Financial Law

Unit 1 Introduction to Financial Law

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Unit Overview

Unit 1 aims to provide a broad overview of the financial system – in particular, the banking system and the capital markets. In doing so, we will examine the role and function of the banking system, analyse the importance of financial law in maintaining the economic system and present the basic components of the legal framework that underpins successful financial systems.

In discussing the importance of legal institutions for the smooth functioning of international financial markets and cross-border transactions, we shall argue that a sound framework of financial law must be complemented by a sound institutional framework under the rule of law, which includes efficient courts and judiciary, transparent and honest public administration and other market-building political and legal institutions.

Learning outcomes

When you have completed your study of this unit, you will be able to:

- critically evaluate the contribution of legal institutions in the creation of strong and vibrant financial markets
- identify the main components of the essential legal framework underpinning modern financial systems
- identify and discuss the main components of the financial system, particularly the British financial system
- assess the importance of the quality of a country's broader political and institutional framework for the development of an efficient, strong and honest financial market.

Reading for Unit 1

Benston GJ (2004) 'What's special about banks?'. *The Financial Review*, 39 (1), 13–33.

Ellinger EP, E Lomnicka and CVM Hare (2011) Chapters 1 'The structure of the British banking world' and 3 'Legal definitions and privileges of banks'. *Ellinger's Modern Banking Law*. 5th Edition. Oxford: Oxford University Press.

Woepking J (1999) 'International capital markets and their importance'. *Transnational Law and Contemporary Problems*, 9, 233–46.

Goodhart C (1997) 'Economics and the law: Too much one-way traffic?'. *Modern Law Review*, 60 (1), 1–22.

Rodrik D and A Subramanian (2003) 'The primacy of institutions'. *Finance and Development*, 40 (2), 31–34. Available from: http://www.imf.org/external/pubs/ft/fandd/2003/06/index.htm

Walker JL (2000) 'Building the legal and regulatory framework'. *Conference of the Federal Reserve Bank of Boston 'Building an Infrastructure*

for Financial Stability', June. Available from:
http://www.bostonfed.org/economic/conf/conf44/

1.1 Introduction

Unit 1 contains an introduction to financial law. It examines the basic legal foundations of financial systems and markets and conveys a key message:

- financial markets are built and operate on the premise of a sound legal and regulatory framework.

In this unit we shall also examine some of the constituents of the financial markets and of their participants.

The structure and primary function of the banking system will receive particular attention. Generally, financial markets and financial institutions comprise a country's financial system. The financial system is broadly the set of markets and institutions that are involved in moving savings from savers (households and firms) to borrowers, and in transferring, sharing and insuring risks. The financial system consists of several components, which include the banking system, the primary and secondary securities markets, insurance markets, the central bank and other financial supervisory authorities and the underlying infrastructure for the clearing and settlement of payments and trades in financial instruments. Much of this unit forms the basis for topics that we will cover in subsequent units.

1.2 The Banking System

Banks play a special and crucial role in all market economies and the banking system is probably the most important component of the financial system, whether national or international.

The banking system comprises the network of institutions responsible for providing banking services. This consists of two parts. First, there are the actual banks providing services to the general public; these may be universal banks, or specialist institutions dealing with particular types of banking business. These range from 'high street' banks, with numerous branches dealing with many small clients, to merchant banks specialising in financing capital market transactions or foreign trade. Second, there are higher-level institutions, which are not involved in direct contact with the general public. These are, *first*, the central banks, which act as bankers for other banks and the government, and are responsible for monetary policy and macroeconomic management of the monetary system; and *second* the supervisory authorities which supervise other banks and check their probity, liquidity and solvency, as is developed in more depth in the module *Regulation of International Capital Markets*.

Banks are special because banking is crucial for the functioning of market economies. The activity of banking includes the provision of payments facilities, credit and capital to individuals, firms and the government.

There are many different types of firms that may be described as banks. Typically, for example, a country would have a *central bank* like the Federal Reserve in the US or the Bank of England in the UK. *Commercial banks,* on the other hand, are in the classic business of banking in the sense outlined above. Commercial banks primarily accept the customers' deposits and lend money for their own account in view of profit. There are two other terms here – *retail banking* and *wholesale banking*. Retail banking refers to small-value banking services offered to the general public. Retail banks collect deposits from individuals and small businesses, and make loans to them. In both cases the sums concerned may be small. Retail banking is distinguished from wholesale banking, which concentrates on large-scale transactions with other financial institutions. Wholesale banking involves low volume and high value. It covers transactions between two banks in the inter-bank market or between banks and the central bank, other corporations, pension funds and other investment institutions.

You may also come across the term *merchant* or *investment* banking. *Merchant* banking is a classic UK term while *investment* banking is the US equivalent. Investment banks play a different role from commercial banks. They do not normally lend money directly but they assist their clients to find the necessary funds by organising securities offerings. They also deal for their own account or for the account of the customer in financial and derivative instruments in capital markets and provide investment advice for a fee.

It used to be the case that investment banking and commercial banking were separate lines of business, each carried out by different institutions. Institutions authorised to accept deposits were prohibited by law from engaging in investment banking activities. Similarly, investment bankers were prohibited by law from accepting deposits from the public. More recently, these rules have been relaxed in most countries of the world and the result has been the emergence of powerful all-encompassing financial institutions that engage in the full range of banking and financial activities – the so-called *universal banks*. Again, you will learn more about the regulatory separation between investment and commercial banking in the module *Regulation of International Capital Markets*.

For the general public, their experience of the banking system is often limited to the high street branch in which they keep their deposit accounts. From a legal point of view, a branch is not a separate legal entity. It is an integrated part of the 'legal person', although the English common law developed a number of rules that sought to separate the branches of a bank for specific purposes. Generally, however, branches are not separately incorporated entities.

In a narrow sense, however, the banking system would be considered to comprise those financial firms whose main or principal line of business is to accept deposits from the public. Commercial banks are the main types of depository institutions that further encompass the deposit-taking institutions outside the commercial banking sector, such as saving banks and cooperative banks. Deposit-taking institutions such as commercial banks accept deposits and, with the funds raised through deposits and other funding sources, both types make direct loans to various entities and invest in securities in the capital markets.

Readings 1.1 and 1.2

You should first read the paper by George Benston, 'What's Special About Banks?', where this author explains six aspects of how banks have been 'special' (although not unique) and then considers whether and to what extent these attributes are still relevant. These include efficiently produced products, importance for the development and growth of economies, international scope, role in economic instability and the conduct of monetary policy, early regulation by governments, and source of data for academic researchers and institutions. He argues that despite recent changes, banks continue to be special.

This article can be found by searching the Business Source Premier database, which is available on the Online Library via the VLE.

When you have finished Benston, read Chapter 1 and pp. 569–71, 588–89, 612–13 and 617–27 of Ellinger, Lomnicka and Hare (2011) *Ellinger's Modern Banking Law*, on the concept and functions of correspondent banking arrangements.

Benston (2004) 'What's special about banks?'. *The Financial Review*, 39 (1), 13–33.

Ellinger *et al* (2011) Chapter 1 'The structure of the British banking world' and extracts from Chapter 13 'The giro system and electronic transfer of funds' in *Ellinger's Modern Modern Banking Law.* pp. 3–25 and pp. 569–71, 588–89, 612–13 and 617–27.

Review Question 1.1

- What are the role and functions of banks in a market economy?
- What is the difference between 'commercial banking' and 'investment banking'?
- Distinguish between a 'branch', a 'representative office' and a 'banking group'.
- Which particular banking activity is probably the most essential contribution of the banking system in the smooth functioning of modern economies?

1.2.1 The legal definition of banking

This section looks at the legal definition of banks and at the special status of bank branches as well as the general role and functions of banks.

The traditional business of commercial banking involves two related types of activities: accepting deposits, and lending. Alongside those two key functions, banks customarily provide a range of other services and facilities. Recently, the predominantly German model of 'universal banking' has spread around the world and influenced the development of national banking systems in Europe and elsewhere. A 'universal bank' is a bank that accepts deposits and lends money, but it also carries out a large range of financial activities, including investment services, property services and insurance services.

Of course, the law does not evolve with the same speed as the market that it seeks to regulate. Hence, the legal definition of banking in English common law does not necessarily encompass the full range of activities that a major branch of a bank in central London is likely to offer.

The most authoritative definition of banking is probably offered by the ruling of the Court of Appeal in *United Dominion Trust Ltd v. Kirkwood* (1966) 2QB 431 (CA), where it was held that banks accept money from their customers in the form of deposits and they collect cheques on their behalf, placing those cheques to the customer's credit. Further, banks must honour the cheques or orders-to-pay drawn on them by their customers. Those two functions carry with them a third one – to carry out their operations, banks maintain current accounts for their customers where they keep a record of the money debited and credited to the customers' accounts.

The common law definition of banking does not have wide legal implications. Normally, whether a particular firm is a 'bank' or not matters only to a limited extent. In particular, there are cases where a financial institution is afforded a specific right or obligation under the law only if it is considered to be a 'bank' in a legal sense. Hence, different pieces of legislation applicable to the banking business may define the concept of 'bank' differently, but these definitions really apply only within the context of the specific legislative instrument.

Although most financial institutions which accept deposits and grant loans are 'banks' for the purposes of law and regulation, it is still conceivable that for specific legal purposes (*eg* taxation, or the rights of the customer or financial regulation), a certain financial institution may be considered to be a 'bank' in some legal context and a 'non-bank' in another legal context. You will see in Ellinger *et al* (2011) how what constitutes 'a bank' is defined differently in common law, in statutory legislation or for the purposes of international or European law.

Reading 1.3

You should now go to Ellinger, Lomnicka and Hare (2011) *Ellinger's Modern Banking Law*, and read Chapter 3 'Legal definitions and privileges of banks', pages 79–86.

Ellinger *et al* (2011) Chapter 3 'Legal definitions and privileges of banks' in *Ellinger's Modern Banking Law*. pp. 79–86.

Review Question 1.2

- How is banking legally defined in English common law?

1.3 Capital Markets

Capital markets are markets in which long-term funds are raised by industry and commerce, the government and local authorities. The money comes from private investors, insurance companies, pension funds and banks, and its administration is usually arranged by issuing houses and by merchant or investment banks. Organised stock exchanges such as the New York Stock Exchange or the London Stock Exchange and other

alternative trading systems are also part of the capital market in that they provide a market for the shares and loan stocks that represent the capital once it has been raised. It is the presence and sophistication of their capital markets that distinguishes the industrial countries from developing countries, in that this facility for raising industrial and commercial capital is either absent or rudimentary in the latter.

The securities issued, sold and bought include both shares in companies and various forms of private and public debt. The capital market allows firms, governments and countries to finance spending in excess of their current incomes. It also enables individuals, firms and countries to lend to others savings they cannot employ as profitably themselves. Some transactions in capital markets involve the sale of newly issued shares and debt instruments, but the vast majority occur in secondary markets (organised stock exchanges and other trading systems) where existing shares and debt instruments change ownership.

1.3.1 Primary and secondary markets

When a government, company or local authority wishes to raise some extra cash in the capital markets to pay for a new project or serve existing financial commitments, the fund-raising will take place in the so-called *primary markets*. Primary markets are the markets into which a new issue of bonds, or any other form of medium- or long-term money-market paper, is launched. The securities – whether shares or bonds – will be issued to the investors for the first time and the money raised will go to the undertaking issuing the securities.

Once securities have been issued they are subsequently traded as claims to ownership on secondary markets. The secondary capital markets are markets in which existing securities are traded, as opposed to a *primary market*, in which securities are sold for the first time. In most cases a stock exchange largely fulfils the role of a secondary market, with the flotation of new issues of securities to the investors representing only a small proportion of its total business. However, it is the existence of a flourishing secondary market, providing liquidity and the spreading of risks, that creates the conditions for a healthy primary market. The best-known examples of secondary markets are stock markets or exchanges where equities are traded.

1.3.2 The role of banks in capital markets

Clearly, one may argue that banks and capital markets are antagonistic institutions. After all, a firm wishing to raise funds will either go to the bank and get a loan or go to the capital markets and receive funds from potential investors in exchange of equity or debt securities. It is therefore obvious that an increase in the share of capital markets in the financial system is followed by a commensurate decline of the share of bank lending in the financial system. A new issue of securities to the public is a lost opportunity for a bank loan to the firm. This competitive relationship

between banks and capital markets has not, however, resulted in the complete separation of the two subjects in legal literature. To the contrary, the ongoing decline of bank lending as a proportion of the overall provision of finance has prompted banks to explore other business opportunities and steadily engage in fee-generating activities in capital markets. Hence, rather than banking and capital markets being two separate issues, the role of banks *in capital markets* has become increasingly important as banks more and more broaden their securities and capital markets activities.

Thus, when commercial banks cannot grant a loan because the borrower has decided to borrow directly from the potential lenders and investors in capital markets, there is always an opportunity for the commercial bank or the investment-banking subsidiary of the commercial bank to earn some fees. Generally, commercial banks, which accept deposits and grant loans, are involved in securities markets directly (when the national legal system does not prohibit the notion of universal banking) or indirectly (through a subsidiary or affiliated investment bank).

In the primary markets, banks in some countries are permitted to underwrite security issues either directly or through subsidiaries. Even where this is not permitted, underwriters will often turn to banks for credit in order to finance their activities. In the secondary market, similar considerations apply. A commercial bank may simply apply for a regulatory license to provide broker-dealer services to its clients, purchasing financial instruments on the customers' behalf. More frequently, a deposit-taking bank will be affiliated to a financial institution engaging in securities activities, including broker-dealer services, investment advice, portfolio management or individual wealth planning and private banking services.

Further, investment bankers and brokers will, on occasion, need to accumulate large amounts of stock in order to satisfy a block purchase and high customer demand, for which they may need short-term credit from a commercial bank in the inter-bank market. Dealers demand credit in order to finance their proprietary positions and to facilitate the buying and selling required of them in their role as market makers. Most financial institutions involved in capital markets normally need access to bank lines of credit to manage settlement delays or failures.

1.3.3 Types of securities

Capital can be classified in various ways but the most important legal distinction is between equity and debt capital and, accordingly, equity and debt securities. Equity capital represents the sharing of the commercial risk. Contributors of equity capital (*ie* the company's shareholders) have rights and obligations as the company's members. The most common form of equity securities is common shares or stock, but there are many different types depending on the rights and obligations attached to different kinds of instrument.

The commonest form of debt is, of course, a bank loan. Debt finance in general involves a promise on the part of the company to repay the money plus interest in the future in exchange for the release of the funds. Debt capital is used to finance an organisation that is subject to payment of interest over the life of the loan, at the end of which the loan is normally repaid.

The legal implications of debt and equity finance are strikingly different. The shareholder is part owner of the company along with the other shareholders. He or she makes money by selling the shares at a higher price than the price originally paid for them. As the owner of the company, the shareholder is set to gain from future profits in the form of dividends but he or she is the ultimate bearer of commercial risk. Should the company fail, shareholders are the last in the long queue of those waiting to be paid from the company's assets. In the event of insolvency, they normally receive nothing. Debt holders, on the other hand, are mere creditors. Their expectations are normally fixed. They will receive the original capital plus interest but they will not enjoy the huge benefits of exceptional corporate performance in the future.

In capital markets, debt capital can take a number of forms. A company may issue debt securities such as bonds, notes, certificates of deposit, debentures, commercial paper and so on. Despite the variations, the fundamental legal character of a debt instrument represents the simplest form of obligation in English financial law (*ie* debt, or the promise of the issuer to repay the amount of the instrument with interest). More on this subject will be discussed in Unit 5, which deals with financial instruments in a more systematic and specific manner.

Reading 1.4

You should now study the paper by James Woepking, 'International capital markets and their importance', making sure that your notes enable you to answer the review questions below.

Woepking (1999) 'International capital markets and their importance'. *Transnational Law and Contemporary Problems*, 9, 233–46.

Review Question 1.3

- What is the role and function of primary capital markets?
- What is the role and function of secondary capital markets?
- What is the role of banks in capital markets?
- What is 'universal banking' and how is it different from commercial banking?

1.4 The Importance of Law for Financial Markets

Financial markets rely on legal institutions. Law and regulation ensure that financial transactions are carried out within a clear, predictable and enforceable legal framework.

Economists have long stressed the importance of institutions for the well-functioning of market economies. Economists, of course, write about

'institutions', but what they primarily mean is law. Most notably, the Nobel Laureate Douglas North has stressed the important role that legal norms and institutions play in the functioning of markets. North defines institutions as the formal and informal rules governing human interactions:

> Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction […]. That institutions affect the performance of economies is hardly controversial. That the differential performance of economies over time is fundamentally influenced by the way institutions evolve is also not controversial.
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> Source: North (1990)

It is now clear that whatever the level of supply or demand for goods, services or capital, markets cannot function unless a sound legal system and a stable political order exist that provide security and stability, enforce contracts, protect property rights, carry out mortgage agreements, facilitate the association of many individuals to a common commercial purpose, safeguard impartial access to courts and generally provide a legal framework which penalises those who cheat, lie, steal or try to defraud others.

Markets require more than the provision of physical facilities in which buying and selling can take place. They require trust that any promises made are kept. They rely on legal and political institutions that enhance trust in the stability and workability of the market.

It is not difficult to see the link between legal institutions and the creation of vibrant and stable financial markets. Financial markets are markets where financial assets change hands. The thrust of any financial asset is a promise to pay money in the future in exchange for payment at present or a corresponding obligation to pay money in the future:

- In a bank loan, the bank pays now in return for a promise that the borrower will pay in the future.
- In insurance contracts, the policyholder pays now in return for a promise that the insurance company will pay in the future if that accident were to happen.
- In equity investments (*ie* investments in company shares), the investor pays now in return for a promise that he or she has a share in the current and future value of the company and potential future profits and that his or her share is marketable at any given time.

It is not difficult to see the fragility of those promises and necessarily the fragility of the relationships underlying financial markets. Some people cheat and lie. Others have no intention of keeping their promises. Some people forget and most people are not always capable of discharging the promised obligations even if they honestly intend to. Records are lost and promises once given are forgotten. All people die. Few people whole-

heartedly trust what they are told. Most people, particularly bankers, want some sort of assurances that promises will be kept.

Unless law recognises and protects promises, financial intermediaries such as banks and investors will only provide funds on the basis of personal experience and trust, normally confined to close friends, family, political and business acquaintances and very wealthy people who can reassure others that they will pay back. The entire financial system would collapse under the uncertainty caused in the absence of legal institutions. Poor people do not tend to have wealthy friends and therefore financial markets operating on the basis of personal connections are grossly unfair for ordinary people. They raise barriers to finance opportunities.

Consider the most basic financial asset – the bank deposit. Have you ever thought about it? Most people have a bank account. They have their salaries paid by way of direct deposits into that account. It is the most mundane of all financial assets.

Now think again. Everybody considers bank deposits as their own money. You draw a cheque or use a service card and your bank balance is used for payment in exchange for goods and services. You place your card in a hole in the wall and you get that nice feeling of cash in your hands. But have you ever thought that your precious bank balance does not represent your money?

Yes, that's right. Bank deposits are not your money. They are the bank's money, to do with as the bank pleases in all respects.

Bank deposits are in law, in all countries of the world, a mere debt owed to you by the bank. It is not your money. It is the bank's money, which the bank has promised to deliver to you or to any other person designated by you if you ask. But it is certainly not your money. If the bank went out of business tomorrow morning, as happened in Argentina a few years ago and in the US during the 1930s, you would have an unsecured claim against the bank to be repaid. But nothing more than a mere promise, which is worthless when no money is left in the kitty. Now try to explain why you place one of your most importance assets, cash, in the hands of the bank in return for a mere promise to be repaid in the future.

It is simple: trust and confidence. The reason why people are content that this intangible promise is 'good money' is trust. People have trust in the banking system. They trust that state-sponsored networks and legal relationships add value to that promise. People know that the bank will pay if asked or, otherwise, the operation of the law and the intervention of other institutions such as the central bank and supervisory authorities will result in the swift satisfaction of the debt. It is their trust in legal and political institutions that induces individuals to place their money into the bank in return for a mere promise to be repaid later.

Similar legal institutions assure investors that it is safe to place their money into companies of which they have no personal perception. Few

people have personal views on the skills and abilities of the managers of companies in which they have invested. They rely on legal institutions that organise the markets for corporate stock so that only decent entrepreneurs may have access in those markets and compete for the attention of potential investors. Legal institutions provide assurances that liars and cheats are expelled from the market and punished. Legal institutions oblige companies to publish their accounts, to inform the public about their business, their successes and their failures, the levels of their debt and their future prospects. Investors are normally concerned with the fluctuations of the share price because they assume that law and enforcement authorities are providing the basic fundamental assurances. Without legal certainty in the obligations and rights of the parties under the rule of law, investing in somebody else's future makes no sense at all.

And then there is distance. Study after study has shown that when legal foundations are lacking, trading occurs in spot markets where people trade face-to-face. This is reasonable. People tend to know those living and trading in their physical proximity. They have their own views on the honesty and integrity of their friends and local businessmen. Law is not a primary consideration in spot markets such as the corner shop and the newsstand outside the local train station. You know what to expect from the local grocer. If the product disappoints you, you may return it. The shopkeeper will normally replace it out of dignity or a sense of good commercial practice. It is unlikely that you will invoke the Consumer Protection Act 1987 to enforce your own perception of justice. Personal contacts operate just fine.

Now consider contracts at a distance. Consider the purchase or sale of a company in another country, perhaps on another continent, or the supply of a loan to a company operating overseas. There are many examples in the financial press. In those markets operating at a distance, this sense of reassurance in personal relationships is lacking and this absence of personal contact and physical proximity create a shortage of trust which must be filled by the parties' confidence in the quality of the legal framework (perhaps in combination with high benefits of the project which render high legal risks worth taking). It is unlikely that you would deposit money in an offshore bank where the legal framework provides no assurances that the money will be returned.

Conversely, a sensible banker would never invest in an overseas market where corruption and ailing legal institutions provide no scope for a reassuring investment. Insofar as financial markets are becoming increasingly international, with global firms, corporations and sophisticated investors engaging in transactions in many different countries at a distance, particularly after the growth of the Internet and other computer networks, sound legal institutions are becoming even more essential components of the global financial order. Law and the orderly regulation of the market by the State provide the necessary safeguards and assurances that money lent beyond the close-ended network of trusted friends will be returned voluntarily or by

legal force. Moreover, in this unit and the additional suggested readings you will see that legal rules protecting investors matter in many ways and that changing domestic legal rules – in particular, through the reform of securities markets – can have a big impact on financial development and financial markets.

Investor confidence in particular – which constitutes an essential condition for the success of any financial system – is largely dependent on the quality of legal and regulatory protection by sound and effective legal institutions. Put simply, it is difficult for firms to raise external funds unless potential investors are confident that their rights are protected by law. It is law in the form of disclosure rules and accounting rules that compels firms to disclose information about their financial affairs and condition and thereby enables investors to exercise their rights and create markets.

There is currently substantial evidence that countries that protect shareholders have consistently had stronger stock markets, a larger number of listed securities per capita and a higher rate of initial public offering (IPO) activity, and that countries that protect creditors have consistently had vibrant credit markets (see La Porta *et al,* 1998: pp. 1113–55.) Of course, the importance of law is not limited to investor protection but encompasses the entire financial system. Financial markets rely on legal rules on a vast array of subjects, including the banker–customer relationship, security interests, the payment system, and the systems of clearing and settlement of agreed transactions. We shall be looking at these aspects in further detail in subsequent units of this module, and some other aspects will be covered in other modules.

While we have looked at some examples of domestic law, international financial contracts, which are tending to be agreed at an increasing pace, will involve two or more different countries, each with its own legal system. The conflict between the laws of different countries on the occasion of a single financial transaction is, of course, a prime source of uncertainty and legal risk in financial markets. No contract can exist in a legal vacuum and conflict-of-laws principles determine which country's law will govern it.

The *conflict of laws*, otherwise known as *private international law*, is a branch of law that deals with facts relating to more than one country and decides which law will apply on the basis of objective criteria. Clarity and predictability over the key questions around 'which law applies' and 'which law decides' with regard to any single financial contract are, of course, essential ingredients of a well-functioning international financial system. Although conflict of laws will be the subject of the specific module dealing with international financial transactions (*Legal Aspects of International Finance*), it is expedient to note the key principles here.

An international loan may give rise to the claims of the following legal systems to govern the legal relationship:

- the law of the borrower's country

- the law of the lender's country
- the law of the market (*eg* London Eurodollar market)
- the law of a neutral country
- public international law.

The differences in every one of these matters can be very significant indeed and very complex, as many transactions normally involve performance and obligations across many jurisdictions. No single set of rules exists for worldwide application that would determine governing law and jurisdiction. All this of course adds to legal uncertainty.

The parties normally expressly choose which of these laws will apply to their contract and the choice of courts of a jurisdiction that will hear a case. It sounds simple but as the case study of Parmalat (which you will study soon) will show, it is far from simple and straightforward.

In conclusion, the legal and regulatory framework is significant for the strength and soundness of the financial system and the certainty of individual contracts and transactions. This argument is certainly not new – although only recently have economists started paying systematic attention to the rule of law. As early as in 1776, the father of modern liberal economics, Adam Smith, emphasised the importance of the legal framework in the following terms:

> Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.
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> Source: Smith (1776) Chapter 3: Book V, Para 7.

Readings 1.5 and 1.6

You should now first study the paper by Charles Goodhart (1997), 'Economics and the law: Too much one-way traffic?'. This is a fascinating article on how the economy and necessarily the financial markets are influenced by legal rules and institutions. It is also a well-balanced response to the traditional law and economics theory that applies cost and benefits analysis in order to analyse legal rules. Goodhart argues that the invasion of economic theory into law is only part of the story. In fact, the opposite is also the case – legal rules and institutions affect economic performance and growth.

When you have finished, you should then study the 2003 article by Dani Rodrik and Arvind Subramanian, 'The primacy of institutions'. In this short paper, the authors present the findings of their ground-breaking research on the direct link between national income and the quality of the rule of law. Their results indicate that the quality of institutions overrides geography, national resources and degree of international integration in determining national income.

Goodhart (1997) 'Economics and the law: Too much one-way traffic?'. *Modern Law Review*, 60 (1), 1–22.

Rodrik & Subramanian (2003) 'The primacy of institutions' *Finance and Development*, 40 (2), 31–34.

1.4.1 Case Study: Parmalat

We are going to look at the example of Parmalat to illustrate the importance of legal certainty in international financial operations. The example is taken from the well-documented insolvency procedure of Parmalat, the fallen European food giant. Parmalat defaulted on a $185 million bond payment in mid-November 2003. That prompted auditors and banks to scrutinise company accounts. Some 38% of Parmalat's assets were supposedly held in a $4.9 billion Bank of America account of a Parmalat subsidiary in the Cayman Islands. But on December 19, 2003, the Bank of America reported that no such account existed. In the ensuing investigation, Italian prosecutors said they'd discovered that managers simply invented assets to offset as much as $16.2 billion in liabilities and falsified accounts over a 15-year period, forcing the $9.2 billion company into bankruptcy on December 27. Trading in Parmalat shares was suspended the same day.

As part of the international insolvency proceedings following the bankruptcy of the corporation, one of its associated companies, the Dublin-based Eurofood IFSC, has had to be wound up. The key issue is one of jurisdiction. Subsequently, the High Court in Dublin ruled that the appointment of a provisional liquidator in Ireland to oversee the winding-up of Eurofood IFSC should be upheld, and that creditors were not required to participate in the Italian administration proceedings, which are aimed at reorganising Parmalat. In the High Court in Dublin the battle lines are between the Italian government-appointed administrator of Parmalat and the US-based creditors of an Irish financing subsidiary of the Italian dairy group.

The judge, Mr Justice Kelly, declared that, 'I am satisfied that…the centre of main interests of Eurofood was and is within this state'. But the Irish court decision is completely at odds with a ruling in a Parma court in late February, which declared Eurofood insolvent and found that the centre of its main interest was in Italy, not Ireland.

That was in line with the argument put forward by the Italian Administrator, that Eurofood – although registered and incorporated in Dublin – was simply a conduit for Parmalat's financial policy and merely a financial division of the main group. Accordingly, the Parma court concluded that the 'main office' coincided with the office in which Parmalat's main management was based, and Italian jurisdiction was appropriate.

Plainly, this creates a significant problem. Pearse Farrell, of the Dublin firm Farrell Grant Sparks, had already been appointed to act as liquidator for the Irish subsidiary, with powers to manage Eurofood's affairs and take possession of its assets.

This followed a petition for the winding up of Eurofood presented in late January by Bank of America, which claims to be owed $3.5m. Other creditors, mainly US financial institutions represented by Metropolitan Life, maintain that they are owed a total of more than $122m.

Mr Bondi, the Italian administrator of Parmalat, appealed against the Irish judgement and the Supreme Court decided to stay the proceeding and to refer the case to the European Court of Justice (ECJ), for a preliminary ruling.

Underlying the Eurofood dispute is the broader question of what interpretation should be put on the phrase 'Centre of Main Interests' ("COMI"), which lies at the heart of the European insolvency regulations that came into force in 2002. The Eurofood case has brought out, the question of where the application of the European Union insolvency regulations was deemed to be located – 'whether the centre of the debtor's main interests is in a relevant [EU] member state, and not where a debtor is incorporated'. On the other hand, the clash is with another argument – that it is where the centre of main interests was usually defined as the location in which the business was established, but that more elucidation is needed of the grounds on which this could be overridden.

The succeeding ECJ decision in the case Eurofood was a milestone in cross-border insolvency regulation. It stated in clear words that, according to the European Insolvency Regulation, corporate bankruptcies are governed by the member state where the registered office is, unless evidence is given that the debtor's COMI is elsewhere. In order to give such evidence, it is necessary to show that objective factors exist that are ascertainable by third parties. In other words: a corporate COMI is in the place of the registered office unless creditors can clearly ascertain that the corporation was managed from another member state.

This example clearly demonstrates the importance of clarity and predictability of law in cross-border transactions and corporate operations. The reason for this, from a creditor's perspective, is that insolvency is a predictable risk and the rules governing a debtor's insolvency are part of such risk. An enormous amount of money will now be spent in international litigation merely to decide which country is responsible for the insolvency proceedings of a bankrupt company. It goes without saying that none of the company's creditors – already suffering considerable losses – are particularly happy at having to spend litigation money for a preliminary issue such as this.

1.5 The Legal Preconditions for Efficient Financial Markets

This section examines the essential components of a sound financial architecture – in other words, the required ingredients for the development of strong, vibrant and successful banking and capital markets. In short, modern financial systems rely on the following seven conditions:

1. legally binding rules ensuring that promises must be kept and fulfilled, either voluntarily or by compulsion of law
2. impartial courts and lawyers

3. clearly defined property rights, certainty and predictability in the obligations and rights attached to financial instruments and assets
4. the ability to provide security by mortgaging land or other forms of personal wealth
5. clearly defined instances of liability for lies, cheating and fraud
6. sound mechanisms of investigation and punishment of financial crimes
7. political institutions that ensure the openness of competition.

Law underpins stable financial markets and is an important source of their vitality. It provides both the rules by which firms and investors in the market must play and a vital part of the environment in which savings and investment are encouraged. Legal rules enable financial commitments to be created and honoured. They also govern the conduct of the market in which the underlying transactions are carried out.

Strong financial markets require not only that these legal rules exist, but that they operate in an environment where they are effective. However, in the absence of adequate foundations for sound finance, the trust and confidence of savers and investors can easily be misplaced, particularly when they are inexperienced. There have been high-profile examples of misplaced confidence in transition economies – such as pyramid schemes that promise high returns which can only be met by attracting new investors. Perhaps the most extreme examples of misplaced confidence were the Albanian pyramid schemes of the 1990s. These promised returns as high as 100% in six months, sold claims to half the population of Albania, and attracted sums equivalent to the total GDP. Their collapse contributed to civil unrest and a change of government. (If you wish, you can research Albania further in Jarvis, 2000.)

In times of market euphoria and increased market activity, the challenge for the legal systems is to keep abreast of the market developments. With regard to the causes of the damaging financial crises in Asia, Latin America and Russia of the mid and late 1990s, the jury is still out, but there is broad consensus that those crises tended to occur when financial markets were liberalised from the earlier suffocating state control but when supervision and regulation (in other words, the government oversight of the system) were not upgraded to cope with expanded activity. Supervision of markets and financial institutions is a core element of a sound financial system and is examined in its own right in a separate module of this programme (*Regulation of International Capital Markets*). Notwithstanding the importance of supervision, a lot can be said about the remaining components of a sound financial architecture.

While the regulation and supervision of markets and firms are central to a sound and stable financial system, they come into play only if savers and investors have the confidence and means to engage in financial activity. Creating confidence in this activity requires the intensive use of legal and accounting services. Law serves to establish and enforce property rights

and contracts, as well as creditor and shareholder rights. Accounting and auditing practices generate the reliable financial information required by savers and investors to ensure their rights are being respected and to perform an active corporate governance role. The availability and quality of these services are thus crucial factors in determining how well a financial system performs.

The absolutely essential rules and institutions required for the functioning of robust and market-based financial systems are well documented and defined. The essential legal framework comprises the following:

- Laws that clearly define and protect private property rights: finance is predominantly concerned with promises to pay money made by borrowers, investors, intermediaries or lenders. Contractual claims are the foundations of finance and the law of financial contracts fulfils the function of enabling financial exchanges and protecting property rights and expectations. Financial markets absolutely rely on efficient contract laws that protect the rights and enforce the obligations of counterparties, including lenders and borrowers.
- A framework for creating and enforcing collateral and security interests which protects the rights of lenders through obtaining a pledge of assets, including real property (mortgages).
- Laws and regulations which govern the non-cash payments system and the clearance and settlement systems for the transfer of funds between lenders, borrowers and intermediaries and the completion of securities transactions in organised stock exchanges or alternative markets, including depository and custodian facilities for securities.
- Laws which support and organise governance standards and protect shareholders' rights; the roles, rights, and responsibilities of directors, managers, and shareholders must be legally defined, as was highlighted in the module *Legal Aspects of Corporate Finance*.
- A legal framework for the establishment and operations of a central bank with responsibility for overseeing the liquidity and stability of the financial system; the central banking law should establish a politically independent but accountable central bank that is mandated with the responsibility to maintain price stability and to act as the 'lender of last resort'.
- Laws that provide for a transparent, fair, and effective legal and regulatory environment for capital markets, including laws to protect investors and regulate the issuance of securities, broker-dealers and stock exchanges, and laws that provide for financial transparency through adequate disclosure, accounting and auditing. Laws and regulations governing collective investment vehicles (for example, investment companies) are an important component of capital market regulation.
- All markets, including financial markets, cannot achieve their full potential without laws and institutions which encourage the creation of competent, ethical, politically independent judiciary.

Such a judiciary must be supported by a sufficient number of lawyers with appropriate legal training and by credible and honest law enforcement authorities.

Reading 1.7

You should now study the 2000 paper by John Walker, 'Building the legal and regulatory framework'. Walker uses six emerging market countries as case studies in order to demonstrate the essential elements of a sound legal infrastructure for financial markets.

Walker (2000) 'Building the legal and regulatory framework'. *Conference of the Federal Reserve Bank of Boston 'Building an Infrastructure for Financial Stability'*, June.

1.6 The Institutional Preconditions for Efficient Financial Markets

A sound framework of financial law is not sufficient. The importance of a general political and institutional framework subject to the rule of law should not be underestimated.

The rule-of-law provides an essential framework for investment and financial activity. Without a certain and enforceable set of rules and standards, economic activity is distorted by the lack of a climate conducive to individual planning and lack of predictability. Without transparent legal rules enforced by a competent and honest judiciary, the cost of investment goes up and the prospects of economic growth go down. Investors require higher returns on their investments, raising capital becomes more expensive, and debtors may not repay debts knowing that laws and contracts are not consistently enforced. Lack of confidence in law enforcement and fair, effective dispute resolution supervised by the courts also leads to the creation of alternative institutions, opens the door to criminal elements, and creates a fertile breeding ground for corruption and money laundering.

An effective and well-functioning legal system based upon the rule-of-law underlies a sound financial system. The rule-of-law encompasses:

- a system of government where institutions and officials are guided by and constrained by the law – that is, a government accountable to, not above, the law
- a body of laws that is transparent, reasonably predictable, validly derived, and fairly and equitably applied
- laws, principles and procedures that protect those civil, political and economic rights that have become enshrined as universal human rights
- a fair and effective legal system led by an independent and professionally competent judiciary that acts as the final arbiter of the law.

1.7 Conclusion

It is now established that financial systems cannot operate in a legal vacuum. The importance of legal rules and institutions for the creation of financial markets cannot be underestimated. A legal system defines property rights, allows for exchange of property rights, and protects property rights. Countries with a rule of law and well-established property rights are more prosperous and grow more quickly than countries lacking such a system. An important function of the rule of law is to protect property rights from governments and market participants who fail to keep their promises and participate in markets in bad faith. Rules also facilitate private exchange through contract. Financial markets are particularly vulnerable to abuses and contractual failures which puts further emphasis on the importance of enforceable rules, government supervision and the rule of law for the creation and well-functioning of financial systems.

You should now be able to confirm your understanding of this unit by completing the learning objectives listed on the introductory page.

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