Introduction: Law *in* Finance[1]

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Law's relevance to finance is by now well recognized, in no small part due to the literature on "law and finance" (La Porta et al. 1998; La Porta, Lopez-de-Silanes, and Shleifer 2008) celebrated in this journal ten years ago under the heading "the new comparative economics" (Djankov et al. 2003). There will always be some debate as to whether a specific law or regulation distorts or supports markets, but few would argue today that law is irrelevant to financial markets or that they could operate entirely outside it.

This special issue takes the debate about the relation between law and finance a step further by proposing that law is more central to contemporary finance than acknowledged in existing literatures: It lends authority to public and private financial instruments or means of pay; delegates power to different regulators, public or private; and vindicates financial products rooted in private contracts if they are generally consistent with the law. The relevance of law to finance has arguably increased with the shift from relational to entity and ultimately market-based finance: The fungibility of financial instruments in anonymous markets depends on credible contractual commitments that are enforceable in a court of law without prior

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investigation into the creditworthiness of the borrower, originator or intermediary. In short, law is not just an add-on to but is “in” finance.

The papers presented in this issue are the product of a collective, multi-year, interdisciplinary research endeavor. The project set out to critique existing theories in economics and sociology on the relation of law to finance and culminated in the development of a new theory, the legal theory of finance (Pistor 2013). Each participating researcher (or team) developed a case study to assess the explanatory powers of existing theories, identify their shortcomings and suggest alternative approaches. The case studies were drawn from an array of financial markets: credit markets, derivatives, sovereign debt and foreign exchange. Implicit in this approach was the notion that not all markets are alike and that therefore a single case, say a securities exchange, might not be able to capture all relevant attributes of financial markets. Some case studies focus on events in the development of a given market, others on structural features; some devote greater attention to the institutional details, others to forces that drive deep structures. Yet all strive to explain observable characteristics of actual markets, not idealized models. Jointly, these case studies offer a vast amount of material and insight regarding how markets evolve and what factors contribute to their rise and fall.

The legal theory of finance (LTF) presented in the first contribution of this issue was distilled from the case studies and discussions with participating researchers. It has four key components: (1) financial markets are rule-bound systems; (2) finance is essentially hybrid between state and markets, public and private; (3) law and finance stand in an ambiguous, even paradoxical relation to one another where law is indispensable to markets but can also hasten their demise; (4) law is not equally rigid but is relatively more elastic at the apex than on the periphery of the financial system, and where law is elastic power becomes salient. This introduction demonstrates aspects of the case studies presented in this issue that support and illuminate one or more of these features; it will skip over many other important insights and analyses which are best discerned by reading the full articles.

In her contribution, “The Legal Construction of Foreign Exchange Markets” (2013), Rachel Harvey traces the evolution of governance arrangements for foreign exchange (FX) markets in the wake of the collapse of the Bretton Woods System. Relying on archival research at the Federal Reserve and the Bank for International Settlement, she shows how private and public actors collaborated to create a system that is rule-bound and anchored in state law, while allowing key market participants to pick the rules by which they wish to be governed. Far from standing outside the law, FX markets are embedded in the legal systems of the two dominant markets, New York and London. Indeed, the scope of private rule making is determined by boundaries legislatures and regulators draw explicitly or implicitly in public regulation. The prime example of this “boundary drawing” function of law is the “Treasury Amendment” of the Commodity Futures Trading Commission Act of 1974, which carved out futures and swaps in FX, securities and mortgages from the jurisdiction of the Commodity Futures Trading Commission (CFTC). It set the stage for the development of privately regulated derivatives markets and the collaborative governance of FX markets by the New York Fed and private market participants, who jointly formed committees and drafted model rules for FX.

The second case study on FX developed by Perry Mehrling (“Essential Hybridity: A Money View of FX” (2013) confirms the rule-bound nature of FX markets. He argues that contrary to conventional accounts, exchange rates do not reflect the value of tradable goods or financial assets in different markets; instead, an exchange rate is the price of “one money in terms of another money”. This holds in domestic and global settings. Domestically, the price at which other financial assets are converted into cash is the internal exchange rate. This rate can fluctuate and reflects the location of different private moneys in the domestic system at any moment in time. Internationally, "[t]he exchange rate is where one national *financial system* confronts another, but it is also where one nation state confronts another" (ibid at []; emphasis added). The national system – politics and finance – jointly lend credibility to the currency. Further, the confrontation between different nations in FX markets is structured by complex payment and settlement systems created and maintained by central banks – also a creature of law. They create what David DeRosa, Mehrling's commentator, calls "sponsored transactional patterns" (DeRosa 2013), or in North's terms the "rules of the game" for FX markets (North 1990). Central banks maintain a monopoly over these systems even as private dealers populate the markets they sponsor. In short, FX markets are best described as "essentially hybrid".

Sovereign debt markets are another prime example of the "essential hybridity" of financial markets. Debt is issued by sovereign states that have the power to unilaterally determine its legal structure and yet, when traded on international markets, is treated as just another fungible financial instrument. In "The Wonder Clause", Anna Gelpern and Mitu Gulati show that in fact, sovereign debt appears as a different kind of asset in the domestic as compared to the international context (Gelpern and Gulati 2013). While in international markets it is one of many financial assets, in the domestic context the sovereign in sovereign debt is more apparent. Not only is the issuance of sovereign debt often a rather informal affair, but governments take the liberty to regulate its riskiness -- a practice that has made its way into international capital adequacy rules as well. The power sovereign states exercise over their debt is most obvious in the vicinity of sovereign default. Sovereigns can avoid technical default by changing the rules underpinning the debt issuance (after all, sovereigns have legislative powers); they also benefit from sovereign immunity rules when creditors seek to enforce claims against their overseas assets. These peculiarities of sovereign debt contracts notwithstanding, issuers of and investors in sovereign debt have a keen interest in making sovereign debt markets rule-bound. Sovereign debt contracts issued under foreign law contain more elaborate provisions on the parties' rights and obligations. In fact, contractual provisions have acquired outsized proportion by seeking to govern the process of debt restructuring – which in the world of private contracting would be left to a third party, such as a bankruptcy court. Collective Action Clauses (CACs) are the "Wonder Clause" meant to accomplish this feat. First inserted in emerging market debt contracts in the early 2000s, they have re-emerged in the context of the European sovereign debt crisis of the 2010s. They have been hailed as a market driven alternative to a full-fledged sovereign bankruptcy regime, yet *cannot* possibly offer a comprehensive solution for sovereign default. After all, a collective action clause is just another contractual provision that is hardly more credible than the sovereign's commitment to pay. Indeed, as Gelpern and Gulati show, there is little empirical evidence that the inclusion of CACs has had much of an effect on the pricing of sovereign debt or that they have been invoked in actual debt restructurings. Thus, their attractiveness stems not so much from what they actually do, but from the signal they are meant to send, i.e. that an orderly procedure for the worst case scenario is in place.

Derivatives markets straddle foreign exchange, sovereign debt and private credit markets. They pose a challenge to the legal theory of finance because two markets for derivatives, publicly regulated exchange traded (ET) and privately regulated over-the-counter (OTC) markets have coexisted for quite some time. Both have expanded rapidly since the mid 1980s, yet "unregulated" OTC markets have grown much faster than their regulated counterpart. Bruce Carruthers examines the puzzle of these “Diverging Derivatives” in his contribution (2013). Based on a detailed institutional account of the rise of OTC markets, he shows that they do not exist separately from but are deeply intertwined with ET markets: They are linked by major actors that operate in both. This also helps explain why exchanges that lost business to OTC were not more forceful in advocating their regulation: Their biggest clients were also the main issuers of OTC derivatives – a market dominated by just a few players. In this account ET and OTC markets are not distinct markets – one regulated, the other unregulated – that compete with each other for business, but interdependent venues. They offer key players the opportunity to benefit from price discovery in one and hedge their exposure in the other, to take advantage of rule-bound systems while arbitraging the effects of costly rules.

In “Towards a Supply-side Theory of Financial Innovation”, Dan Awrey (2013) offers a slightly different perspective on derivatives markets but one that reinforces Carruther’s basic points. Like Harvey and Carruthers, he traces the rise of OTC markets to the Treasury Amendment of 1974, which protected certain futures and swaps from the CFTC’s regulatory oversight. This boundary drawing created the opportunity for financial innovation in markets left to regulation by participants. Awrey suggests that innovation took different forms and produced different outcomes: It is not always or necessarily associated with progress and thus does not enhance social welfare *ipso facto*. This, however, is what regulators on both sides of the Atlantic have assumed when exempting these markets from public oversight and reinforcing this exemption in different laws and regulations. Instead, OTC markets were regulated by private agents, foremost among them the International Swaps and Derivatives Association (ISDA). ISDA developed model contracts for different instruments and tailored them to different legal systems; last but not least, it lobbied legislatures in over 50 countries to bring their laws into compliance with these contracts. This finding corroborates the claim that financial markets are rule-bound systems: Private actors are acutely aware of the importance of being inside rather than outside the law, which lends predictability and coercive enforcement to privately created financial instruments.

In a system that is legally constructed, the ability to participate in the making of rules and the framing of markets is itself a source of economic and political power. It creates comparative advantages in good times as well as in downturns when existing rules are relaxed or suspended to protect the system from collapse. Close inspection of the legal construction of financial markets thus reveals the Janus face of law in finance: The credibility law lends to financial contracts is critical, but the inflexibility that goes hand in hand with credible commitments can hasten financial markets' demise in times of crisis. This outcome can be avoided by renegotiation or refinancing financial commitments – effectively suspending ex ante contracts or regulation. Evidence from the different markets discussed so far suggests that resourceful private and public actors rewrite the rules of the game in times of crisis. Central Banks intervene directly in foreign exchange markets to protect their currencies or throw each other FX swap lines when private dealers withdraw their intermediation services. Sovereigns cajole creditors into debt renegotiation by threatening default, and private actors that benefit from unregulated markets when markets rise seek lender of last resort services from central banks to survive their own day of reckoning in market downturns. Lastly, key actors in markets for derivatives and other assets benefit from a central bank 'put' at times when no one else is willing to hold innovative instruments that have become toxic.

This “differential relation” of market participants to law is apparent not only in times of crisis but also in normal times; indeed it is apparent not only in legislation but also in contractual design, as Akos Rona-Tas and Alya Guseva (2013) suggest in their analysis of emerging consumer credit markets in Eastern Europe (“Information and Consumer Credit in Central and Eastern Europe”). Consumer credit contracts tend to give the two parties to the contract different degrees of flexibility in adjusting their commitments in light of future events. Banks frequently preserve the right to adjust interest rates or condition the issuance of credit cards on direct access to the bank account in which employers deposit the borrower’s salary. These “salary projects” were a critical step in the rise of consumer credit card markets in post-communist countries, in contrast to Western markets where issuers relied to a greater extent on voluntary compliance or the court system to protect their legal claims. In short, both law and contracts exhibit different degrees of elasticity for different parties and in different systems. Consumers tend to command little flexibility in most jurisdictions to adjust contractual commitments when future events undermine their ability to perform relative to lenders (non-recourse mortgages in some US states being an exception to this rule). This is the case even though, contrary to widely held assumptions, default is less frequently the result of consumer fraud or conceit than of changes in life circumstances, such as disease or divorce. These events are difficult if not impossible to foresee and yet are widely disregarded in contracts. In fact, privacy considerations bar lenders from probing into personal issues in many jurisdictions – an example of how law frames private contracting.

Law’s role in finance is ambivalent in more than one way: As stated previously, law is critical for lending credibility to commitments even as this impedes future adjustments necessary for averting a full blown crisis. Further, the ideal of equality of all before the law is in tension with finance's inherent hierarchy – a feature reflected in several papers in this issue. Mehrling, who has previously written about the "inherent hierarchy" of money (Mehrling 2012), shows in his contribution to this project that not all currencies are equal: Some are minor while others are major; and some (the US dollar) are more major than others. Moreover, Awrey shows that not all innovative financial instruments find buyers in times of liquidity shortage. Finally, Rona-Tas and Guseva allude to the hierarchical relation and the inverse relation of law's rigidity in relation to it not only of consumers and lenders in a given market, but also of consumers in different markets relative to one another: Some benefit from non-recourse loans while others don't; some carry currency risk while others always borrow in their domestic currency.

What then explains the hierarchy of finance is the critical question Anush Kapadia addresses in his essay, "Europe and the Logic of Hierarchy" (2013). He uses the sovereign debt crisis in Europe to examine the economic and political conditions for maintaining integrated financial markets and a common currency. Scalability is his answer. Those with bigger balance sheets can afford to lend support to those with smaller ones. But size is not just given or a function of available resources but also of the legal and political ability to pool dispersed resources. When central banks bail out the financial system they mutualize or socialize private debt in direct contradiction to the legal and contractual underpinnings of the financial system they wish to rescue. This is a political act of redistribution. Whether it will succeed in stabilizing the financial system depends on the credibility of decision makers to pool future resources to make good on the socialized, now public debt. That is not only a question of economic capacity but also of political coordination. States that have relinquished their currency face greater challenges on both fronts, as the European sovereign debt crisis demonstrates, because they cannot use monetary policies to accomplish this task. They must generate sufficient income by increasing taxation or cutting spending, i.e. by imposing austerity measures -- and trying too hard can cost them their political mandate. This leads Kapadia to argue that in light of the rise of integrated financial markets, Max Weber's well-known definition of a state as a community that claims monopoly over the means of coercion should be restated as a "*human community that successfully claims the apex of a hierarchical credit system because it is legitimate within a given territory" (*ibid at [], emphasis in original). Applying this definition to the Eurozone, it is evident that it lacks statehood at the moment, because the legitimacy to pool resources to protect the common currency remains deeply contested. From Kapadia's vantage point, resolving this problem does not necessarily require full political integration. What is required, however, are legitimate institutional arrangements for pooling resources in times of distress. Whether such an arrangement can be found or will be sustainable is critical well beyond the survival of the Euro; it will determine the fate of globally integrated financial markets.

In short, LTF offers a new conceptual framework for analyzing domestic and global financial markets. Just as the comparison between capitalism and socialism appeared out of date to proponents of "law and finance" ten years ago, the global crisis has rendered the comparison of state vs. market-friendly law equally stale. When financial assets that are created under the most market-friendly conditions find themselves on the balance sheet of central banks, it is apparent that the key question is not either state *or* market, but *what* states and *what* markets. LTF suggests that neither question can be answered without recognizing the central role of law.

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