Financial Law
Financial Law

Course Introduction and Overview

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1 Course Objectives

The course aims to examine and critically discuss the fundamental concepts of financial law in the light of market developments in national and international financial markets. It builds upon the introductory course, *Introduction to Law and to Finance*, and complements the more specialist courses, *Legal Aspects of International Finance*, *Legal Aspects of Corporate Finance* and *Regulation of International Capital Markets*.

This course (*Financial Law*) will examine the legal aspects of finance. It will outline the basic legal principles and institutional preconditions of finance and financial markets. It will therefore complement the remaining law courses, which are concerned with more specific topics. Indeed, the course *Legal Aspects of Corporate Finance* is specifically concerned with the legal aspects of equity and debt finance from the point of view of corporations as borrowers in national and international financial markets. On the other hand, *Legal Aspects of International Finance* is not concerned with any type of lender or borrower in particular but it focuses on the transactions and instruments by which borrowers and lenders come together and exchange money in financial markets.

This course, *Financial Law*, will neither focus on borrowers and lenders nor will it exclusively examine the instruments, contracts and transactions by which finance is supplied. It will nevertheless focus on the broader picture; it will examine finance against the general institutional framework of market-based economies. It will seek to outline the legal institutions which are necessary for the development of financial markets and then it will provide a concise overview of the most basic of them. The course will be based on English financial law although it may occasionally adopt a comparative perspective of the laws of other jurisdictions with key international financial centres.

There is no generally accepted definition of financial law. Generally, the concept relates to the legal rules relating to finance, finances and financiers – in other words, the rules relating to the process of raising or providing funds or capital or furnishing credit to another person. Financial law is therefore a broad concept, which may include the legal framework applicable to investors, depositors or lenders, financial intermediaries, borrowers and issuers, financial instruments, transactions and contracts, markets and exchanges, or even public authorities overseeing that process. In short, the subject matter is so wide that it cannot possibly be examined in its entirety. Hence, this introductory note will set the boundaries of this course in the light of the objectives of the programme and the content of the remaining courses.

As a first rule of thumb, this course will not examine issues that form part of the remaining courses. As a result, the course will not examine the important question of regulation and supervision of financial markets by public authorities, which is the subject of the elective course, *Regulation of International Capital Markets*. Further, it will not examine the most basic and fundamental rules of contract law, fiduciary duties and tortious liability, which are examined by *Introduction to Law and to Finance*. It goes without
saying that an understanding of the basic concepts of English law as they were presented in that first course is essential for students studying this present course. In addition, this course will not address the question of corporate finance from the perspective of the borrowing or issuing corporation. This does not mean that the legal aspects of corporate finance as such will not be addressed at all. We will simply ignore those legal aspects that are exclusively relevant for corporate borrowers and issuers to the extent that they are studied in the course, Legal Aspects of Corporate Finance.

Further, the purely contractual framework of international finance, including the practicalities and mechanisms of international loans, bonds and derivative transactions will also not be addressed. To offer a somehow crude example, the technicalities of international syndicated loans will be ignored as they form part of Legal Aspects of International Finance, but the basic foundations and principles of the law of loan agreements will be examined. Clearly, the basic law of loan agreements applies not only to international commercial loans but also to other forms of finance, including consumer finance and lending.

Essentially, this course will be concerned with the key legal aspects of finance in an attempt to present rules of general application regardless of the specific form that a financial transaction may take in a given context. The objective of the course is to enable you to understand the broader legal framework within which financial markets operate, delegating the study of more specialist topics to the remaining law courses of the programme. Within the ambit of the course objective, this course also reflects on the contemporary issue in the financial markets, i.e. the banking crisis of the Northern Rock, which lead to the promulgation of the Banking Act 2009.

2 The Course Authors

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Federico Mucciarelli is Reader in Financial Law at the Department of Financial and Management Studies, SOAS, University of London and holds a Laurea in Law from the University of Bologna, an LL.M. from the University of Heidelberg and a Doctorate from the University of Brescia. Dr. Mucciarelli is joint Academic Director of the Finance and Financial Law programmes at SOAS and teaches Legal Aspects of Corporate Finance and Corporate Governance courses. His areas of interest and research include takeover regulation, corporate and insolvency law, international corporate law and the freedom of establishment. Dr. Mucciarelli’s publications include Società per azioni e offerta pubblica d’acquisto. Le difese successive contro offerte pubbliche d’acquisto di azione quotati (Public companies and takeover bids: Defensive measures against hostile takeovers) Quaderni di Giurisprudenza Commerciale, Giuffrè, Milan, 2004, Società di capitali, trasferimento all’estero della sede sociale e arbitraggi normative (Transfer abroad of corporations’ registered office and regulatory arbitrage) Giuffrè, Milan, 2010 as well as articles in the Tulane Journal of International and Comparative Law, European Company and Financial Law Review, Giurisprudenza Commerciale and European Business Organization Law Review.

3 The Course Structure

Unit 1 Introduction to Financial Law
1.1 Introduction
1.2 The Banking System
1.3 Capital Markets
1.4 The Importance of Law for Financial Markets
1.5 The Legal Preconditions for Efficient Financial Markets
1.6 The Institutional Preconditions for Efficient Financial Markets
1.7 Conclusions
Unit 2 The Needs of Finance and the Character of English Financial Law
  2.1 Introduction
  2.2 The Needs of Finance
  2.3 The Nature of English Financial Law
  2.4 The Principal Sources of English Financial Law
  2.5 Conclusions

Unit 3 Deposits and Bank Accounts
  3.1 Introduction
  3.2 Bank Deposits and the Financial System
  3.3 The Banker–Customer Relationship
  3.4 The Legal Properties of Bank Accounts
  3.5 Confidentiality and Data Protection
  3.6 The Law of Electronic Banking
  3.7 Conclusions

Unit 4 The Law Relating to Money and Payments
  4.1 Introduction to Money and Payments
  4.2 The Legal Concept of Money
  4.3 The Legal Concept of Payment
  4.4 Payments by Bank Transfers
  4.5 Payment Systems – Clearing and Settlement
  4.6 Conclusions

Unit 5 The Law Relating to Loans and Credit
  5.1 Introduction to Lending and Bank-Based Finance
  5.2 Forms of Credit
  5.3 The Loan Agreement and Principal Questions of Law
  5.4 The Law Relating to Consumer Lending
  5.5 Conclusions

Unit 6 The Law of Secured Finance
  6.1 Introduction to the Mechanisms of Credit Enhancement
  6.2 The Economic Rationale of Secured Finance
  6.3 Forms of Security – Pledge, Mortgage and Charge
  6.4 Issues of Priority and Enforcement
  6.5 Key Considerations
  6.6 Conclusions

Unit 7 The Law Relating to the Control of Financial Crisis
  7.1 Introduction to the 2008–2009 Financial Crisis
  7.2 The Northern Rock Banking Crisis
  7.3 The Banking Act 2009
  7.4 The Definition of a Failing Bank
  7.5 Conclusions
4 Learning Outcomes

When you have completed your study of this course and its core readings, you will be able to

- outline and discuss the importance of financial law for the creation and development of strong financial markets
- analyse the institutional framework that is necessary for the provision of credit and the operation of financial markets
- explain and critically discuss the basic legal components of the financial system
- examine and discuss the key legal problems that relate to the provision of finance and the ways in which financial institutions address such problems
- critically discuss the legal principles and rules applicable to bank deposits and the relationship between the banker and the customer
- discuss and analyse the basic legal principles underpinning commercial and international banking transactions
- identify and critically evaluate the legal risks involved in the process of agreeing and documenting the most basic financial agreement
- analyse and discuss the basic legal components of the payment systems of key jurisdictions of the world
- critically evaluate the nature, scope, economic function of security in the provision of finance
- identify and critically evaluate the systemic risk in the financial market encountered by the financial authority.

5 Study Materials

This Study Guide is your central learning resource as it structures your learning unit by unit. Each unit should be studied within a week. It is designed in the expectation that studying the unit and the associated core readings will require 15 to 20 hours during the week. In addition to the Guide, you will receive two textbooks and a Course Reader.

Textbooks


Course Reader

In your Course Reader, you are provided with a selection of academic articles and extracts from books, which you are expected to read as part of your study of this course. You will note from reading them that the topics covered in these articles often vary widely from the Study Guide. The Course Reader articles are often more technical or adopt a more in-depth approach. This should not put you off, as many were written with an academic audience in mind. These articles were selected so that the central arguments and concepts could be understood and appreciated at a level appropriate to this course.

Optional Reading

You are provided with all the reading essential for this course, and we do not expect you to undertake extra reading on your own, partly because not all students have ready access to good libraries or bookshops. However, useful articles are sometimes suggested to augment your study of the Course Guide, and the reference section of each unit lists academic articles, book chapters or web based sources that you can choose to read if you wish to further investigate a particular topic. Many of these readings can be accessed on the Internet, but it is important to note that they will not be assessed in examination or assignments.

Although not required, we think that you will enrich your study of this course by looking at such articles. Indeed, you are encouraged to choose your own additional reading on topics related to global finance. You can do this through searching the internet and by making use of the online academic journals through the Library resources on the CeFiMS Online Study Centre.

You are also recommended to browse through your textbooks for additional coverage of the topics studied in this course.

6 Study Guidance

As with all other units, you are advised to have a pen and paper while you are studying the text. Make sure that you complete the readings, making clear notes on important points, and answer any questions or exercises set. If you are not confident that you have understood a particular section, go back and try again. It is better to spend more time in understanding a particular point than continuing regardless. The course is structured in its development of the study material, and so future sections build on previous information, and you will be at a disadvantage if you did not understand it in the first place.

We do not assume that you have access to well-stocked libraries or bookshops, but we do assume that you have access to the web and to specialist electronic resources, which form part of the course material, like WESTLAW. You will be told when to connect to the internet and for what purpose.
Assignments

There will be two assignments for you to complete for this course, which are to be sent to CeFiMS for tutor marking and feedback – one is due after Unit 4 and one at the end of the course. You also have a specimen examination, which shows the format and expectations (though not, of course, the precise questions) of the final exam paper.

7 Assessment

Your performance on each course is assessed through two written assignments and one examination. The assignments are written after week four and eight of the course session and the examination is written at a local examination centre in October. Because this Course has two distinct parts, the assignments will be quite different from each other.

The assignment questions contain fairly detailed guidance about what is required. All assignment answers are limited to 2,500 words and are marked using marking guidelines. When you receive your grade it is accompanied by comments on your paper, including advice about how you might improve, and any clarifications about matters you may not have understood. These comments are designed to help you master the subject and to improve your skills as you progress through your programme.

The written examinations are ‘unseen’ (you will only see the paper in the exam centre) and written by hand, over a three hour period. We advise that you practice writing exams in these conditions as part of you examination preparation, as it is not something you would normally do.

You are not allowed to take in books or notes to the exam room. This means that you need to revise thoroughly in preparation for each exam. This is especially important if you have completed the course in the early part of the year, or in a previous year.

Preparing for Assignments and Exams

There is good advice on preparing for assignments and exams and writing them in Sections 8.2 and 8.3 of Studying at a Distance by Talbot. We recommend that you follow this advice.

The examinations you will sit are designed to evaluate your knowledge and skills in the subjects you have studied: they are not designed to trick you. If you have studied the course thoroughly, you will pass the exam.

Understanding assessment questions

Examination and assignment questions are set to test different knowledge and skills. Sometimes a question will contain more than one part, each part testing a different aspect of your skills and knowledge. You need to spot the key words to know what is being asked of you. Here we categorise the types of things that are asked for in assignments and exams, and the words used. All the examples are from CeFiMS examination papers and assignment questions.
Definitions
Some questions mainly require you to show that you have learned some concepts, by setting out their precise meaning. Such questions are likely to be preliminary and be supplemented by more analytical questions. Generally ‘Pass marks’ are awarded if the answer only contains definitions. They will contain words such as:

- Describe
- Define
- Examine
- Distinguish between
- Compare
- Contrast
- Write notes on
- Outline
- What is meant by
- List

Reasoning
Other questions are designed to test your reasoning, by explaining cause and effect. Convincing explanations generally carry additional marks to basic definitions. They will include words such as:

- Interpret
- Explain
- What conditions influence
- What are the consequences of
- What are the implications of

Judgment
Others ask you to make a judgment, perhaps of a policy or of a course of action. They will include words like:

- Evaluate
- Critically examine
- Assess
- Do you agree that
- To what extent does

Calculation
Sometimes, you are asked to make a calculation, using a specified technique, where the question begins:

- Use indifference curve analysis to
- Using any economic model you know
- Calculate the standard deviation
- Test whether

It is most likely that questions that ask you to make a calculation will also ask for an application of the result, or an interpretation.

Advice
Other questions ask you to provide advice in a particular situation. This applies to law questions and to policy papers where advice is asked in relation to a policy problem. Your
advice should be based on relevant law, principles, evidence of what actions are likely to be effective.

- Advise
- Provide advice on
- Explain how you would advise

Critique
In many cases the question will include the word ‘critically’. This means that you are expected to look at the question from at least two points of view, offering a critique of each view and your judgment. You are expected to be critical of what you have read.

The questions may begin
- Critically analyse
- Critically consider
- Critically assess
- Critically discuss the argument that

Examine by argument
Questions that begin with ‘discuss’ are similar – they ask you to examine by argument, to debate and give reasons for and against a variety of options, for example
- Discuss the advantages and disadvantages of
- Discuss this statement
- Discuss the view that
- Discuss the arguments and debates concerning

The grading scheme
Details of the general definitions of what is expected in order to obtain a particular grade are shown below. Remember: examiners will take account of the fact that examination conditions are less conducive to polished work than the conditions in which you write your assignments. These criteria are used in grading all assignments and examinations. Note that as the criteria of each grade rises, it accumulates the elements of the grade below. Assignments awarded better marks will therefore have become comprehensive in both their depth of core skills and advanced skills.

70% and above: Distinction As for the (60-69%) below plus:
- shows clear evidence of wide and relevant reading and an engagement with the conceptual issues
- develops a sophisticated and intelligent argument
- shows a rigorous use and a sophisticated understanding of relevant source materials, balancing appropriately between factual detail and key theoretical issues. Materials are evaluated directly and their assumptions and arguments challenged and/or appraised
- shows original thinking, supported by strong argument and a willingness to take risks

60-69%: Merit As for the (50-59%) below plus:
- shows strong evidence of critical insight and critical thinking
- shows a detailed understanding of the major factual and/or theoretical issues and directly engages with the relevant literature on the topic
• develops a focussed and clear argument and articulates clearly and convincingly a sustained train of logical thought
• shows clear evidence of planning and appropriate choice of sources and methodology

**50-59%: Pass below Merit (50% = pass mark)**
• shows a reasonable understanding of the major factual and/or theoretical issues involved
• shows evidence of planning and selection from appropriate sources,
• demonstrates some knowledge of the literature
• the text shows, in places, examples of a clear train of thought or argument
• the text is introduced and concludes appropriately

**45-49%: Marginal Failure**
• shows some awareness and understanding of the factual or theoretical issues, but with little development
• misunderstandings are evident
• shows some evidence of planning, although irrelevant/unrelated material or arguments are included

**0-44%: Clear Failure**
• fails to answer the question or to develop an argument that relates to the question set
• does not engage with the relevant literature or demonstrate a knowledge of the key issues
• contains clear conceptual or factual errors or misunderstandings

[approved by Faculty Learning and Teaching Committee November 2006]

**Specimen exam papers**

Your final examination will be very similar to the Specimen Exam Paper. It will have the same structure and style and the range of question will be comparable.

CeFiMS does not provide past papers or model answers to papers. Our courses are continuously updated and past papers will not be a reliable guide to current and future examinations. The specimen exam paper is designed to be relevant to reflect the exam that will be set on the current edition of the course

**Further information**

The OSC will have documentation and information on each year’s examination registration and administration process. If you still have questions, both academics and administrators are available to answer queries.

The Regulations are also available at [www.cefims.ac.uk/regulations.shtml](http://www.cefims.ac.uk/regulations.shtml), setting out the rules by which exams are governed.
UNIVERSITY OF LONDON
Centre for Financial and Management Studies

MSc Examination
Postgraduate Diploma Examination
for External Students

91DFMC240
BANKING
91DFMC340
FINANCE & FINANCIAL LAW

Financial Law

Specimen Examination

This is a specimen examination paper designed to show you the type of examination you will have at the end of the year for Financial Law. The number of questions and the structure of the examination will be the same but the wording and the requirements of each question will be different. Best wishes for success on your final examination.

The examination must be completed in THREE hours.

Answer THREE questions, at least ONE question from Section A. The remaining two questions can be chosen from either Section A or Section B.

The examiners give equal weight to each question; therefore, you are advised to distribute your time approximately equally over the three questions. The examiners want to see evidence of your ability to use legal authorities, including legislation and case law, to back up your arguments. Answer all parts of multipart questions.

In the questions in Part A, it is essential that you give reasons for your answer, applying the law appropriately to the situation described.

In the questions in Part B, it is important that your answers not only show an accurate knowledge of the law but also contain a reasoned analysis of the question, with a contribution of your own thought.

PLEASE DO NOT REMOVE THIS PAPER FROM THE EXAMINATION ROOM.
IT MUST BE ATTACHED TO YOUR ANSWER BOOK AT THE END OF THE EXAMINATION.

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PLEASE TURN OVER
Section A
(You must answer at least ONE question from this section)

1. Buchanan Trading Ltd has borrowed: £300,000 from Thamesside Bank plc, secured by a mortgage on its premises; £20,000 from Dominic Finance Ltd., secured by a fixed charge on a packaging machine; and £30,000 from Carter Finance plc, secured by a floating charge over its stock. On 25 January 2005, Buchanan Trading Ltd went into insolvent liquidation owing: £5,000 to Pacific Fruit Company in respect of stock supplied but not yet paid for; £10,000 to Adam Brown in respect of a consultancy fee; and £30,000 in salaries owed to its 15 employees. On that date Buchanan Trading Ltd had: a bank balance of £1,000; stock at its premises valued at £35,000; and, a fleet of three vans, valued at £3,000 each.

To what extent will each of the company’s creditors recover what they are owed?

2. Peter has an account with Bloomsbury Bank plc. In settlement of a fee of £150 owed to Chancery Consultancy Ltd, he sent them a cheque. Charlotte Villiers of Chancery Consultancy paid this cheque into the company account at Camden Bank plc on 9 November 2004. On 16 February 2005, Chancery Consultancy receive a letter from Camden Bank plc, informing them that the cheque has been dishonoured; it subsequently transpires that the reason is that Peter Macmillan closed his account with Bloomsbury Bank on 31 January 2005.

Advise Chancery Consultancy Ltd.

3. Answer both parts of this question.

a. Charlotte’s handbag is snatched in Marchmont Street. It contained £80 in cash. 45 minutes later, after she provides a description to the police of the thief, the thief is apprehended coming out of the Kings Arms pub. He still has Charlotte’s purse but it now contains only £20; with the remainder, he admits to have paid off a £50 debt to Jimmy and then had a few beers in the pub.

Can Charlotte recover her money from either Jimmy or the management of the King’s Arms?

b. Sandra owes £200 to Davidson’s in respect of work done. She offers to pay in cash, but Robert, Davidson’s Finance Manager, explains that it is their company policy not to accept payments of more than £50 in cash; payment should be by credit or debit card or cheque. Sandra has only recently arrived in the UK from Argentina and does not yet have a UK bank account; further, the use of either her Argentina debit card or credit card will involve large bank charges.

Advise Sandra.
4. Charles is the senior portfolio manager of Judd Investments Ltd., a small securities company. One of his customers is Sophie, who has invested £15,000 with Judd over the last 5 years. Sophie is not at all happy to discover that, despite the fact that it was agreed that Charles would only invest her money in low to medium risk investments, her portfolio now has a value of approximately £3,000. Charles explains that he always made clear that the value of securities could go down as well as up and, further, that the investments he chose were low to medium risk and that no one could have foreseen that a terrorist attack on the United States would damage the profits of Disney World, a tsunami would damage the Thai hotel industry or that a boycott would reduce the profits of French and Spanish companies exporting to the United States. Sophie is less than convinced and is even more displeased when she discovers that Charles personally owned securities in the Thai holiday corporation and French glassware manufacturers in which he invested much of her funds, while he also received substantial commissions from the brokers through whom he made these investments but never disclosed these to her.

Advise Sophie on the possible remedies that she may have.

Section B

5. Discuss the different sources of English financial law. What part has each played in the creation of the body of commercial/financial law as a whole?

6. Discuss the various forms of obtaining security for a loan. What are the advantages and disadvantages of each, from the standpoint of both lender and borrower?

7. The value of the Banking Act 2009 is diminished by the complexity and inconvenience of many of its provisional sections requiring participation or consultation with tri-parties in a marriage decision.

Discuss.

8. “The legal rules relating to consumer credit are all that stand in the way of personal borrowers being left to the mercy of lenders. This being so, it is essential that they be robust.”

Discuss.

[END OF EXAMINATION]
Financial Law

Unit 1  Introduction to Financial Law

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Unit Content

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 Objectives

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

Textbook


Course Reader


Online Study Centre

George Benston (2004) ‘What’s Special About Banks?’
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 course 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 course 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

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 OSC.

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.

Review Questions

- 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 (e.g. 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 your textbook how what constitutes ‘a bank’ is defined differently in common law, in statutory legislation or for the purposes of international or European law.

Reading

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.

Review Questions

- 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 instru-
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, 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 (i.e. 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 (i.e. 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

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.

Review Questions

- 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.

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 (i.e. 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 wholeheartedly 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 worth-
less 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 rela-
tionships 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 fund-
damental 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 prac-
tice. 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 reas-
urance 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: 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 course, and some other aspects will be covered in other courses.

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 course 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 (e.g. 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.


Readings

You should now first study the paper by Charles Goodhart, ‘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 article by Dani Rodrik and Arvind Subramanian, ‘The Primacy of Institutions’. In this short paper, the authors present the findings of their groundbreaking 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.

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 exists 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 per cent 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 course 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 fulfills 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 course 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.
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 Conclusions

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.
References and Websites


Parmalat website: http://www.parmalat.com


