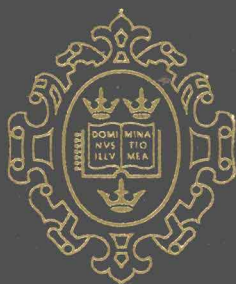

LEGAL RISK IN THE FINANCIAL MARKETS

SECOND EDITION

ROGER McCORMICK



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To Sophie and Lucy

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FOREWORD TO THE FIRST EDITION

Legal risk is a subject that has gained increasing attention from banks and other financial institutions over the past 15 years. Legal risk takes many forms but they may be broadly divided into two groups: transactional risk, where because of legal doubts or difficulties a financial institution may be exposed to liability on a dealing or be unable to enforce a contract or security; and regulatory risk, which exposes the institution to restrictions, penalties, or criminal sanctions for breach of regulatory rules that may be complex or unclear. Central to both forms of risk is uncertainty: uncertainty as to the way a transaction will be characterized or as to whether a particular mode of business is or is not legally permissible or as to the law to be applied to determine the rights and duties of the parties. The perceived predictability of English law and, more particularly, of decision-making by English judges, is one of the reasons why English law is so regularly selected as the governing law in transactions which have little or no connection with this country. Yet every now and then uncertainty is created by new instruments or by unexpected judicial decisions, of which the most regrettable was that of the House of Lords in *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1, overturning an eminently sensible and realistic ruling by the Court of Appeal.

This new book by Roger McCormick provides a clear and up-to-date analysis of the nature of legal risk, the different forms it can take, the various initiatives that have been taken to identify and manage legal risk, and the lawyers' responsibility for risk management. As co-chair of the International Bar Association's Working Party on Legal Risk, Roger McCormick is particularly well placed to offer guidance on this complex topic and his measured approach and lightness of touch combine to make this book not only informative but a good read. Characterization deservedly receives a good deal of his attention, whether it relates to set-off (as in the *British Eagle* case), the distinction between a sale and a security interest (as in the *Welsh Development Agency* case), or between a fixed and a floating charge (as in *Spectrum*), the legal effect of a charge-back (as in *Re Charge Card Services Ltd*, and the subsequent *BCCI* case), or the nature of an investor's interest in securities held through an account with an intermediary. The last part of the book focuses on the management of legal risk, including the role of legal opinions and the range of issues which a well-drawn opinion can be expected to cover in relation to financial transactions, with particular reference to the legal efficacy of close-out netting agreements.

Foreword

I have no doubt that this new book will be widely welcomed by the practising profession as well as by scholars having an interest in this field. It is impossible for those engaged in business to avoid legal risk; the best that can be done is to take reasonable steps to manage it. *Legal Risk in the Financial Markets* shows how this might be done.

Roy Goode
Oxford
August 2005

PREFACE TO THE FIRST EDITION

This book has been brewing for some time. The idea of writing it was first put to me while I was still in full-time legal practice. Naturally, I gave it very serious consideration; it seemed to have some merit, fitting well with my areas of professional interest. So I did absolutely nothing about it for the best part of a year. I did not get around to putting pen to paper with any serious intent until the period of transition (for me) had started, which now finds me largely (but not entirely) free of commitments to clients and engaged much more in academic activities.

At first, I was far from certain that legal risk (and our perception of it) was anything more than the manifestation of an ephemeral preoccupation that had been spawned by modern society's fear and dread of risk of any kind. Our obsession with risk seems to go hand-in-hand with the so-called compensation culture (and its close companion, the blame culture) that dominates public life, at least as it is reported, day in and day out, by the 24-hour news 'media'. This scepticism is still with me up to a point, and is partly reflected in the book. However, I did (as the production of this book shows) eventually come to the conclusion that there is in fact a relatively modern phenomenon—represented by the notion of legal risk—that is likely to be with us for the foreseeable future and merits some attempt at analysis and comment. I decided to take the plunge.

The writing of the book took place, for the most part, between October 2004 and August 2005. Much of the data extracted from media commentary originates in that period. However, legal risk does have a 'history' and the first part of the book therefore looks at how the idea first came to be a talking point in the financial markets and how it led, in time, to the formation of the Legal Risk Review Committee. An account (which happens to be closely linked to my own experience as a practitioner) is also provided of the development, through case law and legislation, of the issues (which, in my view, comprise some of the most interesting legal issues that have confronted City lawyers in the past 20 years) that were of primary concern at the time legal risk first surfaced and was perceived to be something to be taken seriously. The later parts of the book are concerned with what legal risk is now thought to signify, where the pressure points are currently felt most keenly, and, inevitably, how we might set about managing the various aspects of legal risk. The net result is something that is partly a law book, partly social commentary, and partly a guide to risk management.

Any period of transition involves doubts and uncertainties and the time of my own move away from City legal practice proved to be no exception. This book would not have been written without the support and encouragement of a great many friends and colleagues. It is not possible to name them all. However, the following (no doubt to their great embarrassment) deserve special mention for the assistance (which took many forms) they have given me along the way: Hugh Pigott, Joanna Benjamin, Michael Crystal QC, Colin Bamford, Paul Watchman, Hugh Bryant, Philip Wood, Nigel Asprey, William Elliott, Adrian Marsh, Martin Thomas, Mark Harding, Penny Curtis, Bill Parker, Alan Redfern, Ian Hewitt, Guy Morton, Peter Bloxham, Richard Drummond, Michael Allen, Sebastian Hofert, John Thirlwell, Mark Johnson, Mike Power, Andrew Whittaker, Richard Rosenfeld, Gavin Watson, and John Heath. They are not, of course, to be blamed for any of the content!

I would also like to thank Grant Sullivan for his unfailing and timely help with my computer, which on more than one occasion pushed me to the brink of nervous breakdown. (Can't live with it; can't live without it.)

Finally, and most important of all, my eternal gratitude goes to my wife, Sophie, and my daughter, Lucy, for their patience and understanding, as well as a good deal of very practical help and advice. Without them, none of this would have seen the light of day.

The law and general position is stated as at 31 August 2005.

Roger McCormick
31 August 2005

PREFACE TO THE SECOND EDITION

When I finished writing the first edition of this book, in August 2005, it did not occur to me that it might lend itself to successive editions. The global financial crisis changed all that! The temptation to look again at the issues raised by legal risk against the backdrop of entirely new scenarios presented by the Crisis proved irresistible. The Crisis has not been a pleasant experience for anyone but it has provided a rich new context against which issues can be analysed.

The second edition has also provided an opportunity to explore in greater depth various issues associated with globalization, the environment and sustainability that I did not feel able to cover adequately in the first edition. These are enormously important, of course, and many commentators, more learned than I, have already had much to say about them. I hope that I have been able to present them in a slightly different, legal risk-focused, light. They are of key importance in any assessment of the roles played by banks in modern society and the responsibilities that attach to those roles.

Thanks are due to many friends and colleagues who have provided support and encouragement. It is impractical to name them all and unfair to single out just a few by name. I would like to thank all those who have supported my Law and Financial Markets Project at London School of Economics, whether financially or by contributing to our sessions (or both!). Also, a big thank you to those who have helped on the LSE course that is based on this book—and to my long-suffering students, many of whom have offered insights that have helped give my ideas some shape. Last but certainly not least, thank you to my wife, Sophie, for putting up with me as I have selfishly disappeared into my study on a regular basis in my efforts to bring this book to life. Her patience, understanding, and encouragement have kept me going.

As the deadline for finishing the book approached, I became conscious of how many times I had to use the phrase ‘at the time of writing’ in the text, knowing that things were likely to change even before the book was printed. Like the first edition, the book is partly about law and partly about its social context. More than ever, that context seems to be a fast-moving picture as society reassesses what is expected of banks and financial markets. I have, perhaps too boldly, described the Crisis as something that came to an end last year. I hope I was right about that—even though

it is clear, as doubts about certain sovereign credit risks (and bank exposure to them) persist, that we are by no means out of the woods just yet.

I finished writing this in May 2010.¹ I have tried to set out the position as at that date.

Roger McCormick
Esher
31 May 2010

¹ *Post scriptum*. I feel I have to mention that, a few days after the above was written, in his Mansion House Speech of 16 June 2010, the Chancellor of the Exchequer, George Osborne, announced that, after a transition period, the Financial Services Authority would 'cease to exist in its current form' and that a new 'prudential regulator' would be created, operating as a subsidiary of the Bank of England. The changes are to be completed in 2012. Over time, many of the references in this book to the FSA will therefore become outdated (as will the references to how the 'tripartite system' works, eg, under the Banking Act 2009) although it remains to be seen to what extent the substance of relevant rules and practice will change.

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