

A Fine and Private Place: The Lex Mercatoria of Finance

Cally Jordan

c.jordan@unimelb.edu.au

Melbourne Law School

Reconceptualising Global Finance and its Regulation

University of Hong Kong, Hong Kong

December 13-14, 2013

“The past is never dead.
It’s not even past.”

William Faulkner (1951)

Crisis and International financial standards

- GFC casts a strong light in the fine and private places of finance
- Surge in interest in international financial standards and calls for concerted international action
 - Prophylactic and diagnostic tool
 - Focus on “soft law” discourse at expense of critique of substance
 - Decidedly mixed experience in last decade

The Financial Stability Forum (FSF)

- Created in 1999 at instigation of G7
- National finance ministries, central banks, international financial institutions
- Response to Asian Financial Crisis when “contagion” entered financial lexicon
- To promote cross-border financial stability

FSF

- Early warning system: detect “vulnerabilities”
- Promote development of international standards
- Implementation by means of Financial Sector Assessments (FSAPs) conducted by the IMF or IMF/World Bank teams

Patent failure

- FSF did not avert the global financial crisis
- FSF did not see it coming
- Relegated to the dustbin of history in April 2009
- Successor: the Financial Stability Board (FSB)

FSF and “Soft Law”

- FSF an exclusive and reclusive club
- Obscure to the point of being “invisible” (Tett, 2009)
- “Never clear what action will follow or indeed ‘who will act’” (Eatwell, et al, 2008)
- Lack of transparency and contestability

The 12 Sets of International Financial Standards

- FSF adopts 12 sets of International Financial Standards in 1999
- To be used in Financial Sector Assessments (FSAPs) conducted by the IMF and The World Bank

The 12 sets of International Financial Standards

“The 12 standard areas highlighted here have been designated by the FSF as key for sound financial systems and deserving of priority implementation depending on country circumstances. While the key standards vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice.”

The 12 sets of International Financial Standards

1. Code of Good Practices on Transparency in Monetary and Financial Policies

- International Monetary Fund (IMF)

2. Code of Good Practices on Fiscal Transparency

- IMF

3. Special Data Dissemination Standard/General Data Dissemination System

- IMF

4. Insolvency and Creditors Rights

- The World Bank

The 12 Sets of International Financial Standards

5. Principles of Corporate Governance

- Organization for Economic Cooperation and Development (OECD)

6. International Accounting Standards (IAS)

[Now International Financial Reporting Standards or IFRS]

- International Accounting Standards Board (IASB)

7. International Standards on Auditing (ISA)

- International Federation of Accountants (IFAC)

The 12 sets of International Financial Reporting Standards

8. Core Principles for Systemically Important Payment Systems Recommendations for Securities Settlement Systems

(now replaced by Principles for Financial Market Infrastructures, April 2012)

- **Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS/IOSCO)**

9. The Forty Recommendations of the Financial Action Task Force/9 Special Recommendations Against Terrorist Financing

- **Financial Action Task Force (FATF)**

The 12 Sets of International Financial Principles

10. Core Principles for Effective Banking Supervision

- **Basel Committee on Banking Supervision (BCBS)**

11. Objectives and Principles of Securities Regulation

- **IOSCO**

12. Insurance Core Principles

- **International Association of Insurance Supervisors (IAIS)**

The 12 Sets of International Financial Standards

- FSF NOT a standard setter
- Somewhat arbitrarily picked existing standards – a collection of convenience
- No particular systematization
- Overlapping, duplicative, conflicting

The 12 Sets of International Financial Standards

- Not all of the same calibre
 - Some decades in the making by technical experts
 - Some brand new, untried
 - Some intended to have strong normative force
 - Others simply aspirational – airy vagueness

The 12 Sets of International Financial Standards

- Some ideologically driven by geopolitical forces
- Very different originators
 - Private sector initiators
 - Treaty organizations
 - International Financial Institutions
 - Ad hoc intergovernmental task forces
 - Industry associations and SROs
 - Associations of regulators

The WHY and HOW of International Financial Standards

- Myriad different INDIVIDUAL uses
 - Commercial expediency
 - International coordination
 - Gap filling
 - Political hegemony
 - Mitigation of systemic risk
 - Signalling

The Significance of the “SET” and the FSAP process

- By grouping these 12 very disparate standards together for purposes of IMF and World Bank Financial Sector Assessments
 - Took on a very different role and significance
 - All “legitimized” and given equal credibility

The Significance of the “SET” and the FSAP process

- FSAPs – IMF/World Bank teams spread the standards throughout the world
 - Used to “rate” countries’ financial systems
 - Senegal better than France?
 - “Conditionalities” – comply or else no funding

FSAP execution

- “Parachuting”
- Failure to take into account local circumstances
- Data not scrutinized rigorously enough
- Ratings and “check the box”
- Standardized advice (regardless of the country or problem)

FSAP execution

- “overly simplistic” messages
- Gaming of system
- Voluntary (not China, Indonesia, US)
- “20-25% systemically important countries didn’t participate” (IMF Evaluation 2006)

IOSCO Objectives and Principles of Securities Regulation

- 1998 : backward looking to US regulation and institutions of the 1990s
- Update in 2003 – reluctance to revisit substance
 - Tinkering at the margins in the footnotes
- Updated in 2008 – “absolutely identical to 2003” except for some footnotes (IOSCO, January 2010)
- June 2010 – new principles added in response to financial crisis

IOSCO Objectives

- Subsume the hidden assumptions of US securities regulation
- Reluctance to revisit substance
 - Tinkering with methodologies
 - Path dependency
 - Soft to hard law in many countries
 - Awkward to return and admit advice was flawed

Hidden Assumptions of US Securities Regulation

- 1930s retail investor/equity culture
- Debt markets ignored
- No derivatives (usually debt)
- Inadequate treatment of private market
- Intensely domestic focus
- In sum, the “hot buttons” of the financial crisis

The Elephant in the Parlour

- US law and ideology drives some international financial standards
- US would not participate in the FSAPs (until forced to by the global financial crisis)
- Canada, that boy scout of the international community, was the first

Why did the US not participate in the FSAPs

- Official reason: Did not want to overly tax IMF staff
- IMF - attributed its own inability to foresee the global financial crisis to the refusal of the US to participate in the FSAP process

US FSAP

- Made public May 2010 (not all countries agree to release of information, but US could not refuse)
- Paradox: benchmarking SEC and US securities markets and regulation to IOSCO Objectives (which are based ultimately on US institutions and regulations)

US FSAP

- “...the SEC believes that the Report’s conclusions are seemingly at odds with those of investors from around the world, both large and small....Judging by the degree of global investment in the U.S. market and taking into account the cost of capital in the United States, it would appear that those whose money is at stake view the U.S. regulatory system in a different, more positive light –even in light of recent regulatory failings.”

US FSAP

“In sum, the U.S. authorities firmly believe that the overall ratings are not reflective of the U.S. system for the *regulated marketplace*.” *(emphasis added, US FSAP, May 2010)*

Difficulties with the soft law discourse and international financial standards

- Recent experience with soft law international financial standards decidedly mixed
 - Top down, assumption riddled, international financial standards looking in the wrong place (national legislation)
 - Concept reveals profoundly different patterns of legal thought cutting across national boundaries

Differing patterns of legal thought and the soft law discourse

- US fixation on law emanating from the state and judicial enforcement
- UK more comfortable with more diffuse sources of law
- Continental jurists *relatively* unconcerned by judicial enforcement?

US soft law discourse

- Concepts of normativity floating free of state and judiciary problematic
- Formal written law, and its judicial enforcement, imprinted on US legal psyche
- The “particular genius” of US legal system
 - “constructive combination of elements of both civil and common law” (Glenn, 2004)

The UK and soft law

- UK – land of customary law and the judiciary
- Statutory law a second best
 - Represents a failure of the common law
- Transatlantic debate on financial regulation
 - Principles based or rules based
 - Voluntary codes of commercial behaviour
 - Comply or explain

Continental codal jurisdictions

- Different role for judiciary
- Triumvirate of the written word authoritative ?
 - Doctrine
 - Code
 - Statute

Patterns of legal thought and international financial standards

- UK and Europe open to concepts of transnational norms in a way the US is not
- UK – such norms represent an extension, internationally, of principles based, voluntary codes (if rooted in commercial reality)
- Europe – written nature of norms provides inherent authority, irrespective of provenance (and who cares about judicial enforcement)

Patterns of legal thought and soft law international financial standards

- International financial standards will have different “traction” depending on legal system in which operating

IFS and the Hidden World of International Commerce

- IFS and soft law discourse is more or less unknown or irrelevant in international commercial practice
- Focus
 - Effectiveness, not enforcement
 - Balancing of risk
 - Multiplicity of perspectives
 - Multiplicity of mechanisms
 - Instinctive recognition of multiple forms of normativity

International Financial Standards and the Lex Mercatoria

- International finance predates the nation state
- International capital markets supported by a large body of their own lex mercatoria

- *The Romance of the Law Merchant*

- What is lex mercatoria

- “...first stage concerns an ancient lex mercatoria in the Middle Ages, a transnational set of norms and procedural principles. established by and for commerce in (relative) autonomy from states”

(Michaels, 2007)

What is Lex mercatoria (cont'd)

- “New lex mercatoria” – 20th C
 - informal net of rules and arbitrators – “amorphous and flexible soft law”
- “New New lex mercatoria”
 - codified legal rules, institutionalized court-like international arbitration, eg. UNIDROIT Principles of International and Commercial Law
- No lex mercatoria (Kadens)

International Capital Markets and the Lex Mercatoria

• “The first stage concerns an ancient lex mercatoria in the Middle Ages, a transnational set of norms and procedural principles, established by and for commerce in (relative) autonomy from states.” (Michaels, 2007)

- Perhaps numerous distinct varieties
- Separate sets of transnational commercial law for specialised areas of international business (Berger)
 - *Lex sportiva*
 - *Lex petroli*
- And *lex financeria*?

International Capital Markets and the Lex mercatoria

- Demonstrating continuity and persistence over centuries
 - It has never died
 - Legacy of autonomy and self-regulation
 - Power of oral contracts

Lex financieria of international capital markets

- Autonomy and self-regulation of the City of London (600 acres, geographically defined)
- “...it was made an express provision of the Magna Charta [1215] itself, that the City of London should have all its ancient liberties and customs”

(The City of London Corporation Inquiry, 1854)

Autonomy, Self-Regulation and the City of London

- “It is laid down...that the City customs are of such force that they shall prevail against a general Act of Parliament”

(ibid)

- Autonomy and self-regulation defined finance in the City of London till 2000, in a strong form, and persist today

- “Received” in the United States in the 18thC

The Power of the Oral Contract

- *Nudem pactum*, ie, contract without formalities such as a writing or special words, did not exist in Roman law
- But oral contracts recognized among merchants
 - Expediency, generalized illiteracy
- Distinction continues in French “civil” and “commercial” codes

The Power of the Oral Contract

- Exception to the Statute of Frauds (1677) in the “City” of London (even land could be transferred by oral contract)
- *Dictum meum pactum* (my word is my bond) – motto of the London Stock Exchange (1801)
- “...morality and mutual trust” characteristic of “international business which turns the contractual promise into a categorical imperative”
(Berger)

The Power of the Oral Contract

- City of London home to the swaps and derivatives markets and currency markets
 - Developed in 1980s as a “telephone” market: long term, oral contracts, among relatively small number of traders (called merchant banks)
 - Despite technology and standardized contracts, still a telephone market

The Power of the Oral Contract

- “Computers and Bloomberg terminals dominate trading floors, but the human element remains a crucial feature of transacting across derivatives and other parts of the global financial system. This is no better illustrated than by the presence of so-called “voice brokers” who act as middle men for banks trading swaps and other fixed income securities in financial centres that link Asia, Europe and the US” (Financial Times, Feb.16, 2012)

The Power of Oral Contracts

- Traditional oral contract in *lex mercatoria a faute de mieux*
- Now – intimacy and immediacy of human voice create mutual trust in face of rampant self-interest and cut-throat competition
 - Speed and opportunity for repositioning
 - Security – remarkable capacity for human voice recognition, especially “active” voice recognition associated with negotiation

Implications of a lex financieria

- Did the GFC expose hidden worlds of lex financieria?
- Was the GFC triggered, in part, by a breakdown in the operation of a lex financieria?
 - Cultural and institutional rupture with past
 - Homogenous, culturally distinct enclaves of finance breached
 - Unspoken assumptions and understandings confused
 - Long term and intergenerational reputational pressures dissipated

Implications of a lex financieria

- Are international financial standards an attempt to create a new lex financieria?
- Will waves of re-regulation and scrutiny drive the lex financieria temporarily into hiding?
- On the contrary, will regulatory disarray give rise to new, opportunistic, forms of lex financieria?