

HUDSON

THE LAW OF FINANCE

FIRST EDITION

ALASTAIR HUDSON



SWEET & MAXWELL

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First Edition

by

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PREFACE

Creating the law of finance

The aim of this book is to create a comprehensive account of the law of finance which marries a discussion of the most significant substantive law principles in England and Wales with the principles of financial regulation in the UK which have been implemented by the Financial Services Authority (further to the Financial Services and Markets Act 2000 and a number of EC directives). This book provides a comprehensive analysis of the law of finance which can be taught and understood as a discrete legal field, as opposed simply to presenting a description of documentation practices or an account of regulatory principles. The book is divided in half between “General Principles” of the law of finance and “Specific Financial Techniques” which applies those principles to particular kinds of market activity. The effect is a combined analysis of fundamental legal concepts with the detail of financial regulation and of the structure of financial products.

This book is the product of my work in the law of finance in a variety of contexts: in particular three books for finance law practitioners and scholars on *The Law of Financial Derivatives*, *The Law on Investment Entities*, and *Securities Law*; treatises on general areas of English law including *The Law of Trusts* and *Equity & Trusts*; a variety of essays and conference papers, culminating in publications such as *Credit Derivatives*, *Modern Financial Techniques*, *Derivatives and Law*, and *New Perspectives on Property Law, Obligations and Restitution*; and contributions over many years to *Palmer's Company Law*.

One of the great concerns among people—practitioners, publishers, scholars—to whom I have spoken over the years about writing books in the finance law field has been the perceived difficulty of describing a “moving target”, in that financial innovation and financial markets are constantly in flux and consequently that these markets are thought by some to be impossible to describe. I have never agreed. It is of course true that the products used in financial practice have changed rapidly in recent years—particularly with the development of financial derivatives and securitisation—and that financial theory has consequently undergone many changes too. However, the fundamental principles of the substantive law have not changed. When a lawyer is analysing a financial transaction, her tools have

remained much the same: contract, tort, property, criminal law and so forth have remained within predictable boundaries, even if the practice of finance has not. Indeed the financial crisis of 2008 can be understood in part as a failure to understand the underpinnings of financial products as being built on simple foundations which do not change. Assuming that finance is too complex to describe means that we are more likely to overlook simple errors: such as lending money to people who cannot pay it back. That crisis is discussed in Chapter 32.

Most of the developments in finance law in recent years have been caused by legislative change—particularly in relation to EC financial services directives, and the Financial Services and Markets Act 2000 and its subordinate legislation—and by the concomitant development of financial regulation at the national and at the international levels. Consequently, the principal intellectual goal of this book is to present an understanding of how the context of financial regulation and substantive legal concepts combine to constitute a comprehensive “law of finance”.

Companion website: podcasts, supplementary text, teaching materials, updates and case notes

This book functions in a very different way from any other book in publication at this time (except for my *Equity & Trusts*). The book is supported by a free-to-view website—<http://www.alastairhudson.com>—which supports all of my books with podcasts, updates on cases and legislative developments, inter-active on-line links, detailed research essays and also essays on introductory material.

In relation to this book specifically, it contains *podcasts* covering the core elements of a finance law course and discussing key issues in finance law. On that website are a series of “Author’s Cuts” of my books which extend beyond the material which it was possible to include in this book. The law of finance is a potentially enormous subject and therefore this book cannot contain every item of detail relating to it. So, my website will supplement this core text with a large amount of further material and text. In the “finance law” area of my website are *course documents* and supporting podcasts for law of finance courses as I would suggest teaching them both to undergraduates and to postgraduates; that material is intended to encourage the teaching, discussion and dissemination of this subject to a broader audience than has been possible up to now. The podcasts comprise a series of brief explanations of finance law terminology and short, *summary lectures* covering the whole of a university finance law course. The underlying aims of this book are to facilitate the teaching of the law of finance at university and to help to educate any other professional who wants an explanation or a refresher in the law of finance. The finance area of my website also includes *links* to other useful websites, and links directly to regulatory material. The website will grow over time and will cater for new developments and for material which it was not possible to consider in this book in detail. That website will also include *videcasts* soon. Consequently, this book is more than just a book.

How to read this book

I have written this book both as a book which can be read from beginning to end as a single, coherent text, and also as a reference work which can be dipped in and out of as the reader requires. If you are studying the law of finance, I suggest you approach reading it in the following way. Each chapter begins with a summary of the core principles which are contained in that chapter, and then the chapter demonstrates how those principles arise in detail in the law of finance; use those core principles as a map through the detail, together with the online podcasts. The text combines clear definitions of the legal concepts and of the financial products with easy-to-understand examples of those legal principles being put to work.

I have divided this book in half: *Section One: General Principles* sets out the principles on which financial regulation and finance law operates in the UK, and *Section Two: Specific Financial Techniques* puts those general principles to work in relation to particular financial markets. So, instead of repeating the same basic information in relation to different products, such as the structure of master agreements or the most effective means of taking security in financial transactions, *Section One* centralises the discussions of the core legal and regulatory concepts before *Section Two* puts them to work in context. For most students, and nearly all practitioners, the core legal principles will be familiar (issues of contract, tort, property and criminal law), but their application to finance and the principles of financial regulation may not be. Nevertheless, familiarity with those core legal concepts should make the study of finance law less forbidding than otherwise it might be. My aim is to consider finance law from a lawyer's perspective, using language and concepts which are familiar to lawyers, and not to begin with the mysteries and idiosyncrasies of finance theory.

Beginning with a statement of principle, laying out the core concepts and then demonstrating how those concepts apply in context, is a teaching technique which I have always employed and which I dub "cognitive reinforcement". By starting with familiar legal concepts and fusing them together with financial regulatory concepts, the reader can understand the basis of finance law more easily. Undoubtedly the integrity of our economies and of our financial systems will benefit from a clearer understanding among lawyers, students and teachers of how the law of finance functions. So each chapter begins with a simple statement of the concepts and then moves into the detail: *Section One* of this book sets out the core material before *Section Two* applies those concepts to the detail of particular financial techniques and products. To help the student reader (and possibly the practitioner too) I have included a number of podcasts explaining the key principles from each chapter on my website, as explained above.

Glossary

This book contains a short glossary of useful market expressions and terminology as it is used in this book. My website contains a much larger glossary than was possible to include in this book, incorporating a more

thematic discussion of the terms which are defined in that glossary. The glossary in this book defines and explains the main products and jargon terms which the newcomer will encounter—of course, where those terms arise in the text they are discussed in detail. The online glossary explains more the financial-theoretical background to the terms discussed in the glossary in this book.

The writing of this book

This book has taken a number of years to develop in my mind and was written over a long period of time. It builds on, develops and occasionally adapts and incorporates work from my earlier books—*The Law on Financial Derivatives*; *Securities Law*; *Equity & Trusts*; *The Law on Investment Entities*; *Swaps, Restitution and Trusts*; and numerous essays and articles. However, the bulk of the writing which generated the book which you hold in your hands was undertaken during the spring and summer of 2008; updates were able to be made up to Christmas 2008, and some at proof stage in March 2009. The law and regulation is as it seemed to me from the materials available to me during that period. In each chapter I give the appropriate reference to the appropriate version of regulatory or other material. It was possible to include a discussion of the first Banking Act of 2009 at the eleventh hour. I would like to thank my family, my friends at Queen Mary University of London, and the team at Sweet & Maxwell for their support during the writing of this book (especially Nicola Thurlow and Hannah Turner); and in particular I would like to thank my colleague of many years, Rebecca Howe, whose help during the writing of this book has been quite literally invaluable.

Studying the law of finance

The suggested method for reading this book and for studying this subject is as follows. First, see the themes set out in Parts I and II of this book as setting the scene and explaining the role which the law and regulation play in financial markets. Second, see the principles of financial regulation discussed in Part III and the principles of the substantive law and legal practice discussed in Parts IV through VIII as forming the bedrock of concepts on which the law of finance is built. Third, see the analysis of the various different forms of financial services, the specific legal issues which they raise, the regulation which covers them specifically, and the way in which they are documented as constituting the various contexts in which those bedrock principles are applied. Come to know the law and the detail of the regulation before seeing how it applies to particular markets.

The role of the law of finance

The law of finance is in its infancy. This book attempts to describe it, to lay bare its core principles and to map it out. As lawyers creating the law of

finance we must understand and know the bedrock of the law before we consider how it informs the river of financial activity which washes over it every minute of every day. Our business at the start of the 21st century is to create the law of finance and to understand how it fits together before allowing ourselves to be buffeted by the exigencies and demands of financial practice. The depth of the crisis that engulfed the world's financial system in 2008 demonstrates that the law of finance must be a code of legal principle first and a tool for financiers second. The law and financial regulation must control the excesses of financial practice and it must provide safety nets for banks, customers and the broader economy alike. Consequently, when describing the law of finance we must do so using established legal concepts and legal models instead of using financier's fluctuating models to create models into which we attempt to shoe-horn legal concepts. Even though financial market innovation appears to be creating new structures time and time again, in fact much of the innovation is the adaptation of well-known ideas for a new purpose: for example, securitisations are effectively the same as old-fashioned debt factoring, equity options are at root the same as old-fashioned options to buy land, and so on. The established legal concepts of contract, property, equity, tort, criminal law and so forth are able to meet the challenge of describing financial markets. Financial innovation is not something impossible for lawyers to understand: any suggestion to the contrary is either hubris or cowardice.

For any lawyer, the law is the bedrock; financial practice washes over it. Of course, each influences and shapes the other. The river's course is shaped by the rock, and in turn the shape of that rock is moulded and smoothed by torrent that flows past it. But the bedrock remains.

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ABBREVIATIONS

<i>Equity & Trusts</i>	Alastair Hudson, <i>Equity & Trusts</i> , 6th edn (Routledge-Cavendish, 2009)
<i>Securities Law</i>	Alastair Hudson, <i>Securities Law</i> , 1st edn (London: Sweet & Maxwell, 2008)
<i>Financial Derivatives</i>	Alastair Hudson, <i>The Law on Financial Derivatives</i> , 4th edn (London: Sweet & Maxwell, 2006)
<i>Investment Entities</i>	Alastair Hudson, <i>The Law on Investment Entities</i> (London: Sweet & Maxwell, 2000)
<i>Swaps, Restitution and Trusts</i>	Alastair Hudson, <i>Swaps, Restitution and Trusts</i> (London: Sweet & Maxwell, 1999)
<i>Modern Financial Techniques</i>	Alastair Hudson (ed.), <i>Modern Financial Techniques, Derivatives and Law</i> (Kluwer, 1999)
<i>Credit Derivatives</i>	Alastair Hudson (ed.), <i>Credit Derivatives: law, regulation and accounting issues</i> (London: Sweet & Maxwell, 1999)
<i>Law of Trusts</i>	Geraint Thomas and Alastair Hudson, <i>The Law of Trusts</i> , 2nd edn (OUP, 2009)
<i>Capital Issues</i>	Alastair Hudson, “Capital Issues” in G. Morse <i>Palmer’s Company Law</i> (London: Sweet & Maxwell)
<i>Open-ended Investment Companies</i>	Alastair Hudson, “Open-ended Investment Companies” in G. Morse <i>Palmer’s Company Law</i> (London: Sweet & Maxwell)

INTRODUCTION

AT THE ROOTS

The purpose of this *Introduction* is to provide a map through the law of finance as it is presented in this book. It is much easier to understand how the law of finance functions if we first have some overarching understanding of how its principles operate and how they knit together. In particular it is important to understand the many different sources of the law of finance so that it is possible to understand how they will interact. 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.

The criminal law interacts with financial regulation in many contexts, for example to prevent market abuse,¹ money laundering² and insider dealing,³ where one involves formal legal prosecution and the other involves merely civil penalties being imposed by a regulator.⁴ Similarly, private law may impose liabilities to pay damages,⁵ or may recognise rights in property,⁶ or may enforce the performance of contractual obligations;⁷ all of which are dependent upon formal litigation and the use of centuries-old legal principles. By contrast, statute also provides rights to compensation which operate sometimes in parallel to private law and sometimes in place of private law.⁸ There is also the very important international dimension to financial law whereby regulators in other jurisdictions and other systems of law may be important in resolving disputes.⁹ There is then also the very important role played by financial regulation in the operation of financial

¹ See para.12–01.

² See para.15–01.

³ See para.14–01.

⁴ See para.9–01.

⁵ See para.20–01.

⁶ See para.23–01.

⁷ See para.20–01.

⁸ e.g. Financial Services and Markets Act 2000 s.90 and s.90A respectively.

⁹ See para.6–01.

markets, entirely outside any role played by the ordinary law.¹⁰ From this very brief overview, we can see that there is a complex web of legal, non-legal, and quasi-legal rules at play. The early chapters of this book outline these various forms of law; this *Introduction* presents them to you briefly.

SOURCES OF THE LAW OF FINANCE

The components of the law of finance

The law of finance is a combination of fundamental legal concepts taken from the general law which when combined with statutory principles and regulatory principles synthesise into a single system of law which is referred to in this book as “the law of finance”. The components of the law of finance are discussed in more detail in Chapter 1: what follows here is an introductory outline of them.

The substantive legal concepts considered in this book are drawn principally from the law of contract, the law of torts, the criminal law, the law of property, equity, and private international law. These principles are referred to in this book as “*substantive law*” and are drawn, for the purposes of this book, from the laws of England and Wales, unless otherwise stated.

The statutory principles considered in this book are drawn either from EC directives and other European Union legislation (which has been implemented into the law of finance in the UK by means of principal or subordinate legislation enacted by the UK Parliament), or else by ordinary legislation enacted by the UK Parliament which is not predicated on EU legislation. The principal Act in this context in this jurisdiction is the Financial Services and Markets Act 2000 (“FSMA 2000”).

The regulatory principles considered in this book are the principles created by the Financial Services Authority (“FSA”) which is the principal regulator for financial services activity in the UK in a number of different contexts, as is discussed in Part III of this book. The FSA draws its powers from FSMA 2000, which in turn implements in this context a number of principles contained in EC directives.

We shall refer to “the UK” as the relevant jurisdiction for statutory and for regulatory purposes because, further to European Union (“EU”) law, it is the United Kingdom (“the UK”) which is a Member State of the EU, and in turn the UK which is required to implement the principles of EU law relating to financial services generally, and to securities and other markets in particular. Therefore, the principles which are implemented by the UK further to EU law apply to the whole of the UK as a single jurisdiction for the purposes of finance law. This is true of company law under the Companies Act 2006, and is also true of tax law. However, for the purposes of substantive law, the relevant jurisdiction remains for most other purposes

¹⁰ See para.3–01.

“England and Wales” and it is to the decisions of the courts of England and Wales that we shall have reference in this book.

Concepts and contexts

The aim of this book is to create a comprehensive account of the law of finance which marries a discussion of the most significant, substantive law principles in England and Wales with the regulation of financial services activity in the UK by the FSA. There are books which seek to explain a narrow range of legal issues which are thought to face finance lawyers in practice, there is a series of books which seeks to describe the principal documentation and regulatory issues facing finance practitioners, and there are a lot of “handbooks” and collections of essays which ruminate about the challenges facing practitioners in easy-to-follow bullet-pointed lists. The first type of book, however, does not seek to present an understanding of how all of the fundamental concepts in the existing law should be understood in the context of finance; the second tends to avoid referring to any or to many substantive legal authorities for its propositions, and certainly avoids a close analysis of any of them; and the third contains no discussion of any law at all, as though financial practice was an entirely closed area containing only those few issues which a consensus of practitioners deem worthy of discussion.

One of the great problems with writing a book about the law of finance is always said to be that one is describing a “moving target” because the pace of innovation means that financial markets are constantly in flux and consequently some people think those markets are impossible to describe. I have never agreed with that point of view. It is of course true that the products¹¹ used in financial practice have changed rapidly in recent years—particularly with the development of financial derivatives and securitisation—and that financial theory has consequently undergone many changes too. However, the fundamental principles of the substantive law have not changed, and the core principles on which most of these financial products are based have not changed from a lawyer’s perspective so much as all that. When a lawyer is analysing a financial transaction, her tools have remained much the same: contract, tort, property, criminal law and so forth have remained within predictable boundaries, even if finance theory has not. The principal area of development for the legal practitioner has been in legislative change—particularly in relation to EC financial services directives, and the FSMA 2000 and its subordinate legislation—and in the concomitant development of financial regulation at the national and at the international levels. Consequently, the principal intellectual goal of this book is to present an understanding of how the context of financial regulation and substantive legal concepts combine to constitute a comprehensive “law of finance”.

¹¹ Bankers like to use the term “product” to describe the financial instruments which they create. I would suggest that they like to use this word because it creates a reassuring image of a factory or a foundry creating solid, useful goods in the traditional manner of heavy industry, as opposed to intangible manipulation of mathematical and accounting concepts.

There are concepts at play in finance law which are not simply legal concepts. There are also concepts of financial theory—such as the repackaging of payment obligations by means of interest rate swaps, to take an example from derivatives theory—which alter the understanding of financial markets and the value of financial products. There are concepts of risk and of credit measurement which are very important in the transaction of financial products. Both of these concepts are fundamental to financial practitioners but they may be of only peripheral relevance to a legal analysis of a financial product: after all, a binding contractual obligation to deliver gold is a contractual obligation to deliver gold no matter how it is dressed up in financial pricing models and so forth; unless there is something about the transaction—such as undue influence by one party over the other bound up with the complexity of that financial model or a misrepresentation by one party to the other as to the effect of that financial model—in which case the legal analysis of the transaction may change. Therefore, there is a territory in which non-legal and legal concepts and contexts may overlap in the law of finance.

THE STRUCTURE OF THIS BOOK

This book divides between two sections of about 700 pages each. The first half, *Section One: General Principles*, synthesizes principles of financial regulation with principles of substantive law so as to generate the fundamental principles of the law of finance. The second half, *Section Two: Specific Financial Products*, analyses the principal forms of product in finance practice and shows how the fundamental principles of the law of finance will apply to them, what issues arise in particular in documenting or structuring particular products, and so forth. This book presents a close, scholarly analysis of the substantive law as well as descriptions of the financial products at issue: in that sense it goes beyond the typical thematic descriptions of financial markets which make up so much of the literature at present.

Section One: General Principles considers the context in which the law of finance operates under the Financial Services and Markets Act 2000. In particular it covers the powers and responsibilities of the Financial Services Authority (the “FSA”) under that Act and the key principles of UK financial regulation—covering authorisation to deal in financial services, conduct of business, financial promotion, and market abuse. *Section One* also considers the fundamental concepts of substantive English law which are significant in the law of finance: principally contract law, tort law, property law, criminal law and equity. Within the scope of contract law are issues as to the formation of contracts, the validity of contracts, the key terms in complex financial contracts inter alia permitting termination of such a contract (whether a loan agreement or a master agreement or