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Madness of JPMorgan's $13bn settlement

By Jacob Frenkel

It's a funny old world when a bank doesn't bother fighting a case it can win, says Jacob Frenkel

In ancient times, when gladiators did battle to arbitrary rules, a thumb up determined who lived and thumb down decided who died. The $13bn JPMorgan Chase has agreed to pay to end US government investigations into mortgage bond sales appears just as capricious.

In the depths of the financial crisis, when institutions looked about to crumple like gingerbread houses, regulators encouraged JPMorgan to provide limited life support to leading US banks: Bear Stearns and Washington Mutual. In doing so, they prevented a crisis turning into a catastrophe. As a thank you, the Department of Justice requires JPMorgan to pay a combined fine and penalty that is unwarranted and unprecedented. It is also harmful to law enforcement initiatives aimed at corporations and US capital markets.

What did JPMorgan buy for its $13bn? The price does not include any agreement to close criminal investigations. But it does include the right – no, the privilege – to assist prosecutors with investigations of former employees who helped create the mortgage instruments. Banks have been providing information to investigators for the past five years without noteworthy criminal cases arising.

Will criminal charges be brought against executives for their roles in JPMorgan's mortgage activities? No chance. Knowledge, unlike heat, does not always rise to the top. We have read about the call on the evening of Friday 18 October between Eric Holder, US attorney-general, and Jamie Dimon, JPMorgan chief executive, to break the logjam and settle the case. Prosecutors do not negotiate directly with potential targets or witnesses unless they want to be accused of ethics violations – or unless the price justifies different rules.

America is the most litigious society on earth, so why should the bank settle? Message to JPMorgan: go to trial. The cost would be significantly less in fees than even the $3bn the bank previously offered to settle. Many of us experienced former prosecutors would gladly take it to court. It would be a trial lawyer's dream: cross-examine all the senior government officials who grovelled on the marble floors of JPMorgan, begging it to save the US and take over Bear Stearns and WaMu. Imagine the theme of the bank's closing argument: "Ladies and gentlemen of the jury, the government is asking you to find liable and impose massive fines on this institution, which tried to help, not hurt, the American economy."

But why should a bank bother fighting a winnable case when it can just write a cheque and make it go away? The answer is that JPMorgan is willing to pay an exorbitant price to hear the words "investigations closed". Corporations cannot go to jail; better to pay and refocus on making money. Shareholders are footing the bill. It is not even clear the settlement will make amends to the homebuyers actually affected by the collapse in the property markets that accompanied the financial crisis. The settlement will ensure a group of political aspirants gather around a podium in Washington to take credit for holding accountable an institution willing to hand over billions rather than engage in defending investigations.

There is an interesting comparison with the case of Enron, which collapsed in 2002 amid a previous corporate crisis. For almost 10 years, the justice department overzealously used the honest services fraud statute to prosecute executives at the energy group and countless other corporations. Prisons housed many who either pleaded guilty or were convicted at trial. Jeffrey Skilling, Enron's former chief executive, appealed all the way to the Supreme Court, which ruled that prosecutors had applied the statute improperly.

For JPMorgan, prosecutors dusted off a different statute, which had been enacted in 1989 for the purpose of charging executives of failed financial institutions. Yes, that year, in response to a different crisis, Congress perceived such institutions as victims of fraudulent conduct by senior managers and adopted that law to protect the banks. This year, a federal district court judge found the same statute can now be applied against banks themselves. This novel application, by contrast with the honest services fraud statute, has not yet been tested in higher courts. With active civil cases against other banks in progress, the higher courts could still review this use of the law.

The effect, as seen by the rest of the world, is a suffocating regulatory environment. Exciting young companies that prefer not to pay irrational fines for corporate success could opt to stay away from the land of opportunity. And, as the Securities and Exchange Commission competes to escalate its fines to new heights, public companies may consider going private or relocating.

Settlements such as JPMorgan's weaken rather than strengthen the financial system. They are counterproductive. It is time for Washington to encourage financial institutions and market innovators to lead and stop causing them to bleed.

The writer is a partner at the Shulman Rogers law firm, a former SEC enforcement lawyer and former federal criminal prosecutor of public corruption and securities

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