Queen Mary University of London
School of Law

LAW OF FINANCE

Lecture Course Documents

2009-10

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THE LAW OF FINANCE

The Aims and Objectives of this Module

Teaching and learning method

The principal aim of this module is to enable the study of the law of finance for the first time in the UK at undergraduate level. The Law of Finance will apply students' knowledge of core concepts of English law (from study at Levels 4 and 5) to the contexts of EC and UK financial regulation and financial practice. Students will analyse the regulatory and legal framework created by the Lamfalussy Process at the EU level and by the Financial Services and Markets Act 2000 at the UK level. Students will analyse, *inter alia*, the overlap between substantive law and financial regulation, theoretical questions of law and risk in financial markets, the legal context of financial crime and market abuse, standard market contractual structures, the overlap between tort law and statutory liabilities to pay compensation for wrongs, the role of fiduciary duties in financial transactions, how to take security in financial transactions, financial aspects of tort, contract and property law, specific legal aspects of banking, lending, securities and derivatives activity, and the legal and regulatory context of financial market failures.

Learning outcomes

Students will demonstrate a knowledge of financial regulation, a knowledge of the relevant principles of English and EU law, an analytical understanding of the principal issues relating to the legal analysis of financial markets, and a critical understanding of the social impact of financial law and regulation.

Students will be able to apply their knowledge so as to analyse and to provide arguable conclusions for practical problems; so as to analyse issues arising from the inter-action of principles of private law, financial regulation, and statute to the specific context of financial market activity; so as to analyse the manner in which financial markets inter-act with law and with regulation; and so as to exercise critical judgment in relation to such issues.

Resources

The course will be supported by on-line resources on the Course Organiser's web-site and Blackboard/WebCT, including podcasts, links to further reading and research materials, and vodcasts. These further materials will facilitate student research activity into the principles of financial regulation, the work of trade associations, and standard market contracts which are principally available only on-line.

The purpose of the lectures

These lectures have two purposes. First, to educate you about the law of finance and, secondly, to prepare you for the examination. It is the first goal which is the principal concern of the lectures; although attention will be paid in clearly identified ways to the examination. The seminars will both permit you to discuss the key issues and any other issues arising from this module which you wish, but they will also identify which aspects of this module are specifically examinable and how other material may be used, for example, in writing essays or commenting on the substantive law. The lectures will make it very clear what material will be covered in the seminars (and so which will be examinable) and what material is outside the scope of the seminars. The examination will give you the opportunity to write essays on topics which you have researched for yourself, collecting themes that cross over between seminars and which exist outside the formal "set reading" in the module itself. A specimen examination paper is included at the end of these Course Documents: although, importantly, the precise nature of the May examination may change from that specimen paper as the module progresses, but any such changes will be identified and explained clearly in lectures. A copy of the marking scheme which will be used in assessing this module during the year and in the examination is set out below.

A suggestion for how to go about your study

Given that there is a close structural overlap between the textbook and these Course Documents, it is suggested that you read in advance *before lectures*. It would be enough to skim-read through the bits of the textbook which are to be covered in lectures. You will therefore understand the lectures better and be better able to identify which material is being focused on and which material is not being focused on. If you do not read much of the text, each chapter in the textbook begins with a statement of the general principles covered in that textbook: if you read only those summaries, that would introduce the lecture material instead of hearing it "cold" in the lecture. Then prepare for your seminar after lectures. And as soon as possible after your seminar, while you understand the material best and while it is fresh in your mind, write up your notes for April (so that you do not have to do work from scratch during the revision period).

Advice on how to study for open book examinations and open book courses

In an open book examination you may take any notes, textbooks, print-outs of any material whatsoever – as long as it is not brought into the exam on a computer or other electronic device. *But in the exam you should not rely on your notes or other material. You must know the material.* You should only bring in aides-memoire, essay plans, and similar short notes. If you do not actually know the material then you cannot spot the issues in problems nor the key focus of essay questions. You will also waste time looking up material when you should be thinking or writing.

Your preparation must fit your own personal work method, of course. It is suggested that open book examinations favour people who work hard, steadily and well during the year, and they stop examinations being merely a memory test. If you have worked hard through the year, then you will be able to take the fruits of your work into the examination with you. You do not have to worry about forgetting something. Therefore, you can focus on writing the best script you can. You will, however, get no

credit for simply copying passages out of textbooks or articles or cases; you will get credit for your own ideas. Consequently, open book examinations allow you to prepare for what you will do in the exam room in advance of the exam.

It is suggested that you work in the best way for you to revise as though you were going to sit a closed book exam, and that you seek to reduce your notes, etc., to as short a version as you can (probably no more than a single ring binder for the whole course, with one or two pages of brief notes or diagrams for each topic you choose). So, after seminars it is suggested that you try to prepare these short notes which you will use in the examination, and so in the revision period you will have less core work to do and instead you will have more time to plan and practise for the examination.

The Syllabus

(1) Sources of finance law
- "Money", "finance" and the role of law in financial markets
- Risk
- (Key financial markets, products and instruments)

(2) Financial regulation
- EU financial regulation
- UK financial regulation
- Market abuse

(3) Conduct of business regulation
- Markets in Financial Investments Directive
- Conduct of Business Sourcebook
- Themes in the overlap of private law and financial regulation

(4) Financial crime
- Market abuse and insider dealing
- Money laundering

(5) Contract law
- Creation of contracts in the light of conduct of business regulation
- Master agreement structures and standard market agreements
- Loan contracts and syndicated lending
- Termination of financial contracts and remedies

(6) Lending transactions
- Ordinary lending
- Syndicated lending
- Bonds

(7) Securities regulation
- Offers of securities to the public
- Prospectus regulation
- Transparency obligations
- Listing of securities
- Liability for issues of securities

(8) Tort Law
- Tort of deceit
- Negligence
- Application of tort law to takeovers and issues of securities
- FSMA 2000 specific liabilities for wrongs

(9) Breach of fiduciary duty
- The concept of fiduciary liability in finance law
- Dishonest assistance
- Unconscionable receipt
- Proprietary liabilities

(10) Banking law
- The banker-customer relationship
- Payment systems
- Principles of banking regulation

(11) Banking regulation
The tri-partite regulatory structure
The Banking Act 2009
The legal context of the financial crisis of 2007-09
(12) Derivatives (lecture only)
The nature of financial derivatives
The documentation of financial derivatives
Collateralisation and taking security

Lay-out of the materials

These lecture materials cover the module for the entire year. Each chapter in these materials correlates with the same numbered topic in the Seminar Materials. So, Chapter 2 in this document provides all of the reading for Seminar 2 in the Seminar Materials, etc..

You are expected to read all statutory and relevant regulatory material - this will be essential for an understanding of the subject. You are also expected to read all cases marked with an asterisk * at the very least in outline or at least to have familiarised yourself with their principles, but you are advised to read them in full in the law reports. Cases marked ** are essential reading, being leading or very important cases, and so must be read in full in the law reports. All other cases can be researched in a textbook to identify their key principles.

Copies of these materials

Materials for this course can be found on-line at:
www.alastairhudson.com/financelawindex.html and on QM's WebCT/Blackboard.

Reading Materials

Textbooks

Alastair Hudson, *The Law of Finance* (1e, Sweet & Maxwell, 2009). *This is the first textbook in the world to attempt to describe the whole of the law of finance for undergraduate and postgraduate students. The author's web-site contains podcasts by Professor Alastair Hudson on various aspects of this course and other materials, as well as links to other people's podcasts. This book is referred to as "Hudson" in these materials.*

Other textbooks

Wood, *The Law and Practice of International Finance (University Edition*, Sweet & Maxwell, 2008).
Ellinger and Lomnicka, *Modern Banking Law* (Oxford, 2009).
Cranston, *Principles of Banking Law* (Oxford, 2002).

Cases and materials books

There aren't any. Sorry. However, a large amount of material will be made available on an ongoing basis on www.alastairhudson.com in relation to each seminar before that material is covered in lectures, and on WebCT/Blackboard.

Practitioners' texts:-

Butterworths Banking Law Encyclopaedia, (LexisNexis, looseleaf) covers a part only of the module.

Financial Services Law Encyclopedia, (Sweet & Maxwell, looseleaf), annotated statutes only.

Alastair Hudson, *Securities Law* (1e, Sweet & Maxwell, 2008)

Alastair Hudson, *The Law on Financial Derivatives* (4e, Sweet & Maxwell, 2006)

Alastair Hudson, *The Law on Investment Entities* (Sweet & Maxwell, 2000)

Alastair Hudson, "Capital Issues" in *Palmer's Company Law* (Sweet & Maxwell, loose-leaf)

A McKnight, *The Law of International Finance* (1e, OUP, 2008)

W Blair and G Walker (eds), *Financial Services Law* (2e, OUP, 2009)

W Blair and G Walker (eds), *Financial Markets and Exchanges Law* (1e, OUP, 2005)

On-line materials

- www.ft.com – you should take out a free subscription to the Financial Times web-site. Financial markets move on news, and this is the world's best business newspaper.
- http://online.wsj.com/home-page - the USA's leading financial newspaper, although much of its material is becoming subscription only.
- http://europe.wsj.com/home-page - this is the European edition of the WSJ
- www.fsa.gov.uk – this is the only place you can find the detail of the Financial Services Authority's regulations which govern a large part of the financial activity which we shall cover in this course. The regulatory rulebook is known as the "FSA Handbook" (http://fsahandbook.info/FSA/html/handbook/).
- www.economist.com – The Economist is a weekly newspaper with at least one section devoted to financial issues. It has an impressive coverage of world and business news in both short and long articles. There are special rates for students and the web-site provides other material too.
- You can look at the Business/Financnial pages of any quality newspaper but they are less good (except, sometimes, if you want to consider "personal finance" as opposed to corporate finance issues). Among the good newspaper business pages are:
    - the US "newspaper of record" *The New York Times* (http://www.nytimes.com/pages/business/index.html).
    - Oddly good on the financial crisis has been a series of lengthy articles in *Vanity Fair* (http://www.vanityfair.com/)
- Legal databases – you will to access the usual databases: Westlaw, LexisNexis, www.bailii.org, etc., in the usual way.
- Journals – there are some journals, like the Journal of International Banking Law and Regulation, The Company Lawyer, European Financial Services Law, PLC, and the Journal of Business Law which have articles on finance law and very specific financial law issues – they are mostly written by practitioners and so tend to focus on practical questions.

Introductory reading

Hudson's *Law of Finance* has a large amount of further reading in its footnotes containing a large amount of journal and treatise literature. This is how you will find a lot of further reading, as well as the articles to which you are referred in these Course Documents. A number of further files and web-links can be found in .pdf format via:

www.alastairhudson.com/financelawindex.html.

General background reading
None of this reading is compulsory, but you may find it useful. Hudson's textbook contains a Glossary of key terms, and his web-site contains even more.

Background reading on finance
These books will give you definitions of particular market sectors and products, and/or descriptions of how finance works in practice. If you familiarise yourself with these books, then it will make your study more rewarding. There are many other books (have a look on Amazon!) but these are some of the more useful.

- Michael Brett, *How to Read the Financial Pages* (Random House)
- Philip Coggan, *The Money Machine – how the City works* (Penguin)
- William Clarke, *How the City of London Works* (Sweet & Maxwell)
- *Barron's Dictionary of Financial and Investment Terms*

There are lots of books on the seismic financial crisis of 2007-09 specifically (and on historical comparisons), but those books are listed in detail in Topic 11.

Do I need to know all about finance before the course starts?

The short answer is: "no". Oddly you do not need to understand finance before you start to study finance law. Somewhat sarcastically, one might wonder how much some practising lawyers know about finance. Clearly, the more you know about finance, the more comfortable you may be with the course; however, the textbook explains all of the financial products we are covering and many others besides. The textbook also includes a *Glossary* to explain those terms further, and www.alastairhudson.com has a number of podcasts to explain them further still. So, do not worry. The lectures will explain everything you need to know. More important, in fact, for some aspects of finance law is understanding the sort of issues which arise in financial markets – and that is why keeping up with the Financial Times, the Economist, and so on, is probably as useful a form of education as any other because the issues and the products change so fast and so often.

The prescribed reading

The bulk of the prescribed reading refers to Alastair Hudson, *The Law of Finance* (Sweet & Maxwell, 2009) which is referred to in these Course Documents as "**Hudson**" at the right-hand edge of the materials. The reading is identified by the specific numbered paragraphs in that textbook. You should of course read whatever you wish, although this module expects you to be familiar with the law, regulation and issues raised in the Course Documents and in particular the material specified more narrowly in the Seminar Materials. You can assume that all of the sections below a reading reference are covered by that reference. In numerous places other reading is also suggested. You may choose to refer to any of the texts identified above, although by no means all of them consider all of the substantive law covered by this module.

Note: the Seminar Materials specify precisely with which paragraphs you are expected to be familiar. The Seminar Materials make it clear on which sections of these Course Documents the examination will focus, as will be explained in the lectures. However, the Course Documents contain further material on which you may choose to write and, more importantly, which will constitute your education in the law of finance.

Assessment

Examination

This subject is examined by one three-hour **open book** examination with fifteen minutes reading time. You are required to answer **three** questions in those three hours. There were no past papers in 2009, so a specimen exam paper is attached to these course documents and examples of possible exam questions are included in your seminar materials. The specimen exam paper will form the subject of the two revision lectures at the end of the course.

In-course written work

Each student is expected to produce one piece of written work in each semester. These assessments are contained in your separate Seminar Materials pack. The aim of these assessments is to educate as to what the end-of-year examiners are looking for in a good law of finance script. Students should also refer to the *Guidance for Students* issued at the beginning of the year for details of our marking schemes: i.e. how to get a 2:1, etc.. A copy of the marking scheme which explains those distinctions is included in the Seminar Materials.

Seminars

You will be issued with Seminar Materials separately. Your seminar group will meet fortnightly. You are expected to contribute to seminars: there is no doubt that an ability to verbalise your ideas in this subject will help your written work immeasurably. It goes without saying that you are expected to be fully prepared for seminar sessions and able to answer the questions included on the seminar sheets.

Teaching Staff

Lectures will be delivered by Alastair Hudson. Seminars will be led by Magdalena Latek.

Marking Scheme

The marking scheme is that set out in the Department of Law's Guidance for Students. A copy of it is attached to the Seminar Materials.

Timetable of Lectures

Week: week commencing	*Topic: first lecture / second lecture*
1: 29 / 9	To begin at the beginning / Financial Regulatory Fundamentals (FRF) 1: The Lamfalussy process
2: 6 / 10	FRF 2: The Financial Services Authority / FRF 3: The s.19 principle
3: 13 / 10	FRF 4: Conduct of business (i) / FRF 5: Conduct of business (ii)
4: 20 / 10	FRF 6: Market abuse / Crime: Insider dealing (i)
5: 27 / 10	Crime: Insider dealing (ii) / Crime: Money laundering
6: 3 / 11	Contract 1: Formation of contracts / Contract 2: Validity of contracts
7: 10 / 11	***Reading week***
8: 17 / 11	Contract 3: Master agreements / Contract 4: Taking security
9: 24 / 11	Contract 5: Termination and Remedies / Ordinary lending (i)
10: 1 / 12	Ordinary lending (ii) / Syndicated lending and bonds (i)
11: 8 / 12	Syndicated lending and bonds (ii) / Securities regulation (i): outline
12: 15 / 12	Securities regulation (ii): prospectus / Securities regulation (iii):transparency
	Christmas Vacation
1: 11 / 1	Securities regulation (iv): listing / Securities regulation (v): liability
2: 18 / 1	Tort: Fraud / Tort: Negligence (i)
3: 25 / 1	Tort: s.90 + s.150 / Fiduciary liability
4: 1 / 2	Dishonest assistance / Knowing receipt
5: 8 / 2	Constructive trusts / Banking law: banker-customer relationship
6: 15 / 2	Banking law: banker-customer relationship / Banking law: payments
7: 22 / 2	***Reading week***
8: 1 / 3	Banking Regulation (i) / Banking Regulation (ii)
9: 8 / 3	Derivatives: products / Derivatives : documentation
10: 15 / 3	Derivatives: collateralisation / Derivatives: termination
11: 22 / 3	Themes: the future for finance law / Reflections: the Credit Crunch 2007-09
12: 29 / 3 **End of term**	*Revision / Revision*

Chapter 1: Introduction: The Sources of Finance Law

The material in this chapter introduces the course, and the general discussion you will have in Seminar 1 is covered by this material.

All references to **Alastair Hudson, *The Law of Finance*** (Sweet & Maxwell, 2009) are referred to as "**Hudson**".

1. BEGINNINGS

Hudson, "Introduction" & 1.01-1.29

- What is finance law about?
- Finance does not exist; rather, we are creating finance law.
- Finance law may encompass all legal concepts – the best finance lawyers are creative users of law.
- Seeing the world of finance through *The Matrix* of law.
- The lawyer as a "risk manager".
- The overlap between substantive law, financial regulation and market practice.

2. SOURCES OF THE LAW OF FINANCE

Hudson, "Introduction"

The principal sources of the law of finance are financial regulation (drawn ultimately from European Union law), English case law (from common law and equity), and UK statute. The law of finance is a synthesis of these sources, and understanding the practice of the law of finance requires us to consider the standard market contracts used in many financial markets and the extant market rules which apply in other markets.

2.1 EU law

The Lamfalussy Process
Financial services directives
Commission technical regulations
(Other international regulatory initiatives)

2.2 UK Statute

Financial Services and Markets Act 2000
Companies Act 2006
Banking Act 2009, etc.

2.3 UK financial services regulation

FSA Handbook

Principles for Businesses
Conduct of Business

2.4 The general, substantive law

Contract law
Tort law
Property law
Equity & trusts
Criminal law, etc.

2.5 The structure of private law

Concepts & Contexts

3. THE METHODOLOGY OF FINANCIAL REGULATION IN A NUTSHELL

- The regulation of information
- No protection from your own stupidity
- Expert and inexpert investors – suitability
- Banking – protecting the economy and the mass of the population
- Divisions in finance – are each regulated differently?:
    - Investment/Securities v. Banking
    - Investment banking v. Retail banking v. Commercial banking
    - Trading v. Corporate Finance
    - Speculation v. Funding v. Risk management
- Cf. Glass-Steagall Act, post-1929 Great Crash

4. THE ROLE OF THE LAWYER

Hudson, pages lvi-lviii

- Risk manager
- Translator
- "Structuring" products

5. THE AMBIT OF THE LAW OF FINANCE

5.1 The definition of "finance"

Hudson, 1.01-1.08

- The word *finance* comes from the Latin "finis" meaning an "end"
- "settling a debt"
- "to pay a ransom"
- "fineness" of gold
- "to furnish with finances and to find capital for"
- *the wherewithal to act*

5.2 Finance does not exist … but thinking makes it so

Hudson, 1.09-1.15

- "Tlon, Uqbar, Orbis Tertius", in *Fictions* by Jorge Luis Borges (1946)
- Money never sleeps: global financial marketplaces

5.3 The distinction between the substantive law and financial regulation

Hudson, 1.17-1.22

- substantive law
- financial regulation

6. PRIVATE INTERNATIONAL LAW / CONFLICT OF LAWS

Hudson, 1.24-1.29
Hudson, chapter 6

This topic is not strictly part of this course, but understanding the context of Conflict of Laws issues will help to understand how the financial markets operate.

- Contract law
  - What is the governing law / proper law of the contract? (i.e. which system of rules will govern disputes)
  - Which jurisdiction governs the contract (i.e. which courts will decide any dispute)
  - Where is the contract formed? E.g. traders in different countries dealing with assets in a third country.
  - What remedies are available
- Tort law
  - Where was the tort committed?
  - Which system of law will decide liability?
  - Which remedies are available?
- Property law
  - Where are the assets located? (what if they are intangible assets?)
  - Distinguish between land (immovable property) and movable property

7. THE SEVEN CATEGORIES OF FINANCE

Hudson, 1.30-1.45

The 7 categories of finance from a lawyer's perspective

1. Banking
2. Lending
3. Stakeholding
4. Speculation
5. Refinancing
6. Proprietary finance
7. Communal investment

8. RISK

Hudson, 1.46-1.79

8.1 Financial risk management

- "All investment involves risk": so said Lord Nicholls (*Royal Brunei Airlines v Tan* [1995] AC 378). Indeed, all banking involves risk.
- Volatility
- Risk = opportunity

- Glass-Steagall Act: separation of investment banking and retail banking
- Risk management: e.g. *Black-Scholes* option pricing model
- Dangers of the use of financial models: Taleb, *Black Swan* (2008)

8.2 Financial conceptions of risk

- Mathematical modelling of products
- Risk management across markets

8.3 The "Risk-Return" calculation

- A measurement of the *risk* associated with an investment compared to the expected *return* from that investment
- e.g. Capital Asset Pricing Model, which measures the perceived risk of an investment against its expected return (or, profit)

8.4 Types of financial risk

(1) Systemic risk
(2) Market risk
(3) Counterparty credit risk
(4) Collateral and credit support risk
(5) Insolvency risk
(6) Payment risk
(7) Documentation risk
(8) Personnel risk
(9) Regulatory risk
(10) Tax risk
(11) Cross-default risk

8.5 Social risk

- Risk as choice
- The new risk society (Beck, *The Risk Society* (1992))
- Financialisation and risk (e.g. Thomas Palley)
- Risk allocation in law
- Law as a risk in itself

Chapter 2: Financial Regulation

The material in this chapter constitutes the reading for Seminar 2.

1. EU FINANCIAL REGULATION

General reading
Hudson, Chapter 7
Moloney, *EC Securities Regulation* (2e, 2009)
Ferran, *Building an EU Securities Market* (2004)
Usher, *The Law of Money and Financial Services in the EU* (1999)

1.1 Central principles of EU law

Hudson, 7.01-7.13

1.1.1 Treaty provisions

EC Treaty, article 2: (common market)

> 'The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious, balanced and sustainable development of economic activities …, sustainable and non-inflationary growth …, and economic and social cohesion and solidarity among Member States.'

EC Treaty, article 3: (free movement)

> '(c) an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital; …
> (h) the approximation of the laws of Member States to the extent required for the functioning of the common market …'

EC Treaty, article 56: (free movement of capital)

> '(1) … all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.'

EC Treaty, article 249: (direct effect of directives)

> 'A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.'

1.1.2 Key concepts of EU law during 2000-09

- The single market – "passporting" / "single licence" theory
- The use of directives to establish high-level principles
- General EU legal concepts
  - Direct effect
  - Subsidiarity

- Proportionality

1.1.3 Direct effect of financial services directives

Marleasing SA v La Comercial Internacionale de Alimentacion SA [1990] E.C.R. I-4135, [8].

> "in applying national law, whether the provisions in question were adopted before or after the directive, the national court called upon to interpret it is required to do so, as far as possible, in the light of the wording and the purpose of the directive in order to achieve the result pursued by the latter and thereby comply with [art 189(3) EC]".

Unilever Italia SpA v Central Food SpA [2000] E.C.R. I-7535, [50].

> "[w]hilst it is true … that a directive cannot of itself impose obligations on an individual and cannot therefore be relied upon as such against an individual … that case-law does not apply where non-compliance with [the relevant directive giving rise to the technical regulation], which constitutes a substantial procedural defect, renders a technical regulation adopted in breach of [the directive] inapplicable".

1.2 The evolution of EU financial regulatory policy

Hudson, 7.14

1.2.1 EEC policy proposals

- 1957 Treaty of Rome = free movement of capital
- 1966, The Segré Report ("Report by a Group of Experts Appointed by the EEC Commission, *The Development of a European Capital Market*") = harmonisation of national laws.
- 1977, EC Commission: a draft "European Code of Conduct relating to Transferable Securities" (Recommendation 77/534/EEC ([1977] OJ L212/37).
- 1985, Commission White Paper: "Completing the Internal Market" (COM (85) 310, 14 June 1985) = harmonisation.
- 1993, Investment Services Directive: Directive 93/22/EEC ([1993] OJ L141/27); but no derivatives, etc..
- 1999, Financial Services Action Plan (COM (1999) 232).

1.2.2 Case law on the use of passporting

- Case 120/78 *Rewe-Zentral AG v Bundesmonopolverwaltung fur Branntwien (Cassis de Dijon)* [1979] ECR 649 (instrument acceptable in one member state = acceptable in all).
- Case 262/81. *Citodel v Cine-Vog Films* [1982] E.C.R. 649 (applied *Cassis de Dijon* to financial services).

1.3 "The Lamfalussy Process"

Hudson, 7.15-7.21

1.3.1 Report of the Committee of Wise Men, February 2001.
www.europa.eu

- Previous policies not working so as to create a single market for securities
- Passporting

    - Regulatory authorisation in one member state = authorisation in all
- Methodology
- 1: high-level principles in directives
    - Framework principles
    - Allows legislation to react to market changes
    - E.g. ISD 1993 was out-of-date before its implementation due to expansion of derivatives markets
- 2: Commission technical directives
    - The meat-and-pith of the rules
    - Generally copy-and-paste by FSA in the UK
- 3: CESR (Committee of European Securities Regulators)
    - Sounds like "Caesar"
    - Promotes co-ordination between regulators
- 4: Enforcement
- Methodology now used for all financial services activity, not just securities

1.3.2 Issues with EU financial regulation

- Different language in the directives
    - Harmonisation
    - Approximation
    - Co-ordination
    - Not "equalisation", not "the same"
    - "Approximate harmonisation"
- Note: there is no single regulator for securities markets nor for banking activity in the EU

1.4 The Markets in Financial Instruments Directive

Reading:
Hudson, 7.22-7.38
C. Skinner (ed), *The Future of Investing in Europe's Markets after MiFID* (Wiley Finance, 2007)

This Directive is covered in much greater detail in Chapter 3 in relation to "Conduct of Business" regulation, and so is only considered here in outline terms.

1.4.1 The purpose of MiFID

The Markets in Financial Instruments Directive ("MiFID"), 2004/39/EC.
MiFID Implementing Directive ("MID"), 2006/73/EC.
Commission technical regulation 1287/2006/EC.
Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007 (S.I. 2007/126).

- 3 activities covered by MiFID:
    - the authorisation of people to conduct investment business,
    - the regulation of the markets on which investments are bought and sold, and

    - the regulation of the conduct of business.
- Encourages competition in the provision of securities markets
    - Exchanges
    - On-line exchanges
    - Multi-lateral trading platforms (“MTS’s”)
    - Systematic internalisers
- Movement towards principles-based regulation
- Passporting regulatory approvals
- NB: imposition of positive obligations

1.4.2 Authorisation and organisation of investment firms

Article 13, MiFID:

2. … establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under the provisions of this Directive as well as appropriate rules governing personal transactions by such persons.
3. … maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in art.18 from adversely affecting the interests of its clients.
4. … take reasonable steps to ensure continuity and regularity in the performance of investment services and activities. To this end the investment firm shall employ appropriate and proportionate systems, resources and procedures.
5. … ensure, when relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, that it takes reasonable steps to avoid undue additional operational risk. Outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the supervisor to monitor the firm’s compliance with all obligations.

An investment firm shall have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems.

6. … arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable the competent authority to monitor compliance with the requirements under this Directive, and in particular to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients.
7. …, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients’ ownership rights, especially in the event of the investment firm’s insolvency, and to prevent the use of a client’s instruments on own account except with the client’s express consent.
8. …, when holding funds belonging to clients, make adequate arrangements to safeguard the clients’ rights and, except in the case of credit institutions, prevent the use of client funds for its own account.

1.4.3 Conduct of business regulation

See Chapter 3.

1.4.4 "Best execution"

art.21, MiFID:

> "investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order."

1.4.5 "Best interests of the client"

art 19(1), MiFID:

> Investment firm must act "honestly, fairly and professionally in accordance with the best interests of its client"

1.4.6 Expected benefits of MiFID

- Increased competition between market service providers and within securities markets
- Enhanced investor protection through new conduct of business rules
- Increased transparency as to the practices of service providers, the costs of services, and best execution for the customer
- Increased transparency about available markets
- More effective and more approximate regulation between member states
- Principles-based regulation

1.4.7 Why markets were concerned about "build your own" regulation

- Movement away from "box-ticking"
- Requires institutions to consider their practices
- For firms, box-ticking is easier to comply with
- Concern about unknown breaches of regulations
- How to know what FSA's approach would be?

1.5 Securities regulation directives

Hudson, 7.39-7.43

The regulations are:

- Consolidated Admissions and Reporting Directive
- Prospectus Directive
- Transparency Obligations Directive

Securities regulation is considered in depth in Chapter 7 of these Course Documents.

1.6 Banking regulation directives

Hudson, 7.44-7.47

The principal regulations are:

- [Basel II Accord – Bank of International Settlements]
- The Second Consolidated Banking Directive 2006/48/EC

Banking regulation is considered in depth in Chapter 11 of these Course Documents.

1.7 General financial services directives

Among the other notable regulations are:

- Market Abuse Directive
- Accounting Standards Directive

2. UK FINANCIAL REGULATION

Hudson, Chapter 8

2.1 The Financial Services and Markets Act 2000 regime

Hudson, 8.05-8.18

2.1.1 The central principle

It is a criminal offence under s.19 of FSMA 2000 to conduct any of the activities identified in Sch.2 FSMA 2000 or the Regulated Activities Order 2001 without authorisation to do so from the FSA or from the competent authority of another member state of the EU.

2.1.2 The Financial Services Authority

- The Financial Services Authority ("FSA") was created by the Financial Services and Markets Act 2000 to regulate investment and non-banking activity.
- Banking is regulated by the Bank of England, the FSA and the Treasury (tri-partite authority.
- Previously, a series of self-regulatory organisations ("SRO's")

2.1.3 The regulatory objectives of the FSA

FSMA 2000, s.2(2)

> "market confidence, public awareness, the protection of consumers, and the reduction of financial crime".

Issues with those regulatory goals.

- "Market confidence" is not the same as investor protection.
- "Public awareness" includes promotion of understanding of the financial system among the public (i.e. education)
- "Protection of consumers" = "the appropriate degree of protection for consumers". Including, FSMA 2000, s.5(2):

- "(a)… the different degrees of *risk* involved in different kinds of investment or other transaction;
- (b) the differing degrees of *experience and expertise* that different consumers may have in relation to different kinds of regulated activity;
- (c) the needs that consumers may have for advice and accurate information; and
- (d) the general principle that consumers should *take responsibility* for their decisions."

- Proportionality: FSMA 2000, s.2(3)(c): "a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be *proportionate* to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction…"

2.2 The six tiers of regulation

Hudson, 8.19-8.27

1. high level principles
2. generally applicable regulatory standards
3. supervisory rules
4. prudential rules
5. specific market regulation, and
6. complaints and compensatory mechanisms

2.3 The *FSA Handbook*

www.fsa.gov.uk: everything is on-line
general survey, Hudson, 8.42-8.53, with more specifics set out below.

2.4 "Principles for Businesses"

Hudson, 8.28-8.32
& 9.17-9.29

'1. *Integrity.* A firm must conduct its business with integrity.
2. *Skill, care and diligence.* A firm must conduct its business with due skill, care and diligence.
3. *Management and control*. A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. *Financial prudence*. A firm must maintain adequate financial resources.
5. *Market conduct*. A firm must observe proper standards of market conduct.
6. *Customers' interests*. A firm must pay due regard to the interests of its customers and treat them fairly.
7. *Communications with clients*. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. *Conflicts of interest*. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. *Customers: relationships of trust*. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

10. *Clients' assets*. A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. *Relations with regulators*. A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.'

2.5 Principles-based regulation

Hudson, para 3-32-3.34
& 8.33-8.41

- *Principles for Businesses*: "integrity" – the letter and the spirit of the rules
- Similar to the common law method
- Similar to "conscience" in equity?
- The Lamfalussy methodology – recognition that markets move too fast for detailed legislation alone
- But does high-level principle mean regulation is too "hands-off" (and lazy?)
- "Light touch" regulation (see below – is this light touch at all?)
- A jurisprudence needs to emerge; a jurisprudence based on fundamental principles applied coherently and consistently to subtly different situations.

2.6 The general prohibition: s.19 FSMA 2000

Hudson, 9.05-9.16

2.6.1 The general prohibition itself

Section 19(1) FSMA 2000 "The general prohibition":

'No person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is –
(a) an authorised person; or
(b) an exempt person.
(2) The prohibition is referred to in this Act as the general prohibition.'

2.6.2 The classes of "regulated activity"

Section 22 FSMA 2000

'(1) An activity is a regulated activity for the purposes of [FSMA 2000] if it is an activity of a specified kind which is carried on by way of business and –
(a) relates to an investment of a specified kind; or
(b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind.
(2) Schedule 2 makes provision supplementing this section.
(3) Nothing in Schedule 2 limits the powers conferred by subs.(1).
(4) "Investment" includes any asset, right or interest.
(5) "Specified" means specified in an order may by the Treasury.'

2.6.3 The classes of 'regulated activity' and 'investment' under Sch.2

Part I of Schedule 2 to the FSMA 2000:

- dealing in investments (whether by buying, selling, underwriting, offering or agreeing to do any of those things as principal or agent);
- arranging deals in investments (for example as an intermediary or broker or otherwise);
- accepting deposits (just as a bank accepts deposits);
- safeguarding or administering assets in the form of investments (such as custodian or trustee services whereby any investment asset is held by the professional);
- managing investments;
- giving or offering investment advice;
- establishing collective investment schemes; and
- using computer-based systems for giving investment instructions.

The categories of "investment" identified in Part II of Sch.2, FSMA 2000:

- securities
    - "shares or stock in the share capital of a company" (any body corporate other than an oeic)
    - convertible bonds
    - warrants
    - securitised derivatives
- instruments creating or acknowledging indebtedness
    - debentures,
    - debenture stock,
    - loan stock,
    - bonds,
    - certificates of deposit and
    - any other instruments creating or acknowledging a present or future indebtedness
- government and public securities,
    - loan stock,
    - bonds and
    - other instruments creating or acknowledging indebtedness and issued on behalf of a government, local authority or public authority
- instruments giving entitlement to investments, inc.
    - warrants or
    - other instruments entitling the holder to subscribe for any investment
- certificates representing securities, (inc. certificates or other instruments which confer contractual or property rights in respect of any investment by someone other than the person on whom the rights are conferred and the transfer of which may be effected without requiring the consent of that person)
- units in collective investment schemes,
- options, (inc. options to acquire or dispose of property)
- futures,
- contracts for differences,
- contracts of insurance,
- participation in Lloyd's syndicates,
- deposits,
- loans secured on land, and

- rights in investments.

2.4.4 The exemptions from regulatory coverage

Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

2.4.5 The effect of breach of the general prohibition by acting

Section 20 FSMA 2000 Authorised persons acting without permission

(1) If an authorised person carries on a regulated activity in the United Kingdom, or purports to do so, otherwise than in accordance with permission--

(a) given to him by the Authority under Part IV, or

(b) resulting from any other provision of this Act,

he is to be taken to have contravened a requirement imposed on him by the Authority under this Act.

(2) The contravention does not--

(a) make a person guilty of an offence;

(b) make any transaction void or unenforceable; or

(c) (subject to subsection (3)) give rise to any right of action for breach of statutory duty.

(3) In prescribed cases the contravention is actionable at the suit of a person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

2.4.6 The criminal law effect of breach of the general prohibition

Section 23 FSMA 2000 "Contravention of the general prohibition"

(1) A person who contravenes the general prohibition is guilty of an offence and liable--

(a) on summary conviction, to imprisonment for a term not exceeding six months or a fine not exceeding the statutory maximum, or both;

(b) on conviction on indictment, to imprisonment for a term not exceeding two years or a fine, or both.

(2) In this Act "an authorisation offence" means an offence under this section.

(3) In proceedings for an authorisation offence it is a defence for the accused to show that he took all reasonable precautions and exercised all due diligence to avoid committing the offence.

2.4.7 The meaning of "business"

Morgan Grenfell & Co v Welwyn Hatfield DC [1995] 1 All E.R. 1 Hobhouse J

The badges of "business":

- time,
- volume,
- profit and
- quality

2.5 Financial promotion: s.21 FSMA 2000

Hudson, Chapter 11 (outline only)

Section 21 FSMA 2000 "Restrictions on financial promotion"

(1) A person ("A") must not, in the course of business, communicate an invitation or inducement to engage in investment activity.

(2) But subsection (1) does not apply if—

(a) A is an authorised person; or

(b) the content of the communication is approved for the purposes of this section by an authorised person.

(3) In the case of a communication originating outside the United Kingdom, subsection (1) applies only if the communication is capable of having an effect in the United Kingdom.

(8) "Engaging in investment activity" means—

(a) entering or offering to enter into an agreement the making or performance of which by either party constitutes a controlled activity; or

(b) exercising any rights conferred by a controlled investment to acquire, dispose of, underwrite or convert a controlled investment.

(9) An activity is a controlled activity if—

(a) it is an activity of a specified kind or one which falls within a specified class of activity; and

(b) it relates to an investment of a specified kind, or to one which falls within a specified class of investment.

(10) An investment is a controlled investment if it is an investment of a specified kind or one which falls within a specified class of investment.

(13) "Communicate" includes causing a communication to be made.

(14) "Investment" includes any asset, right or interest.
(15) "Specified" means specified in an order made by the Treasury.

2.8 The Supervision process ("SUP")

Hudson, 9.38-9.43

2.8.1 The SUP sourcebook

Supervision manual ("SUP")

- a "risk based approach"
- an "impact and probability" risk assessment approach

- "standard risk assessment process applied consistently across all of its activities" which more specifically assesses "the risk posed by [each regulated] firm against a number of impact and probability factors, both initially and on a continuing basis"
- The matters which are to be taken into account are:
    - the firm's strategy;
    - the level of the firm's business risk;
    - the financial soundness of the firm;
    - the nature of the firm's customers, products and services;
    - the culture of the firm's internal systems and compliance systems; and
    - the organisation of the firm and its management
- Cf. the Northern Rock farrago.
- See now, "stress-testing".

2.8.2 Other FSA sourcebooks in the FSA Handbook

- FSA "Threshold Conditions" sourcebook ("COND") provides the minimum standards with which the organisation and composition of a regulated firm are required to comply.
- FSA "Senior Management Arrangements, Systems and Controls" sourcebook ("SYSC") sets out principles relating to the way in which firms must be organised, internal systems created suitable for the conduct of financial services business, senior staff sufficiently well trained, and suitable controls in place over its employees
- FSA "Statements of Principle and Code of Practice for Approved Persons" ("APER")
- FSA "Fit and Proper Test" rulebook ("FIT") identifies the criteria which are used by the FSA when assessing the fitness and propriety of a candidate for a "controlled function". It considers:
    - that person's "honesty integrity and reputation";
    - that person's "competence and capability"; and
    - that person's "financial soundness"

2.9 The FSA's power to conduct investigations

Hudson, 9.44-9.46

Section 165 FSMA 2000 "Authority's power to require information"

(1) The Authority may, by notice in writing given to an authorised person, require him—

(a) to provide specified information or information of a specified description; or

(b) to produce specified documents or documents of a specified description.

(2) The information or documents must be provided or produced—

(a) before the end of such reasonable period as may be specified; and

(b) at such place as may be specified.

(4) This section applies only to information and documents reasonably required in connection with the exercise by the Authority of functions conferred on it by or under this Act.
(5) The Authority may require any information provided under this section to be provided in such form as it may reasonably require.

2.10 The Prudential sourcebooks

Hudson, 9.47

The General Prudential Rulebook ("GENPRU")

- the level of capital which regulated firms are required to hold
- the risks to be considered are:
    - credit risk;
    - market risk;
    - liquidity risk;
    - operational risk;
    - insurance risk,
    - concentration risk,
    - business risk; and
    - interest rate risk

3. UK INVESTOR PROTECTION

3.1 Conduct of business regulation

Hudson, 8.43

- Considered in Chapter 3.
- EC Markets in Financial Instruments Directive 2004
- FSA Conduct of Business Sourcebook

3.2 The Financial Services Compensation Scheme

Hudson, 9.58

- Section 212 FSMA 2000
- EC Deposit Guarantee Directive (94/19/EEC) relating to bank deposits
- EC Investor Compensation Scheme Directive (97/9/EEC)

3.3 The Financial Services Ombudsman

Hudson, 9.56-9.57

- Section 225 FSMA 2000
- "FOS" is a person who is intended to provide "a scheme under which certain disputes may be resolved quickly and with minimum formality by an independent person"

3.4 The Financial Markets Tribunal

Hudson, 9.63

- The FSA Market Tribunal established by s.132 FSMA 2000
- Financial Services and Markets Tribunal Rules 2001

4. THEMES

Hudson, Chapter 3

4.1 What does "regulation" mean?

- A rough definition of "regulation" by AH: "Oversight by some external statutory, public body by reference to formal principles which do not carry the sanction of law by means of the powers of a court. This may include two forms of power (a) the power to impose penalties but not sanctions under the criminal law; (b) the power to deny authorisation / permission to act but not the power to award damages (except in an arbitral sense) nor rights in property under the general law."
- Is "regulation" the same as "law"?
- How does jurisprudence define "law"?

4.2 Who or what is being regulated?

- Should we regulate people or markets?
- Regulation of people performing specified activities under Sch 2, FSMA 2000 and RAO.
- Why are hedge funds not regulated? Why not regulate all market actors by regulating entire markets?

4.3 The regulation of information

- Regulation does not promise protection from any loss
- Regulation requires proper treatment of clients (COBS) and provision of necessary information (Prospectus Rules)

4.4 The FSA has a number of different roles

Hudson, 3.07-3.12

4.4.1 The FSA's economic role

The FSA must

- bear in mind the "international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom" (FSMA 2000, s.2(3)(e)).
- avoid "adverse effects on competition" resulting from the exercise of its activities (s.2(3)(f);
- advance competition between regulated entities (s.2(3)(g)).
- not interfere with "the desirability of facilitating innovation in connection with regulated activities" in financial markets. (s.2(3)(d))

4.4.2 Maintenance of the integrity of the system

4.4.3 A responsive dialogue with clients

Hudson, 3.13

- banks are consulted on the content of regulations

- banks are consulted on the manner of implementation of regulations
- murderers are not consulted about the law on murder nor on the judges' approach to sentencing
- in what ways is finance different so that it requires this treatment?
- Can we support one rule for one but another approach for others?
- Is "regulation" the same as "law"?

4.4.4 The objectives of substantive law

Hudson, 3.14-3.24

- Enforcement of contracts
- Protection of property rights
- Compensation for wrongs
- Punishment
- Positivism = obedience to the law
- Law is not market-orientated
    - e.g. *Westdeutsche Landesbank v Islington* [1996] AC 669: banks are treated the same as everyone else
    - but e.g. *Salomon & Co v Salomon* [1897] AC 22, sometimes the law is commercial, though (Hudson, 4.33)

4.4.5 Overlaps between law and regulation

Cowan de Groot v Eagle Trust [1992] 4 All ER 700
Considered in Chapter 9 of these Course Documents

This is an important theme in this module to which we shall return in later lectures.

4.6 The desirability, or otherwise, of high-level principles

Hudson, 3.32-3.34

See 2.7 above.
Question: Given the detail of the regulations set out in sections 2 and 3 above, is all of this really "light touch" regulation at all? Or is it just regulatory practice which is "light touch"?

Chapter 3: "Conduct of Business" Regulation

The material in this chapter constitutes the reading for Seminar 3.

General reading:
Hudson, Chapter 10

1. The Significance of Conduct of Business Regulation

- The heart of investor protection
  - Ensures proper treatment, "suitability"
  - But no insurance or compulsory remedies or protection against all loss
- "Know your client" regulation
- Establishment of high-level principles
- A change in regulatory style, as well as content
- Creation of positive obligations (as with money laundering)

2. The purpose of the Markets in Financial Instruments Directive

Reading:
Hudson, 7.22-7.38
C. Skinner (ed), *The Future of Investing in Europe's Markets after MiFID* (Wiley Finance, 2007)

2.1 The purpose of MiFID

The Markets in Financial Instruments Directive ("MiFID"), 2004/39/EC.
MiFID Implementing Directive ("MID"), 2006/73/EC.
Commission technical regulation 1287/2006/EC.
Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007 (S.I. 2007/126).

- 3 activities covered by MiFID:
  - the authorisation of people to conduct investment business,
  - the regulation of the markets on which investments are bought and sold, and
  - the regulation of the conduct of business.
- Movement towards principles-based regulation
- Passporting regulatory approvals

2.2 "Best execution"

art.21, MiFID:

> "investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size,

nature or any other consideration relevant to the execution of the order."

2.3 "Best interests of the client"

art 19(1), MiFID:

Investment firm must act "honestly, fairly and professionally in accordance with the best interests of its client"

2.4 Communications

art 19(2), MiFID

all information addressed to clients or potential clients "shall be fair, clear and not misleading"

2.6 Expected benefits of MiFID

- Increased competition between market service providers and within securities markets
- Enhanced investor protection through new conduct of business rules
- Increased transparency as to the practices of service providers, the costs of services, and best execution for the customer
- Increased transparency about available markets
- More effective and more approximate regulation between member states
- Principles-based regulation

2.7 Why markets were concerned about "build your own" regulation

- Movement away from "box-ticking"
- Requires institutions to consider their practices
- Box-ticking is easier to comply with, for firms
- Concern, in the firms, about unknown breaches of regulations
- How can firms know what the FSA's approach would be?

3. The FSA Conduct of Business Sourcebook ("COBS")

The Conduct of Business Sourcebook is part of the *FSA Handbook*. It implements MiFID and its attendant Commission regulations.

3.1 "Suitability"

- Suitability of the treatment of the client
- Suitability of the investment product for the client's purposes

3.2 Treatment of the client

- Investment firms are required to act "honestly, fairly and professionally in accordance with the best interests of their clients"

- Is the “best interests” principle a fiduciary duty?
    - Millett LJ, a fiduciary is “someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence” (*Bristol and West Building Society v Mothew* [1998] Ch 1, 18)
    - Lord Browne-Wilkinson, a fiduciary duty where “one party, A, has assumed to act in relation to the property or affairs of another, B’ (*White v Jones* [1995] 2 AC 207 at 271)
    - Asquith LJ, a ‘“fiduciary relation” exists … whenever the plaintiff entrusts to the defendant a job to be performed, for instance, the negotiation of a contract on his behalf or for his benefit, and relies on the defendant to procure for the plaintiff the best terms available …’ (*Reading v A-G* [1951] 1 All ER 617).
- The client “must receive from the investment firm adequate reports on the service provided to its clients”, including information about costs and services undertaken on his behalf (MiFID, art 19(8))

3.3 Communications

- All information addressed to clients or potential clients “shall be fair, clear and not misleading”.
    - Coverage (?):
        - Promotional literature
        - Conduct of business letter
        - Statements at meetings
        - Statements on the telephone
        - Ordinary correspondence
        - Generic circulars, as well as bespoke literature
    - Misleading information = *Hedley Byrne*
    - What does “fair” mean? (E.g. market maker quoting a fair price.)
    - “Clear” = designed for level of client expertise?

- Provision of information about the firm itself that is comprehensible
- Provision of information about the investment that is comprehensible

- Transparency (a) about fees charged to the client and (b) about other commissions the firm earns on the business: MiFID, art 19(3):

    ‘Appropriate information shall be provided in a comprehensible form to clients or potential clients about:
    - the investment firm and its services,
    - financial instruments and proposed investment strategies; this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies,
    - execution venues, and
    - costs and associated charges
    so that they are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis. This information may be provided in a standardised format.’

- No exclusion of liability, (COBS, 2.12R.):

'A firm must not, in any communication relating to designated investment business seek to:
(1) exclude or restrict; or
(2) rely on any exclusion or restriction of
any duty or liability it may have to a client under the regulatory system.'

3.4 Client Classification

- The investment firm is obliged to take active steps to identify the client's level of expertise, in the form of that client's "knowledge and experience in the investment field relevant to the specific type of product or service", as well as his personal circumstances. (MiFID, art 19(4))

- Obliged only to warn the client, not prevent transaction

- Different categories of client:
  - retail clients, without expertise in financial matters;
  - "professional clients", people with some expertise in financial matters;
    - per se professional client
    - elective professional client
  - "eligible counterparties" (i.e. market counterparties), other financial institutions with expertise
  - cf. **Bankers Trust v Dharmala* [1996] CLC 252
  - clients made elect to "trade up"

- MiFID, art 19(4): *Classifying client knowledge*

  'When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him.'

- MiFID, art 19(5): *Warnings - what the firm must do if the product is unsuitable -*

  'Member States shall ensure that investment firms, when providing investment services other than those referred to in paragraph 4 [set out immediately above], ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client.

  In cases the investment firm considers, on the basis of the information referred to under the first subparagraph, that the product or service is not appropriate to the client or potential client, the investment firm shall warn the client or potential client. This warning may be provided in a standardised format.

  In cases where the client or potential client elects not to provide the information referred to under the first subparagraph, or where he provides insufficient information regarding his knowledge and experience, the investment firm shall warn the client or potential client that such a decision will not allow the firm to determine whether

the service or product envisaged is appropriate for him. This warning may be provided in a standardised format.'

**Bankers Trust v. Dharmala* [1996] C.L.C. 252
**Morgan Stanley v. Puglisi* [1998] C.L.C. 481

- MiFID, art 19(6): exception where the "services that only consist of execution and/or the reception and transmission of client orders".

3.5 Assumption of risk by the client

- What if client's knowledge or risk appetite or behaviour changes?
- What if client seeks to give an instruction?
- Cf. *JP Morgan v Springwell* [2008] EWHC 1186, "experienced individuals"

3.6 Other obligations

- Obligation to document transactions appropriately
- Obligation to provide adequate reports
- Client order handling – "prompt, fair, and expeditious execution of client orders"

4. Theme: the overlap between Regulation and the Substantive Law

It is in relation to Conduct of Business regulation that the potential for overlap between financial regulation and substantive law is most evident. This issue is pursued most clearly in relation to Chapter 9 "breach of fiduciary duty" in these Course Documents.

Chapter 4: Criminal Law in Finance

The material in this chapter constitutes the reading for Seminar 4.

1. The role of the Criminal Law in Financial Transactions

Hudson, 13.01-13.09

- The criminalisation of particular activities
  - Market abuse
  - Insider dealing
  - Market manipulation
- To support the FSA by criminalising some breaches of rules
- As part of the general criminal law
- Punishment
- Preservation of a level playing field for all investors
- To encourage participation in investment markets
- To facilitate "deep, liquid pools" of capital

2. The regulation of market abuse by the FSA

Hudson, Chapter 12

This section on FSA regulation is primarily intended to allow you to compare civil regulation of market abuse with the criminal offences considered next in relation to criminal law.

1.1 The Market Abuse Directive

Hudson, 12.02-12.07

1.1.1 The policy underpinning the directive

- the preservation of "market integrity"
- an "integrated and efficient financial market"
- "economic growth and job creation" in the EU
- "market abuse harms the integrity of financial markets and public confidence in securities and derivatives"
- to develop a pool of liquid capital needs the confidence of a concomitant pool of investors

1.1.2 "Inside information"

"Inside information" is:
"information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments". (MAD, art.1(1))

1.1.3 "Market manipulation"

"Market manipulation" is:

"(a) transactions or orders to trade:

- which give, or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments; or
- which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level,

unless the person who entered into the transactions or issued the order to trade establishes that his reasons for so doing are legitimate and that these transactions or order to trade conform to accepted market practices on the regulated market concerned;

(b) transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance;

(c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading. In respect of journalists when they act in the professional capacity such dissemination of information is to be assessed […] taking into account the rules governing their profession, unless those persons derive, directly or indirectly, an advantage or profits from the dissemination of the information in question.'

1.2 The scope of the market abuse provisions

Hudson, 12.10-12.35

1.2.1 "Market abuse"

s.118 of the FSMA 2000, as amended to give effect to MAD, provides that:

'(1) For the purposes of this Act, market abuse is behaviour (whether by one person alone or by two or more persons jointly or in concert) which -

(a) occurs in relation to –

(i) qualifying investments admitted to trading on a prescribed market,

(ii) qualifying investments in respect of which a request for admission to trading on such a market has been made, or

(iii) in the case of subsection (2) or (3) behaviour, investments which are related investments in relation to such qualifying investments, and

(b) falls within any one or more of the types of behaviour set out in subsection (2) to (8).'

There are therefore seven types of behaviour which will constitute market abuse.

1.2.2(1) Dealing in a qualifying investment: "insider dealing"

s.118(2) FSMA 2000:

'The first type of behaviour is where an insider deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information relating to the investment in question.'

1.2.2(2) Disclosure of inside information: "improper disclosure"

s.118(3) FSMA 2000:

'The second is where an insider discloses inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duties.'

The FSA gives two examples of behaviour which it considers would fall within this head of behaviour in MAR:

'(1) disclosure of inside information by the director of an issuer to another in a social context; and

(2) selective briefing of analysts by directors of issuers or others who are persons discharging managerial responsibilities.'

1.2.2(3) Use of inside information in breach of standard of reasonable behaviour on the market: "misuse of information"

s.118(4) FSMA 2000:

'The third is where the behaviour (in falling within subsection (2) or (3)) –

(a) is based on information which is not generally available to those using the market but which, if available to a regular user of the market, would be, or would likely to be, regarded by him as relevant when deciding the terms on which transactions in qualifying investments should be effected, and

(b) is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.'

1.2.2(4) Causing a false or misleading impression: "manipulating transactions"

s.118(5) FSMA 2000:

'The fourth is where the behaviour consists of effecting transactions or orders to trade (otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market) which –

(a) give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, one or more qualifying investments, or

(b) secure the price of one or more such investments at an abnormal or artificial level.'

1.2.2(5) Employing fictitious devices or contrivances: "manipulating devices"

s.118(6) FSMA 2000:

'The fifth is where the behaviour consists of effecting transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance.'

1.2.2(6) The dissemination of information giving a false or misleading impression: "dissemination"

s.118(7) FSMA 2000:

'The sixth is where the behaviour consists of the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading.'

1.2.2(7) Failure to observe standard of behaviour reasonably expected of a person in that market: "misleading behaviour and distortion"

s.118(8) FSMA 2000:

'The seventh is where the behaviour (not falling within subsection (5), (6) or (7) [the three preceding types of behaviour]) –

(a) is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for or price or value of, qualifying investments, or

(b) would be, or would be likely to be, regarded by a regular user of the market as behaviour that would distort, or would be likely to distort, the market in such an investment,

and the behaviour is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.'

1.3 Definitions

1.3.1 The meaning of the term "insider"

s.118B FSMA 2000:

'For the purposes of this Part an insider is any person who has inside information–

(a) as a result of his membership of an administrative, management or supervisory body of an issuer of qualifying investments,

(b) as a result of his holding in the capital of an issuer of qualifying investments,

(c) as a result of having access to the information through the exercise of his employment, profession or duties,

(d) as a result of his criminal activities, or

(e) which he has obtained by other means and which he knows, or could reasonably be expected to know, is inside information.

1.3.2 The general definition of "inside information"

S.118C(2) FSMA 2000:

'(2) In relation to qualifying investments, or related investments, which are not commodity derivatives, inside information is information of a precise nature which

(a) is not generally available,

(b) relates, directly or indirectly, to one or more issuers of the qualifying investments or to one or more of the qualifying investments, and

(c) would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.'

1.3.3 Whether or not information is "precise"

s.118C(5) FSMA 2000

'(5) Information is precise if it –

(a) indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur, and

(b) is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments.'

1.3.4 Whether or not information will have a "significant effect"

s.118C(6) FSMA 2000:

'(6) Information would be likely to have a significant effect on the price if and only if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions.'

1.3.5 Generally availability of information

s.118C(8) FSMA 2000:

'(8) Information which can be obtained by research or analysis conducted by, or on behalf of, users of a market is to be regarded, for the purposes of this Part, as being generally available to them.'

3. Insider Dealing and Market Manipulation

1.1 Sources of law

1.1.1 Insider dealing

EC Insider Dealing Directive (89/592/EC, [1989] O.J. L334/30)
Part V, Criminal Justice Act 1993 ("CJA 1993"), ss.52-64, Schedules 1 & 2

1.1.2 Market abuse regulation

Market Abuse Directive
FSA Market Abuse Rulebook
FSA Model Code in FSA Disclosure and Transparency Rules

A. INSIDER DEALING

Hudson, 14.01-14.04

2.1 The three offences of insider dealing

Hudson, 14.05-14..08

2.1.1 The offences in outline

Three offences relating to insider dealing:

- insiders who deal in "price-affected" securities using "inside information"
- encouraging others to deal in price-affected securities
- disclosing inside information

2.1.2 The power of the Financial Services Authority

FSMA 2000, s.402: FSA has power to prosecute insider dealing.

2.2 The principal offence of insider dealing in s.52(1) CJA 1993

Hudson, 14.08-14.50

s.52(1) CJA 1993:

'(1) An individual who has information as an insider is guilty of insider dealing if, in the circumstances mentioned in subsection (3), he deals in securities that are price-affected securities in relation to the information.'

The six elements of the offence:

1. the offence is committed by an individual
2. that individual must have information as an "insider"
3. the individual must "deal" in securities
4. the securities in which the individual deals must be "price-affected securities"
5. the securities must be price-affected securities "in relation to the information"
6. as s.52(3) CJA 1993, acquisition or disposal on regulated market, etc.

s.52(3) CJA 1993:-

'(3) The circumstances referred to above [in s.52(1)] are that the acquisition or disposal in question occurs on a regulated market, or that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary.'

2.3 The two inchoate offences relating to insider dealing: s.52(2) CJA 1993

s.52(2) of CJA 1993:

'(2) An individual who has information as an insider is also guilty of insider dealing if –

(a) he encourages another person to deal in securities that are (whether or not that other knows it) price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place in the circumstances mentioned in subsection (3); or

(b) he discloses the information, otherwise than in the property performance of the functions of his employment, office or profession, to another person.'

2.4 Definition of terms in the statutory offences

Hudson, 14.12-14.50

2.4.1 The definition of "dealing in securities"

s.55 CJA 1993:

'(1) For the purposes of this Part, a person deals in securities if –

(a) he acquires or disposes of the securities (whether as principal or agent); or

(b) he procures, directly or indirectly, an acquisition or disposal of the securities by any other person.

s.55(2) and (3) CJA 1993:

'(2) For the purposes of this Part, "acquire", in relation to a security, includes –

(a) agreeing to acquire the security; and

(b) entering into a contract which creates the security*.

(3) For the purposes of this Part, "dispose", in relation to a security, includes –

(a) agreeing to dispose of the security; and

(b) bringing to an end a contract which created the security.'

*includes derivatives (e.g. options)?

2.4.2 Securities to which Part V applies

Schedule 2, CJA 1993:

- shares,
- debt securities,
- warrants,
- depositary receipts,
- options,
- futures, and
- contracts for differences.

2.4.3 The definition of "inside information"

s.56(1) CJA 1993:

> '(1) For the purposes of this section and section 57, "inside information" means information which –
>
> > (a) relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally;
> > (b) is specific and precise;
> > (c) has not been made public; and
> > (d) if it were made public would be likely to have significant effect on the price of any securities.

Points of note:

- limits scope of information
- "relates to specific securities" = one issuer, a group of issuers, or entire market?
- "particular issuers of securities" suggests numerous – e.g. irt takeover
- "specific and precise" – not mere nervousness nor mere management concerns; but would include specific impact of business unit on financial condition of company. In Australia, *Ryan v Triguboff* [1976] 1 NSWLR 588, at 596, *per* Lee J: the information should be "unequivocally expressed and discerned" and not require too much deduction on the part of its recipient.
- "has not been made public" – e.g. RIS publication = no longer *inside* information; but what of speculative journalism? What of "market rumours"? What of leaks to the press? Cf. the film *Wall Street* and how information leaked to the Press.
- "significant effect on the price" – not mere tittle-tattle. A movement of fifty pence on a share worth £20 would be less *significant* than a movement of fifty pence on a share worth £2. See fears over Lehman Bros in press over summer 2008.

2.4.4 The definition of "price-sensitive information"

s.56(2) CJA 1993:

> '(2) For the purposes of this Part, securities are "price-affected securities" in relation to inside information, and inside information is "price sensitive information" in relation to securities, if and only if the information would, if made public, be likely to have a significant effect on the price of the securities.'

2.4.5 What manner of information relates *to a particular issuer*

2.4.6 A person having information in a capacity as an insider

s.57 CJA 1993:

'(1) For the purposes of this Part, a person has information as an insider if and only if –

(a) it is, and he knows that it is, inside information; and

(b) he has it, and knows that he has it, from an inside source.'

Two requirements here:

- insider must know the information is inside information
- insider must know that information acquired from an "inside source"

"inside source" s.57(2) CJA 1993:

'(2) For the purposes of subsection (1), a person has information from an inside source if and only if –

(a) he has it through –

(i) being a director, employee or shareholder of an issuer of securities; or

(ii) having access to the information by virtue of his employment, office or profession; or

(b) the direct or indirect source of his information is a person within paragraph (a).'

2.4.7 Information "made public"

s.58 CJA 1993:

'(1) For the purposes of section 56, "made public", in relation to information, shall be construed in accordance with the following provisions of this section; but those provisions are not exhaustive as to the meaning of that expression.

(2) Information is made public if –

(a) it is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisors;

(b) it is contained in records which by virtue of any enactment are open to inspection by the public;

(c) it can be readily acquired by those likely to deal in any securities-

(i) to which the information relates; or

(ii) of an issuer to which the information relates; or

(d) it is derived from information which had been made public.'

Publication of information takes place in one of four contexts.

- publication in accordance with the ordinary rules of a regulated market
- "records" made available for inspection by the public; including published accounts and information as to directors' remuneration
- information which can be "readily acquired" by those who are "likely to deal" in those securities or in relation to that information, e.g. analysts' reports
- generally, information being derived from information which has been made public

s.58(3) CJA 1993:

'(3) Information may be treated as made public even though –

(a) it can be acquired only by persons exercising diligence or expertise;

(b) it is communicated to a section of the public and not to the public at large;

(c) it can be acquired only by observation;

(d) it is communicated only on payment of a fee;

(e) it is published only outside the United Kingdom.'

2.4.8 The meaning of the term "issuer"

s.60(2) CJA 1993:
"issuer" = "means any company, public sector body or individual by which or by whom the securities have been or are to be issued".

2.5 Defences

s.53(1) CJA 1993

2.6 The private law enforceability of contracts

s.63(2) CJA 1993: 'No contract shall be void or unenforceable by reason only of s.52'.

2.7 Why criminalise insider dealing?

Hudson, 14.64-14.70

Arguments con:

- Life is to the swift and the clever
- There is not really such a problem because little of it happens
- Rider and Ashe, *Insider Crime* (Jordans, 1993)
- Rider, Alexander and Linklater, *Market Abuse and Insider Dealing* (Tottel, 2002)

Arguments pro:

- Insider dealing = exploiting the ignorance of those without the inside information
- For every winner, there must be a loser
- It is not taking advantage of honest hard work, it is taking advantage of clandestine sneakiness
- A lack of integrity will dissuade ordinary investors, and so the pool of investment capital will dry up
- Markets have integrity only if every investor has access to the same information on which to base their decisions

B. OFFENCES RELATING TO MARKET MANIPULATION

Hudson 14.71-14.81

3.1 The offence of making misleading statements

3.1.1 The activity which will give rise to the offence

s.397(1) FSMA 2000:
'(1) This subsection applies to a person who –

(a) makes a statement, promise or forecast which he knows to be misleading, false or deceptive in a material particular;
(b) dishonestly conceals any material facts whether in connection with a statement, promise or forecast made by him or otherwise; or
(c) recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular.'

3.1.2 The further requirement of inducing behaviour in the representee

s.397(2) FSMA 2000:

'(2) A person to whom subsection (1) applies is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person (whether or not the person to whom the statement, promise or forecast is made)-

(a) to enter or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement; or

(b) to exercise, or refrain from exercising, any rights conferred by a relevant investment.'

3.1.3 The statutory defence

s.397(4) FSMA 2000:

'(4) In proceedings for an offence under subsection (2) brought against a person to whom subsection (1) applies as a result of paragraph (a) of that subsection, it is a defence for him to show that the statement, promise or forecast was made in conformity with –

(a) price stabilising rules;

(b) control of information rules; or

(c) the relevant provisions of Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments.

3.2 The offence of creating a false or misleading impression as to the market

3.2.1 The components of the offence

s.397(3) FSMA 2000:

"(3) Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any relevant investments is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments."

3.2.2 The statutory defence

s.397(5) FSMA 2000

"(5) In proceedings brought against any person for an offence under subsection (3) it is a defence for him to show –

(a) that he reasonably believed that his act or conduct would not create an impression that was false or misleading as to the matters mentioned in that subsection;

(b) that he acted or engaged in the conduct –

(i) for the purpose of stabilising the price of investments; and

(ii) in conformity with price stabilising rules; …

(c) that he acted or engaged in the conduct in conformity with control of information rules; or

(d) that he acted or engaged in the conduct in conformity with [regulations for] buy-back programmes and stabilisation of financial instruments."

4. Money laundering

Hudson, Chapter 15
Peter Alldridge, *Money Laundering Law* (2003)

4.1 Definition of "money laundering"

HM Treasury, *Anti-Money Laundering Strategy*, October 2004, HM Treasury:

> 'a term generally used to describe the ways in which criminals process illegal or "dirty" money derived from the proceeds of any illegal activity (e.g. the proceeds of drug-dealing, human trafficking, fraud, theft, or tax evasion) through a succession of transfers and deals until the source of illegally acquired funds is obscured and the money takes on the appearance of legitimate or "clean" funds or assets.'

4.2 Section 327, Proceeds of Crime Act 2002

Hudson, 15.09-15.32

4.2.1 The principal offences

Section 327(1) provides:

> 'A person commits an offence if he –
> (a) conceals criminal property;
> (b) disguises criminal property;
> (c) converts criminal property;
> (d) transfers criminal property;
> (e) removes criminal property from England and Wales or from Scotland or from Northern Ireland.'

4.2.2 Case law on s.327

R v Montila [2004] 1 W.L.R. 3141
R v Saik [2006] UKHL 18, [23], per Lord Nicholls: "the property in question must emanate from a crime"

4.2.3 Definition of "criminal property"

s.340(3) POCA 2002:

> '(3) Property is criminal property if-
>
> (a) it constitutes a person's benefit from criminal conduct or it represents such a benefit (in whole or part and whether directly or indirectly), and
> (b) the alleged offender knows or suspects that it constitutes or represents such a benefit.

R v Loizou [2005] EWCA Civ 1579; noted by D Ormerod [2005] Crim LR 885

4.2.4 "Knowledge" that there has been an offence

R v Montila [2004] 1 WLR 3141: meaning of the word to "know" meant to have actual knowledge
R v Ali [2006] 2 WLR 316, 335, para [98] where it was suggested that to "know" meant simply to "believe"
**R v Saik* [2006] UKHL 18, para [25], *per* Lord Nicholls: test of knowledge limited strictly to actual knowledge

4.2.5 "Suspicion" that there has been an offence

R v Da Silva at first instance: a person may be "suspecting" of another person's engagement in criminal conduct if that person has "the imagining of something without evidence or on slender evidence, inkling, mistrust"

R v Da Silva [2006] EWCA Crim 1654; [2007] 1 WLR 303, CA, Longmore LJ took a slightly different approach in the Court of Appeal, when his lordship held:

> 'It seems to us that the essential element in the word "suspect" and its affiliates, in this context, is that the defendant must think that there is a possibility, which is more than fanciful, that the relevant facts exist. A vague feeling of unease would not suffice. But the statute does not require the suspicion to be "clear" or "firmly grounded and targeted on specific facts", or based upon "reasonable grounds". To require the prosecution to satisfy such criteria as to the strength of the suspicion would, in our view, be putting a gloss on the section.'

R v Saik [2006] UKHL 18, [2007] 1 A.C. 18, para *[52], per* Lord Hope*:*

> '… the assumption is that the person has a suspicion, otherwise he would not be thinking of doing what the statute contemplates. The objective test is introduced in the interests of fairness, to ensure that the suspicion has a reasonable basis for it. The subjective test – actual suspicion – is not enough. The objective test – that there were reasonable grounds for it – must be satisfied too.'

K v National Westminster Bank, HMRC, SOCA [2006] EWCA Civ 1039 suggests that the civil and criminal standards should be the same in relation to notions of "suspicion", *per* Longmore LJ.

4.2.6 Defences and exceptions: s.327

(2) But a person does not commit such an offence if--

(a) he makes an authorised disclosure under section 338 and (if the disclosure is made before he does the act mentioned in subsection (1)) he has the appropriate consent;

(b) he intended to make such a disclosure but had a reasonable excuse for not doing so;

(c) the act he does is done in carrying out a function he has relating to the enforcement of any provision of this Act or of any other enactment relating to criminal conduct or benefit from criminal conduct.

[(2A) Nor does a person commit an offence under subsection (1) if--

(a) he knows, or believes on reasonable grounds, that the relevant criminal conduct occurred in a particular country or territory outside the United Kingdom, and

(b) the relevant criminal conduct--

(i) was not, at the time it occurred, unlawful under the criminal law then applying in that country or territory, and

(ii) is not of a description prescribed by an order made by the Secretary of State.

(2B) In subsection (2A) "the relevant criminal conduct" is the criminal conduct by reference to which the property concerned is criminal property.]

[(2C) A deposit-taking body that does an act mentioned in paragraph (c) or (d) of subsection (1) does not commit an offence under that subsection if--

(a) it does the act in operating an account maintained with it, and

(b) the value of the criminal property concerned is less than the threshold amount determined under section 339A for the act.]

(3) Concealing or disguising criminal property includes concealing or disguising its nature, source, location, disposition, movement or ownership or any rights with respect to it.

4.3 Duties on banks, etc. to make disclosure to authorities: s.328

4.3.1 s.328 POCA 2002

(1) A person commits an offence if he enters into or becomes concerned in an arrangement which he knows or suspects facilitates (by whatever means) the acquisition, retention, use or control of criminal property by or on behalf of another person.

(2) But a person does not commit such an offence if--

(a) he makes an authorised disclosure under section 338 and (if the disclosure is made before he does the act mentioned in subsection (1)) he has the appropriate consent;

(b) he intended to make such a disclosure but had a reasonable excuse for not doing so;

(c) the act he does is done in carrying out a function he has relating to the enforcement of any provision of this Act or of any other enactment relating to criminal conduct or benefit from criminal conduct.

[(3) Nor does a person commit an offence under subsection (1) if--

(a) he knows, or believes on reasonable grounds, that the relevant criminal conduct occurred in a particular country or territory outside the United Kingdom, and

(b) the relevant criminal conduct--

(i) was not, at the time it occurred, unlawful under the criminal law then applying in that country or territory, and

(ii) is not of a description prescribed by an order made by the Secretary of State.

(4) In subsection (3) "the relevant criminal conduct" is the criminal conduct by reference to which the property concerned is criminal property.]

[(5) A deposit-taking body that does an act mentioned in subsection (1) does not commit an offence under that subsection if--

(a) it does the act in operating an account maintained with it, and

(b) the arrangement facilitates the acquisition, retention, use or control of criminal property of a value that is less than the threshold amount determined under section 339A for the act.]

4.3.2 Case law

**Squirrell Ltd v National Westminster Bank plc* [2006] 1 WLR 637, para [16], *per* Laddie J:

> 'The purpose of s.328(1) is not to turn innocent third parties like [banks] into criminals. It is to put them under pressure to provide information to the relevant authorities to enable the latter to obtain information about possible criminal activity and to increase the prospect of being able to freeze the proceeds of crime. To this end, a party caught by s.328(1) can avoid liability if he brings himself with the statutory defence created by s.328(2)".

**Bowman v Fels* [2005] 1 W.L.R. 3083, para [83], *per* Brooke LJ *(disclosure by lawyers:* s.328 "is not intended to cover or affect the ordinary conduct of litigation by legal professionals"*)*

4.4 Is money laundering law too draconian?

- B Rider, 'An insider paradox?', (2008) Vol. 29 *The Company Lawyer* 1
- R Forston, 'Money Laundering Offences under POCA 2002' in W Blair and R Brent (eds), *Banks and Financial Crime* (Oxford University Press, 2008), 156.
- *R v Gabriel* [2006] EWCA Crim 229, para [29], Gage LJ has said that
  > "[t]here is no doubt that the money laundering provisions of the Proceeds of Crime Act 2002 are draconian"
- *R v (UMBS Online Ltd) v SOCA* [2007] Bus LR 1317, 1321, [9], Ward LJ:
  > "a raft of legislation of which Dracon, the Athenian legislator, would have been proud" … but "SOCA's view [that] the 2002 Act is a sharp but essential modern weapon in the fight against organised crime which gives SOCA and other law enforcement bodies the ability to counter-attack, and then pursue and recover the proceeds of the criminal activity"
- *R v (UMBS Online Ltd) v SOCA* [2007] EWCA Civ 406, [2007] Bus LR 1317, para [58] Sedley LJ:
  > 'In setting up the Serious Organised Crime Agency, the state has set out to create an Alsatia – a region of executive action free of judicial oversight.'

Chapter 5: Contract Law in Finance

The material in this chapter constitutes the reading for Seminar 5.

Reading:
Hudson, chapters 17 through 20
Note we will focus on the sections specified below.

1. Introduction

Hudson, 17.01-17.13

1.1 Contract is at the heart of finance law

1.1.1 The overlap between regulatory norms and contract law

Beary v Pall Mall Investments [2005] EWCA Civ 415
Loosemore v Financial Concepts [2001] 1 Lloyd's Rep 235
Gorham v British Telecommunications Plc [2000] 1 WLR 2129
Seymour v Christine Ockwell [2005] PNLR 39
JP Morgan Chase Bank v Springwell Navigation Corporation [2008] EWHC 1186 (Comm)

1.1.2 Conduct of business and contract law

**JP Morgan Chase Bank v Springwell Navigation Corporation* [2008] EWHC 1186 (Comm)
***Bankers Trust v. Dharmala* [1996] C.L.C. 252
Morgan Stanley v. Puglisi Consentino [1998] C.L.C. 481.

1.2 The process of negotiating contracts in financial transactions

Hudson, 17.04-17.13

1.2.1 The structure of banks

- Structure of investment/commercial banks
  - Trading banks
    - Traders
    - Fund managers
    - Back office
      - Operations
      - Settlement
      - Cash management
    - Middle office
      - Compliance
      - Legal
      - Treasury
      - Credit

    - Trading areas
        - Shares (equities)
        - Debt
            - bonds
            - syndicated loans
            - capital markets
        - Derivatives
            - interest rate swaps
            - equity derivatives
            - debt derivatives,
            - securitisation
        - Foreign exchange / money markets
- Structure of retail banks
    - High street branches
    - Policy set at Head Office
    - Proprietary trading

1.2.2 The trading negotiation process

- Oral conversations between traders
- Formation of contract verbally
    - Entry of terms into computer systems
    - Automatic generation of "confirmation"
- What is the role of subsequent documentation?
    - Confirmation of transaction
    - What if no confirmation ever effected?
- The likelihood of mistake
    - Fat finger errors
    - Long negotiation and change of structure
- The use of Master Agreements overarching all confirmed transactions
- The impact of the law of contract

2. Problems with forming contracts in trading transactions

Hudson, 17.14-17.33

***Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2005] EWHC 830 (Comm): para [46]

> '[The account manager] said that when she first saw this Contract Note (apparently in the course of proceedings), she was "mystified, shocked and perplexed all in one". She described it as "a very sloppy operational effort", and "completely bizarre", adding, "It's got wrong written all over it", and that it should never have gone out to the customer" … There was no such thing as a USD GKO.'

***Bankers Trust v. Dharmala* [1996] C.L.C. 252
Boom Time Holdings v Goldman Sachs 25 February 1997, unreported, *per* Colman J

Investors Compensation Scheme Ltd v West Bromwich BS [1999] Lloyd's Rep PN 496

3. Mistake and misrepresentation in the formation of contracts

Hudson, 18.01-18.21

3.1 Mistakes of fact

Cooper v. Phibbs (1867) LR 2 HL 149
Erlanger v. New Sombrero Phosphate Co (1873) 3 App Cas 1218
Cundy v. Lindsay (1878) 3 App Cas 1
Lagunas Nitrate Co v. Lagunas Syndicate [1899] 2 Ch 392
Bell v. Lever Bros. [1932] AC 161
Oscar Chess v. Williams [1957] 1 WLR 370

3.2 Mistakes of law

Barclays Bank v Simms [1980] Q.B. 677
**Kleinwort Benson v. Lincoln C.C.* [1998] 4 All E.R. 513
Nurdin and Peacock plc v D B Ramsden and Co Ltd; *The Times*, 18 February 1999

3.3 Misrepresentation in contract law

Misrepresentation is considered in greater detail in Chapter 8 below.

3.3.1 Misrepresentation under statute

Section 2(1) of the Misrepresentation Act 1967:

> "Where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made that the facts represented were true."

3.3.2 Misrepresentation at common law: statements of opinion and reliance

Smith v Land and House Property Corpn (1884) 28 Ch D 7, 15, *per* Bowen LJ:

> "It is often fallaciously assumed that a statement of opinion cannot involve the statement of a fact. In a case where the facts are equally well known to both parties, what one of them says to the other is frequently nothing but an expression of opinion … But if the facts are not equally well known to both sides, then a statement of opinion by the one who knows the facts best involves very often a statement of a material fact, for he impliedly states that he knows facts which justify his opinion."

Attwood v Small (1838) 6 Cl & Fin 232 (the claimant must rely on the vendor's statements – that cannot be the case if they had a professional report done of their own)
Edgington v Fitzmaurice (1885) 29 Ch D 459 (claimant induced to acquire shares in a company *both* by a misstatement in a prospectus *and also* by his own mistaken belief that there were debentures over the company = can bring action because defendant's statement need not be the only cause of the loss)

3.3.3 Misrepresentation and undue influence (considered in Chapter 8)

Barclays Bank v O'Brien [1994] 1 AC 180

3.3.4 Negligent misstatement (considered in Chapter 8)

Hedley Byrne v Heller [1964] AC 465

3.4 Money had and received

Moses v. Macferlan (1760) 2 Burr 1005
Westdeutsche Landesbank v. Islington [1996] A.C. 669

3.5 Rescission

3.5.1 Rescission

Newbigging v. Adam (1886) 34 Ch D 582
Peyman v. Lanjani [1985] Ch 457
Morgan Stanley v. Puglisi Consentino [1998] C.L.C. 481.

3.5.2 Damages in lieu of rescission

s.2(2) of the Misrepresentation Act 1967:

> 'Where a person has entered into a contract after a misrepresentation has been made to him otherwise than fraudulently, and he would be entitled, by reason of the misrepresentation, to rescind the contract, then, if it is claimed, in any proceedings arising out of the contract, that the contract ought to be or has been rescinded, the court or arbitrator may declare the contract subsisting and award damages in lieu of rescission, if of opinion that it would be equitable to do so, having regard to the nature of the misrepresentation and the loss that would be caused by it if the contract were upheld, as well as to the loss that rescission would cause to the other party.'

3.6 Proprietary claims on termination of a contract

Westdeutsche Landesbank v Islington [1996] AC 669

4. Other issues in contract law

Hudson,18.22-18.38

4.1 Gaming and wagering

4.2 Insurance and financial transactions

4.3 Contracts conducted through agents

5. Unfair Contract Terms

Hudson, 18.39-18.54

5.1 Unfair Contract Terms Act 1977

Unfair Contract Terms Act 1977, s.2(2):

> 'In the case of other loss or damage [which is not liability for death or personal injury resulting from negligence], a person cannot so exclude or restrict his liability for negligence except in so far as the term or notice satisfies the requirement of reasonableness.'

s.3, UCTA:

> '(1) This section applies as between contracting parties where one of them deals as consumer or on the other's written standard terms of business.'
> (2) As against that party, the other cannot by reference to any contract term –
> (a) when himself in breach of contract, exclude or restrict any liability of his in respect of the breach; or
> (b) claim to be entitled –
> (i) to render contractual performance substantially different from that which was reasonably expected of him, or
> (ii) in respect of the whole or any part of his contractual obligation, to render no performance at all,
> except in so far as (in any of the cases mentioned above in this subsection) the contract term satisfies the requirement of reasonableness.'

s. 11, UCTA:

> "is that the term shall have been a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made."

Smith v Eric S Bush [1990] 1 AC 831, [1989] 2 All ER 514

5.2 FSA Handbook restriction on exclusion of liability

FSA *Conduct of Business Sourcebook*:

> 'A firm must not, in any communication relating to designated investment business seek to:
> (1) exclude or restrict; or
> (2) rely on any exclusion or restriction of
> any duty or liability it may have to a client under the regulatory system.'

FSA Unfair Contract Guide ("UNFCOG")

5.3 Unfair Terms in Consumer Contracts Regulations 1994

Director General of Fair Trading v First National Bank [2001] UKHL 52

5.4 Unfair Terms in Consumer Contract Regulations 1999

Regulation 5(1):

> 'a contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.'

Regulation 6:

> 'In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate
> (a) to the definition of the main subject matter of the contract, or
> (b) to the adequacy of the price or remuneration, as against the goods or services supplied in exchange.'

Office of Fair Trading v Abbey National plc [2008] EWHC 875
Office of Fair Trading v Abbey National plc [2008] EWHC 2325
****The Office of Fair Trading v Abbey National plc* [2009] EWCA Civ 116

6. Issues with drafting financial contracts

Hudson, 19.01-19.26

- See the issues above in relation to offer and acceptance, and mistakes.
- See next in relation to the structure of master agreements.

7. Master agreements

Hudson, 19.36-19.55

7.1 Issues with master agreements

- Context
  - High volume of business
  - Conducted through traders
  - Trade associations attempt at informal regulation
  - Commoditization of risk
  - Control systemic risk
  - Concern primarily with insolvency
  - Facilitates termination on a net basis

- Master agreement structure
    - Confirmation
    - Master Agreement
    - Schedule
    - Credit Support
- The rules of the game versus each playing of that game
- Concerns
    - Mismatches
    - Parties to the contract
    - Cross default
    - Cross acceleration
    - Credit support provision

7.2 Master agreement lay-out

The structure of a standard master agreement:

1. Interpretation

- Confirmation contradicting the terms of the Master Agreement.
- Confirmation: time to negotiate
- Single agreement philosophy

2. Payments

- Obligation to make payments
- Business day conventions
- Mechanism for payments

3. Netting

- Netting across payments in solvent transactions
    - Set off to identify a single payment across numerous transactions
    - Can systems cope with set off:
        - Between the same type of transaction
        - Transactions in particular jurisdictions
        - Transactions settled in the same currency
        - Transactions held on the same computer settlement system
- Insolvency netting
    - Close-out netting
    - Rule 4.90 Insolvency Rules
    - Mutual debts and obligations
    - No set off with non-parties to the transaction

4. Withholding Tax

5. Authority

- The power of an individual employee / agent to bind a company to a transaction

6. Capacity

- The capacity of a company is the power of that company to act

7. Tax Representations

- Representation as to the manner in which the transaction will be accounted for tax purposes.

8. Representations

- Condition or mere warranty?
- The representation will usually be to the effect that:

> 'the individual(s) executing and delivering the Master Agreement (and any other documentation (including any Credit Support Document) relating to the Master Agreement) are duly empowered and authorised to do so, and it has duly executed and delivered this Agreement and any Credit Support Document to which it is a party.'

9. Events of Default

- Failure to Pay
- "Events of default" trigger the termination procedure, subject to:
  - Contractual notice requirements
  - Termination triggered by notice or by automatic termination (depending on the contract)
  - Notice allows the parties to control when the contract should be terminated.
  - Automatic termination ensures that the transaction is void even though the parties may not have known it at the time
    - Useful if little is known about the counterparty
    - Not useful if the transaction was in-the-money
- Breach of Contract
- Failure of guarantee
- Misrepresentation
- Cross Default
- Credit Worth
- Corporate Restructuring
- Bankruptcy

10. Non-Fault Termination Events

- "Non-fault" events oblige the parties to seek to restructure the transaction so as to keep it in effect
- Illegality
- Tax Event
- Tax Event Upon Merger
- Credit Event Upon Merger

11. Early Termination

- One-way and two-way payments
- Calculation of a final termination amount
- Termination currency

12. Termination procedures

"Market quotation"
"Loss"
"Replacement value"

8. Taking security

Hudson, 23.01-23.12

This is a short summary of the principles which you will have met in property law. In this discussion it is assumed that they are wrapped up with the contractual negotiation process. This process of "taking security" is generally referred to as "credit support" in master agreement parlance.

Key point:

- Distinguish between personal rights and proprietary rights.

8.1 Transfer of absolute title

Hudson, 23.13-23.15

- Take outright transfer of property
- Possibly with a purely contractual obligation to transfer an equivalent amount of the value of the original property.
- Cf. *Romalpa* clauses

8.2 Trusts

Hudson, Ch.22 generally
Hudson 23.17, 23.24-23.28

- Settlor creates trust with certainty of intention, subject matter and objects.
- Trustee
  - The trustee takes legal title in the trust property
  - The trustee owes fiduciary obligations to the beneficiaries
- Beneficiary
  - There must be a beneficiary ("beneficiary principle")
  - The beneficiary has equitable proprietary interest
- Taking security, the secured party either:
  - Acts as trustee and so takes legal title only qua trustee; but the party providing the security retains an equitable interest
  - Third party may be appointed as trustee with secured party taking only an equitable interest
- *Quistclose* trusts
  - *Barclays Bank v Quistclose* [1970] AC 567, 581, *per* Lord Wilberforce:
    - "[i]t is not difficult to establish precisely upon what terms the money was advanced … to Rolls Razor Ltd. There is no doubt that the loan was made specifically in order to enable Rolls Razor Ltd. to pay the dividend … and for no other purpose. … There is surely no difficulty in recognising the co-existence in one transaction of legal and equitable rights and remedies: when the money is advanced, the lender acquires an equitable right to see that it is applied for the primary designated purpose (*In re Rogers*, 8 Morr. 243, *per* both Lindley LJ and Kay LJ): when the purpose has been carried out (i.e., the debt paid) the lender has his remedy against the borrower in debt: if the primary purpose cannot be carried out, the question arises if a secondary purpose (i.e., repayment to the lender) has been agreed, expressly or by implication: if it has, the remedies of equity may be invoked to give effect to it, if it has not (and the money is intended to fall within the general fund of the debtor's assets) then there is the

> appropriate remedy for recovery of a loan. … I can appreciate no reason why the flexible interplay of law and equity cannot let in these practical arrangements, and other variations if desired: it would be to the discredit of both systems if they could not. In the present case the intention to create a secondary trust for the benefit of the lender, to arise if the primary trust, to pay the dividend, could not be carried out, is clear and I can find no reason why the law should not give effect to it.

- Make the rights clear in the contract
- In the abstract,
  - Does the secured party acquire rights from the outset?
  - Are rights transferred away and then back again on resulting trust?
  - Does the secured party retain rights throughout?

Twinsectra v Yardley [2002] 2 AC 164
Abou-Rahmah v Abacha [2005] EWHC 2662 (QB), [2006] 1 Lloyd's Rep 484
Cooper v PRG Power Ltd [2008] BCC 588

8.3 "Lending" and similar arrangements

Hudson, 23.18-23.28

- "Lending" involves transfer of outright title subject only to a personal obligation to transfer back property of like kind
- Unlike, say, "lending" a coat to a friend.
- Cf. Stock-lending and repo's, Hudson, Ch.50
- The rights are purely contractual

8.4 Mortgages and charges

Hudson, 23.30-23.63

8.4.1 Nature of mortgages

- Mortgage grants right in property; charge grants only a right to petition the court for a right to sell property
  - *Re Bond Worth Ltd* [1980] Ch 228 at 250, Slade J: a mortgage involves a conveyance of the mortgaged property to the mortgagee subject to the mortgagor's equity of redemption, whereas a charge makes no such conveyance and grants merely contingent rights over the property in the event that the underlying obligation is not performed.
- Remedies for mortgagees
  - Sale
  - Foreclosure
  - Possession
  - Appoint receiver
- Power of sale; s.101 LPA 1925:
  - '(1) A mortgagee, where the mortgage is made by deed, shall, by virtue of this Act, have the following powers, to the like extent as if they had been in terms conferred by the mortgage deed, but not further (namely):- (i) A power, when the mortgage money has become due, to sell, or to concur with any other person in selling, the

mortgaged property, or any part thereof … as the mortgagee thinks fit …'

- Power of sale; s.91(1) LPA 1925:
  - '[a]ny person entitled to redeem mortgaged property may have a judgment or order for sale instead …'
- "Mortgage" "includes any charge or lien on any property for securing money or money's worth", s.101(1) LPA 1925

8.4.2 Nature of charges

- Falcon Chambers, *Fisher and Lightwood's Law of Mortgage* (11th ed, Butterworths, 2002), 25:
  - 'A charge is a security whereby real or personal property is appropriated for the discharge of a debt or other obligation, but which does not pass either an absolute or a special property in the subject of the security to the creditor, nor any right to possession. In the event of non-payment of the debt, the creditor's right of realisation is by judicial process.'

- *Swiss Bank Corp v. Lloyds Bank* [1982] A.C. 584, 594, *per* Buckley LJ:
  - 'An equitable charge which is not an equitable mortgage is said to be created when property is expressly or constructively made liable, or specially appropriated, to the discharge of a debt or some other obligation, and confers on the chargee a right of realisation by judicial process, that is to say, by the appointment of a receiver or an order for sale.'

- *Re Charge Card Services Ltd* [1987] Ch 150, 176*, per* Millett J:

> 'Similar definitions of equitable charge are to be found in *National Provincial and Union Bank of England v. Charnley*. It is sufficient to cite the language of Atkin L.J. ([1924] 1 K.B. 431at p. 449), …
>
> > "It is not necessary to give a formal definition of a charge, but I think there can be no doubt that where in a transaction for value both parties evince an intention that property, existing or future, shall be made available as security for the payment of a debt, and that the creditor shall have a present right to have it made available, there is a charge, even though the present legal right which is contemplated can only be enforced at some future date, and though the creditor gets no legal right of property, either absolute or special, or any legal right to possession, but only gets a right to have the security made available by an order of the court."
>
> Thus the essence of an equitable charge is that, without any conveyance or assignment to the chargee, specific property of the chargor is expressly or constructively appropriated to or made answerable for payment of a debt, and the chargee is given the right to resort to the property for the purpose of having it realised and applied in or towards payment of the debt. The availability of equitable remedies has the effect of giving the chargee a proprietary interest by way of security in the property charged.'

8.4.3 Fixed charge versus a floating charge

- *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch. 284, 295, *per* Romer LJ:

> '(1) If it is a charge on a class of assets of a company present and future; (2) if that class is one which, in the ordinary course of business of the company, would be changing from time to time; and

(3) if you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way so far as concerns the particular class of assets I am dealing with.'

- *Illingworth v. Houldsworth* [1904] A.C. 355, 358, *per* Lord Macnaghten:

  'A [fixed, or] specific charge … is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to effect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.'

In re BCCI (No 8) [1998] AC 214, HL.

In re Spectrum Plus Ltd [2005] UKHL 41, [2005] 2 AC 680, para [111], *per* Lord Scott:

"the essential characteristic of a floating charge, the characteristic that distinguishes it from a fixed charge, is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event."

Lord Walker, para [138]:

'Under a fixed charge the assets charged as security are permanently appropriated to the payment of the sum charged, in such a way as to give the chargee a proprietary interest in the assets.'

8.4.4 Registration of charges against companies

Companies Act 2006, s.860(1):

'A company that creates a charge to which this section applies must deliver the prescribed particulars of the charge, together with the instrument (if any) by which the charge is created or evidenced, to the registrar for registration before the end of the period allowed for registration.'

Companies Act 2006, s.860(7):

'This section applies to the following charges …
(a) a charge on land or any interest in land …,
(c) a charge for the purpose of securing any issue of debentures, …
(f) a charge on the book debts of the company,
(g) a floating charge on the company's undertaking or property …'

8.4.5 Charges over book debts

Agnew v IRC [2001] 2 AC 710
In re Spectrum Plus Ltd [2005] UKHL 41

8.5 Pledge

Official Assignee of Madras v Mercantile Bank of India Ltd [1935] AC 53 at 58:

'At common law a pledge could not be created except by a delivery of possession of the thing pledged, either actual or constructive. It involved a bailment. If the pledgor had the actual goods in his physical possession, he

> could effect the pledge by physical delivery; in other cases he could give possession by some symbolic act, such as handing over the key of the store in which they were. If, however, the goods were in the custody of a third person, who held for the bailor so that in law his possession was that of the bailor, the pledge could be effected by a change of the possession of the third party, that is by an order to him from the pledgor to hold for the pledgee, the charge being perfected by the third party attorning to the pledgee, that is acknowledging that he thereupon held for him; there was thus a change of possession and a constructive delivery; the goods in the hands of the third party became by this process in the possession constructively of the pledgee.'

8.6 Lien

8.6.1 Possessory lien

8.6.2 Contractual lien
Re Cosslett (Contractors) Ltd [1998] Ch 495

8.6.3 Equitable lien
Bowles v Rogers (1800) 31 ER 957
In re Welsh Irish Ferries Ltd [1986] Ch 471

8.7 Guarantees

8.7.1 Distinction between guarantees and indemnities
- Guarantee is a promise to pay for the liability of primary debtor
- Indemnity is promise to pay whether or not primary debtor would be liable

8.7.2 Guarantee must be in writing
Pitts v Jones [2008] 2 WLR 1289

8.8 Letter of comfort
Grants no property right and no guarantee. Merely a form of comfort.

9. Damages for breach of contract

Hudson, 20.03

9.1 The measure of damages

Robinson v Harman (1848) 1 Ex 850, 855, Parke B:

> 'The rule of the common law is, that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed.'

Ruxley Electronics and Construction Ltd v Forsyth [1996] AC 344, Lord Lloyd:

[the authorities do] “not say that the plaintiff is always to be placed in the situation physically as if the contract had been performed, but in as good a situation financially, so far as money can do it”

Lord Jauncey:

‘Damages are designed to compensate for an established loss and not to provide a gratuitous benefit to the aggrieved party from which it follows that the reasonableness of an award of damages is to be linked directly to the loss sustained.’

Banque Bruxelles Lambert SA v Eagle Star Insurance Co Ltd [1995] QB 375

South Australia Asset Management Corporation v York Montague Ltd [1997] AC 191

9.2 Remoteness

Hadley v Baxendale (1854) 9 Exch. 341, Court of Exchequer*, per* Alderson B:

‘Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probably result of the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract.’

9.3 Cash-settled and physically-settled transactions

- Cash-settled transactions
    - No securities nor commodities transferred to buyer/seller
    - Receives that cash profit she would have earned *as if* physical securities had been bought or sold
    - Profit calculated by reference to a nominal amount
    - For speculation or hedging
    - Interest for late payment
- Physically-settled transactions
    - Securities or commodities taken physically
    - Need to consider (i) storage, (ii) transfer conventions
    - Need to consider any prospective loss for late delivery

Chapter 6: Lending Transactions

The material in this chapter constitutes the reading for Seminar 6.

General principles: Hudson, 19.56-19.75
Loans specifically: Hudson, Chapters 33, 34, 35

1. The legal nature of a loan

Hudson, 33.01-33.16

- Payment flow: lender to borrower
- Transfer outright of the money
- Obligation to repay equivalent amount at expiry of loan or on demand, plus periodic interest
- Termination of loan = acceleration of repayment obligations

2. Common loan covenants

2.1 Covenants as to the condition of the borrower

Hudson, 33.18-33.30

2.1.1 The purpose of covenants

- Termination of covenants
- Conditions and mere warranties
- Capacity of company and authority to bind company
- Solvency, insolvency, & bankruptcy
- The financial condition of the borrower
- Calculating credit worth, and risk

2.1.2 Calculating credit risk

- Credit downgrade clause (see below)
- Material adverse change clause (see below)
- Common calculations of credit worth
    - Net worth: assets exceed liabilities
    - Debt coverage ratio
    - Interest coverage
    - EBIT
    - EBITDA
    - Cash flow measurement (liquidity)
- Restructurings
    - Companies

        - Takeovers
        - Mergers
        - Alteration to capital
        - Reorganisation within group of companies
    - Partnerships
        - Addition or removal of partner
        - Alteration to capital
    - Trusts
        - Change of trustee
        - Export of trust
        - Alteration to capital
- Maintenance of credit support
    - Guarantees / collateralisation
    - Provision of information

2.2 Covenants as to the borrower's performance

Hudson, 33.31

- Timely payment
- Provision of information
- Cross default / cross acceleration
- Maintenance of credit support / guarantee

2.3 Covenants as to the continued feasibility of the loan

Hudson, 33.32

- Supervening illegality
- Tax changes (e.g. withholding tax)

2.4 Acceleration of obligations

Hudson, 33.33-33.41

2.4.1 Commercial issues surrounding acceleration of obligations

- Early termination by way of "acceleration of obligations"
- Failure of credit support
- Failure under another loan – "cross acceleration"
- Default under another financial instrument – "cross default"
- Failure of a specified entity – "cross default"
- Triggers immediate repayment of loan
- Cf. penalty clauses

2.4.2 Case law on acceleration – cf. Banking law cases on "demand"

(a) Immediate repayment

Brightly v Norton (1862) 122 ER 116, 118, *per* Blackburn J:

"a debtor who is required to pay money on demand, or at a stated time, must have it ready, and is not entitled to further time in order to look for it"

Lloyds Bank v Lampert [1999] 1 All ER (Comm) 161 CA
Bank of Ireland v AMCD [2001] 2 All ER (Comm) 894
Shepherd & Cooper Ltd v TSB Bank plc [1996] 2 All ER 654

(b) Express contractual provision to the contrary

Shirlaw v Southern Foundries [1939] 2 KB 206, HL
Williams & Glyn's Bank v Barnes (1981) Com LR 205, Ralph Gibson J:

"if a party enters into an arrangement which can only take effect by the continuance of a certain existing state of circumstances, there is an implied engagement on his part that he shall do nothing of his own motion to put an end to that state of circumstances under which alone the arrangement can be operative."

"A reference to usual banking conditions cannot in my opinion override express terms of a contract or terms which are necessarily implied from those express terms."

Cryne v Barclays Bank plc [1987] BCLC 548

2.4.3 Wrongful acceleration

Concord Trust v Law Debenture Trust Corp plc [2005] UKHL 27
Law Debenture Trust Corp v Elektrim Finance BV [2005] EWHC 1999 (Ch)

2.5 Negative pledge

Hudson, 19.57-19.62; 33.42

- A clause which prevents the borrower from agreeing to transfer substantial parts of its assets to anyone else
- Usually no security interest
- Does this create a floating charge?
- Usually breach of negative pledge = event of default

Loan Market Association document:

'No [borrower, nor any member of the same group of companies as the borrower] shall … create or permit to subsist and Security over any of its assets. No [borrower, nor any member of the same group of companies as the borrower] shall …

sell, transfer or otherwise dispose of any of its assets on terms whereby they are or may be leased to or re-acquired by an Obligor;

sell transfer or otherwise dispose of any of its receivables on recourse terms;

enter into any arrangement under which money or the benefit of a bank or other account may be applied, set-off or made subject to a combination of accounts; or

enter into any other preferential arrangement having a similar effect

in circumstances where the arrangement or transaction is entered into primarily as a method of raising [the amount of debt ("financial indebtedness") of the borrower].'

2.6 Pari passu clauses

Hudson, 19.63; 33.43

- No individual creditor is to have advantage over any other in relation to security
- Breach = event of default

2.7 Credit worth

Hudson, 19.64-19.73

2.7.1 See 2.1.2 above in relation to "calculating credit risk"

- Common calculations of credit worth
    - Net worth: assets exceed liabilities
    - Debt coverage ratio
    - Interest coverage
    - EBIT
    - EBITDA
    - Cash flow measurement (liquidity)

2.7.2 Material adverse change

- "material"
    - Identification of source of information
        - Publicly available information only
        - Counterparty can measure from other information
        - **BNP Paribas SA v Yukos Oil Co* [2005] EWHC 1321: non-financial information can be used where contract permits
        - Third party calculation agent
    - Measurement of severity
        - Credit downgrade by rating agency
        - Measurement of credit by other means
- Material adverse change = event of default, or mere "termination event"
- What sorts of event?
    - Depends on contractual provision
    - Counterparty failure
    - "acts of god"
    - Political risk
    - Matters beyond the contemplation of the parties

2.8 Failure to pay

Hudson, 19.74-19.75

2.8.1 Impact of failure to pay

- Default interest for late payment
- Event of default ending entire contract

- Damages for consequent loss, only if specified in contract or foreseeable
- Payment automatic (usual in loans), or triggered by notice?

2.8.2 Date of payment

- Payment conventions
- Definition of "business day"

3. Syndicated loans

Hudson, Chapter 34 generally

1. Structure of syndicated loans

Hudson, 34.01-34.17

***BNP Paribas SA v Yukos Oil Co* [2005] EWHC 1321

2. Arranging syndicated loans: the role of the agent

Hudson, 34.05-34.22

2.1 Structure 1

- Separate loans making up a common amount
- "Several" (i.e. distinct) contracts, each lender with the borrower directly
- So, lender may activate termination and other rights unilaterally
- Agent acts as steward for the various lenders

2.2 Structure 2

- Loans bound into a single contract
  - Lenders may not activate rights unilaterally
  - Pari passu clause among syndicate members
  - Events of default bind all lenders
  - Does this make lenders partners? Usually prefer not to because of fiduciary obligations inter se
- Agent acts on behalf of the syndicate
- Lenders act as democracy voting on action; or more likely agent empowered to act in particular circumstances

2.3 Ordinary process

Hudson, 34.23-34.35

- Lead bank acts as agent
  - Arranges syndicate
  - Negotiates terms
  - Fiduciary liability
- Liability for misstatement: *Natwest Australia Bank v Tricontinental Corporation Ltd* [1993] ACL Rep 45

2.4 Case law on syndicated loans

Hudson, 34.42-34.45

- *Redwood Master Fund Ltd v TD Europe Ltd* [2002] EWHC 2703
- ***BNP Paribas SA v Yukos Oil Co* [2005] EWHC 1321
- *Concord Trust v Law Debenture Trust Corporation plc* [2005] 1 WLR 1591
- *Argo Fund Limited v Essar Steel Limited* [2005] EWHC 600 (Comm)
- ***IFE Fund SA v Goldman Sachs International* [2006] EWHC 2887
- ***Citibank NA v MBIA Assurance SA* [2006] EWHC 3215
- ***JP Morgan Chase Bank v Springwell Navigation Corp* [2008] EWHC 1186
- *British Energy Power v Credit Suisse* [2008] EWCA Civ 53, [2008] 1 Lloyd's Rep 413
- ***Uzinterimpex JSC v Standard Bank plc* [2008] Bus LR 1762

3. Syndicated loan covenants

Many of these covenants arose under ordinary loans above.

3.1 Covenants to provide information to the lenders

3.2 Covenants as to the financial condition of the borrower

3.3 Conditions precedent

3.4 Events of default

3.4.1 Acceleration of obligations
3.4.2 Cross default
3.4.3 Material adverse change
3.4.4 Restructuring

3.5 The role of the syndicate agent

4. Bonds

Hudson, Chapter 35

4.1 Structuring of bond issues

Hudson, 35.01-35.07

- Many lenders but not a syndicate
- A loan combined with the issue of transferable securities
- Dematerialisation; bonds issued under a "global note"
- Bond issues subject to a ratings agency formal rating.

4.2 The role of the trustee

Hudson, 35.12, 35.22-35.27

- Not essential to all bond issues but anticipated in Listing Rules

- Documentation
    - Mandate letter
    - Subscription agreement
    - Pathfinder prospectus
    - Prospectus (offering circular)
    - Managers' agreement
    - Embedded swap agreement ("embeddo")
- Problem of certainty of subject matter

4.3 Case law on syndicated loans compared with bond issues

- *Redwood Master Fund Ltd v TD Europe Ltd* [2002] EWHC 2703
- *Martin Rose Ltd v AKG Group* [2003] EWCA Civ 375, [2003] 2 BCLC 102
- ***BNP Paribas SA v Yukos Oil Co* [2005] EWHC 1321
- **Concord Trust v Law Debenture Trust Corporation plc* [2005] 1 WLR 1591
- **Law Debenture Trust Corp v Elektrim Finance BV* [2005] EWHC 1999 (Ch)
- *Argo Fund Limited v Essar Steel Limited* [2005] EWHC 600 (Comm)
- ***IFE Fund SA v Goldman Sachs International* [2006] EWHC 2887
- ***JP Morgan Chase Bank v Springwell Navigation Corporation* [2008] EWHC 1186
- *British Energy Power v Credit Suisse* [2008] EWCA Civ 53, [2008] 1 Lloyd's Rep 413
- ***Uzinterimpex JSC v Standard Bank plc* [2008] Bus LR 1762

***Question**: what is the difference between a syndication agent and a bond trustee?*

Chapter 7: Securities Regulation

The material in this chapter constitutes the reading for Seminar 7.

Hudson, Chapters 37 through 41
Alastair Hudson, *Securities Law* (Sweet & Maxwell, 2008)

1. THE SOURCES OF SECURITIES LAW

EC securities directives

Consolidated Admission and Reporting Directive 2001 (CARD)
Prospectus Directive 2004
Transparency Obligations Directive 2005
Markets in Financial Instruments Directive ("MiFID") 2004

UK legislation

Financial services and Markets Act 2000 ("FSMA 2000")
Companies Act 2006
Prospectus Regulations 2005

FSA securities regulation

Listing Rules (2005)
Prospectus Rules (2005)
Disclosure and Transparency Rules (2006)

English general law

(Especially the tort of negligence, for the purposes of this course)

2. THE LAMFALUSSY PROCESS

2.1 The process

Final report published in February 2001.
Four tiers for EU regulation in this area:

(1) Framework principles in Directives
(2) Commission technical regulations
(3) Guidance from the Committee of European Securities Regulators ("CESR")
(4) Enforcement mechanism effected by the Commission

2.2 Themes

- Harmonisation – "approximation", "co-ordination"
- Deep pools of liquid capital
- Gold-plating
- Passporting authorisation across the EU
- Provision of information

2.3 Example

First recital to the Transparency Obligations Directive:

> 'Efficient, transparent and integrated securities markets contribute to a genuine single market … foster growth and job creation by better allocation of capital and by reducing costs. The disclosure of accurate, comprehensive and timely information … builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency.'

To be achieved by means of '*transparency for investors through a regular flow of information*'.

3. THE POLICIES UNDERPINNING THE EC SECURITIES DIRECTIVES

3.1 Consolidated Admissions and Reporting Directive

- Listing
- "co-ordination should first be limited to the establishment of minimum conditions" (r.6)
- "closer alignment" of national regulatory rules
- "coordinating the [various national] rules and regulations without necessarily making them completely uniform" (r.9)
- Passporting
- Investor protection

3.2 The Prospectus Directive

3.2.1 The general policies

- Over-arching policy objective of creating a single internal market for the EU (r.4)
- To facilitate the creation of a viable Europe-wide securities market with "deep, liquid pools of capital".
- An "instrument essential to the achievement of the internal market" as part of the Risk Capital Action Plan.
- Single passport to each issue of securities: authorisation by the competent authority in one member state shall be recognised in all other member states (r.4)
- The "country of origin" principle: the issuer's home state regulator assumes control (r.14)
- The issuer bears an "ongoing disclosure obligation" to make "reliable information" available to the investing public throughout the life of the security (r.27).
- Jurisdictional "differences should be eliminated by harmonising the rules … to achieve an adequate degree of equivalence of the safeguards [for investor protection by means of] provision of information" (r.30).

3.2.2 The Prospectus Directive central principles

Recital 41:-

- the need to ensure confidence in financial markets among small investors …;
- the need to provide investors with a wide range of competing investment opportunities and a level of disclosure and protection tailored to their circumstances;
- the need to ensure that independent regulatory authorities enforce the rules consistently, especially as regards the fight against white collar crime;
- the need for a high level of transparency …;

- the need to encourage innovation in financial markets if they are to be dynamic and efficient;
- the need to ensure systemic stability of the financial system by close and reactive monitoring of financial innovation;
- the importance of reducing the cost of, and increasing access to, capital;
- the need to balance, on a long-term basis, the costs and benefits to market participants … of any implementing measures;
- the need to foster the international competitiveness of the Community's financial markets without prejudice to a much-needed extension of international cooperation;
- the need to achieve a level playing field for all market participants by establishing Community legislation every time it is appropriate;
- the need to respect differences in national financial markets where these do not unduly impinge on the coherence of the single market;
- the need to ensure coherence with other Community legislation in this area, as imbalances in information and a lack of transparency may jeopardise the operation of the markets and above all harm consumers and small investors.'

3.3 The Transparency Obligations Directive

The general principle

> 'This Directive establishes requirements in relation to the disclosure of periodic and ongoing information about issuers whose securities are already admitted to trading on a regulated market situated or operating within a Member State.' (art.1)

- Voteholder information
- Gold-plating

4. PROSPECTUSES

4.1 The current legislation

- EC Prospectus Directive implemented by the UK Prospectus Regulations (S.I. 2005/1433); in turn amending existing sections of Part 6 of FSMA 2000 and also introducing new sections to that Part 6.
- FSA Prospectus Rules (2005) implemented the detailed Commission regulations.
- Public Offers of Securities Regulations 1995 (S.I. 1995/1537) revoked by Prospectus Regulations, Sch.3.
- Financial Services and Markets Act 2000 (Official Listing of Securities) Order 2001 (S.I. 2001/2958) revoked by Prospectus Regulations, Sch.3.

4.2 Offers of transferable securities require prospectus: the key provision

s.85(1) of FSMA 2000:

> 'It is unlawful for transferable securities to which this subsection applies to be offered to the public in the United Kingdom unless an approved prospectus has been made available to the public before the offer is made.'

4.3 Definition of "securities"

Prospectus Directive, art.2(1)(a):

'- shares in companies and other securities equivalent to shares in companies,
- bonds and other forms of securitised debt which are negotiable on the capital market [sic] and
- any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement
excluding instruments of payment.'

4.4 Requests for admission to trading on a regulated market require a prospectus

s.85(2) FSMA 2000:

'It is unlawful to request the admission of transferable securities to which this subsection applies to trading on a regulated market situated or operating in the United Kingdom unless an approved prospectus has been made available to the public before the request is made.'

4.5 Breach of s.85 duties grants right to compensation

s.85(4) FSMA 2000:

'A contravention of subsection (1) or (2) is actionable, at the suit of a person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.'

Tort of "breach of statutory duty simpliciter": *X (minors) v Bedfordshire County Council* [1995] 2 A.C. 633

4.6 Exemptions and exclusions from s.85

4.6.1: Schedule 11A FSMA 2000

1. government and similar securities
2. not-for-profit organisations
3. two further types of security which do not constitute "transferable securities"

4.6.2: s.86 of FSMA 2000

1. offers made to or directed at "qualified investors"
2. offers made to fewer than one hundred people
3. large issues beyond the reach of ordinary, retail investors in which the minimum consideration is at least 50,000 euros
4. large denomination issues where the securities being offered are denominated in amounts of at least 50,000 euros
5. small issues where the total consideration for the transferable securities being offered cannot exceed 100,000 euros
6. where non-qualified investor engages a qualified investor to act as his agent and where that agent has discretion as to his investment decisions

4.6.3: s.85(5)(b) FSMA 2000: FSA power to exempt issues

4.7 Issuer may elect to have a prospectus

s.87 FSMA 2000

4.8 The general duty of disclosure of information in prospectuses

4.8.1 The requirement of "necessary information"

s.87A(1) FSMA 2000:

> 'The competent authority may not approve a prospectus unless it is satisfied that-
> (a) the United Kingdom is the home State in relation to the issuer of the transferable securities to which it relates,
> (b) the prospectus contains the **necessary information**, and
> (c) all of the other requirements imposed by or in accordance with this Part or the prospectus directive have been complied with (so far as those requirements apply to a prospectus for the transferable securities in question).'

4.8.2 The definition of "necessary information"

s.87A(2) FSMA 2000:

> 'The necessary information is the information necessary to enable investors to make an informed assessment of –
>
> > (a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the transferable securities and of any guarantor; and
> > (b) the rights attaching to the transferable securities.'

4.8.3 Four significant elements

(1) Duty applies only to prospectuses submitted to the competent authority

(2) The "informed assessment" criterion

s.87A(4) FSMA 2000:

'The necessary information must be must be prepared having regard to the particular nature of the transferable securities and their issuer.'

- Not "reasonableness"
- Not information which a professional advisor would require
- s.87A(2) FSMA 2000 refers only to "investors" making an informed assessment
- Distinction between informed investors and idiots?
- Cf. FSA Conduct of Business Sourcebook classification of customers: market counterparties and inexpert, "retail" clients.

(3) Information to be provided

- the assets and liabilities of the issuer,
- the financial position of the issuer,
- the profits and losses of the issuer, and
- the prospects of the issuer.

(4) Information as to the rights which will attach to the securities

4.9 Prospectus must be comprehensible and easily analysable presentation

s.97A(3) FSMA 2000:

'The necessary information must be presented in a form which is comprehensible and easy to analyse.'

Dictionary definition of "comprehensible" = "may be understood"; but by whom?

4.10 Requirement for supplementary prospectus

s.87G FSMA 2000:

'if, during the relevant period, there arises or is noted a significant new factor, material mistake or inaccuracy relating to the information included in a prospectus [or in a supplementary prospectus] approved by the competent authority.'

4.11 The required contents of a prospectus

(1) The central duty of disclosure: s.87A FSMA 2000

(2) The form of a prospectus
If one document, s.87A(5) FSMA 2000: a "summary must, briefly and in non-technical language, convey the essential characteristics of, and risks associated with, the issuer, any guarantor and the transferable securities to which the prospectus relates."

(3) Building blocks: the regulatory pizza – base with selected toppings

4.12 Omission of information in a prospectus

s.87B FSMA 2000: FSA may permit omission if:

"its disclosure would be contrary to the public interest; or
would be seriously detrimental to the issuer (provided that its omission would be unlikely to mislead the public); or
where the information is only of minor importance."

4.13 The general obligation to obey the Prospectus Rules

s.91(1A) FSMA 2000: contravention = penalty from FSA; or censure

4.14 Listing Particulars

Required only under Ch.13 Listing Rules for limited issues, despite s.79 FSMA.

5. Civil Liability for Preparation of Prospectuses

5.1 The approach of the old cases to issues of securities

The general law of negligent misrepresentation is dealt with in detail in the next topic.

5.2 Compensation under s.90 FSMA 2000

5.2.1 Persons responsible for the contents of the prospectus

In relation to equity securities, the persons responsible for the prospectus are:

- the issuer;
- directors and those authorising themselves to be named as responsible for the prospectus;
- any other person who accepts responsibility for the prospectus;
- in relation to an offer, each person who is a director of a body corporate making an offer of securities; in relation to applications for admission to trading, each person who is a director of a body corporate making an offer of securities; and
- other persons who have authorised the contents of the prospectus. (PR, 5.5.3R)

In relation to securities which are not equity securities, the persons responsible for the prospectus are:

- the issuer;
- anyone who accepts and is stated in the prospectus as accepting responsibility for the prospectus;
- any other person who is the offeror of the securities;
- any person who requests an admission to trading of transferable securities; any guarantor for the issue in relation to information about that guarantee;
- and any other person who has authorised the contents of the prospectus. (PR, 5.5.4R)

That someone has given advice in a professional capacity about the contents of a prospectus does not make that person responsible for the contents of the prospectus in itself (PR, 5.5.9R); unless they consent to being so named or they authorise those contents of the prospectus which are the subject of the action, and even then they are liable only to the extent that they have agreed to be so liable (PR, 5.5.8R).

5.2.2 The basis of the right to compensation under s.90 FSMA 2000

*s.90(1) FSMA 2000:

'Any person responsible for listing particulars is liable to pay compensation to a person who has

(a) acquired securities to which the particulars [or the prospectus] apply; and

(b) suffered loss in respect of them as a result of

(i) any untrue or misleading statement in the [prospectus];

(ii) or the omission from the [prospectus] of any matter required to be included by [the duties of disclosure in] section [*87A or 87B*]'.

5.2.3 Defences to liability under s.90

Schedule 10, FSMA 2000

- when the defendant believed in the truth of the statement that was made in the prospectus;
- when the statement was made by an expert which is included in a prospectus or a supplementary prospectus with that expert's consent and is stated in that document to be included as such;
- when there has been publication, or taking of reasonable steps to secure publication, of a correction;
- when reasonable steps have been taken to secure the publication of a correction of a statement made by an expert;
- when the statement was made by an official person or contained in a public, official document, provided that the statement was accurately and fairly reproduced;
- if the court is satisfied that the investor acquired the securities with knowledge that the statement was incorrect, and therefore that the investor was not misled by it.

6. TRANSPARENCY OBLIGATIONS

6.1 Source

Transparency Obligations Directive 2004/109/EC implemented by Part 43 of Companies Act 2006 and FSA "Disclosure and Transparency Rules" ("DTR").

6.2 Objectives

- "Transparency" means the provision of information, effectively
- Maintain a flow of information to the investing public *after* securities have been admitted to trading on a regulated market
- Voteholder information: s.89B(1) FSMA 2000

- Financial information

6.3 Voteholder information

- "Voteholder information" means "information relating to the proportion of voting rights held by a person in respect of the shares" (s.89B(3) FSMA 2000).
- Monthly disclosure "to the public" the total number of voting rights and capital in respect of each class of issued shares (DTR, para 5.6).
- Voting rights under common control: "voting rights" are rights attaching to a share which permit the shareholder to vote at company meetings (s.89F(4) FSMA 2000); and "common control" includes
    - people who hold a majority of voting rights in other persons, or
    - who have the right to alter the composition of another person's board of directors, or
    - who control the voting rights in another person perhaps by virtue of some shareholders' agreement, or
    - who either have a legal right to exercise a dominant influence over another person or who "actually exercise" a dominant influence over that other person (s.89J(2) FSMA 2000).
- "Voting rights include (s.89F(3) of FSMA 2000):
    - being a shareholder in the issuer; or
    - having an entitlement to deal with those voting rights under an agreement where parties are acting in concert in relation to the use of those shares, or where the shares are "lent" or held as collateral, or
    - where the shares held on trust (whether subject to a life interest, or on discretionary trust or on bare trust), or where the rights in the shares are controlled by some other undertaking, or where control is exercised by an agent as a proxy; or
    - having rights under a derivative, e.g. a call option.
- Notification obligations when thresholds are crossed (TOD, art.9): 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%. Including derivatives to acquire shares (TOD, art.13).

6.4 Misleading statements in discharge of transparency obligations

s.90A(3) FSMA 2000:

'(a) acquired such securities issued by it, and

(b)suffered loss in respect of them as a result of-

(i) any untrue or misleading statement in a publication to which this section applies, or

(ii) the omission from any such publication of any matter required to be included in it.'

s.90A(4) FSMA 2000:

'The issuer is so liable only if a person discharging managerial responsibilities within the issuer in relation to the publication-

(a) knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading, or

(b) knew the omission to be dishonest concealment of a material fact.'

7. THE LISTING RULES

7.1 Nomenclature

- Official listing of securities: Part 6 of FSMA 2000
- Official List in the UK is the list maintained by the "competent authority" under the EC *securities directives* for the purposes of Part 6.
- FSA is the UK Listing Authority ("UKLA")
- The Official List is regulated by means of the *FSA Listing Rules*.

7.2 Securities transactions are contracts

The heart of any securities transaction under the general law is a contract.

7.3 The definition of "transferable securities"

7.3.1: MiFID definition

MiFID, art.4(18):

> "'Transferable securities" means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:
>
> (a) shares in companies and other securities equivalent to shares in companies, partnership or other entities, and depositary receipts in respect of shares;
>
> (b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
>
> (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures'

To summarise:-

- shares,
- bonds, and
- securitised derivatives

7.3.2: FSMA 2000 definition

An "offer of transferable securities to the public", as defined in s.102B(1) FSMA 2000:

> 'For the purposes of [Part 6 FSMA 2000] there is an offer of transferable securities to the public if there is a communication to any person which presents sufficient information on—
>
> (a) the transferable securities to be offered, and
>
> (b) the terms on which they are offered,
>
> to enable an investor to decide to buy or subscribe for the securities in question.'

7.4 Private Companies May Not Offer Securities to the Public

s.756 of CA 2006

7.5 The Listing Principles

These principles inform all of the Listing Rules. They are in Chap. 7 of the Listing Rules.

The Listing Principles are as follows:

Prin 1	A listed company must take reasonable steps to enable its directors to understand their responsibilities and obligations as directors.
Prin 2	A listed company must take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations.
Prin 3	A listed company must act with integrity towards holders and potential holders of its listed equity securities.
Prin 4	A listed company must communicate information to holders and potential holders of

	its listed equity securities in such a way as to avoid the creation or continuation of a false market in such listed equity securities.
Prin 5	A listed company must ensure that it treats all holders of the same class of its listed equity securities that are in the same position equally in respect of the rights attaching to such listed equity securities.
Prin 6	A listed company must deal with the FSA in an open and co-operative manner.

8. CONTINUING OBLIGATIONS

8.1 Conditions as to the nature of the issuer itself

s.75 FSMA 2000:

> 'Admission to the official list may be granted only on an application made to the competent authority in such manner as may be required by listing rules.'

8.2 The principles in outline

8.2.1 General conditions for admission to listing (Chap 2, LR)

- company duly incorporated,
- securities duly authorised for listing under the company's constitution,
- shares must be freely transferable,
- shares must be admitted to trading on an RIE's market for listed securities,
- issuer's securities must have a minimum capitalisation,
- an approved prospectus must be published.

8.2.2 Further general conditions for admission to listing (Chap 6, LR)

- company must have published and filed audited accounts for at least three previous years,
- company must have an independent business,
- company's business activities must have continuous for the previous three years
- must have a minimum working capital identified in the rules,
- securities themselves must be 25% in public hands after the issue within the EU and EEA,
- securities must be capable of electronic settlement.

8.2.3 Special conditions on a particular listing application

- UKLA may impose special conditions "solely in the interests of protecting investors"

8.2.4 That the issuer must have consented to the listing

8.2.5 Conditions to be satisfied in relation to the securities themselves

- securities to be listed must be admitted to trading on a recognised investment exchange's market for listed securities;
- securities must be validly issued according to the law of the place of the applicant's incorporation, must accord with company's constitution, and any necessary statutory or regulatory consents must have been obtained;
- securities must be "freely transferable";
- securities must be eligible for electronic settlement.
- aggregate market value of all securities to be listed must be at least £700,000 for shares and £200,000 for debt securities, although UKLA "may admit securities of lower value if satisfied that there will be an adequate market for the securities."

8.3 The application procedure for admission to the Official List

- Specific to the type of security, or entity

8.4 Sponsors

- There is a requirement for a sponsor in relation to any listing (LR, 8.2.1R).
- Sponsors are usually regulated investment firms required to vet the suitability of an issue of securities, and to warrant that suitability to the FSA.
- Advise issuer and supply information to UKLA
- Sponsors' general duties:
    - exercise due care and skill in advising the listed company;
    - take reasonable steps to ensure that the directors of the listed company understand the nature and extent of their obligations under the listing rules;
    - deal with the FSA in an open and co-operative manner, dealing promptly with all of the FSA's enquiries and disclosing any "material information" of which it has knowledge to the FSA in a "timely manner";
    - required to be independent of the listed company and to complete a form attesting to its independence in relation to each admission for listing in which it participates.
- Sponsors' duties in relation to the listing:
    - form a "reasonable opinion", after making due and careful inquiry, that applicant has satisfied all of the requirements of Listing Rules and Prospectus Rules,
    - ensure the directors of the applicant have put in place adequate procedures to enable the applicant to comply with the listing rules, and
    - ensure the directors of the applicant have also put in place procedures on the basis of which they are able to make "proper judgments on an ongoing basis" as to the applicant's financial position and prospects.

8.5 General Continuing Obligations in the Listing Rules

- Continuing obligations to keep the FSA informed of administrative matters (LR, 9.2.11R)
- Continuing obligations as to the equal treatment of shareholders (LR, 9.3.1R)
- Continuing obligations relating to publicise financial information through RIS (LR, 9.7.1R); unless "contrary to the public interest or seriously detrimental to the listed company" (LR, 9.7.3R) but provided that omission would not be "likely to mislead the public with regard to facts and circumstances, knowledge of which is essential for the assessment of the shares" (LR, 9.7.3R).
- Continuing obligations in relation to market abuse, see below.
- Continuing obligations in the FSA Disclosure and Transparency Rules: notify RIS "as soon as possible" of any inside information which "directly concerns the issuer" unless the issuer (on its own initiative) considers the prevention of disclosure to be necessary to protect its own "legitimate interests" (DTR, 2.5.1R).
- The obligation to communicate information so as to avoid the creation or continuation of a false market in such listed equity securities (Fourth Listing Principle).
- Circulars *(*LR, section 13.8) in relation to constitutional matters, decisions affecting securities, takeovers, etc..

8.6 Penalties for breach of the Listing Rules

- Where any contravention of the listing rules (s.91 FSMA 2000);
- Where any contravention of Part 6 of FSMA 2000 or of the Prospectus Rules (s.91(1A) FSMA 2000).
- The penalty is such as the FSA considers appropriate.

8.7 Discontinuance of listing

- discontinue or to suspend listing further to s.77 of FSMA 2000;
- suspend or prohibit an offer of transferable securities to the public under s.87K of FSMA 2000;
- suspend or prohibit admission to trading on a regulated market under s.87L of FSMA 2000; and
- suspend trading in a financial instrument on grounds of breach of the disclosure rules under s.96C of FSMA 2000.

Chapter 8: Tort Law in Finance

The material in this chapter constitutes the reading for Seminar 8.

1. Fraud

Hudson, 25.01-25.35

1.1 The central principle

Hudson, 25.01-25.03

**Derry v Peek* (1889) 14 App Cas 337, 376

> 'First, in order to sustain an action of deceit, there must be proof of fraud and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (i) knowingly, (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. To prevent a false statement from being fraudulent, there must, I think, always be an honest belief in its truth.'

1.2 The need for a false representation; partial truths

Hudson, 25.04-25.13

Peek v Gurney (1873) LR 6 HL 377
Edgington v Fitzmaurice (1885) 29 Ch. D 459
Bradford Third Equitable Benefit BS [1941] 2 All ER 205, 211
***Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd* [1994] 4 All ER 225: " a cocktail of truth, falsity and evasion is a more powerful instrument of deception than an undiluted falsehood".
Thomas Witter Ltd v TBP Properties Ltd [1996] 2 All ER 573
Bankers Trust v PT Dharmala Sakti Sejahtera [1996] CLC 518

1.3 The defendant's state of mind

Hudson, 25.13

**Derry v Peek* (1889) 14 App Cas 337, 376

> "there must be proof of fraud and nothing short of that will suffice. … fraud is proved when it is shown that a false representation has been made (i) knowingly, (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false"

**Akerhielm v. De Mare* [1959] A.C. 789, 805 (P.C.):

> "The question is not whether the defendant in any given case honestly believed the representation to be true in the sense assigned to it by the court on an objective consideration of its truth or falsity, but whether he honestly believed the representation to be true in the sense in which he understood it albeit erroneously when it was made. This general proposition is no doubt subject to limitations. For instance, the meaning placed by the defendant on the representation

made may be so far removed from the sense in which it would be understood by any reasonable person as to make it impossible to hold that the defendant honestly understood the representation to bear the meaning claimed by him and honestly believed it in that sense to be true."

****Bankers Trust v PT Dharmala Sakti Sejahtera** [1996] CLC 518

1.4 Fraud and securities issues

Hudson, 25.14

Possfund Custodian Trustee Ltd v Diamond [1996] 2 All E.R. 774 Lightman J:

'For the purpose of the torts of deceit and negligent misrepresentation, it is necessary to establish a material misrepresentation intended to influence, and which did in fact influence the mind of the representee and on which the representee reasonably relied.'

Al-Nakib Investments (Jersey) Ltd v. Longcroft [1990] 3 All E.R. 321

1.5 Damages for fraudulent misrepresentation in securities issues

Hudson, 25.18-25.24

****Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd** [1996] 4 All E.R. 769, 778, *per* Lord Browne-Wilkinson:

'(1) The defendant is bound to make reparation for all the damage directly flowing from the transaction.

(2) Although such damage need not have been foreseeable, it must have been directly caused by the transaction.

(3) In assessing such damage, the plaintiff is entitled to recover by way of damages the full price paid by him, but he must give credit for any benefits which he has received as a result of the transaction.

(4) As a general rule, the benefits received by him include the market value of the property acquired as at the date of acquisition; but such general rule is not to be inflexibly applied where to do so would prevent him obtaining full compensation for the wrong suffered.

(5) Although the circumstances in which the general rule should not apply cannot be comprehensively stated, it will normally not apply where either (a) the misrepresentation has continued to operate after the date of the acquisition of the asset so as to induce the plaintiff to retain the asset or (b) the circumstances of the case are such that the plaintiff is, by reason of the fraud, locked into the property.

(6) In addition, the plaintiff is entitled to recover consequential losses caused by the transaction.

(7) The plaintiff must take all reasonable steps to mitigate his loss once he has discovered the fraud.'

1.6 Fraud and the financial crisis

Hudson, 25.25

2. Negligent misrepresentation

Hudson, 26.01-26.52

2.1 The general principle

2.1.1 The development of the central principles

Donoghue v Stevenson [1932] A.C. 562
Hedley Byrne v Heller and Partners [1964] A.C. 465
Home Office v Dorset Yacht [1970] A.C. 1004
Anns v. Merton L.B.C. [1978] A.C. 728
***Caparo Industries plc v Dickman* [1990] 2 A.C. 605, Lord Bridge:

> 'What emerges is that, in addition to the foreseeability of damage, the necessary ingredients in any situation giving rise to a duty of care are that there should exist between the party owing the duty and the party to whom it is owed a relationship characterised by the law as one of "proximity" or "neighbourhood" and that the situation should be one in which the court considers it fair, just and reasonable that the law should impose a duty of a given scope on the one party for the benefit of the other.'

2.1.2 No economic loss

Hedley Byrne v Heller and Partners [1964] A.C. 465
Spartan Steel & Alloys Ltd v Martin & Co (Contractors) Ltd [1973] Q.B. 27

2.1.3 Who may suffer loss

White v Jones [1995] 2 AC 207
Gorham v British Telecommunications plc [2000] 1 WLR 2129

2.1.4 The duty of care in financial transactions

Banbury v Bank of Montreal [1918] AC 626, HL
**Woods v Martins Bank Ltd* [1959] 1 QB 55 Salmon J
***JP Morgan Chase Bank v Springwell Navigation Corporation* [2008] EWHC 1186 (Comm).

2.1.5 Liability of regulators

Yuen Kun Yeu v Att-Gen of Hong Kong [1988] A.C. 175 *(liability of regulators)*
Watson v British Boxing Board of Control [2001] 2 W.L.R. 1256

2.2 The *Hedley Byrne v Heller* principle

2.2.1 The Hedley Byrne principle in the abstract

***Hedley Byrne v Heller and Partners* [1963] 2 All E.R. 575, [1964] A.C. 465, *per* Lord Morris:

> 'I consider that it follows and that it should now be regarded as settled that if someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies on such skill, a duty of care will arise. … Furthermore if, in a sphere in which a

person is so placed that others could reasonably rely on his judgment or his skill or on his ability to make careful inquiry, a person takes it on himself to give information or advice to, or allows his information or advice to be passed on to, another person who, as he knows or should know, will place reliance on it, then a duty of care will arise.'

**Caparo Industries plc v. Dickman* [1990] 2 A.C. 605, 638, *per* Lord Oliver:

'What can be deduced from the *Hedley Byrne* case, therefore, is that the necessary relationship between the maker of a statement or giver of advice (the adviser) and the recipient who acts in reliance on it (the advisee) may typically be held to exist where (1) the advice is required for a purpose, whether particularly specified or generally described, which is made known, either actually or inferentially, to the adviser at the time when the advice is given, (2) the adviser knows, either actually or inferentially, that his advice will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose, (3) it is known, either actually or inferentially, that the advice so communicated is likely to be acted upon by the advisee for that purpose without independent inquiry and (4) it is so acted on by the advisee to his detriment. That is not, of course, to suggest that these conditions are either conclusive or exclusive, but merely that the actual decision in the case does not warrant any broader propositions."

See also Lord Bridge at 620-621 and Lord Jauncey at 659-660 (esp. at 660E "the fundamental question of the purpose").

James McNaughton Papers Group Ltd v. Hicks Anderson & Co. (a firm) [1991] 1 All E.R. 135.

Cf. *Morgan Crucible Co. plc v. Hill Samuel Bank Ltd* [1991] 1 All E.R. 148

2.2.2 Implementations to financial transactions

(Bankers Trust v PT Dharmala Sakti Sejahtera [1996] CLC 518)
Mutual Life and Citizens' Assurance Co v Evatt [1971] A.C. 793
**Henderson v Merrett Syndicates Ltd* [1995] 2 A.C. 145
**Investors Compensation Scheme Ltd v West Bromwich BS* [1999] Lloyd's Rep PN 496

2.2.3 Pragmatism

Commissioners of Customs & Excise v Barclays Bank [2007] 1 AC 181, *per* Lord Hoffmann, para [35]

"It is equally true to say that a sufficient relationship will be held to exist when it is fair, just and reasonable to do so. Because the question of whether a defendant has assumed responsibility is a legal inference to be drawn from his conduct against the background of all the circumstances of the case, it is by no means a simple question of fact. Questions of fairness and policy will enter into the decision and it may be more useful to try to identify these questions than simply to bandy terms like 'assumption of responsibility' and ' fair, just and reasonable'.

3. Liability for securities issues

Hudson, 26.34-26.41
Hudson, 41.01-41.81
AS Hudson, *Securities Law*
(Sweet & Maxwell, 2008), Chapter 24

3.1 Takeovers

Hudson, 26.34-26.37; 41.09-41.13

JEB Fasteners Ltd v. Marks, Bloom & Co [1981] 3 All E.R. 289
***Caparo v Dickman* [1990] 2 A.C. 605, [1990] 1 All E.R. 568
McNaughton Papers Group v Hicks Anderson [1991] 1 All ER 134
Morgan Crucible Co plc v Hill Samuel Bank Ltd [1991] 1 All E.R. 148

3.2 Issues of securities

Hudson, 26.38-26.41; 41.14-41.24

3.2.1 The traditional approach

***Al-Nakib Investments (Jersey) Ltd v. Longcroft* [1990] 3 All E.R. 321

3.2.2 The modern approach

***Caparo v Dickman* [1990] 2 A.C. 605, [1990] 1 All E.R. 568, 576, *per* Lord Bridge:

> "[t]he situation is entirely different where a statement is put into more or less general circulation and may foreseeably be relied on by strangers to the maker of the statement for any one of a variety of different purposes which the maker of the statement has no specific reason to anticipate."

***Possfund Custodian Trustee Ltd v Diamond* [1996] 2 All E.R. 774, [1996] 1 W.L.R. 1351, [1996] 2 B.C.L.C. 665, *per* Lightman J.:

> 'The issue before me is accordingly whether it is arguable that persons responsible for a prospectus owe a duty of care to (and may be liable in damages at the instance of) an after-market purchaser if it is established that such purchaser was intended to rely on the prospectus for this purpose, and in particular whether the necessary proximity exists in such a situation between those responsible for the prospectus and the purchaser.'
>
> 'In 1963 the House of Lords in *Hedley Byrne v Heller & Partners Ltd* established that at common law a cause of action exists enabling the recovery of damages in respect of a negligent misrepresentation occasioning damage and loss where the necessary proximity exists between the representor and representee. It is clearly established (and indeed common ground on these applications) that in a case such as the present, where the defendants have put a document into more or less general circulation and there is no special relationship between alleged between the plaintiffs and the defendants, foreseeability by the defendants that the plaintiffs would rely on the prospectus for the purposes of deciding whether to make after-market purchases is not sufficient to impose upon the defendant a duty of care in such a situation requires a closer relationship between representor and representee, and its imposition must be fair, just and reasonable.'
>
> 'The law has drawn a distinction between representations made to specific persons for specific purposes and representations to the public (or sections of the public e.g. investors). In the case of the former, in general it is

sufficient to establish a duty on the part of the representor that he should reasonably have foreseen that the persons concerned would rely on his representation for the purposes in question. But in the latter, generally it is necessary to establish a proximity between the representor and representee beyond the mere foreseeability of reliance by the representee to render it fair, just and reasonable that such a duty be imposed in respect of the representation.'

"… to provide the necessary information to enable an investor to make an informed decision whether to accept the offer thereby made to take share on the proposed allotment, but not a decision whether to make after-market purchases."

'In *Peek v Gurney* the House of Lords held that (at common law) the object of a prospectus was to provide the necessary information to enable an investor to make an informed decision whether to accept the offer thereby made to take share on the proposed allotment, but not a decision whether to make after-market purchases. … The [Financial Services Act 1986] recognises a wider object in the case of listing particulars in respect of listed securities: the object includes properly informing after-market purchasers and creates a corresponding duty of care.'

'The plaintiffs say the prospectus must be examined in the light of changed market practice and philosophy current at its date of preparation and circulation. The plaintiffs claim that there has developed and been generally recognised an additional purpose, an additional perceived intention on the part of the issuer and other parties to a prospectus, namely to inform and encourage after-market purchasers, and that this is the basis for the pleaded purpose attributed by the plaintiffs to the prospectus. If this is established, then it does seem to me to be at least arguable that a duty of care is assumed and owed to those investors who (as intended) rely on the contents of the prospectus in making such purchases.'

'What is significant is that the courts have since 1873 (before any legislation) recognised a duty of care in case of prospectuses when there is a sufficient direct connection between those responsible for the prospectuses and the party acting in reliance (see *Peek v Gurney*), and the plaintiffs' claim may be recognised as merely an application of this established principle in a new fact situation. … I can find nothing in the authorities or textbooks which precludes the finding of such a duty and at least some potential support in them.'

'The law has drawn a distinction between representations made to specific persons for specific purposes and representations to the public (or sections of the public e.g. investors). In the case of the former, in general it is sufficient to establish a duty on the part of the representor that he should reasonably have foreseen that the persons concerned would rely on his representation for the purposes in question. But in the latter, generally it is necessary to establish a proximity between the representor and representee beyond the mere foreseeability of reliance by the representee to render it fair, just and reasonable that such a duty be imposed in respect of the representation.'

'Whether or not theoretically a subjective intention is sufficient, for all practical purposes, as it seems to me, the intention must in all cases be objectively established. Such intent is objectively established if the representor expressly communicates intent to the representee. On the other hand, where it is not expressly communicated, the representee must establish that he reasonably relied on the representation and that he reasonably believed that the representor intended him to act upon it. Accordingly, if the subjective intention of the representor is not expressly communicated to him,

the existence of a subjective intention alone is insufficient to found an action unless the existence of such an intention on the part of the representor was reasonably to be inferred by the representee: i.e. the objective test must be satisfied. If in all cases the objective test must be satisfied, the subjective (uncommunicated) intention of the representor adds nothing as a matter of law. As a matter of fact, if established it may perhaps assist in establishing what reasonable inference should be drawn from his conduct; and of course it is relevant if the actual state of mind of the representor is in issue (e.g. a fraudulent intent).'

3.3 The golden legacy and the Prospectus Rules

3.3.1 The "golden legacy"

Henderson v. Lacon (1867) L.R. 5 Eq. 249, 262, Page-Wood V-C

3.3.2 Whether or not statements create a misleading impression

R. v. Kyslant [1932] 1 K.B. 442.

McKeown v Boudard Peveril Gear Co. Ltd (1896) 74 L.T. 712, 713, *per* Rigby L.J.:

> "[i]t is not that the omission of material facts is an independent ground for rescission, but the omission must be of such a nature as to make the statement actually made misleading".

3.3.3 Statements about new businesses

City of Edinburgh Brewery Co. Ltd v. Gibson's Trustees (1869) 7 M. 886 (representation in a prospectus to the effect that the members of the company were comprised of "a large number of gentlemen in the trade and others", when only a dozen out of a total membership of 55 were in fact in the trade, was not a material misrepresentation)

3.3.4 Reports referred to in a prospectus

Reese River, etc., Co. v. Smith (1869) L.R. 4 H.L. 64

Re Pacaya Rubber and Produce Co. Ltd [1914] 1 Ch. 542 (report of a Peruvian expert as to the condition of a rubber estate)

3.3.5 Ambiguity will not prevent a statement being misleading

New Brunswick, etc., Co. v. Muggeridge (1860) 1 Dr. & Sm. 363, 383, *per* Kindersley V-C:

> "Those who issue a prospectus, holding out to the public the great advantages which will accrue to persons who will take shares in a proposed undertaking, and inviting them to take shares on the faith of the representations therein contained, are bound to state everything with strict and scrupulous accuracy, and not only to abstain from stating as fact that which is not so, but to omit no one fact within their knowledge, the existence of which might in any degree affect the nature, or extent, or quality, of the privileges and advantages which the prospectus holds out as inducements to take shares."

Venezuela Co. v. Kisch (1867) L.R. 2 H.L. 99, *per* Lord Chelmsford (no misstatement nor concealment of any material facts or circumstances ought to be permitted)

Redgrove v. Hurd (1881) 20 Ch.D. 1, 14, *per* Lord Jessel M.R.

Aaron's Reefs v. Twiss [1896] A.C. 273 (To suggest that the investors bear the risk of the falsity of such statements was considered by Lord Watson to be "one of the most audacious pleas that ever was put forward in answer to a charge" of misrepresentation.)

3.3.6 Remedies at common law

Smith New Court Securities Ltd v. Scrimgeour Vickers (Asset Management) Ltd [1996] 4 All E.R. 769

3.3.7 FSA Prospectus Rules

4. The measure of damages for negligent misrepresentation

Livingstone v Rawyards Coal Co (1880) 5 App Cas 25, at 39:

> '…the sum of money which will put the party who has been injured, or who has suffered, in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation or reparation.'

Chapter 9: Breach of Fiduciary Duty

The material in this chapter constitutes the reading for Seminar 9.

1. The nature of fiduciary duties in finance law

Hudson, Chapter 5

1.1 What is a fiduciary duty?

Hudson, 5.04-5.09

1.1.1 In general

White v Jones [1995] 2 AC 207 at 271, *per* Lord Browne-Wilkinson:

> 'The paradigm of the circumstances in which equity will find a fiduciary relationship is where one party, A, has assumed to act in relation to the property or affairs of another, B'.

Bristol and West Building Society v Mothew [1998] Ch 1, 18, *per* Millett LJ:

> 'A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. The core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary.'

Reading v R [1949] 2 KB 232 at 236, *per* Asquith LJ

> 'A consideration of the authorities suggests that for the present purpose a "fiduciary relation" exists (a) whenever the plaintiff entrusts to the defendant property, including intangible property as, for instance, confidential information, and relies on the defendant to deal with such property for the benefit of the plaintiff or for purposes authorised by him, and not otherwise … and (b) whenever the plaintiff entrusts to the defendant a job to be performed, for instance, the negotiation of a contract on his behalf or for his benefit, and relies on the defendant to procure for the plaintiff the best terms available …'

1.1.2 In relation to finance in particular

Hudson, 5.16-5.32

Woods v Martins Bank [1959] 1 QB 55, 72, *per* Salmon J

**Investors Compensation Scheme Ltd v West Bromwich Building Society* [1999] Lloyds Rep PN 496, 509, *per* Evans-Lombe J:

> 'Where an adviser undertakes, whether pursuant to a contract and for consideration or otherwise, to advise another as to its financial affairs it is commonplace for the courts to find that the adviser has placed himself under fiduciary obligations to that other.'

1.1.3 The effect of a fiduciary office

Hudson, 5.35-5.36

Boardman v Phipps [1967] 2 AC 47
Attorney-General for Hong Kong v Reid [1994]
Sinclair Investment Holdings SA v Versailles Trade Finance Ltd (No3) [2007] EWHC 915:

> "… any identifiable assets acquired by fiduciaries in breach of their fiduciary duty are, and can be declared to be, held upon constructive trust for the principal (*Boardman v Phipps*, *AG Hong Kong v Reid*, *Daraydan Holdings Ltd v Solland*) … There will in practice often be no identifiable property which can be declared by the court to be held upon such a constructive trust, in which case no declaration will be made and the principal may at most be entitled to a personal remedy in the nature of an account of profits. In ***Boardman's*** case the court made a declaration that the shares that had been acquired by the fiduciaries were held on constructive trust (a proprietary remedy), and directed an account of the profits that had come into their hands from those shares (a personal remedy). ***Boardman's*** case can be said to have been a hard case as regards the fiduciaries, whose integrity and honesty was not in doubt; and it well illustrates the rigours of the applicable equitable principle. The recovery by the trust of the shares was obviously a valuable benefit to it; and equity's softer side was reflected in the making of an allowance to the fiduciaries for their work and skill in obtaining the shares and profits. On the very different facts of ***Reid's*** case, there was no question of any such allowance being made."

1.2 When will a bank be a fiduciary?

Hudson, 5.16-5.34

1.2.1 Ordinarily a bank will not be a fiduciary

**Foley v Hill* (1848) 2 HL Cas 28 QB, 9 ER 1002
Kelly v Cooper [1993] AC 205

1.2.2 Circumstances in which a bank will be a fiduciary

***Lloyds Bank v Bundy* [1975] QB 326, [1974] 3 All ER 757

> 'Broadchalke is one of the most pleasing villages in England. Old Herbert Bundy was a farmer there. His home was at Yew Tree Farm. It went back for 300 years. His family had been there for generations. It was his only asset. But he did a very foolish thing. He mortgaged it to the bank. Up to the very hilt. Not to borrow money for himself, but for the sake of his son. Now the bank have come down on him. They have foreclosed. They want to get him out of Yew Tree Farm and to sell it.' …
>
> 'The fundamental rule is that if the parties have made an agreement, the Court will enforce it, unless it is manifestly unfair and unjust; but if it be manifestly unfair and unjust, the Court will disregard it and decide what is fair and just.' …
>
> 'Gathering all together, I would suggest that through all these instances there runs a single thread. They rest on "inequality of bargaining power". By virtue of it, the English law gives relief to one who, without independent advice, enters into a contract or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of

the other. When I use the word "undue" I do not mean to suggest that the principle depends on proof of any wrongdoing.'

Ata v American Express Bank (7 October 1996, unreported) (where advisor has discretionary control of client's funds = fiduciary)

Barclays Bank v O'Brien [1994] 1 AC 180

1.2.3 A new realism?

Securities and Investment Commission v Citigroup Global Markets Australia Pty Limited [2007] FCA 963:

> "a fiduciary relationship arises between a financial adviser and its client where the adviser holds itself out as an expert on financial matters and undertakes to perform a financial advisory role for the client"

1.2.4 Contexts in which fiduciary office may be possible

- Portfolio investment
  - esp where discretionary management of portfolio
  - is portfolio advice the best strategy?
- Unit trusts and open-ended investment companies
- House bank

1.2.5 Exclusion of liability

Hudson, 5.37-5.40

Armitage v Nurse [1998] Ch 241

COBS, 2.1.2R

Secutiries and Investment Commission v Citigroup Global Markets [2007] FCA 963

2. Dishonest Assistance

Reading: ***Hudson***, **section 20.2**

2.1 The basis for the action

Lord Selborne LC in **Barnes v. Addy* ((1874) 9 Ch. App. 244, 251-252):

> "… strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps, of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustee …"

Agip Africa v. Jackson [1990] Ch 265

2.2 The objective test for dishonesty

***Royal Brunei Airlines v. Tan* [1995] 2 A.C. 378, [1995] 3 WLR 64; [1995] 3 All ER 97, *per* Lord Nicholls:

"… acting dishonestly, or with a lack of probity, which is synonymous, means simply not acting as an honest person would in the circumstance. This is an objective standard. ... All investment involves risk. Imprudence is not dishonesty, although imprudence may be carried recklessly to lengths which call into question the honesty of the person making the decision. This is especially so if the transaction serves another purpose in which that person has an interest of his own."

[1995] 2 A.C. 378, 389:

Before considering this issue further it will be helpful to define the terms being used by looking more closely at what dishonesty means in this context. Whatever may be the position in some criminal or other contexts (see, for instance, *Reg. v. Ghosh* [1982] Q.B. 1053), in the context of the accessory liability principle acting dishonestly, or with a lack of probity, which is synonymous, means simply not acting as an honest person would in the circumstances. This is an objective standard. At first sight this may seem surprising. Honesty has a connotation of subjectivity, as distinct from the objectivity of negligence. Honesty, indeed, does have a strong subjective element in that it is a description of a type of conduct assessed in the light of what a person actually knew at the time, as distinct from what a reasonable person would have known or appreciated. Further, honesty and its counterpart dishonesty are mostly concerned with advertent conduct, not inadvertent conduct. Carelessness is not dishonesty. Thus for the most part dishonesty is to be equated with conscious impropriety. However, these subjective characteristics of honesty do not mean that individuals are free to set their own standards of honesty in particular circumstances. The standard of what constitutes honest conduct is not subjective. Honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. If a person knowingly appropriates another's property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour.

Smith New Court v. Scrimgeour Vickers [1997] A.C. 254
Brown v Bennett [1999] 1 BCLC 659
Twinsectra Ltd v. Yardley [1999] Lloyd's Rep. Bank 438, Court of Appeal
**Dubai Aluminium v Salaam* [2002] 3 WLR 1913
***Barlow Clowes v Eurotrust* [2006] 1 All ER 333, [2006] 1 WLR 1476
**Abou-Rahmah v Abacha* [2006] EWCA Civ 1492, [2007] Bus LR 220.

2.3 An alternative test for dishonesty based on subjectivity

R v. Sinclair [1968] 3 All ER 241, applied in *Baden Delvaux v. Societe Generale* [1992] 4 All ER 161, 234
R v. Ghosh [1982] QB 1053, applied in *R v. Clowes* [1994] 2 All ER 316

***Twinsectra Ltd v. Yardley* [2002] 2 All E.R. 377, 387, *per* Lord Hutton:

"There is, in my opinion, a further consideration [than deciding whether the test is one of knowledge or dishonesty as set out by Lord Nicholls] which supports the view that for liability as an accessory to arise the defendant must himself appreciate that what he was doing was dishonest by the standards of honest and reasonable men. A finding by the judge that a defendant has been dishonest is a grave finding, and it is particularly grave against a professional man, such as a solicitor. Notwithstanding that the issue arises in equity law [sic] and not in a criminal context, I think that it would be less than just for the law to permit a finding that a defendant had been 'dishonest' in assisting in a breach of trust where he knew of the facts which created the trust and its breach but had not been aware that what he was doing would be regarded by honest men as being dishonest."

Manolakaki v Constantinides [2004] EWHC 749, [167], *per* Peter Smith J

**Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch), [2005] All ER (D) 397, para [1481], *per* Lewison J: *effect of Twinsectra is to change the test*

Cf. *Royal Brunei Airlines v. Tan* [1995] 3 WLR 64; [1995] 3 All ER 97, *per* Lord Nicholls:

> "… subjective characteristics of dishonesty do not mean that individuals are free to set their own standards of honesty in particular circumstances. The standard of what constitutes honest conduct is not subjective. Honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. If a person knowingly appropriates another's property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour."

Cf. *Walker v Stones* [2000] 4 All ER 412, 444, *per* Sir Christopher Slade:

> "A person may in some cases act dishonestly, according to the ordinary use of language, even though he genuinely believes that his action is morally justified. The penniless thief, for example, who picks the pocket of the multi-millionaire is dishonest even though he genuinely considers the theft is morally justified as a fair redistribution of wealth and that he is not therefore being dishonest."

2.4 Applications of the objective test

Corporacion Nacional Del Cobre De Chile v. Sogemin Metals [1997] 1 WLR 1396
Twinsectra Ltd v. Yardley [1999] Lloyd's Rep. Bank 438
Grupo Toras v. Al-Sabah [1999] C.L.C. 1469
Wolfgang Herbert Heinl v. Jyske Bank [1999] Lloyd's Rep. Bank 511
**Houghton v. Fayers* [2000] 1 BCLC 571, CA
Tayeb v HSBC Bank plc [2004] 4 All ER 1024
***Dubai Aluminium v Salaam* [2002] 3 WLR 1913

***Barlow Clowes v Eurotrust* [2006] 1 All ER 333, [2005] UKPC 37,

> para [10]: 'The judge stated the law in term largely derived from the advice of the Board given by Lord Nicholls of Birkenhead in *Royal Brunei Airlines v Tan*. In summary, she said that liability for dishonest assistance requires a dishonest state of mind on the part of the person who assists in a breach of trust. Such a state of mind may consist in knowledge that the transaction is one in which he cannot honestly participate (for example, a misappropriation of other people's money), or it may consist in suspicion combined with a conscious decision not to make inquiries which might result in knowledge: see *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd* [2003] 1 AC 469. Although a dishonest state of mind is a subjective mental state, the standard by which the law determines whether it is dishonest is objective. If by ordinary standards a defendant's mental state would be characterised as dishonest, it is irrelevant that the defendant judges by different standards. The Court of Appeal held this to be a correct state of the law and their Lordships agree.'
>
> [para 12] "[Henwood had an] exaggerated notion of dutiful service to clients, which produced a warped moral approach that it was not improper to treat carrying out clients' instructions as being all important. Mr Henwood may well have thought this to be an honest attitude, but, if so, he was wrong".

2.5 Persistent shoots of subjectivity

Abou-Rahmah v Abacha [2006] EWCA Civ 1492, [2007] Bus LR 220.

Clarke, "Claims against professionals: negligence, dishonesty and fraud" [2006] 22 *Professional Negligence* 70-85:

> 'The test is an objective one, but an objective one which takes account of the individual in question's characteristics, experience, knowledge etc.. It is a test which requires a court to assess an individual's conduct according to an objective standard of dishonesty. In doing so, a court has to take account of what the individual knew, his experience, intelligence and reasons for acting as he did. Whether the individual was aware that his conduct fell below the objective standard is not part of the test.'

AG Zambia v Meer Care & Desai & Others [2007] EWHC 952 (Ch), para [334], *per* Peter Smith J:

> "[It] is essentially a question of fact whereby the state of mind of the Defendant had to be judged in the light of his subjective knowledge but by reference to an objective standard of honesty" … "The test is clearly an objective test but the breach involves a subjective assessment of the person in question in the light of what he knew at the time as distinct from what a reasonable person would have known or appreciated"

Markel International Insurance Co Ltd v Surety Guarantee Consultants Ltd [2008] EWHC 1135 (Comm), [2008] All ER (D) 10
(Bryant v Law Society [2009] 1 WLR 163)

2.6 Dishonesty and investment risk

***Royal Brunei Airlines v. Tan* [1995] 2 AC 378, 387, *per* Lord Nicholls

> "All investment involves risk. Imprudence is not dishonesty, although imprudence may be carried recklessly to lengths which call into question the honesty of the person making the decision. This is especially so if the transaction serves another purpose in which that person has an interest of his own."

3. Knowing (Unconscionable) Receipt

Reading: ***Hudson***, **section 20.3**

3.1 The basis of liability for knowing receipt

Re Diplock [1948] Ch 465, 478-479
**Re Montagu's Settlements* [1987] Ch 264
**Agip v. Jackson* [1990] Ch 265, 286, *per* Millett J.; CA [1991] Ch 547
**El Ajou v. Dollar Land Holdings* [1994] 2 All ER 685
Meridian Global Funds v. Securities Commission [1995] 3 All ER 918

Westdeutsche Landesbank v Islington [1996] AC 669, [1996] 2 All ER 961, 990, *per* Lord Browne-Wilkinson:

> "If X has the necessary degree of knowledge, X may himself become a constructive trustee for B on the basis of knowing receipt. But unless he has the requisite degree of knowledge he is not personally liable to account as trustee. Therefore, innocent receipt of property by X subject to an existing

equitable interest does not by itself make X a trustee despite the severance of the legal and equitable titles".

3.2 What type of knowledge?

**Baden v. Societe Generale* (1983) [1993] 1 W.L.R. 509 *per* Peter Gibson J, the five types of knowledge:

(1) actual knowledge;
(2) wilfully shutting one's eyes to the obvious;
(3) wilfully and recklessly failing to make inquiries which an honest person would have made;
(4) knowledge of circumstances which would indicate the facts to an honest and reasonable man;
(5) knowledge of circumstances which would put an honest and reasonable man on inquiry.

3.2.1 knowledge can be forgotten

***Re Montagu's Settlements* [1987] Ch 264 (*only first three categories of knowledge; forgetfulness*)

3.2.2 ought you to have been suspicious in the circumstances?

***Polly Peck v. Nadir* [1992] 4 All ER 769, [1993] BCLC 187

3.2.3 account officers are not detectives

**Macmillan Inc. v. Bishopsgate Investment Trust* [1995] 1 WLR 978, 1000, 1014; [1995] 3 All ER 747, 769, 783.

3.2.4 knowledge in complex fraud and money laundering cases

**El Ajou v. Dollar Land Holdings* [1994] 2 All ER 685

3.3 "Unconscionable receipt"

**BCCI v Akindele* [2000] 4 All ER 221, *per* Nourse LJ:

> 'What then, in the context of knowing receipt, is the purpose to be served by a categorisation of knowledge? It can only be to enable the court to determine whether, in the words of Buckley LJ in *Belmont Finance Corpn Ltd v Williams Furniture Ltd (No 2)* [1980] 1 All ER 393, 405], the recipient can "conscientiously retain [the] funds against the company" or, in the words of Sir Robert Megarry V-C in *In re Montagu's Settlement Trusts* [1987] Ch 264, 273, "[the recipient's] conscience is sufficiently affected for it to be right to bind him by the obligations of a constructive trustee". But, if that is the purpose, there is no need for categorisation. All that is necessary is that the recipient's state of knowledge should be such as to make it unconscionable for him to retain the benefit of the receipt.
>
> For these reasons I have come to the view that, just as there is now a single test of dishonesty for knowing assistance, so ought there to be a single test of knowledge for knowing receipt. The recipient's state of knowledge must be such as to make it unconscionable for him to retain the benefit of the receipt. A test in that form, though it cannot, any more than any other, avoid difficulties of application, ought to avoid those of definition and allocation to which the previous categorisations have led. Moreover, it should better enable the courts to give commonsense decisions in the commercial context in which claims in knowing receipt are now frequently made…'

*_Charter plc v City Index Ltd_ [2008] 2 WLR 950, Carnwath LJ:

> 'liability for "knowing receipt" depends on the defendant having sufficient knowledge of the circumstances of the payment to make it "unconscionable" for him to retain the benefit or pay it away for his own purposes'.

3.4 The requirement of receipt

3.4.1 traceable proceeds beneficially owned

El Ajou v Dollar Land Holdings [1994] 2 All ER 685, 700, _per_ Hoffmann LJ:

> 'For this purpose the plaintiff must show, first, a disposal of his assets in breach of fiduciary duty; secondly, the beneficial receipt by the defendant of assets which are traceable as representing the assets of the plaintiff; and thirdly, knowledge on the part of the defendant that the assets he received are traceable to a breach of fiduciary duty.'

Charter plc v City Index [2007] 1 WLR 26, 31, Morritt C (approved _El Ajou_)
Uzinterimpex JSC v Standard Bank plc 2008] EWCA Civ 819, [2008] Bus LR 1762, para [37] _et seq_., _per_ Moore-Bick LJ.

3.4.2 possession and control is enough

Agip (Africa) Ltd v Jackson [1990] Ch 265, 286, Millett J

> "… there is receipt of trust property when a company's funds are misapplied by any person whose fiduciary position gave him control of them or enabled him to misapply them."

4. Liability to account in corporate contexts.

Hudson, 27.07-27.31
Hudson, Equity & Trusts section 20.5

4.1 Controlling mind test

Tesco v Nattrass [1972] AC 153 (_controlling mind test_)
**_El Ajou v. Dollar Land Holdings_ [1994] 2 All ER 685, CA, overruling Millett J (_controlling mind in relation to the particular transaction at issue_)
Crown Dilmun v Sutton [2004] EWHC 52 (Ch), [23] (_controlling mind test_)

4.2 Liability of employee

Royal Brunei Airlines v. Tan [1995] 2 AC 378
Brown v Bennett [1999] 1 BCLC 649 (_assisting a director_)
Standard Chartered Bank v Pakistan National Shipping Corp [2003] 1 AC 959

4.3 Risk in commercial transactions

**_Royal Brunei Airlines v. Tan_ [1995] 2 AC 378

> "All investment involves risk. Imprudence is not dishonesty, although imprudence may be carried recklessly to lengths which call into question the honesty of the person making the decision. This is especially so if the transaction serves another purpose in which that person has an interest of his own. … [Where a person] takes a risk that a clearly unauthorised transaction

> will not cause loss ... If the risk materialises and causes loss, those who knowingly took the risk will be accountable accordingly."

Catch-22: *Tayeb v HSBC Bank plc* [2004] 4 All ER 1024 (*bank may breach contract if it refuses to accept payment*)
Cf. Criminal Justice Act 1988, s.93A (*bank may commit offence to accept payment from suspicious client*)

4.4 Standard commercial conduct in the context in that market

Reading: Alastair Hudson, 'The Liability of Trusts Service Providers in International Finance Law', in J Glasson and GW Thomas (eds), *The International Trust* (Jordans Publishing, 2006), 638 *et seq*.

- **Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700, 761, *per* Knox J (*a person guilty of "commercial unacceptable conduct in the particular context" is likely to be held to have been dishonest*)
- **Polly Peck v Nadir (No 2)* [1992] 4 All ER 769 (*liability of financial advisors dependent on context and whether they ought to have been suspicious*)
- **Royal Brunei Airlines v. Tan* [1995] 2 AC 378
- *Heinl v Jyske Bank (Gibraltar) Ltd* [1999] Lloyd's Rep Bank 511, at 535, *per* Colman J (*contravention of financial regulation*)
- *Bank of Scotland v A Ltd* [2001] 3 All ER 58 (*contravention of financial regulation*)
- *Sphere Drake Insurance Ltd v Euro International Underwriting Ltd* [2003] EWHC 1636 (Comm) (*taking unacceptable risk in contravention of conduct of business regulation = dishonesty*).
- **Manolakaki v Constantinides* [2004] EWHC 749 (*clear dishonesty where contravention of financial regulation, backdating of documents and including untrue statements in documents; absence of personal profit would militate against finding of dishonesty*)

E.g. Financial Services and Markets Act 2000 – FSA Conduct of Business Rules: Hudson, 20.5.2.
Hudson, *Securities Law* (Sweet & Maxwell, 2008), para 3-60 *et seq*.
Hudson, *The Law of Finance* (Sweet & Maxwell, 2009), para 27-23 *et seq.*

5. Tracing

5.1 Common law tracing

FC Jones & Sons v. Jones [1996] 3 WLR 703; [1996] 4 All ER 721

5.2 Equitable tracing

5.2.1 Need for an equitable proprietary base

Re Diplock [1948] Ch 465 - *fiduciary relationship required to base equitable proprietary claim.*

Westdeutsche Landesbank v. Islington LBC [1996] AC 669, [1996] 2 All ER 961

5.2.2 Honest trustee approach

Re Hallett's Estate (1880) 13 ChD. 695

5.2.3 General approach: proportionate share

Re Diplock [1948] Ch 465
Foskett v. McKeown [2001] 1 AC 102, [2000] 3 All E.R. 97

5.2.4 Specific rule for current bank accounts

Clayton's Case (1816) 1 Mer 572
Re Ontario Securities Commission (1985) 30 DLR (4d) 30
Barlow Clowes International v. Vaughan [1992] 4 All ER 22, [1992] BCLC 910, *per* Woolf LJ: "There is no reason in law or justice why his depredations upon the fund should not be borne equally between [the parties]. To throw all the loss upon one, through the mere chance of his being earlier in time, is irrational and arbitrary, and is equally a fiction as the rule in *Clayton's Case*. When the law adopts a fiction, it is, or at least it should be, for some purpose of justice. To adopt it here is to apportion a common misfortune through a test which has no relation whatever to the justice of the case."
Russell-Cooke Trust Co v Prentis [2003] 2 All ER 478
Commerzbank AG v IMB Morgan plc [2004] EWHC 2771

5.2.5 Loss of the right to trace

Roscoe v. Winder [1915] 1 Ch. 62 - cannot claim more than lowest intermediate balance.
Bishopsgate Investment Management v. Homan [1995] Ch 211
Ultraframe (UK) Ltd v Fielding [2005] EWHC 1638 (Ch), [2005] All ER (D) 397

5.3 Equitable remedies

- Charge
- Lien
- Constructive trust
- Subrogation

5.4 Defences

5.4.1 Change of Position
Reading: ***Hudson*, para 19.7.1**

a) The test for change of position

Lipkin Gorman v. Karpnale, supra; per Lord Goff:- *'Where an innocent defendant's position is so changed that he will suffer an injustice if called upon to repay or to repay in full, the injustice of requiring him so to repay outweighs the injustice of denying the plaintiff restitution.*'

b) Bad faith as a barrier to change of position

**Niru Battery Manufacturing Co and anor v Milestone Trading Ltd and ors* [2003] EWCA Civ 1446

c) Activity which will constitute a change of position

**Philip Collins Ltd v Davis* [2000] 3 All ER 808
**Scottish Equitable plc v. Derby* [2001] 3 All ER 818

d) When must the change of position have taken place?

**Dextra Bank and Trust Co v Bank of Jamaica* [2002] 1 All ER (Comm) 193

e) Is change of position now equitable as opposed to restitutionary?

Niru Battery Manufacturing Co and anor v Milestone Trading Ltd and ors [2003] EWCA Civ 1446

5.4.2 Is change of position now to be understood in terms of estoppel by representation?

**National Westminster Bank plc v Somer International* [2002] QB 1286, CA.
Niru Battery Manufacturing Co v Milestone Trading Ltd and ors [2003] EWCA Civ 1446

5.4.3 Bona fide purchaser for value without notice of the defendant's rights

**Westdeutsche Landesbank v Islington* [1996] AC 669

Chapter 10: The banker-customer relationship

The material in this chapter constitutes the reading for Seminar 10.

General reading:
Hudson, Chapters 30 & 31.

1. The relationship between banker and customer

Hudson, Ch.30

1.1 Ordinarily a purely contractual relationship

Hudson, 30.01-30.04

**Foley v Hill* (1848) 2 HL Cas 28, 9 ER 1002, 1005, *per* Lord Cottenham:

> "[M]oney placed in the custody of a banker is, to all intents and purposes, the money of the banker, to do with it as he pleases; he is guilty of no breach of trust in employing it; he is not answerable to the principal if he puts it into jeopardy, if he engages in a hazardous speculation; he is not bound to keep it or deal with it as the property of his principal; but he is, of course, answerable for the amount, because he has contracted, having received that money, to repay to the principal, when demanded, a sum equivalent to that paid into his hands."

Hirschhorn v Evans (Barclays Bank garnishees) [1938] 2 KB 801, 815, *per* Mackinnon LJ
Box v Barclays Bank plc [1998] Lloyd's Rep Bank 185
Turner v Royal Bank of Scotland [2001] EWCA Civ 64

1.2 Implied terms of the banking contract

Hudson, 30.05-30.10

**N Joachimson v Swiss Bank Corporation* [1921] 3 KB 110, 127, *per* Atkin LJ:

> 'I think that there is only one contract made between the bank and its customer. The terms of that contract involve obligations on both sides and require careful statement. They appear upon consideration to include the following provisions. The bank undertakes to receive money and to collect bills for its customer's account. The proceeds so received are not to be held in trust for the customer, but the bank borrows the proceeds and undertakes to repay them. The promise to repay is to repay at the branch of the bank where the account is kept, and during banking hours. It includes a promise to repay any part of the amount due against the written order of the customer addressed to the bank at the branch, and as such written orders may be outstanding in the ordinary course of business for two or three days, it is a term of the contract that the bank will not cease to do business with the customer except upon reasonable notice. The customer on his part undertakes to exercise reasonable care in executing his written orders so as not to mislead the bank or to facilitate forgery. I think it is necessarily a term of such contract that the bank is not liable to pay the customer the full amount of his balance until he demands payment from the bank at the branch at which the current account is kept. Whether he must demand it in writing it is not necessary now to determine. The result I have mentioned seems to follow from the ordinary relations of banker and customer, but if it were necessary to fall back upon the course of business and the custom of bankers, I think that

> it was clearly established by undisputed evidence in this case that bankers never do make a payment to a customer in respect of a current account except upon demand.'

Libyan Arab Foreign Bank v Bankers Trust Co [1989] QB 728, 746 (proper law = jurisdiction in which account is held)

1.3 The banker's duty of confidentiality

Hudson, 30.11-30.19

1.3.1 What is the duty?

Tournier v National Provincial and Union Bank of England [1924] 1 KB 461, 472-473, *per* Bankes LJ.:

> "In my opinion it is necessary in a case like the present to direct the jury what are the limits, and what are the qualifications of the contractual duty of secrecy implied in the relation of banker and customer. There appears to be no authority on the point. On principle I think that the qualifications can be classified under four heads: (a) where disclosure is under compulsion by law; (b) where there is a duty to the public to disclose; (c) where the interests of the bank require disclosure; (d) where the disclosure is made by the express or implied consent of the customer."

Turner v Royal Bank of Scotland [1999] Lloyd's Rep Bank 231, CA.

1.3.2 When does the duty begin?

Importers Co Ltd v Westminster Bank Ltd [1927] 2 KB 297, Privy Council:

> '… the word "customer" signifies a relationship in which duration is not of the essence. A person whose money has been accepted by a bank on the footing that they undertake to honour cheques up to the amount standing to his credit is, in the view of their Lordships, a customer of the bank … irrespective of whether his connection is of short or long standing.'

1.3.3 The extent of the duty

Great Western Railway Co v London and County Banking Co Ltd [1901] AC 414, 420.
Woods v Martins Bank Ltd [1959] 1 QB 55
Sutherland v Barclays Bank Ltd (1938) 5 LDAB 163

1.4 The Banking Codes

Hudson, 30.20-30.21

- The Banking Codes
- The FSA Banking Conduct of Business Sourcebook – (to be implemented 1 November 2009, material to follow).

2. Bank mandates and payments

Hudson 30.22-30.40

2.1 Meaning of a "mandate"

A statement of the powers which a bank possesses when acting on behalf of each of its customers in operating their accounts and making payments under the instructions

2.2 Loss suffered further to fraudulent cheques

**London Joint Stock Bank Ltd v Macmillan* [1918] AC 777, 789:

> "if [the customer] draws the cheque in a manner which facilitates fraud, he is guilty of a breach of duty as between himself and the banker, and he will be responsible to the banker for any loss sustained by the banker as a natural and direct consequence of this breach of duty"

London Intercontinental Trust Ltd v Barclays Bank Ltd [1980] Lloyd's Rep 241
Symons v Barclays Bank [2003] EWHC 1249 (Comm)

2.3 Payments discharging another person's debts

Grosvenor Casinos Ltd v National Bank of Abu Dhabi [2008] EWHC 511 (Comm), *per* Flaux J

2.4 Compensation for wrongful repudiation of a cheque

Wilson v United Counties Bank Ltd [1920] AC 102, 112, *per* Lord Birkenhead:

> "… the refusal to meet the cheque, under such circumstances, is so obviously injurious to the credit of a trader that the latter can recover, without allegation of special damage, reasonable compensation for the injury done to his credit."

2.5 Fraud and forged payment instructions

**London Joint Stock Bank Ltd v Macmillan* [1918] AC 777, 789, *per* Lord Finlay:

> "The relation between banker and customer is that of debtor and creditor, with a superadded obligation on the part of the banker to honour the customer's cheques if the account is in credit. A cheque drawn by a customer is in point of law a mandate to the banker to pay the amount according to the tenor of the cheque. It is beyond dispute that the customer is bound to exercise reasonable care in drawing the cheque to prevent the banker being misled. If he draws the cheque in a manner which facilitates fraud, he is guilty of a breach of duty as between himself and the banker, and he will be responsible to the banker for any loss sustained by the banker as a natural and direct consequence of this breach of duty."
>
> "It has been often said that no one is bound to anticipate the commission of a crime, and that to take advantage of blank spaces left in a cheque for the purpose of increasing the amount is forgery, which the customer is not bound to guard against. It has been suggested that the prevention of forgery must be left to the criminal law. I am unable to accept any such proposition without very great qualification. Every-day experience shows that advantage is taken of negligence for the purpose of perpetrating

frauds. … As the customer and the banker are under a contractual relation in this matter, it appears obvious that in drawing a cheque the customer is bound to take usual and reasonable precautions to prevent forgery. Crime, is indeed, a very serious matter, but every one knows that crime is not uncommon. If the cheque is drawn in such a way as to facilitate or almost to invite an increase in the amount by forgery if the cheque should get into the hands of a dishonest person, forgery is not a remote but a very natural consequence of negligence of this description."

Societe Generale v Metropolitan Bank Ltd (1873) 27 LT 849
Greenwood v Martins Bank Ltd [1933] AC 51
Tai Hing Cotton Mill v Liu Chong Hing Bank Ltd [1986] AC 80, [1985] 2 All ER 947, PC
Yorkshire Bank v Lloyds Bank [1999] Lloyd's Rep Bank 191

2.6 Bank's duties in relation to misappropriation from client's account

2.6.1 The traditional approach

Gray v Johnston (1868) LR 3 HL 1
Selangor United Rubber Estates Ltd v Cradock (No 3) [1968] 2 All ER 1073, [1968] 1 WLR 1555
Karak Rubber Co Ltd v Burdon (No 2) [1972] 1 All ER 1210, [1972] 1 WLR 602

2.6.2 Modern cases

Barclays Bank v Quinecare Ltd [1992] 4 All ER 363
Lipkin Gorman v Karpnale Ltd [1992] 4 All ER 409, CA, May LJ:

"For my part I would hesitate to try to lay down any detailed rules in this context. In the simple case of a current account in credit the basic obligation on the banker is to pay his customer's cheques in accordance with his mandate. Having in mind the vast numbers of cheques which are presented for payment every day in this country, whether over a bank counter or through the clearing [system], it is in my opinion only when the circumstances are such that any reasonable cashier would hesitate to pay a cheque at once and refer it to his or her superior, and when any reasonable superior would hesitate to authorise payment without enquiry, that a cheque should be paid immediately upon presentation and such enquiry made."

Parker LJ: whether or not "a reasonable and honest banker knew of the relevant facts".

2.7 Mistake

Barclays Bank v WJ Simms Son [1980] QB 677, 695, *per* Goff J:

"(1) If a person pays money to another under a mistake of fact which causes him to make payment, he is prima facie entitled to recover it as money paid under a mistake of fact. (2) His claim may however fail if (a) the payer intends that the payee shall have the money at all events, whether the fact be true or false, or is deemed in law so to intend; or (b) the payment is made for good consideration, in particular if the money is paid to discharge, and does discharge, a debt owed to the payee (or a principal on whose behalf he is authorised to receive the payment) by the payer or by a third party by whom

he is authorised to discharge the debt; or (c) the payee has changed his position in good faith, or is deemed in law to have done so."

Westdeutsche Landesbank v Islington [1996] AC 669

3. Payment methods

Hudson, 31.01-31.22

1. Bills of exchange

s.3, Bills of Exchange Act 1882:

> '(1) A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer.'

2. Cheques

s.73 of the Bills of Exchange Act 1882:

> 'A cheque is a bill of exchange drawn on a banker payable on demand.
> Except as otherwise provided in this Part, the provisions of this Act applicable to a bill of exchange payable on demand apply to a cheque.'

3. Collection

Honourable Society of the Middle Temple v Lloyds Bank plc [1999] 1 All ER (Comm) 193
Linklaters v HSBC Bank plc [2003] 2 Lloyds Rep 545

4. Bank's duty to honour and liability for dishonouring cheques

4.1 The "reasonable banker" test

Marfani & Co Ltd v Midland Bank Ltd [1968] 1 WLR 956, 972, per Diplock LJ:

> What the court must do is "to look at all the circumstances at the time of the acts complained of and to ask itself: were those circumstances such as would cause a reasonable banker possessed of such information about his customer as a reasonable banker would possess, to suspect that his customer was not the true owner of the cheque?"

Architects of Wine Ltd v Barclays Bank plc [2007] EWCA Civ 239, [2007] Bus LR Digest D37, para [12]:

> "the courts should be wary of hindsight or of imposing on a bank the role of an amateur detective".

4.2 Liability for dishonouring cheques

**Marzetti v Williams* (1830) 1 B & Ad 415
Evans v London and Provincial Bank The Times, 1 March 1917
Westminster Bank Ltd v Hilton (1926) 43 TLR 124
Royal Products Ltd v Midland Bank Ltd [1981] 2 Lloyd's Rep 194

Chapter 11: Banking regulation

The material in this chapter constitutes the reading for Seminar 11.

Hudson, Ch.29

1. International Regulatory Initiatives

Hudson, 29.02-29.16

- The Basel II Accord ("Basel II")
- the Committee on Banking Supervision
- Bank for International Settlements ("BIS"), Switzerland

'The fundamental objective of the Committee's work to revise the 1988 Accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.'

The 3 pillars

The first pillar: regulatory capital

Type of security	Risk weighting	Capital requirement in £
OECD Country bond rated AAA	0%	0
Company bond rated B+	50%	40,000

- Setting capital aside to cover losses
- Risk weighting by market
- Shortcomings of mathematical models

The second pillar: supervisory review process

- Value at Risk (VaR)
- "evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate"

The third pillar: market discipline and disclosure of information

- "a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment procedures, and hence the capital adequacy of the institution"
- a measure of "materiality"

- "a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process"

2. EU Banking Regulation

Hudson, 29.17-29.21

- Second Consolidated Banking Directive 2006 (2006/48/EC)
- Capital Adequacy Directive 2006 (2006/49/EC)
- Deposit Guarantee Directive (94/19/EEC)
- Electronic Money Directive 2000 (2000/46/EC)

3. UK Banking Regulation

Hudson, 29.23-29.39

3.1 History of bank regulation in England & Wales

- Bank of England Act 1694
- "South Sea Bubble" 1720
- Nationalisation of the Bank of England 1945
- October 1997 a Memorandum of Understanding ("MOU")
    - the FSA,
    - the Treasury and
    - the Bank of England
- Bank of England Act 1998
- Bank of England functions:
    - monetary
    - fiscal
    - integrity of the financial system
- Johnson Matthey
- BCCI
- Barings Bank
- *Three Rivers DC v Bank of England* [2001] UKHL 16, [2003] 2 AC 1

3.2 FSA regulation

- GENPRU – general prudential regulatory principles (see topic 1).
- BIPRU – prudential regulation of banking
- Capital Requirements Regulations 2006, reg.11, FSA is required:
  "to take such steps, in going concern and emergency situations, as it considers appropriate –
  (a) to co-ordinate the gathering and dissemination of relevant or essential information; and
  (b) in co-operation with the relevant competent authorities [across the European Economic Area], to plan and co-ordinate supervisory activities".

3.3 Terrorism

s.4 of the Anti-Terrorism, Crime and Security Act 2001:

- making funds available to any identified person
- can be subject to a freezing order
- so as to prevent:

> '(a) action to the detriment of the United Kingdom's economy (or part of it) has been or is likely to be taken by a person or persons, or
> (b) action constituting a threat to the life or property of one or more nationals of the United Kingdom or residents of the United Kingdom has been or is likely to be taken by a person or persons.'

3.4 Money laundering

See Topic 4.

4. Bank Failure in the UK

Hudson, 29.40-29.79

4.1 Background

Hudson, ch.32

Legislation introduced to cope with the financial crisis of 2007-09 and to have powers available in the future. The Northern Rock collapse was the catalyst.

4.2 The Banking (Special Provisions) Act 2008

Hudson, 29.40-29.44

4.2.1 The genesis of the Act in the Northern Rock crisis

- Any "UK deposit taker"
- Two principal powers under the Act:
  - to order the transfer of ownership of a bank or
  - to order the transfer of a bank's property.

4.2.2 The purposes for which the powers may be exercised

- Two purposes for which the powers in the B(SP)A 2008 may be exercised:
  - '(a) maintaining the stability of the UK financial system in circumstances where the Treasury consider that there would be a serious threat to its stability if the order were not made;
  - protecting the public interest in circumstances where financial assistance has been provided by the Treasury to the deposit-taker for the purpose of maintaining the stability of the UK financial system.'

5. The Banking Act 2009

Hudson, 29.45-29.78

This Act was passed after the book was written, so an updated file will be placed on www.alastairhudson.com before the lectures.

HM Treasury, *Financial Stability and Depositor Protection* (CM 7459, July 2008)

5.1 The seven Parts of the Act

- "Special Resolution Regime": the takeover of banks which are in difficulties.
- "Bank Insolvency": the appointment and role of a liquidator in relation to a bank which is unable to meet its debts.
- "Bank Administration": the administration of any part of a bank ("the residual bank") which remains unsold under the special resolution regime, and the attempt therefore to maintain the viability of that residual bank.
- Financial Services Compensation Scheme
- Inter-bank Payments
- Banknotes
- Misc., including Bank of England and FSA functions.

5.2 The Special Resolution Regime

5.2.1 The purpose of the SRR: s.1(1) BA 2009

The underlying purpose of the SRR is to identify a procedure by which failing banks can be taken over either by banks in the private sector or by the State or by a "bridge bank" owned by the State.

- Financial crisis
- (Northern Rock in particular)
- Nationalisation
- A liquidity crisis which became a solvency crisis

5.2.2 The five objectives behind the Act: s.4, BA 2009

- First objective is "to protect and enhance the stability of the financial systems of the United Kingdom"
- Second objective is "to protect and enhance public confidence in the stability of the banking systems of the United Kingdom".
- Third objective is to protect depositors.
- Fourth objective is to protect public funds.
- Fifth objective is to "avoid interfering with property rights in contravention of a Convention right" further to the Human Rights Act 1998.
    - Is there "theft" of shares by the State in nationalisation?

- Or would the shareholders otherwise have lost everything in the insolvency? (cf Lehman Bros)
- Investors must accept the risk of loss when buying shares
- (Otherwise, there is moral hazard)

The Code of Practice

s.5, BA 2009: Treasury to create a code of practice, to cover:

- The stabilisation powers
- The bank insolvency procedure
- The bank administration procedure

5.2.3 The conditions precedent to the FSA being permitted to use its powers under the SRR: s.7, BA 2009

- First condition: "the bank is failing, or is likely to fail, to satisfy the threshold conditions [set out in s.41 of the FSMA 2000]".
- Second condition: "having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions".
- The FSA must consult the Bank of England and the Treasury before reaching a decision on the second condition.

s.7, BA 2009:

> "(2) Condition 1 is that the bank is failing, or is likely to fail, to satisfy the threshold conditions (within the meaning of section 41(1) of the Financial Services and Markets Act 2000 (permission to carry on regulated activities)).
> (3) Condition 2 is that having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions."

5.2.4 The three stabilisation options

- find a private sector purchaser of the failing bank,
- use a "bridge bank",
- take the failing bank into "public ownership".

5.2.4(1) Private sector purchaser

Specific conditions for a private sector purchaser taking over a bank, s.8 BA 2009:

> s.8(2) "Condition A is that the exercise of the power is necessary, having regard to the public interest in--
>
> (a) the stability of the financial systems of the United Kingdom,
>
> (b) the maintenance of public confidence in the stability of the banking systems of the United Kingdom, or
> (c) the protection of depositors."

- The power is held by the Bank of England
- Must consult FSA and the Treasury

s.8(5): "Condition B is that--

(a) the Treasury have recommended the Bank of England to exercise the stabilisation power on the grounds that it is necessary to protect the public interest, and
(b) in the Bank's opinion, exercise of the stabilisation power is an appropriate way to provide that protection.

s.11, BA 2009: "the first stabilisation option"

- To effect a private sector purchase, "all or part of the business" of the failing bank may be sold to "a commercial purchaser"
- No requirement that that person must be a "bank" within the terms defined in the Act.

5.2.4(2) Bridge bank, s.12 BA 2009

- The second stabilisation option is a sale to a bridge bank
- Transfer to a company which is wholly owned by the Bank of England

5.2.4(3) Temporary public ownership, s.13 BA 2009

- The third stabilisation option is temporary public ownership
- What is "temporary"?

5.2.6 Compensation, s.49 BA 2009, etc..

- Compensation for those who lose shares
- Valuation by expert panel

5.3 Bank insolvency

5.3.1 Background

- Difficult to know when a bank is insolvent, especially when banking regulation in the USA permitted Lehman Bros to operate with liabilities: capital at 44:1
- S.90, BA 2009 deals with "Bank Insolvency"

5.3.2 Insolvency process, s.94-95, BA 2009

- FSA, Treasury or Bank of England applies to the court
- Court makes an order
- A liquidator is appointed

- Liquidation committee (s.100) appointed by the tri-partite bodies)
- The liquidation committee must recommend one of three actions:
    - To work with the FSCS to protect depositors; or
    - To wind up the affairs of the bank so "as to achieve the best result for the bank's creditors as a whole"
    - Or to do one for one part of the bank, and another for the others.

5.3.3 Grounds for making insolvency order, s.96 BA 2009

- Ground A: bank is "unable, or likely to become unable, to pay its debts"
- Ground B: "winding up in the public interest"
- Ground C: "the winding up of a bank would be fair"

5.4 Bank administration

- S.136 et seq BA 2009
- Bank administration relates to the administration of the "residual bank" if there has been a sale of the bank to a private sector purchaser or to a bridge bank
- Known colloquially as the running of the "bad bank" (often)
- Administration of a "bad bank" seeks to sell off the assets which no purchaser wants to take on
- Two objectives (s.137):
    - 1. support for commercial purchaser
    - 2. "normal" administration –
        - Rescue the bank as a "going concern"
        - Achieve a better result for the residual bank's creditors than winding up

5.5 Financial Services Compensation Scheme ("FSCS")

Discussed in Topic 2.

5.6 Inter-bank payments

- The underlying purpose is to prevent the seizure experienced by the inter-bank lending system in 2008 whereby:
    - banks were not lending money to one another and
    - inter-bank payment systems interfered with the ordinary operation of the banking system.
- Bank of England is able "to oversee certain systems for payments between financial institutions", including but not limited to the activities of banks, including clearing and other systems for processing payments.

6. The Future for Bank Regulation

Hudson, Ch.32
See generally: www.alastairhudson.com

The reading for this topic will be made available closer to the time because it is expected that governmental and regulatory proposals will continue to emerge during the life of this course. In the meantime, the following are important reports and commentaries to which you should refer.

6.1 Official reports

- HM Treasury (UK), *Reforming Financial Markets*, July 2009, CM 7667
- EU Commission, "Financial Services Action Plan – White Paper"
- Paul Myners, "Institutional Investment in the UK – A Review"
- Walker, "A review of corporate governance in UK banks and other financial industry entities", 16 July 2009

6.2 General Commentary

This reading is intended to give you ideas of the sorts of things you could read. Find material that interests you.

6.2.1 Financial markets commentary and theory

- Gillian Tett, *Fool's Gold*, (Little Brown, 2009)
- Nicholas Taleb, *The Black Swan* (Penguin, 2008)
- El Erian, *When markets collide* (McGraw Hill, 2008)
- Michael Lewis, *Panic* (Penguin, 2008)
- Philip Augar, *The Death of Gentlemanly Capitalism* (Penguin, 2008)
- Robert Skidelsky, *Keynes: Return of the Master* (Allen Lane, 2009), esp Ch.1
- Andrew Gamble, *The Spectre at the Feast* (Palgrave Macmillan, 2009)

6.2.2 History

- JK Galbraith, *The Great Crash 1929* (1955; Penguin, 2002)
- Niall Ferguson, *The Ascent of Money* (Penguin, 2009; Allen Lane 2008)

6.2.3 Current affairs and politics

- Irwin and Cho, "In Geithner's Overhaul, Aggressive Use of All Available Tools Expected", *Washington Post* 8 Feb 2009
- Gordon Brown, "We will put people first, not bankers", *The Observer* 22 Feb 2009
- Niall Ferguson, "Empire Falls", *Vanity Fair* October 2006
- Elliott and Atkinson, *The Gods that Failed* (Bodley Head, 2008)
- Niall Ferguson, "Wall St Lays Another Egg", *Vanity Fair* December 2008
- Joseph Stiglitz, "Capitalist Fools", *Vanity Fair* January 2009

6.2.4 Economic theory

- George Cooper, *The Origin of Financial Crises* (Harriman House Publishing, 2008)
- Archarya and Richardson, *Restoring Financial Stability* (Wiley, 2009)

6.2.5 Historical economic theory

- Adam Smith, *The Wealth of Nations*
- Karl Marx, *Capital*
- Milton Friedman, *Capitalism and Freedom* (1962)

6.2.6 Finance law

- Alastair Hudson, *The Law of Finance*, Ch.32

6.2.7 Some classic good reads about financial markets (and other things)

- Michael Lewis, *Liar's Poker* ()
- Charles Dickens, *Little Dorrit* (the bits about Mr Murdle)
- Anthony Trollope, *The Way We Live Now*

A variety of perspectives on financial crises will be made available via Alastair Hudson's website.

Chapter 12: Financial Derivatives

The material is not the subject of a seminar in itself. Other arrangements may be made to allow you to discuss this material. Derivatives are being covered for completeness of your education, so that you can understand the background to the financial crisis of 2007-09 better (because derivatives were part of the problem), and to provide you with another topic on which you may choose to write.

Hudson, Chapters 43-47
Hudson, *The Law on Financial Derivatives*
(4e, Sweet & Maxwell, 2006; 5e, 2010)

1.1 What is a derivative and what is its purpose?

What is a "derivative"?

> 'A derivative product is a financial product that derives its value from another, underlying financial product.'

Commercial uses of derivatives

There are two fundamental reasons why derivatives are used:
- Earning income
- Managing risk

To achieve these core goals there are four basic forms of activity:-
1. Speculation
2. Hedging
3. Asset liability management
4. Arbitrage

1.2 Law as risk management

The following are the main risks involved:-

Systemic risk	Management risk	Equity risk
Market risk	Concentration risk	Call risk
Counterparty risk	*Limit risk*	Yield curve risk
Payment risk	Rollover risk	Raw data risk
Documentation risk	*Hedging risk*	*Regulatory risk*
Operations risk	*Credit risk*	*Tax risk*
Technology risk	Interest rate risk	Capital risk
Audit risk	*Pre-payment risk*	Liquidity risk
Personnel risk	Re-investment risk	*Insolvency risk*
Performance risk	Volatility risk	*Collateral risk*
Measurement risk	*Netting risk*	Modelling risk
Accounting risk	*Currency risk*	*Cross-market risk*
Political risk	Commodity risk	*Cross-default risk*

1.3 The structure of derivatives: from options and forwards to interest rate swaps

There are three basic forms of product:

- the swap,
- the forward and
- the option.

All other derivatives are built on these building blocks.

Forms of settlement

- Cash settlement
- Physical settlement
- Settlement 'either way'

Options

- Put option
- Call option

- Cash settled
- Physically settled

- American
- European
- Asian

A physically-settled, equity-based option gives the buyer the ability to have delivered to it the underlying stock which is the subject of the contract. This can be an option to buy or sell shares. Alternatively, it could be a contract to receive / pay the return on the appropriate stock exchange or index.

The two main types of option are the *put option* and the *call option*. A put option is an instrument granting the purchaser the right, but not the obligation, to sell the underlying instrument to the counterparty at a given price on a given date. Whereas a call option gives the buyer the right, but not the obligation, to acquire the underlying product at a given price on a given date.

The buyer's aim is to make premium (one-off) income. The seller's risk is that of having to deliver under the option. The buyer's bet is that the value it is entitled to buy or sell the underlying stock at, will be better than the price on the open market at the time when the option can be exercised.

Such an option may specify physical delivery of the share or it may instead specify that the cash equivalent be paid by one party to the other.

Forwards

The forward is a promise to supply a particular commodity or security at a set price on a set date (often in a set place) in the future. In the commodity markets it is usual to buy wheat, for example, at a given price in a given amount at a pre-determined time to be delivered in a given place. In the time it takes for the contract to mature (which might include the wheat to grow be harvested and shipped) the price of wheat can fluctuate wildly.

The contract, that is the right to receive the wheat at a price at a time in the agreed place, can be sold to others at a greater or lower price than that paid for it originally. The same is true, to a greater or lesser extent, of contracts entered into between private parties.

Interest Rate Swaps

Definition

An interest rate swap was described by Woolf LJ in *Hazell v Hammersmith & Fulham LBC* [1990] 2 Q.B. 697, 739; [1990] 3 All E.R. 33, 63 in the following terms:

> "[An interest rate swap is] an agreement between two parties by which each agrees to pay the other on a specified date or dates an amount calculated by reference to the interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case. For example, one rate may be fixed at 10% and the other rate may be equivalent to the six-month London Inter-Bank Offered Rate (LIBOR). If the LIBOR rate over the period of the swap is higher than the 10% then the party agreeing to receive "interest" in accordance with LIBOR will receive more than the party entitled to receive the 10%. Normally neither party will in fact pay the sums which it has agreed to pay over the period of the swap but instead will make a settlement on a "net payment basis" under which the party owing the greater amount on any day simply pays the difference between the two amounts due to the other."

This definition was cited with approval by Lord Templeman in the House of Lords in *Hazell v. Hammersmith & Fulham L.B.C.* [1991] 1 All E.R. 545, 550.

Example

> The amount of cash to be paid as this interest rate is calculated by reference to a notional amount of money. For example, where A Ltd has a loan from Y Bank of GB£10mm at floating rate of LIBOR+100 basis points, it may seek to pay a fixed rate of interest at 9%. The reason for this may be to fix its future cash outflows for strategic planning purposes but it is most probably based upon an expectation that LIBOR will rise, such that LIBOR +100bp will be more than 9%.

Therefore, X Bank will pay A Ltd's obligation of LIBOR +100bp to Y bank. In consideration for X Bank discharging A Ltd's obligation to Y Bank, A Ltd pays a fixed rate of 9% to X Bank.

A Ltd's gain is the fixing of its interest payments and a profit where LIBOR +100bp exceeds 9%. X Bank makes a profit on any fee it charges for the transaction (which is usually built into the fixed rate of interest which it receives) and also makes a profit where LIBOR +100bp on GB£10mm is less than an interest rate of 9% on GB£10mm.

Equity swaps

Definition

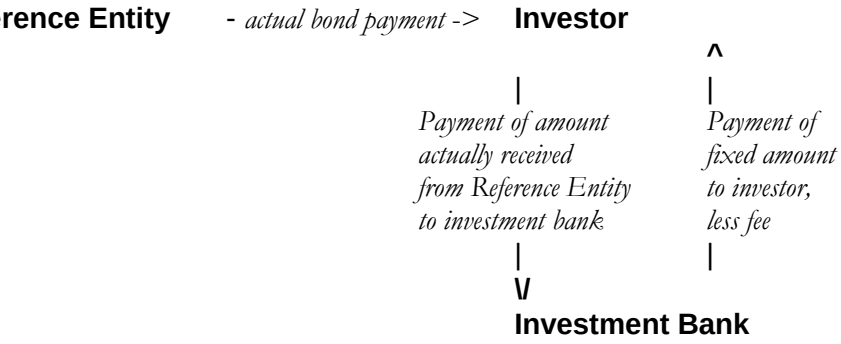
The equity swap uses the idea of the swap to enable two parties to benefit from the difference rates of appreciation between two indicators. Typically these products can cover the full range of equity products. It is possible to match the movement in the price of a particular equity, of a given equity index or of a non-equity market indicator.

Example

The structure is usually for the payment of a fixed amount of money by one party the other in return for a floating amount. For example, X might wish to speculate on the performance of the Nikkei 225 index against LIBOR. Therefore X would seek to pay LIBOR to Y and in return receive from Y the cash equivalent of the performance of the Nikkei 225 over a given period of time. The benefit to X is a receipt of cash flow equal to the performance of the Nikkei 225 without the expense or administrative difficulties of purchasing a range of stocks appearing on the Nikkei 225. Alternatively, X could pay a fixed amount of interest on a notional amount of money in return for a payment from Y equal to the return on the Nikkei 225 from Y.

Credit Derivatives

- Credit default swaps
- Credit options



- A form of synthetic insurance against a "reference entity" failing to make payment on the "underlying obligation"
- Trigger for the payment
  - Credit event affecting reference entity
  - Credit downgrade clause
  - Publicly available information, or some other prescribed information
- Cf. the Lehman crash, where CDS used to speculate on reference entities crashing and not simply to insure against a crash.

The ISDA credit events

- Bankruptcy
- Failure to pay
- Obligation acceleration
- Obligation default
- Repudiation of reference obligation, or moratorium
- Restructuring

2.1 The documentation architecture: ISDA and beyond

"ISDA" = International Swaps and Derivatives Association

There are four aspects of the documentation which are of interest here:

1. Confirmation
2. Master Agreement (usually in a standard form)
3. Schedule to the Master Agreement
4. Credit Support documentation

2.2 Role of the calculation agent

The calculation agent's role is particularly significant being the person who identifies the amounts to be paid by each party.

2.3 Master Agreements

The structure of a standard master agreement:

1. Interpretation

- Confirmation contradicting the terms of the Master Agreement.
- Confirmation: time to negotiate
- Single agreement philosophy

2. Payments

- Obligation to make payments
- Business day conventions
- Mechanism for payments

3. Netting

- Netting across payments in solvent transactions
    - Set off to identify a single payment across numerous transactions
    - Can systems cope with set off:
        - Between the same type of transaction
        - Transactions in particular jurisdictions
        - Transactions settled in the same currency
        - Transactions held on the same computer settlement system
- Insolvency netting
    - Close-out netting
    - Rule 4.90 Insolvency Rules
    - Mutual debts and obligations
    - No set off with non-parties to the transaction

4. Witholding Tax

5. Authority

- The power of an individual employee / agent to bind a company to a transaction

6. Capacity

- The capacity of a company is the power of that company to act

7. Tax Representations

- Representation as to the manner in which the transaction will be accounted for tax purposes.

8. Representations

- Condition or mere warranty?
- The representation will usually be to the effect that:

> 'the individual(s) executing and delivering the Master Agreement (and any other documentation (including any Credit Support Document) relating to the Master Agreement) are duly empowered and authorised to do so, and it has duly executed and delivered this Agreement and any Credit Support Document to which it is a party.'

9. Events of Default

- Failure to Pay

- "Events of default" trigger the termination procedure, subject to:
    - Contractual notice requirements
    - Termination triggered by notice or by automatic termination (depending on the contract)
    - Notice allows the parties to control when the contract should be terminated.
    - Automatic termination ensures that the transaction is void even though the parties may not have known it at the time
        - Useful if little is known about the counterparty
        - Not useful if the transaction was in-the-money
- Breach of Contract
- Failure of guarantee
- Misrepresentation
- Cross Default
- Credit Worth
- Corporate Restructuring
- Bankruptcy

10. Non-Fault Termination Events

- "Non-fault" events oblige the parties to seek to restructure the transaction so as to keep it in effect
- Illegality
- Tax Event
- Tax Event Upon Merger
- Credit Event Upon Merger

11. Early Termination

- One-way and two-way payments
- Calculation of a final termination amount
- Termination currency

12. Termination procedures

12.1 "Market quotation"

ISDA Master Agreement, s.14:

"Market Quotation" means, with respect to each Terminated Transaction or group of Terminated Transactions, as the case may be, and a Determining Party, an amount determined by the Determining Party or its agent on the basis of quotations from Reference Market-makers. Each quotation will be for an amount, if any, that would be paid to the Determining Party (expressed as a negative number) or by the Determining Party (expressed as a positive number) in consideration of an agreement between the Determining Party (taking into account **[**the current creditworthiness and relevant documentation and credit policies of the Determining Party,**]** any existing Credit Support Document with respect to the obligations of such party**[**, the size of the Terminated Transaction or Terminated Transactions, market liquidity and other factors relevant under then prevailing circumstances**]**) and the quoting Reference Market-maker to enter into a transaction (the "Replacement Transaction") that would have the effect of preserving for such party the economic equivalent of the payments, deliveries or option rights (whether the underlying obligation or option right was absolute or contingent and assuming the satisfaction of each applicable condition precedent) in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required under Section 2(a)(i) or exercisable after that date. For this purpose, Unpaid Amounts in respect of the Terminated Transaction or group of Terminated Transactions **[**and legal fees and out-of-pocket expenses referred to in Section 11**]** are to be excluded but, without limitation, any payment or delivery that would, but for the relevant Early Termination Date, have been required (assuming satisfaction of each applicable condition precedent) after that Early Termination Date is to be included. The Replacement Transaction would be subject to such documentation as such party and the Reference Market-maker may, in good faith, agree.

[The Determining Party (or its agent) may seek quotations in respect of Replacement Transactions for all Terminated Transactions, any group of Terminated Transactions or individual Terminated Transaction, but, in aggregate, the Determining Party (or its agent) will seek quotations in respect of Replacement Transactions for not less than all Terminated Transactions.**]** The Determining Party (or its agent) will request each Reference Market-maker to provide its quotation to the extent reasonably practicable as of the same day and time (without regard to different time zones) on or as soon as reasonably practicable after the relevant Early Termination Date. The day and time as of which those quotations are to be obtained will be selected in good faith by the Determining Party, and, if each party is obliged to make a determination under Section 6(e), in good faith by the Determining Party after consultation with the other party.

If more than three quotations are provided, the Market Quotation will be the arithmetic mean of the quotations, without regard to the quotations having the highest and lowest values. If exactly three such quotations are provided, the Market Quotation will be the quotation remaining after disregarding the highest and lowest quotations. For this purpose, if more than one quotation has the same highest value or lowest value, then one of such quotations shall be disregarded. If fewer than three quotations are provided, it will be deemed that the Market Quotation in respect of such Terminated Transaction or group of Terminated Transactions cannot be determined.

Peregrine Fixed Income Ltd v. Robinson [2000] C.L.C. 1328, [2000] Lloyd's Rep. Bank. 304
(*Associated Provincial Picture Houses Ltd v. Wednesbury Corporation* [1948] 1 K.B. 223)
Enron Australia Finance Pty v Integral Energy Australia [2002] NSWC 819
Dampskibsselskabet "Norden" AS v Andre & Cie SA [2003] EWHC 84 (Comm); [2003] 1 Lloyd's Rep 287

12.2 "Loss"

Australia and New Zealand Banking Group v. Societe Generale, unreported, 21st September 1999, Aikens J
Australia and New Zealand Banking Group v. Societe Generale [2000] 1 All E.R. (Comm) 682 (CA)
Kleinwort Benson v. Birmingham C.C. [1996] 3 W.L.R. 1139, [1996] 4 All E.R. 733

12.3 "Replacement value"

ISDA Master Agreement, s.14:
"Replacement Value" means, with respect to each Terminated Transaction or group of Terminated Transactions, as the case may be, and a Determining Party, an amount that the Determining Party or its agent determines in good faith using commercially reasonable procedures to be the amount of the costs (expressed as a positive number) or gains (expressed as a negative number) of the Determining Party that would be incurred or realised to replace, or to provide the economic equivalent of the remaining payments, deliveries or option rights in respect of, that Terminated Transaction or group of Terminated Transactions. A Determining Party (or its agent) may determine Replacement Values for all Terminated Transactions, any group of Terminated Transactions or individual Terminated Transaction, and may apply different valuation methods to different Transactions or groups of Transactions, but, in aggregate, the Determining Party (or its agent) will determine Replacement Values for not less than all Terminated Transactions. Each Replacement Value shall be determined as of the relevant Early Termination Date, or, if that would not be commercially reasonable, as of the latest date or dates before or the earliest date or dates after the Early Termination Date as would be commercially reasonable under then prevailing circumstances.

A Determining Party (or its agent) may determine a Replacement Value by reference to information either available to it internally (including from any Affiliates) or supplied by one or more third parties including, without limitation, quotations (either firm or indicative) of relevant rates, prices, yields, yield curves, volatilities, spreads or other relevant market data in the relevant markets. If information is obtained from internal sources, it should be the same type of information as used by the Determining Party for the valuation of similar transactions for purposes of its own books and records. A Determining Party (or its agent)

may use such information to determine a Replacement Value either directly or through application to such information of pricing or other valuation models that are used by the Determining Party in pricing or valuing similar transactions at the time of the determination of Replacement Value. Third parties supplying such information may include, without limitation, dealers in the relevant markets, end-users of the relevant product, information vendors**[**, brokers**]** and other sources of market information that are used by the Determining Party in pricing or valuing similar transactions at the time of the determination of Replacement Value.

A Determining Party (or its agent) may take into account, or may require third parties supplying such information to take into account, the current creditworthiness and relevant documentation and credit policies of the Determining Party, the size of the Terminated Transaction or Terminated Transactions, market liquidity and other factors relevant under then prevailing circumstances.

A Determining Party's (or its agent's) determination of Replacement Value may reflect one or more of the following, but without duplication:

(a) any cost or gain (whether or not incurred or realised) of entering into one or more transactions that would have the effect of preserving for the Determining Party the economic equivalent of payments, deliveries or option rights in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required or exercisable after that date whether the underlying obligation or option right was absolute or contingent;

(b) any cost of funding; or

(c) any loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position (or any gain resulting from any of them), whether in one or a group of transactions.

Unpaid Amounts in respect of a Terminated Transaction or group of Terminated Transactions and legal fees and out-of-pocket expenses referred to in Section 11 are to be excluded in all determinations of Replacement Value but payments or deliveries that would, but for the relevant Early Termination Date, have been required (assuming satisfaction of each applicable condition precedent) after the Early Termination Date may be included."

2.4 Schedule

Insolvency netting

Rule 4.90, Insolvency Rules 1986:

'(1) This rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation. (2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other. (4) Only the balance (if any) of the account is provable in the liquidation, Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets.'

British Eagle International Airlines v. Air France (1975) 2 All ER 390 HL
Stein v. Blake [1996] 1 A.C. 243, *per* Lord Hoffmann
Re BCCI No.8; Morris v. Rayners Enterprises Incorporated [1998] AC 214, *per*
Lord Hoffmann:

'When the conditions of the rule [4.90] are satisfied, a set-off is treated as having taken place automatically on the bankruptcy date. The original claims are extinguished and only the net balance remains owing one way or the other: *Stein v. Blake*. The effect is to allow the debt which the insolvent company owes to the creditor to be used as security for its

debt to him. The creditor is exposed to insolvency risk only for the net balance.' …

'[The appellant] cannot manufacture a set-off by directing that the deposit be applied to discharge someone else's debt, even though it may, as between itself and the debtor, have a right to do so. This is the very type of arrangement which the House declared ineffective in *British Eagle*.'

The English local authority swaps cases

Hazell v. Hammersmith & Fulham [1991] 1 All E.R. 545, HL

'[b]y 31 March 1989 the council had entered into 592 swap transactions and 297 of these were still outstanding. The total notional principal sum involved in all the transactions entered into by the council amounted in the aggregate to £6,052m … These figures distort the position because some swap transactions were a hedge against others. But there is no doubt that the volume of swap business entered into by the council was immense. The council's actual borrowing on that date amounted to £390m, its estimated expenditure for the year ending 31 March 1989 was £85.7m and its quoted budget for that year was £44.6m.'

Morgan Grenfell v. Welwyn Hatfield DC and others [1995] 1 All E.R. 1, Hobhouse J.

Westdeutsche Landesbank Girozentrale v. London Borough of Islington [1994] 4 All E.R. 890, Hobhouse J., CA; [1996] A.C. 669, HL.

Kleinwort Benson v. Sandwell Borough Council [1994] 4 All E.R. 890, Hobhouse J. *Kleinwort Benson v. Birmingham City Council* [1996] 4 All E.R. 733, CA

Kleinwort Benson v. South Tyneside Metropolitan Borough Council [1994] 4 All E.R. 972, Hobhouse J.

Market disruption and extraordinary events

Bank Line Ltd v. Arthur Capel & Co. [1919] A.C. 435, 460 whether or not the contract is rendered "as a matter of business a totally different thing" … "for business purposes something else"

Multiservice Bookbinding v. Marden [1979] Ch. 84

Severance

Pickering v. Ilfracombe Railway (1868) L.R. 3 C.P. 235, 250

"… where you cannot sever the illegal from the legal part of a covenant, the contract is altogether void; but, where you can sever them, whether the illegality can be created by statute or by common law, you may reject the bad part and retain the good."

Spector v. Ageda [1973] Ch. 30 Megarry J.

The End

ASH