

Systemic Risk and the Future of Regulation: The Role of the Courts

by Jeffrey Golden

*Visiting Professor, London School of Economics and Political Science; Retired
Founder Partner, US Law Practice, Allen & Overy LLP*

Ladies and Gentlemen,

It is truly an honour and a privilege to address you today — and to be able to offer a few opening remarks.

When I finish those remarks, we will have the benefit of a panel discussion about systemic risk and the role of securities regulators in mitigating that risk.

-- one of the objectives of IOSCO is the reduction of systemic risk

-- you will be challenged to question the notion that systemic risk is only a matter for prudential regulators and central banks

-- and I am sure that you will be further challenged and encouraged to consider the role securities market regulators can best play to reduce systemic risk and ensure financial stability.

But before we convene that panel, I want to pose another challenge.

I want you to think outside the current regulatory debate for a moment.

I want you to pause for a moment as you contemplate systemic risk, and I want you to think about courts and judges and how they fit in.

The courts as hospitals

You know our newspapers are full of articles about financial market *regulation*. Parliamentarians and congressmen are not shy about weighing in on this subject too.

-- Regulation as a form of “preventive medicine”.

-- And the importance that we attach to getting it right.

That is as it should be. Preventive medicine in matters of both personal and financial health is important. Moreover, in the recent crisis, the malaise afflicting the financial markets had arguably reached epidemic proportions.

-- Financial market participants were, and some still are, seriously, if not terminally, ill.

-- And we can expect more accidents to occur, more victims in the future.

By analogy, the courts are our “hospitals”.

-- Perhaps we should worry more about their condition and whether we have enough qualified staff for them.

It is indeed a little surprising that, with all the debate around us about the future of financial regulation and the statements being made or reported by politicians, economists, academics -- by you, the regulatory community — and even by the legal profession, so little attention has been paid to our judges.

-- Judges around the world who can be expected to interpret that regulation, fill in the gaps or resolve ambiguities in it.

-- And peacefully settle any number of disputes — some of them highly complex and technical — that are likely to follow from the considerable losses, and in some cases the demise, of major financial institutions and their counterparties.

That is what I want us to think about for the next 20 minutes:

What role would we wish to see our courts play in dealing with complex financial instruments, disputes arising from the financial crisis and, in due course, matters requiring interpretation of the new regulatory regime that you are discussing and which will emerge from the crisis?

Do we think that the courts, as currently constituted, are prepared to play that role?

Is there more, in any event, that the markets, the regulatory community and the legal profession can do to ready them?

Why courts are important

Why do I think that courts are relevant to your discussions about systemic risk?

Well, for a start, courts are potentially an ally of yours in the battle to guard against systemic risk in the financial markets.

Courts in the United States and elsewhere have played a hugely important role in “fleshing out” securities regulation in the past — by promoting legal certainty and, as a result, contributing to market stability.

-- As law students and young lawyers, we were taught black letter law and we read regulations.

-- But we spent a lot more time reading the cases. We studied the cases:

‘How much due diligence should I do in connection with this IPO?’

-- This case told me what one lawyer did — and it wasn’t enough.

-- This case told the story of a lawyer who *did* do enough.

The facts will change, and the facts will always be important. Intelligently interpreting financial market regulations in light of new facts will be important too.

Judges who understand finance can do this.

The courts, therefore, are potentially your ally.

However, when it comes to the derivatives markets and complex product litigation, as things stand now the courts can be a *source* of systemic risk.

I will tell you why I think that and suggest something that we can do about it.

But first two more reasons why I think this issue — the role of the courts -- is so important at this point in time for derivatives product regulation and complex product litigation.

1. *The stakes are high.*

The stakes are high. The amounts at risk are staggering.

-- The current size of the OTC derivatives market alone in terms of notional amounts outstanding was last estimated to be \$583 trillion by the BIS.

-- More than \$500 trillion of that amount is thought to be governed by a single standard form contract and terms.

-- I am viewed by the market as a principal author of that contract (although in fact 100s of lawyers from around the globe have contributed to the process).

-- So I hope that we got it right!

In a single pending court case (in which I have been retained as an expert witness) the amount in dispute is \$1.5 billion. And the outcome may turn on the court's interpretation of two

words in the parties' ISDA Master Agreement.

And the cases are pouring in.

2. The stuff is complicated.

The contracts, the issues and the products are all complicated . . . And the track record of the courts to date is less than satisfactory. We now have significantly contradictory results on similar facts, even as between NY and English courts.

Thought of globally, those courts represent a very de-centralised system — with no Supreme Court to “fix” things.

The markets worry all the time: wrong place, wrong party, judges and lawyers who would brief them who don't get it.

The nature of the cases is also evolving:

-- From things that judges were comfortable with: authority (*ultra vires*); was a contract formed? If so, on what terms?; counterparty relationship; duty of care.

-- Now: flawed asset and anti-deprivation theories; modeling; formulaic calculations; subtle global insolvency-proofing techniques have been carefully woven into the fabric of the documents by those hundreds of lawyers over a period of decades.

The remedies in the derivatives markets, for example, are very different from the remedies of the loan and bond markets, even though the contemplated case flows may be similar.

Global market facts and practices are highly relevant, and need to be understood and accounted for.

There is little to demonstrate a propensity for this across all the courts that find complex product litigation before them.

Standardisation

In addition to these two factors — high stakes and complexity — there is a third issue of particular importance: the phenomenon of standardisation.

Widespread usage of master agreements and standard terms — across geographical, cultural and language divides — has great benefits:

- legal certainty**
- huge cost efficiencies**

We don't have a world parliament to legislate such matters, but the markets have created a kind of global law by contract.

But the risk is that widespread usage of the same terms can amplify a court's mistake in deciding a term's proper meaning. "Whosh" -- that mistake goes around the globe, affecting trillions of dollars of trades.

As a result, the market (i.e., parties outside the dispute) may have a greater interest in the outcome of a particular case than the two private parties who are litigating it.

And the parties to a dispute may not spot an issue of importance to the markets.

- Or, having spotted it, they may have difficulty finding the requisite experts to give evidence in court.**

- They may not wish to, or may be unable to, spend what it takes to get a right answer.**

- There may be other strategic reasons why a party may not frame or develop an issue that others in the market view as extremely important.**

There are other challenges too:

-- knowledgeable counsel may be conflicted

-- third party briefs (*amicus briefs*) may not be available in certain jurisdictions, so that it may be difficult to get a market or regulator's view into the proceedings.

And all this may be a source of *systemic risk*.

Can we see, as a result, a blurring of lines in the kind of cases I am describing? Lines that have traditionally, at least in common law courts, divided civil from criminal procedure.

Consider:

A shoots B and stands trial..

B forgives A

State says, "All well and good, but . . . we have an issue with people using guns to settle their disputes and a public interest to protect. It is not for you alone to decide to settle this case. That is for the state to decide, and it is also for the state to decide how to progress this matter."

Now that we have seen considerable systemic consequence from market defaults, not only for counterparties but also for a wide range of stakeholders, including pensioners and taxpayers, do we need a better way of ensuring that the more public and wider market interest in such cases is protected?

Settled law; global markets

There are two other factors worth mentioning:

1. ***We need a settled body of law for the global financial markets.***

We need at least to learn from our mistakes. We need to nurture a collective, and probably specialist, wisdom about the issues in these cases.

2. ***This is a very international affair — a particularly global business.***

We are apt to see two counterparties (for example, an African commodity producer hedging its risk with a European bank), each possibly from a civil code jurisdiction, each possibly a native French speaker but using an English language, common law contract (like the ISDA Master).

Ideally we would want judges who literally speak the language of the parties. Judges with a strong comparative law background.

Is it correct that the parties should need to fly off to London or New York to settle their disputes? Even if the judgments of those courts are not enforceable in either party's home jurisdiction?

So,

Decentralised courts, decentralised parties, common law contracts, civil code country players (or perhaps Islamic finance inspired), complicated cases, a serious potential for wrong results, disaster if we get wrong results!!!

What can we do about this? What would move things forward in a more positive way?

PRIME Finance Initiative

Well, I hope that it will be good news that some of us are trying, pro-actively to make a difference.

Six months ago, convened by Lord Woolf, the former Lord Chief Justice of England and Wales, and with support from the Dutch authorities, a group of 60 senior experts quietly gathered in the Peace Palace in The Hague to brainstorm about this issue.

There were 20 legal practitioners who among them represented 5 centuries of “lawyer years” counseling in the derivatives markets.

There were another 20 from the market. CEOs, CLOs, dealers, buy-side, several (including the first) Chairmen of ISDA and of other relevant trade bodies.

The President of the Dutch Central Bank and Chairman of the Basel Committee on Banking Supervision, and senior figures, participating in their individual capacities, from the European Central Bank, the Fed and the SEC and some of the leading academics in the field.

But perhaps most importantly, senior judges: from the Delaware Supreme Court, the Australian Federal Court, the New Zealand Court of Appeals and other national courts.

We worked hard then and, with continued Dutch government support, we have worked hard since. I am amazed, and gratified, by the progress that has been made. Some of you may have seen recent coverage in The Economist, the Guardian and the trade press.

And I am pleased to report that we hope to announce the formation of a Panel of International Market Experts in Finance (we call it “PRIME Finance”) this summer.

-- A truly international panel of the senior most legal and market experts in the field, committed to providing training for judges in national courts, expert testimony and advisory

opinions, and offering where appropriate mediation and arbitration services as well.

Dispute settlement support not just for big bank cases, but for the developing markets and for clearing houses and exchanges as well.

-- You see with all the focus on central counterparties and clearing, dispute settlement between clearing houses and their members and between clearing houses across jurisdictions has been given short shrift.

-- There are some very thorny legal issues lurking (many untested).

-- The less sophisticated procedures and rule books of the past are unlikely to be fully up to the task of settling these disputes. Yet the decisions in future may have greater systemic consequence.

We intend to take full advantage of a sociological phenomenon: we are about to 'graduate' by retirement a generation of market participants and their advisors, the real experts in this field.

-- They built the legal theory and infrastructure of the derivatives and structured finance industry through the formative years of the business.

-- They understand it.

-- And many of them are prepared to "give back".

But they need your support. There is mutuality of interest.

Remember, the courts can be your ally in promoting financial stability. But, from where we currently stand, they can also be a source of systemic risk.

Conclusion

To conclude:

Financial market law litigation is probably increasing.

-- It is certainly potentially complicated.

-- And, partly because of standard contracts and terms, and the volume of trading covered by these, wrong decisions threaten systemic risk.

In this sense at least, the interest of the markets in the outcome of a case may be far greater than the interest of the parties to that case.

The current reliance on national tribunals of general jurisdiction and ad hoc arbitration is unsatisfactory.

-- It is too decentralised, too inefficient and too expensive, and, perhaps most importantly, it is failing to produce a settled and authoritative body of law or the predictability that the markets crave and on which financial stability may depend.

Let me leave you with a question:

Why do we have special subject matter courts for everything from family law to trade to tax and insolvency — but in most jurisdictions at national level we don't have dedicated courts for finance?

Do we need a world financial court?

Think about it. World trade benefits from the existence of the WTO tribunal and the dedicated bar it has nurtured.

-- Is international finance law any less global, complicated or systemically relevant than international trade law?

-- I don't think so. What do you think?

Some say that creating a truly World Court for finance is too ambitious — that it would take too long and that we can't wait.

-- Maybe.

-- But I say that if that is right then we should roll up our sleeves, not put *all* our eggs in the regulatory basket and start focused training for our judges on derivatives right away!