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INTRODUCTION

When I first visited … Washington some three years ago accompanied only by my secretary, the boys in your Treasury curiously inquired of him – where is your lawyer? When it was explained that I had none – 'Who then does your thinking for you?' was the rejoinder.

John Maynard Keynes[1]

Lord Keynes did not like lawyers. His words are heavy with irony. However, many a true word is spoken in jest, and in modern financial markets it often falls to the lawyers to do the thinking about the nature and consequences of the structures and products that their clients have invented. The purpose of this book is to help the lawyers who advise clients on financial law in this task of analysis. **1.01**

It might be thought that the same aim could be made for any legal textbook, with the substitution of the relevant area of law for the reference to the law of financial transactions. However, financial law, in its current stage of development, is different from many other areas of legal practice in some important ways. The cumulative effect of these differences is to make it important that practitioners have a clear understanding of the concepts and principles which underlie the applicable legal rules, in addition to a knowledge of the detailed rules themselves. **1.02**

The Special Position of Financial Law

Legal advice in financial markets

The first characteristic which distinguishes the legal advice given in financial markets from that given in most other areas concerns the objectives of clients in asking **1.03**

[1] Speech made to the US delegation to the Bretton Woods Conference, recorded by Sir Roy Harrod in *The Life of John Maynard Keynes.*

for legal advice. Litigation lawyers, asked to advise a client in relation to a dispute which has already arisen with another party, or with a regulator or other public authority, have two questions to address:

1. What facts will the court decide are relevant?
2. How will the court apply the law to those facts?

The first question has nothing to do with the law or legal principles. The second looks to the lawyer's evaluation of the relevant rules of law. This evaluation, however, is heavily influenced by the lawyer's knowledge of the particular court which will hear the case and of the prevailing judicial and social attitudes. Deciding what the law is, and predicting what a particular court will do, are not necessarily the same exercise. The skill of the litigator lies as much in the organization and presentation of facts and in the understanding of judicial thinking and attitudes as it does in a detailed knowledge of the law.

1.04 Financial lawyers operate in a different climate. Their advice is usually sought in connection with the structuring of financial transactions or the documenting of agreed proposals. The client is looking for a way to set up arrangements so that disputes will not arise or, if they do, there should be as little doubt as possible that they will be resolved in favour of the client.

1.05 In some respects, the task of the financial lawyer is much simpler than that of the litigator: he or she does not need to deal with any vagaries of evidence or other factual matters; nor are the sensitivities of particular courts or judges relevant. The question facing a legal advisor dealing with a financial transaction is simpler, but also wider: 'If something goes wrong with the operation of this transaction, and the matter comes before a court for decision, what will the judge do?'

1.06 The financial lawyer need not be concerned with the need to prove or disprove allegations of fact, nor with the attitudes of particular judges. However, he or she cannot avoid facing the much wider questions which arise from the possibility that all sorts of things might go wrong, the nature of which cannot be foreseen, and that any resulting dispute might come to be considered by one or more courts in different places. The nature of financial law is now transnational and any document which is drafted on the basis that it is to be governed by the law of England and Wales (or that of any other country) might, in the event, fall to be interpreted and enforced by a court where the judge has no qualification or experience in the chosen governing law.

Legal developments and economic change

1.07 The common law develops in response to changes in behaviour which produce new situations and disputes. In the commercial sphere, developments in the law have normally been preceded by changes in technology, which have, in turn, brought about changes in trading patterns. Perhaps the best known example follows the invention of the marine steam engine. With the introduction in the mid-nineteenth

century of ships which were much faster than the standard sailing cargo vessels, a major change in trading activity came about. A bill of lading, representing the goods loaded on a vessel, could be dispatched by steamer at the time when the cargo left on a sailing ship. The documents of title would reach their destination long before the cargo itself. This meant that the goods could be traded and financed on the basis of the bill of lading, without the goods being in the same country. This produced a large number of cases, and a great deal of new law about the nature of ownership and possession of goods, in the context of international trade.

1.08 The explosion in the use and the sophistication of computer technology in the late twentieth century has had a similar effect on financial activity. Not only has the technology enabled the creation of increasingly sophisticated financial instruments. More importantly, it has allowed trading activity to take place through the exchange of digital information, rather than physical book entries. Moreover, geography has become irrelevant in financial trading. It is just as easy to effect a transaction with a counterparty on the other side of the world as it is to do it with someone who is sitting next door.

1.09 For the financial lawyer, one of the most complex consequences of globalization is that for many transactions, the draftsman must assume that any future problems might occur, or be litigated, in a foreign jurisdiction. Private international law, once considered the preserve of the more academically minded practitioners, has become a central area of focus for all financial lawyers.

The process of development of the common law

1.10 Human beings are creatures of habit. They feel most comfortable, when presented with a problem, in dealing with it as they have dealt before with similar problems. To the extent that a problem has novel characteristics, the human instinct is to find the nearest proven approach, and to make only such changes as are necessary to deal with the novelty. Our instinct is to adapt to change incrementally.

1.11 Common lawyers are no different from other people. In 1833[2] James Parke J explained how the common law would approach the problem which was then before the court, and for which there was no precedent:

> The case … is in some sense new, as many others are which continually occur; but we have no right to consider it, because it is new, as one for which the law has not provided at all; and because it has not yet been decided, to decide it for ourselves, according to our own judgment of what is just and expedient. Our common law system consists in the applying to new combinations of circumstances those rules of law which we derive from legal principles and judicial precedents; and for the sake of obtaining uniformity, consistency and certainty, we must apply those rules, where they are not plainly unreasonably and inconvenient, to all cases which arise; and we are not at liberty to reject them, and to abandon all analogy to them, in those to which they have not yet been judicially applied, because we think that the rules are not as

[2] *Mirehouse v Rennell* 1 Clark & Finnelly 527.

> convenient and reasonable as we ourselves could have devised. It appears to me to be of great importance to keep this principle of decision steadily in view, not merely for the determination of the particular case, but for the interests of law as a science.

More recently, Lord Simon of Glaisdale made the same point more succinctly:[3]

> … English law develops by applying an established rule of law to new circumstances which are analogous to the circumstances in which the established rule was framed.

1.12 When new circumstances come before a court for decision, the closer those facts are to those of a previous case, the easier it is to see how the court will make the analogy with previous circumstances, and so predict the way in which rules of law will be applied to the new facts.

The challenge for financial lawyers

1.13 When drafting the documentation for a transaction, or advising clients on how to devise trading systems or operating systems, the financial lawyer has a task which is made more complex by the combination of the three factors described above. He or she is asked to predict how the proposed arrangements will be viewed by a future court, which may or may not be in the jurisdiction of the lawyer's own expertise. The area of activity involved may well be one where there is little or no decided case law or statutory guidelines. There may be no closely related decisions which have an obvious analogy to the situation under review.

1.14 The lawyer must therefore predict how a court might apply to the new circumstances principles and rules of law devised to cover quite different factual circumstances. The courts may well be obliged to apply an analogy across a large factual gap. The wider the gap which must be jumped, the harder it is to predict where the court will land.

1.15 It is not enough, therefore, for financial lawyers to have a thorough knowledge of the rules of law relating to the activity with which they deal. There may well be situations where there are no specific rules to be derived from decided cases, nor even any rules that are almost on the point. In predicting the future approach of the courts, the financial law practitioner must have a sound understanding of principles and concepts which underpin the existing rules of law in areas which are removed from areas of current market activity, because these principles are the foundations on which future decisions will be built.

The Choice of Topics

1.16 It is not possible to draw up a list of 'foundation concepts' which can be confidently forecast to be those which will underpin future decisions in cases involving financial

[3] *Mardorf, Peach & Co. Ltd v Attica Sea Carriers Corporation of Liberia.* [1977] AC 850.

transactions and markets. There are, however, a number of legal principles which have already been shown to be central to issues in this field, and which can be predicted to arise again in different circumstances. It is possible to put these into a number of categories, examples of each of which form the subject-matter of one or more chapters of this book.

1.17 First, there are those concepts which have not needed, as a matter of English domestic law, to be analysed in any great detail in the past, but which are likely to become more significant in the context of globalized financial trading. Among these are the concepts of money and of payment. Payment, for example, has been regarded traditionally as a mechanical matter, relevant only to the determination of whether a particular payment obligation had, or had not, been performed. However, when payments in large amounts are made internationally, the mechanical process involves many steps being taken by a number of institutions, perhaps in several different countries. The legal consequence of the failure of this complicated chain is much more complex than the determination simply of whether A did, or did not, make a payment to B.

1.18 Second, there are core legal concepts which are different in common law and civil law countries. As long as disputes are factually confined to a single jurisdiction, these differences are unimportant in practice. When several countries are involved, the differences become crucial. Each system of law has its own concepts of property and of the nature of personal rights. In each case, this understanding determines the way in which rights may be exercised or dealt with. There is a fair degree of harmony between systems, when they deal with physical property. However, when legal systems consider intangible assets, such as debt or intellectual property, their understanding of the legal nature of those assets differs very widely. When intangible property is traded across national boundaries or moves its location from one jurisdiction to another, complex issues of conflicts of laws regularly arise. Before a financial lawyer can begin to address these issues, he or she must have a clear understanding of the nature of property rights and obligations under the law of his or her own jurisdiction.

1.19 Some issues in financial law involve not only an understanding of the legal rules which now apply, but also knowledge of how they developed. Some international markets, and in particular the international bond market, have developed (rather like the common law) incrementally. The form and structure of the market and of transactions which take place in it are the creature of a number of small steps, each of which prompted a minor change to the legal arrangements of the market. When there is a major shift in the way in which the market operates, for example by the move to electronic trading instead of the transmission of pieces of paper which represent the items sold, problems arise. The legal effect of the new methods of dealing has to be analysed against the backdrop of a structure which was designed for a different era. In order to address these issues at all, it is necessary to understand where the present structure came from and why it evolved as it did.

1.20 In structuring or documenting transactions, the financial lawyer must often choose how best to secure his or her client's interests. The possible mechanisms available, whether by way of property-based or contract-based security or by way of credit support, are all familiar. However, these mechanisms are usually taught in connection with specific areas of law. For example, most lawyers learn about mortgages and charges in connection with their study of land law and about guarantees as part of a contract law course. For a financial lawyer deciding upon a structure or documenting a transaction, it is important to see these disparate concepts as belonging to the same available tool kit. The ability to see the use of these concepts in combination is an important skill in structuring financial transactions.

1.21 Some legal concepts, which at first sight appear to have little to do with international financial markets, regularly present themselves as potential problems. The most persistent of these is probably the issue of fiduciary relationships and fiduciary duties. To many in the financial markets, fiduciary duties belong to the law of trusts and are designed to protect the interests of vulnerable individuals. They cannot see that this branch of law should have anything to do with international financial markets, which are populated by large and supposedly sophisticated organizations. To others, the claim that a fiduciary duty exists has the effect of shifting commercial responsibility for the actions of one of the parties onto to the shoulders of the other.[4] The concept of fiduciary relationships is just as relevant in financial markets as it is in any other walk of life. However, in order to understand why this is so, and why it need not be a matter of concern for responsible market participants, one needs to understand in some depth the origins of the doctrines and the way in which they are now applied.

1.22 The chapters which follow aim to bring to the attention of financial law practitioners the concepts which underpin some of the more difficult and important issues in financial law. No chapter claims to be the definitive treatment on the topic which it discusses. Indeed, most of the topics are the subject of complete textbooks in their own right. It must be remembered that these topics are not matters on which it is possible simply to 'look up the law'. Each lawyer must form his or her own understanding of the concepts and issues, in order to apply that understanding to the facts of new transactions and arrangements. The aim of the ensuing chapters is to point practitioners towards their own understanding.

[4] For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act, designed as a regulatory response to the banking crisis of 2008, contains provisions which impose specific duties on those who conduct swaps business with 'special entities'. 'Special entities' are, broadly, state and municipal bodies and pension plans. The original draft of the Bill proposed in rather simpler terms that the swaps dealers, when dealing with such bodies, should have fiduciary duties. The phrase was an inappropriate term to use, in order to achieve the effect sought, and was changed before the final text was agreed. It use does, however, illustrate the very broad-brush misunderstanding which many have of the term.