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

IoU
Competing Claims

IoU
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

- Citi
- UBS
- Trust
- CDO
- Inc.
- BNP
- Paribas
- China IC
- Bayer.
- LB
- Mezz
- tranches
- RMBS
- Senior
- Tranches
- Senior
- Note holders
- Senior
- Tranches
- Notes
- Junior
- Note holders
- Hedge
- ISDA MA
- Underwriter
- CDO squared
- Fannie Mae
- Notes
- Senior
- Note holders
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-destroy
  - 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 G6
❖ 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