What is this thing called international financial law? Part 5

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This is the final part of a five-part series where the author investigates the nature of international financial law (IFL). After discussing the multi-jurisdictional nature of IFL, and how this fundamental attribute determines many of its distinctive features as a legal discipline, previous articles touched upon a number of the recurrent legal issues which professionals face on a daily basis in cross-border financial transactions, and the techniques that markets have evolved to deal with them. Any model of IFL needs also to take account of the impact of public law norms on international financial activity. Such is the concern of the present article.

Many of the legal issues which in the past have impacted cross-border financial transactions are clearly not issues arising solely from the application of rules and principles deriving from private law, in particular, contract law. As parties hone their commercial agreements and convert these into legal language in the form of written agreements, they are in effect setting down their legitimate expectations as, from their particular perspective, they perceive them to be. Apart from some adroit legal manoeuvring and perhaps astute legal drafting – which may even catch one of the parties out – contractual arrangements tend to reflect the basic understanding of participants in relation to the financial deal being agreed. Party autonomy is a recognised principle of most systems one usually comes across in international finance. Consequently, it is usually open to parties freely to reach agreements on whatever terms they – and the markets – see fit, as long as these are within the law.

Within the law? What, exactly, does that actually mean?

As we saw in the previous articles of this series, in international financial law (IFL) to be "within the law" means making sure one is in compliance with the governing rules of law applying to the relationship (instrument or transaction). Clearly this almost trite observation also holds true for any domestic transaction. In reality, a better description of the prevailing state of affairs in IFL is that being compliant with the "law" in a cross-border situation entails being compliant with more than one law. In IFL, being "within the law" necessarily entails being within "the laws": the agreement entered into between parties and their subsequent conduct needs to be consonant with the legal rules of several jurisdictions, not just one.

That is why it is readily understood by all concerned that any agreement underlying or constituting a financial transaction, instrument or relationship should, first of all, not be in conflict with the principles and formal and substantive requirements of the applicable systems of private law. For this reason, great care is taken to make sure that the relationship appears to conform to the basic legal principles of the systems of private law which are identified as being relevant to the deal. Otherwise, the applicable law (or laws, in the case of IFL) may act to invalidate, vitiate or otherwise do legally unpleasant things to the transaction, and generate dire negative consequences in relation to it. Not unexpectedly, in view of the multijurisdictional setting of IFL , a number of legal strategies are employed to manage the legal risks inherent in its essentially cross-border environment, an aspect on which we touched in the last article in the series[1].

The flip side to private law issues are public law concerns. In a broad sense, the concern of private law is with establishing the substantive boundaries within which parties are free to agree, and the legal formalities according to which this must be done; public law norms more often than not have a different focus. While it is not necessary for private law to appraise the content of the private covenant entered into (agreements with different commercial terms may be equally valid), public law norms will tend to latch onto and scrutinise the very subject matter of that arrangement. When we talk of public law, amongst other things, we generally mean legislation (in whatever form) whereby the state (or a public body) intervenes in some form to decide on the legitimacy of private treaties on a particular subject matter and of the appropriate limits to be observed. Arguably, it does so to protect what it perceives to be its own specific interests (which it will also tend to identify with those of the general public).[2] In consequence, it seems to be the case that such norms will decree what they regard as the proper content of private arrangements and the proper manner in which these may be carried out in relation to specific interests of the state (which may include for the purpose of the particular regulation, the government and specific or broad segments of the public). In finance, this approach has over time translated into general financial regulations, specific market legislation, rules affecting particular sectors, and considerations of public policy and public order relating to financial matters.[3] A critical feature and significant consequence of public involvement through public law norms is that otherwise perfectly valid private law agreements may be scuttled by community intervention, perhaps to the dismay of participants.

As we saw in the case of the swap contract and derivatives contracts generally, actual historical experience often counsels public authorities to assume defensive measures of some kind to protect the public interest (as they perceive it to be). This caution is understandable and may be consid-

ered commendable, given the nature of many of these arrangements (particularly susceptible as they are to creating possibly devastating effects in the hands of the inexpert, or of those with particularly adventurous natures) and the consequent danger of systemic crisis. Nonetheless, from the purely private law point of view, public law intervention can lead to situations of acute legal discomfort. This would be the case when otherwise compliant private law contracts (swaps, futures) risk being voided by legislation dealing with gambling and betting.[4] What is most upsetting is (from the private law viewpoint) perhaps the unexpectedness of the application of a public law principle. If the arrangement is valid from a private law perspective, then, barring obvious illegality for being contrary to some reasonably connected public law principle (in the case of financial instruments, legislation relating to finance and banking) it is naturally assumed to be compliant. Unhappily, the logic of public law reasoning tends to be quite different from that underlying private arrangements and from the legal syllogisms underpinning private law remedies. While public intervention able to affect a particular transaction is relatively simple to predict in any one single jurisdiction (public norms are part of the local law, and one ought to be in a position to know local rules), it is clearly more difficult to manage potential impact of public norms generated by more than one jurisdiction. In IFL, part of the difficulty is therefore trying to identify *a priori* all the jurisdictions that may be potentially attracted to the transaction under review. Various contractual strategies are adopted in order to avoid the risk, mitigate the consequences or shift the burden of any undesirable exogenous legal visitations to the extent possible.

Unfortunately, in many situations these contractual techniques sometimes have a limited value. Quite aside from the fact that these techniques may in any particular case not turn out to be perfectly effective in themselves, this may be so for a very practical, market, fact rather than for a strictly legal reason. Essentially, while contracts such as swaps and international loans tend to be two-party affairs, a significant part of the international financial markets deals in multi-party paper rather than the simpler bilateral relationship: equity, debt and hybrid securities are issued, placed and sold in multi-party contexts involving numerous participants. This fact necessarily implies that some of the techniques which are workable in a bilateral situation involving (two) parties in a constant relationship with each other (a closed set), are not feasible in one involving more than two parties not in constant relationship with each other (a potentially wider, or open, set in which new parties may become involved over time). This amplifies the hazards of working in multi-jurisdictional settings, since each new participant can import new law. This is particularly the case in relation to public law matters. Different techniques have therefore evolved to confront and manage this problem.

A. Understanding financial regulation

An understanding of financial regulations as they generally appear to have evolved is an important first step to confronting this potential problem. To begin with, it may be worthwhile constructing a general theoretical model of financial legislation in order to deconstruct existing practice, which may be useful for predictive purposes. To do so, it may be as well first to consider securities legislation, since a significant part of modern international financial activity is focused on this segment of the capital markets.

Even within this relatively limited sphere of public law regulation, it seems that the variety of responses that have historically evolved in the different jurisdictions one is likely to come across in international financial activity is quite bewildering, and indeed has been the subject of extensive literature on the subject. Delving into the detail of each regulatory structure and thumbing through the folds of copious tomes of black-letter law and specific regulation can lead to conceptual confusion and physical strain. And, of course, "what is" can only be a guide to – never an assurance of – what in the future "will be" and "may be", notions that constitute an important component of analysis in IFL. Add to this scenario the existing levels of global financial regulation[5] and the emergence of so called "soft" law, and the situation becomes decidedly complicated. What is needed is some sort of model of reality which can help bring perceptual order of at least an elementary sort.

B. Deconstructing securities legislation

The black-letter law in all possible jurisdictions that may be directly or indirectly encountered is not, in reality, pre-emptively knowable. Even if one were gifted with the quality of omniscience, comprehensive knowledge of black-letter law would in reality tend to be fleeting knowledge, as laws change not just with geography, but also over time. Constant recourse to a local lawyer is important. Yet some sense of what is possible or probable would be helpful. A simple model for predictive purposes (even if merely heuristic) would indeed be useful.

In the next sections I shall attempt to sketch a rudimentary model for securities regulations as they would, should, could or might exist in the legal universes one is likely to encounter in international financial activity. More specifically, the aim of this section is to formulate a rudimentary model capable of predicting what sorts of securities regulations are likely to be relevant to a hypothetical cross-border transaction occurring in, or involving, a number of jurisdictions, either wittingly or not.

C. A market model for securities regulations

It is arguable that whether it was so constructed mindfully or not, in reality most securities legislation can be divided into regulation dealing with primary market activity and legislation dealing with secondary market activity. This fairly standard model reflects a market that distinguishes between two distinctive stages of the securities selling process.

Normally, a primary market is the investor marketplace in which securities are sold for the first time. By contrast, and in contradistinction to this, the term "secondary" market is

usually taken to signify the market where securities are subsequently sold by initial investors to other successive investors (this includes investment and trading activity).

The distinction is not merely theoretical. Underlying it are two distinguishable market processes. Primary market sales occur through distinctive distribution routes that are different from those involved in secondary market activity. Primary market sales may be either "placed" with professional dealers or allotted directly to the public at a fixed price. Often, primary market activity is primarily of a wholesale nature (large lots placed with groups of professional houses). Even direct, initial public offers offered to the public at large are usually executed through institutional distribution channels. Secondary market activity is carried out through different avenues. These sales occur at both retail and institutional levels through brokers and agents and the price is set by market participants according to supply and demand.[6]

In practice, the distinction between primary market and secondary market activity is not a perfect one. Nor is it one that ordinarily underlies legislation in any explicit manner. Nonetheless, generally speaking, securities legislation does seem to naturally reflect this instinctive market dichotomy.[7] Undoubtedly, the original notion underlying the distinction may be rooted in the fact that the primary offer relates to a new security not yet digested by the market processes, while a secondary dealing relates to a seasoned securities for which information and pricing is said to be available and is said to be already assessed by the market. That is why a prospectus is normally required for primary, or first-time, sales: to provide to the market information not yet generally available or generally known.

Indeed, securities law regulates primary market activity primarily through the use of this common fundamental tool, the prospectus document. Any issue of securities that is listed on a stock exchange or offered to the public at large must be made on the basis of a prospectus (variously defined), which must contain certain prescribed content and comply with stipulated provisions of law as to form and distribution.

In modern times, the historic pathfinder legislation seems to have been the US enactments of the early 1930s. Following the investment disasters immediately preceding the Great Depression, the US Congress passed the Securities Act of 1933 and then the Securities Exchange Act of 1934. The former Act sought to require all issues of new securities (within the federal jurisdiction) to be accompanied by an appropriate information document on the issuer and on the issue (ie a prospectus, called a "registration document"). The idea behind the enactment was to ensure that investors were in possession of all material information concerning securities being offered for public sale on the primary market and to discourage deceit, misrepresentation and fraud (not surprisingly, the act was also known as the "Truth in Securities Act"). Similar notions lay behind the Securities Exchange Act, which created the SEC (the US Securities and Exchange Commission) and regulated the secondary markets which arose after the initial public offer of securities.

A requirement to provide a prospectus for primary market activity was also enshrined in the following EU Directives, which together formed the historical basis of the current European primary market regime:

- Stock Market Listing directives (79/279/EEC);
- Prospectus Directives (80/390/EEC and 89/298/EEC) ;
- Council Directive 82/121/EEC of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing;
- Council Directive 88/627/EEC of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of;
- Directive 2003/7/EC adopted on 15 July 2003 which merged the previously separate Stock Market Listing and Public Offer prospectus directives;
- Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC;
- Transparency Directive (2004/109/EC), which came into force on 20 January 2005, deals with financial reporting requirements, disclosure of interests in securities and communications with holders of shares and debt securities and the market;
- Commission Regulation (EC) no 211/2007 of 27 February 2007 amending Commission Regulation (EC) No 809/2004 of 29 April 2004 and relating to the financial information to be provided for in prospectuses where the issuer has a complex financial history or has made a significant financial commitment

The effect of these Directives was to create a "single passport" prospectus, applying the same rules to disclosure documents to be used for public offer procedures and for admission of securities to trading. (In fact the same document could be used for both environments and, once translated, also utilised and distributed Europe-wide.) In order to ensure investor protection, approval is granted only to prospectuses that meet common EU standards in relation to the content of prescribed information and the manner in which it must be disclosed.

Over time, most jurisdictions with any level of sophisticated capital markets activity seem to have introduced legislation governing the primary markets (including, but not exclusively, IPOs – initial public offerings) centred around the basic model of a prescribed information disclosure to be made via an approved disclosure document.

D. Primary market regulation: underlying policy

One of the traditional reasons for securities regulation has been consumer/investor protection: famously, the protection of "widows and orphans" – that is to say, unsophisticated investors. It is felt that market regulations need to insulate the ordinary investor, who does possess specialist knowledge, from the abuses of the unscrupulous and from sharp market practices, by ensuring that enough information of an adequate standard is available to enable the investor to form a sufficiently informed judgment in relation to the nature and merits of an investment

There is some debate over whether primary market legislation (and indeed all securities markets legislation, including

secondary market regulations) is, or is not, a form of consumer protection legislation, and, if it is, whether in fact it should be. According to one school of thought, securities regulations ought to proceed on the assumption that such regulations are in fact primarily a means of ensuring a competitive market for analysts and sophisticated professional investors (deemed "information traders"), helping to create efficient markets and improving the allocation of resources in the economy. Ultimately, this function will have beneficial effects throughout society, benefiting all investors, whether sophisticated or not. This model – its bullish self-assurance perhaps dented by the events of the recent financial crisis – does not seem to be the prevailing legal paradigm.[8]

Small investors, for most intents and purposes seen as being akin to consumers, and worthy of the same level of protection, are not usually forgotten by regulatory regimes. The protections afforded by law to general investors seem to be suitably high, especially when compared with those afforded to professionals, which, if anything, appear to be far less exacting. While no regulation will protect investors (of any level of competence) against innate stupidity (everyone retains the right to make wildly mistaken investments), the level of protection afforded by legislation to protect the retail investor against the effects of his technical incompetence, or innate foolhardiness, are higher than those applied to sophisticated and institutional investors.

Creating this dichotomy seems to be a common ploy of regulatory regimes. Normally, for example, the prospectus regime is less demanding in relation to offerings made to professional or knowledgeable investors. Although the black-letter law standards differ from jurisdiction to jurisdiction, there is a tendency to create a class of investors in relation to which the usual requirements to produce a prospectus in the case of a securities offering is relaxed or done away with altogether. This class of investors tends to comprise professional investors (presumably on the basis that its their job to be informed), institutional investors (presumed to be professional), sophisticated investors (informed and capable of knowledgeably evaluating investments) and perhaps high-worth individuals (presumed to be sophisticated investors). Definitions and prescriptions vary.[9] Understanding and knowledge of the nature of the investment security seems to be the crucial aspect here. While it may be argued that a security that has been on the market for some time has been subjected to the analysis of all the information brokers and will have leaked its secrets, this will not have happened in the primary offering period, which is rather shorter. It may be felt that only professionals should handle such untested property without a full information package being provided (in the form of a government-vetted registered prospectus).

In part, the duality is often supported by market pressure, which is largely self-serving. Being on the right side of the asymmetric information divide (after all, being so often there constitutes part of their job description), professional market players will often be irked by the need to subject themselves to public vetting of any offers they wish to make, or wish to subscribe to, in a professional environment of peers. Convinced of being able to make relevant informed decisions in relation to securities, they prefer not to be burdened by bureaucratic red tape which they feel does not provide them with any additional protection.

There are various indirect means of constructing the dichotomy. Often legislators will declare that placements of securities with a restricted circle of a few investors will not be caught by public offer regulations. Not being "public" (indeed, being deemed a so-called "private" placement) , there is, logically, no offer to the public and therefore no need for the related protections to come into play. What constitutes a limited circle will differ: 200 investors, 100 investors, 50 investors, or 20 investors.[10] In other cases, offers of securities which have minimum denominations of a certain level will, by virtue of this fact, be deemed to be directed to a professional, and not a retail market and therefore not subject to the usual rules; the minimum denomination could be €50,000 or something like US$100,000.[11] Plainly, there is nothing magical about the numbers involved. They are merely a convenient surrogate device for implying potential retail activity.

By the same token, the emphasis on the public/private distinction also seems to reveal the other – macro – side to financial regulations. What consenting investors do in the privacy of their individual offices does not seem to be the problem. It is only a problem when it becomes a widespread or significantly public, activity affecting the structure and workings of the markets at an aggregate level. It may be argued that, despite its consumer protection bias, the ultimate aim of financial regulations continues to be to ensure the orderly running of the markets in their entirety. And to do this by ensuring fair market practices so as to protect confidence in the financial system as a whole. In economic-speak, the aim of legislation is to ensure an "efficient" and "stable" market, on the basis of "transparency" in "price formation", the "protection of competition" and the avoidance of "false markets" or of "false impressions" by encouraging the flow of unmanipulated and adequate information.

E. Secondary market regulation

If we were to model the entire corpus of secondary market activity, one could do worse than approach the matter by adopting what could be termed a "Triple-P" model (a model also applicable to financial regulation generally).

Accordingly, it could be said that secondary market legislation regulates the retail market by regulating the *product*, the *process* and the *players* (or *participants*).

Investor protection legislation adopted in relation to the secondary market activity seems in fact to adopt this strategy. In relation to *product*, the type of deal which can be transacted on the markets will normally be governed by private law principles which derive from considerations of public policy (and which will often also apply to primary market contexts). A renowned example of a set of limitations imposed on products which can be traded on the markets are the rules that prohibit or limit transactions in wagering and gaming contracts. Some financial products will be declared illegal, void, voidable or unenforceable to the extent

that they constitute betting transactions, unless they are transacted in permitted environments or between authorised or professional investors. Some derivative contracts have been exposed in the past to this danger, even in the most financially sophisticated of jurisdictions.[12] Equally, transactions linking advantages for a party to various parameters or to the ability to involve other counterparties in the transaction traditionally also constitute a problem area. Certain products are excluded from sale on a retail level as financial investments and the secondary market limited to strictly professional *milieux*.

Other products may be traded and negotiated only through a predefined *process*. In some jurisdictions, certain financial instruments may only be traded on an official stock exchange or authorised platform or through authorised intermediaries. For certain products, only banking networks can sell to or trade on behalf of investors. Insurance products, in particular, are carefully monitored, and often only insurance companies are authorised to transact business in these instruments. A great deal of care is usually devoted to how investment fund activities, depository business, trust activities, and above all broker and dealer activities are to be carried out, and by whom. Undesirable and sanctionable behaviour is targeted and castigated.

Once the proper channels for secondary market securities activities have been identified, the participating *players* in it are initially screened and then (theoretically) kept under vigilant scrutiny. In legal terms, this strategy tends to translate into rules and regulations of the following sort:

- licensing and authorisation rules for investment businesses (threshold conditions);
- statutory duties of fitness and propriety;
- rules to ensure the integrity, competence and soundness of investment firms, advisers and markets;
- training and competence requirements;
- general law rules regulating sales to the public and codes of conduct;
- criminal sanctions for fraud and misconduct leading to the creation of false prices, market disturbances or market disruption;
- remedies for recovery in tort, contract and according to rules of agency law both in relation to the product (the terms and conditions of the security) and the process (the offering and selling activity);
- disclosure requirements for securities issues to enable investor to make an informed decision;
- financial monitoring of dealers, brokers and agents (client money rules, solvency rules).

In keeping with this general, implicit scheme of things, in relation to secondary markets, the current EU regulatory regime has developed from the following milestone directives and enactments:

- Directive 2004/39/EC on Markets in Financial Instruments (also known as "MiFID") which restyled and expanded the original Directive 2006/73/EC Investment Services Directive of 1993;
- Directive on the Distance marketing of Financial Services. Directive 2002/65/EC adopted on 23 September 2002;
- Commission Communication on the Application of Conduct of Business Rules Under Article 11 of the Investment Services Directive (ISD) (distinction between professional and retail investors), issued on 14 November 2000, Com (2000)722;
- Directive on Insider Dealing and Market Manipulation (Market Abuse): Directive 2003/6/EC of 28 January 2003 (affectionately known in some circles as "MAD", perhaps reflecting initial opinions of the drafting) and related subsequent implementing Directives and Regulations;
- Specific provisions in sectorially focused directives specifically dealing with the insurance, banking, pension funds, investment firms, collective investment funds, and oil and energy segments of the financial markets.

MiFID essentially concerns itself with regulating *process* and *players*. It prescribes that certain secondary market activities in securities can only be carried out through authorised players and on authorised platforms, and requires authorised players to comply with certain capitalisation, organisational and operational prerequisites as well as with prescribed rules of conduct. Without compliance with these requirements, players are not authorised to trade or sell securities on the market.[13]

MAD primarily seeks to ensure that the secondary market *process* is carried out in such a way as to ensure the proper, fair and orderly functioning of the market. It therefore prohibits any activity which could lead to false or misleading signals being given which inhibit proper price formation and cause consequent sanctionable loss to investors due to such market manipulation.[14] It is clearly focused on protecting orderly process (a macroeconomic slant) rather than on considerations of individual investor loss.[15]

A similar implicit Triple-P structure can be seen in the US securities regulatory regime, as in other jurisdictions inspired directly or indirectly by the same.

Sectorial enactments tend to provide the same type of player and process (and at times, product) regulation in more specific detail or in relation to the specific economic or legal characteristics of the entities or activities to which they apply. While most jurisdictions seem to start off with very sectorially based legislation, a tendency in many evolved markets can be discerned towards cross-sectorial legislation providing for across-the-board protection to investors based on general categories of protection. This certainly seems to have been the case in the European arena (starting perhaps with the UK Financial Services Act 1986). It has been self-consciously adopted in Japan,[16] with some development in this direction being attempted in the US following the recent, post-crisis reform of its patchwork regulatory regime.

F. What underlying legal technique and strategies have been universally adopted by regulators?

A brief review of the common concerns in securities legisla-

tion on the basis of a simplified model, might suggest an extension of the model to regulatory practice in financial law generally.

As is evident, one of the common legislative strategies adopted by regulators is to require the production of paper and the creation of paper trails. As we have seen to be the case in primary market legislation, it now appears to be a legal commonplace to seek to protect the investor by requiring a written document to be provided which illustrates the main legal and economic characteristics of the promoter, issuer or proponent and of the investment product being offered.

Although the reasoning underlying this strategy is commendable, the strategy itself is patently not a panacea. Full disclosure is always to be welcomed, as it discourages deceptive behaviour. In the famous words of nineteenth-century US Supreme Court Justice Louis Brandeis: "Sunlight is the best disinfectant".[17] Nevertheless, the limitations of this device are all too obvious. It is difficult to envisage that a retail investor will plough through what to most readers will be reams of very technical language, composed of abstruse economic data, involved accounting presentations and alienating legalese and finally come to feel enlightened, reassured and protected. But perhaps this imperfect stratagem is better than not providing any documentation at all.

Another recurring strategy utilised by regulators seems to be to cast the regulatory net very widely and define financial products or relationships subject to regulation in a very extensive fashion. Having done this, they then provide for a series of carve-outs (exceptions to the rule) which are more or less complicated, more or less logical. This ensures flexibility, if not legal elegance.

In 1933, the US Securities Act defined what constituted a "security" with meticulous care:

> "The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."[18]

It was quickly realised that this may, in fact, have caught far too much within its purview. Not surprisingly, the 1934 version of the definition (utilised for the purposes of the sister Securities Exchange Act) seems to have added an explicit carve-out for certain types of instruments.[19] It appears to be common practice in many jurisdictions to provide for a number of exclusions. Financial paper which has a predominately commercial rather than investment character, such as warehouse receipts, bills of exchange, commercial debt, loans and even negotiable instruments such as commercial paper, are often excluded from market regulations. On the other hand, shares, bonds, notes, debentures (whether in dematerialised or physical form) will certainly be subject to oversight. Whether a financial instrument is caught, or not, may rest on an empirical analysis of the conditions of the local market rather than any *a priori* consideration of its legal or economic nature.

Certain jurisdictions, especially where securities markets are embryonic, will concentrate on just catching traditional equity and debt instruments of a negotiable nature.[20] Others, in developing markets, follow prior examples of close definition but tend to keep their bets open by providing for a catch-all provision that in future could bring other instruments into the current definition.[21]

Habitually, for the purposes of the primary market, sophisticated jurisdictions will tend to circumscribe regulatory reach just to transferable securities, and keep definitions extremely wide for the purposes of catching secondary market activity (trading, dealing and selling of investments). In this manner they can be reasonably sure of being able to regulate not just ordinary securities and investment products, but all instruments and activities of a financial nature considered to be capable of establishing a public financial market. A clear example of this tendency can be seen in the history of the EU regime.[22]

Much will depend on the fundamental nature of the financial market system being regulated and of the type of corporate control system which it reflects. Generally, academic works tend to identify four major forms of financial markets: equity market systems, bank-based systems, bank and industrial crossholding-based systems and state-centred regimes. Each of these financial environments has, at one time or other, been trialled around the globe.[23] Each tends to spawn a particular type of regulatory system and utilise a distinctive set of techniques. Bank-based systems will, for example, more often than not exempt offers made by credit institutions from primary market regulations and relax secondary market rules on the basis of the initial bias in favour of banks in the system and on the presumption that the institutions are already adequately regulated.[24] Traditionally, regulatory surveillance of financial markets tends to vary from almost *laissez-faire* control-at-a-distance (equity market systems) to active and close participation through centralised procedures (state-centred systems). Life in state-led regimes seems particularly pleasant from a regulator's point of view: no *a priori* definitions of what constitutes regulated investments or securities are necessarily imposed – much seems to be left to government discretion.[25]

Quite often the public law norms introduced by regulators tend to be based on conduct of business rules that reflect and improve upon existing principles of company law, contractual and extra-contractual principles. Some of these pre-existing private law principles are merely ordered and codified in the enacted legislation, while in other cases they are modified and improved upon, especially in terms of the nature of the proof required in order to establish breach of

duty or unconscionable conduct. Statutory fraud or malpractice is easier to prove than general law fraud or deceit, for example.[26] Technical content in regulatory statutes will often address areas of conduct that otherwise would pass under the radar screen of normal legal principles based on traditional concepts of fiduciary duty, agency, mandate or even tort (the classic example of this is insider trading). Some conduct which is considered economically harmful to a financial market may not be so considered from the viewpoint of general principles. Nonetheless the role of private law persists in complementing public norms and even extending their ambit to new phenomena not contemplated at the time of regulatory enactment.[27] Consequently, the range and detail of local regulations is extensive. Specific law and legislation differs according to national legal experiences, the structure of the market and the nature of the market players involved.

G. No jurisdiction is an island unto itself

It may at first appear to be overstated to sustain that until fairly recent times local securities legislation often seemed to be relatively unsophisticated. Nonetheless, one of the lessons of recent financial events has undoubtedly been that many systems have been markedly unaware of the interconnections between global markets. While local securities oversight bodies have concentrated on local products, the domestic financial systems have in fact been infiltrated with a myriad of cross-border products, with uneven results from the point of view of investor protection and the stability of financial systems. From the public regulators' point of view, this circumstance means that there may be a need to dedicate more attention in future to carefully defining what financial instruments and investment products will be regarded as subject to vigilant policing. In many sophisticated jurisdictions, there are still what look to be glaring holes in the legislation, through which financial operators can push financial placements which would not be regulated in the same manner in which they would otherwise be elsewhere in equivalent regimes. For example, despite the fact that Swiss Federal Act on Stock Exchanges and Securities Trading contemplated a draconian regime which was to catch most modern traded paper (debt and equity certificates, and, generally, dematerialised rights) as well as derivatives *en masse*, it may well be that it fails to cover various forms of participation certificates (eg in insurance or pension plans).[28] Notwithstanding the numerous categories of securities listed in Japanese Acts prior to the 2006 reform, they may not have contemplated certain foreign instrument products, the reason for which perhaps a concerted drafting effort was made in that direction (which now appears to catch trust instruments for instance). Most jurisdictions were, of course, wrong footed by hedge funds.

Should all financial instruments be regulated, or regulated in the same way? This is a large topic, which cannot be treated here. Clearly there is a difference to be drawn between *securities* (financial paper), *investments* (including interests in funds, and various other types of rights including insurance interests) and *financial instruments* (eg derivatives). Normally, a distinction is drawn, though not always. The risk is over-regulation and inappropriate levels of surveillance and control being introduced which can negatively impact markets. In order to ensure protection to all investors, there is a risk that this may result in the markets being strangled by raising regulatory costs unduly and thereby creating economic inefficiency, generally perceived to be the death knell of vibrant markets. The spectre of regulatory overreach is always a presence hovering in the wings.

H. Extraterritoriality

A constant danger in IFL of which professionals are aware is that many of these regulatory regimes – some of which are relatively unsophisticated, some of which are relatively evolved, while others are seemingly ultra-sophisticated and tendentially bent on overkill – could extend their area of impact to the particular transaction or activity in which one is involved.

One of the instances in which this can happen is where the transaction or relationship physically locates itself in more than one jurisdiction. Examples of this have been numerous in the past and with modern telecommunications increasingly common: a US broker with a place of business in Chicago solicits instructions from non-professional investors in London; a UK option dealer establishes an office in Istanbul; a Korean bank with a portfolio management arm operates from a representative office in Paris; a London-based insurance company offers life contracts exclusively to expatriates and foreigners; a German-based investment and commodity syndicate accepts subscriptions from investors in Rome. And so on.

Another reason for the high probability of public law norms affecting IFL is the penchant of many jurisdictions to apply principles of extraterritoriality. Historically, extraterritorial reach has been a common ambition of many tax laws and natural to systems of military justice. It may be argued, not without some justification, that there may be a growing trend encouraging the use of national law with extraterritorial reach to address the global activities of corporations in order to create appropriate accountability. This may certainly be seen in attempts to rein in global corporate activity in relation to human rights abuses and international crime. Perhaps this is merely the last stage of the dismantling of the Westphalian system of national governance. In any case, financial regulators have traditionally been open to extending their jurisdiction exterritorially to protect their citizens. In finance, this normally entails subjecting all offers of financial instruments made to local citizens to jurisdiction (on the basis of a nationality principle) irrespective of where this occurs in the world, and of subjecting even foreign financial operators to local financial regulations whenever their activity has the potential of involving, directly or indirectly, local citizens or even merely residents of the regulator's jurisdiction.[29] One suspects that this tendency will be reinforced rather than weakened in the wake of the 2007 financial crisis.

A familiar example of laws with explicit exterritorial reach is the US securities laws regulations. There appears to

be no literal territorial limit to the provisions of the US Securities Act and related legislation, and for this reason most public offer prospectuses incorporate specific language which seeks to avoid infringing its provisions.[30] This is the case even though there is no offering being made in the US itself. The language used tends to make reference to specific carve-outs provided in US legislation. The very existence of legislative carve-outs lends support to the conviction that US securities legislation is deliberately intended to be extra-territorial (for if it was not so intended, there would be no perceived need to provide for exceptions within the legislation).

I. An example

Take the example of an international bond issued out of London by a Hungarian corporate specialising in alternative energy, guaranteed by its Italian parent company. What public law norms would be relevant to this transaction? Clearly , those which apply to the place of issue (UK), to the place of incorporation of the issue (Hungary), and perhaps those associated with the guarantor (Italy). If the group of dealers or underwriters involved in the issue and placement of the security were financial firms incorporated in or operating from the US, Japan, Germany, Korea, Australia and China, then the regulations in the associated jurisdictions might be relevant. Even more relevant would be the rules and principles in the jurisdictions in which placement and selling activity is targeted. This will normally be the local markets of the players involved, but may also involve others. In our example, the issue may in fact also target institutional and retail investors in the Near East, Canada and Brazil.

One can visualise the situation as in Figure 1 where the concurrent private law issues are also briefly noted in passing.

The jurisdiction which is most naturally relevant to regulating the *process* of issue will be the UK. However, most of the other jurisdictions will express public law norms which govern the process of placement (to whom, by whom, through which channels, subject to what rules of paper trail and prospectus protection). All jurisdictions will have rules relating to *players* (limits on activity, authorisation criteria) which may incidentally impact. The public norms associated with the place of issue (UK), the issuer's jurisdiction (Hungary) and that of the guarantor (Italy) will directly regulate the *product* involved and the connected questions: is it legal? Does it conform to prescribed characteristics? Together, the diverse criteria applied will determine the jurisdiction and the laws which will apply to the transaction. As we saw to be the case in private law interactions in IFL, jurisdictional boundaries tend to be porous, and the coexistence of simultaneous, concurrent and perhaps conflicting jurisdictions tends to be the rule. One of the possible outcomes of this matrix of jurisdictional influences introduced by public law norms is an additional layer of legal uncertainty to that which exists at the private law level of analysis.

One of the techniques used to manage the legal risk associated in terms of *process* and *player* issues is to introduce

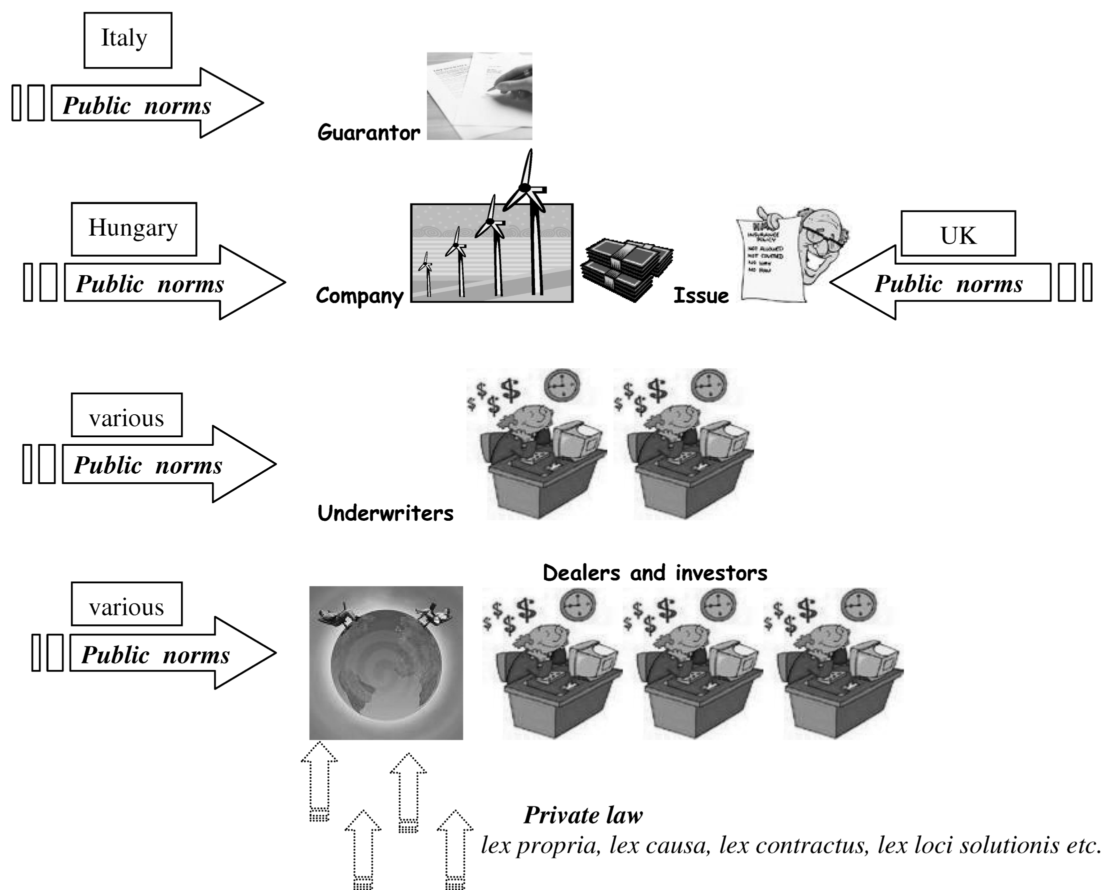

Figure 1

appropriate disclaimers and restrictions in the issue documentation. In our example, one would therefore expect to see a series of selling and subscription restrictions introduced in relation to the main jurisdictions involved in the issue (UK, Hungary, Italy) and caught up in the placement (the jurisdictions of the visible dealers and underwriters). Also customary would be a residual, catch-all, blanket restriction in relation to other potentially involved systems (eg those with targeted investors) which sometimes even needs to extend to the secondary market.[31] In the end, the idea is to prevent breach of public norms (to the degree feasible) by avoiding contact with a particular jurisdiction or by only allowing trades compliant with local law. It would be important to set these stratagems in motion, given the diversity present in even closely related regulatory regimes. An action that may be regarded as permissible in the UK, for example, but may not be so in the US,[32] appropriate safeguards are called for.

In relation to *product* issues, normally there is an attempt to restrict applicable law to a chosen ambit (especially in the determination of the nature of the financial product) in the hope that this will be successful in excluding unwelcome public law norms. In our example, if there were an equity or option element in the security, care would be taken to ensure that the instrument would be continued to be characterised as debt, thus avoiding regulatory norms that would place it under equity or derivatives regimes.

J. From the IFL professional's point of view: how to predict impact

One can easily discern in our example of the international bond issue where points of contact with public law regimes naturally occur. An international bond issue usually entails an issuer and/or guarantor from one or more jurisdictions, subject to one or more applicable laws (private and public). It also involves diverse jurisdictions and applicable laws relevant to the other players involved in the transaction (underwriters, paying agents, stock exchanges, investors, etc). By analogy and experience it would be possible to delineate a set of reasonably foreseeable items affecting international financial transactions which are sourced in public law norms.

K. Points of contact

Public law norms will impact the particular instrument, relationship or transaction through what might be termed the "points of contact". It is at these points of contact that legal interactions between systems take place. Most of these points of interaction are fairly well known, as a class, since they appear to be generated by the typically similar interests common in many jurisdictions (common concerns).

An important aspect of the transience of public norms into the legal space represented by the particular IFL deal is that a number of them may be applied (or ignored) in accordance with principles of private law (including conflicts of law). Interaction is therefore complicated by this fact. For example, in our previous example above, public law norms may attach only to items that are not "debt"; what constitutes debt may not be defined in the public norm and may require reference to concepts based on private law notions. Thus the applicability of the public law norm will naturally involve working through a private law protocol such as that envisaged in a previous article.[33] This overall process can be visualised in Figure 2 which indicates typical points of contact. Storm clouds are inserted merely to graphically highlight the potential for intellectual tempests caused by the stress and strain generated by competing systems.

In any given situation, all or some of the regulatory regimes connected to the illustrated items might determine a number of important questions in relation to any given legal situation. Typically, the following questions would be among those raised by public norms in relation to the product, the process and the participants:

Product

- Whether the financial agreement is a valid contract or null and void as being illegal *per se* or for a given class of participants.
- Whether certain provisions of the contract are invalid *per se* or for a given class of participants.

Process

- If the contract and its terms and conditions can be agreed to by private treaty and freely traded or if it needs to be entered into and traded only on regulated markets.
- If a prospectus needs to be drawn up and delivered or registered for that product to be distributed always, or in relation to a given class of participants or circumstances.
- If the product or contract may only be published in a special form (notarised or registered, dematerialised, etc).
- If permission, authorisation or registration for the product needs to be obtained from a given supervisory agency or body before it can be subscribed to or marketed.
- If and when any of these criteria are not met, then according to the law of that regulatory regime, the product may not be considered legal, or valid, or enforceable, at least with reference to the counterparties situated within its jurisdiction or which it regards as being subject to its jurisdictional reach.

Participants/Players

- If only certain types of entities may engage in underwriting, or otherwise committing to, distributing, negotiating, trading or managing certain products.
- If certain threshold requirements, ongoing obligations and monitoring requirements need to be satisfied.

Failure to satisfy any of the above conditions may result in counterparties to a financial contract being subject to sanctions in a number of regulatory jurisdictions and to the risk that contractual rights be suspended or voided as a consequence thereof. The essential point here is that any of these criteria, to the extent that they are introduced via a point of contact, may impose obligations or strictures on the financial

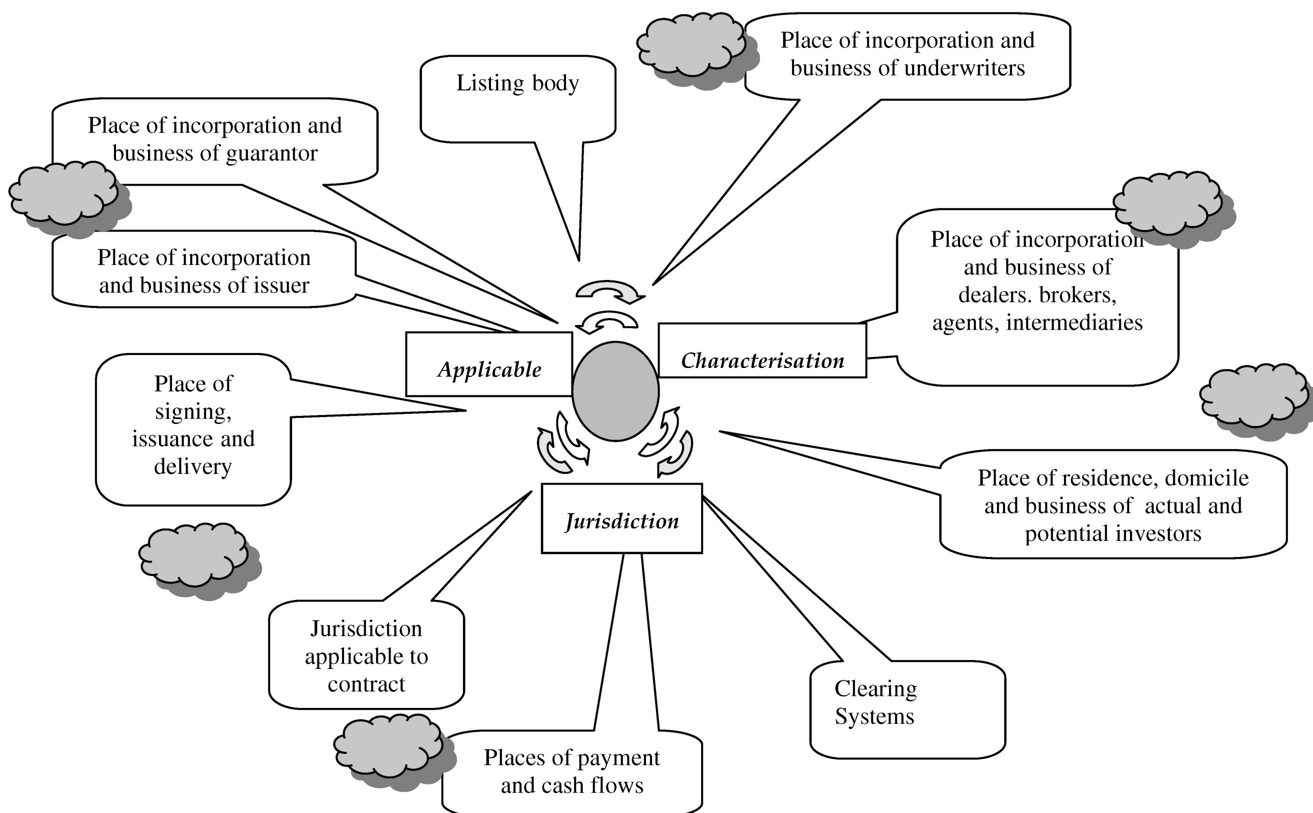

Figure 2

product and the parties involved over and above those that would apply according to the applicable law and jurisdiction initially governing the product.

Not all points of contact attract exogenous regulatory jurisdiction. Often, regulatory regimes do confer specific exemptions on offshore or international contracts, ie contracts not meant to involve the residents of their regulatory jurisdiction. It is also not always the case that regulatory regimes are extraterritorial, being, rather, expressly confined to the strict territorial ambit of the regulatory jurisdiction. Thus, it may be that the requirement to create and register a prospectus with the local securities commission does not apply where local residents subscribe to securities which are not offered or delivered in the regulatory jurisdiction itself, but only outside it.

L. Fundamentals

Thus far, we have in reality only considered what may be termed a descriptive, or kinematic, model of the impact of public law norms in IFL (a model of "what is" and of "how" it seems to work) without considering the nature of the norms themselves and the reasons for their impact (a dynamic model explaining "why" they exist).

In order to better understand the black-letter law as it actually exists in any given regulatory regime, the obvious starting point will be understanding the type of rationale which tends to prevalently, if not universally, underlie regulatory rules. It would probably not be too wide of the mark to assert that these tend to be relatively similar across the globe (where they exist). Similar concepts tend to be used and a similar range of choices available. Hence they are, in general terms, relatively predictable, as a class. The reasons for this are probably historical.[34]

The next step would be to perform an empirical examination of the major regulatory regimes in order to identify recurrent themes and isolate regularities so as to provide some understanding of what to expect when it comes to public norms impinging on financial matters.

I would divide fundamental rationales into three basic categories: sociological (religious, social, political), traditionally legal and economic, in order to arrive at categories of law which I would describe as: sociologically inspired; traditional legal; directly economic. These are what could be said to constitute some of the "deep structures" of regulation.

M. Sociologically inspired regulations

We saw in a previous article how derivatives transactions such as swap contracts or futures contracts risk falling foul of only seemingly related legal regimes and marginally connected sets of laws such as those regulating betting and gaming. In economic terms, these laws would seem to have little or no relevance to the financial market involved. There may also be instances where, to the chagrin of some professional financial operatives, mainstream consumer protection legislation – undoubtedly commendable in the context of normal commercial activity – seems to apply to financial

markets considered the preserve of institutional rather than retail activity.[35] These instances appear to represent the intrusion of sociological interests (social governance, preservation of cultural mores, ideological content) which appear to have little relevance to the real matter at hand: ensuring the proper functioning of financial markets.

Of the sociologically inspired rules that may, from time to time – and sometimes in most unwelcome and unexpected ways – be relevant to financial markets activities the following are, actually, quite commonplace:

- rules relating to wagering and gaming laws;
- rules relating to usury;
- particular rules of a theological nature (eg *sharia* principles or those of other
- ecclesiastical or canon laws);
- consumer protection laws.

The application of these rules may, or may not, take account of the dynamics of sophisticated financial markets, or be suitable for, or adaptable to, the needs and realities of modern economies. Many of these rules themselves date back to preindustrial times and cultural settings when economies were based on distinctly different assumptions. Their function at the time was to ensure the smooth running of the markets as they were then known to perform. These same rules, as in the case of usury laws, at times even found supporters in advocates of minimal government intervention and free markets (even Adam Smith himself!).[36] It is generally thought that laws of this sort aimed at ensuring social welfare and preventing social abuse, even if in some cases this involved undermining or subverting crucial aspects of post-industrial economies.

Understandably, the survival of many of these regulations and their application to financial markets is quite often met with deep irritation by analysts and operatives who feel that the only logic that should govern the markets is a decidedly "commercial" rather than "social" one, and that social welfare should be pursued by other means. To allow any considerations other than purely economic ones to apply to financial market matters would only mean stymying the proper functioning of finance. For some economists, the suspicion has always been that the law in the financial arena constitutes a market inefficiency. For many, the existence of norms of this sort makes that conviction an incontestable certainty.

Not all economic analysts agree with this latter view, and some actually advocate the beneficial effects of these socially generated rules, not only in terms of social welfare, but in relation to the well-being of the economic system as a whole.[37] Moreover, ethical, moral and religious ideology continue to promote in the realm of finance what are considered to be ethical dictates and necessary prohibitions. In reality, and for whatever reason, the fact is that anti-usury and gaming laws still appear to be popular, world wide.[38] The absolute prohibitions on interest payments in Islamic jurisdictions is common knowledge. Perhaps less well known is the existence of prohibitions on interest on interest (compound interest, or anatocism) which still applies in some modern regimes (a traditional concern of old money-lending legislation). In some respects it could be said that consumer legislation is heir to these more ancient forms of social governance. Normally, professional market activities are exempted from the latter, but not always; socially inspired regulations can impact financial transactions quite deliberately, as well as unwittingly.[39]

N. Traditional legal categories

Among the most ancient traditional legal categories which continue to inform regulatory legislation, and case-law, are those used when outlawing categories of nefarious conduct such as fraud, sharp practice and unfair behaviour. In reprimanding what is considered to be improper behaviour, general law and sometimes legislation makes use of traditional notions such as fairness, equity, equality, reasonableness, intentionality, diligence and conscionable behaviour (common law systems), good faith, honest and correct behaviour (civil law systems), all of which have attained the status of specific legal concepts, in addition to being terms of ethical reference. Tests are sometimes employed to discern the appropriate level of conduct (reasonable man test, etc) or their meaning gauged on the basis of past case-law or general practice. Ultimately, they are all concepts drawn from the historical interstices of the legal systems themselves, and tend to be applied to financial activity in the same manner in which they are employed in normal legal discourse in other areas of law.

Thus, financial regulations will often reflect categories of legal thought and remedies used elsewhere in the law, rather than tailor-made legal concepts. Notions of agency law and of fiduciary and contractual duties are commonly applied to the relationships between principals, investors and intermediaries. General good faith concepts, as well as concepts deriving from economic tort law (civil wrongs, wilfully inflicted economic damage, conspiracy to defraud, unlawful interference, intimidation, deceit, malicious falsehood, negligence and unfair competition) are considered appropriate. Given the emphasis of modern financial regulations on paper trails, extra-contractual liability for statements and information (misrepresentation, misleading information, selective or incomplete or unfair disclosure, unlawful omissions) are, of course, highly relevant. Company law categories are also relevant to the extent that they impact on corporate finance and capital markets activities.[40]

As comprehensive and well tested as this corpus of law tends to be, the reality is that it has developed in relation to other more traditional fields of law, which concern interests and expectations which may or may not sit comfortably with the realities or purposes of financial law. Perhaps this is because financial expectations refer to concerns that are essentially economic in nature; and some think that primarily economic interests should be addressed by basically economic logic.

O. Economically inspired regulations

Not surprisingly, in relation to financial transactions, modern

legislation has therefore sometimes been directly inspired by economic theory. In these cases, the legal categories utilised and the legislation consequently passed are directly derived from economic ideology, though coached in legal language and constructed according to legal logic. This is potentially a natural and welcome development. Market "manipulation", "transparent market" and "equal economic treatment" of participants, have been some of the economic concepts introduced into law in this manner. Often, the detailed technical legal rules in the relevant market legislation can only be properly understood by relating them to underlying financial conceptualisations. Rules relating to concepts such as "financial assistance", share purchases and takeovers, tax rules, rules of regulatory competence, operative requirements for the licensing, authorisation and management of market activity are other examples of the emergence of legal conceptualisation on the back of economic theorisation.

These sorts of rules would not necessarily have grown out of a consideration of general principles of law. Take the example of improper market speculation. Long-standing prohibitions such as those relating to cornering the market (*agiotage*) probably grew from an ethical stance incorporated into the then contemporary law – from a general sense of moral repugnance against speculators who were considered to be carrying out immoral acts (stock betting) which fuelled economic crises. Perhaps the important aspect to highlight here is that the need to legislate against *agiotage* – even if consonant with a deeply felt ethical stance – only arose from economic fact (the development of certain market activity in the eighteenth century). Nowadays, the legal concept is clearly outdated and difficult to enforce, and, more importantly, should evidently not be enforced in relation to what in reality may be economically healthy activities of speculation, hedging and arbitrage. Modern law strains to make the distinction. The subsequent need to refine the concept arises from the birth of modern financial techniques. It may not be wrong to assert that neither the original legal prohibition nor subsequent correctives of it, grew spontaneously from the natural evolution of general principles of law.[41] The same may be said for many of the other concepts mentioned above, such as "transparent market". Perhaps a strong indication that this view may be correct lies in the simple fact that not all legal systems presently have, much less always have had, rules governing market behaviour of this sort. Being economic and not conventionally legal (yet) they are simply ignored.

One can cite insider trading legislation as another example. Insider dealing legislation prohibits the exploitation of privileged information lawfully obtained, to make a personal profit on securities and investments. The activity associated with making a buck on inside stock information, now prohibited in many jurisdictions, was until relatively recently quite lawful in the same places. Evidently, insider trading activity was not innately abhorrent to legal systems (no apparent victim or damage, for example). Economic models then held that only by banning insider dealing could transparent markets and market credibility be assured. Convinced by this argument, legislators passed laws enforcing that principle. Interestingly, the argument against insider trading is merely an empirical argument of an economic nature, with which not all legal systems need agree. If they do not, they still remain perfectly coherent. Any sense of it all being slightly sharp practice, and unfair, could be brushed aside as being another example of life's graces being unevenly spread.

Where legislation is directly indebted to economic thought, its purpose and level of effectiveness tends to be judged with reference to a utilitarian economic logic, rather than traditional measures. Not all these laws are uncontroversial, precisely for this reason. For example, not all economists agree on the correctness of the economic model that ostracises insider dealing from efficient markets. One consequence is that these economically inspired norms may not have the staying power of traditional legislation based on conventional considerations of fairness and proper behaviour. So, it is conceivably possible (as unlikely as it may seem) that such laws are repealed or amended in line with new economic ideology. Exchange control laws, sectorial regulation (banking, insurance, fund management, etc) borrowing, lending and dealing controls are examples of laws that have come and gone in the wake of changing fashion in macro-economic theories and shifts in policy stances.

Of course, many types of legislation and other norms are based on technical concepts coming from outside a strictly traditional legal *humus*. What is considered "natural", "fair" or "conscionable" in contract or tort may not be the same as that which is deemed so in family law matters where the ideas may refer to sociological standards and perceived mores. Similarly, not all financial regulation is based on purely time-honoured legal reasoning. Not initially, at least.

P. An uneasy mix

Certain types of sharp practice might not be adequately captured by traditional concepts associated with agency duties, misrepresentation or fraud. Phenomena such as "churning" and manipulative practices associated with new technology (more common than often thought) are sometimes hard to pin down in terms of traditional legal categories and remedies. Other activities such as "front running" and even "short selling" may not even be perceived to be deleterious at the individual level (the traditional concern), although it is arguable that they may constitute a hazard at the macro-economic level (an economic worry). In this field of law, some idea of the economic effects of financial behaviour is clearly necessary in order to cover adequately those areas that need to be regulated.

Even when it is economically inspired, market legislation is nonetheless invariably predicated on traditional moral and legal concepts and couched in such language. These are, however, often extended to suit the situation. Consequently, regulatory legislation often exhibits an uneasy mix of criteria. The resulting legislative brew may be heady (with its emphasis on systemic protection and high theory) but also not altogether free of legal rhetoric which may turn out to be insidious. When this legal rhetoric is encased in legislation, high principle can become very material legal fact. When rules directly derive from principle which relates to

lofty economic thought, there may be difficulty in applying them practically. A financial operative may have to be particularly wary that is not doing anything contrary to law when dealing with regulators who express their aim as being, amongst other things, "promoting the growth of the socialist market economy"[42] or establishing a "a socially conscious, free market".[43] It may be difficult to determine the exact limits in legal terms of such principled ideas.

Why are financial and economic criteria so invasive of traditional legal preserves? The reason may be linked to an historically novel feature of financial regulation. It may be argued that private law deals essentially with protecting private party interests (individual stakeholders). Public law, on the other hand, characteristically deals with protecting the interests of the state and of public bodies, and directly or indirectly the rights of citizens.[44] Unusually, financial law typically also protects the interests of another – third – party: the market. And the market may have needs that are distinct from those of the state and of individual citizens.[45]

Q. A simple general model for securities regulations

I think that it might be useful at this stage to visualise the boundary conditions that seem to define the ambit of security regulations in most of the jurisdictions likely to be encountered in international financial dealings.

Figure 3 illustrates the different categories of policy and legal conceptualisations which act upon regulatory space within the financial markets.

As can be seen from Figure 3, it appears that the sources of influence moulding regulatory space are varied and eclectic. That should come as no surprise given that the law is primarily a social activity. There is much that should be said about the nature of the elements at work and of the nature of the interaction between them. A detailed analysis of how this occurs will be the subject of a separate work. Suffice it to note for present purposes that different approaches will govern the same players, products or processes, and in doing so may either reinforce, or, alternatively, interfere with, the effects of other stimuli, competing as well as complementing. In other words, it is not a linear system. In passing, it may be noted that a number of sociological and organisational factors should not be ignored as attested to in the significant literature on the subject.

Fierce competition among regulators is not unheard of, and this further complicates the already complex situation. Ultimately, there does not seem to be any guarantee that any regulatory system is entirely coherent or that it is a seamless web. Moreover, it is also worth remembering that the costs of regulation may sometimes be criticised for being excessive, counterproductive and economically inefficient. These aspects cannot be dealt with at any length in this paper.

Of course, one thing to keep constantly in mind in this sort of analysis is that when policy is transmuted into legal language and enactments, the two thought worlds are not necessarily coterminous. Fundamental concepts may be different and the propositional structure diverse. In the end, the legal enactment may well assume a life of its own, quite independent of the initial impulse of underlying policy. Black-letter regulation therefore will always need to be evaluated on its own – highly technical – terms and reference to underlying legislative or other policy (if allowed by the legal system in question) will always be conditioned by this fact.

R. Is that all there is my friend, is that all there is?

Clearly not.

This paper has concentrated on public law norms that are

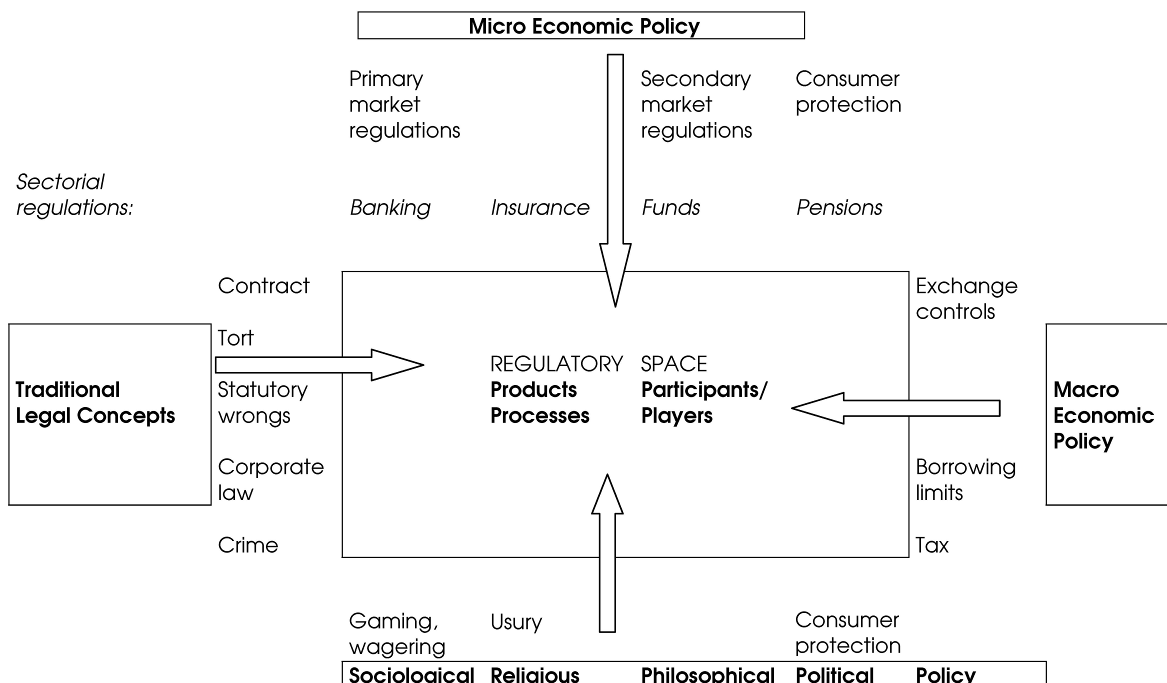

Figure 3

particularly relevant to financial law: that is to say, financial regulations. There are of course other public norms which are also highly relevant to IFL – in particular, tax and insolvency regimes. An understanding of the common themes and common techniques which are associated with these areas of law, globally, is at a well-developed stage and falls outside the purpose of the current work.[46]

S. Conclusion

As we saw in previous articles on IFL, cross-border legal situations are a patchwork of intersecting legal influences. This appears to be true for private law matters and equally so in relation to public law themes. As difficult as it may at first seem for a professional to be able to govern the emergent legal uncertainty, it appears that experience and theory may be able to lend some support. Uncertainty may at times merely be an epistemological, rather than a structural, fact, and of course there may always be method even in apparent madness. There may well be common concerns in jurisdictions which enable the employment of common techniques and effective protocols in order to manage their impact on IFL instruments, relationships and transactions. Some predictability may ultimately derive from the identification of deep structures within legal systems themselves. ■

1 (2009) 3 *LFMR* 348ff.

2 This is a cursory treatment. "Public" law in English-inspired systems is usually taken to signify administrative law – law that specifically has to do with a narrow area related to the powers and actions of governmental and public entities and available remedies in relation thereto. The civil law concept of public law tends to be broader. I think the notion of public law in the text describes what both approaches might agree constitutes common ground. Public law would in this broad sense include administrative law, revenue law, criminal law and market legislation. It could be argued that all private law was once public law.

3 From the earliest modern legislation in financial regulatory matters, the legislator seems to have seen the two concepts – the public interest of the state and the interests of a segment of the public – as being largely synonymous. In the US Investment Companies Act of 1940, for example, the declared policy of the regulation was to protect "the national public interest and the interest of investors". See The Investment Company Act of 1940 (15 USC § 80a-1ff) s 1.

4 See previous articles (2009) 3 *LFMR* 159, 365.

5 A prime example of globalised regulation in the banking sector are the Basel Rules on capital adequacy. Other examples relevant to the financial markets, include the accountancy and insurance standards promulgated through international bodies such as the IAIS and the IASB and the money-laundering proposals of the WTO and OECD. A handy guide to the current situation can be found in: H Davies and D Green, *Global Financial Regulation: The Essential Guide* (Polity Press, 2008). For a brief discussion of what I term the "layering" effect in IFL, see P Sebastianutti, "The Capital Markets", in M van Empel (ed), *Financial Services In Europe* (Dordrecht, Kluwer Law International, 2008), 70ff.

6 Reality is always more complex. Areas of overlap obviously exist. Grey markets are a common instance. Legislators tend to regulate accordingly by deciding which of the two main camps such activity should fall within. Reselling activity is another, particularly sensitive, area. On the European treatment of the resale problem, see eg P Sebastianutti, *supra* n 4, 119ff.

7 Eg Art 1(1) of the original EU 1989 Prospectus Directive explicitly stated that it only applied to securities which were offered to the public "for the first time", thus limiting its purview to the primary market. On the other hand, some jurisdictions may concentrate on the perceived need to protect investors in all circumstances, irrespective of whether a sale to them occurs on the primary market, or by way of secondary trading, and may apply primary market standards to resales on secondary markets. This blurring of the theoretical divide between markets appears to be relatively rare and appears to occur largely in relation to as yet immature markets.

8 See eg Z Goshen and G Parchomovsky, "The Essential Role of Securities Regulation" (2006) 55 *Duke Law Journal*.

9 In European legislation, "qualified investors" means:

(i) legal entities which are authorised or regulated to operate in the financial markets, including: credit institutions, investment firms, other authorised or regulated financial institutions, insurance companies, collective investment schemes and their management companies, pension funds and their management companies, commodity dealers, as well as entities not so authorised or regulated whose corporate purpose is solely to invest in securities;

(ii) national and regional governments, central banks, international and supranational institutions such as the International Monetary Fund, the European Central Bank, the European Investment Bank and other similar international organisations;

(iii) other legal entities which do not meet two of the three criteria set out in paragraph (f);

(iv) certain natural persons: subject to mutual recognition, a Member State may choose to authorise natural persons who are resident in the Member State and who expressly ask to be considered as qualified investors if these persons meet at least two of the criteria set out in paragraph 2;

(v) certain SMEs: subject to mutual recognition, a Member State may choose to authorise SMEs which have their registered office in that Member State and who expressly ask to be considered as qualified investors;

(vi) "small and medium-sized enterprises" means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year

of less than 250, a total balance sheet not exceeding EUR 43000000 and an annual net turnover not exceeding EUR 50000000 (Directive 2003/71/EC- the Prospectus Directive).

In the MiFID Directive there is also a concept of "Professional client" (to whom a lower duty is owed than to the average retail investor). A Professional client is "a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs". In order to be considered a professional client, the client must comply with the criteria in Annex II of the Directive.

US legislation uses different categories in similar situations: it utilises concepts such as "sophisticated investors" and "high-net worth individuals", "accredited investors" and QIBs (qualified institutional buyers).

Yet other developed jurisdictions, such as Switzerland and Japan, have not historically applied the sophisticated/average investor dichotomy. Japanese legislation now seems to contain clear professional investor provisions which differ from those applying to "general investors" (see Financial Instruments and Exchange Act, 2006: http://www.fsa.go.jp/en/policy/fiel/index.html).

Other jurisdictions leave open the possibility for the Securities Commission to identify from time to time what they consider to be non-retail investors. The Philippines, for example, decrees that its oversight body "determine as qualified buyers, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial and business matters, or amount of assets under management". Section 10(l) The Securities Regulation Code (Republic Act No 8799).

10 Current legislation in the People's Republic of China appears to state that less than 200 people will not be deemed to be a public offer (Section 10 of the Securities Law of the People's Republic of China). Under the relevant "private placement" or "restricted circle" exemptions in European legislation, the number is 100, in Japan, it appears to be 50, while in Switzerland, an offer of securities to less than 20 Swiss residents does not appear to constitute a "professional offer" (ie a public offer) subject to registration with the Swiss Federal Banking Commission.

11 The former is the European threshold and the latter a US level used as indicia to indicate relatively little circulation amongst retail investors and a clear targeting of institutional investors.

12 Until a specific carve-out for contracts for differences was enacted in the Financial Services Act 1986 (s 63), this was a legal possibility even in the UK under the terms of the 1845 Gaming Act. Current law on the matter is now governed by s 412 Financial Services and Markets Act 2000 (UK) which provides for a broad carve-out:

"412 Gaming contracts

(1) No contract to which this section applies is void or unenforceable because of –

(a) section 18 of the Gaming Act 1845, section 1 of the Gaming Act 1892 or Article 170 of the Betting, Gaming, Lotteries and Amusements (Northern Ireland) Order 1985; or

(b) any rule of the law of Scotland under which a contract by way of gaming or wagering is not legally enforceable

(2) This section applies to a contract if –

– it is entered into by either or each party by way of business;

– the entering into or performance of it by either party constitutes an activity of a specified kind or one which falls within a specified class of activity; and

– it relates to an investment of a specified kind or one which falls within a specified class of investment "

13 According to Annex 1, s A of the MiFID Level 1 directive, any provider of the following investment services is caught by the legislation:

Receipt and transmission of orders in relation to one or more financial instruments.
Execution of orders on behalf of clients.
Dealing on own account.
Portfolio management.
Investment advice.
Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.
Placing of financial instruments without a firm commitment
Operation of Multilateral Trading Facilities.
Any providers of the following ancillary services are also expressly caught (Annex 1, s B):
Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management;
Granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction;
Advice on capital structure, industrial strategy and related matters and advice and services relating to mergers and on the purchase of undertakings;
Foreign exchange services where these are connected to the provision of investment services;
Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments;
Services related to underwriting.

See Sebastianutti, *supra* n 4, 127ff.

14 According to the directive, "market manipulation" means any of the following activities:

(a) transactions or orders to trade:

– which give, or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments, or

– which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level, unless the person who entered into the transactions or issued the orders to trade establishes that his reasons for so doing are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market concerned;

(b) transactions or orders to trade which employ ficti-

tious devices or any other form of deception or contrivance;

(c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news.

See Sebastianutti, *supra* n 4, 135ff.

15 An integrated and efficient financial market requires market integrity. The smooth functioning of securities markets and public confidence in markets are normally seen as prerequisites for economic growth and wealth. Market abuse is perceived as harming the integrity of financial markets and public confidence in securities and derivatives and as such harmful to the public interest.

16 With the introduction in 2006 of the Financial Instruments and Exchange Act, a myriad of sectorial norms were amended, abolished, superseded or assimilated into a unitary regime.

17 Full disclosure and adequate publicity are justly commended as a remedy for social and industrial diseases in his – still relevant – work: Louis Dembitz Brandeis, *Other People's Money* (FA Stokes, 1914).

18 S 2(a)(1) of the Securities Act of 1933.

19 "The term 'security' means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; *but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited*." S 3a, item 10 of the Securities Act of 1934 (emphasis added).

20 The Belarus securities law of 1992, for example only covered shares and bonds (Law of the Republic of Belarus No 1512-XII of 12 March 1992 [Amended as of November 11, 2002]).

21 S 3 (g) of the The Securities Regulation Code (Republic Act No. 8799) of the Philippines defined securities as including, in addition to instruments specifically enumerated therein, any "Other instruments as may in the future be determined by the Commission".

22 For the purposes of primary market regulation, securities defined as subject to regulation are

"those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:

(a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities and depositary receipts in respect of shares;

(b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;

(c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures."

This definition is taken from that contained in Art 1(4) of Directive 93/22/EEC (strangely, a secondary market legislation but the only directive containing at the time a comprehensive legal definition of security). At the same time, the secondary market was expanded well beyond this restricted class of instruments to include:

(1) Transferable securities;
(2) Money-market instruments;
(3) Units in collective investment undertakings
(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields or other derivative instruments, financial indices or financial measures which may be settled physically or in cash;
(5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
(6) Options, futures, swaps and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
(8) Derivative instruments for the transfer of credit risk;
(9) Financial contracts for differences.
(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls (Annex 1, s C, MiFID Level 1 Directive)

The net was thus cast far wider for secondary market regulation than it was for its primary market counterpart.

For the earlier historical development of these directives, see: P Sebastianutti, "Listing of Securities and Public Offer

Prospectuses", in M Van Empel and J Dalhuisen (eds), *Capital Markets and EC Law* (Dordrecht, Kluwer, 2001).

23 A brief and useful discussion can be found in I Walter and RC Smith, *High Finance in the Euro-Zone* (Pearson Education 2000). Also G Visentini, *Competitiveness in the Italian Financial Market: Past Reforms and the Present State of Affairs* (CERADI, http://www.archivioceradi.luiss.it). The literature is quite extensive.

24 Until 2005, banks in Italy, for example, were totally exempt from having to produce prospectuses in relation to any domestic debt issued by them (pursuant to Art 100 (f)(i) of Decree law no 58 of 24 February 1998 – the Financial Services Code). Exemptions for bank debt in local regulations are not uncommon globally.

25 Art 2 of Chap I of the Securities Law of the People's Republic of China provides that the law applies to all such securities (an undefined term) "as lawfully recognized by the State Council within the territory of the People's Republic of China", the implication being that non recognised instruments may not be issued or traded. The act of recognition is reserved to the State Council.

26 This is generally considered to be one of the benefits of introducing statutory offences to supplement or replace general law offences.

27 With respect to investment schemes that do not fall within the traditional categories of securities listed in the definition of a security (s 2(a)(1) of the 1933 act and s 3(a)(10) of the 1934 Act) the US courts have apparently developed a broad definition for securities that catches new phenomena. When determining if there a is an "investment contract" that must be registered with the SEC the courts have looked at various indicia (investment of money, common enterprise, expectation of profit and so on) on the basis of which to construct investment identity. See early landmark cases such as *SEC v WJ Howey Co* and *SEC v Glenn W Turner Enterprises, Inc.*

28 According to Art 2 of the Federal Act on Stock Exchanges and Securities Trading (Stock Exchange Act, SESTA) "Securities" are defined as comprising "standardised certificates suitable for mass trading", "rights not represented by a certificate" but having similar functions (book-entry securities) and derivatives. In some ways a very broad definition; in other ways, slightly naïve in terms of other, foreign possibilities for structuring investments and securities.

29 In a sense this legal situation may be based on something akin to the "effects" doctrine. In certain areas of law, jurisdiction is said to attach where acts occur outside national territory but nonetheless produce effects felt within the national jurisdictiom. Cases where national antitrust legislation has sanctioned foreign companies for actions occurring outside the jurisdiction with indirect effects within, are well known instances of the doctrine being applied.

30 The following is an example of such customary language: "The Notes have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act." A series of long and detailed prohibitions and provisions then follow in the text, to end with general warnings of dire consequences if any of the restrictions are ignored.

31 For example: "Each Dealer has agreed and each further Dealer appointed under the issue will be required to agree that it will (to the best of its knowledge and belief) comply with all applicable securities laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers Notes or possesses or distributes this prospectus and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of Notes under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and none of the Issuers, the Guarantor or any of the other Dealers shall have any responsibility therefor. None of the Issuers, the Guarantor or any of the Dealers represents that Notes may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating such sale." Fingers are then crossed.

32 The Lloyds series of litigation of the nineties are instructive in this sense. Compare eg *Richards et al v Lloyd's of London*, 1998 US App and *Allen et al v Lloyd's of London*, 1996 US App.

33 (2009) 3 *LMFR* 64ff.

34 It would not be entirely wrong to suppose that securities regulation, at governmental level, are for the most part a response to financial disasters of the past. Principal among these disasters would have been the events of the Great Depression of the late 1920s and early 1930s which led to stringent legislation in many European jurisdictions, in the US and elsewhere, of the sort now classified as prudential measures and as consumer protection regulation. Over time, the US model has been particularly influential and generally copied. As securities regulations were born in avowedly capitalist societies, the basic assumptions behind individual regimes have tended to be similar. For obvious reasons, socialistic regimes have tended not to have complicated securities regimes, if at all. Where such regimes have been introduced, they appear remarkably similar to existing capitalist models, using similar legal terms and concepts, if for avowedly different ideological ends. See, for example, recent Chinese securities laws. On the other hand, it may be argued that since the common concerns of a regulatory regime are structurally similar, it is not surprising that even without external analogy, the same basic concepts would naturally be used. It is the traditional question of whether development may be independent and naturally convergent, or always dependent and reinforcing.

35 Although it must be said that consumer legislation is many jurisdictions does not normally apply to professional market activities by virtue of specific exclusions normally set forth in the same laws containing the relevant consumer protection.

36 See Adam Smith *The Wealth of Nations* Bk 2, ch 4. Also JM Jadlow, "Adam Smith on Usury Laws" (1977) 32(4) *Journal of Finance* 1195. Smith opposed regulations prohibiting payment of interest, but seems to have favoured limited ceilings.

[37] See eg D de Meza and G Coco, "In Defence of Usury Laws", *IDEAS* http://fmg.lse.ac.uk/pdfs/dp369.pdf

[38] See eg PR Wood, *Conflict of Laws and International Finance* (London, Sweet & Maxwell, 2007).

[39] Some legal scholars sustain that socially generated imperatives should be incorporated into legal relationships in order to ensure the proper allocation of risks between stakeholders. In an increasingly ecologically aware global economy, the issue of sustainable economic growth through the empowerment of human rights in a commercial and economic context has become a hotly debated topic. While, in this area of law, initiatives may be centred on private contractual arrangements in the absence of specific, enforceable public norms, one should also consider that environmental protection, health and safety issues have been traditionally areas of public intervention. Consequently, pressure in future to extend these and other socially generated protections to financial transactions in the form of public norms would certainly not be a surprising development. Calls for increased social responsibility in finance are ably advocated, and despite being hotly contested by market orientated operatives will undoubtedly continue to be of persistent and pressing relevance. On the issue of social imperatives and investments, see eg S Leader, "Human Rights, Risks, and New Strategies for Global Investment" (2006) 9(3) *Journal of International Economic Law* 657.

[40] General concepts of corporate law are obviously relevant to the activities of companies, including those involving finance. Unfortunately, the concerns and stakeholder interests protected by company law regimes are not the same as those addressed by financial law, and this may result in unwanted confusion and, on occasion, legal collision between what might appear to be opposing principles.

[41] Deep ethical antipathy to certain practises considered as *agiotage* can readily be seen in works from the period, such as those of the French political economist Jean Baptiste Say (*Cours complet*, 2e ed, t II, ch 16, de 'agiotage' Collect, des princip. Econom.). At the same time, there was a keen sense of the difference between unethical economic activity to be castigated and proper investment (see eg "Differences Between Speculation and Agiotage" in (1857) XXV *British Quarterly Review* 187). The most renowned remark in this context is probably Walter Landor's "Vanity and agiotage are to a Parisian the oxygen and hydrogen of life" ("Miscellaneous Conversations", *The Works And Life of Walter Savage Landor,* vol 6 (London, Chapman & Hall, 1876)).

[42] Chap I (General Provisions) of the Securities Law of the People's Republic of China (Art 1).

[43] Chap 1, s 2 (Declaration of State Policy) of The Securities Regulation Code (Republic Act No 8799).

[44] This is arguable so in criminal law as well. According to classical theory, the offended party in criminal proceedings is the State, not any individual.

[45] To the extent that a system does not agree with this idea, the boundaries of free markets tend to narrow.

[46] On international insolvency law, see eg the masterly work: P Wood, *Principles of International Insolvency* (London, Sweet & Maxwell, 2nd edn, 2007). There is the growing body of legal writing in the fields of comparative international insolvency and tax law. I consider insolvency and tax law, "public norms" for the purposes of IFL in the sense that they do not usually form part of the corpus of common, or general, law (contract, tort, obligations, property, etc) but have been enacted with a specific public interest, and a related social organisational model, in mind.