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The English courts' view of financial derivatives

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I Introduction

In 1997 the International Swaps and Derivatives Association (ISDA) sought legal opinion from an English barrister, Robin Potts QC, on whether a financial transaction known as credit default swap (CDS) was likened to be an insurance or wager¹. His opinion was it is neither insurance nor wager. The concern of ISDA is telling as it bespeaks the ambiguity of the purpose of CDS and derivative transactions in general - whether they are designed for hedging or speculation. But the predominant concern is their speculative nature. If their sole purpose is for speculation, they are opened to the charge that their purpose is wagering. It is inevitable that such a legal problem would find its way to the courts for determination.

In this paper I shall consider the decisions of the English courts on derivatives based on some of the decided cases and discuss the implications of the decisions on the subject. Interestingly, also drawing on the common law courts for an answer on the subject is Lynn Stout. Her view is that the common law rule against contracts for differences is the most prudent way to distinguish hedging from speculation in derivatives. I shall therefore consider her view on the subject.

It is proposed that I shall first discuss what derivatives are, their purpose and their impact on the financial market. This is discussed in Section II of this paper. Section III provides the legal context of this paper which is the common law on wagering, the contracts for differences and the two pieces of legislations which affect the law on wagering, viz. the Gaming Act 1845 (UK) and Financial Services Act 1986 (UK). Section IV considers and discusses some of the decided cases on derivatives. The cases are selected on the insights of the judgement brought to the subject and the legal issues they resolved with some certainty. After considering the details of the cases, I shall provide a summary of the judicial principles and guidelines elicited from the cases. The courts' approach has been criticised by Alastair Hudson² and I shall consider his criticism in Section V. Section VI considers the question that begs to be answered, namely whether the courts could have concluded that derivatives are wagering transactions. The question is asked from the perspective of what is for the best interest of the financial market. Relevant to the discussion is Lynn Stout's analysis of derivatives and her thesis that they are naked bets, which shall be considered in detail. Finally, Section VII provides the conclusion of this paper and Section VIII, its bibliography.

In this paper no comparison is made with the judicial decisions on derivative cases from the United States of America. Whilst there was a lot of litigation in the United States in early 1990s which raised issues similar in importance to *Bankers Trust v Dharmala*,³ most of the cases were settled in advance of full trial.⁴ Moreover, even in the few decided cases it was alleged that they failed to address the core issues and they lacked detailed analysis.⁵ The English courts' approach, on the other hand, is meticulously detailed and facts specific to

¹ The opinion is not accessible. It is referred to in John Kay *Other People's Money. Masters of the Universe or Servants of the People?* (Profile Books, London, 2015) at 61 [“*Other People's Money*”]

² Alastair Hudson *The Law on Financial Derivatives* (5th ed, Sweet & Maxwell, London 2015) at 1-29.

³ *Bankers Trust International Plc v Dharmala Sakti Sejahtera* [1995] QB (transcript) 1, [1996] CLC 518.

⁴ Hudson, n 2 above, at 7-49.

⁵ Frank Partnoy “The Shifting Contours of Global Derivatives Regulation” (2001) 22 J. Int'l L 421 at p 448-450.

the extent that they have been criticised by Hudson that fundamental principles have been sacrificed. This will be discussed later in this paper.

II Derivatives

A What are they?

Derivatives are a “collective term”⁶ of the financial assets developed in the 1980s and 1990s. Their value is derived from another financial product. The inherent connection of derivatives with other products is best explained by examples. Hudson has provided some useful examples which explain the inherent connection and thus define the product:⁷

So, for example, an option to buy a share at some point in the future is a financial product the value of which is derived from an underlying share. Similarly, a swap of an interest rate is a product derived from the underlying loan whose rate of interest the borrower wishes to swap: the value of the swap is derived from the extent to which it exceeds or falls short of the interest rate on that underlying loan. Hence the term “derivative” encapsulates the notion of derived value. The derivative, however, exists as distinct chose in action itself.

The building blocks of the product are essentially the swap, the forward and the option; “All else is embroidery, based on these building blocks.”⁸

A forward, option and swap arrangement can be simply illustrated as follows:⁹

- (a) “I sell my cow to you for 10, delivery in one month’s time”. This is **future** or **forward**. I am sure of receiving 10 for my cow.
- (b) “I have the option to sell my cow to you for 10, delivery in one month’s time.” This is an **option**. I have the right but not the obligation to sell my cow to you (which I will only exercise if cows are worth less than 10).
- (c) “If you pay me amounts equal to the variable floating rate of interest on the loan I owe to my bank, I will pay you amounts equal to a fixed rate of 5 per cent on a loan of the same amount” This is an **interest rate swap**. The effect is that I have made my interest obligation fixed and certain rather than floating and unpredictable (emphasis added).

B Purpose

The deployment of derivatives as a hedge against the uncertainty of the future price of a commodity is an ancient business practice. Apparently the ancient Greeks traded in olive oil futures, that is to say, they fixed the price of olive oil at the time of the transaction to be purchased sometime in the future.

The other objective of derivatives is for speculative purpose. The reason for their deployment for this purpose is “readily comprehensible”.¹⁰ They mimic the result of trading

⁶ Hudson, n 2 above, at 1-06.

⁷ Hudson, n 2 above, at 1-06.

⁸ Hudson, n 2 above, at 1-22.

⁹ Philip Wood *Law and Practice of International Finance* (University ed, Sweet & Maxwell, London, 2008) at 26-01

¹⁰ Hudson, n 2 above, at 1-27.

on the regulated financial market by entering into an off- market transaction. The advantages of such an off- market transaction are: the transaction is not subject to the administrative and compliance costs of the market and it is also free from the scrutiny of the regulators of the market. More pointedly, the parties in an off- market transaction do not need be engaged in the buying or selling of the commodity or share in the market; the parties' sole interest is settlement of their speculations on what the trading results will be.

In practice, the derivatives are employed for mixed purposes. In such a situation it is difficult to determine the objective of the transaction. Hedging against risk could be employed for speculation as well. For instance, one could enter into a forward or option contract to hedge against the fluctuation in oil prices and at the same time agreed on a betting arrangement on what the oil price would be. In such a situation it is not easy to determine whether the predominant purpose of the transaction is hedging or speculating for profit.

C Impact of derivatives

There are two sorts of derivatives being traded in the financial market – the exchange traded (ET) derivatives and the over the counter (OTC) derivatives. Taking the approach of Bruce Carruthers,¹¹ they are distinguished by the place where they are transacted: on organised exchange (for example, on the Chicago Mercantile Exchange [CME] in United States or on the future and securities exchange in Hong Kong [HKEx], or in Europe at the EUREX) or privately between the parties , over the counter. ET derivatives are not designed for a specific type of commercial objective. They are fungible, of a limited variety and of a standard form. The organised exchanges provide for the clearing services for the parties at each transaction and permit price discovery of the transactions. ET derivatives are therefore transparent in the nature of the transactions and they are regulatory supervised by the exchanges. OTC derivatives, on the other hand, are designed by the parties according to the financial needs of the parties. There is little transparency of the transactions and no price discovery (the terms are not made public). They are not centrally cleared nor regulatory supervised.

According to Bruce Carruthers, in the United States, in 1986 the total value of ET derivatives was more than OTC derivatives. By 2008 the total value of OTC derivatives had become ten times greater than the ET derivatives even though the latter had increased by one hundred fold. Lynn Stout¹² gives the figures of the growth of OTC derivatives as follows: according to the Bank for International Settlements, at the end of 1999 the total notional value of OTC derivatives was approximately US\$88 trillion. By 2008 the OTC market value had a value of about US\$600 trillion.

A striking feature of the growth of derivatives was in OTC derivatives. For instance, the notional value of CDS was US\$67 trillion but the total value of bonds and asset based securities issued by United States firms was US\$15 trillion. Such an imbalance of the derivatives and the underlying assets as rightly suggested by Lynn Stout discloses the

¹¹ Bruce G Carruthers "Diverging derivatives: Law, governance and modern financial markets." (2013) 41 Journal of Comparative Economics 386-400.

¹² Lynn Stout "Why the Law Hates Speculators: Regulations and Private Orderings and Market OTC Derivatives" (1998-1999) 48 Duke Law Journal 701 ["Why the Law"].

speculative nature of the business. The CDS could hardly be characterised as insurance against risks.

The financial crisis in the United States in 2008 was attributed to misallocation of resources to real estate financed through exotic financial instruments and the large proportion of these instruments held by commercial and investment banks.¹³ As a result of default in the mortgage payment caused by the fall in the price of real estates, the derivative instruments became complicated and their value could not be determined. They became valueless. And the banks with their large portion of derivatives became illiquid as well.

III Wagering, Gaming Act and Financial Services Act

The topics discussed in this section provide the legal context to the subject of this paper.

A Wagering and Contracts for Differences

There is no statutory definition of a wagering contract. The classical common law definition is found in the judgement of Hawkins J in *Carlill v Carbolic Smoke Ball*:¹⁴

A wagering contract is one by which two persons professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties.

The elements of wagering are: future uncertain event, one to lose the other to win, between two persons and no other interest in the uncertain event.¹⁵ Derivatives transactions manifest the same essential features as wagering.

Of particular relevance is a group of contracts known as contracts for differences at common law. These are contracts in stock exchange or commodity market which sole interest was in the trading results of the market. Such a transaction is regarded by the common law courts to be wagering contract.¹⁶ The only exception that such groups of contracts are not regarded as wagering contracts is where there is some obligation to make or accept delivery of the commodity or facilitate a transfer of the share. As a consequence, in considering such contracts the courts' focus is on the issue as to whether the parties are engaged in selling and buying the commodity or share; "...if neither party intended to buy or sell, it was no bargain, but a mere gambling transaction."¹⁷ The question is how do the

¹³ Douglas W Diamond and Raghuram Rajan "The Credit Crisis: Conjectures About Causes and Remedies" (2009) NBER Working Paper Series 14739

¹⁴ *Carlill v Carbolic Smoke Ball Co* [1892] 2 QB 484, at 490

¹⁵ HG Beale (ed) *Chitty on Contracts* (30th ed, Sweet & Maxwell, London 2008) vol 2 at [1193] to [1194]

¹⁶ Chitty, above n 15, at 40-011

¹⁷ *Grizewood v Blane* (1851) 11 CB 526 at 541 per Creswell J.

courts determine the intention of the parties? They do not take a literalist approach.¹⁸ In some cases they look at the subjective intention of the parties at the time of contract. And in other cases they consider the intention of the parties based on the terms and form of the contract. Closer to the character of derivatives contracts is a new form of commercial contract which is introduced in 1982 by the London International Financial Futures Exchange known as the “FT-SE 100 contract” which provides for cash settlement, that is payment of differences as opposed to delivery of commodity. In determining the element of intention in such a contract, Lord Herschell in *Universal Stock* case¹⁹ put the test as “whether there were real transactions of commerce or whether they were a mere gambling for difference.”

Furthermore, the common law judges do not consider speculation a bad thing in the commodity market. Lord Justice Bramwell LJ in the *Thacker’s* case considered it was of benefit to the community: “... I am not sure that it is a disadvantage that there should be a market where speculation may go on, for it is owing to a market of that kind that we now have so many railways and other useful undertakings.”²⁰ That was said in 1878. Later on in 1997, Lord Goddard, a leading senior judge in his days, at the Selective Committee on Commodity Prices²¹ in the House of Lords, elaborated on the subject in even more benign terms. He considered speculation was about dealing with risk present in a capitalistic system: buyers and sellers waiting for the right moment to buy or sell were speculating. Without speculation, there was no trading in the market. With speculation, there would be more fluidity in the market.

It is suggested that such nuanced approach to contracts for differences and a benign view on speculation are in sharp contrast to Lynn Stout’s description of the common law judgment on the same matter in the United States.

B Gaming Act 1845

The English common law on wagering and gaming is encapsulated in the Gaming Act of 1845. By virtue of s 18 of the Gaming Act, all contracts and agreements by way of gaming or wagering were rendered null and void and therefore no action for recovering of any money or valuable thing under such contracts could be maintained in a court of law.²²

The reason for the Gaming Act 1845 is because under the common law wagering contract was legally enforceable. Apart from civil society’s concern of the social ills in wagering or gaming, the courts’ concern was more specific, namely, that such cases were frivolous and a waste of the courts’ time. It was felt no useful purpose was served in deciding on matters

¹⁸ Dr David A Chaikin and Brendan J Moher “Commodity futures contracts and the Gaming Act” (1986) LMCLQ at 393.

¹⁹ *Universal Stock Exchange Ltd v David Strachan* [1896] AC 166 at 173.

²⁰ *Thacker v Hardy* (1878) 4 QBD 685 at 692. See also Swift J in *Weddle, Beck & Co v Hackett* [1929] 1 KB 321 at 331

²¹ House of Lords, Selective Committee on Commodity Prices, Minutes of Evidence, (1997) Vol. II HMSO at 301 per Lord Goddard, cited by Chaikin and Moher, above n 17, at 392.

²² Chitty, above n 15, at 40-018

which were unknown; for instance, bets on whether a particular legislation would be passed in parliament or on the sex of a particular diplomat.²³

C Financial Services Act 1986 (FSA) and subsequent legislations

The FSA was motivated by Margaret Thatcher's government towards deregulation and European harmonisation of the financial market.²⁴

Two parts of the FSA were drafted to remove the effect of s 18 of the Gaming Act 1845:

- Section 63 of FSA provides as follows:

'(1) No contract to which this section applies shall be void or unenforceable by reason of –
(a) section 18 of the Gaming Act 1845, section 1 of the Gaming Act 1892 or any corresponding provisions in force in Northern Ireland...

(2) This section applies to any contract entered into by either or each party by way of business and the making or performance of which either party constitutes an activity which falls within paragraph 12 Schedule 1 of this Act or would do so apart from Parts III and IV of that Schedule.'

- Paragraph 33 of Schedule 1 of FSA states: "In determining for the purposes of this Schedule whether anything constitutes an investment or the carrying on of investment business section 18 of the Gaming Act....shall be disregarded."

The expectation of the lawmakers is that there should not be any legal uncertainty on trading in derivatives: "The lawmakers thus seemed to be on the same side as the fast burgeoning derivatives market. It did not seem likely that legal technicalities would be allowed to stand in the way of its growth."²⁵

FSA has since been replaced by the Financial Services and Markets Act 2000 (FSMA). But the substance of s 63 of the FSA with regard to s 18 of the Gaming Act 1845 is retained under s 412 of FSMA. Subsequent legislative amendment to FSMA under the Financial Services Act 2012 does not amend s 412 of the FSMA.

IV Derivatives Cases

The cases will be divided into three groups. The first group of cases provides a sample of the derivatives cases from 1996 to 2016. They are selected on the basis of what the judgements have to say about the nature of the derivatives. They are considered chronologically. The second group of cases is considered for their engagement with the FSA. The third group of cases relates to the issue of the status of the ISDA Master Agreement.

²³ Robert Alexander Moodie "Wagering And Gaming Contracts in New Zealand"(PhD dissertation, Victoria University of Wellington, 1976)

²⁴ Roger McCormick *Legal Risk in the Financial Markets* (2nd ed, Oxford University Press, Oxford, 2010), at 14.27

²⁵ Roger, above n 24, at 14.27.

A Cases on the nature of derivatives

The *Hazell* case²⁶ reported in 1992 provides the most authoritative pronouncement by the highest court of the country on derivatives. The case involved Fulham Borough Council (the council) exercising their borrowing powers under the Local Government Act 1972 (the Act) borrowed sums which on 31 March 1989 amounted to 90 million pounds. The borrowing largely represented its capital projects to be undertaken over many years. Each borrowing had its own terms of repayment. The interest rate differed from one loan to another; some loans were at fixed rates of interest and some at variable rates of interest. Between 1983 and 1989 the council entered into numerous interest rates swap contracts. In each contract the council anticipated a rise and fall in interest rates. If its anticipation was correct it would derive a profit which could then be employed in meeting the interest rate burden of its borrowings. The issue is whether such contracts were within the powers of the council to enter into with the bank.

At the House of Lords, Lord Templeman and Lord Ackner made several insightful comments about interest rate swap, namely:

1. In general it was acknowledged the commercial value of swap transaction as a means of carrying on international trade and finance. But Lord Templeman also pointed to its dual purposes in that “swaps may involve speculation or may eliminate speculation.”²⁷
2. He also pointed that the nature of the transaction was such that its success depended on interest rates rising and falling in conformity with the expectation of the council at the date of the swap.²⁸
3. Further it was noted that the swap contract was a “parallel contract” and to “replace” the interest payable under the actual borrowing.²⁹
4. He then made his most defining observation which is “the degree of speculation inherent in a swap transaction which is undertaken solely for the purpose of obtaining a profit by forecasting future interest trends.”³⁰
5. Lord Ackner provided a contractual context to his analysis which was that 80 -90 per cent of the council borrowing was achieved through Public Works Loan Board at advantageous fixed interest rates. “To “hedge” such borrowing with variable rate interest swaps would be to move from certainty to uncertainty.”³¹
6. He then drew the conclusion that “swap transactions are essentially speculative methods of raising money in the hope of reducing the burden of interest payable on money already borrowed.”³²

²⁶ *Hazell v Hammersmith and Fulham London Borough Council* [1992] 1 AC at 24B.

²⁷ *Hazell*, above n 26, at 24B.

²⁸ *Hazell*, at 26E.

²⁹ *Hazell*, at 27F.

³⁰ *Hazell*, at 25B.

³¹ *Hazell*, at 46 E

³² *Hazell*, at 46F

In summary, the two judgements considered the purpose of the transaction was speculative and that the financial instrument itself was equally speculative in character. Therefore the transactions were ultra vires the powers of the council to enter into such transactions.

The *Bankers Trust*³³ case provides a fundamental characterisation of the parties' transactions in derivatives from careful analysis of the parties' contractual relationship. The characterisation and approach have since been followed by subsequent cases. The parties in this case entered into transactions in derivatives which referred to the movements of currency of US dollars based on the rate cited by London Inter-bank Offered Rate (LIBOR). The transactions were referred to as "swap1, swap 2 and amended swap 2". Swap 1 was "time dependent" in nature and its nominal amount was US\$50 million. Its period was for two years. There were two parts to the transactions. Under one, Dharmala was to pay interest in each year at six month LIBOR rate while Bankers Trust was to pay the same rate plus 1.25 per cent thus giving Dharmala a 1.25 per cent margin per annum. Under the other, Dharmala was to pay interest at 5 per cent per annum while Bankers Trust was to pay 5 per cent per annum multiplied by "N" over 183. "N" was defined as the actual number of days in a six month period commencing from 5 August 1994, during which the LIBOR rate was to be less than 4.125 per cent up to 183. If the LIBOR rate exceeded 4.125 per cent Dharmala would receive no interest and suffer a loss of 5 per cent per annum under this part of the transaction. The net loss of the two parts together would then be 3.75 per cent per annum on US\$50 million in each of the two years.

On 4 February 1994, as a result of an upward trend of US dollars, it caused a rise in the 6-month LIBOR rates. The parties agreed to replace swap 1 with swap 2. Swap 2 was described as "LIBOR barrier swap". Its nominal amount and its maturity period was the same as swap 1. The additional element was the "Spread" which Dharmala would pay in addition to the 6-month LIBOR rate. The "Spread" was calculated by taking whatever was the 6-month LIBOR rate and applied it to a formula. The effect of this formula led not to a percentage rate of interest but to a straight decimal to be multiplied by the principal swap amount. The upshot of swap 2 was to give Dharmala a higher interest rate subsidy of 5.25 per cent for one tranche of US\$25 million and 3.125 per cent in respect of the other. On 21 April 1994 with the tightening of interest rate in the United States and resulting rise in the 6-month LIBOR, swap 2 had a negative value of US\$34.5 million.

Over the years, Dharmala had regularly arranged forward exchange rate swaps between US dollars and the rupiah and sales of options for forward dollars. Dharmala group earned dollar revenues at around US\$ 150 million per annum.

On 10 May 1994 at the request of Dharmala the value of swap 2 was amended and its negative value was set at over US\$45 million. On 13 May 1994 Dharmala rescinded swap 2 and Banker's Trust claimed for the amount of loss under the transactions.

Dharmala counterclaimed against Banker's Trust for misrepresentation and breach of duty and the amount of its counterclaim would cancel the amount it had to pay for the loss under the swap transaction.

³³ *Bankers Trust*, above n 3.

Mance J analysed the relationship of the parties as follows:³⁴

1. That it could not be regarded as the conventional banker-customer relationship because the bank were marketing derivative products of its own devising; products which were both novel and complex. “The analysis of the relationship is in the circumstances one of some delicacy.”
2. “A recipient holding himself out as able to understand and evaluate complicated proposals would be expected to be able to do so, whatever his actual abilities. These are problems on which it is commonly not necessary to focus in a commercial context. The assumption on which most business is conducted is that both parties understand, or avail themselves of advice about, the area in which they are operating and the documentation which they use. Business could not otherwise be carried on.”

His analysis of the derivative transactions is that:

1. The derivatives transactions were not entered into in order to hedge against interest rate movements. Dharmala’s aim was to profit by taking a view on future rates. The second transaction (swap 2) was entered into for an even larger profit. Accordingly, it would distort, rather than reflect the nature of the commercial relationship to consider that it was one of advisory duty owed by the bank to Dharmala.³⁵
2. “The financial risks involved in such transactions are not readily quantifiable on any conventional basis. There are computer programs designed to assist the banks and others who market such transactions to assess and lay off such risks. These programs are not generally available to purchasers of such products. Customers surprised by adverse market movement may, as a result of a leveraged formula, face escalating financial loss which, once at least it has materialised, they find that they cannot, or are not prepared to accept.”³⁶

In summary, Mance J’s judgement concluded the purpose and nature of the transaction was speculative in character. Therefore it would be inappropriate to regard the relationship of the parties as one of advisory. It also suggests the appropriate legal way to treat such transaction is one of caveat emptor.

The case of *Morgan Chase v Springwell*³⁷ is distinguished by the Judge’s meticulous analysis of the relationship of the parties so as to determine the nature of its commercial transaction. It followed the approach of the *Bankers Trust* case.

Springwell, which was the treasury company for a group of shipping companies owned by the Polemis family, invested heavily in emerging market securities, including derivative of Russian bonds since 1996. The Russian bonds were known in the markets as “GKOs.”

³⁴ *Bankers Trust*, above n 3, at 11 -12 Lexis Nexis.

³⁵ *Bankers Trust*, at 10 LexisNexis.

³⁶ *Bankers Trust*, at 4 LexisNexis.

³⁷ *JP Morgan Chase Bank (formerly known as Chase Manhattan Bank) and others v Springwell Navigation Corp* [2008] EWHC 1186 (Comm)

Derivatives of the GKO were issued by Chase and the derivatives were known as “GKO Linked Notes.” The parties had a business relationship for many years from 1974. Springwell in the 1980’s was actively trading in foreign exchange not only to hedge against currency exposures to its shipping business but also for speculation.

On 17 August 1998 the Russian government and the Russian Central Bank suddenly declared a 90 day moratorium on foreign debt repayments and a suspension of all trading on Russian issued bonds.

Chase issued its claim against Springwell for a declaratory order that it owed no liability to Springwell and the latter counterclaimed for damages in the region of over US\$ 700 million on grounds of breach of contract, tortious and fiduciary duties in its advice on the nature of Springwell’s investment portfolio.

Gloster J DBE took a detailed and meticulous analysis of the contractual relationship formed between the parties over many years. Out of that analysis she made the following findings:

1. That the business activity between the parties was not limited to currency transactions entered into for the purposes of hedging currency exposures connected to Springwell’s shipping business but included transactions that has a “pre-dominantly speculative purpose (i.e. entered into for the purpose of making profits, rather than purely as an adjunct to a commercial transaction).”³⁸
2. That Springwell was a “highly sophisticated investor” and had experience in the products it was investing.³⁹ A striking feature of its investment over the year had been its interest in foreign currency speculation in emerging markets to the extent that there was some concern expressed by the investment banks of its “speculative tendencies.”⁴⁰

Further, Gloster J DBE made some conclusive decisions on other legal issues which are frequently raised in such cases, namely

1. That the non-existence of a written agreement about the advisory role of the bank is a significant pointer against the existence of an advisory obligation on the part of the investment bank.⁴¹ The rationale for it is that given the complexity of the derivatives instruments and the substantial amount of money involved it would be surprising not to have such a written agreement setting out the specific obligation of advice.
2. That the Unfair Contract Terms Act 1977 (UCTA) is in practice of very limited application in commercial contracts of this sort. The terms of the transaction were reasonable and fair. And the parties were of equal bargaining power.⁴²

³⁸ *JP Morgan Chase*, above n 37, at [75].

³⁹ *JP Morgan*, at [432]

⁴⁰ *JP Morgan*, at [75],[77],[164]

⁴¹ *JP Morgan*, at [434], [440].

⁴² *JP Morgan*, at [603], [605].

Therefore the courts were reluctant to interfere in contracts concluded between commercial parties on such a substantial transaction.⁴³

In summary, by undertaking detailed and meticulous analysis Gloster J DBE's judgement disclosed that the purpose and nature of the transaction was speculative. It also suggested in view of the nature of the relationship and the substantiality of the contract, it is inappropriate to give it a legal characterisation other than the terms of contract had indicated. The approach is a nod to contractual certainty and to the doctrine of caveat emptor.

The case of *Chartered Bank v Ceylon Petroleum*⁴⁴ brought out the difficulty in distinguishing the dual purposes of the derivatives transactions. The case involved Ceylon Petroleum (CP), a Sri Lankan's state owned company which bought crude oil in the international market and imported it to the country for refining and retailing. It was exposed to volatile fluctuation in oil price from 2003 to 2008. In 2007 CP began to enter into oil derivative transactions with Standard Chartered Bank (the Bank). The arrangement of the derivative transactions were: the Bank was required to make payments to CP when oil prices were high. On the other hand CP had to make payments to the Bank if the oil price fell below an agreed floor.

In late August 2008 oil prices began to fall rapidly and the result was CP was in debt under the derivative transactions and it owed the Bank money. The Bank's claim was about US\$ 161 million.

CP raised the issues of lack of capacity, authority and illegality in its defence and counterclaimed alleging breach of duty and contract and misrepresentation. Central to its defence and counterclaim was the issue that the derivative transaction was predominantly speculative in nature.

Hamblen J described the difficulty of the oil derivative transaction as one which involved physical settlement of the purchase of oil which had included a paper position in derivatives to hedge against the price. Citing with approval a report from an expert witness on derivatives who said:

".....at the extreme ends of the spectrum it is clear what is hedging and what is speculating. In the middle of the spectrum there is a grey area where the same action can be hedging or speculation depending on the context, including the party's intention. The existence of a physical position makes it more likely that any particular action involves hedging."⁴⁵

The Judge then proceeded to determine what the parties' intentions were; in the course of which he made the following findings:

1. That the question of the parties' intention has to be determined objectively and not by reference to the subjective states of mind of the parties.⁴⁶

⁴³ *JP Morgan*, at [604].

⁴⁴ *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785(Comm)

⁴⁵ *Standard Chartered*, above n 44, at [340].

⁴⁶ *Standard Chartered*, at [342].

2. That many hedges are not perfect hedges. An interest in the paper position is not necessarily inconsistent with a hedge.⁴⁷
3. That in summary, Ceylon Petroleum's strategy involved a combination of concerns and considerations which differed at various times depending on the market conditions of the oil prices. However all the hedges related to the underlying physicals and provided protection against both high and rising prices. Notwithstanding the extent of the protection became limited and Ceylon Petroleum also became increasingly interested to use the hedging more for cash flow and foreign exchange generation, price protection remained an element of its strategy and that the strategy was never "solely or predominantly driven by speculative profit making."⁴⁸

Finally, on the application of the law on misrepresentation and/or UCTA, the Judge reaffirmed the judicial position that in commercial transactions it is undesirable that the courts should intervene to alter the terms and the reasonable commercial expectations of parties as negotiated with independent legal advice.⁴⁹

In the case of *Cassa v Barclays*,⁵⁰ explicit reference was made to the principle of caveat emptor in the judgement as the most appropriate working principle for the courts.

Cassa was a bank in the republic of San Marino and its business was in private banking, retail banking, sales and trading of securities and asset management. Between 2004 and 2005, Barclays sold to Cassa four sets of structured notes (the Notes), which were later restructured. The Notes constructed by Barclays was embedded with credit derivatives known as collateralised debt obligations (CDO) which was exposed to the credit risk of a pool of reference assets through a portfolio credit default swap. In the restructured Notes the reference assets included further CDOs each of which was referenced to another pool – hence the restructured Notes were called "CDO squared" (CDO n2).

Crucial to the transaction was Cassa's reliance on the credit ratings of the Notes, namely that they should be at "AAA" rating. Cassa's main complaint was that CDO n2 was restructured by Barclays at risks higher than the ratings to the financial advantage of Barclays. As a result CDO n2 incurred huge loss in value. Cassa claimed against Barclays for euro 92million for mis-selling , misrepresentation and deceit.

The case raised two interesting points about the notes. An argument was advanced that it should be implied in the contract that Barclays would not structure the CDO with the intention that its risk of default would be materially different from that indicated by the AAA rating. The reason for it was the legal principle of business efficacy in contract and parties reasonable expectation necessitate such implied term.⁵¹ Hamblen J's response was that: firstly, AAA rating could not be regarded as a statement of fact but an opinion because it

⁴⁷ *Standard Chartered*, at [362].

⁴⁸ *Standard Chartered*, at [389].

⁴⁹ *Standard Chartered*, at [571] - [573].

⁵⁰ *Cassa di Rasparmio della Repubblica San Marino v Barclays Bank* [2011] EWHC 484 (Comm).

⁵¹ *Cassa*, above n 50, at [540].

was at best an estimation of the risk; ⁵²and secondly, “Contracts between banks for the sale and purchase of complicated structured products work perfectly well on the basis of the principle of *caveat emptor*.”⁵³

In the recent case of *Banco Santander v De Ferro*⁵⁴ reported in 2016 the issue as to whether interest rates swap is a game of chance or wager is raised under Portuguese law.

The parties of the case were a Portuguese bank and a state owned transport companies. The transport companies had entered into interest rate swaps for the purpose of managing their mounting debt and funding needs. Their derivative transactions involved interest rate swap with the added feature of a risk spread, calculated to a formula which had a snow like effect where the rates fell outside the fixed range of interest rates. It is held that the swaps were inherently risky as they were sensitive to changes in the interest rate. The applicable law of their contracts was English law providing for Portuguese law to apply on certain aspects of the contracts.

Blair J, adjudged the transaction was not a game of chance or bet, for the following reasons:⁵⁵

1. The purpose of the interest rates swaps transactions was to reduce the transport companies financing costs and therefore the transactions were not for speculative purpose.
2. Generally, speculation in the context of financial dealing was a legitimate activity, different from gaming.
3. It was impractical in a financial context to try to distinguish between speculation and hedging.

Another major issue, among others, raised in the case relates to the civil law concept of good faith in view of the abnormal change of circumstances caused by the financial crisis in 2008 to the transactions. This defence required analysis of the transactions. The Judge found that the parties had not comprehended the volatility of interest rate in the event of a financial crisis. Coupled with the amplification of the loss under the formula for the spread risk, the swaps were held to be risky in nature.⁵⁶ Further, civil law concept did not apply but had it applied, there were abnormal changes in the parties’ circumstances and seven of the nine swaps would be terminable by the transport companies. ⁵⁷

B Cases which engaged the FSA

The next three cases engaged the FSA or the FSMA. In the case *Titan Wheels v Royal Bank of Scotland* ⁵⁸the judge pointed to the type of derivative transaction which would have served

⁵² Cassa, at [267] and [544](1).

⁵³ Cassa, at [544](2).

⁵⁴ *Banco Santander Totta S.A. v Companhia De Carris De Ferro De Lisboa S.A. and others* [2016]EWHC 465 (Comm)

⁵⁵ *Banco Santander*, above n 54, at 443,444 and 453.

⁵⁶ *Banco Santander*, at 132(5).

⁵⁷ *Banco Santander*, at 752 (3).

⁵⁸ *Titan Wheels Ltd v Royal Bank of Scotland Plc* [2010] EWHC 211 (Comm) (transcript) at [51].

for the purpose of hedging in the context of the case. The case involved Titan Wheels, a manufacturer of steel wheels in Europe and its income was predominantly in euros. Its business required it to sell euros and purchase sterling on a regular basis. It purchased currency swaps from the bank for the purported purpose to hedge against currency fluctuation. Titan Wheels's claim was a statutory claim under a provision of the FSMA 2000 as a "private person."

It was held by David Steel J that Titan Wheels was not a private person and therefore its claim failed.

Of relevance is the Judge's decision that the transaction was not entered into for the sole purpose of hedging but for speculation. The piece of evidence which was persuasive referred to what distinguished the two aspects of derivatives transaction; this was the evidence of Mr Annetts, the Financial Controller of Titan Wheels given at cross examination:⁵⁹

Q Clearly you wanted to hedge the large balances of euros which you were receiving.

A Yes.

Q That was vital for risk management. But if that were your sole objective, you could've continued to do that by a simple forward.

A Yes.

.....

Q So if you go for a structured product, you must be looking for something in addition to the hedging.

A Right.

Q And that was some profit as well.

A Yes.

Q Yes. Otherwise you wouldn't have done it that way. It makes sense, doesn't it?

A Sure.

It is suggested that it is not often that such a clear, simple admission of the purpose of a derivative transaction has been made by a party. The Judge is right to rely on it as a means of distinguishing its purpose.

In the case of *City Index v Leslie*⁶⁰ the judges in the Court of Appeal were faced with an admitted betting contract. The brief facts and issues of the case are as follows:

1. City Index was a member of the Association of Futures Brokers and Dealers and 'authorised persons' under the FSA as well as being licenced bookmakers. Leslie applied to City Index for credit betting facilities and entered into index betting, that is betting on the movements of the various indices except sports.
2. At the end of 1988 he was indebted to City Index to the amount of 34,580 pound and the latter sued for the sum. The loss he suffered was bets on Dow Jones Index and the price of Treasury Bonds.
3. Leslie in his defence raised the issue that the transaction was wagering and therefore City Index's claim was unenforceable by virtue of the Gaming Acts of 1845 and 1892

⁵⁹ *Titan Wheels*, at [73]

⁶⁰ *City Index Ltd v Leslie* [1991] CA (Civil Division) 1, [1991] 3 All ER 180.

which in turn raised the application of s 63 of the FSA which disapplied the effect of the Gaming Acts.

Section 63 of the FSA states:

(1) No contract to which this section applies shall be void or unenforceable by reason of –
(a) section 18 of the Gaming Act 1845, section 1 of the Gaming Act 1892 or any corresponding provisions in force in Northern Ireland...

(2) This section applies to any contract entered into by either or each party by way of business and the making or performance of which either party constitutes an activity which falls within paragraph 12 Schedule 1 of this Act or would do so apart from Parts III and IV of that Schedule.'

The Judges in the Court of Appeal held that the betting transaction came within the ambit of s 63 of the FSA for two reasons: firstly, City Index was a party within the meaning of s 63 (2) of the FSA and secondly, the betting transaction was an "activity" within the meaning set out under paragraph 12 of Schedule 1 being: "Buying, selling subscribing for or underwriting investments or offering or agreeing to do so, either as principal or as an agent". The word "investments" in turn referred to s 1 of FSA which definition referred further to Part 1 of Schedule 1. Paragraph 9 of Part 1 of Schedule 1 states:

Rights under a contract for differences or under any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the contract.

The judges found the expression "pretended purpose" odd and could not comprehend the purpose behind those words. As a result they expressed different views on how the betting transaction in this case fell within the provisions. Lord Justices Donaldson MR and McCowan LJ thought it came within "any other contract" but Lord Leggatt LJ took the view that it was a contract for differences⁶¹.

Of relevance to this paper is the judges' view of the betting contract. Lord Justice Donaldson provided a useful background description of the financial markets for derivatives. His Lordship's analysis points to the duality of the purposes and the consequences of the differing purposes:⁶²

The markets exist to reconcile the apparently irreconcilable needs of these two groups, the producer of the commodity and the user of it. It can do this in a number of ways, but in essence those who operate in the markets back their judgement of how the price will move between the moment when the user needs to achieve certainty as to his costs and the moment when the producer is willing to enter into firm contracts to supply....From contracts for differences it is but a short step to contracts based upon the movement of price indices which achieve the same basic objective. Clearly this system would not work if all dealers in the market took the same view as to future movements in price and equally clearly the more

⁶¹ *City Index*, above at n 60 at 7 LexisNexis.

⁶² *City Index*, at 5 LexisNexis.

people there are dealing in the market, the greater the opportunity for a diversity of view. So it comes about that the intervention of 'speculators' from outside the market is not wholly unwelcome and indeed may in some circumstances contribute towards the achievement of the real objective of the market, although in some circumstances they can unsettle a market in no one's interests other than their own.

On the whole his Lordship is benevolent towards the ambiguity of the purpose in financial transaction and speculation. It appears it is not a matter which the courts need to resolve. At the same time the courts are alive to its social harm it could cause.

However his Lordship did express concerns about such betting transaction on young people like Leslie in this case. He was 21 years old. He suggested a limit to the amount of such transaction be imposed through the FSA or the association of brokers and dealers in the market.⁶³

More importantly, Lord Donaldson MR indicated that he might look at the transaction differently if the bet was made on "artificial indices such as the aggregate of all race winners' numbers for each day of a meeting or, in the case of cricket,.."⁶⁴And Lord Leggatt LJ was concerned that the words of "contract for differences" and "any other contract" were wide enough to include betting on sports and suggested that legislators might wish to amend the provision concerned to exclude sporting activities.⁶⁵

The third case in this group for consideration is *Morgan Grenfell v Welwyn*.⁶⁶The case, inter alia, raises two issues which are of interest in this paper, namely whether the contracts entered into was a wagering contract and whether it was a contract "by way of business" within the meaning of s 63 of the FSA. The brief facts of the case are:

1. Morgan Grenfell (the Bank) and Welwyn entered into interest rate swap, the Bank being the fixed interest payer and Welwyn the floating interest rate payer. At the same time Welwyn through the Bank entered into parallel contract with another local authority (Islington BC) as a fixed interest rate payer and the latter as floating interest rate payer. The terms and amount and maturity time of the two arrangements were the same. From Welwyn's point of view these contracts were wholly back- to- back.
2. On 23 June 1989 in the light of the judgement of the *Hazell* case which determined such transaction as ultra vires, no further payments were made by the parties and the Bank claimed against Welwyn for payment made and the latter claimed against Islington BC for the payment under the parallel contract.
3. In the third party proceedings Islington BC raised the following issues as preliminary points:
 - Whether the contract was a wagering contract.
 - If it is, is it a contract by way of business within the meaning of s 63 of the FSA?

⁶³ *City Index*, at 7 LexisNexis.

⁶⁴ *City Index*, at 3 LexisNexis.

⁶⁵ *City Index*, above n 60, at 11 LexisNexis.

⁶⁶ *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council (Islington London Borough Council, third party)* [1995] 1 All ER 1.

- If the answer to the second question is negative, is there a defence based on the fact that it is a wagering contract?

Hobhouse J's reasons for his decisions on the issues are instructive and are considered in greater detail here:

1. He began with the premise that the *Hazell* case was based on the decision that interest rate swap contracts should not be viewed as gaming and wagering contracts. Therefore prima facie they were "legitimate and enforceable commercial contracts."⁶⁷
2. Notwithstanding the interest rate swap contract had the feature of a contract for differences, namely that it was only interested in settlement of the payment difference, it did not mean that it was a wagering contract. "It merely raises that possibility or justifies an inference. If the other features of the relevant transaction show or confirm that it is a wagering contract, then it is unenforceable and void."⁶⁸
3. The Judge then considered the purpose and effect of the swap contracts entered into by the local authorities and that their effect was to incur a revenue liability. Their purpose was not for the purpose or motive to speculate or make profits by speculating. Any such profit or loss would be coincidental to the main purpose which was to mitigate the cost of transaction: "The speculative element was involved in the transaction solely because of the contractual mechanism which Islington were using to obtain, in their revenue account, loans the later years to the first year."⁶⁹ "If there was an element of wagering in what Islington did, it was merely a subordinate element and was not the substance of the transaction and does not affect the validity and enforceability of the transaction."⁷⁰
4. On the issue whether the contract between the two local authorities could be considered a contract by way of business within the meaning of s 63 of FSA, the Judge took a wide interpretation of the word "business:" it was construed to mean business transaction in ordinary parlance and be not given a technical construction. The policy behind the FSA was to remove the legal uncertainty in the gaming and wagering law and provide protection to investors.⁷¹ Accordingly, the local authorities dealing in the capital market and placing large sums of money were clearly entering into interest rate swap contracts which an ordinary person would understand be a business activity.

C *Cases which determined the status of ISDA Master Agreement*

The last group of cases touches on the legality of some of the terms of ISDA Master Agreement and its effect on other legal issues. Underlying the courts' decision is their affirmation of English law principle of certainty in commercial contracts, which is referred to in one way or other in all the derivatives cases. The upshot of the principle is that the ISDA Master Agreement is viewed as defining the contractual relationship of the parties. With

⁶⁷ *Morgan Grenfell*, at 7 LexisNexis.

⁶⁸ *Morgan Grenfell*, at 8 LexisNexis.

⁶⁹ *Morgan Grenfell*, at 8 LexisNexis.

⁷⁰ *Morgan Grenfell*, at 9 LexisNexis.

⁷¹ *Morgan Grenfell*, at 10 LexisNexis.

that contractual estoppel is considered a proper defence to allegation of misrepresentation or breach of duty.

The foundational case on the issue of contractual estoppel in derivatives is the case of *Peekay v ANZ*.⁷² It is based on the principle of commercial certainty of contract. The brief facts of the case were about derivatives been sold by ANZ to Peekay which were referenced to a short term no interest Russian bonds sold at a discounted value. The bonds were known as GKO. It is the same bonds for the derivatives sold in the *JP Morgan* case. The derivatives were GKO-linked notes which were essentially a hedge against default of the bonds. But they provided an interest rate return of 16 to 17 per cent. Unfortunately, as in the *JP Morgan* case, the Russian government in 1998 announced a moratorium of her debts and that affected payment of the GKO on the maturity date. Peekay claimed that the banks had misrepresented the nature of the derivatives.

One of the issues raised in the case was the defence of contractual estoppel. The terms of the commercial contracts between the parties had the following terms:⁷³

- You should also ensure that you fully understand the nature of the transaction and contractual relationship into which you are entering, and
- The issuer assumes that the customer is aware of the risks and practice described herein, and that prior to each transaction the customer has determined that such transaction is suitable for him.

It should be noted similarly worded terms are contained in all ISDA Master Agreement.

Referring the above terms, Lord Moore-Bick, set out his reasons for contractual estoppel as follows: starting with the basic principle of English commercial law his Lordship said:⁷⁴

It was accepted that a person who signs a document knowing that it is intended to have legal effect is generally bound by its terms, whether he has actually read them or not. The classic example of this is to be found in *L'Estrange v Graucob [1934] 2 KB 394*. It is an important principle of English law which underpins the whole of commercial life; any erosion of it would have serious repercussions far beyond the business community.

In this instance, his Lordship found that the true position of the parties was clearly set out in the above terms mentioned above.

His Lordship then went on to say that there is no reason in principle why parties should not be able to agree to a certain state of affairs that form the basis of the transaction, whether it be the case or not. Where the parties had expressed such an agreement which set out the state of affairs between them neither could subsequently deny the existence of the facts and matters upon which they had agreed.⁷⁵ This could include terms which gave up any right to assert that they were induced to enter into it by misrepresentation.⁷⁶ Such a contract

⁷² *Peekay Intermark Ltd & anor v Australia and New Zealand Banking Group Ltd [2006] EWCA Civ 386*.

⁷³ *Peekay*, at 55.

⁷⁴ *Peekay*, at 43.

⁷⁵ *Peekay*, at 56.

⁷⁶ *Peekay*, at 57.

itself gave rise to an estoppel. The case of *Colchester Borough Council v Smith* [1994] Ch 448 was cited in support.

In the case of *Belmont Park v BNY*⁷⁷ one of the many complex issues raised in an insolvency appeal to the Supreme Court was - whether in the event of a default, the priority given to the claimants in the collateral assets of a swap arrangement between the two defendant companies of a group, was contrary to the anti-deprivation rules of solvency. The swap arrangement was contracted under the terms of the ISDA Master Agreement.

The majority view as expressed in the judgement of Lord Collins is that provided the substance of the swap agreement is not intended to evade the insolvency laws, then the priority terms of the swap contract to the claimant would be upheld. The reasons for it are stated as follows:⁷⁸

- As has been seen, commercial sense and absence of intention to evade insolvency laws have been highly relevant factors in the application of the anti- deprivation rule. Despite statutory inroads, party autonomy is at the heart of English commercial law. Plainly there are limits to party autonomy in the field with which this appeal is concerned, not least because the interests of third party creditors will be involved. But, as Lord Neuberger stressed [2010] Ch 347, para 58, it is desirable that, so far as possible, the courts give effect to contractual terms which parties have agreed. And there is a particularly strong case for autonomy in cases of complex financial instruments such as those involved in this appeal.
- The answer is to be found in the fact that this was a complex commercial transaction entered into in good faith. Although, as a matter of law, the security was provided by the issuer out of funds raised from the noteholders, the substance of the matter is that the security was provided by the noteholders and subject to a potential change in priorities.

Lastly, in the case of *Lomas v Firth Rixson*⁷⁹ the most direct challenge to the terms of the ISDA Master agreement was made. For that reason ISDA intervened in the proceeding as an intervening party. The case was also an appeal of an insolvency proceeding before the Court of Appeal. The transactions involved derivatives in the form of interest rate swaps and forward freight agreements on ISDA form of master agreement. One of the issues raised in the solvency proceeding was its challenge of the terms of the ISDA Master Agreement 1992 which provided for the obligation of payment to continue regardless of the event of default; it raised the question whether such a provision was contrary to the anti- deprivation rule in solvency law. The issue in question in broad terms was “whether, when there is an event of default on the part of the party due to receive a payment, there is any obligation at all on the counterparty to make a payment...”⁸⁰

⁷⁷ *Belmont Park Investment Pty Ltd and others v BNY Corporate Trustee Services Ltd and another* [2011] 3WLR 521.

⁷⁸ *Belmont Park*, at 103 and 108 respectively.

⁷⁹ *Lomas and others (joint administrators of Lehman Brothers International (Europe)) v JFB Firth Rixson Inc and others (International Swaps and Derivatives Association Inc intervening) and other appeals* [2013] 1 BCLC 7; [2012] EWCA Civ 419.

⁸⁰ *Lomas*, above n 79 at [6].

Longmore LJ who gave the leading judgement, gave a succinct description of what interest rate swaps is:⁸¹

Although derivatives can be quite complex, the theory behind the ones in issue in these cases is simple. Under the interest rate swaps, one party is to pay a floating rate of interest on a notional sum (notional because there is no actual loan) over a period of (say) six months. The other party is to pay a fixed rate of interest on the same notional sum over the same period. At the end of each six –month period two calculations are done and one party will be ‘in the money’ and the other ‘out of money’. The latter party will then pay the other the difference. This contract can be used as a pure speculation or (as in the present cases) be used as a hedge if one of the parties has a long –terms loan on interest.

On the issue as to whether the obligation of payment was owed under the derivatives arrangements in the event of default, his Lordship held that it remained owing and due for the following reasons:

1. He first affirmed the importance of the principle of certainty of contracts particularly in complex commercial contract, as expressed by Lord Collins in the Supreme Court in the *Belmont Park v BNY* case.⁸²
2. He then held that the specific terms on payment obligations of the parties had to be viewed commercially for the whole duration of the contract and not at the time when the default occurred.⁸³
3. The purpose of the specific provision on obligation of payment in the event of a default was to protect the non-defaulting party from the additional credit risk.⁸⁴

In short, his Lordship held that the specific term provided in the ISDA Master Agreement is a commercial arrangement between the parties and therefore should be honoured.

D A summary and discussion of the cases

By way of conclusions of this section of the paper, the above cases are summed up and discussed under the headings of -

- The legal nature of derivatives.
- Relationship of the parties.
- ISDA Master Agreement, Misrepresentations Act and UCTA.

1 The legal nature of derivatives

The English courts in every case acknowledge the commercial value of derivatives traded in the financial market. At the same time they recognise the speculative aspect of the financial instrument. The ambiguity of the financial instrument is clearly described in the judgements of Lord Templeman in the *Hazell* case, Lord Donaldson in the *City Index* case and Hobhouse J

⁸¹ *Lomas*, at [3].

⁸² *Lomas*, at [85],[86]

⁸³ *Lomas*, at [87].

⁸⁴ *Lomas*, at [92].

in *Morgan Grenfell*. It is easy to accept as a general proposition, as Blair J did in the *Banco Santander* case, that speculation is a legitimate activity in a financial market.

Having stated the ambiguity of derivatives, it is interesting to determine how the courts arrived at their conclusions that the derivatives were speculative in all the cases. More specifically to what did they attribute the speculative element of derivatives - to the nature of the financial instruments or to the intention of the parties? As a starting point they accepted that it is difficult to separate the hedging element from the speculative element of derivatives. Hamblen J in the *Standard Chartered* case and Hobhouse J in *Morgan Grenfell* case in their judgements specifically addressed the difficulty of making such a distinction.

However the courts in their analysis brought out certain features of the derivatives which are indicative of their nature. At the heart of it the parties are taking different position on what they anticipate to be the rise or fall of the price of commodity or rate of interest. This appears to be the predominating factor of the transaction: the commercial value of the contract and the financial consequence depends on this factor. The clearest example of such analysis is in the judgement of Lord Templeman in the *Hazell* case and to a certain extent in Blair J judgement in *Banco Santander* case. David Steel J in the *Titan Wheels* case clearly implied it in citing the evidence of the witness who said if hedging were intended then a simple forward contract would do it. The fact that the derivatives were structured in a complex form, they were for the purpose of speculation for profit. Indeed in all the cases there were generally careful analyses of the nature of the derivatives.

Other features in derivatives were also identified in the judgements in *Bankers Trust* and *Banco Santander* as problematic: the risk which derivatives transactions was purported to cover was not really understood by the parties. The scale of the loss based on the mathematical formulation of the risk was not anticipated. Indeed, the resulting loss was so phenomenally huge in all the cases that it was inevitably contested because the counter party found it impossible to accept. It is this feature of derivatives which the Judge in *Banco Santander* considered the product "risky." No reliance could be placed on the ratings of credit risk as an indicator of the risk because it was held in the *Cassa* case the ratings of the credit agencies are not statements of fact; they are opinions.

The *Cassa* case itself discloses the structuring of the financial instrument and the potential risk it poses to the end user. The instrument was designed to the business advantage of the bank regardless of the customer's specification for a conservative product. It meant in this case the derivative product was embedded with a pool of assets which were of higher risk although the sum total met the generally requirement for a triple A rating. The judgement of Hamblen J is worth citing at paragraph [330]:

Barclays' answer to CRSM's general case was essentially that set out in discussing the technical issues between the parties. It accepted that it had sought to make a profit out of the transaction by selecting high spread names for their ratings. This was the basis of the business. However, it did not consider those profits to mean that there was an equivalent or high real world probability of default.

Later on in paragraph [352], he summed up the evidence of one Mr Agresta, the structure of the product as follows:

As Mr Agresta explained in evidence, as a structure he had no reason to consider issues such as “expected loss” or “probability of default”- “I wasn’t a trader and I’m not a trader myself, so while I was structuring the transactions, I never made considerations around the expected losses as implied by pricing model. I was using the pricing model as a way to understand the feasibility of the transaction....”; “My role as structurer simply did not lend itself to assessing credit risk for an end investor,

This further suggests that the trader and the person who structured the product did not necessarily work together on the product. It leaves the question as to whether the trader of the product knows the product.

It is suggested besides certain features of the derivatives are highlighted, the main part of the judgements in these cases is focused on detailed and meticulous considerations of the contractual relationship of the parties. No doubt this is the result of the legal issues raised about duty of care. However it appears that it is in this exercise that the courts form the view that the commercial transactions were entered for the purpose of speculation for profit.

It is suggested therefore, the courts are constrained to hold to the working principle of caveat emptor in their approach to derivatives. The Judge in the *Cassa* case had clearly given expression to it. Although the other cases did not express it explicitly, the principle underlined the reasons of the judgements. For it explains the courts’ reluctance to hold there is a duty of care on the part of the bank as financial adviser. It also explains the decision that the parties must be taken to have considered the risk; hence it would be inappropriate to apply the laws on misrepresentation and unfair terms on such a commercial contract. But at the heart of it is another fundamental principle that fortifies the courts’ approach. It is the notion of certainty of contract which the English judges considered of particular importance in complex commercial contracts involving substantial sum of money. The *Belmont Park* case is clear expression of this fundamental principle by the highest court of the country.

The challenge lies in a case like *City Index*. It is common ground that the derivatives transactions in that case were betting contracts. The judges had construed the betting contracts were an “investment” under the FSA. But the argument contrary to such a construction was put forward by Miss Gloster, QC who was then counsel for the defendant. The wording of the phrases which were subject for interpretation was: “the purpose or pretended purpose of which is to secure a profit..”. The critical word of the phrases is “secure” which suggests the activity of hedging. As the parties were not hedging but betting, therefore the transaction could not come within the ambit of the provisions that defined “investments”. However the court rejected Miss Gloster’s argument. It is noted that the case was decided in 1991 before the financial crisis and at the time the financial market and its activity were viewed favourably. Different consideration might apply in the current situation after the 2008 financial crisis. It is doubtful that a betting contract could be considered an “investment” in current financial situation.

A final comment is that the judges on the whole take a benign view about speculation. It is considered a good thing. It encourages economic activity. This is accepted as an axiom. No

deeper analysis is taken by the judges on this point. There is greater analysis on speculation in derivatives being done recently and this will be discussed in Section VI and VII of this paper.

2 *The relationship of the parties*

In all the cases above, issues relating to the nature of the contractual relationship are repeatedly raised. The complaint made against the banks relates to breach of duty of care owed as a financial adviser. The reason for it is obvious as the derivatives are sold and in some cases designed by the banks. And the derivatives sold are complex.

The courts' position in this issue is quite settled, namely, it is reluctant to make such finding of duty of care. The reasons of the courts' decision are based largely on the same factors in all the cases: that the counter parties to the banks have some previous experience in the product, that is, they are sophisticated investors; that the product is complex and novel; and that the amount involved is substantial; and that the terms of the agreement are reasonable in defining the relationship of the parties. In the circumstances the courts should not be quick to redefine the relationship of the parties. It makes good sense that certainty of contract is the right thing under the circumstances. For the courts to decide otherwise, they require a written agreement which set out the responsibilities of the financial adviser. Short of that they would not hold that there is an advisory role from the banks on the investment.

It is interesting to note that in the recent case of *Banco Santander* the advisory role of the bank in the sale of the derivatives was not raised as an issue. What was raised was a novel point which referred to certain feature of derivatives as discussed above at paragraph 4, page 23 of this paper, namely that the risk was not understood by the parties and the loss became so large that they constituted an abnormal change in circumstances of the parties.

3 *ISDA Master Agreement, UCTA and Misrepresentation Act*

Other matters which appear quite settled by the cases are the status of ISDA Master Agreement and the application of UCTA and the Misrepresentation Act 1967 in such contracts. The terms of the ISDA Master Agreement which were used in most of the cases above were found by the courts to be reasonable commercial terms. The two decisions considered above in *Belmont Park* and *Lomas* established their legal status in derivatives contract. It follows therefore UCTA and/or Misrepresentation Act 1967 is of limited application. Furthermore on the same reasoning contractual estoppel is an acceptable defence in the circumstances.

V Hudson's criticism

In the introduction of this paper reference is made to Hudson's criticism of the courts' perception that derivative products being speculative could have affected their analysis of the cases and that it is particularly significant in the local authority swap cases.⁸⁵ Unfortunately he did not extend his discussion further than the local authority cases. It is

⁸⁵ Hudson, above n 2, at 1-29.

suggested that on the facts of the case and the legal issues raised in respect of the powers of the local authority it is difficult to see how the courts could have decided otherwise than the interest rate swaps was a speculative transaction. What is striking about the facts of the *Hazell* case is that the local government had entered into the swaps transactions to ease its interest payment burden from borrowings. Its objective was that by entering into the swaps contracts it hoped to make a profit by taking a contrary position from the banks on what it thought the interest rate would be in the future. It is difficult to draw the conclusion that the transaction was for the purpose of financial borrowing.

Hudson's view on speculation in interest rate swaps is that it is an integral part of hedging. Proceeding from the premise of the proposition of Lord Templeman in the *Hazell* case that swaps may involve speculation or may eliminate speculation, he suggested:⁸⁶

This two-dimensional feature of swaps is significant: they can be used to eliminate risk or to take risks, but even in seeking to eliminate risks (as emerged in the *Hazell* case itself) fresh risks may be created by the value of a hedge deteriorating due to unforeseen market movements. Given that a hedge is itself a financial instrument, its market value will fluctuate. Therefore, financial institutions must constantly re-calibrate the level and nature of their hedging strategies (which themselves are fluctuations in value) of the risks which they are seeking to cover. It is this persistent element of speculation in even risk management strategies which caused lawyers to consider that swaps business might be analysed as involving gambling.

He then concluded as follows: "What is important to recognise is that derivatives can nevertheless be designed solely to meet and match an existing, calculable exposure to some market movement, and that they are not simply intended for speculation in all circumstances."⁸⁷

The crucial point of Hudson's analysis is that it is a financial instrument and it is the nature of such financial instrument that its operation is speculative for hedging purpose. The point is not lost to the judges. Indeed the point was expressed by Hobhouse J in *Morgan Grenfell* and Hamblen J in *Standard Chartered*. Notwithstanding the point that hedging could be speculative, the judges appear conclusive in their view that derivatives are inherently speculative in nature and are risky. The reasons for it have been discussed at page 23 above.

The second major criticism of Hudson is that the courts have unduly focused on the documentation and the factual background of the parties. He identified "three key themes"⁸⁸ in his analysis of the court cases:

- The disclaimer terms in the contract have forced the counterparty to frame its cause of action under fraud as in the *Cassa* case. The case would have a better chance of success under an action of negligence.

⁸⁶ Hudson, at 1-141.

⁸⁷ Hudson, at 76.

⁸⁸ Hudson, at 7-16 – 7-19.

- The courts' detailed exposition of the facts and evidence as opposed to the orthodox application of the test or principle in the leading case to the facts is detrimental to the certainty of the law.
- There has been an overemphasis of the documentation and the factual background of the parties as opposed to the regulatory obligations on the seller.

The consequence of such an approach is the conclusion of the judges favours the financial institutions - "In essence, the case law does appear to be loaded in favour of the financial institutions:....."⁸⁹

There is a reason for the courts' approach in their focus on the documents and factual background of the parties. The trend in the courts' analysis of cases has been to take a practical approach as opposed to engage in high abstract application. They follow the directions of the judges of the highest court of the land: it was Lord Hoffman who suggested that the evolution of "lower level principles" is a more useful guide than "high abstractions."⁹⁰ Similarly, Lord Steyn has suggested the primary focus of analysis must be on the exchanges of the parties, things said or done.⁹¹ These two authorities were cited by Gloster J in the *JP Morgan* case and her judgment is noted for her detailed and meticulous analysis of the documentation and background facts of the parties. Her approach and analysis were commended at the Court of Appeal.

It is debatable the practical approach leads to greater uncertainty of the law. The view of this paper has been there is certainty in some of the issues which are usually raised in such cases.

However the point about Hudson's second criticism could be: because of the courts' perception of the transaction, their analysis of the parties' contractual relationship might be compromised or self-confirming. Instead of looking at the issue on the principle of Hedley Byrne duty of care, their detailed analysis of the background facts were aimed at eliciting matters which could put the relationship of the parties on a different footing from what they had contracted. It is suggested that even if it is so, it is a very reasonable approach given that the financial instrument and the relationship purpose are found to be speculative and risky. The problem lies in the nature of the derivatives themselves.

This leads to the next point of Hudson which is about the courts' lack of engagement with the regulatory obligations on the traders and sellers of derivatives such as FSA Conduct of Business Sourcebook when considering the issue of the duty of care. The answer is simply the issue is not raised in the cases considered at the time Hudson wrote his book. This is acknowledged in paragraph 7-15 of his book. Since then, there are several cases where the duty of the traders of such a financial instruments under the rules in the FSA and FSMA are engaged. In this discussion reference is made only to the latest case, namely the case of *Thornbridge v Barclays*.⁹² The case involved a private company which had taken a loan from Barclays to purchase a property. The company then entered into an interest rate swap with

⁸⁹ Hudson, at 7-19.

⁹⁰ *High Commissioner of Custom and Excise v Barclays Bank* [2007] 1 AC at 35 -36.

⁹¹ *Williams v Natural Life Health Foods Ltd* [1998] 1 WLR at 835F.

⁹² *Thornbridge Ltd v Barclays Bank Plc* [2015] EWCA Civ 1197.

the bank to hedge against the interest rate of the loan. The end result was it found itself paying more than the interest rate under the loan. The company claimed that the bank had breached its duty of care and also its duty under the Conduct of Business Rules (COB) under s 138D of FSMA.

Three questions were raised in the *Thornbridge v Barclays* case with regard to the duty of the banks as traders of the derivatives under the FSMA. The first question raised the issue as to whether there was a duty to provide relevant information over and above the duty under the Hedley Byrne duty of care. The Judge held that there was no additional duty imposed under the COB rule. The duty of care to take reasonable steps not to mislead was comprised within the common law duty.⁹³ The second question was whether the terms of the transaction gave rise to an enforceable duty under the FSMA because there was a reference to “applicable regulations” under the contract. It was held the wording was too wide to be applicable; it would render the contract uncertain and unworkable.⁹⁴ The third question was whether there was a right of action under the COB rules and the Judge held there was not under the current case law.⁹⁵

The Judge’s approach on the breach of duty of care in the case is facts specific and detailed as is in all the cases mentioned above. The engagement with the COB rule does not appear to change the courts’ approach of the law on the duty of care of the traders.

VI Could derivatives be wagering?

This part of the paper faces up to the crux of the issue as posed by ISDA in its brief to Robin Potts, as mentioned in the introduction, namely whether the derivatives are wagering. In this regard the courts have significant advantage over Robin Potts, in that since 1997 they have had analysed considerable number of derivatives cases. Based on that experience the question is whether they could have viewed derivatives as wagering transactions.

Before answering the question, two preliminary remarks need to be made. Firstly, it needs to be said what the courts think on the issue is important to the financial market. Scholars and legal practitioners in the financial markets have considered the courts’ role is necessary for the market. In 2012, Jeffrey Golden in a symposium on “The Regulation of Over-The-Counter Derivatives” presented a paper entitled “Judges and Systematic Risk in the Financial Markets.”⁹⁶ He has a section on the question “Why Court are Important” and his answer is that judges are potential allies to regulators in preventing systemic risk⁹⁷. Further as the derivatives transaction is high stake and complicated and international, it needs a settled body of law on the issues in the financial market. He considered it dangerous if such a role

⁹³ *Thornbridge*, at 130-131.

⁹⁴ *Thornbridge*, at 136.

⁹⁵ *Thornbridge*, at 143.

⁹⁶ Jeffrey Golden “Judges and Systemic Risk in the Financial Markets” *Forham Journal of Corporate & Financial Law* (2013) Vol 28.

⁹⁷ Jeffrey Golden, at 329.

be left solely to regulators.⁹⁸ Similarly, Lynn Stout regards an independent judiciary is better placed to regulate over optimistic speculation in derivatives than regulations.⁹⁹

The second preliminary remark is that the issue or the question needs to be looked at with the interest of the financial market in mind. That is quite a different perspective from considering it with the view to uphold commercial contracts. The papers of Jeffrey Golden and Lynn Stout mentioned above, about the role of judges were discussed with the interest of the financial market in mind. Indeed a specialist court has been established on 1 October 2015 in the English civil proceeding to consider exclusively financial matters presumably to serve the interest of the financial market.¹⁰⁰ It is therefore a legitimate approach to derivatives with that perspective which is aimed at serving the best interest of the financial markets.

That leads to the further consideration of a more fundamental question, which is - what are the financial markets for? This will be discussed briefly to provide sufficient understanding what financial markets are meant to do. According to Stephen, Jon and David in their book "*What They Do With Your Money*"¹⁰¹ the financial market exists for four vital services:

- It provides a safe custody for wealth.
- It provides for a payment system.
- It provides intermediation between lenders and borrowers.
- It provides a system to reduce risk.

To sum up in the words of the writers – "These four services are central to a modern economy and are one of the reasons we enjoy our high living standards."¹⁰²

John Kay reiterated the same four fundamental purpose of the financial market in his book *Other People's Money*.¹⁰³ He explained what the intermediation between lenders and borrowers is meant to achieve in the financial market: raises and allocates capital and aids to augment the capital stock on to the following generations:¹⁰⁴

A central function of financial markets is to direct money from savers to businesses, homeowners and governments. They in turn use these savings to build, own and operate houses, shops, offices, warehouses and factories, to buy plant and machinery, and to develop the nation's infrastructure and civil works.....Each generation inherits a stock of assets from one that preceded it. Each generation makes use of that stock and sees it depreciate. Each generation adds to it, and passes an augmented capital stock on to the generations that follow. An effective financial system aids businesses, households and governments to

⁹⁸ Jeffrey Golden, at 333, 337.

⁹⁹ Lynn Stout "Uncertainty, Dangerous Optimism and Speculation: An Inquiry into Some Limits of Democratic Governance" (2012) 97 Cornell L. Rev 1177 at 1198-1199 ["Uncertainty, Dangerous Optimism"].

¹⁰⁰ Financial List Claims under Civil Procedure Rules 1998, Part 63A, Practice Direction 63AA.

¹⁰¹ Stephen Davis, Jon Lukomnik, David Pitt-Watson. *What They Do With Your Money. How the Financial System Fails Us and How to Fix It* (Yale University Press, New Haven and London, 2016) ["*What They Do*"].

¹⁰² *What They Do* at 17.

¹⁰³ *Other People's Money*, above n 1, at 6.

¹⁰⁴ *Other People's Money*, at 143-144.

achieve these objectives – and enables them to leave behind better country than the one they found. Or so it should be.

I will describe these two key functions of the financial system as search and stewardship. Search in the pursuit of new investment opportunities, stewardship the management of long- term assets that have already been created.

Returning to the main question for consideration in the section of the paper, it is suggested based on the analysis of the derivatives cases, what has prevented the courts from characterising derivatives as wagering, is that they consider there is some commercial value in derivatives transactions. The commercial value of derivatives transactions appears to lie in their purported purpose of hedging. It is a point similarly made by Hudson which is discussed at page 26 of this paper. The reality of it is, as discussed, the derivatives could not anticipate the risks and the scale of the loss that would result. In addition the derivatives are structured in a way to the advantage of the seller of the derivatives for speculating on the interest rate or price of the commodity quoted in the various indices. The courts are aware of this reality about derivatives. In the circumstances their most appropriate characterisation of such derivatives transactions is to describe them as speculative or risky. Perhaps those expressions are a coded way of saying that they are wagering transactions. To characterise them as gaming or wagering contracts would have social consequences, not to mention contrary to the policy of the FSA or FSMA.

It therefore requires something of systemic proportion in the financial market for the courts to take a very different perspective of the subject. The 2008 financial crisis in the financial market was such an incident or series of incidents of systemic proportion. Since then there has been much critical scholarship and reports about derivatives and their purported economic benefits.

Lynn Stout has written several articles and papers on derivatives, some of them have been referred in this paper. In her analysis of derivatives, she distinguishes the types of speculation in derivatives. It is generally accepted the economic theory for derivatives is that they are of commercial benefit because they allocate resources to the party which has the resources and the price of commodity to its true value. Lynn Stout attributes the two economic benefits to the “risk hedging model” and “the information arbitrage model” respectively. The reasons for the economic benefit based on the models are self-evident: in the risk hedging model one of the parties in the transaction has more financial capacity for risk than the other in their speculation of future prices. As a result it provides financial resources for the allocation of risk. In the information arbitrage model, one party has invested more in obtaining information than the other on the commodity. As a result the price of the commodity is speculated at its true value. But Lynn Stout suggests a third model which is essentially about two parties taking very different view of future prices for no other reason other than their personal preferences. She called the model “heterogeneous expectations (HE) model”.¹⁰⁵ Recently in an article published in 2011 she

¹⁰⁵ Why the Law, above n 12, at 741.

renamed the (HE) model as the “disagreement” model.¹⁰⁶The key features of the HE model which distinguishes it from the other models are:

- The parties’ perception of the future prices “differ markedly, “based on intuitive “differential beliefs.”¹⁰⁷ The difference of perception of the parties in future prices in the other two models is based on the degree of risk one party is capable of taking (the risk hedging model) and the degree of information one party has over the other(information arbitrage model). In the HE model the expectation of the speculating parties are based on what they perceived subjectively and intuitively.
- In the HE model the two parties are speculators with no interest in the commodity save for its price. It is essentially “speculator-with- speculator trading”. In the other two models, the parties are interested in the commodity and one of the parties is either buying or selling the commodity.
- In the HE model the ex post loss position for the parties is one party wins and the other loses. The winning party’s gain is mirrored by the other party’s loss. Not so for the other models. Both parties benefit from the speculations albeit one party gains more than the other.

Clearly the critical factor of her comparison of the models is that the HE model involves a genuine interest in the delivery of the shares or commodity, not just an interest in their prices. For this reason, key to Lynn Stout’s analysis of derivatives is the common law rule against contracts for differences. In her words -“..the common- law rule against difference contracts created an elegant legal sieve to separate socially useful hedging contracts from risk-increasing purely speculative wagers.”¹⁰⁸ And the classical statement of the common law for her is the Supreme Court judgement of *Irwin v Williar*:¹⁰⁹

The generally accepted doctrine in this country is...that a contract for the sale of goods to be delivered at a future day is valid, even though the seller has not got the goods, nor any other means of getting them than to go into the market and buy them; but such a contract is only valid when the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer; and, if under the guise of such a contract, the real intent be merely to speculate in the rise or fall of process, and the goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void.

Lynn Stout’s conclusion from the above analysis is that derivatives are nothing more than naked bets: “Derivatives are not really “products” and they are not really “traded.” They are simply bets on the future – nothing less and nothing more.”¹¹⁰Her view is fortified by her analysis of the derivatives market with the enactment of the Commodities Futures Modernization Act in 2000 (CFMA), there was a huge upsurge in OTC derivatives and they

¹⁰⁶ Lynn Stout “Risk, Speculation and OTC Derivatives: An Inaugural Essay for Convivium”(2011) 1 Iss.1 Article 2 [“Risk, Speculation”] at 8.

¹⁰⁷ Why the Law, at 741-742.

¹⁰⁸ Lynn Stout “Regulate OTC Derivatives by Deregulating Them” (2009) Cornell Law Faculty Publication, Paper 753 [“Regulate OTC”] at 33.

¹⁰⁹ *Irwin v Williar* (1884) 110 US 499.

¹¹⁰ Regulate OTC at 30.

are speculative after the HE model. The effect of CFMA was spectacular according to Lynn Stout: “The 2000 act declared derivatives exempt from CFTC or SEC oversight. But it also declared all financial derivatives legally enforceable. The act thus eliminated, in one fell swoop, a legal hurdle to OTC derivatives speculation that dated back not just decades but centuries.”¹¹¹

She further suggests that the whole regime of law and legislation in the United States are underpinned by this common law wisdom against speculation¹¹²:

“Antispeculation law” generally is not taught as a subject in modern legal curriculum. Perhaps it ought to be, for hostility towards speculators appears to be a fundamental characteristic of American law. The rule against difference contracts, the CEA¹¹³, the doctrines of indemnity and insurable interest, and SEA’s¹¹⁴ margin requirements and short sales restrictions each play important roles in deterring speculative trading.

The solution for the management of the derivative market is to return to the common law wisdom of characterising such transaction as legally unenforceable. The parties then would have to resort to their own means to redress their own business problems. It would require less financial resources to regulate the derivatives business. What would be envisaged is the traders in derivatives would establish their own private mechanism to regulate their business. Such a mechanism would naturally shut out irreputable members and speculators.¹¹⁵

What is attractive about Lynn Stout’s advocacy of the rule against contracts for differences is the ethical standard it advocates in business. The rule seems to suggest that business is only of commercial value when there is genuine trading of goods between parties. And even if there is speculating in the trading price, the parties are interested in the actual trading of the goods. This is what brings economic value to the community. It is an idea which underlines what the financial market should be doing, as advocated by the authors of *Other People’s Money* and *What They Do*. As John Kay has pointed out this is where there is real contribution to the economic well-being of the community.

For the English courts the issue would be whether they have taken a too benign attitude towards speculation in commercial transactions. Put it in a more pointed way, have they lost sight of the ethical standard in commerce? Could they have taken a too pragmatic view of commerce? It is suggested that they might have done so. A cursory comparison of the case cited by Lynn Stout and the cases cited in this paper, the judgements in the latter cases do not carry the ethical tone of the judges of the United States on speculation. But it is felt that this is what is needed in the financial markets today, as advocated by some scholars and writers of the financial market. They talked about restoring to the market - trust, good faith

¹¹¹ Regulate OTC, at 32.

¹¹² Why the Law, above n 105, at 733.

¹¹³ Commodity Exchange Act 1936.

¹¹⁴ Securities Exchange Act 1934.

¹¹⁵ Why the Law at 777-780 and Regulate OTC at 32.

and fiduciary duty.¹¹⁶ John Kay in his book *Other People's Money* provided a fitting conclusion to this thesis:¹¹⁷

The stakes are high, but finance is not a game, and sporting metaphors are inappropriate. It is time to get back to work: the serious and responsible business of managing other people's money.

It is suggested that in the light of the above, the courts might just consider that certain aspects of derivatives could be characterised as wagering.

VI Conclusion

The courts' view of derivatives has been that they could be employed for the purpose of hedging - which is a good thing - or for speculation. They have found it difficult to distinguish the two aspects of derivatives because hedging could be employed for speculation as well. A very good example is the derivatives in the *Standard Chartered* case which was employed as a hedge for the purchase of oil but included in it was a paper arrangement that speculated on the oil price. It is in such a commercial situation the courts would not wish to venture to say whether derivatives are wagering contracts or not. In any event they are constrained from doing so in view of the legislative policy behind FSA and FSMA which was noted by Hobhouse J in *Morgan Grenfell* case.

However the courts are prepared to hold that the derivatives in the cases are speculative transactions. Crucial to their analysis of the nature of derivatives is that it is the speculation on the fluctuation of the price of the commodity or currency which is the key, deciding factor of the transaction. Other features about the nature of the derivatives were also identified as reflective of the character of the product. The most significant feature identified is that the nature of the risk and the scale of the loss were not fully comprehended by the parties. The cases also disclosed as in the *Cassa* case the structured notes were designed not with the end user in mind but for the business advantage of the bank. It is not a wonder that they consider are inherently speculative.

In the premises, the courts are constrained to say the most appropriate approach to the derivatives cases is the doctrine of caveat emptor as a working principle. The principle is fortified by the English principle of certainty of contract. This is especially important in derivatives contracts where the transactions are substantial and complex.

It follows therefore any attempt at characterising the transactions in the traditional banker-client relationship would not reflect in the commercial reality of the transaction. It also follows that the terms of the contracts which adopt the terms of the ISDA Master Agreement are regarded as defining the commercial relationship of the parties. That being so, the courts consider the legislation on unfair terms and misrepresentations are of limited application.

Finally it has to be said that the courts are alert to the potentiality of wagering in derivatives transactions. The judgements in the *Morgan Grenfell* and *City Index* cases are indications of

¹¹⁶ *What They Do*, above n 101, at 237-231.

¹¹⁷ *Other People's Money*, above n 1 above, at 308.

that. At the same time they are constrained by the legislative policy behind the FSA and FSMA. The courts appear to be placed in a difficult position. It is suggested a possible way forward for the courts is to ask the fundamental question – what is financial market for? There has been considerable consensus opinion by scholars and financial reports what the financial market is meant to do as mentioned in pages 27 and 28 above. With such a perspective the courts may take a different approach when considering derivatives cases.

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