



Guildhall

Managing Legal Risk in Financial Markets: A Business Perspective

Paul Hattori + Craig Kersey

PRMIA/ISDA Seminar

London, 12 June 2007



Paul Hattori

paulkozo@aol.com

www.paulhattori.com

Craig Kersey

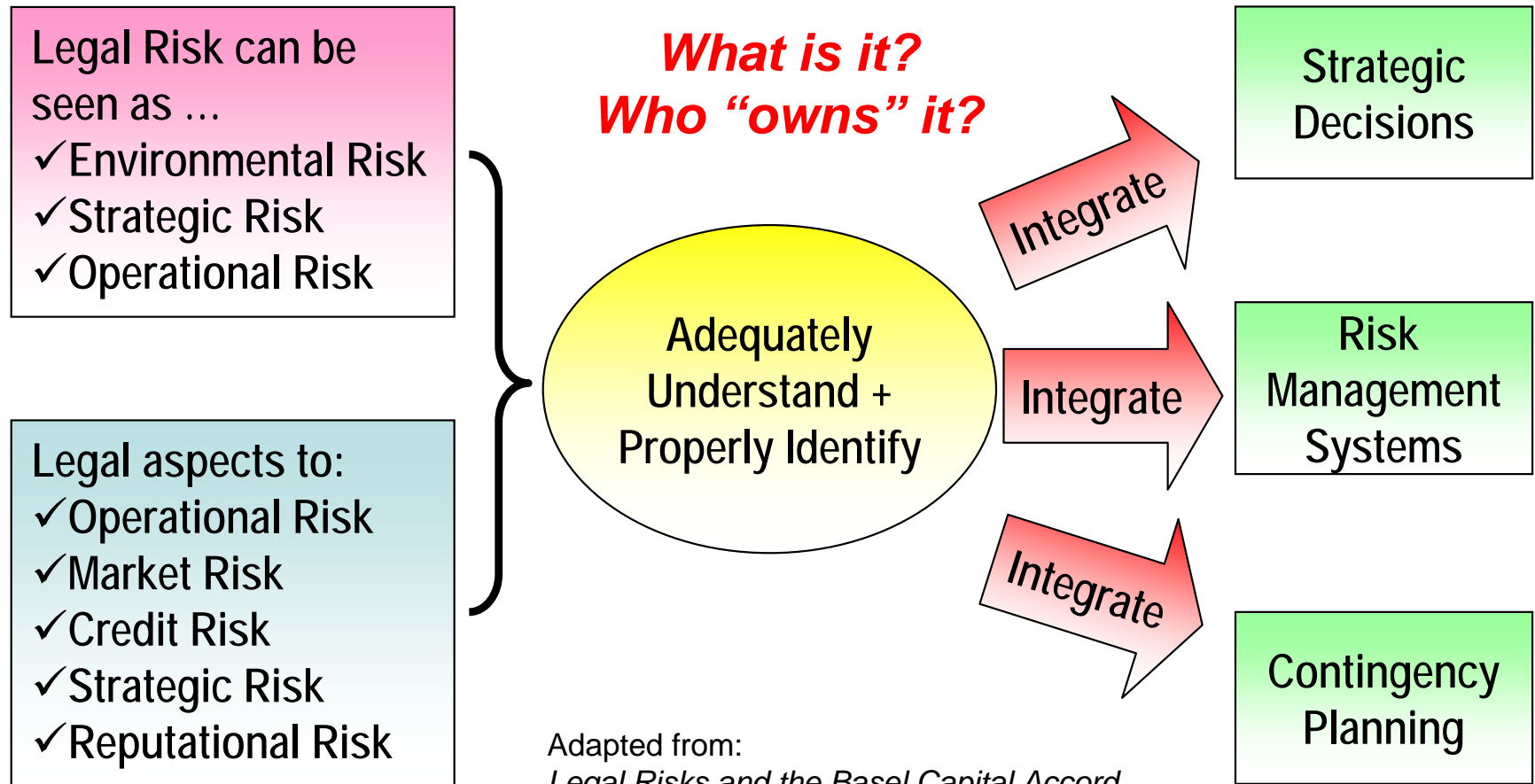
c.kersey@guildhall.co.uk

www.guildhall.co.uk

Disclaimer: While every effort has been made to ensure the accuracy of the material in this presentation, it is provided 'as is' and any use of, or reliance you place upon this material is entirely at your own risk. In particular, recipients should not construe the contents of this document as investment, accounting, tax or legal advice and each recipient is urged to consult with their own professional advisers as to these matters. Furthermore, this document does not constitute an offer to sell or a solicitation of an offer to buy an investment.

Legal Risk Challenges

Omnipresent in intangible products formed from law/regulation



Adapted from:
Legal Risks and the Basel Capital Accord
A Whittaker, FSA 22.05.2003



Presentation Outline

1. Legal Risk Defined
2. Dispute Resolution
3. Managing Legal Risk
 - Sources and impacts of legal risk
 - Ownership and controls
 - Current concerns
4. Question + Answer Session
5. Summary



1. Legal Risk Defined



Types of Legal Risk

- **Type 1 [Claims]:** “... the risk of being sued or being the subject of a claim or proceedings due to some infringement of law or regulations, or the commission of a tort such as negligence or some other act giving rise to civil [or criminal?] liability.”
- **Type 2 [Defects]:** “... the risk of technical defects in the manner in which a transaction is carried out, resulting in loss ... for those that put money at risk in the transaction.”

Legal Risk in the Financial Markets
[R McCormick, OUP, 2006]



A Definition of Legal Risk

“Legal risk is the risk of loss caused primarily by one or more of

- (a) a defective transaction; [*“Type 2” Risk*]
- (b) a claim (including a defence to a claim or counterclaim) being made or some other event that results in a liability for the institution or other loss (for example, as a result of the termination of a contract); [*“Type 1” Risk*]
- (c) a failure to take appropriate measures to protect assets (for example, intellectual property) owned by the institution;
or
- (d) change in law.”

IBA Working Party, 2003



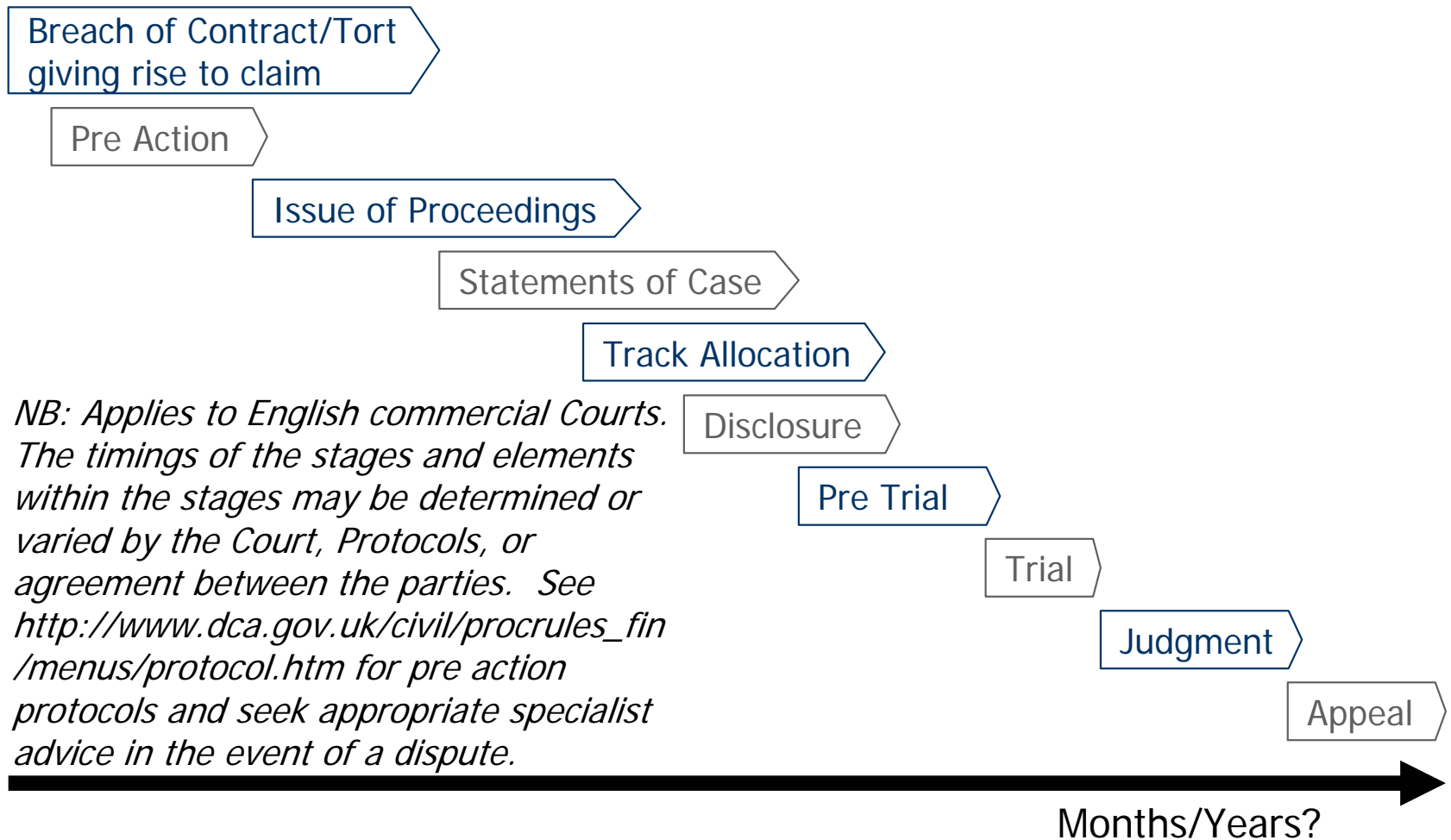
2. Dispute Resolution



A Dispute Resolution Primer

- **Litigation:** Formal, public, binding, dispute resolution through the courts; subject to court procedural rules and to precedent; decisions from judge(s).
- **Arbitration:** Semi-formal, private, binding process, governed by (UK) Arbitration Act 1996; litigation-like procedures; decisions from commercial arbitrator(s).
- **Mediation:** Informal, private, without prejudice, non-binding process; facilitated by experienced neutral; decisions by parties.
- **Expert Determination:** Informal, private, binding or non-binding process; decisions by party-appointed expert(s).

Litigation from Start to Finish



NB: Applies to English commercial Courts. The timings of the stages and elements within the stages may be determined or varied by the Court, Protocols, or agreement between the parties. See http://www.dca.gov.uk/civil/procrules_fin/menus/protocol.htm for pre action protocols and seek appropriate specialist advice in the event of a dispute.



Litigation + Dispute Resolution

- Litigation can be a long, drawn-out process ... even before the case gets into court.
- Either party may win in court and receive a settlement, and may recover a proportion of their costs, but wider impacts can apply win or lose [see below].
- Control of the process of litigation - in particular timing and workload - progressively transfers from the parties in dispute to others such as lawyers and the courts.
- Deadlines are “hard” and often imposed by the court. Missing a deadline may prejudice a case.
- The workload and time pressures imposed on the staff of the parties involved in the dispute may be severe (estimates suggest three man-years of distraction for managerial staff in disputes with a quantum over £1 million).



Experts and Mediators

- **Expert:** a skilled individual consulted for technical knowledge, not necessarily a world leader.
 - **Expert Adviser:** Essentially a consultant to one of the parties to a claim [hired gun?]. Advice on merits of claim, technical issues, disclosure. Possible conflict with role of expert witness.
 - **Expert Determiner:** Expert appointed by parties to decide a dispute.
 - **Expert Witness:** Appointed with permission of, and owes overriding duty to, the court [CPR Part 35, CrPR Part 33] or arbitration panel [i.e. not a hired gun]. Typically most work pre-trial. Written evidence and under cross examination at trial.
- **Mediator:** an independent trained neutral, appointed by the parties to facilitate resolution of their dispute.



Use of Mediation

- Pre trial or hearing – early negotiated resolution
 - A complete solution?
- During proceedings
 - Court ordered stay in proceedings for ADR (power not available to arbitration tribunal) [NB costs sanctions for unreasonable refusal].
 - Disposal of partial/side issues.
 - Negotiated resolution in light of arguments revealed.
- Split resolution
 - Liability/Quantum.
 - Allocation several liabilities/contributory negligence.



3. Managing Legal Risk



Practical Management

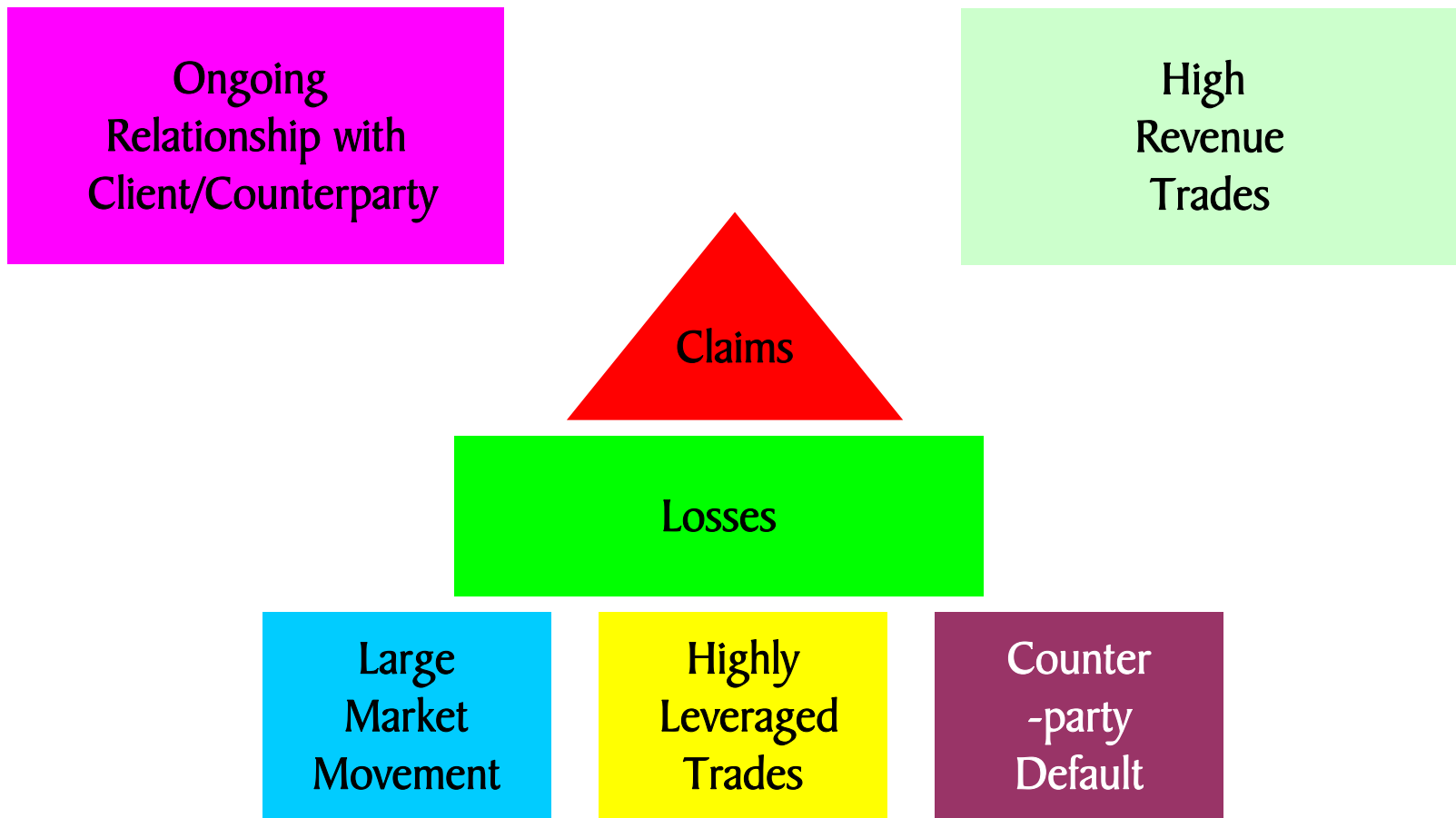
- Focus on:
 - The possibility that an event will occur.
 - The practical consequences should the event come to pass, including both further events and impacts.
- Develop policies and procedures to control risks
 - Roles of internal and external lawyers.
 - Standards for documents and clauses.
 - Use of opinions.
 - Document retention insurance.
 - Ensure appropriate authorities and channels exist to disseminate.
- Learn and apply the lessons
 - Dispute resolution policy.
 - Identification of potential risks from own and third-party experience, generic input from external advisers.
- Measure impacts:
 - Direct costs
 - Management/employee time [+ consequential losses?]
 - Others are difficult [reputations, lost business opportunity]



Examples of Type 1 Risk

- Credit events
 - Russian CLNs
 - Parmalat related claims
 - CDO tranchelets
- Interest rate movements
 - Bankers Trust cases
- Fraudulent Trading
 - Management resolution
- Typical claims
 - Breach of contract
 - Miss-selling / duty of care
 - Conflicts of interest
 - Mismanagement of trades / risks
 - Criminal fraud

Sources of Type 1 Risk

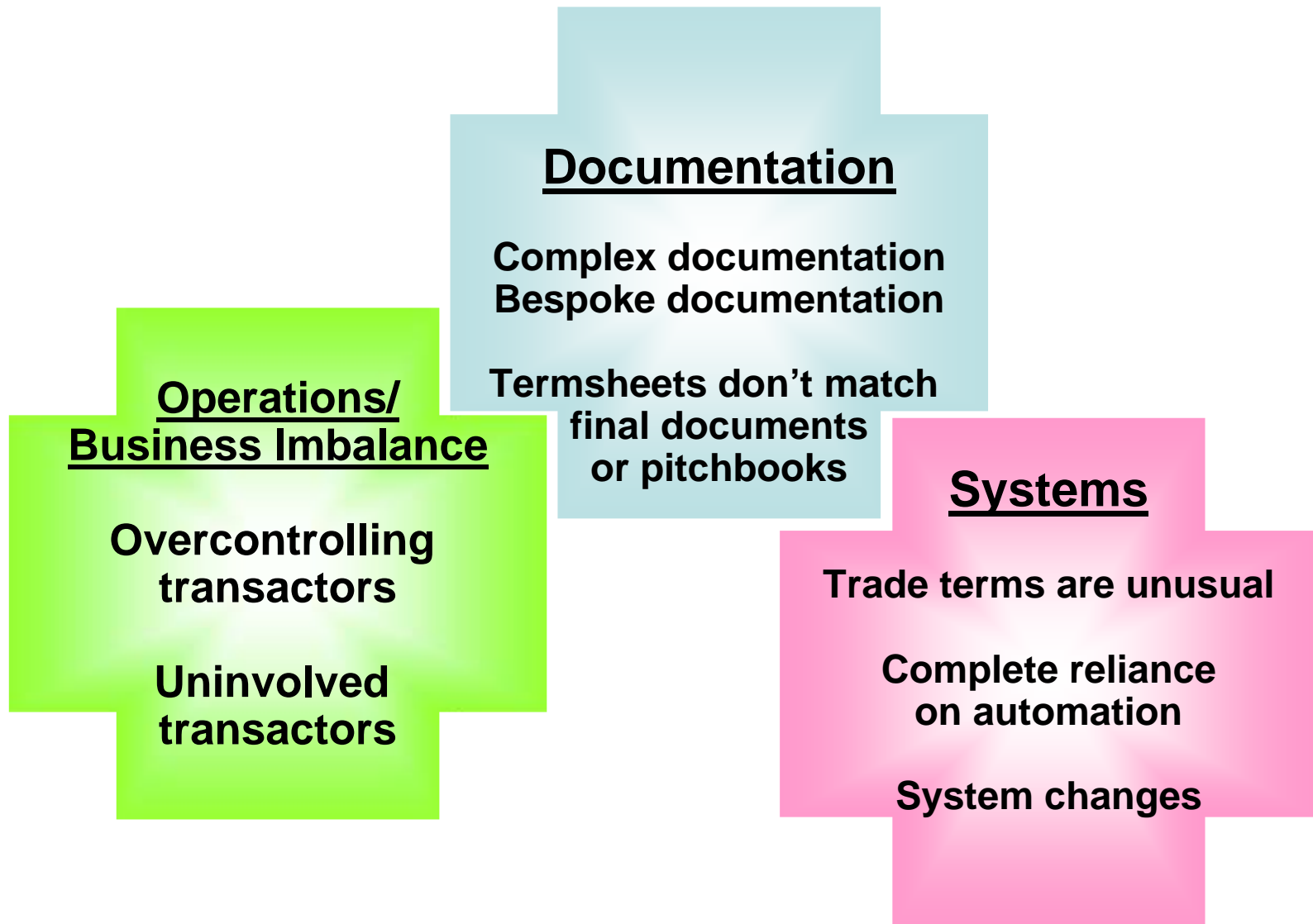




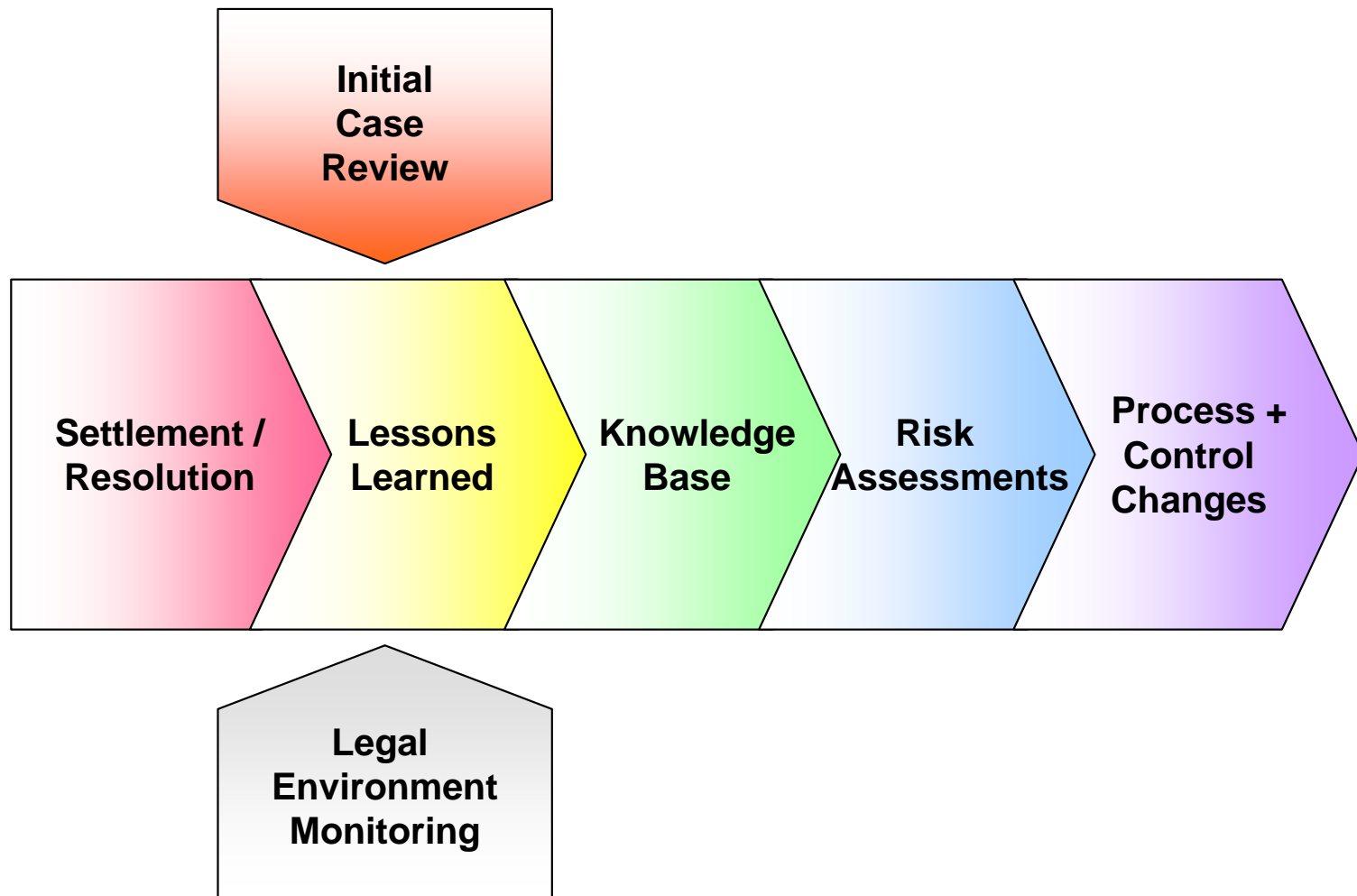
Examples of Type 2 Risk

- Wide range
 - Incoherent ABS documentation
 - Missed option exercise
 - Trader performance + bonus cases
- Typical claims
 - Negligence
 - Market practice vs documentation
 - Policy / calculation errors
 - Perverse exercise of discretion

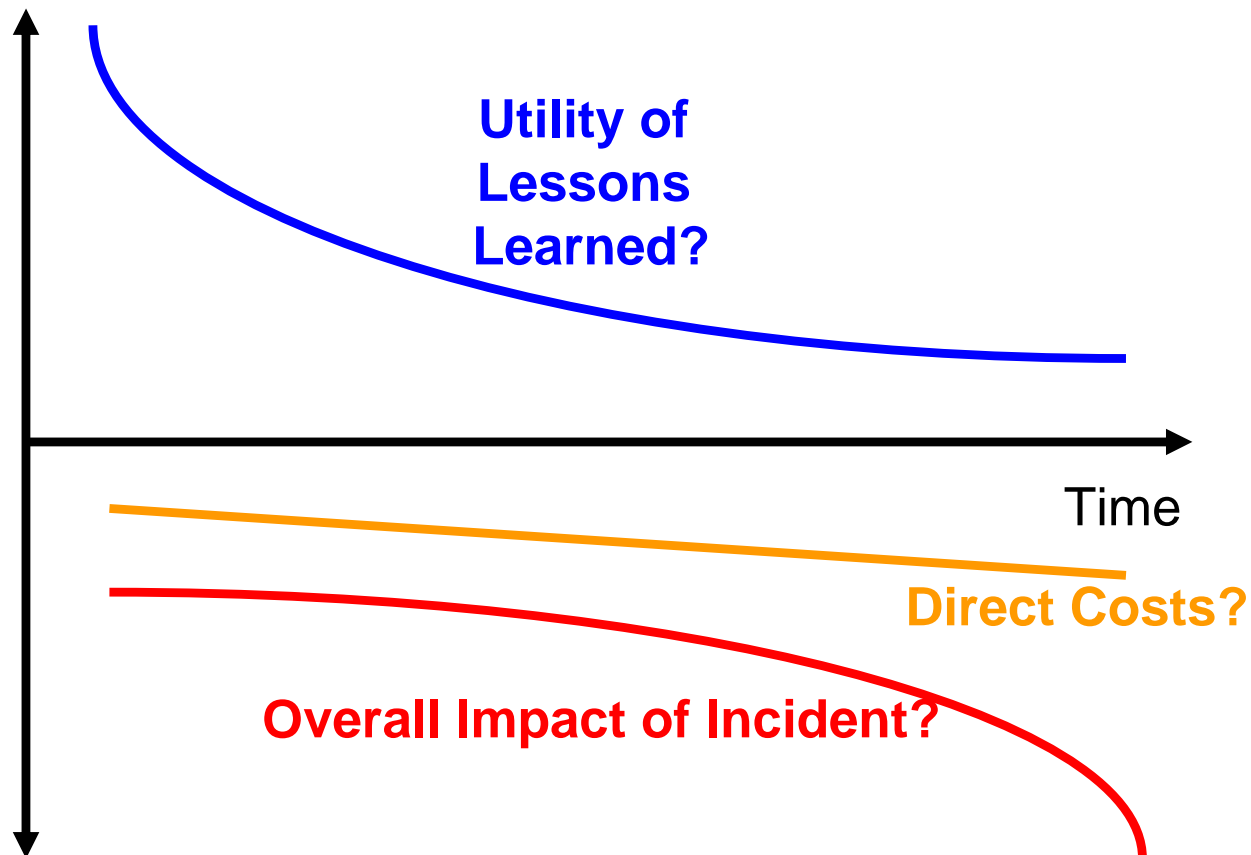
Sources of Type 2 Risk



Lessons Learned: the Risk/Dispute Interface



Assessing the Impact



Impact Quantification

Quantifiable [Data?]

External Costs

- Solicitors
- Counsel
- Expert(s)
- Mediator
- Court/Tribunal
- Costs Draughtsman

Research suggests these are <20% of total impact of a dispute

Internal Costs

- Internal Counsel
- Management Time
- Staff Time
- Other disclosure costs
- Consequential Losses
- Retention + Recruitment

Contingencies

Settlement or Award
Insurance Payment
Costs Award

Difficult to Quantify

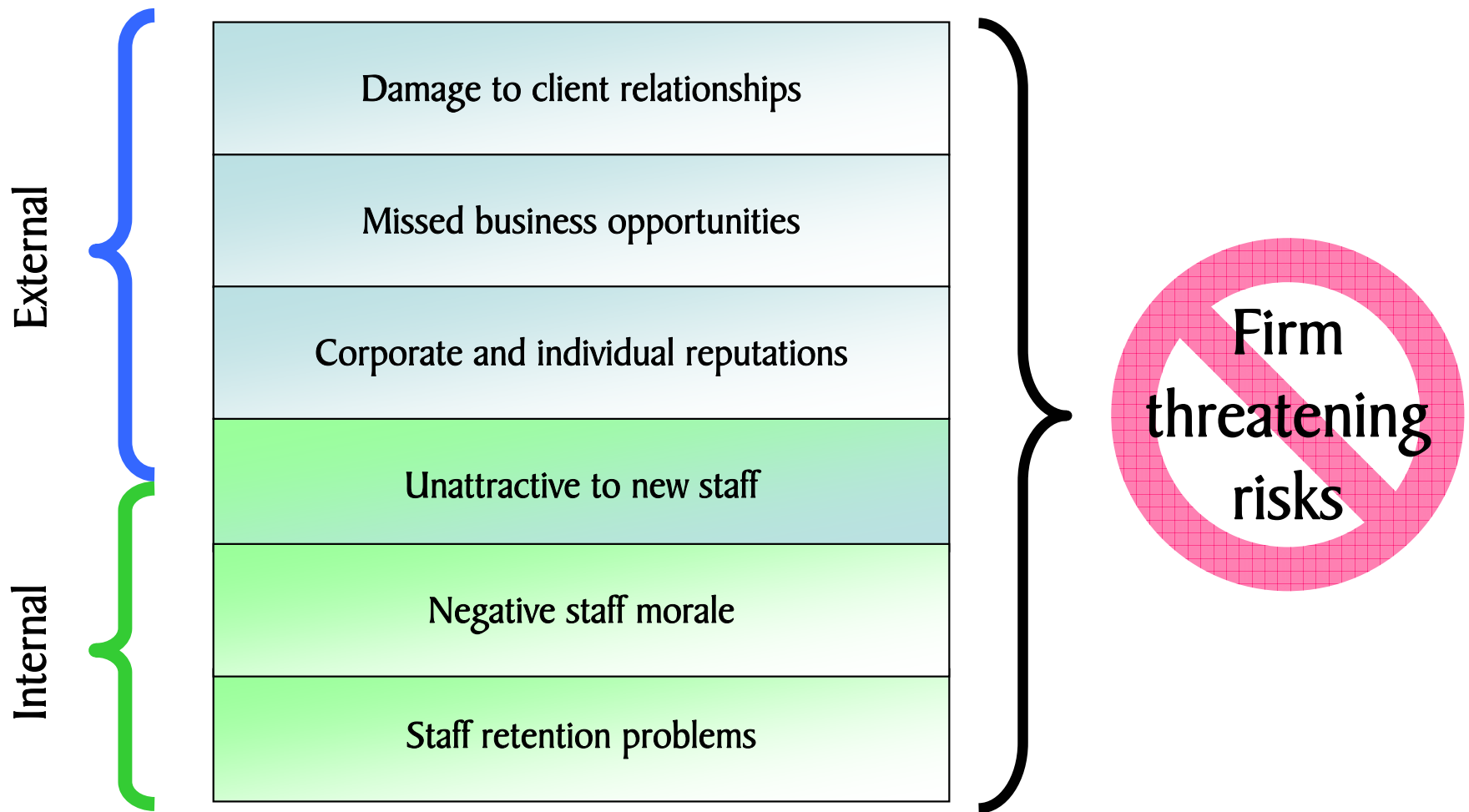
Other Impacts

- Reputations
- Client Relationships
- Missed Opportunities
- Business Disruption
- Staff Morale + Productivity

Can we improve data for and quantification of other impacts?

What are overall effects of using different forms of dispute resolution?

Impacts: Difficult to Quantify





Ownership of Legal Risk

- CEO/Board
- Internal Counsel
 - Policy/knowledge gatekeeper
 - Distinct resource to compliance function
- Operational [Legal?] Risk Function
 - Quantitative legal risk resource for impact measurement?
- Business
 - Understanding of issues
 - Blurring of legal risk and regulatory compliance boundary
- External Advisers
 - Valuable source of knowledge
 - How much control should be delegated?
- Trade + Supervisory Bodies
 - Market/systemic order
- Who Pays?
 - Funding of legal risk management/legal costs
 - Alignment of compensation packages



Controls

- Legal function independent, and appropriately resourced and empowered [distinct from the compliance function?]
- Training and competence for front to back office
- Sales contact and deal records [plus other documentation subject to disclosure e.g. e-mails]
- Industry standard documentation, definitions and protocols [e.g. ICMA, ISDA, TBMA]
- Collective opinions [e.g. ISDA and netting]
- Insurance
- Effective knowledge management
- Say “No”



Stress Testing Legal Risk

- Include within stress tests for other risk types
 - Credit/collateral/netting
 - Insurance contracts
- Embedded legal risk scenarios
- Event and management action focus
 - Improved understanding of impacts will improve analysis
 - Effective contingency planning



Some Issues + Opportunities

- Burden of new law and regulation
- Conduct of business
- Adequacy of standard terms and related protocols
- Cross border collateral interests
- Re-characterisation and structured transactions
- Jurisdictional creep
- Creeping criminalisation
- Adequacy/availability of insurance
- Funding of legal costs



4. Question + Answer Session



5. Summary



Key Messages

- **Legal Risk Management**
 - Clarity of roles and ownership
 - Better knowledge management + dissemination
 - Improved understanding of overall impacts and costs, leading to ...
 - ... accepted cost/benefit algorithms for dispute resolution options ...
 - ... and fully informed consumers of legal services
- **Dispute Resolution**
 - Early use of experts and exchange of information
 - Wider acceptance of need for technical/forensic analysis
 - Early attempts at ADR [expert determination/mediation etc]
 - Customised mediator profiling/increased use of co-mediators
 - Bespoke dispute resolution service(s) organised by trade bodies embracing mediation, expert determination and arbitration [with confidential feedback to progress standard documentation/protocols]