Judges and Systematic Risk in the Financial Markets

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INTRODUCTION

This paper will keep company with others that consider the regulation of over-the-counter (“OTC”) derivatives, and the particular role and potential effectiveness of proposals in the new regulatory regimes that have emerged since the recent financial crisis (or crises, depending on how you count) for central clearing as a means of mitigating systemic risk.¹

† This paper is based on a keynote address to securities regulators delivered at the 36th Annual IOSCO Conference held in Cape Town, South Africa, in April 2011. The paper has been updated to include, among other things, a description of P.R.I.M.E. Finance, the financial markets tribunal and disputes center, which opened for business January 16, 2012. The author gratefully acknowledges the assistance of Komadhi Mardemootoo, a former student at the London School of Economics and Political Science, in preparing this paper for publication.

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However, in what follows, I want the reader to think outside the current regulatory debate for a moment. Instead, I would ask the reader to pause while contemplating the subject of systemic risk in the global financial markets and consider how courts and judges fit in.

I. THE COURTS AS HOSPITALS

Our newspapers are full of articles about financial market regulation. Parliamentarians and congressmen do not shy away from weighing in on this subject too. Financial regulation can be seen as a kind of ‘preventive medicine,’ and we attach great importance to getting it right.

That is as it should be. Preventive medicine in matters of both personal and financial health is important. In the recent crisis, the malaise afflicting the financial markets had arguably reached epidemic proportions. Financial market participants were, and some still are, seriously, if not terminally, ill. Moreover, we can expect more accidents to occur and more victims to surface in the future. However, as the courts are our ‘hospitals,’ perhaps we should worry more about the condition of the courts and whether we have enough qualified staff for them.

It is indeed a little surprising that with all the debate about the future of financial regulation and the statements on the subject that politicians, regulators, economists and academics make—and even statements by the legal profession itself—so little attention has been paid to the role of our judges in mitigating risk. After all, judges around the world interpret regulations, fill in the legislative and regulatory gaps, and resolve ambiguities. In addition, they can be expected to settle any number of financial market disputes—some of them highly complex and technical—that are likely to follow from the considerable losses, and in some cases the demise, of major financial institutions and their counterparties.

This paper aims to address an apparent gap in the debate. What role should we wish to see our courts play in dealing with complex financial instruments, disputes arising from the financial crisis, and, in due course, matters requiring interpretation of the new regulatory regime? Are the courts, as currently constituted, equipped to play that role? Is there more that the markets, the regulatory community, and the legal profession can do to ready them?
II. WHY COURTS ARE IMPORTANT

Why are courts relevant to discussions about financial market systemic risk? Well, for a start, courts are potential allies of regulators in the battle to safeguard our financial markets from systemic risk. Courts in the United States and elsewhere have ‘fleshed out’ securities regulation in the past, thereby promoting legal certainty and, as a result, contributed to market stability. That is why, as law students and young lawyers, although we were taught black letter law and we read regulations, we spent a lot more time reading and studying cases. When addressing questions such as, “How much due diligence should I do in connection with this IPO?”, we looked to the cases: in one such case we read what one lawyer did (poor young Stanton)—and it wasn’t enough; while another told the story of a lawyer who did do enough. The cases showed the way to the ‘safe harbors’ into which to sail, gave examples of ‘shipwrecks’ as a warning along the way, and, most importantly, related the principles of law and regulation to real world facts. The facts will change, and the facts are always important.

Intelligently interpreting financial market regulations in light of new facts will continue to be important. Judges who understand finance can do this. Therefore, the courts can potentially play an important role in the battle against financial market systemic risk. However, when it comes to the derivatives markets and complex product litigation, the courts can also be a source of systemic risk. I will tell you why I think that and suggest steps to address this issue. However, first I will discuss two more reasons why I think this issue—the role of the courts—is so important for derivatives product regulation and complex product litigation.

A. THE STAKES ARE HIGH

The stakes are high. The amount of money at risk is staggering. The Bank for International Settlements estimates the current size of the OTC derivatives market alone in terms of notional amounts outstanding at approximately $639 trillion. More than 90% of this amount is governed by a single standard form contract and terms.

A ‘tsunami’ of financial markets litigation from the financial crisis had been predicted, and the cases are pouring in.\textsuperscript{4} In one pending court case, $1.5 billion is in dispute. The outcome of this case may turn on the court’s interpretation of two words in the parties’ ISDA Master Agreement. Therefore, it is important that the decisions in major financial market cases and the precedent these cases produce are correct.

B. THE STUFF IS COMPLICATED

The contracts, issues, and products are all complicated,\textsuperscript{5} and thus far the track record of the courts is not in all cases satisfactory. For example, the financial crisis ushered in contradictory court decisions from cases based on similar facts, even as between New York and English courts.\textsuperscript{6} Thought of globally, these courts represent a decentralized system, with no Supreme Court to settle contradictory opinions and provide clear precedent.

The markets worry all the time: wrong place, wrong party, judges and lawyers who would brief them who don’t get it. The nature of the cases is also evolving from addressing issues with which judges have historically been both familiar and comfortable—such as authority (\textit{ultra vires}), whether a contract formed and, if so, on what terms, the relationship between the counterparties or whether one party owed and

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\textsuperscript{3} The marked-to-market values of outstanding trades and the estimated credit exposure after netting would be significantly less, although still measured in trillions of dollars.


\textsuperscript{5} Jonathan Ross, \textit{The Case for P.R.I.M.E Finance: P.R.I.M.E Finance Cases}, 7 CAP. MARKETS L. J. 221, 223–26 (2012). According to the author, the community of professionals and jurists with a deep understanding of the issues, however, is quite limited at present.

satisfied its duty of care\textsuperscript{7}—to novel and more technical issues, like flawed asset and anti-deprivation theories,\textsuperscript{8} mathematical modeling, formulaic calculations, and global insolvency-proofing techniques.

The remedies in the derivatives markets, for example, are very different from the remedies of the loan and bond markets, even though the contemplated cash flows may be similar.\textsuperscript{9} As a result, the cases may be especially challenging for judges without considerable familiarity with the relevant industry contracts. Additionally, global market facts and trade usage are highly relevant and must be understood and accounted for. Judges need an appetite for, and understanding of, comparative law and practice, as well as international finance. There is little to demonstrate a propensity for this across all the courts that find complex product litigation before them.

C. STANDARDIZATION

In addition to these two factors—high stakes and complexity—there is a third factor of particular importance: standardization. Widespread usage of master agreements and standard terms across geographical, cultural and language divides, has great benefits, including legal certainty and huge cost efficiencies. We do not have a world parliament to legislate such matters, but the markets have created a kind of global law by contract.\textsuperscript{10} However, the use of such contracts creates significant risk. The widespread usage of the same terms can amplify a court’s mistake in deciding a term’s proper meaning.\textsuperscript{11} “Whoosh”—that mistake goes around the globe, affecting trillions of

\begin{itemize}
\item \textsuperscript{8} See sources cited supra note 6.
\item \textsuperscript{9} There is the risk that when a non-expert court lacks familiarity or experience with derivatives and other complex financial products, the judge may be tempted to re-characterize such ‘new’ products and treat them as something more familiar (like loans or even traditional insurance contracts) but in essence different from what the parties originally intended to create.
\item \textsuperscript{11} Stephen J. Choi & C. Mitu Gulati, Contract as Statute 104 MICH L. REV. 1129, 1130–73 (2006). The authors suggest that standard form contracts, if in widespread use, may be “better viewed as akin to statutes” and should accordingly be interpreted as such. \textit{Id.} at 1130. \textit{See also} Ross, supra note 7 at 241–46 for another discussion on interpretation.
\end{itemize}
dollars of trades.\textsuperscript{12} As a result, the market (i.e., parties outside the dispute) may have a greater interest in the outcome of a particular case than the two private parties who are litigating it.\textsuperscript{13}

Moreover, the parties to a dispute may not spot an issue of importance to the markets. Or, having spotted it, they may have difficulty finding the requisite experts to give evidence in court. The parties may not wish to, or may be unable to, spend what it takes to get a right answer. There may be other strategic reasons why a party may not frame or develop an issue that others in the market view as extremely important.

There are other challenges too. Knowledgeable counsel may be conflicted. Additionally, third party briefs may not be available or even admissible in certain jurisdictions,\textsuperscript{14} so that it may be difficult to get a market or regulator’s view in the proceedings. Collectively, all these possibilities may be a source of systemic risk, particularly where there is commonality of standard contracts and trading terms in what constitutes a global market.


\textsuperscript{13} Choi & Gulati, supra note 11, at 1132 (“[D]eference to the intentions of the specific parties before a court is especially inappropriate where there are third party effects.”)

\textsuperscript{14} In certain cases, an amicus type brief can help bridge the knowledge gap. See, e.g., In re Nat’l Gas Distributors, LLC, 556 F.3d 247 (4th Cir. 2009). This case involved the first major interpretation of the Financial Netting Improvements Act of 2006 and Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. ISDA played an amicus role at all stages through the appeal of the case to the US Court of Appeals. For an example from the English courts, where the use of amicus briefs is more restricted, see Lomas and others v. JFB Firth Rixson Inc. (2012) EWCA Civ 419. In the Lomas proceedings, ISDA perceived that they had a legitimate interest in the true construction of their standard terms and applied for, and were granted, leave to intervene both at first instance and in the appeal of the lower court decision. In the judgment given, the appeals court appears to have relied upon and been largely persuaded by ISDA’s submissions.
Can we see, as a result, a blurring of lines in the kind of cases I am describing? Lines that have traditionally, at least in common law courts, divided civil from criminal procedure. Consider the following: A shoots B and stands trial; B forgives A, but the state objects, noting the state’s issue with people using guns to settle disputes and the need to protect public interest. It is not for the private citizen alone to decide to settle this case, but rather for the state to decide.

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

Standard global contracts, like the ISDA master agreements, function more like treaties or statutes. However, unlike most important treaties, until now no court or tribunal is specifically dedicated to interpreting them. It would be meaningless, when interpreting the provisions of such contracts to ask, “What did the parties intend?” The answer is probably that they intended what the market working groups in some room, possibly long ago, intended—rooms in which the contracting parties were not present and perhaps not represented. We need experienced judges who know these answers or at least have a good grasp of the context in which the contract must be read.

II. SETTLED LAW AND GLOBAL MARKETS

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

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

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

We are apt to see two counterparties (for example, an African commodity producer hedging its risk with a European bank), each possibly from a civil code jurisdiction, each possibly a native French speaker, but using an English language, common law contract (like the ISDA Master). Ideally, we would want judges who literally speak the language of the parties, and with a strong comparative law background.

Is it correct that the parties should need to fly off to London or New York to settle their disputes? Even if the judgments of those courts are not enforceable in either party’s home jurisdiction?16

So, with decentralized courts, decentralized parties, common law contracts, civil code country players (or perhaps Islamic finance inspired), and complicated cases, there is a serious potential for wrong results, and of disaster stemming from those wrong results. What can we do about this? What would move things forward in a more positive way?

III. P.R.I.M.E. FINANCE INITIATIVE

Well, I hope that it will be good news that some of us are trying, proactively, to make a difference. In late October 2010, on a Monday following a weekend meeting of G-20 finance ministers in Seoul, a group of sixty senior experts quietly gathered in the Peace Palace in The Hague to discuss this very issue. The meeting was convened by Lord Woolf, the former Lord Chief Justice of England and Wales, with support from the Dutch authorities. There were twenty legal practitioners representing five centuries of “lawyer years” counseling in the derivatives markets. There were another twenty from the market: CEOs, CLOs, dealers, buy-side, several (including the first) Chairmen of ISDA and of other relevant trade bodies. Additionally, the President of the Dutch Central Bank, the Chairman of the Basel Committee on Banking Supervision, senior figures (participating in their individual capacities) from the European Central Bank, the Federal Reserve and the SEC, and some of the leading academics in the field, were also present.

But perhaps most importantly, senior judges attended the meetings. The judges came from the Delaware Supreme Court, the Australian Federal Court, the New Zealand Court of Appeals and other national courts. We worked hard then and, with continued Dutch government support, we have worked hard since. I am pleased to report the

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formation of a Panel of International Market Experts in Finance (or “P.R.I.M.E. Finance”) devoted to complex product and other financial market disputes, offering arbitration and mediation services, and committed to providing training for judges in national courts, expert testimony and advisory opinions as well.

On January 16, 2012, Jan Kees De Jager, the then Finance Minister of the Netherlands, opened the P.R.I.M.E. Finance Disputes Center in The Hague. It is already a truly international panel of the senior legal and market experts in the field. There are nearly 100 experts currently on the panel representing collectively more than 2,500 years of relevant experience. (There is also a “wait list” of an even greater number of nominee experts, many with impeccable credentials, lined up to help, and it is expected that the panel will continue to grow and broaden the diversity of its representation.)

Diversity is also key because P.R.I.M.E. Finance hopes to play an important role in the resolution of financial market disputes where one or both parties is from a developing economy jurisdiction. Traditionally, many industry standard contracts have included clauses referring disputes to the courts of New York or England. However, the decisions of these courts may not be enforceable in many jurisdictions where the parties may be organized or trade pursuant to these standard terms. By virtue of the New York Convention on the Recognition and Enforcement of Arbitral Awards, P.R.I.M.E. Finance arbitral awards can be enforced in many such jurisdictions.

Now, have we “put our heads in the sand” with respect to central clearing and its relevance to the reduction of systemic risk as well? With all the focus on central counterparties and clearing, there is growing concern that dispute settlement between clearinghouses and
their members, and between clearing houses across jurisdictions, has been given short shrift. We know that there are some very thorny legal issues lurking, many still untested. Many also believe the less sophisticated procedures and rule books used by clearinghouses in the past are unlikely to be fully up to the task of settling these disputes.\textsuperscript{20} Yet the decisions in future may have greater systemic consequence. A panel of prepared international experts could mitigate the risk of unsatisfactory results from dispute settlement efforts at and between clearinghouses and exchanges.

In attracting talent to its rather ambitious task, the P.R.I.M.E. Finance Disputes Center is taking full advantage of a sociological phenomenon: a generation of market participants and their advisors—the real experts in this field—are reaching retirement age. They built the legal theory and infrastructure of the derivatives and structured finance industry through the formative years of the business. They understand it. And many of them are prepared to give back. Many of us thought it would be a shame to let this opportunity slip by.

\textbf{CONCLUSION}

Financial market law litigation is probably increasing. It is certainly complicated. And, partly because of standard contracts and terms, and the volume of trading, wrong decisions threaten systemic risk. In this sense at least, the interest of the markets in the outcome of a case may be far greater than the interest of the parties to that case.

The current reliance on national tribunals of general jurisdiction and ad hoc arbitration is unsatisfactory. It is too decentralized, too inefficient and too expensive, and, perhaps most importantly, it is failing to produce a settled and authoritative body of law or the predictability that the markets crave and on which financial stability may depend.

Let me leave the reader with a question: why do we have special subject matter courts for everything from family law to trade to tax and insolvency—but in most jurisdictions at national level, we do not have dedicated courts for finance? Think about it. World trade benefits from the existence of the WTO tribunal and the dedicated bar it has nurtured. Why then, until now, has there been no institutionalised international

\textsuperscript{20} For a recent article calling for “detailed scrutiny of [central counterparties’] dispute resolution processes,” see Joanne P. Braithwaite, \textit{OTC Derivatives, the Courts and Regulatory Reform}, 7 \textit{Capital Markets L. J.} 364, 379 (2012).
dispute settlement mechanism for finance? Is international finance law any less global, complicated or systemically relevant than international trade law? I don’t think so.

Judges who understand finance can be allies of the regulators and play an important role in fighting systemic risk in the financial markets. Absent an available and ready supply of persons expert enough to play this role, and to train and assist others to do so, too many of the judges around the world, if called upon to decide complex product cases and interpret standard contracts and terms that govern derivatives and other financial product trading, may represent a source of such systemic risk. P.R.I.M.E. Finance aims to make a positive difference in this respect. We must do everything that we can to foster an authoritative and settled body of financial market law and a better understanding of key financial market contracts and relevant financial market practice. It would be dangerous to put all our eggs in the single basket of better regulation.