Universiteit Leiden

Memo

Hazelhoff Centre for Financial Law

To Whom it may concern
From Matthias Haentjens, Rogier Raas, Pim Rank
Date 29 July 2020
E-mail m.haentjens@law.leidenuniv.nl
Subject Research Programme 2020-2023

Securing the integrity of financial markets in times of crisis

The financial system is arguably one of the most important systems of our modern-day societies. Financial markets are a key element in the financial system and can be seen as the 'engine' that keeps the system running. Despite their unique features, all financial markets have several common characteristics. Importantly, as 'markets', they all facilitate that supply – e.g. in the form of cash or financial instruments – meets demand – e.g. in the form of borrowings. Thus, in short, financial markets achieve that resources are allocated. In contrast to other markets, financial markets concern financial instruments and cash. It is on these financial markets that depositors, investors, companies and governments meet. The meeting of market participants is oftentimes facilitated by financial institutions. Notably, banks are and remain an important category of such financial intermediaries.

Whilst financial markets are critical to the functioning of the financial system, and thus to society, they are also prone to failures – called 'market failures'. These market failures stand in the way of economic efficiency. More dramatically, their dysfunction may cause loss of jobs (for employees), wealth (for investors), tax income (for governments), and ultimately poverty. It is mainly for this reason that financial regulators and supervisors around the world see it as their core task to prevent financial market failures from happening and to keep the 'engine' running as smoothly as possible. From a normative perspective, market failures are often caused by, and lead to injustice. The objective of financial market failure prevention therefore is not solely based on economic considerations, but also takes into account other (policy) objectives. The means through which regulators and supervisors aim to prevent financial market failure are laws and other forms of regulation.

An important category of causes of market failures concerns the violation of the integrity of financial markets. Market integrity is broadly understood here to refer to the smooth functioning, i.e. functioning without disruption of the markets. Prominent and relatively recent examples of integrity breaches are the failure of Banco Espirito Sancto (caused by gross management misconduct), the Madoff investment management funds (caused by a giant ponzi-scheme), LIBOR (caused by fraudulent benchmark setting), the aftermath of the Lehman Brothers insolvency (caused by legal uncertainty of which clients owned what assets), and the giant mis-selling of interest rate derivatives to SMEs in the 2000s. A core task for financial regulators and supervisors is to prevent this type of violations of market integrity.

Especially in an economic or financial crisis, market integrity is under stress but of paramount importance. Now that the world experiences the worst economic downturn since the great depression because of COVID-19, it is an appropriate time to investigate market integrity, and the rules and regulations that aim to secure that integrity. Now more than ever, it could be argued, it is important that financial markets continue to function and facilitate the smooth allocation of resources. Whilst the financial markets themselves do currently not seem to be in a crisis, it is essential that they remain operable efficiently so that capital can be acquired by those in need.

An investigation into market integrity is now also appropriate considering several other, recent developments. For instance, alternatives to traditional bank financing are becoming increasingly more important in the European Union. In that same vein, the European Commission has set up the 'Capital Markets Union' (CMU), an extensive action plan to mobilize capital to create a more diversified financial system complimenting bank financing and to develop deeper and more integrated financial markets. It also aims to remove any hindrance investors may encounter investing their funds across borders. Additionally, current economic developments such as negative interest rates, are pulling savings away from banks and into financial markets. To ensure the effective functioning of these alternative ways financing, their integrity must be ensured. Investors will only entrust their savings to financial markets if they deem them safe. But what exactly determines the safety or integrity of financial markets and how can it be secured?

With this new research programme, the Hazelhoff Centre for Financial Law intends to engage in the academic debate on the developments described above. It takes an inter- and multidisciplinary, as well as a multi-jurisdictional approach, in which the integrity of financial markets and possible regulation to secure it will be critically analysed.

More specifically, the research programme "Securing the integrity of financial markets in times of crisis" may address the following topics:

1. Market failures re. the misselling of financial instruments such as derivatives (duty of care);
2. Market failures concerning the custody of financial instruments, including crypto-currencies;
3. Market failures re. lending and collateral of financial instruments;
4. Market failures caused by climate change;
5. Market failures caused by market abuse
6. Unauthorised and/or incorrectly executed payment transactions; and
7. The sanctioning of multinationals to address breaches of integrity.

The integrity of financial markets is both specific a topic as it is broad, for it touches upon a wide range of legal rules. In addition, to truly understand the applicable rules and to put them into context, it often requires to look beyond legal perspectives and take into account multiple disciplines. For example, the rules sanctioning fraud are not only based on legal perspectives, but should also be considered from economic, ethical and social perspectives. Moreover, whilst the focus of the programme is the EU and the laws of the EU and EU Member States, but other jurisdictions may also be considered.

The new research programme builds on our previous research programme "Public and Private Regulation of Financial Markets" that ran from 2017-2019. The current research programme is both more specific, and broader that the former one. It is more specific, as it focuses on the specific objective of securing integrity, i.e. securing safe financial markets. On the other hand, it is broader, as takes a policy objective as it starting point, rather than a theoretical or systematic approach.

The Hazelhoff Centre and its researchers intend to cooperate with economists and social scientists of Leiden and other Dutch Universities (mainly Erasmus and Amsterdam). However, the project is not limited to Dutch law. Its scope is extended to supra-national (European) law, as well as foreign legal systems, such as US law. The individual members of the Hazelhoff Centre have an excellent international network to realise this international aspiration, but the Centre is also institutionally placed at the core of the European Banking Institute.

With its theoretical dimension, this project it is connected with the larger Leiden Law School research programme *Coherent Private Law*. Whilst this project *Securing the Integrity of Financial Markets in times of Crisis* investigates how various legal systems should best address the measures to secure the integrity of financial markets, the larger programme *Coherent Private Law* zooms in on the consequences of this for private law.