CHAPTER 1

THE COMPONENTS OF THE LAW OF FINANCE

CORE PRINCIPLES

The law of finance in England and Wales derives from a number of sources: EU directives, Acts of the UK Parliament, and the general, substantive law of England and Wales as applied to the law of finance. In this book, "finance" is to be understood as being "the wherewithal to act". It is significant that the subject matter of financial transactions is intangible (i.e. it cannot be touched or held) and therefore this poses a number of challenges to traditional legal concepts. Furthermore, the financial system depends on the confidence of its largest participants to continue in existence precisely because its subject matter has no tangible existence. This facet of the financial system was illustrated most starkly by the global financial crisis of 2007–09, as discussed in Chapter 45.

There are seven different aspects to finance as it should be understood from a lawyer's perspective. That is, in spite of the way in which financiers might have understood their activities, it is important that the law of finance understands those markets and those transactions in terms of its own legal categories. Thus, *Section Two* of this book is divided between traditional banking; lending; stakeholding (including shareholding); speculation; refinancing; proprietary finance; and communal investment. Each category involves different core legal *concepts* being applied in particular *contexts*: whether in the form of contract law, property law, tort law, equity, public law or criminal law.

Finance must be understood as being predicated on *risk*. The lawyer advising parties to financial transactions is acting primarily as a risk manager. There are six aspects of risk highlighted in this chapter. First, the manner in which all financial instruments are based and priced on a calculation of the risks contained in them, primarily by means of theoretical models being applied to the circumstances. Secondly, an application of the risk/return calculation to identify the amount of profit which is acceptable for the level of risk that is taken. Thirdly, a panoply of risks which inform legal practice: systemic risk, market risk, counterparty risk, collateral and credit support risk, insolvency risk, payment risk, documentation risk, personnel risk, regulatory risk, tax risk, cross default risk, and so on. Most significant of these during the financial crisis of 2007-09 was systemic risk: that is, the risk that the failure of one particularly significant market participant or marketplace could cause the entire financial system to fail. The lessons which will flow from that systemic risk almost coming to pass in 2008 will (it has to be hoped) haunt the law of finance for the remainder of the 21st century. Fourthly, sociological understandings of risk as being something which the financial system imposes on ordinary citizens. Fifthly, the risks caused by "financialisation": that is, the effect on the economy of huge amounts of capital being funnelled into the financial system, and the reliance on financial models and techniques to manage much economic activity. Sixthly, the law itself as a risk: whether in the form of changes in the common law or changes to regulatory practice or statute.

1. THE AMBIT OF THE LAW OF FINANCE

A. The definition of "finance"

1–01 The first item of business is to identify what we mean by the term "finance". The term "finance" is used deliberately in this book rather than "banking" or "corporate finance" because we are concerned with the effect of financial activity on society generally and not only on the sorts of financial activity which take place in the boardrooms of major companies or on the trading floors of large financial institutions. In this book among the things we shall consider are the legal dimensions to the services which banks and investment firms (collectively, "financial institutions") provide to corporate and private customers in the form of contracts of loan, securities and other instruments traded on exchanges, derivatives traded off-exchange, security taken for performance in financial transactions, and collective investment entities such as unit trusts and occupational pension funds. However, this merely serves as a general description

of the sorts of things which will be discussed under the rubric of "finance"; but it does not give us a definition of what the term "finance" means. So, let us begin by defining what we mean by "finance" for the purposes of this book. We will do that by considering the etymology of that word.

1–02 The English word finance comes originally from the Latin "finis" meaning an "end"; and latterly the modern sense of the word[1] comes from the French verb "finer" meaning "to end or settle", and the French noun "fin" meaning "an end".[2] The pecuniary connotations of the word "finance" derive from its later sense of the activity of "settling a debt". So, when a debt was settled, it was "finished".[3] By 1494 the word "finance" was used more particularly to refer to a person who was required "to pay a ransom". So, a kidnapping would be "finished" when the ransom was paid. In raising ransoms, for example, the ransom needed to release Richard I from imprisonment in Austria in the 12th century, required the levying of taxes and borrowing or taking money from a number of places: in that sense, the ransom itself had to be financed.[4] By 1555, the term "finance" was used to refer to the "fineness" of gold—at that time the most important measure of money. The worth of gold was linked to its quality, or its "fineness". By 1866 a more familiar meaning (to modern ears) of the word "finance" had developed: that is, "to furnish with finances and to find capital for" an activity.[5] So in discussing finance we are concerned with using finance so as to achieve a goal: that is, the wherewithal to act so as to make a goal possible. As in the Latin meaning of "finis", the role of "finance" is to finish or complete an objective by providing the monetary wherewithal to do it. This idea is considered in the next section.

B. Finance as the wherewithal to act

How different forms of finance provide the wherewithal to act

1–03 The modern understanding of "finance", as it is discussed in this book, is concerned with providing a person with the wherewithal to act by means of providing her with sufficient money (or its equivalent) so that she can achieve her goals. Finance is not limited to cash money. It may relate to a bank account facility, or a credit card, or a loan, or an investment portfolio, or one of a number of corporate finance mechanisms for advancing money's worth to a company or for re-calibrating a person's financial assets and obligations. In each sense, the recipient of this financing is able to act. This is also at the heart of economic theory: the ability to borrow money or to access capital markets is considered to

[1] As explained in the *Oxford Shorter English Dictionary*.
[2] *Oxford Shorter English Dictionary* and *Encarta World Dictionary*.
[3] This is the sense in which the etymology is explained in the Encarta World Dictionary.
[4] *Oxford Shorter English Dictionary*. Perhaps this idea of using finance to pay off a ransom will resonate most clearly with people who have mortgages and with businesses which are struggling against the economic current.
[5] *Oxford Shorter English Dictionary*.

be essential for economic activity and for economic growth.[6] Each of the financing models considered in this book is linked by this ability which it grants to the parties.

1–04 The simplest means of providing the wherewithal to act for an individual is by means of earning money, paying it into a bank account and then spending it in cash as necessary. If that person does not have sufficient income to pay for a large capital project in one go, then she may borrow money by way of a loan from her bank. That loan may be secured by way of a mortgage over her house: that is, if she fails to repay the loan then the bank can sell her house to pay off her mortgage debt. If the person were a company then the company could also borrow money by means of issuing a bond in the form of a promise to pay interest to a large group of investors if they each lend her small amounts of money. Instead, a large company could borrow money from one bank or could borrow a very large amount of money from a syndicate of banks necessary to put together enough capital. Alternatively, a company could issue shares to the investing public whereby, in exchange for giving money to the company, the company grants those investors shares which contain rights to vote in decisions over the company's activities, and grants those investors the right to receive a share of the company's distributable profits (if there are any) in the form of a dividend, and also grants those investors an ability to sell their shares to other investors to make a capital profit on their investment. Clearly, all of these means of acquiring finance are concerned with the ability of a person (whether an individual or a company) to acquire money so as to pursue personal or commercial goals which investors or lenders consider to be worthwhile supporting. The investors or lenders may consider those activities to be "worthwhile" in the sense that they support them in an ethical sense, or far more likely because they consider that the person who acquires the finance will act appropriately and so generate a profit for herself and for her investors.

Increasing financial sophistication

1–05 All of the techniques for raising finance which we have been mentioned so far, and which are considered in far greater detail throughout this book, are very well-established. Modern financial markets have developed more sophisticated techniques both for raising finance and for generating profits. Borrowing is now possible for companies in a number of different jurisdictions simultaneously in very large amounts because a number of lenders from different jurisdictions will group together in syndicates to make up the entire loan amount. Borrowers can access money in different currencies through financial institutions which have offices in hundreds of countries worldwide or which transact with financial institutions in other jurisdictions by borrowing on the money markets and the foreign exchange markets. This money could be used as spending money on a foreign holiday at one end of the scale, or it could be used to pay for the construction of a new factory in another country at the other end.

[6] See, the policies underpinning the various EC directives in Ch.7.

1–06 Aside from the achievement of specific goals, financial markets are also used simply to make profit. Clearly a bank which enters into a loan contract is doing so because it wants to earn a profit, principally by means of acquiring a flow of interest payments from the borrower before the capital is repaid. However, financial institutions and increasing numbers of private individuals invest in financial markets in the hope of earning profit. Therefore, we might buy shares simply in the hope that they will be worth more tomorrow than they are today. Financial markets have developed sophisticated instruments called derivatives to allow investors to speculate on the future market value of financial instruments (whether shares, bonds, or whatever) without even needing to buy that particular financial instrument. So, if I have a hunch that technology shares in Thailand will increase in value over the next month, but I do not have the means to actually go to Thailand and buy those shares, then I can enter into what is known as a "cash-settled equity call option" (in return for the payment of a fee) so that I can be paid the profit (if any) which I would have received as if I had actually bought those Thai shares myself, but without my actually having to buy those Thai shares. Increasing sophistication has thus made previously unimaginable ranges of investments open to many people. In each circumstance, finance provides a wherewithal to act.

Finance is intangible but it has real effects

1–07 What is important about derivatives of this sort is that they underline one very important fact about finance: finance is intangible but it has very real effects. The call option we have just considered in relation to the Thai shares enabled me to speculate on the performance of technology companies in Thailand without me needing to interact with anyone in Thailand. The financial institution which sold me that option may have been physically resident in an office block in London just a few miles from me: but I became entitled to receive a payment from that financial institution if my speculation was successful. Similarly, there may have been an effect on technology companies in Thailand if it became known that investors in London were speculating on the future profitability of such companies. Thai technology companies may have been able to acquire finance more easily and more cheaply simply because the perception in the global financial markets was that they were likely to become more profitable in the future, even if no trades relating to their shares were done on a stock exchange in Thailand. Or, contrariwise, if speculators had expected the value of those companies to fall, then their ability to access finance would have shrunk.

1–08 Thus the universe of finance operates on the basis of rumour and opinion. If you read a financial newspaper on any given day, you will see reports of a consensus in international and national markets on the previous day that such-and-such was a good or a bad investment, and you will also see reports of the perceived value of those investments increasing or decreasing as a result. During the financial crisis of 2008, for example, there were huge falls (of up to 60 per cent in a few days) in the share prices of banks like HBOS and Citigroup based on market perception of the risks associated with their business prospects. This has two effects for our purposes. First, it means that a person whose credit worth is

perceived to be low will have trouble acquiring the wherewithal to act by means of finance because investors and lenders will be reluctant to deal with them simply because of the market's perception of them and their area of activity; and by contrast someone whose perceived credit worth has increased will find it easier to acquire finance more cheaply than before because investors and lenders will want to deal with them, again due to market sentiment. Thus, the intangibility of financial markets can have a real effect on someone seeking finance. Secondly, we see that financial markets are both involved in providing the wherewithal to act and also with speculating so as to make profits which give the speculator greater wherewithal to act (often to make further speculation and thus make further profits).

C. The intangible nature of most financial markets

1–09 Language has been a particularly significant part of human evolution: it has effectively created modern humanity. Language also has the ability to call into existence phenomena which have no tangible, physical existence. A joke can make you happy: the words that constitute the joke when spoken by a human being can alter the level of happiness of human beings who hear it. Bad news will make you sad. And so on. This is true of finance. Finance has no tangible existence—being a wherewithal to act, just as strength is a wherewithal to exert force—but its effects are so real in the physical world that it is tempting to assume that finance and also money have a tangible existence. In a short story entitled "Tlon, Uqbar, Orbis Tertius", Jorge Luis Borges[7] tells of an imaginary planet which is created by a shadowy secret society simply by means of writing an encyclopaedia which set out the cultural, psychological and philosophical make-up of that imaginary planet's inhabitants. The conceit underpinning that story was that simply by writing about the detail of a non-existent world as though that world did actually exist would cause that imaginary world to be brought into existence. So, in the story, the world of Tlon does come to exist simply because it was talked about in such a way that it came to be real.

1–10 In a similar way, we might think of finance as being another example of something coming into existence because people talked about it in a way which made it become real. Let us take an example to show how mere words have real effects in finance. Suppose that Profit Bank hears from GoTech Plc that GoTech is going to manufacture an excellent computer games system and the two corporations agree that Profit Bank will lend money to GoTech to do this. What Profit Bank is doing is putting GoTech's ambitions into effect by giving it the wherewithal to act. What Profit Bank is also doing is saying to GoTech "you can spend money because we have credited your bank account with enough money to do so". The money does not exist in cash in the form of physical notes and coins. Rather Profit Bank registers an increase in the value of GoTech's bank accounts by the amount of the loan. Consequently, GoTech can write cheques to its suppliers and employees, or it can make electronic funds transfers into their bank accounts, which in turn will cause the suppliers' banks and the employees' banks

[7] *Fictions* (1944).

to treat those suppliers and employees as though they too have more money, even though all that has happened is that the value of their bank accounts is agreed by everyone to have increased in value.

1–11 If we go further back down the chain, we should ask where Profit Bank got its money from. Remarkably, Profit Bank will not have held an amount of cash in a vault somewhere equal to its loan to GoTech. Instead Profit Bank itself will be treated by other banks as having a value which is sufficiently large to assume that it would be able to provide enough cash to GoTech if it were needed. So, what other banks do is to accept that Profit Bank has a sufficiently high credit rating to meet its obligations. Profit Bank, therefore, does not own very much money in the form of notes and coins, instead Profit Bank has a perceived value among other banks. That value will be based on Profit Bank's success in wringing profits from the loans it makes or from the speculative investments it makes. If the perception among other banks was that Profit Bank was too unprofitable ever to be able to meet its obligations, then it would literally go "bankrupt".[8] Thus, Profit Bank's ability to trade as a bank is built on what is said about it, on its reputation. The bank will be required by its regulator to hold assets in ring-fenced accounts equal to a given percentage of its total obligations to guard against the risk of its insolvency, but otherwise there will be no other obligation to show it actually has the money—those ring-fenced accounts are ordinarily just electronic records that it has assets of a given value and not physical piles of gold.

1–12 We should not fixate on Profit Bank too much because every other bank in the world is similarly reliant on perceptions of their worth and on their ability to trade. Banks borrow money from other banks—on what are known as "the money markets"—because no bank has very much cash stored on deposit. Therefore, banks give each other credit lines. For a bank to have money stored on deposit is a waste. At the end of every business day, or rather during business days in the modern age, every bank's treasurer monitors how much money the bank has and tries to make sure that every penny, cent and rupee is invested in something. Money sitting idly in a bank account is money that is not being invested and so it is money which is not earning a profit.

1–13 Therefore, banks do not have money or assets of money's worth which are equal to all of their obligations. That is the way that our financial markets work. Computers store records of how much each of us is worth. We measure that worth in cash terms in different currencies. If our currency becomes less valuable, then we become worth less too. Consider Germany in the 1930s as the Deutschemark became worth less on financial markets to people outside Germany. It became difficult for Germany to import goods from overseas unless they spent massive amounts of Deutschemarks to do so. As a result, inflation in Germany surged. Eventually, going to do ordinary food shopping required Germans to carry huge quantities of banknotes around in suitcases to have enough Deutschemarks to pay for even the basics. At present, the currency in Zimbabwe is subject to astonishing levels of inflation which make the currency almost worthless.

[8] As is explained in Ch.28, the "bank" comes from the Italian "banco" for bench, being a reference to the benches and tables at which early Florentine bankers used to sit and conduct business. When a banker went into insolvency his bench was broken—it was "ruptured". Hence the term "bankrupt".

1–14 The global financial crisis (or, "credit crunch") of 2007/08 was caused by banks dealing in mortgages made to customers who were unable to make repayment.[9] The effect was that banks became reluctant to lend money to one another because they did not know which other banks had large exposures to this market. Therefore, because banks do not hold all of their assets in cash, they need to be able to borrow from other banks: thus when banks stop lending to one another there is a seizure in the banking sector generally. This is known as a "drying up of liquidity". If banks cannot borrow money then they do not have any money to lend to ordinary customers, and so the economy dries up too. Therefore, these virtual movements of virtual money have very tangible effects in the "real economy". In the summer of 2008 a truly remarkable number of very old banks either went into insolvency (such as Lehman Brothers), or had to be bought up by other banks so as to avoid bankruptcy (such as Bear Stearns, HBOS, Washington Mutual, Wachovia, Merrill Lynch), or had to be nationalised by their governments to prevent them going into bankruptcy (such as Northern Rock, Citigroup, and Fortis). If I had suggested the idea in 2006 that the US and UK governments would ever have to nationalise banks, I would have been laughed at. Such was the change in global banking culture during 2008. The effect of the 2007–09 financial crisis is considered in Chapter 45.

1–15 What we have done with our financial markets then is to describe them in such a way that we have brought them into existence: just like Borges's story about the planet of Tlon which was referred to above. But does that observation have any impact on our discussion of the law of finance? I would suggest that it does. If we are dealing as lawyers with intangible markets then we need to think in that way about the financial instruments involved. What if someone refuses to make payment under a financial contract? How do we take security, for example, over contracts to transfer intangible amounts of money in exchange for intangible securities? The nature of intangible financial products poses subtle challenges for lawyers to ensure that their clients will be paid what they are owed, and also to ensure that those financial markets can continue to function properly. It also impacts on securities markets: for example, whereas once upon a time shares and bonds were bought and sold in the form of physical certificates, a little like banknotes, they are no longer represented by certificates because financial people realised that it was cheaper, more convenient and more secure to have the owners of securities registered on a computer database (rather than run the risk of those physical certificates being lost or damaged or stolen). Whereas once the owner of a bond used to collect her payment of interest by presenting herself at the offices of the bond issuer and by tearing the appropriate coupon off her bond certificate, now those payments of interest are made electronically.[10] To use the financial markets' jargon expression, the financial world has become "dematerialised": that is, fewer and fewer of these financial instruments exist in tangible, physical form anymore. Instead they are registered and traded electronically.

[9] See para.31–01.

[10] Interest on bonds is still known as "coupon" as a result.

D. From domestic banking to cross-border transactions

1–16 Now that we have removed financial instruments from existing tangibly in space in the form of certificates and so forth, it is also important to remember that financial markets reach across national boundaries. As will be discussed below, this means that a number of different legal systems may compete to have the right to decide disputes which arise between people acting through a number of different jurisdictions. What this also means is that financial markets do not need to cease trading because when night-time arrives in Tokyo, people are arriving at work in London; and when night-time arrives in London, people are arriving at work in New York; and when night-time arrives in New York, people are arriving at work in Tokyo.[11] Consequently, we could say that financial markets have conquered time because trading is always occurring somewhere in the world (except for certain parts of the weekend and certain bank holidays). And yet at night-time and over weekends there are still plenty of people at work in the offices of the banks, the law firms and the accountancy firms around the world to keep this vast machine working.

1–17 Finance has therefore conquered time and space. And all because human beings have dreamed it into existence, just like the planet Tlon. Our goal now is to consider how the law deals with these phenomena.

2. CONSTRUCTING THE LAW OF FINANCE

A. The distinction between the substantive law and financial regulation

1–18 It is important to distinguish between substantive law and financial regulation. The substantive law includes private law (contract, property, tort, and so on), criminal law, and judicial review in public law. It is the substantive law specifically of England and Wales which is discussed in this book. Financial regulation is based on the EC financial services directives as implemented into UK finance law principally by the rule-making powers given originally to the Financial Services Authority ("FSA") by the Financial Services and Markets Act 2000 ("FSMA 2000"), but which have now passed to the Financial Conduct Authority ("FCA") and the Prudential Regulatory Authority ("PRA") (as explained in Chapter 8).[12] Substantive law is that system of rules and principles

[11] While those are the principal financial market centres, we should not forget that as the Earth revolves before the sun, there are people across the world going to work, leaving work and trading in financial instruments. Financial activity never ceases. Once you go to bed at night, any money you paid into your bank account that day will be being invested by your bank around the world, and then re-invested by whoever received your original money, and so on and so on. If you have seen the film *The Matrix*, it may help to think of all of this investment capital being invested and reinvested constantly in different financial centres around the world as being a little like "The Matrix" that exists and lives in a parallel, electronic universe.

[12] The Financial Services Authority, which had borne the regulatory responsibility in this context previously, was renamed the Financial Conduct Authority ("FCA") as a result of the enactment of the Financial Services Act 2012, s.6. The bulk of the former authority's responsibilities passed to the

G. Resulting trusts

21–53 Resulting trusts arise either where two or more parties have contributed to the purchase price of property so that each is recognised as having on resulting trust an equitable interest in that property proportionate to the size of their contribution, or where some portion of the equitable interest remains unallocated and so that interest passes back on resulting trust to its last owner.[151] Constructive trusts arise where the conscience of the legal owner of property is affected by knowledge of some factor, such as the fact that a payment has been made to it under a mistake, in relation to the property at issue.[152]

H. *Quistclose* trusts

21–54 *Quistclose* trusts, which are used significantly to take security in loan transactions, are discussed in Chapter 22[153] and in Alastair Hudson, *Equity & Trusts*, in Chapter 22.

[151] See fn.131, above.
[152] See fn.131, above.
[153] See para.22–24.

CHAPTER 22

TAKING SECURITY AND INSOLVENCY

CORE PRINCIPLES

Taking security

"Taking security" is the process of seeking to use one or more of a number of legal structures to protect oneself against the risk that one's counterparty may go into insolvency or fail to perform its contractual obligations, or that one's contract may otherwise be unenforceable, or against any of the other risks discussed in Chapter 1. The menu of legal techniques which may be used are considered in turn in this chapter.

A transfer of title under contract means that the secured party acquires absolute title in assets put up to secure her exposure under a transaction: typically, other assets of the same kind would need to be retransferred to the counterparty once the transaction has been properly performed. This structure is similar to the "personal collateral" structure considered in Chapter 44. By contrast, a *Romalpa* clause provides that the secured party retains absolute title in property which is used by both parties for a transaction in common, even if that property passes into the counterparty's possession.

As considered in Chapter 21, trusts provide that the secured party acquires the equitable proprietary interest of a beneficiary in property set aside to provide security, and the counterparty acts as trustee of that property such that the trust continues in existence regardless of the counterparty going into insolvency. More specifically a *Quistclose* trust provides that a lender retains an equitable interest in money transferred to a borrower under a loan contract provided that that loan contract contained a term which required the borrower to use the money only for a specified purpose.

Mortgages grant a proprietary right to the secured party such that the secured party (the "mortgagee") may seek a sale of that property, or possession of that property, or foreclosure, or the appointment of a receiver (depending on the nature of the secured property). Mortgages are most commonly taken out to secure loans to buy land, although they may be used over chattels. Superficially similar to mortgages, charges provide the secured party with a right to petition the court to seek an order for the sale of the charged property in the event that the chargor fails to make payment to the secured party (the "chargee"); charges do not, however, grant the chargee a property right before a sale is ordered. Charges take effect in equity, and may take effect either over specified property (a "fixed charge") or over a changing, floating pool of property (a "floating charge").

Pledges ordinarily involve a transfer of possession (but not of ownership) in property until a contractual obligation is performed, and if that obligation is not performed then the secured party may seek ownership of the pledged property in lieu of performance (as with a pawnbroking contract). The term "pledge" is used in some markets' jargon to connote an outright transfer of the ownership of property as opposed to a mere transfer of possession. Liens are similar to pledges in that liens transfer possession of property to the secured party so that the secured party may apply to the court for an order for sale of that property if the counterparty fails to make a contractually required payment.

Guarantees do not provide security by way of making property available to the secured party, but rather constitute a contractual undertaking by some third person to meet the unpaid obligations of one party to a transaction to its counterparty. Guarantees must comply with certain formalities (such as the need for the guarantee to be in writing) so as not to be a mere indemnity.

Insolvency

Section 323 of the Insolvency Act 1986 provides that a company is insolvent when it cannot pay its debts as they become due. The question as to whether or not a company is insolvent – particularly deciding whether it will be able to meet its future liabilities or not – is a complex one. There are two principles of insolvency law which might call the validity of contracts into question: the *pari passu* principle (which requires that all unsecured creditors are treated the same) and the anti-deprivation principle (which prevents any assets being taken from the estate of an insolvent person).

A key aspect of seeking security in complex, high-volume financial transactions is the ability to set off amounts owed reciprocally between the parties in the event that one party goes into insolvency. Further to r.4.90 of the Insolvency Rules, set-off between two parties, where one of them is insolvent, is mandatory when there are mutual debts between them. In relation to set-off between more than two parties, matters are more complex. The House of Lords held that set off between multiple parties in a clearing house arrangement would offend against the pari passu principle. The Settlement Finality Regulations have ensured that clearing houses will be valid. The Supreme Court has held latterly that set-off and "flip" provisions in a master agreement will not offend the anti-deprivation principle even if that means that the amount owed by the insolvent person's counterparty is thereby reduced.

1. INTRODUCTION

A. The concepts underpinning the taking of security

The importance of taking security in financial transactions

Taking security is a key part of commercial transactions; particularly when dealing in financial markets. The expression "taking security" refers to the use of any one or more of the techniques considered in this chapter to protect oneself against the risk that one's counterparty will fail to perform its contractual obligations, or that the transaction will be unenforceable for some other reason, or that the transaction will generate a loss in some other way. The concept of risk in financial transactions was discussed in Chapter 1.[1] This chapter considers how the risk of a counterparty failing to perform its obligations can be controlled by providing "security". Under English law, security may be taken in a number of **22–01**

[1] See para.1–47 et seq.

different ways using common law devices or equitable devices which may give rise to proprietary rights or to merely personal rights depending on the structure and the circumstances.

Proprietary and personal rights

22–02 Let us begin by explaining some of the terminology. These terms will be considered in greater detail below but a working knowledge of them from the outset will be useful. A "proprietary right" in this context means a right over property, whether in the form of "absolute title" (that is, outright ownership of all of the possible rights in an item of property), or title recognised by common law (such as the rights of a trustee under a trust), or equitable rights (such as the rights of a beneficiary under a trust).[2] A proprietary right is important because the holder of a right in property can enforce that proprietary right against any third party even if some other person who is using or who has possession of the property goes into insolvency, or purports to transfer that property to a third party, or something of that sort. A proprietary right also gives rise to a range of remedies which are not available to the holder of a purely personal right. It is the opposite of a "personal right", in that a personal right does not grant any rights to property but rather only a right to recover damages or compensation, or to perform some other action short of granting rights in identified property. There have been circumstances in which the term "proprietary right" has been used by the courts to describe circumstances in which the claimant has only a contingent right to property but nevertheless does have some right which may crystallise into a full property right over an identified pool of property at some point in the future.[3] This is, it is suggested, an inaccurate use of the term. If the term "security" were to be used to cover all of the various techniques whether they are proprietary or personal in nature then it becomes a very broad term indeed and would be of little practical use. Similarly, the term "proprietary" right has been used by the courts to cover such a broad range of subtly but significantly different techniques that it may be of little practical use: so we will need to tease apart these differences in this chapter and to keep the proper distinction between proprietary and personal rights clearly in mind.

Structuring security

22–03 The term "structure" is important too. It denotes the practice of financial lawyers of choosing between a range of possible legal techniques to achieve an objective (in relation to taking security that may include selecting between a trust, a charge, a mortgage, a pledge, a contract to pay money, and so on) and then drafting and organising that arrangement so as to be properly analysable as having particular characteristics and as imposing appropriate rights and obligations between the contracting parties. The resulting phenomenon is colloquially known as a "structure". It is a key part of a finance lawyer's practice to organise structures

[2] See A. Hudson, *Equity & Trusts*, 6th edn (Routledge-Cavendish, 2009), Ch.2 for a full discussion of these concepts.

[3] For example *Re Spectrum Plus* [2005] UKHL 41; [2005] 2 A.C. 680, considered below.

which will achieve her client's goals, which will minimise liability to taxation, which will avoid regulatory problems, which will be commercially viable, and which will above all be legally enforceable in all jurisdictions and under all systems of law under which they need to be enforceable.[4] Above all, lawyers should take care to decide exactly what sort of proprietary or personal right is intended and organise their client's affairs accordingly; as opposed to using vague expressions like "security interest" or "hypothecation" which merely beg the question exactly what type of proprietary or personal right is intended.[5]

Credit risk management and the identification of appropriate security

22–04 The term "security" for the purposes of this chapter means *protection against risk*.[6] A contracting party is seeking protection against any one or more of a number of potential risks connected to any financial transaction. Much of the activity within financial institutions which is not concerned with creating or marketing products is concerned with the evaluation and assessment of risk. Of particular importance is credit risk management whereby financial institutions evaluate the risk of each counterparty failing to perform its obligations: this assessment of credit risk is intimately linked with the process of taking security in that the form and size of the security that is required will be relative to the perceived risk of the counterparty's non-performance of its obligations. There are other risks, such as risk that the market will collapse or move so markedly that the financial products at issue will become worthless or will cause the parties loss. Security will often be required so as to control these forms of non-counterparty risk too. The various species of risk were considered in Chapter 1.

22–05 The value of the security acquired could take a number of different forms: whether that is the entire, gross amount owed to the secured party; or a net exposure which the secured party has to its counterparty across a number of transactions, taking into account amounts owed to the secured party and amounts which the secured in turn owes to its counterparty; or an amount which the secured party calculates off-sets the perceived credit risk that the counterparty will not perform its obligations in relation to an underlying transaction or transactions; or some other amount which the parties negotiate between them.[7] By way of illustration, suppose that Alpha Bank owes US$100,000 to Beta Bank and that Beta owes US$80,000 to Alpha across all of their relevant transactions. If Alpha was concerned with its gross obligations, then Alpha would seek protection in the amount of US$80,000. However, seeking to match the net

[4] That is, in all jurisdictions in which the parties are acting or in which the transaction needs to be performed.

[5] See for example *Lowe v National Bank of Jamaica* [2008] UKPC 26 where the term "hypothecation" left an issue between the parties as to exactly what right the claimant had been intended to have.

[6] As opposed to the term "security" as used in Pt 10 of this book to refer to shares, bonds and so forth, which is an entirely different use of the same word.

[7] Where this last example involves a measurement by the secured party's credit department of an amount, typically a proportion of the net exposure of the secured party to the counterparty, which it estimates will be sufficient to offset the risk to it of doing business with the counterparty.

exposure in this instance would require protection to be provided to Beta in the amount of US$20,000, being the net exposure which Alpha owes to Beta across these contracts. In an ordinary personal collateral structure[8] it would be this net exposure which would be covered. Alternatively, the credit department at Beta might decide that the risk of Beta doing business with Alpha would be met if Alpha paid a percentage of that exposure in advance: say US$10,000, being an amount which Alpha's credit department thinks would assuage its credit concerns about doing business with Beta according to its estimate of the likelihood of Beta's default. This would be an entirely commercial decision.

This chapter will consider the various forms of protection offered by the law against a range of possible financial risks.

B. The core techniques in taking security

22–06 The legal techniques for taking security in commercial transactions fall broadly into four categories. The first category is security by means of taking title in some property. This group of techniques includes the trust,[9] transfer of title provisions[10] and retention of title provisions.[11] In each of these situations the legal technique identifies a proprietary right of some sort in some asset to which the rightholder can have recourse if its counterparty fails to perform its obligations under the contract. Further examples of this category are mortgages[12] under which the rightholder acquires a proprietary right in the mortgaged property.

22–07 The second category is comprised of a weaker form of security by means simply of contract: that is, a personal obligation to pay money in the event of some failure to perform an obligation under the contract. This is said to be a "weaker" form of security in that the rightholder does not have any identified asset to which it can have recourse on the default of its counterparty; rather, it is reliant on both the counterparty's ability and willingness to pay, either of which may have been the cause of the original failure to perform under the contract. Within this category are events of default,[13] guarantees to make payment,[14] some collateralisation obligations to transfer value to a collateral fund,[15] and some liens.[16]

22–08 The third category is comprised of quasi-proprietary rights: that is, a group of rights which purport to grant title in assets but which are nevertheless dependent on some contractual right crystallising so as to transform that right into a proprietary right. Thus a floating charge gives the rightholder rights of a given value over a fund but those rights are dependent on the counterparty maintaining

[8] See para.42–33 et seq.
[9] See para.21–01.
[10] See para.21–13.
[11] See para.21–20.
[12] See para.21–30.
[13] See para.19–48.
[14] See para.21–77.
[15] See para.42–33.
[16] See para.21–68.

that fund appropriately.[17] This contrasts, for example, with a trust arrangement in which a trustee holds the trust fund (particularly where a third party custodian is selected to act as trustee, as considered below) rather than the counterparty itself retaining management control of the security assets.

22–09 The fourth category comprises doctrines such as the pledge and the lien which grant only rights of possession, not ownership, of property but with the ability to petition the court for permission to sell the property so as to recover money owed to the creditor.

C. Collateralisation

22–10 The techniques associated with collateralisation are discussed in detail in Chapter 42 of this book. Collateralisation is used to take security in derivatives transactions, and comprises one of a number of hybrids of the techniques discussed in this chapter.

D. Transactions with different forms of entity

22–11 Different issues arise with different forms of entity when seeking to take security. Where the borrower is a member of a group of companies, then there is a question as to which entity will be the borrower under the transaction. Each company within a group of companies is treated by company law as being a separate legal person and therefore an obligation will only be enforceable against the company which is a party to the agreement.[18] Therefore, within groups of companies it is important to identify the company or companies which either hold the group's most valuable assets or which conduct the group's principal trade: these are the companies which have the most valuable assets which could be provided as security and therefore it is these companies which should either be the contracting entities or the entities which are extending any guarantee or other credit support as part of the transaction. There is always a risk, in consequence, that there may be a reconstruction of the group of companies such that the assets which are to be used to provide securities are moved to another company within the group. Consequently, the reconstruction of the counterparty entity will typically be an event of default triggering the termination of the agreement between the parties. It should also be an event which triggers any credit support arrangement between the parties.

22–12 In relation to partnerships, the partnership property is owned by the partners in a manner defined by the partnership agreement: this may include a right for partners to take property out of the partnership's property, for example if they leave the partnership. Consequently, the termination of a partnership or the reconstitution of a partnership once a significant partner leaves or a new partner joins that partnership may have a significant effect on the credit profile of that partnership. Similarly, in relation to trusts it is possible for a beneficiary to

[17] See para.21–50.
[18] *Salomon v A Salomon & Co Ltd* [1897] A.C. 22; *Adams v Cape Industries Plc* [1990] Ch. 433.

exercise a power to remove its share of the trust capital, or similarly for a trustee to exercise a power or discretion effectively removing a large amount of the trust's capital. In relation both to ordinary partnerships and to trusts there is no requirement that any filing or public provision of information is made as to their financial positions. When dealing with these sorts of entity—or indeed any entity which is not a company providing financial information in the ordinary manner—it is important to consider carefully the credit risks associated with that entity and the most appropriate manner in which credit support may be provided.

2. TRANSFERS OF ABSOLUTE TITLE

22–13 Taking security by means of a transfer of title is comparatively straightforward in conceptual, legal terms. What is envisaged is that the party requiring security ("the secured party") is transferred absolute, unencumbered ownership of all of the rights in property by way of an outright gift or assignment (referred to in this book as "absolute title"). In line with the secured party's calculation of its credit risk under the transaction, that property will be of a value which covers, to the secured party's satisfaction, its exposure to its counterparty. In the event that the counterparty does fail to perform its obligations, or more specifically in the event that the counterparty becomes insolvent, then the secured party is the absolute owner of that property and so title in that property will reduce the exposure which the secured party has to the counterparty's failure to perform.

22–14 Given that the property is transferred outright in this context, the secured party can have no obligation to account for that property in the counterparty's insolvency—always assuming that no question of a transfer at an undervalue with a view to defrauding the counterparty's creditors is deemed to have taken place under English insolvency law.[19] If there had been such a transfer at an under-value with a view to putting assets beyond the reach of insolvency creditors, then the court would be empowered to unpick the transaction and restore the status quo ante so that the creditors can have recourse to those assets in the transferor's hands.[20]

22–15 The assumption made here is that the secured party has no obligation at law or in equity as part of the law of property to account to the counterparty nor to make any re-transfer of the specific transferred property to the counterparty. If there was an obligation to hold the original property on trust or to hold that original property separately from all other assets, then the secured party would owe proprietary obligations to its counterparty. In this context, however, the transfer of absolute title to the secured party means that the secured party becomes the absolute owner of that property without any proprietary obligation to account to the counterparty in relation to that property. There may, however, (as in personal collateral structures) be a *contractual* obligation to make a transfer of property of a like kind or of equivalent value (whether in money or money's worth) to the counterparty in the event that the counterparty performs its obligations under a derivatives contract, or to make a re-transfer of property of a like kind or of

[19] Insolvency Act 1986, s.423.
[20] Insolvency Act 1986, s.423.

equivalent value to the extent that the counterparty has performed its obligations under that contract. It is important that this is merely a contractual obligation to make a transfer because the counterparty will have no proprietary right to any specific assets held by the secured party and therefore will have no claim in property law generally nor in the law of trusts specifically to any such property. Rather, the secured party would owe merely a personal obligation to transfer property of a particular type or cash of a given value to the counterparty, such that there was no specified property which was to be so transferred (even if the secured party happened to hold such property in a distinct account in readiness to perform this contractual obligation). A contractual obligation of this sort is said to be "merely a contractual obligation" because it offers no security against the counterparty's inability or unwillingness to perform its obligations: the law of contract will give the counterparty a right of enforcement but no further right (except perhaps a right to damages) if performance is rendered impossible in practice for example if the counterparty has gone into insolvency. This chapter is therefore concerned with mechanisms for the protection of a party to a transaction in the event that the law of contract offers no viable remedy or recourse as a matter of fact, or lest the law of contract should offer no such remedy or recourse at some time in the future.

22–16 The reason for starting this discussion of taking security with this elementary mechanism for taking security is that it is a feature of some collateral security structures and stock lending. Under the ISDA Credit Support Annex, the parties may outright transfers of money or securities (as stipulated in the contract) one to another equal to the payee's net exposure to the payer at the time of calculating the requirement to post collateral.[21] In that contract, the parties usually transfer any amount of money or money's worth required to be transferred under the terms of that contract by means of an outright transfer, such that the recipient is able to treat the property as being absolutely its own, even if it is required to account for the amount of any distribution which the transferor would otherwise have received on any securities transferred under that agreement. The standard market documentation is considered in detail in this regard in Chapter 42.[22] However, a number of other legal structures may also be used in collateralisation: those structures are considered in the remainder of this chapter.

3. TRUSTS

22–17 The preceding chapter considered the law of trusts in detail.[23] The reader is referred to that discussion. For the purposes of taking security, as was considered in detail above,[24] a trust permits a number of different people to have different

[21] The expression "to post collateral" is the jargon used in the ISDA documentation and refers to the obligation of a party to transfer property (that is, the collateral property) to its counterparty in a form stipulated in the contract and in an amount calculated by reference to the provisions of that same contract.
[22] See para.42–33 et seq.
[23] I have written a number of books on trusts law, so readers are referred to G. Thomas and A. Hudson, *The Law of Trusts*, 2nd edn (OUP, 2010) and generally A. Hudson, *Equity & Trusts*. For

develop a conscious ethic and culture of active regulatory compliance, instead of merely the intermittent lodging of reports or capital to achieve the minimum necessary to satisfy the regulator.

B. Transforming the financial system

45–77 This book began with a definition of finance as being "the wherewithal to act", a means of enabling actions to take place. The financial crisis demonstrated that the financial system might not create the wherewithal to act, but that instead it might destroy economic activity. The financial system has no tangible existence, instead it has tangible effects: that means, money and securities are all held electronically and so have no tangible existence, but they nevertheless allow aeroplanes to be made, food to be bought, and corn to be delivered. The purpose of this financial system was to create the wherewithal to act, but a large proportion of it has been shown in this chapter to be concerned with speculative profit that has no other practical use, and to become bound up with fraud and a loss of ethics. In short, we have forgotten what banking and finance is meant to be for. In Chapter 1, we considered a short story written by Borges in which a world was called into existence because scientists wrote about it and imagined every tiny detail of it.[127] Just as Borges described the creation of a planet out of thin air simply because human minds could conceive of it, we created the financial system out of mere words and ideas. In place of coins made of precious metals, we created financial instruments, securities, electronic money, payment cards and even banknotes which claim to be intrinsically worth the number printed on their face. All of this financial system came into existence simply because human minds could imagine it. Now it runs much of our lives. But we have all now realised, after the events of recent years, that the system we had built was dangerous in some contexts and that it was capable of operating unethically. However, we can re-imagine that financial system. We can make it again, and make it better. We can create a financial system which befits the civilised, democratic societies of the 21st century.

[127] See para.1–09: JL Borges, "Tlon, Uqbar, Orbis Tertius", *Fictions* (1944).

CHAPTER 46

REFORM PROPOSALS

CORE PRINCIPLES

This chapter presents a series of proposals for the reform of financial regulation and the financial system in the UK. It builds on the previous chapter which considered in outline the financial crisis of 2007–09. The single most significant

reform which could be made is to make the directors of regulated financial institutions and other nominated officers among senior management personally liable for any losses or defaults of the institution as though they were partners in a traditional English law partnership. This would have the most profound impact on the effectiveness of the internal systems and procedures of financial institutions. Goldman Sachs was organised on this model until a few years ago.

Another important change would be the creation of a professional body for "bankers" and a requirement for independent professional training for identified roles within retail and investment banking and other financial services activity, and in particular the creation of a code of professional ethics.

Other suggested regulatory changes relate to the treatment of ordinary customers and the regulation of derivatives: including a requirement that all commodities traders must take a binding undertaking to acquire the underlying commodity, and that no credit derivative can be acquired without an equivalent to an "insurable interest" in the underlying asset. Several changes are suggested to the substantive law, including a closer proximity between conduct of business regulation and contract law (so that the former become implied terms in the latter), and the outlawing of exclusion clauses in contexts in which liability could not be excluded for the same activity under financial regulation.

1. INTRODUCTION

A. Rethinking financial regulation

46–01 This chapter sets a series of proposals for the further reform of finance law and regulation in the UK. It builds on the many suggestions for reform made throughout this book and focuses on further suggestions which have not been discussed in relation to the reform of banking regulation in Chapter 28 and so forth.[1] These reforms relate to the substantive law as well as to financial regulation because a synthesis of these two sources of law is essential if the law of finance is going to develop in such a way that it can contribute to the stability of the financial system, to the viability of the UK economy, and to the protection of ordinary consumers of financial services. (This chapter was written before the Parliamentary Commission on Banking Standards was due to report in June 2013.)

46–02 Questions about financial regulation are commonly treated as though they are purely economic questions, when in truth they are moral questions, political questions, legal questions and even questions about national security in an age of "cyber attacks". The dominant economic analyses of financial regulation as being part of a free market have failed to accommodate the other conceptualisations of

[1] The principal focus is on the reform of the regulatory and legal system in the UK: the requirement for international regulatory co-operation, the need for conduct of business regulation ensuring consumer protection, the appropriateness of high-level regulatory principles, and so forth, are all taken as read as they have been set out in earlier chapters. The ideas in this chapter go beyond those issues. They suggest a manifesto rather than a textbook chapter; although, it is suggested, any good textbook should challenge its reader either to disagree or at the very least to look under the rocks and think about what is slithering under there.

financial markets.[2] Typically, the argument against financial regulation is taken to be a "yes/no" question of either preventing banks from making profits by regulating them or allowing banks the freedom to make profits by not regulating them. The events considered in the previous chapter demonstrate that the finance industry requires regulation. The real questions are *how* we regulate financial markets and what we allow them to do, as opposed to *whether* we regulate financial markets. In the incontrovertible presence of the tremendous harm caused by financial institutions to the social, political and economic life of those countries impacted directly by the financial crisis of 2007–09, there are different questions which fall to be answered beyond the confines of the dominant free-market ideology in mainstream economics.

B. The welfare principle

The welfare principle in its essence

46–03 At root, it is suggested, the central principle governing financial regulation should be that all regulation is based on a "welfare principle". The welfare principle provides that: the welfare of society and the real economy is paramount. The reference to the "real economy" here is a reference to economic activity beyond the financial sector. It is the real economy which relies upon the utility services which financial institutions like the high street banks provide.

46–04 The corollary to the welfare principle is that public money should never be used to rescue a financial institution from its self-inflicted losses. Instead, regulators should be empowered to separate the "good assets" held in a ring-fenced subsidiary (containing all of the utility operations, assets and liabilities of that institution) from whatever has forced that institution into insolvency or "failure" (under the Banking Act 2009).[3] So, ordinary bank accounts, domestic mortgages, business loans and so forth should be continued within a state-organised entity until that part of the bank can regularise itself. The utility operation must therefore continue as before, entirely distinct from the other operations of that institution (as considered below),[4] and any private law arrangement purporting to bind the utility operations into the performance of the other operations of that institution should be rendered void *ab initio*. Investors in such a financial institution – whether shareholders or bondholders – must bear the entirety of the loss bound up with their investment: thus removing moral hazard from the investment community. Shareholders in the utility operations of the financial institution must be entirely distinct from the other operations in that the utility operations must be contained in a separate corporate entity (in the form of a

[2] e.g. S. Keen, *Debunking Economics* (London: Zed Books, 2011).

[3] The retail banking operations of a financial institution will generally be the "good assets" whereas the investment banking activities will generally contain any "bad assets". The exception to this principle is where the retail bank was mis-selling mortgages to borrowers who could not repay their debts or insurance to customers in breach of their regulatory and substantive law obligations: in such a situation, those mis-sold contracts are bad assets which will create losses (as with the PPI mis-selling scandal considered at para 45-63).

[4] See para 46–13.

public holding company) which is quoted separately on the Stock Exchange and separately subject to the Listing Rules from the other entities and operations which make up its collective operations. In essence, those entities must be held on separate corporate groups. It must be unlawful for the state to intervene to rescue the non-utility activities of any financial institution. Risk must be privatised in the investors in a financial institution; only the utility services of financial institutions can be socialised; whereas at present profit is privatised in financial institutions and risk has been socialised.

The welfare principle in operation

46–05 In financial regulation, the welfare of the customer is paramount.[5] And by extension, therefore, the good health of the economy more broadly which is served by that financial system is of central importance. If one begins every analysis of financial regulatory policy from the position that the questions are all questions of economics then one will necessarily come to a particular answer: that is, an answer based ideologically on the perceived need to protect both the banks' profitability and freedom to conduct their business as they see fit without overmuch regulatory intrusion. By contrast, if one begins an analysis from the perspective that the principal goal of financial regulation is to protect the ordinary customer, then bank profitability and freedom to contract as they wish are no longer the foremost goals. Instead, conduct of business regulation and the control of financial institutions' activities would take priority. If one thinks the policy through from the perspective of the customer and the real economy,[6] then there are many aspects of banking practice which one might wish to control or even outlaw.

46–06 That the welfare of the customer is paramount means that customers must be treated suitably by financial institutions in accordance with their level of expertise as customers, that the risks associated with their transactions must be explained to them, and that any contract created in contravention of that principle must be rendered void *ab initio*. The improvements to conduct of business regulation which this involves are considered below.

46–07 That the welfare of the customer is paramount also means that customers are to be protected from the worst excesses of the financial system, and even from the mundane excesses of banking practice. The proposed "ring-fence" for banks in the UK (in the Financial Services (Banking Reform) Bill 2013 at the time of writing) is both conceptually imprecise and inadequate for the purpose of protecting the customer and the real economy from future shocks, not least because the precise manner in which each bank will construct its "ring-fence" is (currently) entirely a matter for it under the 2013 Bill. The EU system for ring-fencing retail banks remains similarly imprecise at the time of writing.

[5] A.S. Hudson, "Financial Regulation and the Welfare State", in A. Hudson (ed.), *Modern Financial Techniques, Derivatives and Law* (Kluwer Law International, 2000), 235.

[6] That is, that aspect of the economy which relates to employment, the prosperity of ordinary citizens and small businesses, and so forth.

46–08 Ensuring the welfare principle is applied will require detailed changes in the operation of financial markets. This is true at the retail end of the spectrum. Among the worst excesses of the banks during the financial crisis and thereafter were the excesses and failures of its personnel: management, investment bank traders, and call centre operations. The mis-selling of financial instruments was made possible by poor management practices and poor training of sales staff who had the wrong incentives dangled in front of them, as became clear during the sitting of the UK Parliamentary Commission on Banking Standards. There needs to be a profession to govern the training and ethics of bank employees at many levels. This is true at the inter-bank end of the spectrum. The belated regulation of derivatives and similarly complex financial instruments has nevertheless placed responsibility for collating information about those markets into the hands of private-sector bodies—in the form of central counterparties and trade repositories—as opposed to independent regulatory bodies.[7] Moreover, a large number of such transactions will escape even that oversight. A better alternative would have been a more proactive attempt to control the use of derivatives by statutorily-created regulators and to empower regulators to rule (subject to appeal through the courts) that individual transactions which transgress private law or regulatory norms are void *ab initio*. Similarly, the shadow banking system as whole, and all buyers of financial instruments as well as sellers of financial instruments, must be brought within the regulatory net.[8] Nothing can be permitted to be conducted in the dark, as was the case with the credit default swap market before the crash.

46–09 In turn, the regulators must be subject to genuine democratic oversight and a more responsive system of appeals that can create a proper jurisprudence for our regulatory norms, instead of leaving them at the whim of the regulatory authorities. At present, the lines of accountability are tenuous at best.

A wall, not a ring-fence

46–10 Instead of envisaging the UK as an economy with the City of London and the financial sector as its principal drivers, we should think of the UK as being a modern, democratic society with citizens and businesses that deserve to live useful, happy lives, which also hosts a casino enterprise in the City of London. This "casino" comprises all of the speculative and other financial market activity which financial institutions conduct, except for the utility banking and financial services activities which are an essential part of ordinary life. The appropriate metaphor is to think of that casino as being contained within a high wall so that it cannot harm any of the ordinary activities that are carried on beyond that wall in ordinary society. In essence, consumer protection from the excesses of the financial sector is paramount, and must taken priority over the principle of freedom of contract. The idea of a "ring-fence" is simply not enough.[9] What the financial crisis demonstrated is that the City of London is capable of bringing contagion to dull banking activities on the high street and to parts of the economy

[7] See para 40-56 *et seq*.

[8] The welfare idea is considered in further detail at the end of this chapter at para.46–50.

[9] See the discussion of the banking regulation reforms in Ch.28 as to the "ring-fence".

which have no direct connection to the City of London. In an age with the risk of contagion, it is necessary to contain that contagion behind a high wall.

46–11 Many conclusions flow from this idea of a wall. Financial regulation must be astute to preserve a clear, rigid and constant division between speculative and non-speculative activities, as considered below. It is the role of a regulator to assume the worst and thus to prevent the worst from affecting the rest of society, no matter what the activities of financial institutions. This necessitates changes in our private law so that unconscionable or unsuitable or dangerous transactions are simply rendered void *ab initio*. Whatever the potential confusion in financial markets if a contract is held to be void, it is more important that ordinary society is protected from the effects of such contracts: the contagion must be kept behind the wall.

46–12 In essence, we must think of the UK as hosting a very successful casino activity in the City of London in which innovative quantitative analysts and motivated traders develop inter-bank activities as part of a global market; but none of that activity must be allowed to affect pension funds, retail banks and other institutions providing utility functions, public services, or the real economy.

Distinguishing between "utility" and "casino" activities

46–13 There is an important distinction to be made between the "utility" functions of financial institutions and their "casino" functions. The utility functions include deposit-taking, the operation of bank accounts, the provision of overdrafts, credit and ordinary loans, the provision of mortgages, and the payments systems which are now an essential part of economic life. These utility functions were considered in previous chapters. At root, the identification of a utility function is a recognition that while banks are private corporate entities, they nevertheless play a role in society which puts them on a plane of importance with water, electricity, gas and the transport network. By contrast, the casino function is concerned with speculative investment activities which are used by large corporations (which are sufficiently well-advised to fend for themselves if they choose to participate in those markets), and with straightforward profit-seeking by hedge funds, investment banks, and other entities created for the sole purpose of trading professionally in financial risk. In essence, we have forgotten the role that banking, insurance and related services are intended to serve in our society. A clear distinction between the utility and casino functions is necessary to ensure that the welfare principle is observed.

46–14 The difficult middle territory, clearly, for this welfare principle is occupied by the capital markets which are used by large corporate entities to raise share capital, bond capital, and so forth; and, as a separate matter, to manage their financial risk. It is suggested that capital markets should be considered to be part of the utility function of financial markets because they connect investors who have been provided with all the necessary information (as dictated by securities regulation) to make informed decisions as to whether or not they should invest. What is important, as part of the welfare principle, is that short-term investment is outlawed in relation to large corporations with employees and customers in the

real economy; short-selling should be prevented because it is morally objectionable, and investors should only be permitted to enter into physically-settled transactions (where they agree to acquire a company's securities) on-exchange and not cash-settled transactions (where they simply speculate on that company's future performance) in relation to specified groups of companies and public entities off-exchange. As for risk management activities, they should only be permitted where the selling institution can demonstrate precisely the risk which will be covered by risk management instrument, they should be subject to a maximum volatility clause such that the selling financial institution may not take payment beyond a maximum amount specified in the contract, and such that they shall be void *ab initio* in all other circumstances.

A paradigm shift

46–15 If financial regulation is considered first and foremost to be subject to the welfare principle so that regulation constitutes state protection of private citizens, small businesses and other entities of particular significance to the real economy (as opposed to being considered primarily as an economic question), then the answers which are generated in the debate about the appropriate mechanism for financial regulation are different from the answers which are generated by economics. Instead of focusing on economic efficiency and the need for banks to be free to make profits in a free market, the principal focus shifts to the need to protect economically important actors from the excesses, abuses and mistakes of all financial institutions, thus permitting many more practices to be prohibited to prevent the possibility of a repeat of the scandals of recent years, ranging from another systemic financial crisis at one end of the spectrum right down to mis-selling insurance products or unnecessarily complex interest rate swaps to private customers or small businesses at the other end. What became self-evident in the autumn of 2008, even to those who had refused to acknowledge the problem before, is that this current form of capitalism (which is predicated on complex financial markets as a means of creating growth and managing risk through purported mathematical wizardry) is inherently unstable (based as it is on volatile financial markets to turn a profit) and dangerous for people, public bodies and businesses who play no direct part in those markets. If the nation state has a purpose at all, then it is to enhance the security of its citizens.

2. INTERNAL SYSTEMS AND CONTROLS

A. Introduction

46–16 The discussion in the preceding chapter and in Chapter 9 demonstrated both that the *FCA Handbook* and the *PRA Handbook* contain regulations which require the preparation and maintenance of appropriate internal systems and that many banks simply do not observe these regulations (and that their senior executives do not appreciate that they personally are subject to those regulations). The entire financial crisis demonstrated that a lack of effective internal controls has allowed many colossal risks to arise within institutions (such as Citigroup and JP Morgan

Chase). Moreover, a misplaced focus in the Walker Review solely on corporate governance at the level of the board of directors is insufficient to cope with rogue trader and similar problems. The crises are often created deep underground, and not in the sunlight of the boardroom.

B. The personal legal liability of all bank directors and "nominated officers"

46–17 The most far-reaching single reform which could be made to banking regulation, which would have a direct effect on every trading floor and in every branch office, would be to make bank directors and other nominated members of senior management outside the board ("nominated officers") personally legally liable for all of the losses and defaults of the institution as though they were partners under a traditional English law partnership. In this way, a substantive law liability will transform the internal governance of financial institutions.

46–18 In my personal experience, financial institutions which are organised as partnerships are far more responsive to the need to control risks and are far more likely to seek actively to comply with the spirit of financial regulation than financial institutions which are organised as companies. In a classic English law partnership, the individual partners face personal responsibility for any losses suffered by the firm and liability for any wrong or criminal act committed by the partnership. If members of the board of directors and senior managers occupying identified offices (and performing specified functions within the institution) were personally liable for any default made by any officer of that bank (whether in tort, contract, criminal law or equity), then the type of system which would be created would be completely different from the sort of loose systems which are typically created in corporate entities where no individual is likely to face direct personally liability. It would be impossible for a senior manager at JP Morgan to blame underlings for a loss of US$6.2. billion because no information was passed up the chain; it would be impossible for the executives at Citigroup to throw up their hands and say that they did not know that there was a loss of US$60 billion fermenting in the belly of their institutions; and it would be impossible for the CEO of Barclays Bank to say that he did not know well the corner of the bank in which criminal activity appears to have taken place.

46–19 Therefore, the legal liabilities of directors of banks, directors of regulated financial institutions and the equivalent fiduciary officers of unregulated financial actors (such as hedge funds) when falling under the jurisdiction of English law, should mimic those of ordinary partners. For ease of reference, all of the fiduciary officers in any sort of financial institution will be referred to here as "directors", as they are at present. Individual directors should face personal liability both in damages for any losses suffered by any person dealing with the institution or by the institution (and thus its shareholders) directly, and those individual directors shall also be personally liable for any fraud, negligence, criminal offence or other wrong committed by any employee or other agent of that institution, whether or not acting within the terms of her agency but where acting on behalf of the institution. All such liabilities should operate jointly and

severally on all of the directors, so that there is no opiate on the conscience of any single director by dint of saying that the wrong was committed in another department of the institution.

46–20 The benefit of these policy suggestions would be that the directors of financial institutions would be required to take positive steps to ensure that the institution is not taking inappropriate risks or that there are no traders who are indulging in practices which breach conduct of business rules, on pain of being personally liable for any loss or liability caused thereby. In my personal experience, where a large trading floor contains many hundreds of traders, it is very difficult to watch over all of them every minute of every day, but a well-run institution will nevertheless put systems in place—typically having at least one person on each trading desk (aside from any executive or senior trader) whose role is solely to ensure regulatory compliance, appropriate booking of trades with the middle office, and so forth—to oversee all of those traders' activities. By making the directors personally responsible for any loss or liability caused by any trader, the observation of all traders will be much closer and therefore the institution will develop a conscious ethic and culture of active regulatory compliance, instead of merely the intermittent lodging of reports or capital to achieve the minimum necessary to satisfy the regulator.

46–21 In corporate institutions there is otherwise no incentive for managers and senior traders to avoid sharp practice or corners being cut. It is not unknown for compliance departments in financial institutions in London to be located in offices more than a mile away from the building in which the traders sit, so that regulatory compliance is conducted at arm's length. The compliance officers are strangers on the trading floor and their presence is often actively resented. There are many in-house counsel, documentation specialists and compliance officers who know only too well what it is like to receive the sharp end of a senior trader's tongue for suggesting that a practice is being conducted inappropriately and who know only too well what it is like to be told that they are "simply making trouble" when identifying a technical legal problem with a transaction. These sort of badly-run banks are not only treating their lawyers in this fashion but are generally also dismissive of risk management and long-term investment strategies because their traders' goals are to maximise their individual bonuses and not to look to the long-term good health of the institution nor its customers. Poorly run financial institutions cannot anticipate that exposure to some markets runs the risk of bankrupting the entire firm, and so the risk of failure is all the higher.

C. The personal responsibility of nominated officers

46–22 Universal banks are so big that imposing liability on a few sacrificial objects at the top will not ensure that there is proper performance on the trading floor. In banks that size, it is possible never to meet a bank director after years and years of successful service. Therefore, it would make sense within banks to have "nominated officers" from among senior- or middle-management (as appropriate) to be responsible for any of a list of "outward-facing" activities, ranging from