actually threaten a company’s survival’: at 44. Arguably banks are in this position.

65 Lord Justice Brian Leveson, *An Inquiry into the Culture, Practices and Ethics of the Press* (The Stationery Office 2012) <[www.official-documents.gov.uk/document/hc1213/hc07/0780/0780.asp](http://www.official-documents.gov.uk/document/hc1213/hc07/0780/0780.asp)>.

66 Justice Raymond Finkelstein, *Independent Inquiry into Media and Media Regulation* (Australian Government, 2 March 2012).

Department of Justice. Secondly, one can, as Lanny Breuer of the Department of Justice has advocated, use a deferred prosecution to facilitate ‘a truly transformative effect on particular companies and, more generally, on corporate culture across the globe’.<sup>67</sup> Thirdly, if necessary, closure, an option advanced by Senator Carl Levin is available. When the identified problems extend to allegations of collusion between banks, however, the entire social construction of the market itself comes under scrutiny. The corruption of core stated values has reached an inflection point with the multifaceted international investigation now underway into price-fixing within Libor. As the influential UK Treasury Select Committee reported in August: ‘the standards and culture of Barclays, and banking more widely, are in a poor state. Urgent reform, by both regulators and banks, is needed to prevent such misconduct flourishing’.<sup>68</sup>

The now emboldened Department of Justice and, in particular, its Criminal Division under the direction of Lanny Breuer, is playing a pivotal role in these discussions. Its leveraging power in this and other cases is further strengthened by enhanced whistle-blowing legislation in the United States. In particular, the expansion of a bounty system for those willing to report improper, unethical conduct significantly increases the possibility that such conduct will be reported to external agencies.<sup>69</sup> The critical question then will not be on the strength of the legal claim but the calculation on whether the complained of conduct can be defended in the court of public opinion.

The reality of complex litigation is that when taking enforcement action regulatory agencies balance the effect of conviction with the political costs associated with bringing uncertain cases to trial.<sup>70</sup> Beyond the merits of an individual action, wider demonstration effect requires changing both the content and context of the underpinning regulatory regime.<sup>71</sup> First, the preparation of the case and its subsequent staging – including the critical initial presentation of the evidential base – needs to reconfigure media representations of what constitutes acceptable conduct, irrespective of the strength at law of the material claim. Precisely because trial strategies tend to bifurcate between competing (if partially understood) narratives that subsequently gain media traction, it is essential to ‘own’ the

67 Breuer (n 12).

68 Treasury Select Committee, *Fixing Libor: Some Preliminary Findings* (HM Parliament, London, 22 August 2012); see also O’Brien (n 30); and Editorial, ‘Banks Must Learn From Past Scandals’, *Financial Times*, 16 December 2012 <[www.ft.com/intl/cms/s/0/deb826ea-4600-11e2-b7ba-00144feabdc0.html#axzz2FRxBaPIj](http://www.ft.com/intl/cms/s/0/deb826ea-4600-11e2-b7ba-00144feabdc0.html#axzz2FRxBaPIj)> noting: ‘a new culture is required at the top of financial institutions’ precisely because ‘the desire to reinvent banking as a high-growth, high-return business has belied its true social function as a utility . . . This is not something that can be changed by a few rule-tweaks. It requires new direction and leadership.’ The problem, however, extends far beyond British banking as the investigation to UBS’s involvement and the \$1.5bn settlement makes clear (n 16).

69 Wall Street Reform and Consumer Protection Act of 2010 (Dodd–Frank), s 922; see also Securities and Exchange Commission, *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934* (Washington DC, 25 May 2011). Dodd–Frank also provides new enforcement tools to deal with fraud and manipulation in the futures, swaps and broader commodities markets by introducing a reckless standard (s 753), which reduces the scienter threshold from deliberate intent.

70 In an interview conducted in the aftermath of the Enron and WorldCom accounting scandals, Steve Cutler, then Director of Enforcement at the Securities and Exchange Commission, noted, the ‘reluctance on the part of federal prosecutors to take on complicated accounting fraud cases. These are very difficult cases and require lots of resources, lots of time, [are] difficult to explain to juries and that makes for a less than ideal track record as far as a prosecutor is concerned.’ Interview with Steve Cutler, Director of Enforcement, Securities and Exchange Commission (Washington DC, 11 May 2005).

71 A regulatory regime can be defined as the ‘complex of institutional [physical and social] geography, rules, practice and animating ideas that are associated with the regulation of a particular risk or hazard,’ see Christopher Hood, Henry Rothstein and Robert Baldwin, *The Government of Risk* (Oxford University Press 2001) 8.

media agenda.<sup>72</sup> Second, the litigation needs to be capable of recalibrating – without credible dissension – the broader policy reform agenda.<sup>73</sup>

This coupling is essential to ensure that neither judicial failure nor premature settlement will translate into an incremental erosion of wider support for the legitimacy of the regulator's operational imperatives.<sup>74</sup> As a consequence of Dodd–Frank along with public and judicial disquiet at the weakness of settlements, however, the calculation has changed. The agencies most poised to take advantage of looser *scienter* standards include the Commodity and Futures Trading Commission, which has spearheaded the investigation into Libor scandal. According to its head of enforcement, David Meister, the agency 'is looking to bring high impact cases that influence market behavior'.<sup>75</sup> The HSBC settlement is arguably, therefore, the most important and likely to be most influential on both regulator and regulated communities alike as a bargaining chip in this complex negotiation. The unresolved question is whether it is an outlier or reflects a determination to ensure ongoing substantive monitoring in order to prevent what the Assistant Attorney General Breuer terms the 'Sword of Damocles' now hanging over the banking sector from falling.<sup>76</sup>

## 6 Conclusion

All too often in the past banks have made empty promises at congressional hearings before going on to commit further violations, with monetary fines written off as the cost of doing business. In part HSBC's apparent conversion can be traced to narrow self-interest. Senator Carl Levin had warned that regulators must consider the ultimate sanction of bank charter revocation in the US if international banks fail to internally police deviance, the primary reason he endorsed the muscular action taken by the Department of Financial Services in New York.<sup>77</sup> In part, also, however, the HSBC response reflects an awareness of custodian and broader gatekeeper obligation, which if monitored effectively offers a potential model to transform.

The Department of Justice has recognised the value of such an approach but has made it clear that self-regulation can only work effectively if enforced. It feeds into a crisis that

72 See Janet Malcolm, 'Anatomy of a Murder Trial', *New Yorker*, 3 May 2010, 36. For application to financial crisis, see John Cassidy, 'Scandals', *New Yorker*, 3 May 2010, 21: 'Few things excite the public as much as financial scandals . . . the result is a barrage of news stories that most people do not fully understand but which create a widespread sense that some unprecedented skullduggery has been revealed and that villainous investment bankers will finally be held to account.'

73 Jonathan Nash, 'Framing Effects and Regulatory Choice' (2006) 82 *Notre Dame Law Review* 314.

74 For trenchant critique of the deferred prosecution as an abuse of process, see Richard Epstein, 'The Deferred Prosecution Racket', *Wall Street Journal*, 28 November 2006, A14 (arguing that the agreed statement of claims 'often read like the confessions of a Stalinist purge trial').

75 Stuart Gittleman, 'US Regulators Caution Financial Firms to Stay Alert for New Priorities, "Game Changers"', Thomson Reuters Accelus, 14 December 2012, <[www.complinet.com/global/news/news/article.html?ref=160823](http://www.complinet.com/global/news/news/article.html?ref=160823)>.

76 Dominic Ruse and Jill Treaner, 'HSBC's Record \$1.9bn Fine Preferable to Prosecution, US Authorities Insist', *The Guardian*, 11 December 2012 <[www.guardian.co.uk/business/2012/dec/11/hsbc-fine-prosecution-money-laundering](http://www.guardian.co.uk/business/2012/dec/11/hsbc-fine-prosecution-money-laundering)>. The Department of Justice imposed a non-prosecution agreement on UBS in large part because of the scale of cooperation and extent of management change, see Department of Justice, 'Assistant Attorney General Lanny Breuer Speaks at UBS Press Conference', Washington DC, 19 December 2012. It also, however, secured a guilty plea from UBS Securities Japan, the subsidiary at the heart of the deception, which will not invalidate UBS's US banking licence.

77 Carl Levin, 'Levin Statement on Standard Chartered Bank Settlement', Press Release, Washington DC, 15 August 2012). Levin argued that the settlement 'showed that holding a bank accountable for past misconduct doesn't need to take years of negotiation over the size of the penalty; it simply requires a regulator with backbone to act. New York's regulatory action sends a strong message that the United States will not tolerate foreign banks giving rogue nations like Iran hidden access to the US financial system.'

calls into question as never before both the activities of the banks and their regulators. Globally, the practical and conceptual underpinnings of financial regulation are being questioned as never before. The legitimacy problem is serious, pressing and structural. It is one we ignore at our peril. Following the banking scandals of 2012, it is unsustainable for regulation to be decided and implemented and monitored at a national level. As HSBC has acknowledged, global oversight has become an imperative to reduce the conflicts of interest that may create profitable industries, but not socially beneficial ones. The monitor, as custodian of that purpose, will play an essential validating role. As such, the Department of Justice has taken a first, if uncertain, step towards recognition of globalised agendas. It is an exploration to be welcomed, as much in New York and Washington as in London.