Know your limits

The Fair and Effective Market Review has laudable objectives. But history reveals the limits to regulating wholesale markets

Over six years have passed since the failure of Lehman Brothers. Many millions of expert hours have been devoted to framing and implementing financial market regulatory reforms. But there is little sense among the public that the financial services industry is serving the collective good. Hating bankers remains a national sport. Why is successful financial market regulation such a hard nut to crack? There is much distinguished comment on this problem, most of it from economists. Yet regulation is part of law, and its apparent lack of traction is, in part, a legal issue. Some good examples of this – old and new – include the Fair and Effective Markets Review (FEMR), the limits of fiduciary duty, legal factors contributing to short-term investment, and perverse legal incentives.

FEMR and markets

The market welcomed the FEMR, which was launched in June by HM Treasury, the Bank of England and the Financial Conduct Authority under the leadership of Minouche Shafik. It also welcomed the careful research and fresh thinking in its October consultation document.

But despite the propitious start to this project, expectations must be managed, because financial market scandals will not stop. A glancing acquaintance with English case law or, for that matter, English literature demonstrates that this has always been the case. Market professionals have always included bad apples who abuse clients and markets alike. But today, wholesale market misconduct has captured the public imagination, and this cannot be attributed simply to a collapse in standards of market conduct. We should also consider the following three points.

First, expectations have risen. What is a scandal today used to be normal. In living memory, insider dealing was freely described as the way the stockbroker belt was built. The attorney general of a small financial centre memorably commented in the mid-1980s: "We're all insiders here". Associated with this is a decline in deference. Bankers and brokers used to wear bowler hats and attract largely unquestioning respect.

Second, the competitive pressures and operational opportunities heralded by the UK's so-called big bang in stock exchange reforms in 1986 increased the scale of abuse. What had been, in the era of gentlemanly capitalism, a form of discrete pilfering, now seems on a bad day like a kind of industrial production. Hence the explosion of regulation since the mid-1980s. It should be remembered that legal rights are, functionally, remedies. In a democracy cherishing freedom of action, high-minded rules arise only in response to low practices. What regulation gave away with one hand in 1986, it took back with another, with the Financial Services Act of even date.

Third, the press are on to it. A matter as technical as Libor [London Interbank Offered Rate] could only command tabloid front pages in the angry mood of a post-crisis, recession-bitten public looking for someone to blame. The scandals will continue to be exposed, because exposing them sells newspapers.

The measure of FEMR's success will not be the end of reported abuse, but rather the promotion of a culture of shared norms among regulators and the regulated. The industry has lost public trust, and a culture of shared values is the necessary foundation of trust. Pre-big bang, such a culture was based on exclusion, and this belongs to the past. Today, at the heart of popular indignation with the City lies the combination of bailouts and bonuses, or (in simple terms) the lack of mutuality. We need to develop a new culture based on mutuality, and it may be done by reference to the social contract.

Limits of fiduciary duty

As clients of financial intermediaries, end users have always had only indirect access to wholesale markets. This is necessary, both operationally and in terms of risk management. But it does expose clients to the conflicts of interest affecting the intermediaries. The traditional legal solution is implied fiduciary duty, obliging the intermediary in good faith to promote the interests of the client above its own. A principle of the Kay Review of Equity Markets is that:

'All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflicts of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. …Contractual terms should not claim to override these standards".'

But for a number of reasons, fiduciary duty is not an effective solution today.

Contracting out

The first reason is contractual limitation. As the Law Commission points out, and notwithstanding Kay's recommendations, contractual modification is permitted. English law is chosen to govern commercial contracts around the world because it offers legal certainty. English commercial judges cherish freedom of contract in commercial transactions. While the famous positive aspect of freedom of contract involves reluctance to strike down contractual terms, the less known negative aspect is reluctance to imply non-contractual obligations. In this spirit, case law since the 1990s has resisted implied fiduciary duty in commercial transactions, and upheld limitations clauses, on the basis that contract is king.

Length of chains

The second limit of fiduciary duty in the context of wholesale market intermediation is the length of chains of intermediaries, which may have multiple links. The Kay Review calls for fiduciary duties to be owed by all intermediaries in the investment chain directly to the economic investor. But this would involve a radical change from the prevailing position, in which fiduciary duties arise between service providers and their direct clients. The Kay Review calls on the Law Commission to review fiduciary duty in this context. But the Law Commission's report on fiduciary duties finds that: 'The principles set out in the Kay Review are so far removed from the courts' interpretation of fiduciary duties that we do not think that it is possible to create the first from the second.'

Later it states: 'Fiduciary duties do not appear to be an effective means of achieving Professor Kay's policy aims.' The Law Commission recommends that the regulatory rules may be a better way to ensure that intermediaries prioritise the interests of clients.

Good faith not good outcomes

A third limit of fiduciary duty is the nature of its moral ambition. This is the good faith of the intermediary, but not a good outcome for the client. The focus is the state of the fiduciary's conscience, and not the state of the client's account. A pattern of trading that proves disastrous for the client involves no breach of fiduciary duty by the intermediary, provided it was entered into in good faith.

Short termism

Since the crisis, there has been much discussion of the kind of capitalism we want. Many wish to see less gaming and more long-term, active investment that serves industry. As to how we came to be where we are, some commentators have focused on takeover culture, and the short-term pressures on fund managers to perform in industry league tables. There are, however, a couple of other examples of regulatory and market reforms that have excellent objectives, but also unintended consequences.

Securities collateral

Starting in the 1990s, and continuing with the post-crash reforms, the regulatory imperative has been to collateralise financial exposures. There is only one place with capacity to meet the now voracious market appetite for collateral securities, and that is the institutional asset base. Pension funds and insurers' quality assets flow into, and circulate within, the shadow banking system, but not as long-term investments. Indeed, not as investments at all, but as collateral among firms with no economic interest in the issuer. This runs counter to the call in the 2012 Myners Review of Institutional Investment for greater activism among institutional investors, and weakens the already remote relationship between Wall Street and Main Street.

The problem is compounded by the use of custodial intermediaries between the investor and the issuer of securities. The indirect holding system was developed in part as a response to the paper crunch of 1987, in which failed settlements threatened market disruption. The computerisation of settlement through the use of central securities depositories (CSD), relying on common depositories in issuer jurisdictions and admitting only major institutions as participants, transformed infrastructure efficiency. But it also separated investors from issuers. Meanwhile, cross-border investment was facilitated by global custodians, whose local sub-custodian networks provided the local presence often necessary to deal with local issuers, tax authorities and CSDs. Clients were offered one stop shopping and the ability to deal with an international portfolio across a single set of global custodian accounts. But, as a matter of law, the investor was no longer the owner of record of the underlying securities. The separation of legal and economic ownership tends to cut across active stewardship.

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Perverse legal incentives

The fact is that rules don't work, but incentives do. Firms are more likely to stop egregious behaviour if it ceases to serve their interest, than if they are exhorted to stop while it continues to do so. An important but neglected category of perverse incentives is the special rules of financial law.

Rule of law generally serves the collective good by sanctioning harmful behaviour. As such, losses normally lie where they fall (with the risk taker), negligent and foreseeable wrongs must be compensated by the wrongdoer, positions of trust and reliance must not be abused, and speculative contracts are not enforceable.

The proper business of financial institutions is to serve the collective good by granting credit and selling protection, that is, by taking risks (whether on clients or away from clients). To encourage this, special rules of financial law were developed to promote risk taking. They do this precisely by separating players from the adverse consequences of their own actions. If this doesn't sound like moral responsibility, that's because it's not. The supply of credit and the availability of protection are public goods, and through a number of steps in legal history they have served to justify the instrumental irresponsibility this has brought.

First, limited liability separates investors from the excess losses of their undertakings. Shareholders fail as gatekeepers, not just because of short-term and indirect investment, but also because they take all the upside, and limited downside of leveraged, speculative ventures. Of course, in the past, brokers and banks were general partnerships.

Second, directors' duties. John Kay has helped us interpret the statutory duties in an enlightened fashion. But even so, the interests of customers or markets cannot trump those of shareholders, which creates a tension between regulatory and statutory duties.

Third, we have worshipped liquidity, and therefore ease of transfer, but did not foresee the very mixed blessing of high frequency trading. No transaction cost or delay means no stake in the issuer, and endless opportunities for disservice to clients. Remember that common law rules have always restricted the transfer of claims in the interests of moral responsibility and social stability.

Fourth, bad things can come from good things, including the insolvency preference of set-off and security. Had market exposures not been widely collateralised, the crisis would have transmitted absolute insolvency, not merely illiquidity, between financial institutions, and the bank bailouts would have been impossible. The economic and social damage would have been immeasurably worse. But it is also true that collateral causes the interests of the bank to diverge from those of its debtor client, because the bank will be paid even if the client goes under.

A fifth legal challenge for effective regulation relates to private law liability. The rules restricting liability for pure economic loss in negligence (combined with the ready ability of firms to contract out of tortious as well as and fiduciary duties to professional clients) may be linked to the mis-selling scandals that just seem to keep coming.

Sixth is gaming. Since the crisis, most would like to see fewer speculative credit default swaps. Some may begin to see the wisdom of the traditional rule that gaming contracts are unenforceable.

The way forward

Of course we should not abandon these rules. They are too embedded in our practice. But it should be remembered that the rules form part of a social contract. Financial market participants were given extraordinary legal breaks to enable them to serve the public good. Historically, the special rules were justified as a way to protect commercial (not speculative) risk taking, and the supply of credit to industry. Today, many aspects of our daily lives depend on the wholesale markets, from the mortgage finance that permits widespread home ownership, to the availability of imported food in the supermarket. But we are not well served by the abusive market practices that continue to come to light. It is legitimate to expect financial market participants to demonstrate the social utility of their business, as the *quid pro quo* of the special rules of financial law. This expectation may be best delivered by the FCA as a conduct matter.

The wholesale markets are a UK success story, and merit wholehearted commitment to restoring public trust in their fairness and effectiveness. With the FEMR, this work is in a safe pair of hands. But we should not expect the public agencies behind it to deliver a quick fix through new regulatory rules, especially given the legal backdrop to their work.

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