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Law as a protected designation of origin: the case of Financial Law. Or how the delegation of rule making to private entities may lead to vertical economic integration and to barriers to entry

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Law as a protected designation of origin: the case of Financial Law. Or how the delegation of rule making to private entities may lead to vertical economic integration and to barriers to entry.

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Abstract

Starting from the puzzling situation of the US, and above all, the UK financial markets, this paper tries to supplement the current explanations of the constant dominance of these two financial centers. Law has specially mattered in this respect., Rather than the superior economic efficiency of UK-US financial law, as the "Law and finance" theory demonstrates, this paper explores how, in the past two decades, the financial industry, and especially the securities and bonds markets, has experienced a growing trend towards an implicit vertical integration due to the legal framework enforced by its actors. This legal framework plays very much the same role as a "protected designation of origin" mechanism. As in the agricultural and food industry, the legal framework helps building barriers to entry and integrating the different actors of the value chain. This "hybrid organization" model can be identified from originating banks to legal and accounting consultants, rating agencies, investment funds, etc. The movement towards delegation of the rule making function to private entities has greatly helped to establish this model – let alone to produce it. Such a delegation approach helped to spread it all over the world, especially across the Atlantic.

In order to identify this pattern, this paper mobilizes several analytical approaches: the economics of technical standards applied to law and the legal analysis of financial law and regulation, the "hybrid organization" model from New institutional economics, the economic analysis of self regulation and its potential effects on competition. It relies on observations of the positive legal framework and its evolution, as applied to several segments of the financial markets (mainly securitization and loan syndication), bringing some evidences of this strategic use of law.

As a conclusion, this analysis reverses the "Law and finance" analysis. It may also contribute to explain some causes of the current financial crisis, at least of its magnitude[1].

JEL: G10, G18, G28, K22, K23

Key words: Financial Law, Standard, Hybrid organization.

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Table of contents

Introduction

Starting from the late 1990s, a group of economists, known as “LLSV” (for R. La Porta, F. Lopez-de-Silanes, A. Schleifer and R. Vishny) launched the “Law and Finance” movement to advocate that there exists a legal framework especially efficient for the development of financial markets (LLSV, 1997, 1998). They have linked the legal framework to the development of financial markets and, through finance, to growth and development. Their theory could roughly (and then superficially) be summarized as follows:

- Economic development is linked with large and active financial markets;
- The legal rights attached to securities and the protection of minority shareholders are key factors for the development of sound financial markets. This protection may be direct – thanks to voting rights, the right to challenge board’s decisions, etc. – as well as indirect – through the efficiency of courts to enforce contracts, etc.;
- Hence, there exists a specific legal framework that is conducive to growth, because, through the protection of shareholders’ rights, it magnifies the efficiency of financial markets;
- Through econometrics, they identify that Anglo-American financial law, because it grants the best protection to shareholders, is the most conducive to growth.

They then derived from the same methodology a new approach to the interaction between Law and economic development. Their “New comparative economics” states that, from a general standpoint, there exists a legal framework that is more conducive to business and then to growth. This legal framework is very much similar to that of Anglo-American law, the civil law tradition being considered as an impediment to economic transactions (Djankov et alii, 2003). With its “Doing Business” (DB) reports, the World Bank gave a major influence to this theory [World Bank, 2004 to date].

However, this theory as well as its methodology, has spurred a lot of criticisms (see, among many references: Arrunada (2007); Roe (2006); Spamman (2006); Menard & du Marais (2008):

- Legal practitioners and the business community have relied on their experience to stress that there is no *downright superior* legal framework, able to mitigate and maximize all interests of all parties present in a specific transaction;
- Legal academics insisted that, in a globalized world, it is difficult to isolate a specific legal culture. On the contrary, law is increasingly the result of hybridizing between several legal traditions, all the more so as EU law plays an increasing role in business law;
- The law faculty and economists demonstrated that LLSV and DB methodology is fraught with many flaws, as stated in an independent evaluation from the WB itself (Elliott, 2008).

However, LLSV raised a good question. Since R. Coase and D. North[2], economists have demonstrated that “law matters”, as well as institutions, for economic development. Stemming from this approach, LLSV have rightly pointed how UK – US financial Law[3] especially matters for the development of financial markets. Since,

[2] If not from Montesquieu.

[3] We will use this denomination (and “Anglo-American financial Law”) rather than “Common Law”, because most financial Law is not derived from Court’s decision, as in the Common Law purest tradition.

according to their contenders, LLSV did not succeeded in demonstrating its technically relative superiority, how come this UK-US legal framework is especially in favour to their domestic financial markets?

Of course, the size and dynamism of these financial markets may be the consequence of economic physical parameters (such as the width of the US economy) or of path dependency (due, for instance, to the long lasting tradition of UK financial engineering) or of other competitive advantages such as lower wages, more attractive tax regime[4]. It may even be the positive consequences of some specific patterns of Anglo-American law which are particularly favorable to financial lenders –as British bankruptcy law is often described, as well as US Chapter 11[5]. From an even more general point of view, both financial markets may benefit from a comparative advantage due to the systematically business friendly attitude of judges, who are former professional lawyers[6].

But how come that, despite globalization, both financial industries expanded their markets share? In this respect, the case of the British financial industry is particularly puzzling, since the UK economy does not enjoy the comparative advantages of the US economy and the GBP no longer enjoys its role as an international currency. So the main question is not only to assess the dominant position of the UK financial market, but to find explanations to its dynamic.

This expansion can first be described by the dramatic growth of the size of UK financial market. Figures shown in Appendix One especially demonstrate that this expansion started at the turning point of the 1990s[7].

The overwhelming market share of the UK financial industry is so described by its lobbying arms: "UK is the leading exporter of financial services across the world Its trade surplus of USD 51bn in 2011 was than double that of the next largest trade surpluses recorded by Luxembourg, Switzerland and the USA. This trade surplus represents nearly four per cent of GDP in its own right. (…) Around half of European investment banking activity is conducted in the UK. Private equity UK-based private equity firms raised EUR 16.5bn in 2011, one-third of the total funds raised in Europe. (…) **Hedge funds** The hedge funds market in the UK, managing around USD 340bn at end- 2011, is the largest in Europe, accounting for over eighty-five per cent of European-based hedge funds' assets. **Derivatives** The UK is the biggest market in the

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On the contrary, most financial Law comes from written regulation, either enacted by regulators or by the legislator, let alone the industry itself. We do not either use the name "Anglo-Saxon" law, since several countries from the former British Empire never played such a prominent role in the financial sphere (e.g. Australia, New Zealand, etc.).

[4] In this respect, we have demonstrated that the attractiveness of London for the Hedge Fund industry was largely du to a favourable tax regime for the Hedge Funds managers (Boutillier, du Marais and al., 2009). This result does not contradict our analysis, since this tax expenditure policy seems to have been a response to growing competition from other financial centres rather than the cause of the industry initial location in London.

[5] Positive influence that comparative lawyers would nuance, especially pointing out that Chapter 11 is seldom used in the US and that UK bankruptcy law has increasingly become "debtor's friendly", but this discussion would spur another debate that fills hundred of learned article.

[6] Thus, again, reviving the controversy sparkled in the previous century by, among others, Judge R. Posner when he has assessed the comparative efficiency of Common law vs. Civil law judges. But in the following editions of his famous book, he recognized that things are much more complicated… (Posner, 1973, 2003).

[7] This figures have been constructed out of the Financial Structure Dataset (Revised: November 2010) from Thorsten Beck and Ed Al-Hussainy. (Beck et Al., 2009).

world for interest rate derivatives traded over the counter with forty-six per cent of global turnover in April 2010. It is also one of the leading locations for raising capital with ten per cent of initial public offerings (IPOs) worldwide in 2011." (The City UK, 2013). Tables in appendix Two show the comparative size – and strength - of London as a leading financial center, as compared as other major financial centers. Moreover, this figures demonstrate that London's market share enjoyed a continuing expansion in many realms, especially after the beginning of the year 2000s.

Indeed, what is interesting with the UK situation is that this country has lost many of its former comparative advantages in the competition between financial places. This market does not enjoy a size structurally large such as it has been before the loss of the British Empire.

Even for innovative financial schemes, such as Hedge Funds, the London financial centre seemed to get a dominant market share whereas the innovative status of these schemes may have appeared anywhere in the world. According to IFSL, at the end of 2006, two-thirds of European Hedge Funds were managed from London (i.e. 890 funds), which accounted for twenty-one per cent of global flows in alternative funds whereas Paris hosted only three point sixty-seven per cent of the global flows (Tadjeddine 2008; Boutillier, du Marais et al, 2009.).

So this article proposes to question LLSV's argument. The development of UK and US financial markets might not only be a consequence of an intrinsic superior efficiency of UK-US law, but also the effect of a strategic use of financial Law by the local financial industry to secure and expand its market position. The assumption is then the following: UK-US financial law is a driver of GB and US financial markets development because this is a strategic tool to foster a quasi monopolistic position of US and GB financial markets –or moreover operators[8] - by its vertical integration effect along the value chain.

In Section 2, in order to demonstrate this thesis, we will rely on two major economic analytical frameworks applied here to Law: the economics of technical standards, and the economic analysis of the anticompetitive effect of "registered designation of origin", which is considered as an "hybrid institution" by New Institutional Economics (NIE). However, both financial industries have needed other ingredients to reach a worldwide dominance and secure this dominance to date. Section 3 posits that the very decision made by policy makers and regulators to rely on the industry self regulation gave to the UK-US financial law an overwhelming advantage over alternative legal schemes, hence enabling their domestic operators to get a worldwide and long-lasting dominance. As empirical evidences, Section 4 gives several main evidences of the combination of these three factors (standardization; labelling of financial legal arrangements according to a quasi RDO scheme, self-regulation). Section 5 draws some conclusions, especially in the context of the 2008 financial crisis.

[8] This distinction is not neutral, because the virtue of Law – especially its immaterial and cultural nature - makes it possible for the UK-US financial industry to keep its dominant position even if the markets are delocalized or, as it is the case, are expanding all over the world.

1. Analytical framework

1.1 *Applying QWERTY-nomics to Law: UK-US financial Law as standard*

In this paragraph, we would like to apply to Law the analytical framework used by Paul David in its seminal article to explain how technological standards[9] emerge (David, 1985).

We will summarize David's "basic Qwerty-nomics" (or even caricature it) while at the same time applying its legal framework to financial Law[10]. In order for a technical process or innovation to become a de facto technical standard, there should be the combination of a specific context and three factors (we would also add another one to David's initial analytical scheme):

- The context: the process should *be part of a larger, complex production system which is nobody's design* (there is no patent, or intellectual property protection, for instance, granted to a certain actor of the market). Here, no need to say that financial markets are extremely complex, with a complicated matrix of actors of whom none actually owns the general design of the market. IP law plays very little to secure individual's market position.
- Fist factor: there is *technical "interrelatedness*":
  a) There is a need for compatibility between the production equipment of the industry (the equipment using the technology subject to the analysis, also called by David "the hardware") and the skills of the "users" of this production equipment ("the software"). Therefore, users may benefit from positive externality to adopt the standard. Given the worldwide market of financial investment, the "users" of financial law (here, financial products' issuers and their traders, i.e. the selling side of the market) will immensely benefit from a worldwide standard.
  b) For the buyers of the technology, interrelatedness means that the expected Net present value of the equipment using the technology, as a mean of production for the industry, is a positive function of the availability of "users" compatible with this technology. So, reversely, the decision of to buy the technology brings positive externality for users,
- Second factor: The use of the technology therefore produces *system economies of scale*:

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[9] In this article, we will use the word "standard" in its technological meaning. Therefore, "legal standards' should not be confused with what Dean Roscoe Pound meant by "legal standard" in his 1919 address to the American Bar Association, as an average indication of a correct social conduct (Tunc, 1970).

[10] In order to explain the emergence of the QWERTY keyboard as a technical standard, David identified different elements: the QWERTY keyboard order is the technical innovation or the technology; the typewriter is the production equipment or "hardware"; typists are the "users" of the technology, or "software"; typists' employers are the buyer of the technology; typewriters producers are the suppliers of the technology.

By analogy, in the legal services, we would designate US-UK Law as the technology; financial products (such as bonds, security, ABS, etc.) are the equipment for the financial industry or "hardware"; lawyers involved in the financial industry are the "users" of the technology or "software"; lawyers' employers (i.e. investment banks, rating agencies, etc) are the buyers of the technology; law firms are the suppliers of the technology.

These externalities mean that the users' cost will decrease as the technology gains acceptance. These decreasing costs are system economies of scale and lead to *de facto* standardization.
Continuing with the analogy applied to the financial industry, using UK-US Law brings system economies of scale, even for non common law operators.

- Third factor: *irreversibility*
David shows that expectation plays a major role to establish a situation of "lock in": all actors (purchasers of the software as well as that of software) expect the technology to take the lead over alternative technologies, given they witness the economies of scale. Hence, the cost of software conversion to another technology rises. But, interestingly, David shows that there is asymmetry in the conversion cost. For suppliers of the technology, it is relatively (and decreasingly) costless to switch to another technology from a technical point of view, especially in order to turn to the standard. On the contrary, for technology users (the software), it is extremely (and increasingly) costly to switch to another technology, all the more so if they want to avoid the standard.
The same phenomenon may apply to financial law. For non US or UK banks, it is extremely attractive to switch to UK-US financial law. On the contrary, once lawyers have been trained in a certain legal culture, it is extremely costly to be retrained in another legal system. This is another case showing that human capital takes more time and money to build up, than physical capital does.
So, to a certain extent, there is an implicit coalition of employers and employees to stick to the same technological formula, here the UK-US financial law.
- Fourth factor: *the credibility of the new technology sponsor*.
Although David pays little attention to this fact, the dissemination of QWERTY was all the more rapid as its inventor persuaded Remington, the then leading weapons producer, to adopt this technology. Had it been a minor industrialist, might the world use another keyboard arrangement. Other examples of de facto standards –such as Windows from Microsoft, Betamax with Sony – tell us that the choice of the inventor to convince a leading supplier to adopt its technology may be crucial, as Bill Gates did with IBM.

In this respect, the fact that common law lawyers could be "used" by the then leading financial operators –namely the US – was clearly an advantage. Counter evidence is given by the Swiss private banking industry. Although it has a leading market share in the segment of private banking within the financial markets (namely around thirty-five %), Swiss civil law (inspired from the French and German civil law) never succeeded in replacing UK-US law as the leading pattern for the whole financial industry, let alone this segment.

For a group, to adopt a standard, especially if this standard is an institution or a» common order" (to use the words of Brousseau, Raynaud, 2011) provides network positive externalities to the group members, all the more so as the number of members grows. Subject to the raise of costs due to the implementation of this standard in an ever bigger group, and subject to the risk that members on the group's fringe quit the group, the growth of the users' group will provide more positive externalities to its members. However, this dynamic says nothing about the content of the standard or of the "common order". On the contrary, the need to manage a group with more and more members, always more heterogeneous, will lead to change into the substance of the standard. The group membership will make the standard evolves, either to a set of common rules agreed upon by all as a minimum. Or it may evolve to the rules needed to keep the fringe members within the group. In all cases, the standard content will evolve according to coordination needs of the members and their respective bargaining power. In this "lifecycle of institutions", the standard should become increasingly generic.

However, what is striking with US-UK financial law is that it will influence other jurisdictions' business and financial Law. Many examples of this influence exist in French Law: the dissemination of the "Trust", for instance; or the move towards the "compliance approach"; the introduction by competition or financial regulators of plea bargaining, etc. If this influence is asserted, identical solutions given by different legal systems should not be assimilated with "legal transplants" [Baker, 2001]. However, there is very little hybridising or watering down of the initial concepts due to the influence of other legal traditions, except maybe in the UK law, whenever the issue is within the scope of an EU Directives[11].

This then leads to another factor explaining the success of UK-US financial law: the fact that it is territorially grounded.

1.2 UK-US financial Law as a "registered designation of origin": a production process impossible to copy

In the financial industry, the legal framework plays very much the same role as a "registered designation of origin" (RDO) mechanism. RDO can be defined as a scheme which "covers agricultural products and foodstuffs which are produced, processed and prepared in a given geographical area using recognised know-how"

As RDO, Law is linked to a specific territory and culture. Therefore, its components are not replicable elsewhere as it is for a technical process, if we take a "hardware" perspective to speak as David.

New Institutional Economics has documented how RDO can be analyzed as an "hybrid organization" around which a whole sector may integrate vertically and build barriers to entry (Ménard, 2003; 2004). The agrifood industry presents many examples of such local monopoly: Bordeaux for red wine, Parmesan cheese, etc. RDO is both a quality label - hence a signal for the consumers - and a legal protection given to an industrial organization granting privileges to the incumbent. For competition authorities, this pattern has long been considered a threat to fair competition until it has been accepted, especially by the EU Commission and the WTO.

This "hybrid organization" helps an industry to integrate horizontally as well as vertically around a label and a territory, saving its participants costly capitalistic mergers. In the financial industry, the use of UK-US financial law as a quality label helped several actors to aggregate around financial institutions: namely accounting firms, rating agencies and law firms. Their main common characteristics are to belong to the same legal culture, here acting as the territory of an agricultural RDO. More precisely, in the case of financial law, the link with a specific territory is due to two main legal patterns. First, the jurisdiction clauses of contracts designate specific US or British courts to adjudicate conflicts. Second, the extensive principles governing US legal jurisdiction help to build the monopoly of US courts to enforce US financial regulation (as it was the case with the implementation of SOX).

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[11] And assuming that the UK did not influence the Directive negotiations in favour of its own legal framework.

However, the RDO pattern is clearly not sufficient to promote a brand to the extent that all actors within the industry, even when located outside the territory which is linked to the RDO, are compelled to use this brand or to buy to the suppliers protected by the RDO.

As a matter of fact, UK-US financial law doesn't work as the "Champagne" brand does. Champagne, which is both a RDO and a registered trade mark, compels all sparkling wine producers in the world to drop the Champagne's name, and even the reference to "method Champenoise" [Barrere, 2001]. Here, UK-US financial law works as if all sparkling wine producers were compelled to use all, or part of, the Champagne production tools.

In this respect too, UK-US financial law does not work neither as *Lex Mercatoria* did. *Lex Mercatoria* is the product of hybridising between different merchants' customs. It also is grounded on common principles derived to solve same problems encountered by different merchants.

2. The multiplying role of self-regulation

UK-US financial law, from an extremely localized legal culture, became a worldwide technical standard for the financial industry. This result has been achieved by a combination of two factors: a) the RDO logic applies to a standard framing the production factors of other agents within the industry, as the QWERTY did for all office work; b) all actors are compelled to use it. This could only be achieved because regulators delegated the regulation function to the industry itself – especially to its dominant operators. Here is where self-regulation interferes.

In this section, and among the many definitions of self-regulation, self-regulation is taken "As a legal phenomenon, self-regulation is more usually analysed as a deliberate delegation of the state's law-making powers to an agency, the membership of which wholly or mainly comprises representatives of the firms or individuals whose activities are being regulated" (Ogus, 1999).

The drafting function has then been granted to the industry, whereas the enforcement mechanism stays within the governmental sphere, thus giving the maximum efficiency in enforcement.

The leverage effect of self regulation for the industry is great. Indeed, this system may lead to capture (Stiegler, 1971) and rent-seeking (see references in Ogus, 1999) as it has been largely documented in the literature.

But moreover, the financial industry shows a paradoxical situation as regard regulation. Whereas its scope is worldwide or a least based on a market the size of a continent, the regulatory framework is very much fragmented between several jurisdictions (namely, the US, the UK, several EU member states, Japan, Honk-Kong, etc.). Moreover, before the 2008 crisis, many developed countries had several regulators, each addressing sector related issues within the industry. However fragmented this regulatory framework was, all regulators shared two things: a common belief in the virtue of self-regulation; a tendency to align their regulatory policy according to the US-UK practices. The regulators convinced themselves that the paradigm of self regulation and self equilibrium of financial markets was superior, thus being a perfect example of the "regulator's capture" from Stigler.

The easy adoption of IFRS as accounting standard within the EU is a good evidence of this pattern. This common approach has developed thanks to the regulator's capture by the industry: “capture-usage” in the US, “capture-neutralisation” in Europe (du Marais, 2009)

The consequence of these three patterns (standardization according to US-UK financial law, acting as a RDO and made compulsory by regulators) led to the vertical integration of all actors present in the value chain around the “label” of UK-US financial law. At least, two case studies may demonstrate this vertical integration.

3. Empirical demonstration: evidences of the vertical integration around Law

3.1 *The standardization of financial contracts in France through ISDA and LMA standard contracts.*

Standard contracts have always existed in order to ease business, e.g. the IncoTerms (International Commercial Terms) for international trade, drafted under the auspices of the ICC in Paris. Professional customs and usages also have played an important role in private finance. Even in a civil law country like France, were the legal framework relies heavily on State regulation, the “Convention de place” plays a major role and are considered valid regulation by courts and regulators (see art. L. 431-7 C. mon. et fin.).

In the last two decades, legal instruments for financial innovative products such as swaps and derivatives get standardized. In 1992, the French banking association (AFB-FBF) drafted a model contracts for credit syndication. However, this contract was enforceable only between French operators. It did not have a great success.

At the same time, the ISDA, a NGO and a professional association[12], drafted a model contract for derivatives and swaps which soon became a standard. The success of this contract stemmed not only from it use by the dominant operators, but also because it comprised several attractive patterns. This contract was open to all actors as long as they take part to the market.

The same pattern appeared in the attempt of the LMA [13] to impose its model contract for syndicated loans in 2002.

The ISDA model contract imposes the jurisdiction of US or UK Courts in case of litigation. The LMA is within the jurisdiction of French courts but is, accordingly since its presentation in France in 2002, still only available in English. LMA model contract is now widely used in France, even for syndicated loans to French corporations that involve, in the banks’ syndicate, only French banks.

Both standard contracts spread all over the world, thanks to the intense lobbying and PR campaign of each professional union. In this respect, both are extremely active in vocational training, organizing all over the world seminars where professional enjoy networking and exchanging experiences but also where they are taught the standard latest refinements. It acts as a global and permanent university.

Moreover, cooperation with two major global law firms. Allen & Overy - for ISDA - and the same along with Clifford Chance - for LMA. They both provided a pro-bono legal opinion for almost all countries in the world, therefore ensuring users of the model contract its worldwide scope. The Law firms were then contributing to the dissemination of the model contract as well as building the demand for their legal

[12] International swap derivative association: http://www.isda.org/.
[13] Loan Market Association : http://www.loan-market-assoc.com/.

services. They were also securing a competitive advantage. Although there are several law firms involved in the banking industry, these two model contracts lead to a sort of *implicit* integration between these law firms, banks and their clients.

Besides, at least in the case of ISDA, this integration is no longer regarded as *implicit* by the competition authority. The EU Commission has opened an Antitrust case against ISDA. It recently extended CDS information market investigation to International Swaps and Derivatives Association (ISDA) See EU Commission Presse release IP/13/286 of 26/03/2013.

3.2 *The case of the securities industry*

The case of the securities industry –or the securitization industry - is even more interesting. The segment of the financial market called “structured finance” consists in “structuring” a pool of debts – such as mortgages as in the subprime case - or amount receivables – as invoices, credit card accounts, etc. – into a bond (an asset backed security – ABS) which is then tradable on financial markets.

The value chain is complex, from the initial issuer of the individual debts or invoices; to the “originator” which usually is a bank, packaging the initial cluster; to brokers who sell them to Financial Investors (Bank, Pension Fund, Insurance Corp., Hedge Fund, etc.) who act as retailers then to Individual investors. In this value chain, two other actors are crucial for the success of the operations: credit rating agencies (CRAs) and Law Firms.

CRAs act as doorkeepers to the market (du Marais and al., 2007a, 2007b]. Their rating is not only crucial for the financial returns of the whole scheme, but, if they give a low rating, it may impede the flotation of the structured finance product. The assessment of the legal soundness of the scheme is a major component of the final rating.

Observation shows:

- First, it is extremely difficult – if not impossible - to structure such bonds with a different legal framework than US or UK Law, which are *de facto* standards. This obstacle is felt at two levels. On the one hand, a qualitative assessment of the industry practices shows that CRAs are reluctant to validate different legal arrangements. On the other hand, some synthetic indicators used by CRAs quantitative models are biased[14].
- Secondly, and at least before the financial crisis, there was a lack of transparency, to say the least, in the relationships between law firms, CRAs and issuers and/or originators. CRAs were reckoning on the legal opinion given to them by the issuer’s or originator’s lawyers. These lawyers were then subject to a strong incentive to “negotiate” the legal scheme best suitable to CRAs;
- Thirdly, at least in France, there was a mirroring oligopoly between the three CRAs and law firms able to discuss these legal schemes.

Gradually, and through the influence of CRAS, appeared an *implicit* vertical integration built around the use of UK-US financial law, between originating banks, CRAs and law firms. This vertical integration was all the stronger as regulators

[14] We’ve conducted a sample survey of one of the CRA ratio which showed that it was relying on the “Financial maps of the world” edited by P. Wood, “Special Global Counsel” at international law firm Allen & Overy (Wood, 1997 to date).

bestowed to CRAs a quasi regulatory function. First, regulations impose securities to obtain a certain rating before being traded. Second, CRAs themselves were not supervised by public regulators. Managed under the Freedom of speech principle, they were self regulated and their only constraint was the risk of losing their reputation. Moreover, the market legal practices were seldom questioned by regulators.

This paradigm worked as if it were not possible to issue structured finance instruments not legally compatible with the CRAs practice, which mirrored the dominant market practices, i.e. that of the dominant operators – namely US or UK financial operators. And these market practices were only understandable by certain law firms, those with the longer working experience with the two other actors, etc.

Conclusions: an explanation of the magnitude of the crisis?

In the past two decades, the financial industry, and especially the securities and bonds market, has experienced a growing trend towards an implicit vertical integration due to the legal framework enforced by its actors. From this analysis, we can draw several conclusions.

First, LLSV results are self fulfilling: UK-US law is more conducive to financial market growth because it became the unavoidable standard which all financial operators should adopt in order to do business, thus reinforcing the apparent attractiveness of New York and London financial centres.

Second, our analysis may contribute to the explanation of the 2007 – 2008 financial crisis which appeared in the structured finance segment of financial markets. From the one hand, this analysis shows the risk to rely solely on self-regulation. CRAs were self-regulated. If Law firms are regulated – and in some countries, as in France, rather heavily – this regulation does not address the content of their production. It rather deals with their organization, ethics and incorporation. So, the whole legal content on which structured finance was based was the result of market practices, let to the industry. To a certain extent, it was not within regulators' jurisdiction to question the soundness of the legal framework used by the operators.

On the other hand, the fact that all operators relied on the same legal framework – UK-US law being the standard – brought limitation to financial innovation and to the variety of solutions implemented by the industry, thus reinforcing the market position of a limited amount of operators. In terms of risk analysis, standardization of law contributed to the standardization of financial products, and then fostering the exposure of the industry to a flaw in the dominant model. This may have contributed to the magnitude of the crisis once it appears. To a certain extent, "jurisdiversity" helps to spread the risks.

Moreover, the use of various legal arrangements, sometimes in their own legal culture and native language, would have helped final investors to question the soundness of the products they were buying. Rather than relying on the sole reputation of their counterparts, the German buyers of subprime CDOs – whose stupidity is so well described in *The Big short* from Michael Lewis (2010)– might have been in a position to read the product documentation and make a more learned assessment of their soundness. But this is another story…

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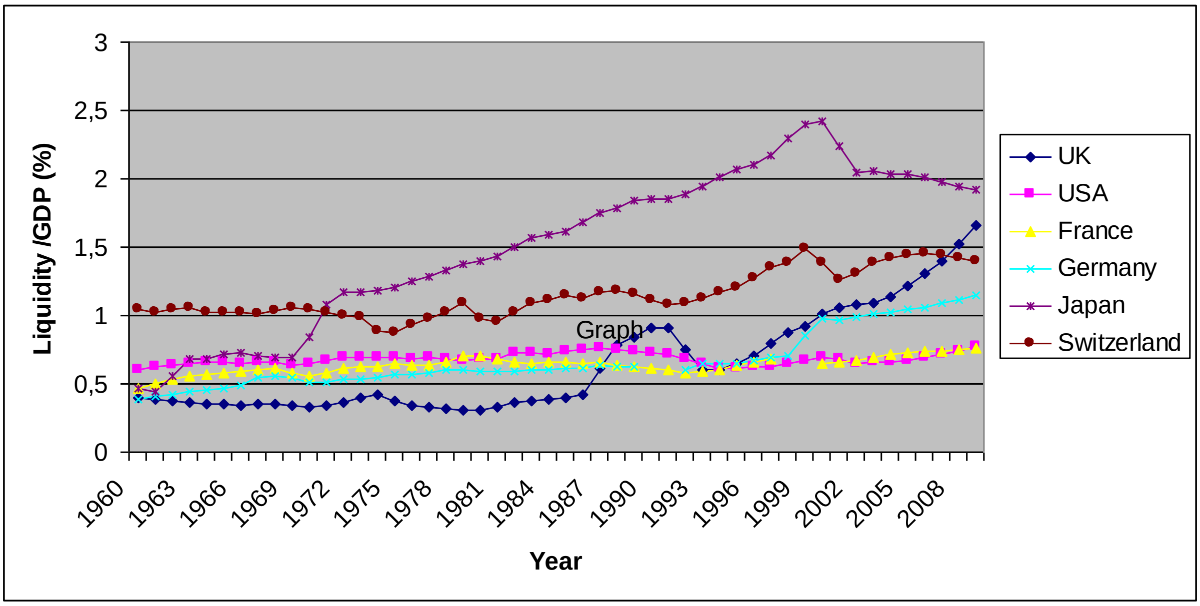
Appendix One



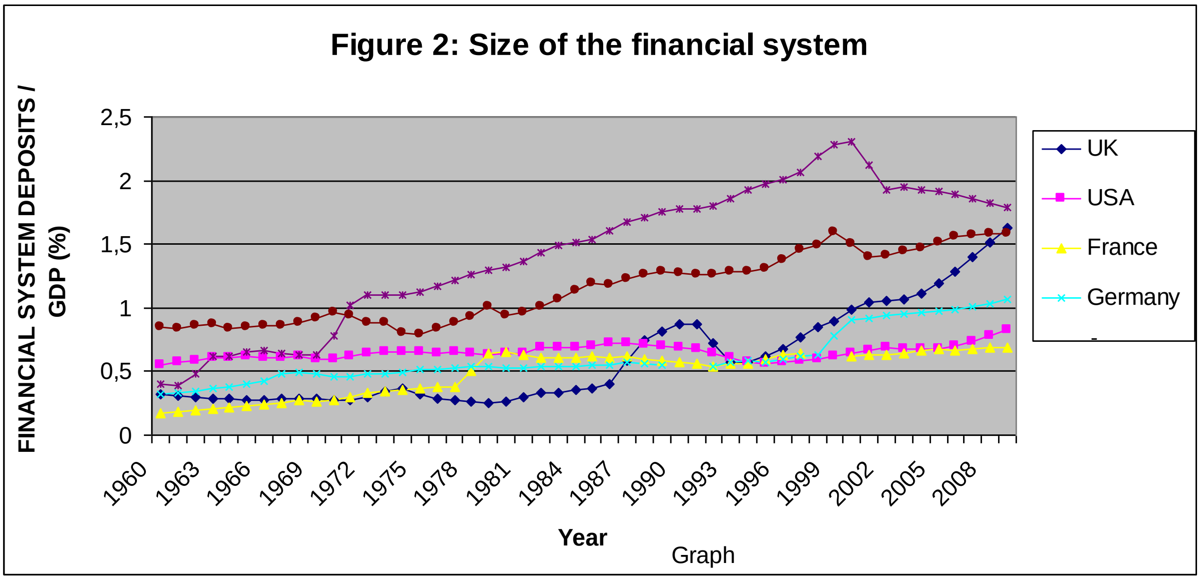
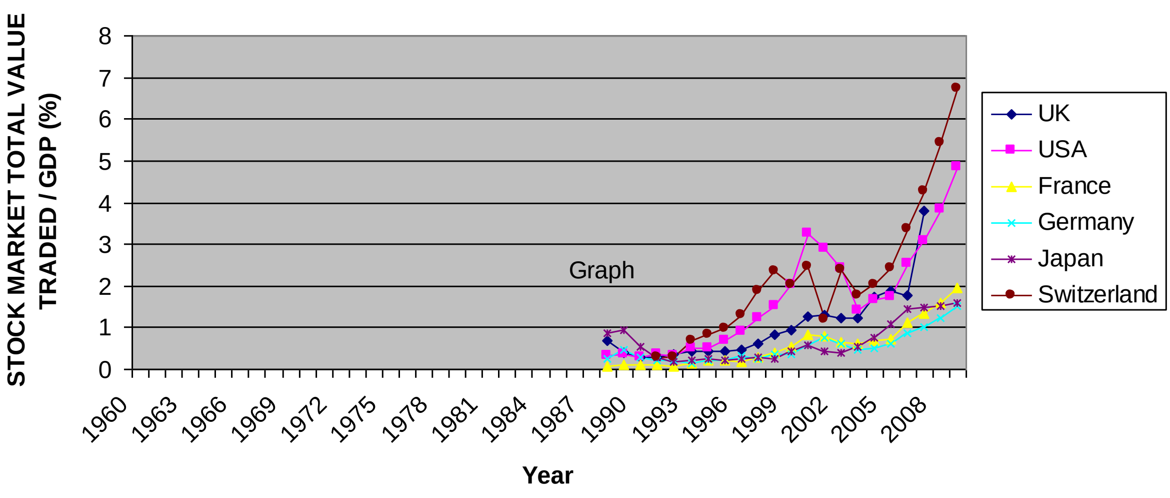


Figure 3: Size and development of the stock market



Appendix Two

FINANCIAL MARKETS SHARE BY COUNTRY (%)

	UK	US	Japan	France	Germany	Singap.	H.Kong	Others
Cross-border bank lending (Sep 2012)	19	11	11	8	8	3	3	37
Foreign exchange turnover (Oct 2012)	37	17	6	3	2	6	5	24
Exchange-traded derivatives, number of contracts traded (2012)	7	34	2	---	8	---	1	48
Interest rates OTC derivatives turnover (Apr 2010)	46	24	3	7	2	3	1	14
Marine insurance net premium income (2011)	19	6	9	4	4	1	1	56
Fund management (as a source of funds, end-2011)	8	46	8	3	2	---	1	32
Hedge funds assets (end-2012)	18	65	2	1	---	1	1	12
Private equity - investment value (2011)	12	46	1	5	2	1	---	33
Securitisation - issuance (2011)	6	73	2	1	1	---	---	17

Market leader

UK SHARE OF FINANCIAL MARKETS (%)

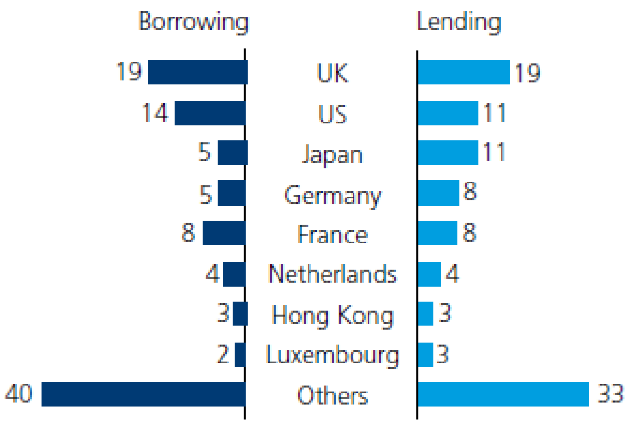
	1992	1995	1998	2001	2004	2007	2010	2012*
Cross-border bank lending	16	17	20	19	20	18	18	19
Foreign exchange turnover	27	30	33	31	32	37	37	37
Exchange-traded derivatives	12	12	11	7	7	6	6	7
Interest rates OTC derivatives turnover	---	27	36	35	42	44	46	---
Marine insurance net premium income	24	21	14	18	19	17	20	---
Fund management (as a source of funds)	---	---	8	8	8	9	8	---
Hedge funds assets	---	---	---	9	22	22	19	18
Private equity	---	---	---	6	24	17	21	---
Securitisation - issuance	---	---	---	---	4	14	6	---

**Latest available data for 2012 (corresponds with dates in the first part of the table)*
Source: TheCityUK calculations and estimates based on various sources

Excerpted from: The CityUK, Key facts about UK financial and professional services

INTERNATIONAL BANK LENDING

% share of total, September 2012



Source: BIS