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Liability of Stock Exchange Authorities and Regulators

THOMAS WERLEN and PHILIP R. WOOD*

I. Introduction

The purpose of this paper is to examine on a comparative basis by reference to the law in a number of illustrative jurisdictions the liability of securities and bank regulators for fault in carrying out their regulatory duties. This will

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be done by examining various background considerations related to regulatory liability, and then conducting an analysis of the regulation of the securities and banking industries in the United States, the United Kingdom, several other EU member states and Switzerland.

Following an explanation of the principal policies behind regulatory liability, we investigate the regulatory structures and liability regimes for the securities and banking sectors in the United States, the United Kingdom, selected EU member states, and Switzerland. We then undertake a discussion of the regulatory structure, presence and scope of regulatory immunity, liability standards, judicial review and case history (as appropriate) in these countries, drawing common themes as well as highlighting certain of the differences between the regulatory regimes, in order to put forth possible trends for the future.

This paper will show that, as a general rule, immunity standards in the United States and the United Kingdom tend to be high, and the use of governmental immunity statutes is widespread. Reliance on specific standards of liability, as well as variants of the governmental immunity doctrine, is more common in other EU member states and in Switzerland. As a result, the fixing of liability on regulators is not easy, due to the existence of such immunisation statutes and liability rules requiring proof of extremely serious misconduct or bad faith by the regulatory authorities, standards which are difficult to meet. The principal result of this is that actions brought by disappointed investors and depositors against national regulators generally have been unsuccessful.

II. Reasons for Growth of Claims Against Regulators

There has recently been a very substantial increase in the number of claims against regulators. There are a number of reasons for this.

(1) *Growth in financial assets*. First, there has been an increase over the past decades in the size and concentration of financial assets, as well as the deinsulation of national boundaries so that events in one part of the world can send shockwaves to financial systems in other countries.

(2) *Formal statutory supervision*. Secondly, supervision is now based on detailed rules and formal obligations in most advanced countries, as opposed to the more informal supervision of a club governed by informal moral suasion which was the main technique, except in the United States[1], up until the 1970s. Now regulation is prescriptive and specific, inviting claims for breach of statutory duty.

1 The United States provides a unique example of the evolution of statutory supervision. The current structure of the banking system in the U. S. today, and the enforcement powers that regulatory authorities have under it, are the consequence of various financial disasters in the country during the 20th century. In particular, the Great Depression of the 1930s and the

(3) *Bank collapses*. Thirdly, banks are the main or even sole source of credit in many countries and there have been a large number of banking collapses throughout the world. Very few countries have not experienced either a systemic or a major collapse of banks since 1975.

The collapse of banking systems can destroy savings, payment systems and ordinary economic life. Banks are particularly vulnerable because they borrow short (deposits) to lend long – a «maturity transformation» or mismatch which results in a liquidity problem if there is a run on the deposits. Loans are difficult to transfer and to value compared with marketable securities, so banks cannot quickly sell assets to meet unusual deposit withdrawals. Hence, banks are vulnerable to loss of confidence and bank runs, with the broader effects of contagion and associated systemic risks. In normal times banks can predict the rate of deposit withdrawals (and maintain sufficient reserves and borrowing lines), but this fails in abnormal conditions.

In addition to the growth in financial assets, formal statutory supervision, and bank collapses, other issues that have contributed to the growth of claims against regulators include problems related to forecasting future events (also known as «prophecy problems»), the interconnectedness of banks (e. g. deposits in interbank markets and payment systems), the practice of «policy lending» in some countries (i. e. government-directed loans and sometimes improper waste of depositors' money by the government), and certain hazards posed by financial conglomerates (e. g. one sector's failure may infect other sectors).

Regardless of the causes of bank failures, there is no doubt that the costs of such failures are huge, and they are often paid for by the depositor or the taxpayer or both. Estimates of the cost of systemic crisis include: China (net losses of 47 % of GDP in 1999), Indonesia (fiscal costs of 55 %, 1997–2003); Japan (fiscal costs of 24 % of GDP, 1991–2002). In other cases the costs were less, but still very significant, e. g. Sweden (recapitalisation costs of 4 % of GDP in 1991); Australia (rescue costs of 2 % of GDP, 1989–1992); United States (in 1984–1991, 1 400 savings and loans institutions and 1 300 banks failed; cleaning up the savings institutions cost $ 180 billion or 3 % of GDP). One the world's largest bank failures was that of Credit Lyonnais in France in 1992–5, with an unofficially estimated price tag of $ 10 billion.[2]

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savings and thrift debacle of the 1980s prompted the government to respond in order to prevent such crises from occurring again. Prior to the Great Depression, regulation of the banking sector in the United States was generally «hands-off» and consultative. This approach was thought by many to have caused the Depression, and subsequently the government shifted away from the earlier dialogue-based supervisory approach. Rather, the government began to employ greater use of formal enforcement actions (such as specific statutory controls, capital regulations and prompt corrective action) and the imposition of sanctions by the various regulatory bodies.

2 Caprio and Klingebiel, «Episodes of systemic and borderline fiscal crises», World Bank, January 2003.

The result of the factors outlined above is that in most countries, there is a dirigiste government regulatory intervention from cradle to grave. This governmental intervention may take a variety of forms, including:

- licensing and officially approving of controllers, managers and business plans;
- monitoring capital adequacy and financial conditions;
- intense involvement in averting collapses (e. g. informal intervention by the authorities in promoting mergers or recapitalisation);
- providing public funds;
- funding management companies for non-performing loans, and nationalising or guaranteeing the banking system; and
- direct intervention sanctioned by law (e. g. a forced change of management, closing down a bank, initiating insolvency proceedings, or administering an insolvent bank via a government agency).[3]

Given that the state assumes the role of custodian, in the above scenarios it is natural that investors suffering loss from the subject bank failure(s) should seek recourse from the custodian.

III. Policies of Regulation

A given regime may seek to employ any of a variety of policies as part of its regulatory agenda. *Inter alia,* the policies of regulation include:

- protection against systemic risk (i. e. protection against the so-called «domino effect» or «ripple bankruptcies» resulting from the failure of one institution which is therefore unable to pay others, resulting in the bankruptcy of the latter institutions as well);
- protection against the insolvency of banks, securities dealers and insurance companies;
- protection of the public and unsophisticated investors against defective or unsuitable investments;
- the maintenance of a level playing field, so that banks should have the same regulatory costs as those in other countries in order to ensure that lesser regulation in one country does not give that country's banks an unfair competitive advantage at the expense of the stability of the system as a whole;

3 An example of a government's direct intervention sanctioned by law is found in the Federal Deposit Insurance Corporation *(FDIC)* in the U. S. In the U. S., the FDIC must intervene by graduated steps if capital falls to prescribed thresholds. This compulsory intervention avoids political objections as well as forestalling any liability problems – though the FDIC is significantly immunised by statute.

- the prevention of crime;
- the maintenance of public confidence in financial markets (i. e. the financial markets' reputation for integrity and safety, in order to encourage investors to invest more and to accumulate capital, which in turn can be used for economic growth); and
- the maintenance of competition in the financial markets by allowing relatively low barriers of entry.

Specific economic arguments for the system of more intrusive governmental regulation include the propositions that the cost of delegating the task to a regulator is less than the cost to investors[4] and that effective regulation reduces the costs to the taxpayer overall. On the other hand, the possible defects of regulation may include moral hazard[5], overly rigid and/or prescriptive regulation, the high costs associated with regulation, protectionist tendencies, and the inherently limited efficiency of regulation. Given the many pros and cons of any given regulatory system, there has developed a sort of tug-of-war between regulatory capitalism (the command-and-control paternalistic state) and the free markets (the market is more efficient at making decisions than is the government). The liability of regulators is part of this battle, as the regulators are part and parcel of the state itself, yet seek to maintain free markets for all.

IV. Methods of Regulation

Various methods of regulation define generally the areas in which state liability may be incurred.[6] As is evident from the discussion below, the scope of regulatory activity is broad and comprehensive. Therefore, it is not surprising that the question of liability for carrying out regulatory duties often arises. The principal methods of regulation in use today may be summarised as follows:

Official authorisation: Most commercial countries require official authorisation in order to engage in banking (accepting deposits from the public to on-lend, or making loans), the securities business (dealing in investments, arranging deals or custodianship, or advising on investments or operating col-

4 Under this hypothesis, the large costs of evaluating and monitoring banks are impractical for most investors to undertake. The result of not doing so is information asymmetry, with banks having superior information than investors.

5 In the present context, moral hazard means over-reliance on regulators by investors, which in turn tends to discourage public prudence, as investors come to expect that the regulators will prevent insolvencies and bail them out in case of crisis.

6 Note that this paper does not address macro-economic regulation (e. g., interest rate controls and control of the money supply). These matters usually are controlled by a central bank.

lective investment schemes), the insurance business, related activities (e. g. participation on stock exchanges and other organised markets), and clearing and settlement systems. The usual requirements are that authorisation is granted on the basis of the competence of management, honesty, capital and financial resources and operation of resources and system. The regulator usually must approve controllers, large shareholder participants and senior managers.

Financial supervision: Also called prudential supervision, this includes regulation on such matters as capital adequacy requirements under the Basel principals, limits on large exposures, and liquidity.

Financial promotion: This method of regulation focuses on the financial promotion of investments, such as prospectuses for new issues of securities. In most jurisdictions, the offering of securities to the public requires the issuer to file a public prospectus with the regulatory authority (typically a securities and exchange commission, a company's registry, or a banking commissioner) prior to the offer. The prospectus must contain prescribed information and must disclose everything that is material to a potential investor. Issuing a prospectus generally attracts stricter liabilities for errors, may entail personal liability for persons other than the issuer (such as directors and underwriters), and often has to be screened by the regulator. It is the regulatory screening which attracts the risk. However, in most advanced countries the wholesale markets (where issues are made to sophisticated investors) are exempt from this regulatory scrutiny.

Regulation of the conduct of business: This type of regulation essentially enhances the general duties of agents and fiduciaries by, *inter alia*, avoiding conflicts of interest, mandating duties of skill, care, diligence and confidentiality by dealers to clients, prohibiting profits from the use of client information or abuse of the fiduciary relationship.

Regulation of market fraud: Regulation also seeks to aim to control various types of market fraud, notably insider dealing, market manipulation and money-laundering. These offences are often criminalised. In addition, in many countries market abuse is also an administrative offence and is prosecuted accordingly.

V. Typical Claims Against Regulated Entities & Regulatory Enforcement Powers

Investors typically bring a claim against a regulated entity when the entity has become insolvent; bringing charges against the regulator thereby provides another source from which compensation may be made. Investors may bring a claim directly against the regulator for allegedly failing to execute his duties

in a timely and appropriate manner. For example, the claim may allege that the regulator improperly authorised the relevant entity, that it failed to warn and/or take other action against such entity early enough when problems came to light, that it failed to discover a problem by the firm (such as fraud) or to conduct in-depth investigations at the appropriate time, or that it should have reacted more quickly to market rumours or complaints by market participants, clients, auditors and other whistleblowers.

For their part, regulators generally have extremely wide powers of enforcement. These powers may include graduated restrictions on business, forced changes of management, the prevention of further business, revoking the authorisation and closing down the regulated entity completely, carrying out investigations, and the right to call for information and to make site visits. Given this broad scope of enforcement powers, when claims are brought against the regulators themselves, such claim is generally that the regulator should have exercised its powers when it was first alerted of the problem in question in order to forestall further losses.

In addition to the traditional forms of regulator liability, there is also the possibility of regulator liability to the regulated entities themselves (or their shareholders or competitors).

VI. Regulatory Practices

The regulatory practices regarding the supervision of the financial sector and securities authorities varies significantly among countries. For example, the regulatory authorities in the United States are highly fragmented, with regulatory powers spread between several entities, while the U. K. and Germany both have one regulator only (the Financial Services Authority, *FSA*, and the Federal Authority for Financial Services Supervision, *BAFin*, respectively). In many countries, the central bank is directly responsible for the supervision of banks. Securities firms and securities markets may be regulated by a governmental entity (such as the Securities and Exchange Commission, *SEC*, in the United States) or by a self-regulatory organisation *(SRO)*.

VII. Policies Regarding the Liability of Regulators

As an initial matter, it is worthwhile to examine the underlying policies that inform whether or not regulators should be held liable for defective and/or inferior supervision of subject entities. There are a variety of reasons why liability should, or should not, attach to regulators in the financial sector.

The following policies generally support the attachment of liability to regulators:

- a robust and efficient legal regime needs to maintain the supremacy of law, which requires that abusive exercise of power by the public authorities is limited and controlled by the rule of law;
- the accountability and discipline of regulators is enhanced by the risk of liability, and in particular the financial system's foundation and credibility is necessarily maintained by effective supervision; and
- the ordinary members of the public are not able to assess meaningfully the credit strength of complex banks, securities markets, and other regulated firms, and therefore it is necessary to delegate such monitoring tasks to a dedicated agency.

In contrast to the above, the policies below argue against imposing liability on regulators:

- regulatory liability has the inappropriate result that the state becomes the guarantor of regulated firms, including banks and securities firms (in other words, regulation should be a secondary check or monitoring device, and not a front-line guarantee by the regulatory authority and/or the state);
- the situation creates moral hazard (i. e. investors would rely on the regulator instead of making their own credit assessment of the entity or investment in question);
- the threat of liability inhibits the regulator's ability to make resolute decisions and to exercise proper judgment. As a result of this constant threat, the regulatory process becomes lawyer-driven and defensive, with potentially overly harsh ramifications for the regulated entities themselves;
- liability opens the floodgates of litigation;
- many of the decisions taken by regulators are non-justiciable (i. e. not susceptible to judicial standard-setting). In this regard, courts are neither equipped to make, nor charged with making, discretionary policy decisions, and they should not second-guess the legitimate decision-making of the regulators;
- liability is too easily fixed on the basis of hindsight, which tends to ignore the incomplete factual picture at the time the investment and/or regulatory decision was made;
- regulatory liability provides a «deep pocket» for compensation, while the real causes for loss may be other circumstances (e. g. poor market conditions or poor management), rather than a regulatory failure;
- regulators have limited resources, and they cannot conceivably monitor every decision in every securities firm or bank; and
- regulators are often caught in situations where investors will be aggrieved regardless of the decision taken by the regulatory authority, and they must

take into account not only the situation of the particular financial entity, but also the effect of their decision upon the financial system as a whole and public confidence generally.

At present, the policies against imposing liability on financial regulators are in general the most compelling in most modern societies. This is subject to an exception for particularly egregious conduct by regulators. In short, some risk of regulatory liability, however small, is necessary to ensure discipline and accountability of regulators in the financial sector.

VIII. Regulatory Liability Analysis: Common Themes Among Countries

To further the regulatory policies as outlined above, the same five conditions required for the attachment of regulatory liability are found in most of the countries analysed in this paper. These conditions are those traditionally associated with a tort and include (i) an act *(actus reus)*, (ii) a requisite state of mind (*mens rea*, i. e. standard of liability), (iii) damages and (iv) causation. In addition, the unavailability of the defense of governmental immunity is often key to attach liability as otherwise no liability may arise notwithstanding the presence of all the conditions set forth above. In other words, even if the regulator may be liable under traditional principles of tort law, the presence of an immunity statute nevertheless may immunise the regulator from liability. For the analysis of regulatory liability in this paper, the factors of governmental immunity and standards of liability are the most salient.

1. Governmental Immunity

Broadly speaking, the doctrine of governmental immunity provides that state actors are immune from legal suit being brought against them for actions undertaken in the course, and within the scope, of their state function and duties, unless such immunity has been waived.[7] In general, most states analysed for this paper have governmental immunity provisions with relatively high standards of liability (see below) and/or which prohibit immunity from attaching when the state actor is acting within prescribed discretionary limits.

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7 In most cases, the regulatory authority (or authorities) of securities firms and other financial institutions has a separate legal personality from the government. This legal independence serves both to insulate the government from reputational flaws, and also technically to shield the government from liability suits. An exception in this regard is France, where the Banking Commission is a department of state and does not have separate legal personality. The case of France is discussed in section XI of this paper.

One form of governmental immunity is commonly called the «proximity principle». This principle, which is found in certain EU countries (e. g. the U. K. and the Netherlands), provides that liability will attach only if the regulator's duty of protection of the «public interest» at large (e. g. protection of the financial system as a whole) has been violated. In other words, if there is no regulatory duty of authorities towards individual investors, these investors cannot attach regulatory liability.

It should be noted that, within the EU and other federal states, the result of governmental immunity and/or proximity principle analysis may be overridden in certain narrow circumstances by EU law (e. g. the Francovich doctrine discussed below) or other central government law.

2. *Standards of Liability: Negligence, Gross Negligence and Bad Faith*

In circumstances in which the regulatory authorities owe a duty of care to individual investors, it is necessary to determine the standard of liability to be applied. Mere negligence (an act that would not be committed by a «normal» supervisor in the same circumstances), gross negligence (an act that even a non-professional (i. e. a non-supervisor) would not have committed), and bad faith are the most common standards used. These standards are present to varying degrees in each of the jurisdictions considered in this paper (see Sections IX.–XII. below).

IX. Liability of Banking and Securities Regulators in the United States

1. *Regulatory Structure*

The structure of banking regulation in the *United States* is relatively unique in the world, in that there are a number of regulatory agencies that are responsible for safeguarding the country's banking system as a whole.[8] The primary federal banking regulators are the Federal Reserve Board *(FRB)*, the Federal Depository Insurance Corporation *(FDIC)*, the Office of the Comptroller of

8 National banking rules are found in Title 12 of the United States Code *(U. S. C.)* and Title 12 of the Code of Federal Regulations. In addition to the Federal Reserve Act (12 U. S. C.; ch. 6, 38 Stat. 251, December 23, 1913) which established the FRB, the principal laws affecting the regulation of banking today are the Federal Deposit Insurance Act of 1950 *(FDIA)*, the Financial Institutions Reform Recovery and Enforcement Act of 1989 *(FIRREA)*, the Federal Deposit Insurance Corporation Improvement Act of 1991 *(FDICIA)*, and the Financial Modernization Act of 1999 *(FMA)*, also known as the Gramm-Leach Bliley Act. The purpose of the FMA is to protect consumers' personal information held by financial institutions.

the Currency *(OCC)*, and the Office of Thrift Supervision *(OTS)*. Each has its own area of responsibility. In addition, individual state agencies share certain supervisory responsibilities. Despite the complex and somewhat «balkanised» nature of the institutional structure of banking regulation in the United States, as evidenced by the numerous responsible agencies, the legal structure for the enforcement of regulatory rules affecting banking activities is somewhat more centralised.

In terms of securities regulation, the SEC is the primary federal agency in the U. S. responsible for the regulation of securities. The SEC is also responsible for regulating various SROs such as the New York Stock Exchange *(NYSE)* and the National Association of Securities Dealers *(NASD)*. An SRO is a member organisation that creates and enforces rules for its members based on the federal securities laws; in other words, an SRO is required to carry out a self-regulatory function as a condition of its status.[9] In the context of securities regulation and liability, the SEC regulates the securities exchanges, and the exchanges in turn regulate day-to-day securities transactions and related activities. Depending on the circumstances, technically liability may rest with either the SRO or the SEC, although the doctrine of governmental (and quasi-governmental) immunity usually functions to bar its attachment to either entity.

The substantive liability issues that result from the relationship between the SEC (as an administrative agency) and the NYSE (as an SRO) are governed by Section 19 of the Securities and Exchange Act of 1934 *(Exchange Act)* (Registration, Responsibilities, and Oversight of Self-Regulatory Organisations): 15 U. S. C s78s. Section 19 provides for, *inter alia*, review and administrative disciplinary action to be taken by the SEC. To this end, SEC rulings and case law indicate that formal disciplinary proceedings by the exchange itself are not a prerequisite for SEC review of actions taken by the exchange; the decision of the SEC is, however, directly reviewable in a court of appeals: 15 U. S. C s78y(a)(1). Judicial review of SEC actions is also subject to the limitations set forth in section 701(a) of the APA. As legislative history indicates that Congress intended to endow the SEC with broad powers to conduct investigations in order to fulfil its statutory mandate to protect the public interest through enforcement of the federal securities laws, one may expect to find liability on behalf of the SEC only in exceptional cases: *See e. g. Treats International Enterprises v. SEC*, 828 F. Supp. 16 (1993), *Adonnino v. SEC*, 111 Fed. Appx. 46 (2004).

9 Securities exchange SROs are subject to SEC oversight pursuant to 15 U. S. C. §§ 78c, 78f, 78s.

2. *Governmental Immunity*

Under the doctrine of governmental immunity, the government of the United States and its agencies generally are immune from the jurisdiction of the domestic courts, unless the immunity has been waived. Therefore, in the absence of such a waiver, the FRB, FDIC, OCC and OTS are not subject to lawsuits regarding claims arising under commercial contracts. The doctrine of governmental immunity applies equally to the SEC, given the latter's federal agency status, and also to the NYSE as an SRO.

Under the Federal Tort Claims Act *(FTCA)*, the United States has waived immunity insofar as tort claims against it and its agencies are concerned. However, this immunity is subject to a key «discretionary function» exception. Under the discretionary function exception, the United States and its agencies are immune from suits in respect of:

> «... any claim based upon an act or omission of an employee of the government, exercising due care, in the execution of a statute or regulation ... or based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the government, whether or not the discretion involved be abused.»

Therefore, in considering whether the discretionary function exception applies, a court must determine (i) whether the government or agency conduct involved an element of judgement or choice, and (ii) whether the decision was essentially a matter of policy. If both of these issues are answered affirmatively, then the discretionary exception will apply to grant immunity to the subject matters in question. If not, however, then an individual may inform the federal regulator of alleged violations of the law so that the agency may take appropriate action under the circumstances. This latter scenario would be the case, for example, if an individual were to discover irregular banking practices or fraud on behalf of banking directors.

Under the *quasi-governmental immunity doctrine*, private actors (such as the NYSE) are protected if their actions are «fairly attributable» to the state. In order to qualify as state action, there must be a sufficiently close nexus between the state and the challenged private entity action and subsequent federal agency proceeding, that the agency's behaviour may be fairly attributable to the state. Although immunity is to be decided on a case-by-case basis, courts «have not hesitated to extend the doctrine of absolute immunity to private entities engaged in quasi-public adjudicatory and prosecutorial duties»: *Barbara v. NYSE*, 99 F.3d 49 (1996) (the NYSE's suspension of a floor clerk following the filing of disciplinary charges by the SEC against the clerk, pending a formal hearing, was upheld, as the NYSE's actions were conducted in compliance with both the Exchange Act and the NYSE's own rules and regulations).

3. *Standards of Liability*

The standards of liability in the United States are similar to those employed in other countries analysed in this paper. However, given the strength of the governmental immunity doctrine and its consistent enforcement by the courts, standards of liability factor in to regulatory liability analysis to a significantly lesser degree than elsewhere, a fact which is also reflected in the limited number of cases brought on this basis.

4. *Case History*

Given the broad scope of governmental immunity and the limited bounds of judicial review described above, it is not surprising to find a relative paucity of case law which delineates the scope of banking and securities regulators' liability. In regards to liability of banking regulators, one case that received widespread attention and led to a spate of litigation is *United States v. Winstar*, 518 U. S. 839 (1996). In this case, federal banking agencies had made contractual assurances to financially sound thrifts to take over the assets and liabilities of certain failing thrift institutions; these assurances included favourable accounting treatment, which would help the acquiring banks to meet their regulatory capital requirements. Subsequently FIRREA was enacted, whose requirements (including regulatory capital requirements) resulted in the failure of two thrifts and the near-failure of a third. The Supreme Court held that sovereign immunity did not apply to the federal banking regulators in this case, as they had incurred *contractual* liability and were thereby obliged to indemnify the acquiring thrifts for damages incurred as a result of their obligations under FIRREA.

In regards to liability of securities regulators, under the Exchange Act substantial authority is delegated to the securities exchanges themselves to regulate their own conduct and the conduct of their members. The Exchange Act mandates that the exchanges comply with and enforce both the Exchange Act rules and the exchange's own rules. If misconduct is alleged, and such misconduct involves the discharge of the exchange's regulatory duties, then the doctrine of quasi-immunity applies to bar the suit. *See e. g. MFS Securities Corp. v. SEC*, 380 F. 3d 611 (2004) (revocation of securities firm's NYSE membership by the NYSE was within the scope of the NYSE's duties delegated by the SEC, and quasi governmental immunity applied to bar suit), *D'Alessio v. NYSE*, 258 F. 3d 93 (2001) (NYSE's regulation of broker's stock-flipping practice upheld, as within the scope of its duties delegated by the SEC), and *D'Alessio v. SEC*, 380 F.3d 112 (2004) (no bias exists as between the SEC and NYSE regarding the execution of their regulatory func-

tions). In other words, «[t]he NYSE, as an SRO, stands in the shoes of the SEC in interpreting the securities laws for its members and in monitoring compliance with those laws. It follows that the NYSE should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it under the SEC's broad oversight authority»: *D'Alessio v. NYSE*, 258 F.3d 93 (2001). See also *Barbara v. NYSE*, 99 F.3d 49 (1996) («absolute immunity is particularly appropriate in the unique context of the self-regulation of the national securities exchanges», where the NYSE «performs a variety of regulatory functions that would, in other circumstances, be performed by [the SEC]»). In summary, the case history presented here shows the strength of the governmental immunity doctrine in the United States. At the same time, it shows the limited relevance of standards of liability as indicators of when regulatory liability might attach in the United States.

X. Liability of Banking and Securities Regulators in the United Kingdom

1. Regulatory Structure

In contrast to the United States, the banking and securities sectors in the *United Kingdom* are subject to a more direct, consolidated and integrated regulatory scheme. The U. K. regime is also somewhat more informal than that of the U. S., with less reliance upon statutory provisions and more significant agency discretion.

For purposes of this paper, the most significant changes to the U. K. banking and securities sectors occurred with the passage of the Financial Services Act of 1986, the Bank of England Act of 1998, and the Financial Services and Markets Act of 2000 *(FSMA)*. Under the Financial Services Act of 1986, the Bank of England technically was the principal regulator for both banks and securities firms and markets; however, in practice most regulatory powers were delegated to the Securities and Investment Board *(SIB)*. The style of regulation established under the Financial Services Act was described as «self-regulation within a statutory framework».[10] However, during the 1980s and 1990s, this structure led to fragmented regulation of the securities system, which was further undermined by financial scandals (such as the Maxwell af-

10 The SIB was a private company limited by guarantee and financed by a levy on market participants. The SIB set the overall regulatory framework but did not itself act as the direct regulator of most investment firms. Direct regulators were mostly second-tier regulators, including most importantly several SROs. Among these SROs were the Securities and Futures Authority *(SFA)*, the Investment Managers' Regulatory Organization *(IMRO)*, and the Personal Investment Authority *(PIA)*. In turn, the SROs were funded, and partly managed, by investment firms.

fair, the BCCI collapse and the Barings collapse). Public confidence in the self-regulatory system began to wane, and there was a growing dissatisfaction about gaps between the responsibilities of the different SROs.

The entry into power of the Labour Government in 1997 initiated a series of changes to the U. K. regulatory scheme. These changes sought to reflect the changing nature of the financial markets, where the old distinctions between banks, securities firms and other financial institutions had become increasingly blurred. Key among these reforms were the following:

- the Bank of England Act of 1998 transferred responsibility for regulating depository institutions from the Bank of England to the SIB;
- the SIB was renamed as the Financial Services Authority *(FSA)*, and most of the existing regulatory agencies were collapsed (on an ad hoc basis) into this single regulatory agency; and
- the FSMA subsequently provided the legislative framework for the new single regulatory regime.[11]

Since 2000, the FSA has been charged with the regulation of banking, securities and insurance firms operating in the U. K. It also carries out the functions of the U. K. Listing Authority. It is a private company, independent from the government, limited by guarantee and funded entirely by industry levy. Under the FSMA, the FSA must make annual reports to the HM Treasury; and as a private company, it is subject to company legislation regarding annual reports and accounting. HM Treasury appoints the board of the FSA; in addition, it can order independent reviews of its financial affairs and can commission independent inquiries into regulatory failures. HM Treasury cannot, however, directly intervene in the affairs of the FSA (save in limited circumstances relating to competition policy). The fact that the FSA must give effect to all applicable EU laws may act as a further constraint on the FSA's rule-making discretion.

In terms of judicial review in the U. K., the Financial Services and Markets Tribunal *(FSMT)* was established under the FSMA. It is an independent review body which hears references from firms and individuals who wish to challenge the FSA's decisions and supervisory notices. The FSMT panel is appointed by the Lord Chancellor's Department. FSMT decisions may be made by majority, and appeals to the Court of Appeal may be made. To date, the FSMT has not yet heard a case through to completion; this makes it difficult to assess its efficacy. However, it is envisaged that over time the FSMT will play a key role in relation to FSA accountability.

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11 Details for the FSMA framework are found in secondary legislation, statutory instruments made by the HM Treasury, and rules promulgated by the FSA.

2. *Governmental Immunity*

As in the United States, the doctrine of governmental immunity exists in the U. K. In addition to statutory provisions (see below), regulators have traditionally been well protected by the common law in the U. K.[12] Prior to the FSMA, the Bank of England generally had immunity as regulator. Under the FSMA, statutory immunity provisions for financial regulators provide that «neither the FSA nor any member, officer or employee of the FSA is to incur any liability in damages for any act or omission in the discharge or purported discharge of the organisation's functions»[13], unless the claimant can demonstrate that the relevant act or omission was taken in bad faith.

In addition, plaintiffs may allege the common law tort of «misfeasance in public office» in certain circumstances. Misfeasance may be defined as the exercise of power by a public official in bad faith that causes loss to the claimant. Attachment of liability requires that the public officer act with (i) targeted (i. e. intentional) malice, or (ii) untargeted malice coupled with the knowledge of such officer that he exceeds his powers and that his act would probably injure the claimant. Generally, case history indicates that an action in neg-

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12 *See, e. g., X (Minors) v. Bedfordshire County Council*, 2 AC 633 (1995) (a public authority cannot be liable in tort merely because it has acted in excess of its powers). The issue of whether a regulator may be liable to the institutions it regulates, as well as to such institutions' shareholders and competitors, has been considered by courts in the U. K. Typical cases of this type have involved the improper refusal of a license, overly harsh action in closing down a regulated institution (e. g., closing down a bank prematurely), and violation of the regulator's duties of confidentiality. Cases involving the Bank of England and the regulation of financial institutions in particular include the following:

- The Bank of England, when acting in its regulatory capacity, is dissatisfied with the management of a regulated institution, and therefore imposes limits on such institution and demands a change of management, the result of which adversely affects the interests of the prior management, the prior management's allegations of fraud against the Bank of England are dismissed, if it can be shown that the Bank of England exercised its powers in good faith with a view to protecting the interests of investors and depositors. *Hall v. Bank of England* [1995] 2 WLR 247.
- The Bank of England is not responsible for the closure of a bank subsidiary, whose closure was due to bad management rather than improper regulation. Further, the Bank of England, as regulator, has no liability to the bank subsidiary's parent company, because the parent had ample means to monitor the management of its subsidiaries. *Minories Finance Ltd v Arthur Young, Johnson Matthey plc v Arthur Young* [1989] 2 All ER 105. Note that in this case the court applied the proximity principle, and applied it in a more stringent manner than in previous cases.
- The claim of a regulated firm that alleged the wrongful disclosure of information by the regulator did not stand, because the firm was unable to prove the bad faith necessary to deprive the regulator of its statutory immunity. *Melton Medes v Securities and Investment Board* [1995] 2 WLR 247.

13 Sch. 1, para. 19 of the FSMA.

ligence (i. e. as opposed to gross negligence) cannot be brought against a public entity insofar as the action relates to policy (rather than operational) matters or involves the exercise of discretion or a quasi-judicial function. Incidentally, although the tort of public misfeasance is well established in the U. K.[14], it had been little used prior to the BCCI case.

In short, in the U. K. the FSA is granted immunity unless its actions constitute (i) bad faith or (ii) the common law tort of misfeasance in public office, whose knowledge requirement is similar to the condition of bad faith under statutory law. In addition, as set out in Section XII.1. below, liability may attach pursuant to EU law as it applies in the U. K.[15]

3. *Standards of Liability*

In the United Kingdom, liability cases in negligence have generally not been successful. They have not imposed any duty of care upon regulators in respect of economic loss, nor with regard to negligent supervision of financial institutions. However, despite this common law approach favourable to regulators, as the common law develops and tort liability expands, it is possible that the role of statutory immunity may become more important.

4. *Case History*

There is relatively extensive case law in the United Kingdom involving governmental immunity (in particular the proximity principle). However, there is limited case law covering standards of liability in this context for the reasons set out above.

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14 In England, the tort of misfeasance in public office is traceable back to *Ashby v White* (1703), Smith's Leading Cases (13th edn.) 253, where a returning officer deliberately refused to register the right to vote of a lawful voter.

15 There is a final means by which liability may attach based on breach of the European Convention on Human Rights *(ECHR)*, as incorporated by the Human Rights Act of 1988. In regards to the ECHR, the FSMA provides that the standard governmental immunity provisions may not apply if the FSA acted in contravention of section 6(1) of the Human Rights Act of 1988, which renders it unlawful for a public authority to act in a manner incompatible with certain rights established by the ECHR, including the right to a fair and public hearing. The practical effect of this in the U. K. is that blanket immunity (i. e., exoneration of a regulator solely on the basis of its statutory immunity) is effectively a bar to a claim, because the court cannot consider meritorious cases and thus is in contravention of the ECHR. However, it is not a contravention of the ECHR if the court in fact reviews the case, even if it concludes that there is no duty of care under the circumstances.

In what is perhaps the best-known recent governmental immunity case, *Three Rivers District Council v Bank of England* (No. 3) [2000] 2 WLR 1220, HL, BCCI, a large bank incorporated in Luxembourg but having its principal office in London, collapsed as a result of fraud and gross mismanagement. Depositors alleged that the Bank of England should not have granted a licence to the bank in view of the lack of competence and integrity of the management and should in any way event have revoked the licence much earlier than they did. The then regulatory statute the Banking Act 1979 immunised the Bank of England and its officers in the performance of their official functions unless they acted in bad faith. The depositors brought an action and the House of Lords was requested to strike out the claim on the basis that it had no possibility of success. It was held that the case could go to trial, and the depositors would have to show bad faith. On 2 November 2005 the lawsuit against the Bank of England was discontinued, based on the High Court's ruling that it was no longer in the best interests of the creditors for the litigation to continue.

In terms of the proximity principle, in *Yuen-Ken-Yen v A-G for Hong Kong* [1988] AC 175, PC, a financial company in Hong Kong failed and depositors alleged that the company should not have been licensed and the licence should have been revoked earlier. The Privy Council held on appeal from Hong Kong that the regulator had no liability because the regulator had no duty to depositors individually (i. e. no proximity), but had only had broad discretions in the general public interest. Licensing was not a seal of approval by the regulator. In another appeal to the English Privy Council from the Isle of Man, *Davis v Radcliffe* [1990] 1 WLR 821, PC, a depositor sued the Isle of Man regulator for breach of duty in supervising a failed savings bank. The Privy Council again held that the regulator was not liable, on the basis that the duties of the regulator were owed to the public generally and not particular depositors. In addition, the default was caused by the saving bank and the regulators only had a secondary degree of control.

Two other common law cases are worthy of note in regards to the proximity principle. First, in the Canadian case of *Cooper v Hobart*, 2001 SCC 79, a mortgage corporation raised funds from investors to make real estate mortgage loans. The company collapsed. The depositors alleged that the funds had not been properly used for making real estate loans, that the regulator was aware of the serious irregularity and that it should have promptly acted to cut losses and to reduce the investors at risk. The Canadian court held that the regulator had no duty of care because the duties were owed to the public generally and not to particular investors (the proximity test). Furthermore, the relevant legislation exempted the regulator except in the case of bad faith. The court held that it could not substitute its own judgment on matters of government policy; the regulatory functions were quasi-judicial and therefore not

subject to additional scrutiny by the court. Finally, the court held on policy grounds that regulatory liability would lead to disproportionate liability (the so-called «floodgates» argument) (see also *Edwards v Law Society of Upper Canada*, 2001 SCC 80). Second, in the New Zealand case of *Fleming v Securities Commission* [1995] 2 NZLR 514, the regulator was responsible for supervising offering circulars advertised in newspapers. An investor suffered loss from an erroneous circular. The court held that (i) the regulator was not liable because the regulator owed no duty of care to private investors, and (ii) the statute protected the regulator if it acted with reasonable care, which it had in this case.

XI. Liability of Banking and Securities Regulators in Other EU Countries

1. Regulatory Structure

At a basic level, the regulatory structures found in EU member states are characterised by diversity. This fact makes general discussion of them relatively difficult for the purposes of this paper. Therefore, this section focuses less on those countries' regulatory structures, and more on the various laws and standards applicable to liability analysis within the EU. For example, some states have no specific liability statutes, while other states provide for statutory regulatory liability subject to certain thresholds (typically, gross negligence or bad faith standards); some states mandate regulatory immunity by statute, while in others limitations on regulatory liability are derived from general tort law principles. In this regard, one may consider that the issue in an EU perspective is still a work in progress, on both domestic and supra-national levels.

2. Governmental Immunity

Within the EU, governmental immunisation statutes are common; in part, these statutes are a result of large recent claims against regulators. Moreover, the proximity principle applies in several EU member states.

The degree and scope of statutory immunity provided for the regulators of the banking and securities sector varies between EU member states. In *Germany*, section 839 of the BGB (Bürgerliches Gesetzbuch) provides that public servants can be held personally liable for damages for breach of a profes-

sional duty owed to third parties[16]. However, section 4 para. 4 of the German Financial Services Supervision Act *(Finanzdienstleistungsaufsichtsgesetz, FinDAG)*[17] stipulates that the BaFin fulfils its tasks and exercises its capacities solely in the interest of the public *(öffentliches Interesse)*, excluding any duty of care owed by the banking supervisor to individual depositors or other (indirectly) damaged third parties and thereby overriding the BGB section 839. Consequently, the German regulators are immunised to a substantial degree by this proximity principle *(Unmittelbarkeitsgrundsatz)*.

Article 20 of the *Luxembourg* Law of 23 December 1998 provides that the Commission de Surveillance du Secteur Financier *(CSSF)* serves the public interest (i. e. the proximity principle) and not individual interests and is liable only for gross negligence.

In *Belgium*, Article 68 of the Banking and Finance Commission Law of 2 August 2002 also states that the *BFC's* regulatory function is in the general interest only and that the regulator is liable only for fraud and gross negligence.

In *Ireland*, the central bank is immunised except for actions taken in bad faith, pursuant to Article 25A of the Central Banking Act.

In *France* there are no statutory provisions regarding supervisory liability; rather, the concept has been developed through case law. Moreover, the proximity principle does not apply in France. France is also characterised by the fact that, in contrast to other EU jurisdictions, liability under French law rests directly with the French state, as the regulatory entities do not have independent legal personality.

Finally, in *Spain* the Bank of Spain Act of 1998 provides that the Spanish central bank is subject to standards of liability as set out in the *Codigo Civil* (civil code), except when exercising the administrative authority conferred on it by law.

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16 NB. Article 34 of the German Constitution *(Grundgesetz)* provides that a public servant's personal liability arising pursuant to section 839 of the German Civil Code is automatically assumed by the Federal Republic of Germany (or other authority on behalf of which the relevant public servant was acting when breaching his/her professional duties). Therefore, the liability of the Federal Republic of Germany or BaFin would, if applicable, arise under section 839 of the German Civil Code in conjunction with. Article 34 of the German Constitution *(Grundgesetz)*.

17 The relevant provision was re-located to the FinDAG in 2002. Previously, it was incorporated in section 6 para. 3 (until 1997) and section 6 para. 4 (from 1997 to 2002) of the German Banking Act (*Kreditwesengesetz*, KWG).

3. *Standards of Liability*

While governmental immunity and the proximity principle are important in the determination of regulatory liability in some countries, in other countries – such as France and Spain – standards of liability play a greater role in such determination. As a general rule, the very high liability standards shown by most courts within the EU are an effective immunisation of regulators.

4. *Case History*

Given that both governmental immunity and standards of liability may vary between countries, comparative analysis of the case history in several EU countries is a useful means by which to examine their scope and application within the EU. The existence of the governmental immunity doctrine as manifest in the proximity principle was established in *Germany* in 1979 in two principal cases, the *Wetterstein* case[18] and the *Herstatt* case[19], and the events that occurred thereafter. In both *Wetterstein* and *Herstatt*, the German Supreme Court determined that, contrary to previous case law and the opinion of the majority of legal writers, the German Banking Act of 1961 was intended to protect individual bank depositors who therefore had a right of action against regulators. In *Wetterstein*, the regulator knew of the fact that a company had issued securities which only an authorised bank was legally able to issue; and in *Herstatt*, the regulators were charged with defective supervision of a (subsequently failed) bank. Subsequent to these cases in 1984, the German legislator passed an amendment to the German Banking Act, which provided for the immunisation of the banking regulator, by introducing section 6 para. 3 of the German Banking Act.

In terms of standards of liability within the EU, *France*, *Luxembourg* and *Belgium* formally recognise a duty of care to investors and depositors, but each country appears to adopt the lesser standard of gross negligence (as opposed to bad faith). In France there have been a large number of cases brought alleging regulatory liability, but very few have succeeded.[20] It appears that the French courts have only twice imposed liability on regulators, once in 1964 and a second time in 2001 in the *Kechichian* case.[21] In *Kechichian*, which in-

18 Wetterstein BGHZ, 74, 144 at 147 (Feb. 15, 1979), NJW 1979, p. 1354.

19 Herstatt BGHZ, 75, 120 at 122 (July 13, 1979), NJW 1979, p. 1879.

20 For example, apparently there were 60 cases brought in relation to the collapse of BCCI, and 80 cases brought in relation to the collapse of United Banking Corporation.

21 Kechichian Juris-Classeur Periodique 2002, edition Generale II, No. 10 042, Conseil d'Etat, 30 Nov. 2001 (No. 219, 562).

volved the collapse of United Banking Corporation, the court held that the regulator was liable only in the case of gross negligence, not normal negligence. Normal negligence had been upheld as a basis of liability in one of the cases on the BCCI collapse, however.[22] Nevertheless the regulator was held to be liable in *Kechichian* on the basis that it had been grossly negligent in its supervision and actions regarding the bank.[23] The liability of the regulator was capped at 10% of the lost deposits, however, because the primary cause of the losses was determined to be the fraudulent actions of the bank.

In summary, in Germany a gross negligence standard of liability applies but is subject to the proximity principle; in practice, this results in governmental immunity the majority of the time. In Luxembourg and Belgium, both the bad faith standard and the gross negligence standards apply. Finally, in France both gross negligence and normal negligence standards may apply depending on the circumstances.

XII. Liability of Banking and Securities Regulators in Switzerland

1. Regulatory Structure

In *Switzerland*, the banking and securities sector is regulated by several federal laws, including the Federal Act on Banks and Savings Institutions as amended on October 3, 2003 *(the Banking Act)*, the Stock Exchanges and Securities Trading Act of March 24, 1995 *(the Stock Exchange Act)*, the Investment Fund Act of March 18, 1994 *(the Investment Fund Act)* and the regulations enacting each of these laws. The regulatory authority in charge of the supervision of banks, brokers and stock exchanges is the Swiss Federal Banking Commission *(FBC)*.

2. Governmental Immunity

In Switzerland, as in France, the governmental immunity doctrine is less important than standards of liability in the determination of regulatory liability. The regulatory immunity of the FBC is not limited by special governmental immunity legislation; rather, it is determined according to the general tort law principles as reflected in Art. 3 of the Act on the responsibility of the confederation and of its officials of March 14, 1958 (the *Responsibility Act*).

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22 El Shikh, AJDA 1999.951, Court administrative d'appel, Paris, 30 March 1999.

23 In this case, when the bank's troubles began, the regulator requested a capital injection of FFr 50 million, and then later – for no good reason – reduced this to half the amount payable in six months.

3. *Standards of Liability*

Liability analysis in Switzerland is somewhat unique, in that the liability is rooted in violation of a particular law (i. e. violation of which may be considered «negligence per se»), rather than meeting an independent negligence standard. Specifically, a claim for damages resulting from the action or inaction of the FBC may be raised against the Swiss confederation on the basis of Art. 3 of the Responsibility Act. Pursuant to this article, the Swiss confederation as the competent sovereign entity to which the FBC belongs can be sued for the action or inaction of the FBC or its employees to the extent that the following requirements are met:

- the action or inaction of the FBC must have resulted in *damage*, as defined by general tort law principles;
- the person who caused the damage is an official of the FBC and caused the damage *in connection with the performance* of its duties as an official of the FBC;
- the action that caused the damage is *related* to the exercise of official duties by the FBC;
- the action that caused the damage qualifies as a *violation of one or more laws of Switzerland*; and
- there must be a sufficient link of *adequate causation* between the damaging action and the damages actually sustained.

4. *Case History*

Recent rulings by the Federal Supreme Court have demonstrated the limits of liability of the Swiss confederation for actions of the FBC. The key question that has been raised by the court in different instances is the extent to which the FBC can be liable for neglecting its supervisory duties.

In connection with the liquidation of *Häberle Invest & Treuhand AG*, the Federal Supreme Court denied the liability of the Swiss confederation for omissions of the FBC.[24] Creditors of Häberle Invest & Treuhand AG that had not been paid in full brought a claim against the Swiss confederation on the basis that the FBC did not recognise in time that Häberle Invest & Treuhand AG was subject to its supervision and therefore did not take the requisite preventive measures to protect the interests of the investors. The ruling of the court was based on the reasoning that there was no sufficient link of adequate causation between the omissions by the FBC and the damages alleged, be-

24 Decision no. 5A.9/2000 of March 22, 2001. The decision has not been published (see FBC bulletin of 2001, p. 95 ff.).

cause the damages could not have been avoided even if the FBC had come earlier to the conclusion that Häberle Invest & Treuhand AG was subject to its supervision.

On May 4, 1990[25], the Federal Supreme Court ruled on claims of creditors against the Swiss confederation regarding the issue of whether the FBC had neglected its obligations as supervisor by not taking any action in time to protect the creditors of X AG, a banking institution subject to the supervision of the FBC. The court denied the liability of the Swiss confederation on the basis that the plaintiffs could not demonstrate that the actions causing the damages qualified as a violation of the laws of Switzerland. According to the relevant principles of tort law, where the damages that have been caused do not constitute a personal injury or the damaging of property rights, but merely the loss of a financial asset, e. g. the loss of a claim or money *(reiner Vermögensschaden)*, the plaintiff has to demonstrate that the damaging event qualifies as a violation of a specific rule designed to protect the plaintiff against the damaging behaviour *(Schutznorm)*. In the case before the Federal Supreme Court, the creditors of X AG argued that the scope of the Banking Act was to protect the creditors of the bank. The court held that this argument was not sufficient to protect the creditors of the bank from the damaging behaviour of the FBC, and that damages could be claimed from the Swiss confederation only where the creditors can show that the inaction of the FBC violated specific provisions of the Banking Act. As this requirement was not satisfied in the present case, no liability could attach to the FBC.

The issue whether and if so to what extent the functional affiliates a bank (e. g. a bank liquidator) could claim damages from the Swiss confederation for the exercise or the neglect of supervisory powers by the FBC on the basis of a violation of the Banking Act was decided by the Federal Supreme Court in a decision rendered on July 11, 1980 in connection with the liquidation of *Banque de Crédit International*.[26] In this case, the court did not allow the liquidators of a bank to claim damages for violations of the FBC in the supervision of a bank, because the rules of the Banking Act grant protection only to the creditors of a bank, not to its functional affiliates or other such entities.

Finally, on September 10, 2004, the Swiss claims tribunal for the liability of the confederation ruled on a claim for an injunction raised by the Canton of Geneva against the Swiss confederation with regard to alleged omissions of supervisory duties by the FBC over the *Geneva Cantonal Bank*.[27] The tribunal denied granting the Canton of Geneva an injunction.

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25 BGE 116 Ib 193.

26 BGE 106 Ib 357.

27 Decision of September 10, 2004, available at *http://www.reko-efd.admin.ch/fr/content/Decisions%20CRR/CRR2004–002.pdf*.

XIII. Additional Considerations

There are two additional topics that merit discussion in regards to regulatory liability analysis as it has been undertaken thus far in this paper. First, with respect to EU member states, it is necessary to conduct such analysis pursuant to EU law in addition to the relevant domestic rules that are in place, as in certain instances EU law will pre-empt national law. Second, with respect to regulatory immunity generally, there may remain the possibility of bringing an action against a foreign regulator in the claimant's home state, in order to circumvent immunity provisions in place in the regulator's home country that prevent actions from being brought against it. Each of these unique facets of regulatory liability analysis is discussed in turn below.

1. Regulatory Considerations Under EU Law

Under EU law, an immunisation statute (and any restriction on liability) may be overridden if an EU law or directive applies and is supreme to the domestic statute or restriction in question. Specifically, the European Court of Justice *(ECJ)* has held that the effectiveness of EU law would be prejudiced if individuals were deprived of EU rights merely on the grounds that their national states failed in their obligations to implement those rights in national law or if the EU statute has direct effect.[28] Therefore, if an EU law establishes a particular standard or liability regime for financial institutions, then immunity provisions of member states would be required to comply with the EU standard, and would not apply if such standard were not met.

In order to show that the above holding applies to a particular case, the ECJ has determined that the following conditions must be fulfilled:

- the EU law or directive must not have been fully implemented by the member state;
- the EU law or directive must have been intended to confer direct rights on individuals (i. e. the proximity rule);
- the rights affected must be unconditional and sufficiently precise;
- there must be a serious breach, so as to counter excessive claims; and
- the breach must have directly caused the claimant's loss, and the loss was not the result of some other cause.

28 This principle is known as the Francovich doctrine, after the case *Francovich v. Republic of Italy* (1991) ECR I-5357. *See also R. Secretary of State for Transport, ex p Factortame Ltd.* [1996] ECR I-1029, and *Dillenkoffer v. Federal Republic of Germany* [1996] ECR I-4845.

The leading case of the ECJ applying the above principles is *Paul v. Federal Republic of Germany*, Case C-222/02 (October 12, 2004).[29] In this case, bank depositors brought claims against the government of Germany for (i) failing to implement the EU Deposit Guarantee Directive in a timely manner, and (ii) defective supervision of the bank. With regard to the first claim, the ECJ held that if the German government had implemented the Deposit Guarantee Directive (which it had failed to do for three years after the deadline for its implementation, due to the government's objection to the directive), then the government would have been protected by the proximity rule, and the depositors would be entitled to the protections provided pursuant to the Deposit Guarantee Directive. With regard to the second claim, the ECJ held that the various regulatory directives on financial services were intended mainly to harmonise EU law, and not to confer direct (personal) rights on investors and depositors against the subject supervisory bodies. On this basis, the ECJ determined that the Deposit Guarantee Directive did not override rules of German law stipulating the banking regulator's duties as duties solely in the public interest, but not owed to (indirectly) damaged third parties, and the plaintiff's claim failed on this count.

In the *U. K.*, the House of Lords held that the First Banking Directive[30] was not intended to confer direct rights on depositors, but rather was merely a harmonising directive for purposes of EU law.[31] Accordingly, it determined that the directive did not clearly and unconditionally create a liability of the regulator to depositors for defective supervision.

Finally, it should be noted that where there is an effective restriction on action being brought against public officers (by means of either a high liability standard, or a specific immunisation statute) within the EU, the issue arises as to whether the statute in question is consistent with the constitutional safe-

29 In this case, Paul and others were depositors of a failed German bank. They alleged that Germany had belatedly implemented the Deposit Guarantee Directive of 1994 and that the German regulator had supervised the bank defectively. With regard to the deposit guarantee scheme in place, the German government had a system of unlimited deposit guarantees but had not yet implemented the EU Deposit Guarantee Directive. The failed bank had applied to join the existing German scheme, which was more generous than the € 20 000 coverage required under the EU directive; however, the German bank was unable to fulfil various conditions of the German scheme and withdrew its application. The result was that the depositors were not insured as they would have been if the German government had implemented and applied the EU Deposit Guarantee Directive. With regard to the claim of defective supervision, although German law provided for the liability of public officials for maladministration, the relevant regulatory statute prescribed that the regulator exercised its functions only in the public interest; in other words, the regulator had no duty to private individuals. The ECJ considered whether this duty was overridden by EU law pursuant to the Francovich principle.

30 Directive 77/780/EEC.

31 *Three Rivers District Council v. Bank of England* (No. 3) [2000] 2 WLR 1220.

guards of a particular state, which impose the rule of law and the right to a fair trial.[32]

2. *Foreign Actions Against Regulators*

A final issue that merits discussion is whether an investor or a depositor may bring an action against a foreign regulator in the investor-depositor's home state, in order to circumvent an immunity bar that may exist in the regulator's home jurisdiction. In such a case, the investor or depositor would have to have jurisdiction over the foreign regulator in such investor's home state; in addition, the regulator must not be entitled to immunity under the laws of its home state.

With regard to the jurisdictional issue in such a situation, many countries provide that the courts have jurisdiction in torts cases if the tort was committed within the jurisdiction, or if damage (resulting from the tort) was suffered in the jurisdiction. In this regard, the tort of negligence (i. e. allegedly committed by the regulator in the securities or banking context) would be committed where the regulator is situated; however, the damage may be suffered in the jurisdiction where the investor or depositor is located. Therefore, depending on the local rules, it may be possible to obtain jurisdiction over the regulator in the investor-depositor's jurisdiction.

Despite the possibility of obtaining jurisdiction over the regulator as described above, however, the type of regulation at issue in such case is governmental (as opposed to commercial) activity. It is almost universally the case that, in such situations, governmental actions of foreign governments and their instrumentalities are immune from suit and execution in home courts. The effect of this is that the investor or depositor is normally forced to bring its claim in the home state of the regulator, and hence to be subject to the rules of the regulator's home state, including immunisation. On the other hand, the advantage of this structural regime is that it increases the legal certainty for regulators, who may pursue their mandated objectives without fear of being hailed into the courts of a foreign state.

XIV. Conclusions

Several conclusions may be drawn from the discussion and analyses of this paper about the liability regimes that apply to securities and other financial

32 For example, Art. 34 of the German Constitution provides that where «any person, in the exercise of a public office entrusted to him, violates his official obligations to a third party», the jurisdiction of the ordinary courts is available to bring claims arising out of such violation.

sector regulatory authorities in many countries. First, the widespread presence of governmental immunity statutes often serves as an effective bar to liability actions being brought against regulators. In addition to (and at times independent of) these statutes, relatively high liability standards in many countries provide another obstacle to successful regulatory liability actions. Depending on the particular country, the doctrine of governmental immunity or standards of liability may prove to be the more determinative factor. Second, case law in the advanced jurisdictions examined in this paper shows that it is extremely difficult in practice for disappointed investors and depositors to claim successfully damages for the behaviour of stock exchanges or their regulators. This is generally because (i) the existence of immunisation statutes eliminates the possibility of bringing such claims against the regulators, (ii) case law holds that the regulators have no duty at all to the private individual (i. e. the proximity principle), or (iii) the claimant must satisfy high standards of liability. Finally, for purposes of this paper, it does not appear that constitutional objections to immunisation statutes, including those in the EU, have had (or will have) much success under the current regime. Furthermore, actions against regulators in foreign courts appear unlikely to succeed, due to foreign state immunity provisions.

From a policy perspective, for several of the reasons discussed in this paper, one may conclude that the overall trend towards not holding regulators responsible for the institutions that they regulate is proper, except in the cases of extremely serious misconduct (e. g. gross negligence) or abuse of power by the regulators (i. e. including violation of the proximity principle). As a general rule, it would not be fair to widen the scope of liability currently in place, because such claims against the government and its regulatory agencies would have to be paid with taxpayers' funds, and taxpayers should not be obliged to pay for damaging behaviour that may also have been avoided by the banks and other regulated institutions themselves. In practice, in contrast to the limited liability for banking and securities regulators, a trend towards increasingly strict issuer liability (also known as prospectus liability) appears to be underway. This type of liability structure requires that liability be borne by the issuer, underwriters, participating banks and other parties involved in the subject transaction, and it has been highlighted in recent highly publicised cases (e. g. WorldCom).[33]

33 In re *WorldCom Inc. Securities Litigation*, 2004 U. S. Dist. LEXIS 25 155 (S. D. N. Y. Dec. 14, 2004).