

IMFS, Frankfurt 9 December 2015

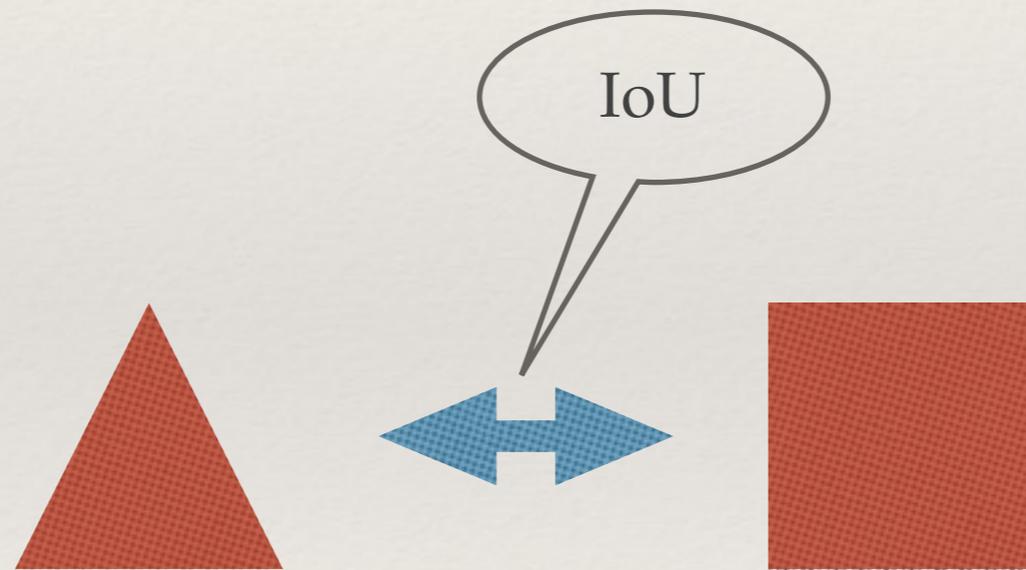
The Legal Code for Global Capital

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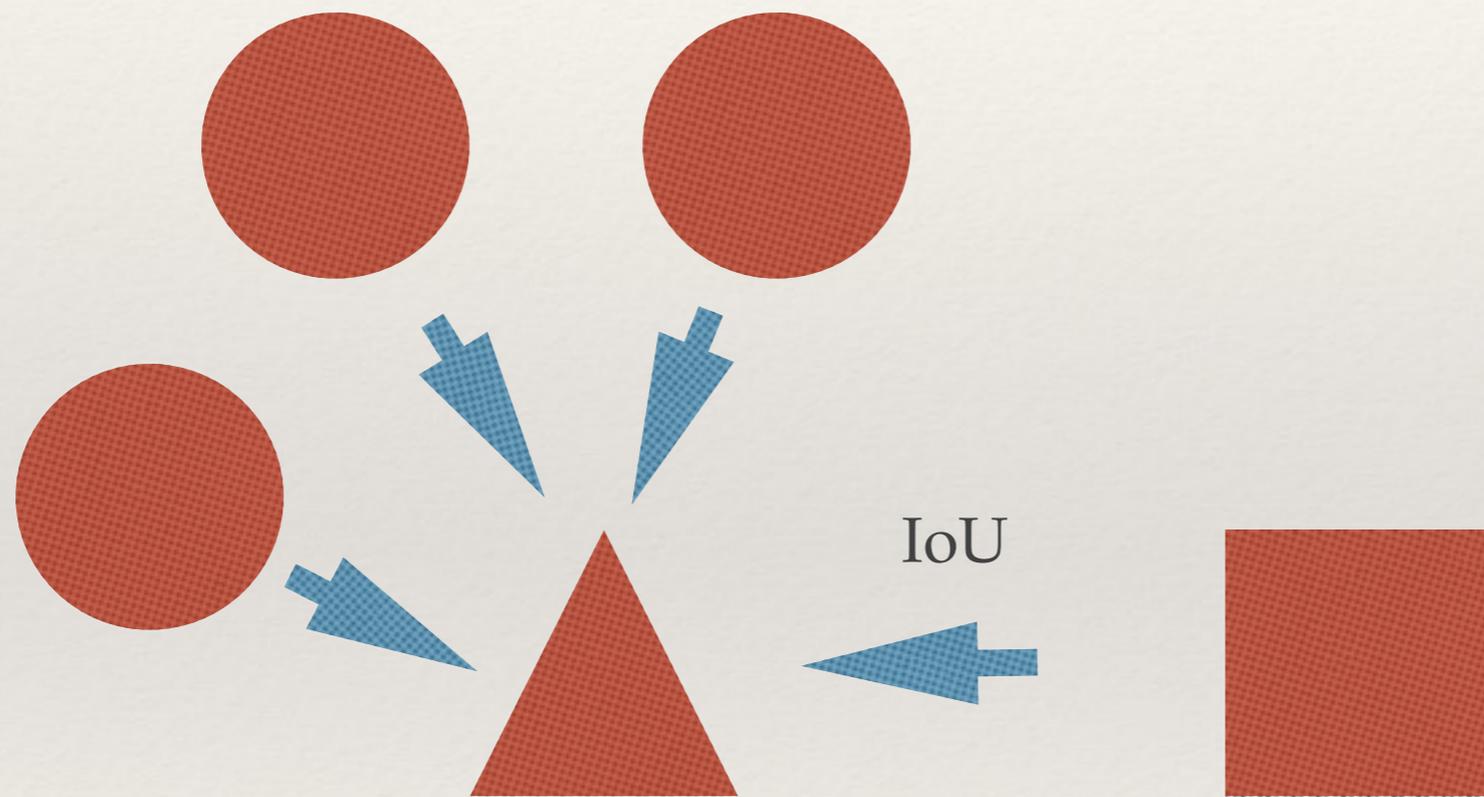
Law in Finance

- ❖ Finance is coded in law
- ❖ Private agreements allocate rights and responsibilities between the parties to the contract, but can't impose burdens on others
- ❖ Law or Power is needed to enforce priority rights and other legal privileges “against the world”

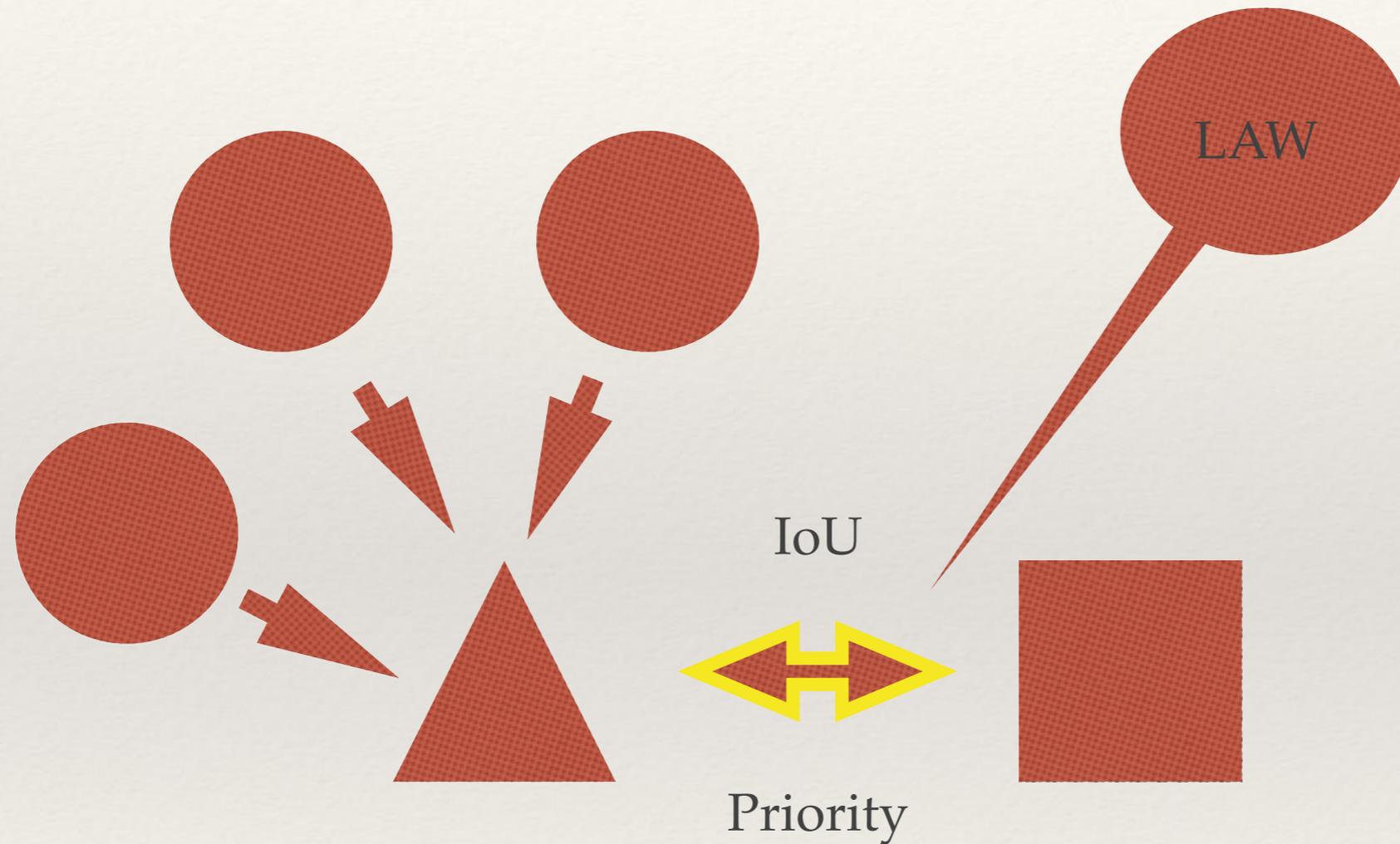
Financial Contracts



Competing Claims



A Legal Code



Property, Collateral, Trust, Entity & Bankruptcy Law

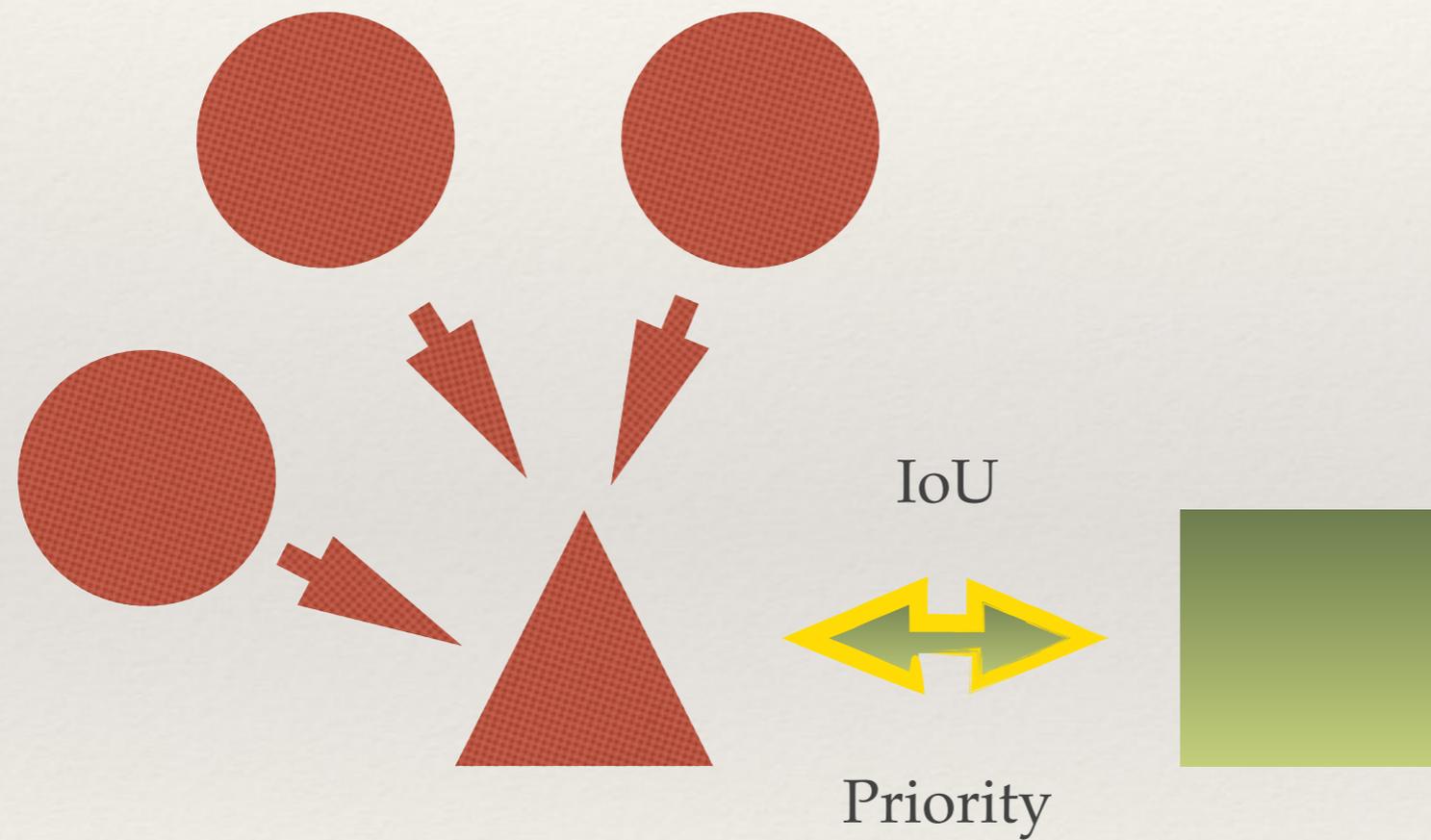
Hierarchy of Rights

- ❖ Property rights trump contractual rights
 - ❖ pull out *in bankruptcy*
- ❖ Secured rights trump unsecured rights
 - ❖ priority right *in bankruptcy*
- ❖ Within same class: seniors trump juniors
 - ❖ first served *in bankruptcy*
- ❖ **Enforceable against the world**

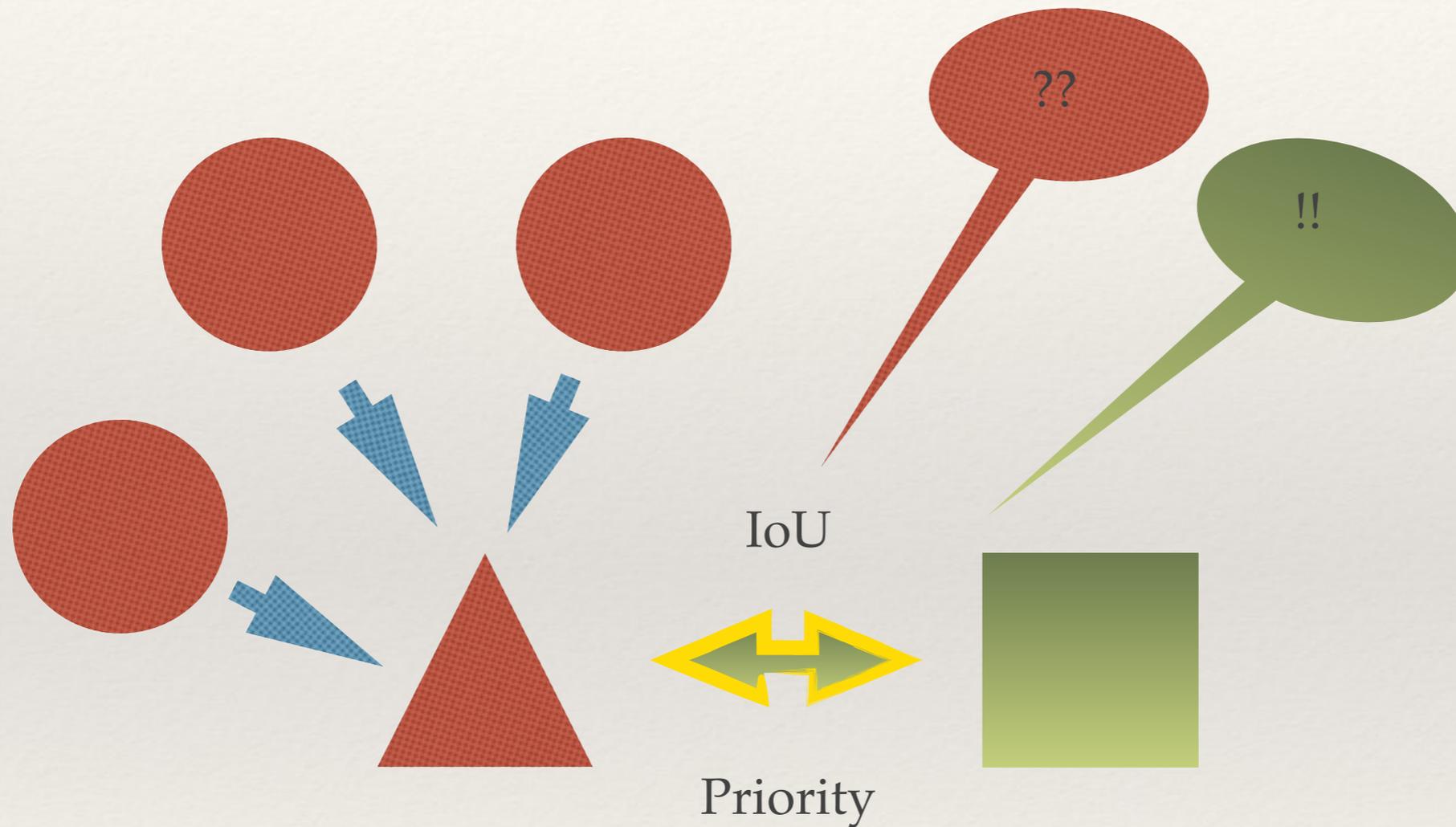
Global Finance without Global Law

- ❖ Puzzle: How is Global Finance sustained without a Global State and a Global Law?
- ❖ Given the need to avoid a run on entities or markets and therefore
 - ❖ shield assets against competing claims
 - ❖ enforce privileged rights over others
 - ❖ across multiple legal orders

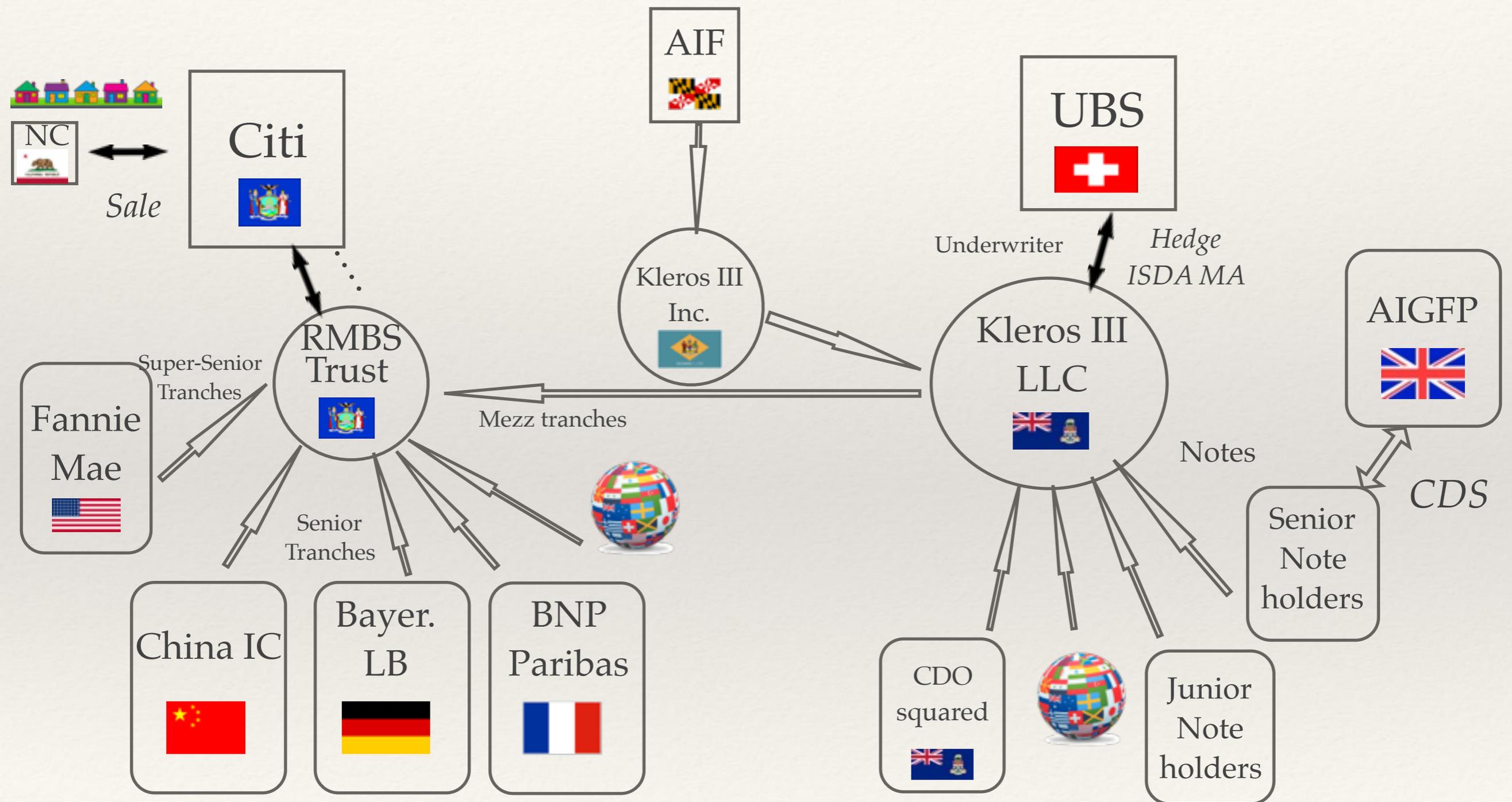
Competing Laws



Whose Law Prevails?



MBS in Global Context



Which Claim Trumps?

- ❖ Who holds the mortgage?
- ❖ What laws are in play?
- ❖ Which court will decide?
- ❖ Who has standing in court to foreclose?

Global Finance without Global Law

- ❖ Harmonization
- ❖ Choosing a single (domestic) law for global finance
- ❖ Private Law beyond states? Lex Mercatoria

Limits of Harmonization

- ❖ Path Dependence of Legal Systems
 - ❖ *Formal vs. substantive convergence*
 - ❖ *Enforcement: home bias*
- ❖ Legal sovereignty
 - ❖ *Property rights*
 - ❖ *Monopoly of bankruptcy law*

The Limits of Choice of Law

- ❖ Private autonomy
 - ❖ in principle, only for contracts
- ❖ Relocating relevant activities to single jurisdiction
 - ❖ Real things (including paper) must move physically
 - ❖ Financial assets have been de-materialized and de-mobilized
 - ❖ *all that moves are digitized legal claims held by intermediaries*
 - ❖ *location of intermediary trumps*

New Lex Mercatoria

- ❖ Global trade and finance sustained by private contracts, private transactional lawyers and private arbitration tribunals
- ❖ Largest industry organization, ISDA, develops a “Master Agreement” for OTC derivatives that govern over 90 percent of all contracts
- ❖ Value of entitlements hinges on rights enforceable against third parties
 - ❖ *validity & enforceability of collateral*
 - ❖ *close-out netting in the event of bankruptcy*

Connecting the Dots

- ❖ Most aspects of the web of financial claims and counter-claims are governed by one or two legal systems
 - ❖ *England & New York*
- ❖ Their laws are recognized by other sovereign states
 - ❖ *Conflict of law rules, OR*
 - ❖ *Exemptions from local law for global actors*
 - ❖ *Even for matters of property law*

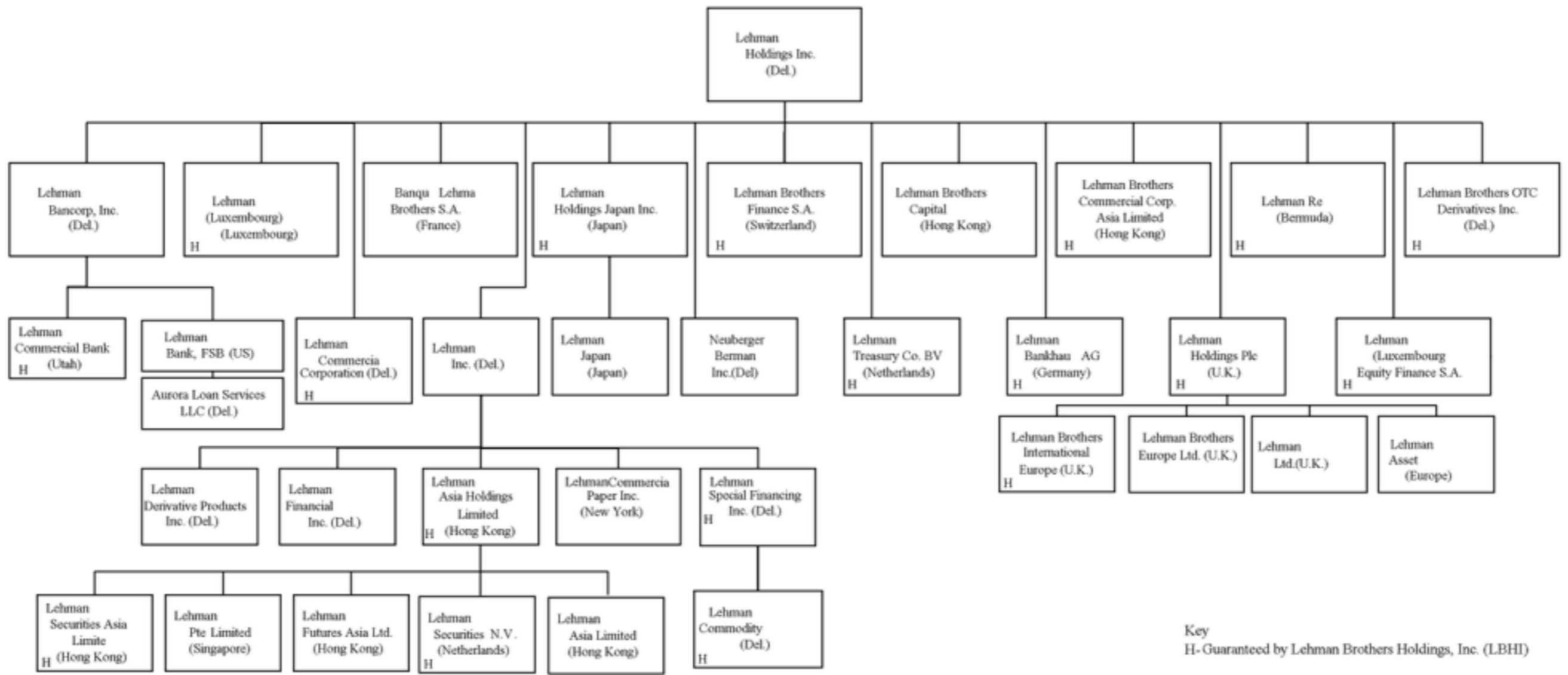
Global Finance

- ❖ Public / Official system
 - ❖ Organized around state regulation of select financial intermediaries (banks)
 - ❖ State-state coordination of regulation
- ❖ Parallel private (shadow) system:
 - ❖ Organized around private contracts and property rights
 - ❖ Choice of governing law
 - ❖ Priority rules enacted by regulatory competition

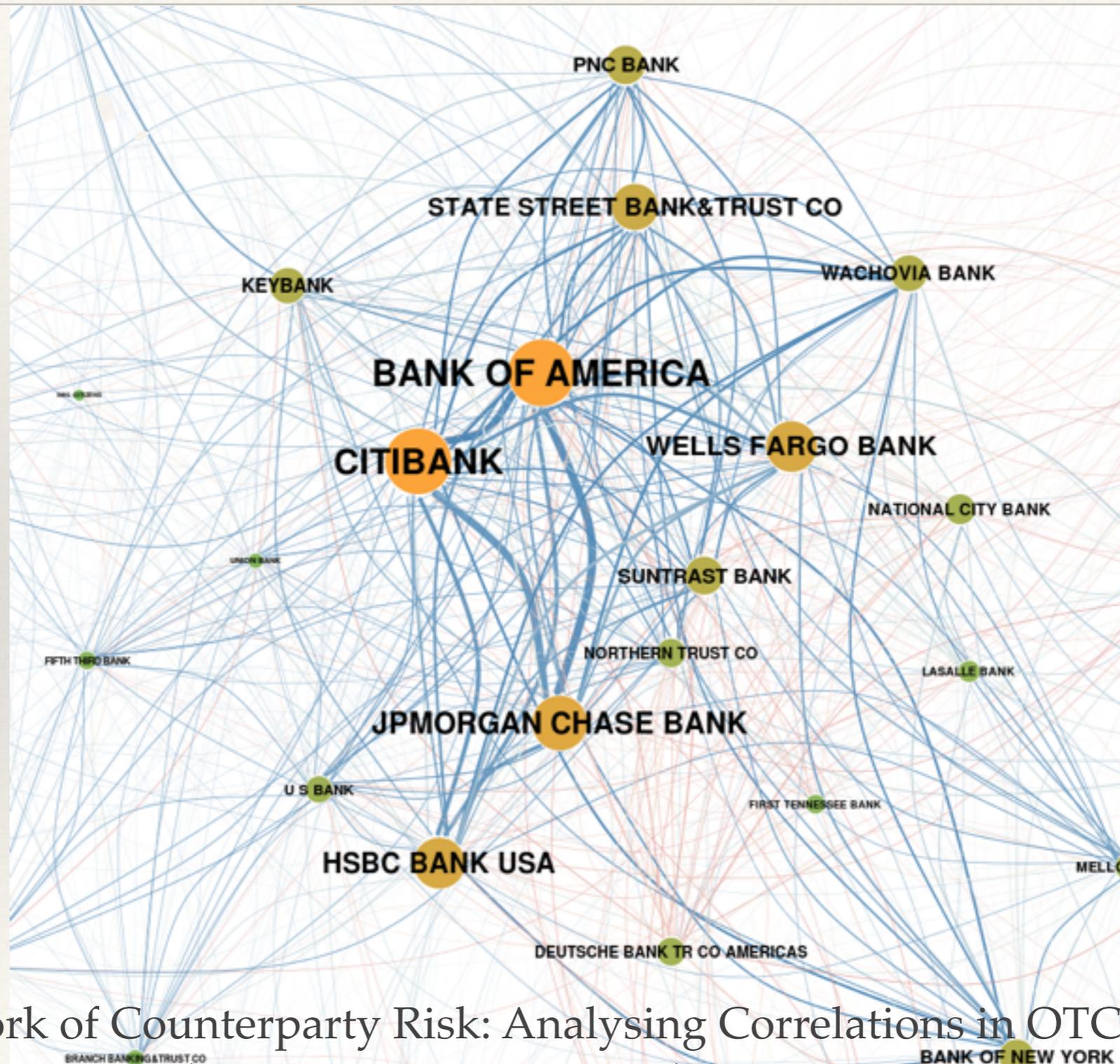
When Systems Collide

- ❖ Under BIS principles, “home country” is responsible for supervision and liquidity support
- ❖ Resolution of financial intermediaries under local law
- ❖ Yet, transnational private contracts provide for termination and close-out netting

Lehman Brothers

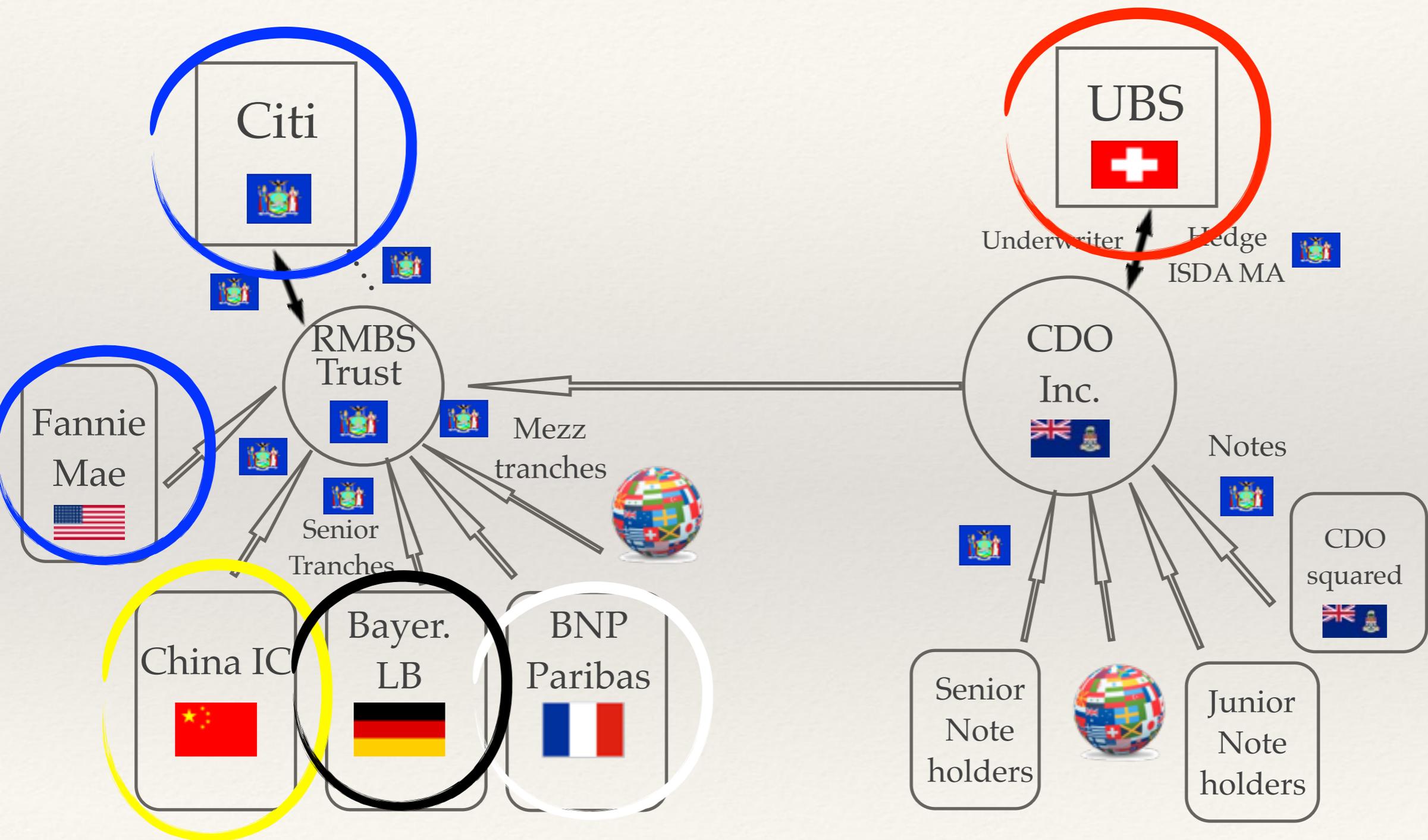


“Spaghetti Bowl” of Derivatives



The Network of Counterparty Risk: Analysing Correlations in OTC Derivatives
Nanumyan, Vahan; Garas, Antonios; Schweitzer, Frank [2015], ETHZ

The Limits of National Regulators



Enhanced Global Coordination



Public v. Private Regime

- ❖ **Domestic Resolution Regimes**
 - ❖ Automatic stay on all claims
 - ❖ Recapitalization, stabilization of entities
- ❖ **ISDA MA Close out Netting Provisions**
 - ❖ Counter-parties don't stay, they net
 - ❖ Integrity of derivatives markets

Who Wins?

- ❖ Can foreign counter parties still terminate and close out transactions under the Master Agreement when a domestic RR imposes a stay on the bankrupt intermediary?

Global Arms Twisting

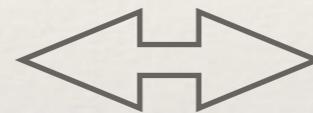


4.6 billion people



208 Primary Members

284 Associate Members



ISDA Resolution Stay Protocol

- If only one party subject to SRR
- No netting during stay
- Even if other party not bound by same law
- Future deals only with compliant partners



18 Major Banks Sign up

Hedge Funds Protest



Who Should Win?

- ❖ Property rights, collateral, bankruptcy safe harbors and other legal privileges enhance the credibility of financial instruments
 - ❖ *Backbone of global finance*
- ❖ Yet, if all privileges created *ex ante* are enforced *ex post*, the system will self-destruct
 - ❖ *Law-Finance Paradox*
- ❖ It can be rescued only by invoking *ex ante* safety valves or relaxing the full force of law *ex post*

Our Global Backstops

- ❖ Hierarchy of Global Central Banks
 - ❖ Fed & Friends
 - ❖ *Permanent FX swap lines among the C6*
 - ❖ And the Rest...
 - ❖ *At the Discretion of Fed & Friends*



Concluding Comments

- ❖ Law orders social system by differentiating rights
- ❖ Better rights trump weaker rights
- ❖ The key normative question is who decides who gets to hold the jokers
- ❖ For finance, this question is not determined in political discourse, but in private law offices, courts and arbitration tribunals, and vindicated from time to time by laws in select jurisdictions
- ❖ This is nothing new. What has changed is the scale and scope of this phenomenon and its implication for democratic self-governance in a world in which most states and many private actors depend on this system