

## Lawyers and systemic risk in finance

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DOI:

[10.1080/1460728x.2016.1189115](https://doi.org/10.1080/1460728x.2016.1189115)

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*Document Version*

Peer reviewed version

*Citation for published version (Harvard):*

Gray, J 2016, 'Lawyers and systemic risk in finance: could (and should) the legal profession contribute to macroprudential regulation?', *Legal Ethics*, vol. 19, no. 1, pp. 122-144.  
<https://doi.org/10.1080/1460728x.2016.1189115>

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## **Lawyers and Systemic Risk in Finance : Could (and should) the legal profession contribute to Macroprudential regulation?**

**Professor Joanna Gray (University of Birmingham)**

### **Introduction**

The aim of this paper is two-fold. Firstly to examine questions about the role and responsibilities of transaction lawyers working in the financial sector that, it is argued, deserve closer scrutiny than they have hitherto received since the banking and economic crisis of 2008. In pursuit of those questions it examines the academic literature, Government and Parliamentary, and regulatory and independent commentary and inquiries on some of the more significant financial institution failures that characterised the turbulence that hit the financial system (and real economy) in 2008. It asks of those sources (primarily drawn from the UK and, to a lesser extent, the US) the question ‘Of the many different factors identified that were present in the pre-2008 financial markets for the scale and seriousness of the crisis which of those factors were financial transaction lawyers most closely associated with?’

Having identified those aspects of the pre-crisis financial markets where lawyers played a particular role it asks ‘Could (and should) they have acted differently?.’ Or at the very least, should greater responsibility be attributed to lawyers or some of the consequences of their transaction lawyering?

The first section concludes that there are strong and persuasive arguments both for and against reorienting the responsibilities of the transaction lawyer to include some obligation to take account of the risk to the financial system which the transactions they are conducting for their clients may pose. However, it argues that it would be difficult, if not conceptually impossible, to concretise and render operative such an obligation for financial transaction lawyers.

Following on from that first part of the analysis the second part of the paper explores ways in which, nonetheless, financial sector lawyers (by which is meant primarily external legal advisers rather than in-house counsel) could and indeed should be expected to play a part in the efforts of regulators who *do* now have a clear legislative obligation (with all the weight of

public expectation that accompanies such a mandate)<sup>1</sup> to detect, minimise and prevent a repeat of the eruption of systemic in the financial sector. It concludes with specific proposals for regulators to enrol lawyers in this important regulatory enterprise which, it is argued, would be difficult for the legal profession to resist engaging with.

### **Part I: Where were the lawyers before the dancing stopped?**

The allusion above references the now infamous words of Chuck Prince, former Chief Executive of Citigroup, uttered in the summer of 2007 during an FT interview. He was explaining the group's continuing involvement in financing highly leveraged private equity transactions in the face of rising levels of concern around the risks posed by such leveraged finance should investors ever lose confidence in the complex collateralised debt instruments employed to effect such lending. He justified the group's position thus: 'When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.'<sup>2</sup>

As is now widely documented in a vast multidisciplinary literature and public record of the global financial crisis things did, indeed, get complicated. Already deeply troubled financial markets became wholly dysfunctional in September 2008 when the US Government declined to rescue yet another ailing financial institution and the collapse of the global investment banking giant Lehman Bros duly followed.<sup>3</sup> This was the nail in the coffin for wholesale interbank money markets around the world (which had been growing more illiquid and difficult places for banks to tap into since problems first emerged in 2007 in the US sub-prime mortgage sector).<sup>4</sup> Money stopped circulating and interbank credit supply froze. The contagion spread and led to the failure of emergency public recapitalisations and rescues of many other financial intermediaries all around the world who were suddenly starved of liquidity with devastating effects on broader credit markets and hence the real economy, real

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<sup>1</sup> Andrew Haldane, 'Why Institutions Matter (More Than Ever)' (speech given at Centre for Research on Socio-Cultural Change (CRESC) Annual Conference, School of Oriental and African Studies, London, 4 September 2013) <[www.bankofengland.co.uk/publications/Pages/speeches/default.aspx](http://www.bankofengland.co.uk/publications/Pages/speeches/default.aspx)> accessed 29 March 2016

<sup>2</sup> Citigroup chief stays bullish on buy-outs' *Financial Times* (London 9 July 2007) <<http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz41c7wmzqn>> accessed 1 March 2016.

<sup>3</sup> Final Report Of The National Commission On The Causes Of The Financial And Economic Crisis In The United States (Washington D.C. January 2011) hereafter referred to as 'The US Financial Crisis Inquiry Report'

<sup>4</sup> Ibid Chapter 13; House of Commons Treasury Committee Financial Stability and Transparency (Sixth Report of Session 2007–08, HC 371) [Chapter 3].

households and real lives.<sup>5</sup> Instability, fear and contagion followed as a death spiral of decline and panic took hold of a financial system and spread through channels of complex financial risk transfer instruments that had previously seemed to so many an engine of efficiency, growth and optimal risk reduction and allocation that were positively *conducive* to financial stability.<sup>6</sup>

In order to understand the centrality of lawyers and transaction lawyer expertise to sowing the seeds of the financial crisis there is one in particular of its multiplicity of sources that must be examined. That source lies in the web of highly complex, infinitesimally structured and opaque derivative financial instruments built by lawyers for banks through which to distribute credit risk to others (often combined with other unconnected instruments), rather than to hold such risk on their own balance sheet and thus avoiding the regulatory cost of having to hold additional capital to buffer against it.. By such means, banks and other lenders could pass on the credit risks of the very considerable amount of lending (not all of it of the highest quality) that they had been engaging in prior to 2008. The mechanics of these types of instruments, often described as ‘OTC derivatives’<sup>7</sup> and their ability to spread contagion rapidly throughout the relatively small numbers of systemically significant financial institutions that enter into them had featured before the crisis as a source of concern to central banks<sup>8</sup> and regulators, and warnings sounded in comment within the law and finance literature long before the financial crisis took hold.<sup>9</sup>

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<sup>5</sup> The US Financial Crisis Inquiry Report (n 3) [Chapter 13] in particular the discussion of effects on households and businesses in Chapter 21; UK Parliamentary Commission on Banking Standards *First Report* (HL Paper 98 HC 848 2012-2013) [14 para 16]; Misbah Tanveer Choudhry Enrico Marelli Marcello Signorelli, ‘Youth unemployment rate and impact of financial crises’ (2012) *International Journal of Manpower*, Vol. 33 Iss 1: 76 – 95 <http://dx.doi.org/10.1108/01437721211212538>; Crujisen, Carin, de Haan, Jakob and Jansen, David-Jan ‘Trust and Financial Crisis Experiences’ (2013) DNB Working Papers, Netherlands Central Bank, Research Department. <http://EconPapers.repec.org/RePEc:dnb:dnbwpp:389>

<sup>6</sup> IMF Global Financial Stability Report Market Developments and Issues (Washington DC: April 2006) Chapter II <http://www.imf.org/External/Pubs/FT/GFSR/2006/01/>

<sup>7</sup> ‘OTC’ meaning over the counter in the sense that they are not traded on any organised marketplace or exchange but are purely private and bilateral arrangements made between the counterparties with each other and settled bilaterally.

<sup>8</sup> Yutaka Yamaguchi ‘Challenges raised by recent changes in the financial system’ (2000) Remarks by Deputy Governor of the Bank of Japan, at the Joint Bundesbank/BIS conference on ‘Recent developments in financial systems and the challenges for economic policy’, held in Frankfurt, 28-29 September 2000 (Basel, Switzerland; BIS Review 2000).

<sup>9</sup> One excellent and prescient study in which the ability of these instruments to channel contagion through tightly coupled webs of connectivity is provided by Adam Waldman ‘OTC derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?’ (1994) 43 *Am. U. L. Rev* 1023; the political economy of the (lack of) pre-crisis regulation and oversight of these instruments is discussed in Lynn A. Stout ‘Derivatives and the Legal Origins of the 2008 Credit Crisis’ (2011) 1 *Harvard Business Law Review* 1.

The US Financial Crisis Inquiry Report identified the toxic effect of these instruments in their conclusions:

The scale and nature of the over-the-counter (OTC) derivatives market created significant systemic risk throughout the financial system and helped fuel the panic in the fall of 2008; millions of contracts in this opaque and deregulated market created interconnections among a vast web of financial institutions through counterparty credit risk, thus exposing the system to a contagion of spreading losses and defaults. Enormous positions concentrated in the hands of systemically significant institutions that were major OTC derivatives dealers, added to uncertainty in the market. The ‘bank runs’ on these institutions included runs on their derivatives operations through novations, collateral demands, and refusals to act as counterparties.<sup>10</sup>

*Lawyers: their role in the dance.*

Enter now stealthily (and profitably) the financial transaction lawyers to whom we must turn our focus for Shiller reminds us that even the most complex of financial instrument is constituted by law and thus by lawyers, ‘[l]awyers are fundamentally involved with finance. Every financial device...is represented by a long and complex legal contract...the lawyers are the real engineers who construct financial devices.’<sup>11</sup>

Pistor too has explored this essential constitutive role of law in shaping and making our modern financial system.<sup>12</sup> She uses the emergence of the global derivatives market by means of a market and user driven private legal infrastructure of standardised cross-referential global contracts<sup>13</sup> in order to develop a legal theory of finance which can encompass and explain the

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<sup>10</sup> *The US Financial Crisis Inquiry Report* (n 3) [386].

<sup>11</sup> Robert Shiller *Finance and the Good Society* (Princeton University Press: 2012).

<sup>12</sup> Katharina Pistor ‘Towards a Legal Theory of Finance’, European Corporate Governance Institute: Law Working Paper N°. 196/2013, (February 2013) [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2262936](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2262936)

<sup>13</sup> Through the work of the International Swaps and Derivatives Association (ISDA) a supranational and private sector trade association for repeat users of derivative financial instruments whose key objectives are stated to be reduction of counterparty credit risk, increasing transparency, and improvement of the industry’s operational infrastructure <http://www2.isda.org/about-isda/>. ISDA members comprise financial institutions and their legal and professional advisers from 67 different countries who meet regularly and keep under review the standard form contractual documentation which forms the design template for individual derivatives transactions. For a view on ISDA as a private transnational regulatory mechanism that can shape national public policy with distributional consequences see John Biggins and Colin Scott. ‘Public-Private Relations in a Transnational Private Regulatory Regime: ISDA, the State and OTC Derivatives Market Reform’ (2012) *European Business Organization Law Review* 13: 309-346.

fragility and instability, hierarchy and varying degrees of legal elasticity to be found in the financial system.

Indeed the legal profession itself does not shrink from proclaiming its pivotal role in the growth and success of international capital markets. For example, the continuing pre-eminence of the City of London as a global financial centre is frequently attributed both by the City itself and by the legal profession and Government to the intellectual dexterity and facility of its major 'Magic Circle' law firms.<sup>14</sup>

Despite the central role of lawyers in transacting what the US Financial Crisis Inquiry report described as the millions of contracts in an unregulated and opaque market through which financial contagion spread in 2008 the role of lawyers seems to have largely escaped public scrutiny. For the question of the responsibilities of transaction lawyers (if any) for the state in which the global financial system found itself Autumn of 2008 appears to have slipped under the radar of the very many Parliamentary, Government, regulatory and independent inquiries that asked questions as to the causes, origins and cures of the 2008 crisis. For example, one of the earliest UK inquiries to examine the causes of emerging systemic instability in the UK emphasised the destabilising effects of the innovation of tranching, pooling and onward dispersion of layers of risk from already opaque and complex derivative products created on the back of commercial lending.<sup>15</sup> Yet it failed to consider *how* such innovation takes place for financial innovation owes as much to *legal* innovation as it does to any innovation in quantitative technique or technology. Howarth, whose analysis is explored more fully below, employs the compelling metaphor of lawyer *qua* engineer to convey the essence of this core function of lawyering.<sup>16</sup> This design, build and adapt role that lawyers play in financial intermediation is of far greater importance to the shaping of the financial system and distribution of risks within it than is the more popularly imagined adversarial role of the

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<sup>14</sup> The UK has been described as '... a leading provider of many professional and support services associated with the financial services industry [and that] Legal services generated £20.9bn in 2011, 1.6% of GDP, and net exports of £3.3bn. The UK is one of two leading centres for international legal services, including corporate finance, corporate and commercial law and tax. Four of the ten largest global law firms are from the UK...' An Indispensable Industry: Financial Services in the UK report published by the City of London Corporation in 2011 <https://www.cityoflondon.gov.uk/business/economic-research-and-information/statistics/Documents/an-indispensable-industry.pdf>; The Bar Council, Law Society and UKTI have all emphasised recently that the UK accounts for 7% of all global legal services with the largest international law firms in London being lead advisers on many international capital markets deals. (The City UK Professional Services Series: Legal Services January 2014) <<http://www.barcouncil.org.uk/media/278588/legal-services-2014.pdf>> accessed 29 March 2016

<sup>15</sup> House of Commons Treasury Committee 'Financial Stability and Transparency' (Sixth Report of Session 2007–08: HC 371) .;Law Society statistics published March 2016 claim a considerable GDP enhancing role for the UK legal sector too <http://www.lawsociety.org.uk/News/Pressreleases/a25billionlegalsectorsupportsahealthyeconomy/>

<sup>16</sup> David Howarth *Law as Engineering: Thinking about What Lawyers Do* (Edward Elgar: 2013).

lawyer derived from their involvement in litigation.<sup>17</sup> McBarnet too has used the engineering metaphor to describe lawyering and the financial crisis,<sup>18</sup> while Loughrey highlights this law shaping and constitutive role of the non-contentious business transaction lawyer in the course of theorising the proper accountability of large firm lawyers.<sup>19</sup> In exploring the normative question of ‘What should transactional lawyers be accountable for?’ she emphasises the activism of lawyers in transaction design, acting as far more than ‘neutral conduits’ of commercial objectives. Indeed with OTC derivative transactions (and many other forms of financial transaction) the prior approval and sign off of key terms of the transaction by external legal advisors is very often a condition of their proceeding and gaining the release of requisite funding.<sup>20</sup> Whether it be financing a private equity leveraged acquisition or purchasing a tranche of collateralised debt presenting a bundle of remote, diverse and relatively opaque lending, the lawyer’s professional assurance opens the tap for further financing of the deal in the same way that the reputable firm of Chartered Engineers attesting for the safety, compliance and performance of a new product or technical process will provide assurance to the venture capital investor. They have, to put it simply, checked under the bonnet and chassis, and all we be as well as it can be reasonably expected to be in their expert view.

*But when all does not turn out well: where are the transaction design lawyers then?*

Much of the credit risk subsequently sliced up and sold on through esoteric OTC derivative instruments derived from commercial lending to the private equity industry to conduct highly leveraged acquisitions and even prior to the collapse of Northern Rock concerns were emerging as to the ‘covenant-lite’ nature of this lending.<sup>21</sup> Yet, despite clear warnings from (inter alia) senior officials at the Bank of England as to the effects on financial stability that could well ensue from this weakening of debt conditionality coupled with increasingly unclear ultimate ownership of economic risk due to the opacity of the instruments that transferred it onwards, no thought appears to have been given to the responsibilities of the

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<sup>17</sup> Ibid [Chapter 2].

<sup>18</sup> Doreen McBarnet, ‘Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis’ in Iain MacNeil and Justin O’Brien (eds.) *The Future of Financial Regulation* (Hart Publishing, 2010).

<sup>19</sup> Joan Loughrey, ‘Accountability and Regulation of the Large Law Firm’ (2014) 77(5) MLR 732–762.

<sup>20</sup> Steven Schwarcz, ‘The Limits of Lawyering : Legal Opinions in Structured Finance’ (2005) Texas Law Review 84:1: 1-58.; John A. Flood ‘Lawyers as sanctifiers: The role of elite law firms in international business transactions.’ (2007): Indiana Journal of Global Legal Studies 14.1, 35-66.

<sup>21</sup> House of Commons Treasury Committee *Private equity* (Tenth Report of Session 2006–07, Cm 567-I, 2007).

lawyers who transacted this lending then helped disperse its downside away from its originator.<sup>22</sup>

Likewise there was only passing mention of lawyers in a 500 plus page report of a 2013 Parliamentary Commission for Banking Standards (whose most famous member was of course the Archbishop of Canterbury).<sup>23</sup> In a wide ranging report into both the need and means to change the culture and behaviour of individuals who constitute the banking sector no consideration at all is given to the internal ethical culture within one important constituency – advisory transaction lawyers - who trade in the art of the possible and the materialisation of commercial objectives. Ought they to pay any regard to the public good of financial system stability or is that the province solely of external regulators? This question was not addressed and the report’s only direct reference to the legal profession was in fact to use it as a positive comparator with which to contrast the lack of a professional role of ‘banker’.<sup>24</sup> No discussion of whether those requirements and disciplines could have something useful to contribute to the task of promoting overall financial stability (surely a *sine qua non* of the ‘more secure financial system’ the commission repeatedly calls for<sup>25</sup>) just as much as they do to promoting individual client interests and the reputation of the profession overall.<sup>26</sup>

Furthermore, scrutiny of the various UK reports and inquiries into the failure of specific UK financial institutions during the course of the banking crisis does not reveal any consideration of the role of these institutions’ own advisory lawyers in enabling the ill-fated commercial strategies of each individual institution which, when unravelled, collectively contributed to instability throughout the system.<sup>27</sup> The only point at which specific involvement with legal

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<sup>22</sup> Ibid Ch 4, the conclusions drawn by the Treasury Select Committee are directed towards the Bank of England and FSA primarily and not to the architects and draftsman of the covenant-lite loans themselves whose role is never mentioned

<sup>23</sup> Parliamentary Commission on Banking Standards *Changing Banking for Good* (First Report of Session 2013–14 HL Paper 27-I, HC 175-I June 2013).

<sup>24</sup> HL Paper 27-II, HC 175-II Chapter 6 ‘Discussion in Chapter entitled ‘Lessons from other sectors’.

<sup>25</sup> Ibid [Para 247].

<sup>26</sup> HL Paper 27-I, HC 175-I [Para 19 and Para 90] where the Commission contrasts banking as an activity with those of the professions saying ‘ It is a long way from being an industry where professional duties to customers, and to the integrity of the profession as a whole, trump an individual’s own behavioural incentives.’ Yet fails to canvas the possibility of desirability of extending the ambit of those duties to include the stability of the financial system from which the bulk of their legal work is generated.

<sup>27</sup> House of Commons Treasury Committee ‘The run on the Rock’ (Fifth Report of Session 2007–08 HC 56–I , 2008) ‘The Supervision of Northern Rock: A Lessons Learned Review’ (March 2008, FSA); House of Lords House of Commons Parliamentary Commission on Banking Standards ‘An accident waiting to happen: The failure of HBOS’ (Fourth Report of Session 2012-13, HL Paper 144 HC 705, 2013), Report by the Financial



advisers receives mention is in the 2011 FSA Report into the failure of Royal Bank of Scotland (RB) in the context of the bank's lawyers (Linklaters) having been present at the board meeting at which the bank's (subsequently proven to be) disastrous acquisition of ABN/AMRO was signed off.<sup>28</sup> Reference was made to their having given legal advice to the RBS board as to the soundness of the transaction but that advice, being protected by professional privilege, could not be referred to in the report. And so it seems throughout the construction of post-crisis blame narratives, while bankers were being stripped of knighthoods and publicly shamed<sup>29</sup> and regulators quietly moved on,<sup>30</sup> there was a resounding silence around lawyers.

Turning to the academic literature we find that, although discussion of issues of responsibility and accountability for the 2008 crisis are extensive lawyers as a professional group receive nowhere near the same scrutiny as have senior management<sup>31</sup>, the accountancy profession<sup>32</sup> and credit rating agencies.<sup>33</sup>

*Lawyers as gatekeepers and sentries for a wider public interest: Lessons from elsewhere*

Questions surrounding lawyers' motivations and behaviours in designing, negotiating and then transacting many of the opaque financial products, lengthy financial value chains, and weaving the criss-crossing patterns of interconnectivity that funnelled the market contagion of 2008 have yet to receive full discussion but, importantly, they are beginning to be raised.<sup>34</sup> What emerges is that the issue of whether lawyers could realistically have been expected to

Conduct Authority and the Prudential Regulation Authority 'The failure of HBOS plc (HBOS)' (November 2015).

<sup>28</sup> FSA Board Report 'The failure of the Royal Bank of Scotland' (November 2011) [www.fsa.gov.uk/rbs](http://www.fsa.gov.uk/rbs) p 415

<sup>29</sup> 'Goodwin stripped of Knighthood' *FT* 1 February 2012, <http://www.ft.com/intl/cms/s/0/89dc0d42-4c2a-11e1-b1b5-00144feabdc0.html#axzz41n33hNDf>; 'Disgraced HBOS chief Crosby is stripped of knighthood' *Glasgow Herald* 12 June 2013.

<[http://www.heraldscotland.com/news/13109045.Disgraced\\_HBOS\\_chief\\_Crosby\\_is\\_stripped\\_of\\_knighthood/](http://www.heraldscotland.com/news/13109045.Disgraced_HBOS_chief_Crosby_is_stripped_of_knighthood/)> accessed 29 March 2016.

<sup>30</sup> *Daily Telegraph* 20 March 2008 <<http://www.telegraph.co.uk/finance/markets/2786710/Northern-Rock-fiasco-forces-out-FSA-director.html>> accessed 29 March 2016.

<sup>31</sup> Johan J. Graafland and Bert W. van de Ven 'The Credit Crisis and the Moral Responsibility of Professionals in Finance' *Journal of Business Ethics* (2011) 103: 605–619.

<sup>32</sup> Prem Sikka 'Financial crisis and the silence of the auditors' (2009) *Accounting, Organizations and Society* 34: 868–873.

<sup>33</sup> Peter Yeoh 'The global financial meltdown: what happened to the gatekeepers in the US and the EU and what to do about them?' (2012) *Journal of Transatlantic Studies* 10:3 271-293.

<sup>34</sup> Donald C. Langevoort 'Getting (Too) Comfortable: In-House Lawyers, Enterprise Risk, And The Financial Crisis' (2012) *Wis. L. Rev.* 495; Julija Kiršienė 'The Bank And Credit Union Disasters In Lithuania: Where Were The Lawyers?' (2014) *Baltic Journal of Law & Politics* 7:2 : 77-94; Stephen Schwarcz 'The public responsibility of structured finance lawyers' (2006) *Capital Markets Law Journal*, Vol. 1, No. 1.

have raised concerns about destabilising effects of some of the business they were facilitating is not as straightforward as it may seem at first blush. There are no easy analogies to be found by examining other areas of work where either lawyers already have, or are subject to growing demands that they should have, some wider responsibilities to a ‘public’ interest beyond that (and possibly even in conflict with) the interest of their client alone.

There has certainly been vigorous and extensive discussion over the years on to whom, and how extensively beyond the client’s interests alone a lawyer should owe her ethical and professional obligations as a general matter<sup>35</sup>. Following the corporate governance scandals of the late 20<sup>th</sup> Century culminating in the collapse of Enron much debate centred around lawyers as gatekeepers in ‘good’ corporate governance and management conduct and how extensive the duties of securities lawyers in public securities transactions were and ought to be.<sup>36</sup> The mechanism of harnessing independent actors to pledge expertise, judgment and reputational capital in ways on which others can rely and plan ‘ex ante’ is widely observed.<sup>37</sup> It offers transaction cost efficiencies<sup>38</sup> and is also attractive to regulators and public institutions as a means of co-opting, or as Black has termed it ‘enrolling’ private sector market participants who are either members of or service providers to a regulated constituency in the objectives and agenda of the regulator.<sup>39</sup>

But not all gatekeepers are the same, it is easier to see how responsibility for failures within the gatekeeping role could attach to some categories than to others, such as auditors responsible for the statutory audit for example . As Coffee points out, in the course of examining the SEC’s rule making powers to establish minimum standards of professional conduct for lawyers in securities business before it<sup>40</sup>, ‘...[A]ttorneys are not predominantly gatekeepers, as are, in theory, auditors and analysts. Rather, they play multiple roles with

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<sup>35</sup> William H. Simon *The Practice of Justice: A Theory of Lawyers’ Ethics* (Harvard University Press 2000); D. Rhode *In the Interests of Justice: Reforming the Legal Profession* (OUP 2003); c.f. Stephen L. Pepper ‘The Lawyer’s Amoral Ethical Role: A Defense, A problem and some possibilities’ 1986 Am. B. Found. Res. J. 613 1986.

<sup>36</sup> John Coffee ‘The Attorney as Gatekeeper: An Agenda for the SEC’ (2003) Columbia Law Review Vol 103 No 5 pp 1293-1316; Stephen M. Bainbridge ‘Corporate Lawyers as Gatekeepers’ Journal of Scholarly Perspectives, 8(01) 2012; David A. Skeel, Jr. et al ‘Inside-Out Corporate Governance’ (2011) The Journal of Corporation Law Vol. 37:1: 147.

<sup>37</sup> Ibid; Coffee (n 36) [1297].

<sup>38</sup> Reinier Kraakman, ‘Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy’ (1986) 2 J.L. Econ & Org 53.

<sup>39</sup> Julia Black ‘Mapping the contours of contemporary financial services regulation’ (2003) CARR Discussion Papers, DP 17. Centre for Analysis of Risk and Regulation <http://eprints.lse.ac.uk/36045/>

<sup>40</sup> section 307 Sarbanes-Oxley Act 2002, Pub. L. No. 107-204, 116 Stat. 745

respect to the corporate client: (1) advocate; (2) transaction engineer; and (3) disclosure supervisor - or gatekeeper. Critics of the SEC's proposed rules have been quick to assert that imposing gatekeeper-like duties on the attorney would compromise the attorney's loyalty to the client, thereby subordinating the attorney's primary role to the secondary role of gatekeeper.<sup>41</sup>

Arguments against seeing lawyers as gatekeepers or guardians of any interests other than client-focussed ones are commonly justified in terms of individual autonomy under the rule of law,<sup>42</sup> and ease of privileged communication between lawyer and client justified as a bulwark against state power.<sup>43</sup> And yet, with anti-money laundering and terrorist financing obligations and responsibilities now incumbent on lawyers in jurisdictions around the world that have implemented the relevant recommendations of the supranational Financial Action Task Force (FATF)<sup>44</sup> the precedent has been set for a significant erosion of legal professional privilege<sup>45</sup>. That erosion is motivated by the deliberate prioritisation of a public good (the prevention and detection of use of the financial system for furtherance of crime or for financing terrorism) over the values inherent in the impregnability of the lawyer-client. Such an incursion was naturally the subject of fierce resistance from the legal profession itself<sup>46</sup>

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<sup>41</sup> Coffee (n 36) 1302 referring to the criticisms of the notion of 'attorney as gatekeeper' made by Jill E. Fisch and Kenneth M. Rosen, 'Is There a Role for Lawyers in Preventing Future Enrons?' (2003) Villanova Law Review, Vol. 48, No. 4, 1097.

<sup>42</sup> C. Fried 'The Lawyer As Friend The Moral Foundations Of The Lawyer-Client Relationship' (1976) Yale Law Journal, Vol. 85, No. 8, 1060; Robert W. Gordon 'The Citizen Lawyer-A Brief Informal History Of A Myth With Some Basis In Reality', (2009) 50 Wm. & Mary L. Rev. 1169 2008-2009. Alice Woolley, 'Rigorous, Relevant, and Right: The Scholarship of Monroe Freedman' (2015) The Professional Lawyer Volume 23, Number 2: 1.

<sup>43</sup> Andrew Paizes, 'Towards a broader balancing of interests: exploring the theoretical foundations of the legal professional privilege' (1989) 106 S. African L.J. 109.

<sup>44</sup> FATF Recommendation 22 of the 40 Recommendations on International Standards On Combating Money Laundering And The Financing Of Terrorism & Proliferation (2012) lawyers are included within the list of designated non-financial businesses on whom various due diligence and regulatory reporting obligations attach when they act in the course of buying and selling of real estate; managing of client money, securities or other assets; management of bank, savings or securities accounts; organisation of contributions for the creation, operation or management of companies; creation, operation or management of legal persons or arrangements, and buying and selling of business entities.

<sup>45</sup> Case C-305/05 Ordre des barreaux francophone and germanophone & others v Conseil des Ministres [2007] All ER (EC) 953 ; J. Komarec 'Legal Professional Privilege And The EU's Fight Against Money Laundering' (2008) Civil Justice Quarterly, Vol. 27, 13

<sup>46</sup> European Bar leaders unite against plans for broader money laundering reporting' *Law Society Gazette* 9 December 2000 <http://www.lawgazette.co.uk/news/european-bar-leaders-unite-against-plans-for-broader-money-laundering-reporting/31441.fullarticle>; Simmons & Simmons 'The Third European Union Anti-Money Laundering Directive' *In House Lawyer* website Wednesday, 25 April 2007 <<http://www.inhouselawyer.co.uk/index.php/fraud-and-corporate-crime/6862-entire-agreement-clauses-excluding-earlier-agreements-and-representations>> accessed 29 March 2016

and continues to be the subject of controversy.<sup>47</sup> Nonetheless, the application of anti-money laundering reporting obligations to transaction lawyers is now firmly encoded into both legislative and regulatory requirements and lawyer's own ethical codes in many jurisdictions.

Indeed eight years before the seeds that financial transaction lawyers had been busy and profitably sowing were to bear their destabilising fruit, Sir Mark Potter highlighted the change in societal expectations of lawyers' conduct around financial crime and money laundering and warned that '[I]t is not fanciful to suppose that, in future years, further statutory inroads will be made into the protection afforded by legal privilege in the interests of regulation.'<sup>48</sup>

So too with the practice of tax law, there is a growing body of literature on Tax Ethics from the perspective of advisors which this paper cannot even begin to do justice.<sup>49</sup> However the salient point is that in this context too questions are often asked of lawyers' responsibilities (if any) to consider any concerns other than the cost minimisation horizon of the client before them. Should they at least consider the less visible interests represented by the shortfall in aggregate tax take that may result from their advisory and transactional work? Thinking about 'the tax gap' as a public good in this way ought to at least point any internal ethical compass towards those interests - state and good governance, essential public services, monetary stability, and the adviser's fellow citizens. The introduction into UK legislation of a new Generalised Anti Avoidance rule,<sup>50</sup> along with accompanying HMRC guidance, has triggered further public and political debate<sup>51</sup> around the role of professional advisory firms in structuring and design of schemes and transactions whose primary purpose is to arbitrage the letter of formal tax codes rather than achieve any genuine commercial purpose of the business client.

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<sup>47</sup> Paul D. Paton 'Cooperation, Co-option or Coercion? The FATF Lawyer Guidance and Regulation of the Legal Profession' (2010) *J. Prof. Law.* 165.

<sup>48</sup> Sir Mark Potter 'The Ethical Challenges Facing Lawyers in the Twenty-first Century' (2001) 14 *Legal Ethics* 23, 34.

<sup>49</sup> Milton C Regan Jr 'Tax Advisors and Conflicted Citizens' (2013) *Legal Ethics*, 16:2, 322-349; Richard Lavoie 'Am I My Brother's Keeper? A Tax Law Perspective on the Challenge of Balancing Gatekeeping Obligations and Zealous Advocacy in the Legal Profession' (2013) 44 *Loyola U. Chi. L. J.* 813 (2013), 813-864.

<sup>50</sup> Finance Act 2013 Part 5.

<sup>51</sup> See for example reader comments posted online to Law Society Gazette article, Michael Cross 'Society condemns new tax avoidance penalties' (2015) *Law Society Gazette* 16 March 2015.

<http://www.lawgazette.co.uk/law/society-condemns-new-tax-avoidance-penalties/5047546.fullarticle> including one suggesting 'while I agree that acting on a lawyer's advice that the scheme is legal should exonerate the taxpayer whose behaviour is judged illegal, I don't know why HMRC doesn't go after the lawyer whose advice caused the behaviour and the SRA penalise him/her for being incompetent, at least barring her/him from giving advice on tax matters again.'

*Is stability of the financial system a different form of public good to tax ethics and a clean and terror free financial system?*

But there is a real difference between extending lawyers' horizon and duty beyond the immediate interest of their client in contexts like money laundering and tax avoidance (where the spirit and general purpose of revenue raising frameworks are easier to discern) and extending that horizon to worry about and ask questions of the potential destabilising effects *on the functioning of the financial system itself* of their advisory and transactional work. For the goals of optimal revenue collection in accordance with the legislative purpose and design of discrete taxes, and of a financial system that is out of bounds to criminals and terrorists, are forms of public good that are much easier to imagine, identify and agree upon for both lawyer and client than is the far more open ended and contestable notion of 'systemic risk'. Systemic risk is what materialises when financial system instability ensues, it is said, but that is little more than a reformulation of the concept.<sup>52</sup> From the extensive literature around systemic risk no clear single definition emerges other than a generalised notion of malfunctioning in light of societal expectations and societal tolerance. Instead descriptions rather than definition abounds one of the most useful for our purposes being Edwards characterisation of systemic risk as being '...a unique social pollutant... an abstract concept that is not susceptible to physical sampling or physical measurement, and it can only be 'produced' through some combination of actions in a system. Accordingly, the definitions used to explain what systemic risk 'is' often take the form of explaining how the markets understand the various conditions that create risk of harm (whatever that is) to the financial system (however that is defined).'<sup>53</sup>

History tells us that although we may know it when it comes to pass our track record in its prediction and prevention remains imperfect.<sup>54</sup>

Surely it is impracticable and naïve to have any expectation that a financial transaction lawyer ought to be aware of and consider the risk that the transaction she is designing for the client, either in isolation or as part of a wider pattern of transactional business she may have

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<sup>52</sup> 'a precise definition of systemic risk is still lacking' Basel Committee on Banking Supervision (BIS 2012), Steven Schwarcz 'Systemic Risk' (2008) 97 Geo. L.J. 193.

<sup>53</sup> D Edwards 'Systemic Risk and Taxation' (2011) 31 Virginia. Tax Rev. 331.

<sup>54</sup> Carmen Reinhart & Kenneth Rogoff *This time it's different* (Princeton University Press 2009).

concluded or be about to conclude for that client, could cause feedback effects elsewhere in the financial system that have serious implications for the ability of that system to function effectively?

Howarth, in developing his analysis of what insights and lessons in ethics the technical engineering profession may offer other types of engineers (such as transaction lawyers) working and innovating in complex, uncertain and open systems (such as the financial system undoubtedly is), digs deep into the involvement of lawyers in transactions for financial sector clients prior to the 2008 crisis.<sup>55</sup> He uses the example of the financial crisis of 2008 to tease out and investigate the different aspects that emerge for legal ethics when asking ‘What responsibility do lawyers bear for harmful effects on third parties of the transactions they facilitate?’<sup>56</sup> Specifically he examines the public record concerning the legal advice given by Linklaters in London to Lehman Brothers in enabling it to undertake short term sale and repurchase financing transactions (‘repo’ transactions) which moved liabilities off its balance sheet and out of sight of regulators<sup>57</sup>, as well as the involvement of transaction lawyers for Goldman Sachs in the structuring of the ill-fated ABACUS transactions in order to take short positions in products it had itself designed and sold to counterparties (in effect betting against its own customers).<sup>58</sup> Kershaw and Moorhead too have, in what is a most timely enquiry into of the ethics of transaction lawyering, dissected Linklaters’ involvement in Lehman Brothers’ repo financing strategies.<sup>59</sup> Whilst they acknowledge the accuracy of the legal opinion itself as a matter of law, they have gone on to theorise the consequential responsibility of transaction lawyers for client wrongs in light of the criminal and civil law framework around accessory liability and complicity for the acts of others. They test the idea of consequential responsibility against different models of lawyering as well as the current professional regulatory framework and propose it be amended to require lawyers not to assist a client in a manner which “creates a foreseeable likelihood of wrongdoing by that client. Wrongfulness [to] be defined by reference to breach of any criminal law, civil law, or regulation.”<sup>60</sup>

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<sup>55</sup> Howarth (n 16) [Chapter 4].

<sup>56</sup> Ibid [97].

<sup>57</sup> Ibid [97-103].

<sup>58</sup> Ibid [103-105].

<sup>59</sup> David Kershaw and Richard Moorhead ‘Consequential Responsibility for Client Wrongs: Lehman Brothers and the Regulation of the Legal Profession’ (2013) *Modern Law Review*, Vol. 76, 26

<sup>60</sup> Ibid 61

Howarth drives home the point made earlier in the discussion here that lawyers were far more than peripheral players or accessories to the main authors of the very many causal factors that led to systemic collapse within the financial system. They were not just present at the scene of the ‘crime’ itself – they were integral to weapons design, supply, battle tactics and strategy at every stage of the process:

The transactions required to create all the relevant investment instruments were complex enough to need repeated legal activity. For example, structured finance, at an absolute minimum, requires, well before the sale of securities to investors, the creation of a new company, a special purpose vehicle, and the transfer to it of assets, a process that requires detailed knowledge and use of the rules concerning the assignment of obligations. All of these effects have to be achieved in specific jurisdictions using the law of that jurisdiction and understanding its relationship to other jurisdictions.

Kershaw and Moorhead also emphasise the crucial centrality of Linklaters’ opinion to the construction of the repo transaction as a whole which simply could not and would not have proceeded in its absence.<sup>61</sup> This echoes the arguments made by Pistor, Shiller and others.<sup>62</sup> So in light of this central and constitutive role of transaction lawyers within the very DNA of the financial system itself what ethical implications arise?

### *Lawyers and Systemic Risk : Unfamiliar bedfellows*

The Solicitors Regulation Authority (SRA), the regulatory body for City of London transaction lawyers (and indeed all solicitors in England and Wales) has enthusiastically adopted the language, rhetoric and techniques of ‘risk based regulation’<sup>63</sup> in its discharge of its statutory responsibilities of oversight of solicitors. However the Code of Conduct, Principles and accompanying Guidance to lawyers contained in the 2015 version of its Handbook do little to extend the responsibility of lawyers beyond that of their clients’ interests, risk management of their business and practice environment.<sup>64</sup> To the extent that duties extend as far as relations with third parties and others it is envisaged only that these

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<sup>61</sup> Ibid 40-41

<sup>62</sup> Langevoort ‘Taking Myths Seriously: An Essay for Lawyers’ (2000) 74 Chi.-Kent L. Rev. 1569-1597.

<sup>63</sup> Robert Baldwin, Martin Cave, Martin Lodge *Risk-based Regulation Understanding Regulation: Theory, Strategy, and Practice* (2nd Edition) (OUP 2011).

<sup>64</sup> Joan Loughrey ‘Accountability and the Regulation of the Large Law Firm Lawyer.’ (2014) MLR 77.5: 732-762.

responsibilities are directed to ‘the proper operation of the legal system’<sup>65</sup> and not any other system in which lawyers play an integral and constitutive role such as the financial system.

There appears to have been no suggestion from within the profession itself or from its regulatory body, the SRA, that its members might in future at least consider the systemic risk implications of some of the financial sector advisory and transaction design work they undertake at a more meta level than that of their client’s own experience of the system. Howarth’s analysis questions this omission in the post-crisis and explores the assumptions underlying the continued myopic client- focus of the transaction lawyer and resistance to suggestions of any wider systemic stability awareness and concerns if not more concrete responsibility. He canvasses the objections raised by the legal profession to any expectation that they incorporate, within their ethical compass, the ways in which the effects of instruments and structures they produce for clients may, when they operate in conjunction with other factors within an open and complex system fraught with uncertainty such as the financial system is, produce eventual feedback effects that trigger damage to system functionality and losses to third parties

As Howarth demonstrates, in support of his argument that the ethical code of the practising engineer has much to teach the legal profession, upon closer examination of the standard arguments from the legal profession, namely that transaction lawyers should be seen to have borne any responsibility for the financial instability of 2008 beyond the usual professional responsibility to clients, it becomes clear that such arguments do not withstand close scrutiny. He considers the charge that the multifaceted and barely understood nature of systemic risk itself absolves lawyers from any responsibility since they in particular, amongst all of the advisory disciplines within the financial system such as economists and accountants, are the least equipped and able to conduct complex risk modelling and stress testing exercises that might be called for to extrapolate and imagine potential uses of their legal outputs across different dimensions and time series. Too vague, too messy, and too difficult for lawyers (of all people) to have to do. But Howarth points out that the engineering profession realised it needed to adapt its training and process of professionalization to enable its members to

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<sup>65</sup> Chapter 11 4<sup>th</sup> Section SRA Code of Conduct for Solicitors (2011) <<http://www.sra.org.uk/solicitors/handbook/code/part5/content.page>> accessed 29 March 2016. It has been argued however that the 10 SRA Handbook Principles could indeed support a more public interest oriented interpretation of the extent and nature of corporate lawyers professional obligations - Steven Vaughan, ‘Corporate Lawyers and the Public Interest.’ (2015) CEPLER Working Paper. <http://epapers.bham.ac.uk/1990/> University of Birmingham, Birmingham.



achieve a more nuanced and subtle understanding of factors beyond their traditional applied science skill set. This was so engineers could better understand the potential uses and behaviour of their design output and take greater ownership and responsibility for safety and reliability within a complex open system where human error and biases abound. The current process of reform to legal education would appear to offer a golden opportunity for a more imaginative and societally valuable legal profession.<sup>66</sup>

But, it is said in defence of the transaction lawyer's current position on their (lack of) any responsibility for the financial crisis that if economists failed to predict the risk multiplying effects of the complex instruments that channelled contagion through close webs of interconnection between systemically important institutions then why should the lawyers have been expected to? Again Howarth points out that engineers engage in prototype testing of the individual products they design for signs of flawed scientific bases (being alive to the simplification bias within science itself) and this prototype testing for safety, reliability and real world functionality does not stop once the product is delivered to the client and in use – instead vigilance is maintained to ensure it does not behave in unexpected and harmful ways thereafter. Yet, Howarth raises the obvious question, 'Did lawyers exercise similar caution and vigilance as risk-multiplying financial devices were deployed at scale? One suspects not.'<sup>67</sup>

Howarth dismisses arguments for a lack of wider responsibility for the financial crisis based on the financial system being somehow a given, a *fait accompli* designed and constituted by others within which lawyers simply advise and feed in a degree of legal ordering. Such arguments ignore the constitutive nature of private law explored earlier, and Howarth argues that certain responsibilities arise as a result of this system productive and system shaping role of the transaction lawyer '[L]awyers take an idea from bankers about how a transaction might work and put it into a form in which it does work. In such circumstances, responsibility for safety and sustainability for the whole device remains with lawyers.'<sup>68</sup>

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<sup>66</sup> As Howarth puts it 'It might well be the case that lawyers lacked the expertise necessary to understand the impact of their activities on the financial markets, but that should have been a spur to change, not an excuse for inaction. Establishing relationships of strict causation between what specific lawyers did and specific aspects of the subsequent disasters might be difficult, since one cannot rule out the possibility that bankers and accountants might have tried to set up risk-multiplying transactions by themselves, without the benefit of legal input, but that does not relieve lawyers of all obligation to think about the consequences of what they were asked to do and in particular of an obligation to engage in the legal equivalent of safety engineering.' Howarth (n 16) [?? ]

<sup>67</sup> Ibid 129]

<sup>68</sup> Ibid 130??

Finally lawyers may well argue that the regulators as ultimate referees and guardians of the financial system bore ultimate responsibility for what happened. Yet, once again, closer analysis of both the sources of financial system instability and the nature of financial regulatory requirements (at least in the UK where much of the OTC derivative business was engineered) negate such a view. A very large part of the reason for the amplification and rapid spread of contagion across borders, asset classes and institutions was as a result of long, convoluted, highly complex contracts (often across jurisdictional borders) transferring credit risk that itself had been originated under contracts that were unrealistic and loosely drafted. These were all private law institutions created and endorsed by at every stage of the chain by private transaction lawyers. More often than not they were simply not visible to regulators and the web of inter connectivity that existed between them was certainly not visible at a whole system or market level to any one regulator. Indeed this invisibility was as often as not the outcome of deliberate and intentional efforts to game prudential standards in force. Lawyers knew this at the time. Indeed, many of the elite financial sector law firms to which these transaction lawyers belong would have been at the forefront of lobbying and advocacy with national legislators and regulators that ensured the much of the market activity in these instruments (such as the wholesale money markets in which the Repo transaction upon which Linklaters opined for Lehman was conducted) remained minimally regulated if at all. As highlighted earlier transaction lawyers also play a key role in ISDA which, prior to the financial crisis, had successfully managed to resist moves to introduce greater transparency to holdings of OTC derivatives. Once again the engineering analogy used by Howarth is both instructive and ought to trigger soul-searching within the legal profession.

‘Engineers are also subject to safety standards imposed by regulation, but merely complying with those standards does not relieve engineers of thinking about safety (or sustainability). Equally lawyers have an obligation to comply with regulations but they also have obligations about safety that go beyond mere compliance that flow from their own responsibilities as designers.’<sup>69</sup>

The attitudes, in the wake of 2008, of financial transaction lawyers to suggestions of any broader notion of duty or responsibility for a stable financial system are only beginning to be

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<sup>69</sup> Howarth (n 16) Ch 4]130

explored empirically,<sup>70</sup> yet it is encouraging to see evidence of such questions beginning to be asked from within the profession.<sup>71</sup>

So to conclude this section by returning to the question originally posed at the start, namely, ‘Did the conduct of those lawyers contribute in any way to the systemic risk that led to the financial stability in 2008?’ The answer to this is of course, ‘yes’ they clearly did. For it was the legal engineers in the form of financial transaction lawyers who developed and employed innovative techniques of structured products such as OTC derivatives to construct a web of opaque and unregulated connections between actors within the financial system which channelled and amplified contagion once defaults within that system began to occur. But as Howarth so rightly points out the empirical question ‘did they’ is very different to the evaluative question ‘ought they to have’?

The answer to this latter question to many practising transaction lawyers would most likely be ‘No’ and that a lawyer’s approach to transaction engineering and design should continue to be (as borne out by the research conducted by Vaughan and Oakley that is presented in this volume), first and foremost, to seek to achieve a client’s commercial objectives in ways that are optimal to the client yet minimise legal risk, in accordance with the lawyer’s professional judgement of what is possible under law at the time of the advice being given.<sup>72</sup> The profession’s rejoinder would most likely continue that to expect lawyers to look beyond those aims, be to some vaguer notion of public interest or some even more amorphous and uncertain concept of what the external effects of what individual steps within the financial system that they facilitate is, at best naive and impractical or, at worst, downright sinister and inimical to professional independence, individual autonomy and the rule of law.

## **Part II: How *could* lawyers help?**

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<sup>70</sup> Ibid; Steven Vaughan, Linden Thomas and Alastair Young ‘Symbolism over substance? Large law firms and corporate social responsibility’ (2015) *Legal Ethics*, 18:2, 138-163.

<sup>71</sup> As in the course of one of the interview comments (CP 11) reported by Steven Vaughan and Emma Oakley in their contribution to this volume entitled ‘The Gorilla Exceptions and the Ethically Apathetic Corporate Lawyer’

<sup>72</sup> Vaughan and Oakley, *ibid*; Moorhead, Richard, and Victoria Hinchly. ‘Professional Minimalism? The Ethical Consciousness of Commercial Lawyers.’ (2015) *Journal of Law and Society*, Vol. 4, 387-412.

On the assumption that the objections outlined above would be made to any attempts to introduce (either through statute or through the SRA Code of Conduct) considerations of systemic risk into lawyers responsibilities to either decline specific instructions, exit client relationships or desist from pursuing otherwise effective legal engineering strategies to further client commercial objectives then the question still remains, ‘Do transaction lawyers have *any* role to play at all in promoting a more stable financial system in the future?’ It is argued here that they do. For there is now, as a result of post-crisis reforms to the financial regulatory framework in the UK, both a clear legislative mechanism as well as a new approach to day to day supervision may offer scope for lawyers to engage more fully with issues of systemic risk and financial stability. These changes allow for a potentially very useful degree of continuous involvement of transaction lawyers in rendering assistance to the enormously difficult and complex task the regulatory bodies now have of countering systemic risk in the financial system. Rendering co-operation with any use of these new powers by the regulators, as well as an imaginative and expansive engagement with the new philosophical approach to regulators’ supervisory functions, offers the legal profession an opportunity to assist regulatory intelligence effort in the Financial Services and Markets Act 2000 in a generic manner that does not jeopardise their ability to pursue any individual client’s interests or engage in legal innovation in order to implement a client’s commercial objectives.

In order to understand how this new role that lawyers could usefully play would work in practice some preliminary explanation of that new ‘macroprudential regulatory’,<sup>73</sup> (as it now termed) framework is necessary. Such explanation in turn calls for a return to and closer scrutiny of the concept of systemic risk.

### *Systemic Risk – Complex, Collective and Constantly on the Move*

Stung by mounting criticism of its relevance and value<sup>74</sup> economists have been spurred by the crisis of 2008 to devote greater intellectual energy to understanding systemic risk and the financial system.<sup>75</sup> In a recent review of Central Bank and academic literature on the subject

<sup>73</sup> P Clement ‘The term ‘macroprudential’: Origins and evolution’ (2010) BIS Quarterly Review 59.

<sup>74</sup> David Colander, Michael Goldberg, Armin Haas, Katarina Juselius, Alan Kirman, Thomas Lux and Brigitte Sloth ‘The Financial Crisis And The Systemic Failure Of The Economics Profession’ (2009) Critical Review: A Journal of Politics and Society, 21:2-3, 249-267.

<sup>75</sup> For example the ESRC provided early funding for a Systemic Risk Centre in established in 2013 at LSE in conjunction with other academic and policy making partners with the objective to ‘study the risks that may trigger the next financial crisis and to develop tools to help policymakers and financial institutions become better

to better inform understanding of the concept Smaga identifies how the sands beneath it are constantly moving across different spaces within the financial system and across time series:

Systemic risk turned out to be much more than just the composition of individual types of risks affecting financial institutions. While credit risk, liquidity risk, operational risk, etc. can be directly attributed to a given institution, systemic risk can only be attributed indirectly. Before the financial crisis those types of risk were usually considered separately. However, the interaction (correlation) between them leads to undesired and unexpected consequences and when aggregated to systemic risk. Systemic risk *evolves* [emphasis added] along with the development of financial markets, regulations and collective behavior of market participants, and it may be prompted by regulatory arbitrage.<sup>76</sup>

As shown in the first part of this paper it is constant innovation from transaction lawyers that drives much of the evolutionary paths along which system risk builds up. For it is transactions lawyers' unique ability to employ private law institutions such as contract, trust and incorporation with ingenuity in structuring, drafting and project management of clients' commercial strategies that is the source of their competitive advantage as a profession. That is what legal innovation and legal engineering are all about. Whether or not it is motivated by any desire to engage in regulatory arbitrage is really beside the point. It may be or it may not be but regardless of that fact it is most certainly right at the heart of understanding systemic risk. For any regulatory body tasked with assessing and countering financial system risk the behaviour and views of these transaction lawyers are equally as important to improving their understanding as are the behaviour and views of any other financial system actors.

A fascinating literature is emerging in the wake of the financial crisis offering policy insights that cross disciplinary boundaries as economics learns from disciplines more versed in dealing with complex and ever shifting systems.<sup>77</sup> These disciplines long ago realised that, in the face of such complexity the study of isolated individual component parts and actors alone in a system is of limited predictive value in understanding how the system as a whole may

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prepared' <http://www.systemicrisk.ac.uk/about-centre>; Jon Danielsson and Jean-Pierre Zigrand 'Systemic Risk : A Research and Policy Agenda' (2015) 7 August 2015 (Vox- Online portal of the CEPR) <<http://www.voxeu.org/article/systemic-risk-research-and-policy-agenda>> accessed 29 March 2016.

<sup>76</sup> Pawel Smaga 'The Concept of Systemic Risk' (2014) Systemic Risk Centre (SRC) Special Paper No 5 August 2014, <<http://eprints.lse.ac.uk/61214/1/sp-5.pdf>> accessed 29 March 2016.

<sup>77</sup> S Cantono and S Solomon 'When the collective acts on its components: economic crisis autocatalytic percolation' (2010) New Journal of Physics 12 075038, published online 30 July 2010 <http://www.njp.org/>

operate.<sup>78</sup> Epidemiology, genetic and biological sciences, meteorology and physics have all grappled with the problem of the relationship between individual agents and collective behaviour in order to understand collective effects at systemic level. As modelling and data collection and analysis techniques from those disciplines develop there is growing scholarly<sup>79</sup> and regulatory<sup>80</sup> interest in whether these techniques are applicable across different domains and systems. If so what help might they offer regulatory efforts to achieve a better understanding and picture of where sources of instability may lurk within the financial system when viewed as more than merely the sum of its component parts? These efforts are taking place within reformed institutional structures designed to marry up micro level regulatory monitoring and intervention actions with macro system oriented regulatory monitoring and intervention actions. The term ‘macroprudential’ best describes this paradigm shift in financial regulation and what it means in practice in the UK regulatory framework is now discussed.

### *Macroprudential Financial Regulation – Why? What? How?*

One common theme emerges from the many inquiries into the intellectual and practical policy failures that led to the financial crisis of 2008 and that is that there was no effective systemic oversight. In particular there was no intellectual paradigm or institutional toolkit to offer a view of how all the different component parts of the financial system fed into and off each other to aggregate to a level of riskiness and danger that examination of one sector, asset, market or institution alone would never have suggested when looked at in isolation. Perhaps *the* central policy lesson that emerged from the global financial crisis was the realisation that, no matter how effective the level of ‘micro’ supervision was, without a big picture ‘macro’ view of risk within the system, regulators (and therefore users of the financial system) cannot

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<sup>78</sup> Pierre F.J. Lermusiaux, ‘Adaptive modeling, adaptive data assimilation and adaptive sampling’ (2007) *Physica D. Nonlinear phenomena* 230: 1 p.172 – 196; Lee Chapman, John Thornes, ‘The use of geographical information systems in climatology and meteorology’ (2003) *Progress in Physical Geography* Volume27, Issue3, pp13-330; Marc Barthélemy, Alain Barrat, Romualdo Pastor-Satorras, Alessandro Vespignani ‘Dynamical patterns of epidemic outbreaks in complex heterogeneous networks’ (2005) *Journal of Theoretical Biology*, 2005, Vol.235(2): 275-288.

<sup>79</sup> S. Cincotti, D. Sornette, P. Treleaven, S. Battiston, G. Caldarelli, C. Hommes, and A. Kirman ‘An Economic and Financial Exploratory’ (2012) *Eur. Phys. J. Special Topics* 214, 361–400.

<sup>80</sup> P. Gai, A. Haldane, and S. Kapadia, ‘Complexity, concentration and contagion’ (2011) *Journal of Monetary Economics* 58: 453–470; Andrew Haldane and Robert May ‘Systemic risk in banking ecosystems’ (2011) *Nature* Vol 469 [351] (20 January 2011); John Hill and Jamie Coen ‘Extracting Insight from Complexity’ (2016) 11 January 2016 Bank Underground Blog (Bank of England) <<http://bankunderground.co.uk/2016/01/11/extracting-insight-from-complexity/>> accessed 29 March 2016.

be informed of the likelihood of the financial system encountering shock and instability again.<sup>81</sup> Macroprudential financial regulation (itself not a new idea) finally seemed to have come of age and be ripe for implementation.<sup>82</sup>

Hence the last UK Government dismantled the financial regulatory architecture introduced by their predecessors and amended both the Bank of England Act 1998 and Financial Services and Markets Act (FSMA) 2000 to introduce major structural reforms<sup>83</sup>. These saw the abolition of the FSA and its replacement with two ‘micro’ level supervisors – the Prudential Regulation Authority (PRA) (established as a subsidiary within the Bank of England<sup>84</sup>) and the Financial Conduct Authority (FCA).<sup>85</sup> These two new regulatory bodies regulate between them across the entire range of entities authorised to carry on what are classed as regulated activities for the purposes of the FSMA and thus cover a vast industry from wholesale markets to retail finance. They are between them responsible for all ‘micro’ level oversight and, for the purposes of supervision of institutions which face prudential risks that might spill over and cause contagion throughout the wider financial system it is the PRA that takes the lead role and is the more important of the two for the argument of this paper concerned as it is with risk to the system in aggregate. For the PRA is now tasked with supervisory responsibility for banks, insurers and other systemically significant market participants with its primary objective expressed as being: ‘... promoting the safety and soundness of PRA authorised persons... primarily by (a) seeking to ensure that the business of PRA-authorised persons *is carried on in a way which avoids any adverse effect on the stability of the UK financial system*, and (b) seeking to *minimise the adverse effect that the failure of a PRA-*

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<sup>81</sup> Turner Review – A Regulatory Response to the Global Banking Crisis (FSA March 2009); Report of the High Level Group on Financial Supervision in the EU, Brussels, Belgium, 2009 (the ‘De La Rosiere Report’); European Commission Communication on European Financial Supervision (May 2009) COM (2009) 252; Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (10 February 2011).

<sup>82</sup> Sir Jon Cunliffe ‘Macroprudential policy: from Tiberius to Crockett and beyond’ (2015) Speech given to CityUK on 28 July 2015  
<http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech836.pdf> accessed 29 March 2016; Simon Gleeson ‘Macroeconomic regulation: new regulators, new powers’ (2009) Capital Markets Law Journal, 4(1): 99-111; Bank of England ‘The role of macroprudential policy’ (2009) Bank of England discussion paper, 19 November 2009,  
<http://www.bankofengland.co.uk/publications/Documents/other/financialstability/roleofmacroprudentialpolicy091121.pdf> accessed 29 March 2016; Iris H-Y Chiu ‘Macroprudential supervision: critically examining the developments in the UK, EU and internationally’ (2012) LFM 6(3): 184-195.

<sup>83</sup> HM Treasury *A new approach to financial regulation: the blueprint for reform* July 2011 Cm 8083.

<sup>84</sup> Graham Nicholson and Michael Salib ‘The Regulatory Powers and Purview of the Bank of England: pre-and post-crisis’ (2013) Butterworths Journal of Banking and Financial Law November, 636-640.

<sup>85</sup> Eilis Ferran ‘The Break Up of the Financial Services Authority’ (2011) OJLS Vol 31 (3) pp 455-480; Iain Macneill ‘The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis’ (2010) European Business Organization Law Review 11: 483-526.

*authorised person could be expected to have on the stability of the UK financial system...[emphasis added]*<sup>86</sup>

The PRA, along with the FCA (whose importance to monitoring sources of possible systemic risk as in pursuing its objective of enhancing its objective of integrity within the financial system must not be overlooked<sup>87</sup>), together deliver micro level supervision and in so doing will uncover much that may be of relevance to those concerned, less with the safety, soundness and conduct of individual institutions, financial products or practices but more with the stability and functionality of the system in aggregate. This level of regulatory oversight is now provided for in the UK following the establishment and empowerment of a Financial Policy Committee (FPC) within the Bank of England with responsibility to assist the Bank implement its strategy with respect to financial stability and the FPC is directed to exercise its powers and functions to contribute to the Bank's overall financial stability objective.<sup>88</sup> The legislation envisages that the FPC's function will primarily be as a macro system-wide intelligence and early intervention agent concerned with '... the identification of, monitoring of, and taking of action to remove or reduce, *systemic risks* with a view to protecting and enhancing the resilience of the UK financial system. ...[t]hose systemic risks include, in particular (a) systemic risks attributable to structural features of financial markets, such as connections between financial institutions,(b) systemic risks attributable to the distribution of risk within the financial sector, and (c) unsustainable levels of leverage, debt or credit growth....'<sup>89</sup>

Operating as a form of meta-regulator<sup>90</sup> of systemic risk the FPC itself does not have a frontline supervisory role interacting with and learning about the affairs and riskiness posed by each individual regulated actor. That 'micro' role belongs to the PRA and FCA. So, given that each level of regulation has contained within the relevant statutory mandates exhortations to keep vigil against systemic risk in the interests of stability, the intensely practical question

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<sup>86</sup> Financial Services and Markets Act 2000 s 2A, Part 2.

<sup>87</sup> Justin O'Brien, George Gilligan and Seumas Miller 'Culture and the future of financial regulation: how to embed restraint in the interests of systemic stability' (2014) 8(2) LFM 115-127.

<sup>88</sup> Bank of England Act 1998 Part 1A.

<sup>89</sup> Bank of England Act 1998 s 9C (2)-(3).

<sup>90</sup> B, Morgan, 'The Economization Of Politics: Meta-Regulation As A Form Of Nonjudicial Legality' (2003) *Social and Legal Studies* Vol. 12(4), 489-523.



of how these different layers mesh together to marry up to produce a coherent and co-ordinated approach to systemic risk arises.<sup>91</sup>

It is at this interface between the two layers that the effectiveness of macro-prudential policy depends. Information, insights and discussion must constantly feed to and fro across that interface. The FPC needs to rely on insights and messages that flow up to it from the PRA and FCA that will inform its view of systemic risk in particular (but not only) its three indicative potential sources set out in the legislation (velocity and level of credit, concentrated connectivity and other structural risks, along with risk distribution patterns). These insights and data help inform its decision as to whether and when to exercise its powers of direction over those two bodies requiring that they themselves take some form of macroprudential intervention.<sup>92</sup> Likewise in deciding whether or not to exercise its various powers of recommendation<sup>93</sup> in furtherance of the Bank financial stability objective the FPC relies in part on what it learns from the micro level of supervisory activity.

*A closer look at the powers and functions of the PRA and FPC – Opportunities for engagement with transaction lawyers*

Monitoring systemic risk in a complex domain like finance which, unlike a physical or natural science based systems, exhibits mercurial and uncertain behaviours (or ‘animal spirits’) that so often defy quantification, is both a data intensive exercise and one that sometimes calls for discretionary action based on supervisory judgment of what is most likely to further supervisory objectives. Both of these features became apparent early on in the practical implementation of UK macroprudential policy.<sup>94</sup> Effective macroprudential supervision

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<sup>91</sup> Andrew Crockett ‘Marrying the micro- and macro-prudential dimensions of financial stability’ (2000) Speech by Mr Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, before the Eleventh International Conference of Banking Supervisors, held in Basel, 20-21 September 2000 <<http://www.bis.org/speeches/sp000921.htm>> accessed 29 March 2016; Paul Tucker ‘Macro and Microprudential supervision’ (2011) Speech to British Bankers’ Association Annual International Banking Conference, London 29 June 2011. <<http://www.bis.org/review/r110704e.pdf>> accessed 29 March 2016.

<sup>92</sup> Bank of England Act 1998 s 9H.

<sup>93</sup> Ibid [ss 90-9R].

<sup>94</sup> The Bank of England noted in its 2009 Discussion Paper (n 82 ) both that ‘... unless effective rules could be designed, macroprudential policy choices would likely be based significantly on judgement. Importantly, this would include qualitative evidence, such as that gathered from market participants. A discretionary approach would also allow policymakers to learn from observing the interaction between macroprudential instruments, the financial system and the economy, helping them improve modelling approaches and data collection and, ultimately, the quality of policy judgements.’ (Para 6.1 Rules vs Discretion) and also that ‘There are large data gaps that would need to be filled before a macroprudential policy regime could be made operational. Sufficient

hinges on the PRA informing itself so that it can react quickly either itself through use of intervention or enforcement or recommend that others (such as the FPC) act to use their new macroprudential powers to effect some re-engineering within the financial system. The post crisis legislative reforms strengthened regulatory information gathering powers and PRA now has a power, contained in s165A FSMA, to require from those it regulates and certain others the disclosure of certain information and documents that considers are or might be ‘relevant to the stability of one or more aspects of the UK financial system.’<sup>95</sup> There is now scope to use this power to require information from persons outside of the regulatory perimeter if an Order has been made under s 165C FSMA that the power is to be so exercisable. HM Treasury can therefore extend the scope of PRA’s data inquiries to a wider group of market participants or financial sector gatekeepers should they see fit under s165C and one of the conditions for making such an order is receipt of a recommendation from the FPC that they so do. The Draft Financial Services Bill Parliamentary Committee which considered these reforms in detail at pre-legislative stage debated this extended data inquiry mechanism in terms of its usefulness for shining a light in the murkier corners of shadow banking, financial intermediation by unregulated institutions.<sup>96</sup> Neither its discussion nor evidence submitted to it on these powers precluded their extension to transaction lawyers. Indeed the Committee was sympathetic to Sir Mervyn King’s view that the FPC should not have to wait for the PRA to use any extended data gathering power it may recommend it be given but should instead be able to call for systemically relevant information from those directly outside of the regulatory perimeter directly in support of its financial stability objective.<sup>97</sup>

There therefore seems no reason in principle why this power could not one day be exercisable over lawyers who fulfil a creative and constitutive role for financial sector clients and design innovative structures and instruments on their behalf which may, in the PRA’s and FPC’s judgment at least, have effects at a later date that imperil systemic stability. This argument has

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data would be needed to capture the evolution of both the aggregate risk of the consolidated financial system over time and the network risk operating across institutions at any point in time.’ (Para 7.3); See too all papers published in 2013 Special Issue: ‘The Future of Financial and Regulatory Data’ (2013) *Journal of Banking Regulation* Volume: 14, Issue: 3-4. There continues to be vigorous discussion amongst central bankers now tasked with macroprudential tools about the need to make robust use of them despite the predictive limitations of systemic risk modelling see for example 29 January 2016 Bank Underground blog –: <<http://bankunderground.co.uk/2016/01/29/uncertainty-is-no-excuse-for-not-using-macroprudential-tools/#more-1145>> accessed 29 March 2016.

<sup>95</sup> S 165A(3).

<sup>96</sup> Joint Committee on Draft Financial Services Bill Report 2010-2012 paragraphs HL Paper 28, HC 1447 at paragraphs 144-148.

<sup>97</sup> That Committee recommendation was not incorporated into the legislation and the FPC must rely on PRA to exercise any such data requests.

been made in more detail elsewhere with the risk of legal challenges from third parties subject to its use and in receipt of such a data disclosure requirement considered.<sup>98</sup> Claims of legal advice privilege would inevitably be made in response to any use of this power in relation to transaction lawyers but, as the precedent has already been set in the area of anti-money laundering and terrorist financing controls as noted above, and these arguments can be met by equally strong ones such as those made by Loughrey (2014) that it may be time to revisit the boundaries of this protection and ‘... ask whether [legal advice privilege] should be absolute or, being based on collective welfare considerations, should give way when more weighty considerations of collective welfare support disclosure.’<sup>99</sup>

*Informing Regulatory Judgments – How lawyers could usefully engage in dialogue with regulators*

The experience of 2008 led to questions being raised about both the design and efficacy of the risk related model of supervision employed by the FSA prior to the inception of the crisis in the UK with the run on Northern Rock in September 2007. This model had relied on the identification, assessment and continuous monitoring of discrete risks to the attainment of regulatory objectives with each risk being scored for both its probability and likely impact on regulatory objectives. Termed an Advanced Risk Responsive Operating Framework (ARROW) and used to allocate and prioritise supervisory resource and effort it was seen by many within and outside of the regulator as the ultimate in SMART regulatory technique.<sup>100</sup> However the experience of crisis revealed it may have been blinded by the apparent sophistication and capabilities of its desk based technocratic risk based operating framework and serious flaws and deficiencies in effectiveness, especially, in relation to systemic

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<sup>98</sup> Joanna Gray and Peter Metzger ‘Defining and delivering judgement-based supervision: The interface with the legal system’ (2013) *Journal of Banking Regulation* Vol. 14, 3/4, 228–240.

<sup>99</sup> Joan Loughrey ‘An unsatisfactory stalemate: *R (on the application of Prudential plc) v Special Commissioner of Income Tax*’ (2014) *The International Journal Of Evidence & Proof* (2014) 18 E&P 65–77 [73]. C.f. the House of Lords acknowledgement that privilege is not an absolute concept but involves a balancing of interests in *Three Rivers District Council and others v Governor and Company of the Bank of England (No 5)* - [2004] UKHL 48

<sup>100</sup> The framework began to take shape in an FSA Statement Paper, *A New Regulator for the New Millennium*, (FSA January 2000) had been last revised prior to the crisis in 2005/2006 and was set out in detail in *The FSA’s Risk-Assessment Framework* (FSA August 2006); see further J Black, ‘The Emergence of Risk-based Regulation and the New Public Risk Management in the UK’ (2005) *Public Law* 512 – 548; J Black, ‘The Development of Risk Based Regulation in Financial Services: Just ‘Modelling Through’’, in J Black, M Lodge & M Thatcher (eds) *Regulatory Innovation: A Comparative Analysis* (Edward Elgar 2005).

oversight have been revealed.<sup>101</sup> Post crisis reflection led to conclusions that regulators had been insufficiently on the front foot, streetwise and intensive in their pursuit of a sophisticated understanding of how factors within a particular institution and indeed any surrounding environmental factors could impact on the attainment of their objectives.<sup>102</sup> This led to a conclusion that supervision may well have been too ‘light touch’ to be effective or informative and a rather different supervisory approach to was called for in the future that would be as the Turner Review put it ‘more intrusive and systemic.’<sup>103</sup> The PRA has taken this forward with a clear commitment to using its supervisory powers and performing day to day supervisory tasks and, if need be, escalating intervention firmly on the basis of its own informed judgments rather than being driven by risk scores or fixed rules alone. This ‘Judgment-related’ approach is explained in terms of its objectives and how it will be applied by the PRA and is kept under regular review.<sup>104</sup> Its prospective, forward looking nature is emphasised,<sup>105</sup> as is its need for data but equally its insistence that it alone has discretion to make use of and interpret that data in the final analysis<sup>106</sup>. So too is emphasis laid on the need for co-operation and continuing dialogue and interaction with firms’ senior management, external auditors in order to help inform judgments what must be ultimately those of the PRA.<sup>107</sup> The opportunity has been taken elsewhere to argue that these continuing conversations to inform supervisory judgments on systemic risk could be taken further beyond what is outlined in the PRA Approach document.<sup>108</sup> For the PRA could seek to engage with certain firms of transaction lawyers that are repeat players in the market for engineering legal services for PRA regulated persons. These conversations would take place on a voluntary basis rather than as a result of any exercise by the PRA of a mandatory statutory request in as sharp a form as the new s165A FSMA discussed above. They could be just as easily undertaken at the instigation of lawyers themselves who have generalised

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<sup>101</sup> Julia Black ‘Paradoxes and Failures: ‘New Governance’ Techniques and the Financial Crisis’ (2012) 75(6) MLR 1037-1063; Joanna Gray ‘Is it time to highlight the limits of risk-based financial regulation?’ (2008) Capital Markets Law Journal 4 (1): 50-6.

<sup>102</sup> ‘The Supervision of Northern Rock: A Lessons Learned Review’ FSA Internal Audit Division Report (March 2008).

<sup>103</sup> (n 81) [Chapter 3 Part 7].

<sup>104</sup> *The Prudential Regulation Authority’s approach to banking supervision* PRA June 2014 <<http://www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1406.pdf>> accessed 29 March 2016.

<sup>105</sup> Rosa Lastra ‘Defining forward looking, judgement-based supervision’ (2013) Journal of Banking Regulation Volume: 14 Issue: 3-4 Supplement: Special Issue: The Future of Financial and Regulatory Data, 221-227.

<sup>106</sup> Andromachi Georgosouli, ‘Judgement-led regulation: Reflections on data and discretion’ (2013) Journal of Banking Regulation Volume: 14 Issue: 3-4 Supplement: Special Issue: The Future of Financial and Regulatory Data, 209-220.

<sup>107</sup> *PRA’s Approach to Banking Supervision* (n 98) [para 171-181].

<sup>108</sup> Gray and Metzger (n 98).

concerns as to plausible (or even unlikely but still imaginable) systemic consequences of some of the types of risk distribution chains and patterns of connection that they can see emerging across clients in a particular sector that are perhaps not visible to, or of any concern to, any particular client. This would not involve a transaction lawyer in any breach of any client confidences, neither would it engage issues of legal advice privilege due to its general, anecdotal and perhaps impressionistic nature – it may be no more than some cognitive dissonance or unease that transaction lawyers feel in moments of quiet reflection after a particularly busy market or flurry of client activity settles down. But nonetheless as has been shown in the first part of this article the engineering expertise and practical perspective of the transaction lawyer as to areas that are perhaps legally contentious or uncertain could help refine and inform supervisory judgments on systemic risk.

There is no reason either why the Bank of England could not turn to lawyers to help it map nascent and emerging risks to financial stability through the means of its biannual Systemic Risk Survey.<sup>109</sup> That survey is currently wide ranging in scope of its inquiry and is directed to market participants soliciting their views as to aggregate risks to the UK financial system, sources of risk to the UK financial system, as well as which risks they themselves find the most challenging to manage. It is designed to inform the Bank of England, and particularly the work of the FPC, to help it formulate and implement financial stability strategy. Through the inclusion of law firms that specialise in financial sector transaction engineering in the addressees of this wide ranging survey of questions of the Bank of England could gain valuable high level perspective from a key constituency as close to the creation and constitution of the financial system itself as any other category of market participant.

Obviously participation in both of these processes would be entirely voluntary on the part of law firms invited since neither the FPC nor PRA has any direct regulatory jurisdiction over them. However a certain degree of moral suasion could be applied by the SRA and leadership shown by those lawyers who are concerned that legal expertise and ingenuity in shaping the financial system should be directed towards a sustainable and secure financial system as well as satisfying client objectives within it. After all, as the first Part of this article highlighted, concentration of risk exposures along chains of opaque and often highly leveraged contracting (such as through cross border OTC derivatives) by systemically significant financial

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<sup>109</sup> Sarah Burls 'Bank of England Systemic Risk Survey' (2009) *Bank of England Quarterly Bulletin* Q3.

institutions was a key source of instability. So is it really too much to ask that the law firms which engineered those chains for their clients give some thought on a regular and systematic basis to aggregation of their transaction work for many different clients across the whole law firm so as to form judgments on the potential systemic effects of default in these networks with a view to feeding into the supervisory judgments of the FPC and PRA?

## CONCLUSION

Financial transaction lawyers could indeed have a role to play in the institutional framework ushered in by the post-2008 reforms to regulation of the financial sector. Were either of the suggestions outlined above taken up this would mark a starting point towards greater enrolment of transaction lawyers in regulatory efforts to counter financial system instability. Now that there is clearly scope within the UK regulatory framework for making innovative and imaginative use of the judgments and perspective that external legal advisors can bring to bear on questions that are highly pertinent to the level and nature of systemic risk within the financial system it would seem to be a missed opportunity not to use it. And who knows? It may even sow the seeds for more reflective and ethical transaction lawyering in the future if the legal profession begins to think more deeply about the pivotal and constitutive role it plays in financial markets on behalf of an industry sector that itself benefits directly from the implicit subsidy of ‘Too Big To Fail’<sup>110</sup>. Banks themselves are now waking up to the responsibilities that accompany this societal licence to operate and thinking much harder about what and whose interests they are there to serve beyond their own. Their industry engineers, transaction lawyers, also benefit indirectly from this societal licence. Transaction and deal-making lawyers in finance enjoy a unique, privileged and highly profitable position that is attendant on and derived from both the special monopoly position in money creation<sup>111</sup> and societal licence of the banking industry.<sup>112</sup>

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<sup>110</sup> Joseph Noss and Rhiannon Sowerbutts ‘The implicit subsidy of banks’ (2012) Financial Stability Paper No. 15 Bank of England, London, May 2012.

<sup>111</sup> Christine Desan *Making Money: Coin, Currency, and the Coming of Capitalism* (OUP 2014) for an excellent historical discussion of how private banks came to acquire this constitutive role in money itself.

<sup>112</sup> Rhiannon Sowerbutts and Peter Zimmerman 8 July 2015 <<http://bankunderground.co.uk/2015/07/08/who-benefits-from-the-implicit-subsidy-to-too-big-to-fail-banks/#more-230>> accessed 29 March 2016

What responsibilities should accompany that privileged position? Shiller answers, using the simplest of examples, in a manner with which many lay people would agree (and indeed many pre-financialisation era lawyers):

There are some who argue that financial and legal advice would not have prevented some of the errors that led to the current financial crisis. This may be true- most lawyers ...were not immune to some of the basic errors that led to the crisis...(eg AAA means AAA and house prices are on a one way bet) but even so legal and financial advisers who sat down with their clients and patiently talked through the issues would most likely have reduced the extent of the errors that so many made just before the crisis erupted...such as that they should buy the biggest possible house or even two houses. Borrowing leverages risk...any competent adviser should know this...<sup>113</sup>

And so indeed when engineering and transacting contractual networks often across jurisdictions and off balance sheets perhaps transaction lawyers should learn to think beyond the here and now as to how those risks might combine with other apparently unrelated risks one day behave in unexpected ways with unexpected results. Why do we allow lawyers to steal away silently from the social and economic wreckage wrought by the near collapse of the financial system? Surely it is no longer enough to say that consideration of such questions is not within the client engagement letter? How could the legal profession itself work to show a greater sense of 'Financial Social Responsibility' (for want of a better phrase) towards the stability and sustainability of the financial system itself when engaging in innovation and engineering within it? It has been argued here that one way they could so do is by engaging fully with financial regulators in their difficult task of macroprudential oversight, thus assisting efforts to map nascent and emerging risks to financial stability. That would be one small step on what could become a very long and interesting road towards a legal profession with a real sense of 'Financial Social Responsibility'.

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<sup>113</sup> Shiller (n 11) [86].