The Financial Crisis and "toxic" Retail Derivatives: Fraud by Hindsight or Mis-selling?[1]

Manuel Conthe[2]

During the period 2007-2008 two major events, of very different nature, took place in European financial markets:

1. On November 1, 2007, Directive 2004/39/EC on Markets in Financial Instruments Directive (MIFID) entered into force, requiring national legislations to dispense special protection to non-professional investors and clients of financial institutions.

2. Starting in mid-2008, markets were buffeted by a crisis of unexpected severity which, sparked off original in the US by the crisis of the subprime mortgage market, soon engulfed financial markets across the world.

Under article 19 of the then brand-new Directive, financial intermediaries are enjoined to "*act honestly, fairly and professionally in accordance with the best interests of their clients*" and to provide them with "*fair, clear and not misleading information*", including "*appropriate guidance on, and warnings of, the risks associated*" with financial instruments and proposed investment strategies. Under MIFID financial instruments include not only traditional securities, but financial derivatives as well, whether sold by investment firms or banks. Thus, the Directive imposed on banks and financial intermediaries a new fiduciary duty of acting "*in the best interest of their clients*" and warning about the risks associated with any financial products.

Almost concurrently with the entry into force of MIFID, an international financial crisis of unexpected severity brought to its knees or bankrupted banks and financial intermediaries – including Northern Rock in the UK or Bear Sterns and Lehman Brothers in the US-and led to wild gyrations in currency and financial markets. In the euro interbank market, euribor rates, on an upward trend until October 2008, suddenly reversed their trend and, as a result of the exceptional liquidity injections approved by monetary authorities –including the European Central Bank (ECB)-, dropped like a stone to historically low, close to zero levels. In currency markets, currencies of European countries, like the Polish zloty, which had been strengthening against the euro on market expectations that they would soon join the Exchange Rate Mechanism in their way to being replaced by the euro, unexpectedly changed course and weakened abruptly.

These reversals changed dramatically the market value of financial contracts which banks and clients –including retail ones- had entered before the crisis on the basis of the then prevailing, benign market expectations. Thus, Polish firms which had made bets on a further appreciation of the zloty by selling put options to banks, in the expectation that they would expire out-of-the-money, found themselves saddled, as writers of options, with huge obligations stemming form well in-the-money "toxic" FX options. Similarly, floating rate borrowers in Spain who had entered interest rate swaps and similar derivatives to protect themselves against potential increases in the interest rates to be paid on their mortgages, suddenly found themselves unable

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[1] Published in English as chapter VI of Annals of the 60th Anniversary of the Polish Arbitration Court, Warsaw 2010, pgs. 735-738.

[2] Arbitrator and Of-Counsel of Bird & Bird.-Madrid. Chairman of Spain´s Securities Commission (CNMV) 2004-2007.

to benefit from the spectacular drop in interest rates and became net payors under their swaps and derivatives´contracts.

In the wake of these events, clients have sued their banks or financial intermediaries, both in jurisdictional and arbitration courts, mostly seeking that the contracts are declared void. For courts and arbitration panels, the key issue involved is to judge to what extent banks mis-sold financial derivatives to misinformed retail customers, in breach of the investor-protection principles enshrined in MIFID, and failed specifically to warn them of the potential risks implicit in the option and swaps.

I should start by stressing that each specific dispute is different, needs to be analysed individually, and few general conclusions can be drawn which apply uniformly to all cases. Nonetheless, I will dare mention two aspects which might be relevant in some of them.

Fraud by hindsight?

There is now an extensive literature, written mostly in the United States by experts in Behavioural Law and Economics, on the difficulty of assessing *ex post*, after a crisis or event has actually taken place, the level of care or diligence which would have been regarded as reasonable *ex ante*, before the crisis or event took place. The problem stems from our tendency to overestimate the predictability of past events, once they have occurred. This "hindsight bias" does not consist of using known outcomes to update one´s beliefs about <u>future</u> events –a learning process which is quite rational-, but of using known outcomes to assess the predictability <u>at some earlier time</u> of something that has already happened.

One classical judicial opinion in which the court fell prey to hindsight bias was rendered in New Jersey in 1931 and held a trustee liable for failing to sell stock before the stock market crash of 1929[3]. The court reasoned that "*it was common knowledge, not only among bankers and trust companies, but the general public as well, that the stock market condition at the time of the testator´s death was an unhealthy one, that values were very much inflated and that a crash was almost sure to occur*". Obviously, the court´s ex post assessment of the ex ante likelihood of the crash was influenced by being aware of the crash.

In a more recent case in Alabama - *First Alabama Bank vs. Martin (1982)*-, the court held that the trustee ´s sale of certain stocks from from a large and diversified common trust fund was imprudent because he sold the stocks "*at the bottom of the market*". The court initially acknowledged the potential hindsight problem, but the immediately drew an inference about the propriety of the sale´s timing against the trustee: "*It is true that that a trustee will not be held liable under ordinary circumstances for losses due to unforeseen depression or recession of the stock market*". In the next sentence, the court undermined its acknowledgement by implicitly relying on a presumption that the trustee had abused his position: "*Yet, where the course of dealing of the trustee is such that it causes the loss, a trustee will be liable*"[4].

In another case, trustees were found liable for investing in a company in spite of "red flags", suggesting poor performance and for selling securities at the "bottom of the market". How the trustees in such cases were supposed to have known that the red flags were more predictive than the positive signals or that a stock price had actually reached bottom is unclear. The defendant in such cases were victims of the hindsight bias".

[3] Chris Guthrie, Jeffrey J. Rachlinski and Andrew J. Wistrich,*Inside the Judicial Mind*, Cornell Law Review Vol. 86: *777 (200.*

[4] Gregoy S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, Cornell Law Review, Vol. 85:767, 2000.

"What looks today like fraud, in many circumstances might have once been nothing more than misplaced optimism. Small wonder then that courts worry about "fraud by hindsight" in cases alleging securities fraund"[5].

Mis-selling?

But any court or arbitrator having to rule on the alleged negligence or even fraud by professional financial intermediaries when selling derivatives (e.g. currency options or interest rate swaps) to retail customers in recent years –particularly after November 1, 2007- must also pay due attention to the special fiduciary duties imposed by MIFID to investment firms.

MIFID lays much emphasis on the prevention of conflicts of interest: article 18 requires investment firms "to take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services or combinations thereof". It further adds that "when organisational or administrative arrangements made by the investment firm to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf".

Some financial intermediaries may have been somewhat slow in adjusting to the new fiduciary duties imposed on them by the new legislation. Traditional practices which might have prevented some investment firms from acting "in the best interest of their clients" –the new standard set out by MIFID- might include:

- Systems of incentives (e.g. bonuses, promotions…) for bank employees based on the volume of business or products sold to clients.

- Lack of coordination –or even the existence of Chinese walls- between managers of branches dealing directly with clients and negotiating with them standard products (e.g. mortgages) and specialized personnel from market departments selling derivatives products to retail clients, without adequate knowledge of the latter´s individual circumstances or investment objectives.

- Deliberate design of contracts to provide clients with an up-front advantage playing on their greed (e.g. initial reduction of interest rate to be paid by client, as a result of the implicit premium in the option sold by the client to the bank), with actual risks borne postponed until later.

- Mis-representation of multi-year nature of contract, without adequate disclosure of potential cost for the client of early cancellation "at market prices" in case of an adverse movement against the client.

[5] MItu Gulati, Jeffrey J. Rachlinski and Donald C. Langevoort, *Fraud by Hindsight*, Northwestern University School of Law Review, 98:773 (2004).

Conclusion

Each dispute is indeed different and has to be judged on its own merits.

At the same time, it is also true that, in assessing claims which involve passing judgement in retrospect on the conduct of financial intermediaries which sold financial derivatives to retail clients during the years 2007-2008, judges and arbitrators should be aware of two potential mistakes:

- Assuming inadvertently, on the one hand, that the wild gyrations and havoc wreaked by the international financial crisis in currency markets and interest rates were more predictable than they actually were, even for market professionals and experts in banks and financial institutions (*hindsight bias*); but, on the other hand,

- Failing to realize that the stricter standard of diligence expected from investment firms in their dealings with non-professional client and the higher level of protection afforded to investors by MIFID might have transformed into "*mis-selling*" practices which until then might have been regarded as normal under the traditional principles of freedom of contract and *caveat emptor*.