KEY POINTS

- Is the lawyer expected to advise not only whether a transaction complies with the law and regulatory standards, but also whether it is ethical?
- Given the economic resemblance between some of these complex financial contracts and insurance there may be room for an inventive application of the duty of utmost good faith, but that is not a step the law has yet taken.
- The Financial Services Authority has not considered it right or practical to seek to define more prescriptive standards of ethical behaviour in the markets.

Spotlight

Author Charles Flint QC

Ethical considerations for lawyers in complex financial transactions

Charles Flint QC questions the role of in-house counsel in shaping and applying ethical standards in complex financial transactions. This article was written for, and delivered at, the American Inns of Court Symposium at Georgetown University Law Center on 1 April 2011.

Those of you who have read *Liar's Poker* by Michael Lewis may recall the account of his first trade as a bond salesman at Salomons. He is allocated some bonds to sell to a client. Only when the successful trade is announced on the tannoy and he sees the mocking reaction of the other traders, does it dawn on him that he has actually sold some loss-making bonds from the firm's own book. The purpose of the trade was to transfer loss to the client. The sale was lawful, but was it right to take advantage of the client's lack of understanding? In that context the answer appears clear: proper ethical values should discourage profiting at the expense of clients. But how is that general principle actually understood and applied in more complex financial transactions?

And there is a more fundamental question as to the need for financial firms to adopt ethical values. Is this merely based on enlightened long term self-interest in the reputational standing of the firm, or is there a wider social need for ethical values in the financial markets? And if there is that need what role does in house counsel play in shaping and applying those ethical values? Is the lawyer expected to advise not only whether a transaction complies with the law and regulatory standards, but also whether it is right?

The problem of the sharp selling to the unwitting is hardly novel, and as I shall suggest it is imperfectly regulated by the law. This is not so much a problem on the regulated markets, where listed securities with clearly defined characteristics ought to be traded between counterparties operating on the basis of information available to the market as a whole. Nor should it be a problem in the sale of financial products to retail consumers where the law and regulation provides comprehensive protection, although compliance is often weak. In those areas the law, and regulation, may be expected adequately to define responsibility.

But over-the-counter innovative financial instruments are created where the risk embedded in the instruments may not be fully understood by those who end up holding it. The size, scale and complexity of that financial activity can have serious implications not just for the parties to those transactions, and those who depend on those parties, but for the proper functioning of the financial markets. The experience of the financial crisis would suggest there is a need for an ethical self-restraint on the originators and sellers of these arcane securities.

I therefore wanted to take as background to our discussion on ethical considerations for lawyers in the financial crisis the circumstances of two bond transactions which suggest the need for a much stronger culture of ethical responsibility on those who originate complex financial transactions. You may be able to join up the dots and identify transactions to which I may be referring, but of course I could not possibly comment on the facts of particular cases.

A TALE OF TWO BONDS

An investment bank designs Bond A which pays a high interest rate in euros for the first five years of its life. For the remainder of the 25-year term it pays a floating interest rate equivalent to four times the difference between the ten-year and two-year Euro swap rate. The notes are secured by a swap agreement of the dollar cash flows from a collateralised debt obligation assumed by a special purpose banking vehicle.

The terms of the structure are complicated, but at least they can be worked out by an expert lawyer or banker. What is impossible to work out is why any ordinary investor would want the interest rate on his bond set in the future by reference to the spread between different maturities of Euro swap rates. An unsophisticated investor would be attracted by the high initial rate of interest. It would take a peculiar attitude to risk, and a surprising interest in an arcane corner of the currency and bond markets, for any investor actually to want to purchase a bond whose long-term returns depended on factors which he could not begin to understand. On the other hand a sophisticated trader who wanted to gain exposure to future movements in swap rates

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would not be at all interested in paying for a fixed rate of interest for the first five years.

This was in effect a type of precipice bond. It could offer the initially attractive rate of interest only because it was priced to assume a large element of risk to capital, which was not evident from the headline terms included in the term sheet. If there was a downgrade in the value of the collateral the holders of the notes would take a heavy loss. The initial rate of interest was highly attractive to investors, and the risk to capital was not at all obvious to the unwary.

The bonds could not easily be sold to retail investors in the UK, for whom they were clearly not suitable. Instead they were sold to a broker in another jurisdiction, helpfully packaged in small amounts which could be sold on – as they were – to retail investors and small pension funds – attracted by the high rate of interest paid on bonds issued by a reputable bank. Neither the counterparty nor the ultimate investors understood what they were buying. The investors included (and I am not making this up) an order of nuns looking for a safe home for their savings.

Four years later – in late 2008 – the underlying collateral was downgraded, the investment was closed out, the bank recovered its share in full and the investors lost 90 per cent of their capital.

The investment bank complied with the law, and its minimal regulatory obligations, in selling the bonds to a counterparty which was responsible for understanding the risk it was assuming. There was no misrepresentation and the term sheet excluded any potential liability. The fact that the bank knew that in all probability the bonds would end up in the hands of investors looking for a high but reasonably safe 25-year income stream is – for the law – wholly immaterial.

Bond B is also between sophisticated counterparties who might be expected to understand the risks that they were assuming. A hedge fund with a bearish view on collateralised debt obligations ('CDOs') secured on the US residential market approaches a number of investment banks with a view to acquiring protection on a number of the riskiest securities through a synthetic CDO. The word 'protection' is in any event an interesting way of describing a naked short, under which the hedge fund bets that securities which it does not hold will fall in value. The ultimate buyer of the other side of the position does not know that the instrument which has been put together by the investment bank is designed to reflect those CDOs which the initiator of the transaction considers most likely to fail. The bank is happy because it is intermediating in the transaction – it takes a substantial profit for designing the security, but no substantial risk when it sells it on. The hedge fund is ecstatic when its bet pays off. The purchasers include overseas savings institutions. But the ultimate losers are their savers and pensioners.

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Some investment banks were reportedly concerned about the ethics of selling these securities to their clients and declined such transactions.[1] But others did not.

LEGAL AND REGULATORY STANDARDS

What is there in common between these two bonds? Their complexity is only matched by their lack of social utility. They could not have been designed in the interests of the ultimate purchasers, still less for those who might depend on the ultimate purchasers for their savings or pension payments. But the law is not very good at looking beyond the immediate parties to a transaction to protect the interests of those who suffer the ultimate loss. On the other hand, the terms and pricing of these transactions are likely to have yielded a recognisable profit for the banks, and an immediate and substantial addition to the bonus pool for those who devised these potentially toxic instruments.

Let us make the assumption that the transactions under which bonds A and B were sold were entirely lawful. After all the common law is fairly undemanding in the standards it sets for financial transactions. In the absence of positive misrepresentation any well drafted term sheet will comprehensively exclude any advisory or other liability to the buyer.[2] Given the economic resemblance between some of these financial contracts and insurance there may be room for an inventive application of the duty of utmost good faith, but that is not a step the law has yet taken.

Why then does the regulatory system not prevent the astute from transferring risk to the unwitting? In the UK the regulatory system, as a system, adequately protects retail consumers from the mis-selling of financial risk. But the proposition that sophisticated counterparties should not be able to take full advantage of an asymmetry of information is still greeted with surprise in some quarters. As the big beasts consider themselves as at least as swift of foot as their counterparties they see no reason why the law of the jungle should not apply.

On the regulated markets this is not such a problem, for the law of market abuse,[3] which regulates inside information, may be expected to prevent the most serious abuses of the financial markets. However that law does not extend to over-the-counter transactions,[4] and in any event would not have prevented the vice inherent in these bonds.

For well over 20 years all regulated financial firms in the UK have been subject to the general, and overriding, obligation to conduct their business in accordance with the Principles, which form part of

Biog box
Charles Flint QC is a commercial barrister and mediator specialising in banking and financial services. He practises from Blackstone Chambers, Middle Temple, London.
Email: clerks@blackstonechambers.com

the regulator's rules. On the face of it these Principles are powerful universal statements of good conduct. However the Principles do not give rise to civil liability and their regulatory impact is limited. They are easily applied to cases where a firm has acted in breach of detailed rules, or where misconduct is clear. But how effective are they in influencing the conduct of business which appears to be profitable, legal and not in breach of the letter of regulatory requirements?

Principle 1 articulates the overriding standard: 'A Firm must conduct its business with integrity'. But is integrity a sufficient statement of ethical values? Integrity may serve as a touchstone for deciding whether statements to the market are true, but may not assist in deciding whether a transaction is fair.

Applying a personal value to a corporation may not be straightforward in principle or in practice. The varying degrees of knowledge within an institution raise a practical problem of enforcing proper ethical standards through this Principle. It may require a detailed knowledge of both the design and proposed marketing of the product to understand its potential toxicity for the ultimate purchaser, and however high the standards of the individual is it wrong to allow an institution to profit from inadequacies in the law and regulation, and inefficiencies in the market?

Principle 6 requires a firm to treat its customers fairly, but the ambit of this principle is contentious and in any event it is only intended to protect retail customers. These principles do not require market counterparties to be treated fairly.

The principles also include the requirement to comply with 'proper standards of market conduct'.[5] The limitations of that principle, in the context of the bond transactions which I have been discussing, are self-evident. The principle itself is a relativist statement and the market standards may not be easily defined. Too often compliance with proper standards of market conduct is interpreted in practice as requiring only compliance with the lowest acceptable standard of behaviour.

ETHICAL CONSIDERATIONS

These then are the rules which come closest to imposing external ethical standards on financial institutions doing business in or through the UK. But the UK regulator, the FSA, has not considered it right or practical to seek to define more prescriptive standards of ethical behaviour in the markets.[6] Instead the regulator seeks to influence corporate culture so that those standards are defined from within the institution. Freely adopted standards going beyond what the law requires may be more effective; ever more intrusive prescription of standards may have the perverse effect of encouraging the competitive exploitation of the regulatory gaps, so that general business standards revert to the minimum which is legally acceptable.

The recent review of business standards by Goldman Sachs [7] appears a paradigm high-level articulation of proper standards, but its generality leaves many issues open in practice.

This then raises a real problem for lawyers within financial firms. It is easy to state that firms should treat their clients properly, and with integrity, but it may be less easy to define who is to be treated as a client and where the line should be drawn in certain types of transaction. More worryingly it is not at all obvious that ethical considerations have played a real role in the consideration of the design and marketing of new products. I doubt that any lawyer was asked to consider the ethics of the bond transactions to which I have referred. It would be a strong step for counsel to advise that ethical considerations should prevent the firm from entering into legal and apparently profitable new areas of business. The lawyer's role may be seen as limited to advising the institution whether the transaction will comply with the law and regulatory obligations, or raises reputational and other risks. Surely it is for the business heads to decide whether the transaction is right.

I return to where I began with the sale by a sharp bond trader to an unsuspecting client. He, or those responsible for his trading, failed to understand the difference between a market counterparty and a client. We all know that traders will often cross the line, but the line is at least capable of clear definition in market transactions. But the originate and distribute transaction model raises issues which go far beyond the immediate parties to a particular transaction, and affect the proper functioning of the global financial markets. After all it was the collapse in trust which caused the inter-bank market to seize up in the autumn of 2008.[8] Trust in markets rests not just on compliance with the letter of the law and regulation, but the implicit assurance that institutions apply proper standards to their business. The validity of that assurance must depend in significant part on the guidance given by in-house counsel. ■

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1 The Greatest Trade Ever – Zuckerman – p 181.
2 See *Springwell Navigation v JP Morgan* [2010] EWCA 1221; *Cassa Risparmio v Barclays* [2011] EWHC 479.
3 Financial Services & Markets Act 2000 s 118.
4 FSMA s 118A.
5 Principle 5.
6 FSA Discussion Paper 18 – 'An ethical framework for financial services' – October 2002.
7 Goldman Sachs – Report of the Business Standards Committee January 2011.
8 'Lost Trust – the real cause of the financial meltdown' – Bruce Yandle – *The Independent Review* 2010.