Briefing

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Commentary: Dodd-Frank, Magna Carta and the New Financial Services Regulatory Regime in the United Kingdom

by Patrick Cook

The implications of the Magna Carta

The Magna Carta, the 800th anniversary of which is celebrated this year, is a fine example of the law of unintended consequences and should serve as a warning to all legislators and parliamentary draftsmen.

It is not, of course, a piece of legislation at all. At most, it was an agreement or treaty imposed upon a medieval king by a group of barons who did not want to help the king fund a foreign war and who by good luck had seized control of London while the King was away campaigning. As the king needed the revenues generated through the London tradesmen more than he needed to defeat these barons in battle, he had little choice but to capitulate to their demands.

It should not, however, be thought that the barons were pursuing a high-minded cause, such as championing the interests of the common man. All they wanted was to preserve their own wealth, power and traditional rights, to be free from having to meet the king's excessive demands for money, and to ensure that, if they did wrong, they would be tried by their own class (thereby making it more likely that they would get off). There was no thought given to the common man, most of whom were more or less chattels as far as the barons were concerned. There was certainly no intention to deviate in any way from the rigid feudal system that had been imported into the UK from France as a consequence of the Norman invasion 150 years earlier.

And yet the Magna Carta has survived, not as a practical piece of law — since all but three of its provisions have long since ceased to apply — but as a concept. There is still no written constitution in the UK and no Bill of Rights such as is found in the United States and in much of mainland Europe. Nevertheless, the propositions that no man or woman, including the monarch, is above the law, that nobody can lawfully be imprisoned without a fair trial (habeas corpus), and that when accused everyone has the right to have their case heard by a jury of their peers, are as entrenched into the British psyche as if these had been included in the Ten Commandments handed down to Moses on Mount Sinai.

That these principles should apply to everyone ("any freeman" according to the Magna Carta) would have horrified the barons. The term "freeman" was substituted for the original term "baron" in subsequent versions of the Magna Carta, probably without most of the barons ever knowing, since many of them would not have been able to read at that time. The change was probably a a concession to those very few individuals that made up the merchants, town guildsmen and lower aristocracy, and, of course churchmen, who were recognized as "freemen" at the time and who had helped deliver London into the hands of the barons.

What no one at the time anticipated was that eventually everyone would be considered to be a "freeman." In England that took many hundreds of years, and came about as a result of the collapse of the feudal system, the self-destruction of the barons during the Wars of the Roses, the Reformation, the influence of the Renaissance from mainland Europe, the Civil War, the execution of Charles I, and so on. It is indeed less than 100 years ago that women took the first steps towards equality and became entitled to vote.

The key principles of the Magna Carta were used to justify the removal and eventual execution of the English king, Charles I, and by the American colonists in their revolt against the British Crown, and found their way into the Declaration of Independence and were enshrined in the Bill of Rights. In this way, what set out as a bit of self-interest on the part of a few medieval barons in a muddy field by the River Thames 800 years ago turned into the principal tenets upon which one of the world's largest democracies based its rule of law.

Of course other jurisdictions came to similar concepts in their own way and in their own time, perhaps most notably France with its revolution and the subsequent codification of its laws under the Emperor Napoleon. There are, however, clear echoes of the Declaration of Independence ("We hold these truths to be self-evident, that all Men are created equal, that they are endowed by their Creator with certain unalienable Rights, that

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among these are Life, Liberty and the Pursuit of Happiness") to be found in the French Revolutionary principles of *Liberté, Egalité et Fraternité*. Might this indicate that consciously or unconsciously and directly or indirectly the Magna Carta concepts found their way into the underlying principles not only of common law jurisdictions such as the UK, Australia and New Zealand but also of those western democracies based on the Code Napoleon or other similar written constitutions?

Financial regulation

Against this background how do we judge Dodd-Frank and its equivalent in the United Kingdom? For a start, the Magna Carta was very much shorter – 37 operative articles, each no longer than a short paragraph, as compared to 2,300 pages of primary legislation in the case of Dodd-Frank. It should of course be conceded that in 1215 everything had to be written by hand on vellum and relatively few people could read or write, so comparatively speaking it was a significant piece of work. It was also written in Medieval Latin, which possibly was as opaque as some of the language of Dodd-Frank and its equivalent English legislation.

The UK Legislation has, in addition to the influence and effect of Dodd-Frank, been influenced and to an extent dictated by European legislation, in particular by the European Market Infrastructure Regulation (EMIR) relating to OTC derivative trading. The terms and effect of UK legislation to be found in the Banking Reform Act, which received Royal Assent in December 2013, and the Financial Services Act, which came into force in April 2013, differ from —but have many similarities to — its US and EU counterparts.

Thus, common themes are the following:

- The requirement for certain OTC derivatives entered into between authorized counterparties, certain relevant non-financial counterparties and certain non-UK entities to be subject to mandatory clearing.
- The introduction of a review process for mandatory clearing of classes of OTC derivative contracts.
- The regulation of derivative dealers and the requirement to register.
- The extraterritorial application of regulations relating to OTC Derivatives.
- The exemptions from clearing for certain products (eg FX and covered bonds).
- The acceptance of certain non-UK CCPs to provide clearing services for derivatives.
- The exemptions from clearing mandate of certain counterparties (eg pension schemes, intra-group transactions, certain non-financial counterparties).
- Reporting requirements.
- Requirement for banks that represent a significant systemic risk if they were to fail there to increase the ratio of equity to risk likely well beyond the Basel III requirements.
- The introduction of new regulatory oversight.
- The introduction of measures to protect smaller investors.
- The introduction of new governance requirements.
- The introduction of more robust compensations schemes.

Further legislation will implement the proposals of the Independent Commission on Banking, which among other things will require the separation of retail banking functions from wholesale and investment banking activities (including swaps business).

There are other common themes but also some substantive differences and differences of emphasis between the US and EU legislation on the one hand and the UK legislation on the other. There are no current plans to impose a Financial Transaction Tax as has been proposed by the EU and adopted by a number of European countries. Some of the differences are due to the operations of common law as opposed to codified law. Others are of a more political nature and some reflect perceived national interests. Banking and financial services play a very significant role in the UK economy and there is a reluctance to adopt measures that might harm this sector unduly or diminish the importance of London as a financial centre. Indeed there is a fair amount of xenophobic antipathy towards some of the proposals of the EU Commission, which are perceived to be aimed at reducing London's position and transferring it to Frankfurt or Paris.

As with the Dodd-Frank legislation and the EU regulations and directives, in the UK much is still outstanding, to be implemented over a period of years and much relies on secondary legislation that is as yet undrafted. This creates uncertainty which is always unhelpful.

Because of the global nature of financial services and banking, participants in one jurisdiction now have to have regard not only to the legislation and rules applicable in that jurisdiction but also to those which are applicable in others. In some cases this has led to the cessation of certain cross-border trading. The rules are detailed and complex and the cost of complying high. Participation in clearing is necessarily expensive and it is only the larger organizations that can afford to take part. All this inevitably leads to higher costs for the investor.

Implications for the future

It is far too early to be able to tell whether the raft of legislation and secondary legislation will achieve its intended effect. Indeed it is not entirely clear in all cases what the intended effect is.

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It remains to be seen whether the credit risk of the various financial instruments that are the subject of the new rules is going to be reduced or effectively contained. Where products are effectively bets, it is difficult to see how this will be the case.

One of the real issues that caused the most recent financial crisis was the failure of confidence, which in turn resulted in a freeze on liquidity. The legislation does not appear to address liquidity risk. Financial markets rely on trust and confidence. Value, much as the Emperor's New Clothes, is just what people perceive it to be. While vast sums of money are extracted from the system for the benefit of a relatively few individuals, is any real wealth actually created for society as a whole? Cycles of boom and bust have been endemic throughout the 20th century and into the 21st. Will any of this put a stop to such cycles? If not, then at some stage in the future there will be another liquidity freeze — and it is questionable whether this legislation will help a great deal when that happens.

In the meantime, thousands of transactional lawyers have had to become regulatory lawyers and the creative brainpower that went into doing deals is now deployed in avoiding regulatory mantraps.

It is inevitable — and not necessarily a bad thing — that, when something gets as out of control as the financial markets did by the mid-2000s, there is a reaction. Some of that reaction is bound to be of a knee-jerk variety and some vengeful. In the public arena politicians will sometimes insist on doing things simply so as to be seen as having done something. As a result some of what has been enacted will not survive the long term. It may be that a wholly different and more radical approach to banking and financial services will emerge in time.

It took hundreds of years and the novel re-interpretation of it by Sir Edmund Coke in the early 17th century before the true merit of the Magna Carta was revealed. Things move more quickly nowadays, but I suspect that it will be a number of years before we know whether Dodd-Frank and its equivalents in mainland Europe and in the UK have resulted in the development of new fundamental principles that can form a cornerstone of a free society of the future, let alone whether it will have any effect on the position of the Common Man.

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