

## ***Legal risk in the Financial Markets following the Global Financial Crisis: a UK perspective***

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How has the Global Financial Crisis affected legal risk in the financial markets? Legal risks are a part of the spectrum of risks that are inherent in the operations of banks and other financial institutions, affecting the lives of the people who work there and customers of all kinds who put their trust in them as well as, in more extreme cases, the financial system itself. Banking is, by nature, risky. It involves, at its core, the process known as “maturity transformation”, i.e. “lending long and borrowing short”. A bank takes money in (i.e. borrows it) from many sources, including individual and corporate customers and the money markets. Much of that money is withdrawable virtually at will – with little or no notice required to the bank. However, much of the money that banks lend out – say, to householders for mortgages or to industry to finance development – is lent on a medium or long term basis. There is, therefore, a “liquidity risk” (not, itself, a legal risk) built into the system. Society needs banks to perform this “utility” role – and it expects them to manage the risk that comes with it. Part of the theoretical “bargain” between society and the banks includes giving the banks financial support from the authorities, usually the central bank, if the risk becomes unmanageable for some reason (although such support is not guaranteed).

As has been all too graphically demonstrated by the Crisis, the more serious risks taken by banks (including liquidity risk) also affect, in some cases, the financial stability of modern economic life. It is in our collective interest that the banking system and the financial markets are reasonably secure. This is not the same as guaranteeing banks’ profits, still less the financial rewards payable to individual bankers. Rather, the desire for stability reflects the need to ensure as far as possible that, to put it rather crudely, our money is ‘safe’ when it is placed in the hands of banks and financial institutions for non-speculative purposes.

Prior to the Crisis, the City of London’s success (and the stability of the UK financial system) was built upon the relationship between market participants, those who regulate them, and those responsible for the laws that apply to market transactions. This will remain the case. Although any successful marketplace needs more than just a reliable legal system, if it does not have that as a foundation, it will not last for very long. Bad laws, which may threaten the reliability of bargains entered into in good faith or expose honest businesses to unacceptable hazards, cause risks to arise which, ultimately, can drive markets

away. Although the financial markets will tolerate a degree of legal risk, it is rarely welcomed and generally only accepted, grudgingly, if it is unavoidable. The need to be vigilant in this area has been intensified as new laws, such as the Banking Act 2009, have been enacted, in some cases as a matter of urgency, in response to issues raised by the Crisis. Such laws have had a radical effect on the legal risks faced by banks, their shareholders and contractual counterparties. In addition, the risk profile is affected by the continuing development of anti-terrorist and anti-money laundering laws, an increasingly uncompromising attitude of regulators to fraud and other kinds of financial crime and an apparently ever-growing need for additional consumer protection measures to combat perceived unfair practices. All this has an impact on how banks manage their business. They play a central role in our lives. Their access to our money, and information about what we do with it, has caused that role to be extended into areas, such as the criminal justice system, that place heavy responsibilities on them. The risks that flow from this “come with the territory”.

Some legal risks are quite easy to understand and some are much more complex. However, they are all of concern to all of us, and their importance has increased markedly over the last twenty-five years. The concern extends not only to the risks themselves but also the cost of managing them and the impact of that cost on running a financial services business. Before the Crisis some commentators felt such businesses were subject to ‘over-regulation’. Following the Crisis, many commentators have voiced criticism to the effect that the pre-Crisis regulatory regime followed an excessively “light touch” approach. There certainly seem to have been some regulatory shortcomings, whether due to the “regime” or the manner in which it was operated. Inevitably perhaps, there are now fears that the regulatory reaction to the Crisis might be too heavy-handed (although tougher regulation certainly has popular support). There are also differences of opinion at international level as to how and where any such “heavy hand” should fall and the extent to which regulatory power should be handed over by national bodies to international bodies.

The regulator for financial market activity in the UK is of course the Financial Services Authority (FSA), which covers banking, mortgage lending and advice, all kinds of insurance, and investment business. The regulatory regime is complex and its “architecture” is currently a matter of intense political debate. Whatever the architecture, regulated financial institutions are not only governed by laws (as we all are) -- they are also bound by ‘rules’ (some of which are expressed as very broad principles), told what to do by ‘directions’ and ‘requirements’, expected to be steered by ‘guidance’, protected by ‘safe harbours’ (but potentially damned by other ‘evidential provisions’), and required to comply with an ever-increasing number of codes of conduct. And that is just in the UK. The appropriate multiplier can be applied, depending on the number of jurisdictions in which a regulated business has activities. Managing the risks associated with this costs a great deal. It is understandable, especially following the “Run on the Rock” (i.e. the near-failure and rescue of Northern Rock in late 2007) and other Crisis-related developments that led to concerns about deposit-

taking institutions that we should ensure as far as possible that the regulatory system protects consumers who have savings, or indeed any credit balances, with banks and building societies. But does the system over-protect in certain areas? And is there now a risk that, following the Crisis, we will over-regulate – in an attempt to react to every conceivable link in the causation chain that led to the Crisis? This risk may be exacerbated (in the UK) by the desire of the FSA to correct the impression that it had an unduly “light touch” approach to regulation in the past – an impression that some feel owed more to a desire to promote London as a financial centre than to the substance of how it actually fulfilled its role. No one suggests that the banks should be let off lightly for their role in the Crisis but regulation’s purpose is not punishment and an over-reaction would have harmful consequences for society as a whole. So it is crucially important to proceed carefully with the reform agenda, linking change, wherever possible, to significant Crisis causes rather than mere “*sine qua non*” links in the causation chain.

It is also important that our zeal for change does not cause us to lose sight of how important legal risk is for the financial markets (and how it may be triggered inadvertently by poorly thought out new laws or regulations). Banks and financial institutions trade, for the most part, in products that are ‘creatures’ of the law rather than tangible goods. Commercial banks, for example, are regulated because they accept deposits from the public. Their business is the creation of, and trade in, ‘intangibles’, such as debts and similar obligations, of varying degrees of complexity. These intangibles (unlike tangible property such as land, ships, or aircraft) exist, in law, as ‘things’ (or ‘choses in action’, to use a legal term) capable of being owned as property only because we, through our financial dealings with each other, bring them into existence. Trade in goods and other physical ‘things’ frequently involves credit, and so the ordinary trade transaction, which is primarily about something that we can touch and see, also gives rise to things that we cannot touch or see—‘invisibles’ and ‘intangibles’, such as debts and various other kinds of claim. Things that fall into this latter category, which may themselves be owned and traded, owe their existence (and value) to the legal infrastructure that recognizes the intellectual concepts that underpin them. They are the lifeblood of banking business. For a bank, therefore, legal risk, when it threatens the legal validity of an ‘intangible’ asset owned by it or exposes the bank to large claims, is somewhat akin to, say, engineering risk for an aircraft manufacturer, maintenance risk for a railway operator, or fire and earthquake risk for an owner of valuable real estate. In the worst case, the bank may lose a great deal of money, its reputation, and/or the ability to continue in business. And, as the Crisis has all too clearly demonstrated, a major loss for a bank, if it threatens a bank’s financial survival, frequently causes reverberations around society as a whole. It is indicative of the importance of legal risk that in the “War Game” exercise carried out by the UK regulatory authorities in 2004, to simulate risks to the financial system, the trigger event in the exercise was an imaginary unfavourable decision of the European Court of Justice: a classic

example of legal risk. The simulation assumed that the ruling of the court “created a behind-the-scenes run on banks that were heavily exposed to the property sector” according to the Financial Times report of the exercise.

The recent history of the financial markets, from around the time of the first major UK privatization share issues of the 1980s, has featured a number of significant developments that have tended to bring concern about legal risk, albeit in specific contexts, to the fore. These include the growth of global markets, the arrival of ‘universal’ banks (whose business involves much more than banking, as traditionally understood, and has been criticized for linking “casino banking” to “utility banking”) and the huge expansion of markets in instruments commonly known as ‘derivatives’ and other highly structured financial products. These products are created, in some cases, as a result of “securitization” transactions whereby loans and other assets which, in the 1970s and 1980s would generally have been held on an originating bank’s books are converted, in effect, into tradeable securities issued by a special purpose vehicle (or SPV). Such developments have brought benefits but they have also added greatly to the complexity of financial activity. Many argue that they (or, rather, their misuse or misapplication) have been direct contributors to the underlying causes of the Crisis. No one would deny that the complexity has led to increased risks of, for example, misunderstanding the nature of the instruments in question or of their economic implications. Their complexity has also increased awareness of legal risk.

The events that led up to the Crisis and the various responses of government and others in its early phases have had clearly had an impact on legal risk. The Crisis has, for example, caused new legislation to be introduced in the UK (the Banking Act 2009) that affects the rights of shareholders in banks, giving the authorities the right to exercise so-called “stabilisation powers” that can result in the effective confiscation of either their shares or the assets of the banks themselves. That legislation also gave rise to important technical concerns about, for example, the impact on netting arrangements of using the stabilization powers to transfer some (but not all) of a bank’s assets to another institution.. The Crisis has raised concerns about the effectiveness of governance regimes in banks and other financial institutions and, especially, the effectiveness of non-executive directors. It has, generally, triggered widespread demands for more effective regulation in a great many areas, including, possibly, “direct product regulation”. On a more technical level, it has demonstrated the inadequacy of the general corporate insolvency regime for dealing with the complex issues that arise when a high profile international financial institution gets into financial difficulties and has raised some issues of particular complexity in the context of the insolvency of investment banks. (The Banking Act 2009 serves as the backdrop to a consultation exercise on whether or not to change insolvency law for investment banks in order to address various issues raised by the Lehmans failure.) The combined effect of the changes in the bank insolvency regime in the UK, the likely changes in governance rules and the fact that (for the time being at

least) so many major banks have large public sector shareholders goes to the heart of what kind of legal animal a bank actually is.

Bank insolvencies triggered by the Crisis have also caused market participants to re-think some of the standard provisions in documentation that had tended to be based on the assumption that the collapse of a bank as well known as, say, Lehman Brothers was, in practice, “unthinkable”. Documentary legal risk is still with us.

The various “Ponzi” schemes and other frauds exposed by the Crisis have had their own legal risk consequences. It is still too early to assess the impact of Crisis-related litigation, criminal charges and regulatory action but it is clear that it is very significant. On the 30<sup>th</sup> June 2009 the Financial Times featured news stories on three issues (two of them on its front page and one as the lead item) that involved Crisis-induced court proceedings (or potential proceedings). The first concerned the 150 year sentence handed down to Bernard Madoff for his role in the notorious \$65 billion<sup>1</sup> “Ponzi scheme” that had defrauded so many in the US and elsewhere (and has given rise to associated lawsuits<sup>2</sup>). The Crisis has tended to expose a number of “Ponzi” frauds –where, typically, the fraudster pays existing investors from the proceeds of new investments because the downturn has forced many investors to seek the return of capital invested rather than simply enjoy the above-average “income”<sup>3</sup>. Indeed it is thought that the publicity generated by Madoff may have caused other investors to ask questions leading to the exposure of comparable frauds<sup>4</sup>. The scandal is also thought to have inflicted

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<sup>1</sup> This is an estimated figure. The full extent of the fraud remains a matter of conjecture at the time of writing.

<sup>2</sup> “Feeder funds” and others that made investments with Madoff have been the target of various claims. According to the Financial Times (30<sup>th</sup> June 2009) an Austrian bank, Bank Medici, ran a number of such funds in Luxembourg and Ireland. Bank Medici was brought under the control of the Austrian authorities in 2009. UBS has also come under attack by the Luxembourg financial regulator because of its custodianship role for a feeder fund based in that country. In May 2009 Banco Santander settled (for US\$235 million) a claim made by the trustee seeking to recover money on behalf of the victims of the fraud (Irving Picard). This related to investments made by two of the bank’s hedge funds and the withdrawal of funds from Madoff in the 90 day period before Madoff’s arrest (such moneys being vulnerable to “clawback” under New York law). Mr Picard is pursuing a great many other claims and Santander itself is also making various claims in relation to Madoff-related losses.. The consequences of the fraud have rippled through the financial system. For example, Wells Fargo announced in January 2009 that it had lost US\$294million on loans made to customers who could not repay because of losses they suffered with Madoff. Various firms of auditors have also been sued on the basis of their association with the “feeder funds”.

<sup>3</sup> As the Sunday Times put it: “The credit crunch was the undoing of Madoff. Tightening purse strings around the world encouraged many of his long standing investors to ask for their cash back and Madoff could no longer maintain the pretence.” (Business section, p.5. 21<sup>st</sup> December 2008).

<sup>4</sup> According to the Financial Times of 6<sup>th</sup> March 2009, “While investigations into Bernard Madoff’s alleged \$50bn fraud.....have dominated the headlines, virtually every week has brought at least one new Ponzi scheme charge from the US Department of Justice, Securities and Exchange Commission of the Commodity Futures Trading Commission.” One industry specialist (from the investigative practice of a firm of accountants in the UK) commented: “It’s not increased fraud. It is increased detection. We’ve been cleaning out the market.”

reputational damage<sup>5</sup> on the hedge fund industry, which shrank by 1,200 funds to just over 9,050 funds between mid-2008 and mid-2009.

The second story related to a legal action brought by various “green groups” against the Treasury to require it to use the government shareholding in RBS to force the bank to give financial support only to projects that satisfied certain environmental and human rights standards. A lawyer representing the plaintiffs was quoted: “The government has the power and control to ensure public money provided to UK banks is not invested or lent to projects that harm the climate or individual human rights.” The newspaper’s Lombard column (written by Jennifer Hughes) having noted that the government had in the past “banged on and on about the need to “green” business” commented:

“This is worth watching. No matter how much distance the government tries to put between itself and the banks it controls, the public perception will always assume these companies should be a test case for government policies – from executives’ pensions and pay to its environmental thinking. It will have to accept this.”

The third story concerned the EU competition law implications of the UK government’s assistance (“state aid”) to the banking sector. It was expected (rightly, as it turned out) that warnings would be given (not for the first time) from the EU authorities that in order for the state aid to be compliant with the relevant EU rules the banks who had benefited would be expected to make significant assets disposals. It was noted that RBS was already reducing its balance sheet by about a fifth, with a hive-off of £240 billion of loans and the sale of its Asian operations being planned. Disposals may also be under consideration at Lloyds Banking Group. The Financial Times lead Editorial of 2<sup>nd</sup> July 2009 commented:

“The commissioner’s concerns about British banks are clearly right. The UK has deployed state aid to allow its banks to support large balance sheets. And, in addition, it now only has five large banks that serve customers. Lloyds enjoys the custom of almost one in three UK current account

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<sup>5</sup> The Times lead Editorial of 23<sup>rd</sup> December 2008 commented that Madoff’s downfall “must be seen as an indictment of his era,” and noted that his actions “have turned a bad year for hedge funds into a catastrophe.” In his article (“Warning signs were ignored”) in the same newspaper of 16<sup>th</sup> December 2008, David Wighton had said: “Although not strictly speaking a hedge fund, the Madoff scandal is another blow to the struggling hedge fund industry. It is likely to encourage investors to take their money out of other funds, which could force further sales of assets putting further pressure on prices and giving the downward spiral another twist.” On the same day, the Daily Telegraph published an article (“Funds face regulation in the wake of Madoff” by Ebrahimi and Aldrick) that quoted a “leading hedge fund manager” as saying, “The fund industry will never recover from this – it is more or less game over for many fund of funds. People like pension fund managers and investment fund managers are supposed to be the custodians of money. They are supposed to know what is going on and they should have been able to tell that something was wrong.”

customers. Britain's financial sector, never very competitive, has become less so."

The EU Commission has said that it will publish rules on disposal requirements in the context of state aid. These are expected this July.

Whenever significant amounts of money are lost, disputes are likely to follow if the making of a claim (preferably against a deep-pocket target) has the remotest chance of resulting in some recovery – even after an out-of-court settlement. The Crisis is no exception to this general rule of behaviour. As with the Madoff affair, criminal charges also tend to be on the agenda and heightened regulatory scrutiny is inevitable<sup>6</sup>. Claims have fallen broadly into the following categories:

- complaints that an investor was not properly informed about a risk or otherwise misled or that funds held were in some way mismanaged<sup>7</sup>; this may or may not involve allegations of fraud<sup>8</sup>;
- complaints about the management of a bank (usually, but not necessarily, by its shareholders)<sup>9</sup>;

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<sup>6</sup> On 6<sup>th</sup> July 2009, the FSA announced "the sharpest increase in penalties for improper conduct since it was formed.." (see the Times 7<sup>th</sup> July 2009: "Fines to double or triple as FSA gets tough with City wrongdoers" (Patrick Hosking)). In some cases fines could equal twenty per cent of revenues: potentially a huge sum. This followed a number of arrests over the preceding twelve months for insider dealing (the first successful conviction having been in March 2009), which suggested that the FSA has also "got tougher" in this area – an impression which various interviews with FSA personnel suggested it was anxious to convey.

<sup>7</sup> The Madoff affair has of course prompted a number of claims of this kind, some of which raise complex points of law (in various different jurisdictions) on the duties of custodians for the behaviour of sub-custodians. It was reported on 14<sup>th</sup> January 2009 that: "UBS and HSBC are being targeted by investors who lost money in the alleged \$50bn fraud run by Bernard Madoff. They argue the two banks should have guarded assets allocated to Mr Madoff's business more carefully." (Financial Times: "Banks accused of failure to protect assets" (James Mackintosh). The Times also reported, on 23<sup>rd</sup> December 2008, that a class action had been launched against Fairfield Greenwich Group by some of its investors, alleging negligence in relation to potential Madoff-related losses of around US\$7.5 billion.

Another, high profile, example is provided by Sir Keith Mills' complaint against Coutts & Co (the "private banking arm" of RBS). In an open letter to "Coutts customers", printed in the Daily Telegraph of 19<sup>th</sup> December 2008 (and other newspapers), Sir Keith drew attention to a website he had set up "to bring Coutts customers together in a combined action" in relation to a complaint about client money that had been invested in AIG Life Premier Bonds. Sir Keith alleged that he has been told that his money would be "safe" whereas (in September 2008) payments had been frozen. The website subsequently contained notes from Sir Keith encouraging other investors to write to the FSA and the Financial Ombudsman Service and provided template letters for the purpose.

<sup>8</sup> The Guardian reported ("Barclays sues over sub-prime losses" by Andrew Clark) in December 2007 that Barclays had started a lawsuit against Bear Sterns "for fraud and deception over the loss of hundreds of millions of dollars in an ill-fated hedge fund." The same article states that other investors were also suing Bear Sterns "over the debacle" and that criminal charges were being considered.

<sup>9</sup> On 16<sup>th</sup> March 2009 the Times reported ("Pensioners hire Cherie Blair to sue Sir Fred Goodwin and RBS" (Michael Herman) that two British pension funds were suing RBS and Sir Fred Goodwin (in the US courts) for "hundreds of millions of pounds" claiming that "on multiple occasions" Sir Fred and RBS

- complaints about the behaviour of a bank by its customers<sup>10</sup>;
- complaints about auditors<sup>11</sup>;
- complaints about conflicts of interest;
- complaints about negligence of a professional adviser;
- claims in connection with insolvency<sup>12</sup>; and
- complaints against regulators and other public bodies thought to have failed in their duties in some way<sup>13</sup>.

At the time of writing the tsunami of litigation, criminal proceedings and regulatory action shows no signs of abating. Not only has the Crisis made certain kinds of claim virtually inevitable, it has also worsened the reputation of banks (which was not very high in the first place) to the point where they are “fair game” for any reasonably inventive litigant who can find an ambitious lawyer prepared to take a risk on a contingency fee arrangement.

There have been many “responses” to the Crisis from regulators, governments, supra-national authorities and others. Everyone has had a chance to “have their say” and few have resisted the opportunity. In some cases, the

“falsely reassured” investors that the bank was in good health when it was “effectively insolvent” because of bad loans.”

On May 18<sup>th</sup> 2009, the Financial Times reported (“Fund cites BofA chief over mortgage group sale” (Greg Farrell) that a hedge fund, SRM Global, was suing various executives of Countrywide Financial (in which the hedge fund had once had a substantial shareholding) and the chief executive of Bank of America (Ken Lewis) in relation to various statements allegedly made about the financial position of Countrywide. (Countrywide, an entity that had sustained significant sub-prime losses, had been bought by Bank of America in January 2008). The same article also mentions that Lewis is “fighting claims made by BofA shareholders over the way he handled the acquisition of Merrill Lynch.” (That acquisition had proved to be financially very disappointing: the share price of Bank of America fell by 78% in the period following and additional government support was needed for the merged entity).

<sup>10</sup> The legal actions relating to charges for unauthorised overdrafts are an example of this (although they were not triggered directly by the Crisis. The FSA has said that it plans to be more vigilant and “crack down hard” on bank practices that are not in consumers’ interests “because it is concerned customers will be treated unfairly in the . . . recession.” This was reported in the Daily Telegraph of 22<sup>nd</sup> December 2008, (“Watchdog warns banks to treat customers fairly” (Philip Aldrick)). The same article commented that lawyers were claiming that mortgage borrowers were using banks’ “duty of care” to their customers as a defence argument against repossessions. A variation on the theme was the argument that banks who lent more than a property was worth were not acting responsibly.

<sup>11</sup> Again, the Madoff affair has proved a fertile source of claims: see “Accounting firms drawn into Madoff scandal” (James Mackintosh) Financial Times 18<sup>th</sup> December 2008. Their role as auditors of “feeder funds” appears to have made them vulnerable.

<sup>12</sup> The restructuring plans of the monoline insurer, MBIA also triggered claims in 2009 from banks such as RBS, Barclays and HSBC who claimed they would be unfairly prejudiced. MBIA had itself previously (October 2008) brought an action against Countrywide Financial (see footnote 310 above) alleging that fraudulently induced it to guarantee billions of dollars of mortgage bonds. MBIA alleged that Countrywide has developed a “systematic pattern and practice of abandoning its own guidelines for loan origination: knowingly lending to borrowers who could not afford to repay the loans, or who committed fraud in loan applications.” (See Financial Times 1<sup>st</sup> October 2008, “MBIA sues Countrywide Financial” (Saskia Scholes))

<sup>13</sup> See [SRM] v HM Treasury {ref}

responses have tended to reflect a pre-existing political agenda. In the UK, the very nature of the regulatory system has become a party political issue. The responses reflect the passions that the Crisis has aroused. This is hardly surprising, at least at the political level. However, the contribution of lawyers to finding the best road forward needs to be in the best traditions of the profession: analytical, objective and dispassionate. That contribution should also, perhaps, be a little more forthcoming than has been the case to date?

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