

Queen Mary University of London

LLB LAW OF FINANCE

SPECIMEN EXAM PAPER

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The likely contents of the examination paper may change during the course of the year as we see how seminars, in-course assessments and the lectures progress. Any changes in focus which may deviate from this Specimen Exam Paper will be notified to you in lectures.

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SPECIMEN EXAM PAPER 2009/10

OPEN BOOK

Answer ANY THREE QUESTIONS.

3 hours plus 15 minutes reading time.

1. “The regulatory objectives which govern the activities of the Financial Services Authority when regulating investment business demonstrate a political and economic understanding of financial services in the UK which is at odds with the needs of the financial system and the needs of society more generally.”

Discuss.

2. “The future of the law of finance is dependent on the general law synthesising properly with the principles of financial regulation.”

Discuss.

TURN OVER

3. EITHER

(A) Josephine had been a junior bond trader with Schneider Bank for six years. She was the daughter of Wilhelm Schneider, and part of the Schneider family which had founded Schneider Bank originally in 1910. Wilhelm Schneider died in January 2006. Josephine has an undergraduate degree in Business Studies from the University of Leiden and an MBA from the Insead business school, Paris. After her father's death, Josephine left Schneider Bank to take control of the Schneider family's own investments. The family's own investments included a fund of GB£20 million over which Josephine had complete control. Josephine had no practical, professional experience of investment outside bond markets.

In January 2009, Josephine decided to find a new advisor in relation to portfolio of GB£20 million. Josephine hired River Bank and told their head trader, Barney, that she was going to retain their investment advice because they had a reputation for taking bolder investment risks in a broader range of markets than more traditional investment firms. River Bank did not do any regulatory due diligence on Josephine because they knew she was a former bond trader and so did not think it necessary. River Bank classified Josephine as an "elective professional" client. They advised her to invest in the most complex products they sold. River Bank gave Josephine no risk warnings at all about the effect of those products.

There is evidence in the form of recorded telephone conversations between Barney and another River Bank trader that Barney instructed River Bank traders to act as follows:

"Really push the envelope hard on this one. The Schneiders want to get a 6% return, which is 1% higher than we can ordinarily manage in this market. Do not tell her about our commissions or about any trades that fall below 5% until she gives us all her business."

River Bank did not tell Josephine about trades which fell below a 5% return. Later they claimed that failure to inform her of this for six months was "due to clerical error" and that emails had simply got lost. No emails can be proved to have been sent. In February 2009, River Bank also earned £10,000 in undisclosed commissions on trades which they organised for Josephine in Suntopia which were sold by a subsidiary of River Bank: those investments have since lost Josephine's fund £40,000 in total.

Advise Josephine.

OR

(B) "Conduct of business regulation is at the heart of financial regulation. It will revolutionise the operation of financial markets. However, there are numerous legal issues raised by conduct of business regulation which will require resolution."

Discuss.

TURN OVER

4. Consider whether there are any criminal offences in the following:

Jerry was a director of Seinfeld plc, a successful company which supplied DVD's and popular music CD's to supermarkets. At a board meeting on 11 March 2009, Jerry heard two pieces of information.

First, Jerry heard about a report which had been prepared privately for Seinfeld plc by financial analysts using publicly available information relating to the financial performance of record companies. The report had analysed that information in such a way as to show for the first time that record companies were moving many of their new or less popular artists' catalogues into subsidiary companies: the analysts considered that this was because the record companies knew that sales were poorer than anticipated. Therefore, the analysts expected that this would hit the profits of Seinfeld plc. This particular analysis was not available anywhere else.

Secondly, Jerry heard that there had been fraud and embezzlement in Seinfeld plc's accountancy department such that half of that year's profits were thought to have been stolen. Annual profits were expected to be £24 million.

On 12 March 2009, Jerry had dinner with his brother George. George owned £20,000 worth of Seinfeld plc shares. George asked about the company's prospects. Jerry whispered: "Well neither of us have bought a new CD in months; and according to a very clever report I heard about today, it sounds like about 50% fewer people will be buying any of our CD's this year." George sold all of his Seinfeld plc shares for a small profit the next day.

Starting at 10.00am on 13 March 2009, the Chairman of Seinfeld plc, Kramer, was interviewed live over the internet via the web-site of a financial newspaper: this video feed was watched regularly by stockbrokers and financial analysts. Kramer admitted the embezzlement by the company's accountants but said that the losses were thought to be £24 million, and so to constitute a loss of the entire year's profits. The share price halved within thirty minutes. At 12.00pm Kramer bought 40,000 shares in Seinfeld plc. At 2.00pm Kramer insisted on having another interview on the web-site so that he could correct his mistake. Once the market realised the embezzlement only concerned £12 million, the share price rose again. Kramer sold his 40,000 new shares at the higher price and made a profit of £10,000.

TURN OVER

5. EITHER

(A) Waugh plc is the holding company in a group of companies which manufactures spare parts for luxury cars. Waugh plc has three key assets. First, its cash flow from long term contracts to sell parts to car manufacturers directly. Waugh plc has generated profits of, on average, £30 million per annum for the last ten years (1999 to 2008 inclusive). The company's principal market was selling parts to car manufacturers themselves to incorporate into their cars. These contracts guaranteed Waugh plc a minimum number of sales which would equate to profits of £20 million. However, all of its principal contracts expired in 2009. Half of the car manufacturers have refused to sign replacement contracts. Profits in 2009 are expected to be only £5 million: all of which constituted sales of spare parts directly to garages mending old cars.

The second asset is the value of the stock of parts which Waugh plc holds in its Oxford warehouse. In 2008, before the credit crunch caused a slump in car sales, its stock was worth £10 million. In 2009, because production of new cars stopped for three months, the stock held by Waugh plc fell to £5 million. The stock is owned by A Ltd, a wholly-owned subsidiary of Waugh plc.

Third, the freehold over two factories in the West Midlands. One factory remains closed because car sales fell so sharply during the recession in 2009. It is unclear whether or not Waugh plc will sell that factory. Before the recession, both factories were worth £12 million. Valuations cannot be obtained during the recession, although one valuer suggests that the factories could be sold for £8 million to be converted into luxury flats. The factories are both owned by B Ltd, a wholly-owned subsidiary of Waugh plc.

Waugh plc has approached Forster Bank seeking to borrow £35 million for three purposes. First, to upgrade its factories. Second, to enable it to branch out into types of car for which it does not currently manufacture parts. Waugh plc argues that only providing parts for twenty makes of car has limited its resilience to the recession and instead it has argued that providing parts for thirty types of car would offer it greater protection. Third, to pay wages totalling £1 million while sales have dipped in 2009.

Forster Bank must decide which form of debt is most appropriate in this context and which legal issues arise in relation to that sort of loan financing.

Advise Forster Bank

OR

(B) “No meaningful distinction can be made between a syndicated lending agent and a bond issue trustee in the abstract. A distinction can only be made if one looks closely at the terms of each specific contract. Typically the differences then are quite subtle.”

Discuss.

TURN OVER

6. Asa is a trader working on the bond desk at Cowdenbeath Investments, a UK resident investment firm regulated by the FSA. Cowdenbeath held two classes of bonds in December 2008, both of which were managed by Asa. Asa needed to sell those bonds quickly while they had briefly increased in value so that Asa would increase his profits for that calendar year and thereby increase his personal bonus for the year. (The contract between Cowdenbeath and its clients provided: "Cowdenbeath Investments shall bear no fiduciary duties to its clients".)

The first bonds were ordinary bonds in Nutmeg plc traded on a regulated market. On 18 December 2009 at 2.30pm, Asa received an email from an old friend, Billy, which read: "Our lunch partner has just had a visit from the police in the middle of reception at his office building. It does not look good. I heard someone say it's fraudulent trading." Asa and Billy regularly had lunch with their school-friend Colin. Colin was Finance Director of Nutmeg plc.

Colin knew that if news of Colin's police interview leaked out, then the price of the bonds would plummet. Therefore, Colin disposed of all of the bonds which Cowdenbeath owned in Nutmeg plc immediately by selling them at their market value at 2.35pm in equal amounts to each of the clients over whose funds he had discretionary control. The rumour about Colin reached financial news web-sites by 3.00pm. It transpired that the rumour was false and that Colin had only been asked to contribute to a police benevolent fund and not interviewed about a crime at all.

The second bonds were ordinary bonds in Cinnamon plc, a food production company, traded on a regulated market. On 20 December 2009, the Whoomberg TV network had transmitted a programme which had recommended Cinnamon plc as a good buy for private investors. All of Asa's clients had seen this programme and so asked Asa to invest in Cinnamon for them the next day.

Colin had been handed an internal analyst's report the week before on Cinnamon plc and other companies which were also in the food production industry. The report identified in bold type on page 24 that there was concern that a food additive which Cinnamon and other companies used would be found to cause cancer in rats in upcoming scientific test results. On 21 December 2009 the scientific report did find that the food additive caused cancer in rats. As a result, the price of Cinnamon's securities, including its bonds, fell sharply in value.

Both sets of bonds have since fallen in value by 15%.

Advise Beryl, who is one of Cowdenbeath's clients and whose fund is controlled by Asa.

TURN OVER

7. Radio plc intended to issue shares to the public and to admit them to trading on the Main Market of the London Stock Exchange. In 2008, Radio plc operated two regional radio stations, making income from advertising revenue. The board of directors comprised Daphne (Chief Executive Officer) and Niles. Niles is a qualified solicitor; Daphne has no professional qualifications.

In October 2008, Radio plc placed a bid for licences to operate ten new radio stations on digital radio frequencies from the Radio Licence Authority.

Roz was a financial analyst employed by Profit Bank who had particular expertise in new media markets. In November 2008 Roz wrote a report for the board of directors of Radio plc. It was agreed with Radio plc that: "Roz may be identified as the author of this report, but Profit Bank accepts no responsibility for its contents". The report expressed the following opinion:

"Each radio station will bring in the same amount of advertising revenue. I assume there will be ten new radio stations. The level of advertising income will depend upon the number of digital radio receivers that are bought by new listeners during 2009. If 1 million new receivers are bought, then advertising income will be about £15 million; whereas if less than 50,000 new receivers are bought, then advertising income will not reach above £500,000."

Roz had made an error when typing "£15 million", when she meant "£10 million".

On 8 January 2009, Niles completed drafting Radio plc's prospectus. The prospectus contained only this statement as to Radio plc's future prospects:

"Roz of Profit Bank, an expert media analyst, has expressed the firm view that Radio plc's ten new digital radio stations will generate £15 million per annum in advertising income; and furthermore that purchases of digital radio receivers by consumers above 1 million per year may raise revenues even higher. We are confident that our income from these new stations will therefore be in excess of £15 million per annum."

The prospectus was authorised by the FSA and the shares were admitted to trading in February 2009. Daphne and Roz were presented with copies of the prospectus before it was authorised but neither of them read it.

On 30 March 2009 it was announced that Radio plc had only been awarded two radio licences: its share price halved immediately. Tariq had bought shares in Radio plc in the after-market on 1 March 2009. He spent £50,000 on those shares.

Advise Tariq.

TURN OVER

8. Dipali was a senior trader with Credit Bank, a bank with 100 traders in the UK, and also one of the thirty members of the board of directors. Dipali had personal responsibility within the bank for all investments made through Freedonia. Credit Bank is regulated by the Financial Services Authority.

Johnny contacted Dipali in March 2007 by telephone. He introduced himself as the trustee of a group of Freedonian investment trusts which raised investments from Freedonian investors. Johnny asked Dipali to invest £5 million on behalf of this trust. The documentation which Johnny provided to Dipali disclosed that the investors were ordinary members of the public in Freedonia. That documentation also disclosed that the trust's total investment capital was about £100 million.

During 2007 the first investments came from Johnny as anticipated and were paid into the investment trust's account held with Credit Bank. The profits were returned to Freedonia and were paid into the trust's accounts in Freedonia.

Then in December 2007 Johnny flew to London to meet Dipali for the first time. He told Dipali that he expected the trust's activities and investor base to expand hugely in the coming months and that he would be passing all of his investment business through Credit Bank. Dipali said she was very interested in providing whatever services Johnny needed. Johnny then told Dipali that he wanted to invest the entire £100 million from the Freedonian investment trust through Credit Bank over the next five months, in amounts of £20 million per month. The capital investments and their profits were, however, to be changed into US dollars and paid in small parcels into a number of different bank accounts in Johnny's name in Panama, in the Cayman Islands and in the British Virgin Islands.

Dipali agreed to the arrangement. She asked no further questions about the trust's activities. She earned her usual commission from Credit Bank in relation to this business. When asked by her fellow directors how she had acquired such large investments from Johnny, she replied: "My personal moral code in relation to clients is that I follow their instructions completely. Johnny has instructed me to maintain complete confidentiality." The other directors were very angry at this, demanding more information, but Dipali refused to change her mind.

Later that day, it transpired that Johnny had stolen the entire £100 million from the trust. Both he and the money have now disappeared.

Advise the beneficiaries of the trust.

TURN OVER

9. Frankie was a customer of Boyle Bank. He had held a current account and deposit account with Boyle Bank for ten years. Frankie is a practising barrister.

On 1 January 2009, unbeknownst to Frankie, his current account details had been illegally obtained by criminals in the USA using “spyware” technology to read the contents of his desktop computer’s hard drive. The bank account was used to launder the proceeds of human trafficking and prostitution in the UK. Frankie was involved in a big murder trial and so did not read any of his bank statements until he was contacted by the police on 20 March 2009, by which time the criminals had been using his bank account for nearly two months.

On 28 February 2009, Adam (an employee of Boyle Bank) had become aware of the payments into and out of Frankie’s account via Belarus. The payments had been spotted Boyle Bank’s “Snoopster” software which identified suspicious patterns in client accounts. Consequently, Frankie’s account was frozen on 10 March 2009.

On 21 March 2009, Russell, the clerk to Frankie’s chambers (who managed the business affairs of the entire set of chambers), visited the bank to discuss the chambers’ banking affairs with a bank employee, Mary. The meeting was intended to relate only to the general bank account of that set of chambers (whereas each barrister’s personal accounts were confidential to them). However, Mary assumed that Russell would know all of Frankie’s financial affairs and so mentioned that Frankie’s account had been frozen by the police. When asked why that would be, Mary answered that “it usually relates to international crime: prostitution or drugs”. The next day Russell began the chambers procedure to oust Frankie from chambers for gross misconduct. Frankie has since lost instructions for a number of trials which would have been expected to make Frankie £200,000 in total.

Meanwhile, on 1 April 2009, the junior clerk in chambers, Julie Hand, was handed a cheque by Frankie for the final payment of chambers expenses before he left. The cheque was made payable to “Julie Hand Chambers Account” (the usual way payments were made to chambers) in an amount of “one thousand pounds”. Julie scratched out the words “Chambers Account” from the payee line of the cheque and changed the amount to “twenty thousand pounds”, initialling both changes. Julie then paid the cheque into her current account and paid Frankie’s debts to chambers out of her own money.

Advise Frankie.

TURN OVER

10. EITHER

- (A)** “The financial crisis of 2007-09 has demonstrated the limitations of financial regulation and that the financial markets have been in denial for some time about their self-evident deficiencies. The Banking Act 2009 has gone some way to addressing these key failings.”

Discuss.

OR

- (B)** “In what way could the risks associated with financial derivatives be controlled more effectively?”

Discuss.

END OF PAPER