Journal of Comparative Economics 41 (2013) 315–330

Contents lists available at SciVerse ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

A legal theory of finance ☆

Katharina Pistor

Center on Global Legal Transformation, Columbia Law School, 435 West 116th Street, New York, NY 10027, United States

ARTICLE INFO

Article history:
Available online 15 March 2013

JEL classification:
B26
F65
G20
G28
K2
N20
P16

ABSTRACT

Pistor, Katharina—A legal theory of finance

This paper develops the building blocks for a legal theory of finance. LTF holds that financial markets are legally constructed and as such occupy an essentially hybrid place between state and market, public and private. At the same time, financial markets exhibit dynamics that frequently put them in direct tension with commitments enshrined in law or contracts. This is the case especially in times of financial crisis when the full enforcement of legal commitments would result in the self-destruction of the financial system. This law-finance paradox tends to be resolved by suspending the full force of law where the survival of the system is at stake; that is, at its apex. It is here that power becomes salient. *Journal of Comparative Economics* **41** (2) (2013) 315–330. Center on Global Legal Transformation, Columbia Law School, 435 West 116th Street, New York, NY 10027, United States.

1. Introduction

This paper develops the contours of a legal theory of finance (LTF) for contemporary financial systems, i.e. systems that mobilize capital today for future returns. The history of money and credit dates back millennia (Hodgson, 2013), but the configuration of global financial capitalism is of more recent vintage. It is this system that is the concern of this paper and the theory it develops. LTF asserts that finance is legally constructed; it does not stand outside the law. Financial assets *are* contracts the value of which depends in large part on their legal vindication (Bradley, 1902). Which financial assets will or will not be vindicated is a function of legal rules and their interpretation by courts and regulators. This may vary from legal system to legal system. In a world of free capital flows, legally enforceable financial commitments that link market participants from different countries and legal systems to one another determine the scope of the financial system. The ability to design instruments that are not obviously in conflict with existing rules in different jurisdictions even as they seek to mitigate their costs on the issuers or holders renders a comparative advantage. In short, law and finance are locked into a dynamic process in which the rules that establish the game are continuously challenged by new contractual devices, which in turn seek legal vindication.

☆ The paper is the product of a 2-year research project, the Global Finance and Law Initiative. Funding from the Institute for New Economic Thinking is gratefully acknowledged. The paper could not have been written without the research of those who have participated in this project, their input in the discussions at the workshops that have accompanied it and the many comments I have received from them on earlier drafts of this paper. In alphabetical order these researchers are Dan Awrey, Bruce Carruthers, Anna Gelpern, Mitu Gulati, Alya Guseva, Rachel Harvey, Anush Kapadia, Tamara Lothian, Perry Mehrling and Akos Rona-Tas. This paper has also benefited from comments by Geoffrey Hodgson, Simon Deakin and Ernst-Ludwig von Thadden. Special thanks go to Casey Quinn and Agnieszka Janczuk-Gorywoda for excellent comments and editing and to Ron Gilson, Locke McMurray, Jeremiah Pam, Richard Shamos and Matthias Thiemann for detailed comments on earlier drafts. All remaining shortcomings are mine.

E-mail address: kpisto@law.columbia.edu

0147-5967/$ - see front matter © 2013 Association for Comparative Economic Studies Published by Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jce.2013.03.003

LTF is based on two premises outside of yet, as will become clear, reinforced by law: Fundamental uncertainty and liquidity volatility. The two go together: If the future were known we could take precaution to deal with future liquidity scarcity; if liquidity were always available on demand, i.e. a free good, we could refinance commitments as needed when the future arrives. Based on these premises LTF can illuminate core features of the contemporary global financial system, including its inherent instability, its organization into an apex and a periphery, the differential application of law in its different parts and last but not least the locus of discretionary power. As such LTF can serve as the foundation for a political economy of finance. Within this framework there is ample room for analyzing the behavior of actors using rational choice models, but also a more socially embedded approach in socioeconomics (see infra under 5). LTF's critical contribution is to emphasize that the legal structure of finance is of first order importance for explaining and predicting the behavior of market participants as well as market-wide outcomes.

2. Uncertainty, liquidity and the instability of finance

Before explaining the elements of LTF in greater detail I turn to the two premises on which it rests – uncertainty and liquidity volatility – and their implications for the nature of finance, namely its inherent instability. Frank Knight argued long ago that any attempt to capture dynamic rather than static phenomena must grapple with the problem of fundamental uncertainty; that is, with risk that *cannot* be quantitatively measured (Knight, 1921). This is the case whenever circumstances are unique and deviate from "invariable and universally known laws" (Knight, 1921 at III.VII.3). Such circumstances cannot be reduced to variables that lend themselves to probability calculations, and the distribution of possible outcomes is unknown (Knight, 1921 at III.VIII.2). These cases call for judgment, not calculus. Keynes developed a similar concept in his *Treatise on Probability*, also published in 1921 (Keynes, 1921(2010)). Building on this insight, he later emphasized that the process of accumulating wealth is necessarily a long-term project that is beset by our inability to know the future. Writing in 1937, he elaborated:

> The sense in which I am using the term [uncertainty] is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth-owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know (Keynes, 1937, 214).

It follows that we cannot fully predict the future and that, therefore, any investment strategy devised today will have to be adjusted should the future deviate from assumptions made today. This does not have to but frequently goes hand in hand with a financial crisis, in particular when substantial readjustments have to be made throughout the economy. The frequency of financial crises in the history of financial markets corroborates these predictions (Kindelberger, 2005). Reinhart and Rogoff offer eight hundred years of evidence that financial crises occur much more frequently than people are willing to believe (Reinhart and Rogoff, 2009). In fact, there is little disagreement even among proponents of the efficient capital market hypothesis (ECMH) that at least some aspects of finance are beset by inherent instability. Specifically, entities that engage in maturity transformation, i.e. banks, are widely held to be vulnerable to crises (Allen and Gale, 2001; Levine, 1998). They finance long-term commitments with short-term funds that can be withdrawn on demand. Whenever too many depositors seek to withdraw their money these entities face extinction with potential repercussions for other entities and the system. The vulnerability of financial markets to such bank runs has found a regulatory response in the form of deposit insurance. Private intermediaries that engage in similar bank-like activities, such as hedge funds, have instead at times unilaterally imposed redemption restrictions to ensure their survival in times of liquidity shortage.

Where there is disagreement is whether instability extends beyond intermediaries to financial markets, or whether financial markets can instead solve the instability problem by diversifying risk. Financial innovation has made possible the splitting of credit, default and interest rate risk; prior to the global crisis it was widely believed that this kind of risk diversification had ushered in a period of "great moderation", where instability was contained.[1] There are, however, good reasons to believe that the root causes of instability are the same for banks and markets. Both offer mechanisms for investing capital today in the hope and expectation of positive future returns, and both have to confront the conundrum that knowledge about the future is imperfect and liquidity is not a free good. Under these conditions, splitting risk cannot offer full protection against future events or a reversal of liquidity abundance.

The concept of liquidity as used in this paper is the ability to sell any asset for other assets or cash at will.[2] Selling or buying assets is intertwined with balancing one's assets and liabilities and as such necessarily links funding liquidity and market liquidity. This definition differs from others used in the literature. Brunnermeier and Pedersen, for example, define market illiquidity as the "difference between the transaction price and the fundamental value" and funding illiquidity as "speculators' scarcity (or shadow costs) of capital" (Brunnermeier and Pedersen, 2009 at 2202). This assumes that it is possible to determine an asset's fundamental value as compared to its value or volatility relative to other assets and to conceptually differentiate

[1] See Ben Bernanke, "The Great Moderation", 20 February 2004, available at http://www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm, for an argument that macroeconomic policies account for the decreased volatility in the economy.

[2] See also Keynes, who defines "liquidity preferences" as "a schedule of the amounts of his resources, valued in terms of money or of wage-units, which he will wish to retain in the form of money in different sets of circumstances". (Keynes, 1937, Chapter 13 at II). See also Mehrling, who associates liquidity with shiftability (Mehrling, 2011, at 38).