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Inequality, Law and Distribution in Transnational Financial Markets

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Abstract

Since the financial crisis of 2007–2008, the legal infrastructure of transnational financial markets has attracted much attention in international legal scholarship. Yet, few legal researchers have looked at these markets from a specifically distributional perspective. Drawing on insights from political economy and transnational legal theory, this article addresses the question of how to politicize the distributional choices inherent in the legal infrastructure of transnational financial markets.

1 Introduction

The financial crisis of 2007–2008[1] has had the effect of fundamentally challenging the political and economic project of the (post-)Washington Consensus.[2] The concept of market efficiency – or, rather, Eugene Fama's *Efficient Capital Market Hypothesis*[3] – was once again confounded by real life economic developments. Against this background, transnational financial markets have posed some of the most pressing regulatory challenges during the last decade. For, these markets have been considered

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1 See UNCTAD, *The Global Economic Crisis: Systemic Failures and Multilateral Remedies* (2009) (Report by the UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation, UNCTAD/GDS/2009/1).

2 See Stiglitz, 'Is There a Post-Washington Consensus?', in N. Serra and J. Stiglitz (eds), *The Washington Consensus Reconsidered: Towards a New Global Governance* (2008), 41.

3 Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work', 25 *Journal of Finance* (1970) 383.

to have an influence on, among other things, food price volatility,[4] sovereign debt markets[5] and world economic stability.[6] What is more, scholars also suspect that the legal infrastructure of transnational financial markets is one of the key drivers of increases in global economic inequality.[7] Few legal researchers, however, have looked at these markets from a specifically distributional perspective. I will argue that the reason for this disregard for distributional aspects lies in a particular understanding of the relationship between law and economic transactions that pervades the dominant literature on transnational and international economic law. According to this understanding, the law's primary function is to facilitate efficient economic transactions. In this article[8] I combine insights from political economy[9] and transnational legal theory[10] to address the question of how to politicize the distributional choices

4 See O. De Schutter, 'Food Commodities Speculation and Food Price Crises: Regulation to Reduce the Risks of Price Volatility (2010) (UN Special Rapporteur on the Right to Food Briefing Note No. 2); Guilleminot, Ohana and Ohana, 'The Interaction of Speculators and Index Investors in Agricultural Derivatives Markets', 45 *Agricultural Economics* (2014) 767, at 788; Gilbert, 'How to Understand High Food Prices', 61 *Journal of Agricultural Economics* (2010) 398; C. L. Gilbert, *Speculative Influences on Commodity Futures Prices 2006–2008* (2010) (UNCTAD Discussion Papers No. 197); Esmel, 'Food Speculation: Between Virtual … and Reality', 31 *American University International Law Review* (2016) 507; Gonzalez, 'World Poverty and Food Insecurity', 3 *Penn State Journal of Law & International Affairs* (2015) 56, at 66; Williams, 'Feeding Finance: A Critical Account of the Shifting Relationships between Finance, Food and Farming', 43 *Economy and Society* (2014) 401; A. Chadwick, *Law and the Political Economy of Hunger* (2019), at 84ff.; J. Horst, *Transnationale Rechtserzeugung* (2019), at 109ff.

5 See G. Palladini and R. Portes, *Sovereign CDS and Bond Pricing Dynamics in the Euro-Area* (2011) (NBER Working Paper Series, No. 17586), available at http://www.nber.org/papers/w17586 (last visited 21 April 2022); Coudert and Gex, 'The Interactions between the Credit Default Swap and the Bond Markets in Financial Turmoil', 21 *Review of International Economics* (2013) 492; Aktug, Vasconcellos and Bae, 'The Dynamics of Sovereign Credit Default Swap and Bond Markets: Empirical Evidence from the 2001 to 2007 Period', 19 *Applied Economics Letters* (2012) 251; International Monetary Fund, *Global Financial Stability Report: Old Risks, New Challenges* (2013), at 57, available at https://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/Global-Financial-Stability-Report-April-2013-Old-Risks-New-Challenges-40202 (last visited 14 April 2022); J. Aizenman, M. Hutchison and Y. Jinjarak, *What Is the Risk of European Sovereign Debt Defaults? Fiscal Space, CDS Spreads and Market Pricing of Risk* (2011) (NBER Working Paper Series, No. 17404), available at http://www.nber.org/papers/w17407.pdf (last visited 21 April 2022); Calice, Chen and Williams, 'Liquidity Spillovers in Sovereign Bond and CDS Markets: An Analysis of the Eurozone Sovereign Debt Crisis', 85 *Journal of Economic Behavior & Organization* (2013) 122.

6 See UNCTAD, *Trade and Development Report, 2013: Adjusting to the Changing Dynamics of the World Economy* (2013), at 125; Fletcher, 'Hazardous Hedging: The (Unacknowledged) Risks of Hedging with Credit Derivatives', 33 *Review of Banking & Financial Law* (2014) 813.

7 K. Pistor, *The Code of Capital: How the Law Creates Wealth and Inequality* (2019); Pistor, 'A Legal Theory of Finance', 41 *Journal of Comparative Economics* (2013) 315; T. Piketty, *Capital in the Twenty-First Century* (2014).

8 For a more extensive treatment of the subject, see Horst, *Transnationale Rechtserzeugung, supra* note 4.

9 Purdy *et al.*, 'Building a Law-and-Political-Economy Framework: Beyond the Twentieth-Century Synthesis', 129 *Yale Law Journal* (2020) 1784; Grewal and Purdy, 'Inequality Rediscovered', 18 *Theoretical Issues in Law* (2017) 61; Hockett, 'Putting Distribution First', 18 *Theoretical Inquiries in Law* (2017) 157; Deakin *et al.*, 'Legal Institutionalism: Capitalism and the Constitutive Role of Law', 45 *Journal of Comparative Economics* (2017) 188.

10 E.g. Zumbansen, 'Transnational Private Regulatory Governance: Ambiguities of Public Authority and Private Power', 76 *Law and Contemporary Problems* (2013) 117; A. Fischer-Lescano and G. Teubner,

inherent in the legal infrastructure, using transnational financial markets as an example. I will begin by introducing the markets for over-the-counter (OTC) derivatives and the International Swaps and Derivatives Association (ISDA) (Section 2) and discussing the distributional effects of those markets (Section 3). Then, after critically analysing some of the assumptions underlying the dominant understanding of the relationship between law and economic transactions, I will identify the characteristics of a distributional perspective on transnational law (Section 4). To conclude, I will argue that a distributional perspective needs to draw on both legal pluralism and universalism in developing an integrative approach to tackling distributive choices in transnational law (Section 5).

2 OTC Derivatives Markets and ISDA

A *OTC Derivatives Markets*

Financial derivatives can serve a variety of purposes: they may be used, among other things, as insurance, to hedge against or acquire different types of risk, in arbitrage activities or purely or partly for speculative purposes.[11] The constant characteristic is that their value is derived from an underlying asset.[12] At the most basic level, derivatives enable a person or entity to participate in the price development of the underlying asset without owning it. Derivates can be traded either via an exchange or over the counter. Participants in OTC derivatives markets traditionally take positions directly by means of individual bilateral contracts.[13] In 2011, the notional value of OTC derivatives was USD 707 trillion.[14] Their sheer volume indicates the importance of OTC derivatives markets for the global economy. The role played by OTC derivatives markets during the 2007–2008 financial crisis[15] has meant that they have recently attracted much attention in legal scholarship.[16] Discussions have focused in

Regime-Kollisionen: Zur Fragmentierung des globalen Rechts (2006); Cutler, 'The Judicialization of Private Transnational Power and Authority', 25 *Indiana Journal of Global Legal Studies* (2018) 61; Volk, 'Enacting a Parallel World: Political Protest against the Transnational Constellation', 15 *Journal of International Political Theory* (2018) 100.

11 See, e.g., Lynch, 'Derivatives: A Twenty-First Century Understanding', 43 *Loyola University of Chicago Law Journal* (2011) 1.

12 On the distinctive characteristics of derivatives, see Awrey, 'The Mechanisms of Derivatives Market Efficiency', 91 *New York University Law Review* (2016) 1104, at 14ff.

13 Schüwer, 'Funktionen und Einsatz von Finanzderivaten', in J.-C. Zerey (ed.), *Finanzderivate: Rechtshandbuch* (4th ed., 2016) 51, at para. 10.

14 See Braithwaite, 'Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets', 75 *Modern Law Review* (2012) 779, at 785.

15 See UNCTAD, *supra* note 6, at 125.

16 See Chadwick, 'Commodity Derivatives, Contract Law, and Food Security', 9 *Transnational Legal Theory* (2019) 371; Chadwick, *supra* note 4; D'Souza, Ellis and Fairchild, 'Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market', 12 *University of Pennsylvania Journal of Business Law* (2010) 473; Baker, 'Regulating the Invisible: The Case of Over-the-Counter Derivatives', 85 *Notre Dame Law Review* (2010) 1287; Nietsch and Graef, 'Regulierung der europäischen

particular on proper prudential regulation[17] and democratic oversight.[18] One of the most important characteristics of these markets is that parties are exposed to the default risk of their respective counterparties.[19] Several contractual arrangements have consequently been developed specifically to minimize the exposure of market participants to default risk.[20] The most prominent examples are collateralization[21] and close-out netting.[22] Although traditionally regarded as highly unregulated,[23] OTC markets have been the subject of several regulatory reforms in recent years.[24] The introduction of mandatory clearing obligations via central Counterparties (CCPs)[25] is of particular relevance here. In accordance with FSB recommendations,[26] such obligations have been introduced in the United States[27] and the European Union.[28] A CCP[29] is a legal entity that acts as both the buyer and the seller of an OTC contract,

Märkte für außerbörsliche OTC-Derivate' *Betriebs-Berater* (2010) 1361; Latysheva, 'Taming the Hydra of Derivatives Regulation: Examining New Regulatory Approaches to OTC Derivatives in the United States and Europe', 20 *Cardozo Journal of International and Comparative Law* (2012) 465; Sharma, 'Over-the-Counter Derivatives: A New Era of Financial Regulation', 17 *Law and Business Review of the Americas* (2011) 279.

17 See Verdier, 'The Political Economy of International Financial Regulation', 88 *Indiana Law Journal* (2013) 1405; C. Tietje, *Architektur der Weltfinanzordnung* (2011) (*Beiträge zum transnationalen Wirtschaftsrecht*, No. 109).

18 See Becker, 'Die Demokratisierung des Finanzsystems', in E. Kempf, K. Lüderssen and K. Volk (eds), *Ökonomie versus Recht im Finanzmarkt?* (2011) 195; Calliess, 'Finanzkrisen als Herausforderung der internationalen, europäischen und nationalen Rechtsetzung', in B. Grzeszick, C. Calliess and G. Lienbacher (eds), *Grundsatzfragen der Rechtsetzung und Rechtsfindung*: *Referate und Diskussionen auf der Tagung der Vereinigung der Deutschen Staatsrechtslehrer in Münster vom 5. bis 8. Oktober 2011* (2012) 113.

19 See Schüwer, *supra* note 13, at 10. For a definition of credit risk, see Krawiec, 'More than Just New Financial Bingo: A Risk-Based Approach to Understanding Derivatives', 23 *Journal of Corporation Law* (1997) 1, at 31.

20 See Fletcher, *supra* note 6, at 867; Paech, 'The Value of Insolvency Safe Harbours', 36 *Oxford Journal of Legal Studies* (2016) 855.

21 See A. Riles, *Collateral Knowledge* (2011).

22 See Paech, 'Close-Out Netting, Insolvency Law and Conflict-of-Laws', 14 *Journal of Corporate Law Studies* (2014) 419.

23 For a critique of this characterization, see Pistor, 'A Legal Theory of Finance', *supra* note 7.

24 On the legal reforms in the European Union and the United States, see Kerkemeyer, 'A Decade after Lehman: An Assessment of Key Regulatory Responses to the Global Financial Crisis', *European Company and Financial Law Review* (2019) 457; Garslian, 'Towards a Universal Model Regulatory Framework for Derivatives: Post-Crisis Conclusions from the United States and the European Union', 37 *University of Pennsylvania Journal of International Law* (2016) 941, at 979.

25 See Chamorro-Courtland, 'Central Counterparties (CCP) and the New Transnational Lex Mercatoria', 10 *Florida State University Business Review* (2011) 57.

26 Financial Stability Board (FSB), *Implementing OTC Derivatives Market Reforms* (2010), available at https://www.fsb.org/wp-content/uploads/r_101025.pdf (last visited 21 April 2022).

27 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723.

28 Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation, or EMIR), OJ 2012 L 201/1, Art. 4. See also J. Friedrich and M. Thiemann, *A New Governance Architecture for European Financial Markets? Towards a European Supervision of CCPs* (2018), SAFE White Paper No. 53, available at https://safe-frankfurt.de/de/policy-center/publikationen/detailsview/publicationname/a-new-governance-architecture-for-european-financial-markets-towards-a-european-supervision-of-ccps.html (last visited 21 April 2022).

29 See M. Brambring, *Zentrales Clearing von OTC-Derivaten unter EMIR* (2016).

meaning that the market participants on contractual relations are solely with the CCP.[30] As a consequence, counterparty risk is borne by the CCP,[31] supposedly to minimize systemic risk in OTC markets.[32] Whether this is actually the case and what kinds of risk a CCP may itself pose for market stability are debated questions, however.[33] While CCPs have considerable influence on the market structure of OTC derivatives, large numbers of OTC contracts remain outside the central clearing mechanism.[34] A recent BIS study, for example, found that the clearing rate on CDS markets was between 38 and 55 per cent.[35] Thus, despite the important reforms that have been introduced, the markets for OTC derivatives still differ substantially from exchange-based markets.[36]

B *ISDA*

At the centre of the legal infrastructure of OTC markets is the International Swaps and Derivatives Association. Founded in 1985, ISDA is a private trade association incorporated in New York.[37] It rapidly developed into a large and powerful institution that dominates broad segments of the OTC derivatives markets.[38] It also engages in lobbying[39] and provides amicus briefs for cases related to ISDA documentation in

[30] See the definition in EMIR, *supra* note 28, Art. 2(1).

[31] Braithwaite, 'The Inherent Limits of "Legal Devices": Lessons for the Public Sector's Central Counterparty Prescription for the OTC Derivatives Markets', 12 *European Business Organization Law Review* (2011) 87, at 105

[32] See EMIR, *supra* note 28, preambular para. 15; Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSC), *Margin Requirements for Non-Centrally Cleared Derivatives* (2015), at 3, available at https://www.bis.org/bcbs/publ/d499.pdf (last visited 21 April 2022).

[33] See, e.g., Peirce, 'Derivatives Clearinghouses: Clearing the Way to Failure', 64 *Cleveland State Law Review* (2016) 589; McNamara, 'Financial Markets Uncertainty and the Rawlsian Argument for Central Counterparty Clearing of OTC Derivatives', 28 *Notre Dame Journal of Law, Ethics & Public Policy* (2014) 209; Brambring, *supra* note 29, at 396ff.; Braithwaite, *supra* note 31, at 116; Chamorro-Courtland, 'The Trillion Dollar Question: Can a Central Bank Bail Out a Central Counterparty Clearing House Which Is "Too Big to Fail"?', 6 *Brooklyn Journal of Corporate, Financial & Commercial Law* (2012) 433, at 437. On ISDA Determinations Committee (DC) decisions, see Baker, 'When Regulators Collide: Financial Market Stability, Systemic Risk, Clearinghouses, and CDS', 10 *Virginia Law & Business Review* (2016) 343, at 371.

[34] BCBS and IOSC, *supra* note 32, at 3.

[35] Aldasoro and Ehlers, 'The Credit Default Swap Market: What a Difference a Decade Makes', *BIS Quarterly Review* (2018), at 5.

[36] For a historical account of the divergence between OTC and exchange-traded derivatives, see Carruthers, 'Diverging Derivatives: Law, Governance and Modern Financial Markets', 41 *Journal of Comparative Economics* (2013) 386.

[37] On ISDA and its history, see Flanagan, 'The Rise of a Trade Association: Group Interactions within the International Swaps and Derivatives Association', 6 *Harvard Negotiation Law Review* (2001) 211.

[38] See Biggins, '"Targeted Touchdown" and "Partial Liftoff": Post-Crisis Dispute Resolution in the OTC Derivatives Markets and the Challenge for ISDA', 13 *German Law Journal* (2012) 1297.

[39] See J. Biggins and C. Scott, *Extending and Contracting Jurisdictions in a Transnational Private Regulatory Regime: Efficiency, Legitimacy, ISDA and the OTC Derivatives Markets*,' (2011) (University College Dublin Working Papers in Law, Criminology & Socio-Legal Studies Research Paper No. 51/2011), at 15.

national courts.[40] ISDA now has more than '980 member institutions from 78 countries',[41] making it 'the world's largest global financial trade association'.[42] ISDA issued several model forms for financial derivatives documentation, which quickly became the industry standard. The most important of these is the ISDA Master, a framework agreement functioning as an umbrella under which a multiplicity of individual contracts between two parties can be negotiated.[43] Alongside the ISDA Master, several so-called Definitions further standardize the contractual arrangements for certain product classes, such as credit default swaps (ISDA Credit Derivatives Definitions, 2014) or commodity derivatives (ISDA Commodity Definition, 2005). In summary, the ISDA has developed standardized rules for the derivatives markets relating to such matters as the conclusion of the individual contracts (via confirmation), the particularities of different product classes, as well as performance and payment.[44] In some cases, ISDA rules even provide for authoritative interpretations of contract clauses.[45] Approximately 90 per cent of OTC derivatives contracts use the ISDA Master,[46] making it the market's 'industry-wide constitution'.[47] Market participants are predominantly large financial institutions such as big banks, which often hold 'hundreds or even thousands of open financial contracts with one another at any given point in time'.[48] These financial institutions account for more than 80 per cent of the derivatives trade.[49] This means that OTC derivatives markets are characterized by a high level of interconnectedness between these institutions.[50] Thus, the legal infrastructure of OTC derivates markets consists of a network of countless bilateral contracts based on the standardized rules of ISDA, with the ISDA Master as its core.[51]

3 The Effects of OTC Derivatives Markets

Due to their size, markets for OTC derivatives are also of macroeconomic significance.[52] For crises, volatility and perturbations on these markets can affect other markets, too,

[40] For a list of amicus briefs issued by ISDA, see https://www.isda.org/category/legal/amicus-briefs (last visited 21 April 2022).

[41] See 'About ISDA' at http://www.isda.org/about-isda/ (last visited 21 April 2022).

[42] See Johnson, 'Things Fall Apart: Regulating the Credit Default Swap Commons', 82 *University of Colorado Law Review* (2011) 167, at 229.

[43] For an overview of the contractual arrangement, see Horst, *supra* note 4, at 34f.

[44] See *ibid.*, at 37ff.

[45] See Horst, 'Lex Financiaria: Das transnationale Finanzmarktrecht der International Swaps and Derivatives Association (ISDA)', *Archiv des Völkerrechts* (2015) 461.

[46] See Braithwaite, *supra* note 14, at 784.

[47] Gelpern and Gulati, 'CDS Zombies', 13 *European Business Organization Law Review* (2012) 347, at 357.

[48] Paech, *supra* note 20, at 861.

[49] See *High-Level Expert Group on Reforming the Structure of the EU Banking Sector* (2012) at 42, available at https://ec.europa.eu/info/sites/default/files/liikanen-report-02102012_en.pdf (last visited 21 April 2022); see also Biggins, *supra* note 38, at 1303f.

[50] F. Fuchs, *Close-Out Netting, Collateral und systemisches Risiko* (2013), at 24.

[51] Horst, *supra* note 4, at 37 ff.

[52] See, e.g., UNCTAD, *supra* note 1.

or even the whole economy.[53] Initially, these markets attracted little attention from international legal research. However, the financial crisis of 2007–2008 dramatically spotlighted the problematic effects of financial markets, as they were regarded as having played a significant role in this crisis.[54] The bankruptcies of Lehman Brothers[55] and AIG[56] were but the most prominent examples of the effects. The fundamental economic questions underlying the new interest in the derivatives markets are (i) whether and how the OTC derivatives markets can affect the markets and prices of the underlying assets;[57] (ii) to what extent they destabilize the economy through contagion effects and the build-up of systemic risk;[58] and (iii) whether, and if so how, they redistribute wealth.[59] In recent years, a number of studies have investigated economic effects of the OTC markets,[60] certain product classes[61] and contractual arrangements,[62] but a coherent analysis of the distributional aspects of the legal infrastructure of the OTC derivatives markets from the perspective of international law is still lacking.[63] To help fill this gap, below I will highlight three of the most prominent distributive effects of OTC derivatives markets.

A *Close-Out Netting and the Reallocation of Counterparty Risk*

The first distributive effect of OTC derivatives markets concerns the redistribution of counterparty risk via so-called insolvency safe harbours.[64] As mentioned above, one of the defining characteristics of OTC derivatives markets is that market participants are exposed to counterparty credit risk. This is 'the risk of loss in the event of default by a counterparty'.[65] Arguably, therefore, one of the most important aspects of the

[53] See, e.g., Dowell-Jones and Kinley, 'Minding the Gap: Global Finance and Human Rights', 25 *Ethics & International Affairs* (2011) 183.

[54] See, e.g., Johnson, *supra* note 42, at 206. On government bond volatility, see Morgan, 'Reforming OTC Markets: The Politics and Economics of Technical Fixes', 13 *European Business Organization Law Review* (2012) 391.

[55] See Whitehead, 'Destructive Coordination', 96 *Cornell Law Review* (2011) 323, at 355; Schwarcz, 'Derivatives and Collateral: Balancing Remedies and Systemic Risk', *University of Illinois Law Review* (2015) 699, at 715.

[56] See Henkel, 'Harmonizing European Union Bank Resolution: Central Clearing of OTC Derivative Contracts Maintaining the Status Quo of Safe Harbors', 22 *Transnational Law & Contemporary Problems* (2013) 81, at 97.

[57] See, e.g., A. Kerkemeyer, *Möglichkeiten und Grenzen bei der Regulierung von Derivaten* (2018), at 138ff.

[58] See Schwarcz, 'Systemic Risk', 97 *Georgetown Law Journal* (2008) 193.

[59] See Horst, *supra* note 4, at 103ff.

[60] See Chadwick, *supra* note 16.

[61] With regard to credit default swaps, see Fletcher, *supra* note 6; with regard to collateralized debt obligations, see Garslian, *supra* note 24, at 971.

[62] On so-called insolvency safe harbours, see Bolton and Oehmke, 'Should Derivatives Be Privileged in Bankruptcy?', 70 *Journal of Finance* (2015) 2353; Johnson, 'International Financial Law: The Case against Close-Out Netting', 33 *Boston University International Law Journal* (2015) 395, at 409; Fuchs, *supra* note 50, at 277; Paech, *supra* note 20; Schwarcz, *supra* note 55; Henkel, *supra* note 56, at 97.

[63] See, e.g., Horst, *supra* note 4, at 103ff.

[64] See Paech, *supra* note 20.

[65] Krawiec, *supra* note 19, at 31.

legal infrastructure based on the ISDA Master is the mechanism known as close-out netting. Article 1(c) of the ISDA Master states:

> All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties … and the parties would not otherwise enter into any Transactions.[66]

The 'single agreement' clause of the Master Agreement allows for defining contractual rules that apply to all individual contractual positions between the two parties of the Master Agreement. One of these rules – section 6 of the ISDA Master – provides that all transactions under the ISDA Master may under certain conditions be terminated together through 'the payment of a single net sum'.[67] The purpose of this clause is to reduce the credit risk of the contracting parties by preventing cherry-picking.[68] This is the 'selective rejection of unfavorable contracts to the debtor'.[69] This mechanism to prevent cherry-picking is known as close-out netting.[70] Close-out netting clauses 'allow the non-defaulting party to calculate a single settlement amount by offsetting its scheduled future payment and delivery obligations to the bankrupt party against the bankrupt party's obligations to it'.[71] If the transactions between the parties were treated separately from another, the bankruptcy of one party would lead to the following situation: the non-defaulting party would bear the risk of having to fulfil all obligations towards the defaulting party, while itself receiving only (often negligible) portions of the insolvency assets from the defaulting party. What is more, we need to keep in mind that it is not uncommon for two financial institutions to be connected by several hundred financial contracts at the same time.[72] The credit risk in the OTC markets would therefore be almost impossible to calculate,[73] since it would amount to the sum of all single contractual obligations where the defaulting party is in the money.[74] ISDA claims that close-out netting is necessary because it protects individual market participants from incalculable counterparty risk.[75] Proponents of close-out netting further argue that reducing the counterparty risk of individual market participants reduces systemic risk and contagion, too.[76] Simply put, systemic risk refers to 'the probability of breakdowns in an entire system, as opposed to breakdowns

66 See G. Reiner, *ISDA Master Agreement* (2013), at 1.

67 Braithwaite, *supra* note 14, at 788; see also Reiner, *supra* note 66, at 196.

68 See K. Günther and S. Randeria, *Recht, Kultur und Gesellschaft im Prozeß der Globalisierung* (2001) (*Suchprozesse für innovative Fragestellungen in der Wissenschaft*, No. 4), at 56; Reiner, *supra* note 66, at 51.

69 Biggins and Scott, *supra* note 39, at 14.

70 See Paech, *supra* note 22; Fried, Finanzderivate in der Insolvenz', in J.-C. Zerey (ed.), *Finanzderivate: Rechtshandbuch* (4th ed., 2016) 411, at para. 6; Fuchs, *supra* note 50; Reiner, *supra* note 66, at 197.

71 Flanagan, *supra* note 37, at 230; see also Reiner, *supra* note 66, at 197.

72 See Paech, *supra* note 20, at 861.

73 See Fried, *supra* note 70, at 2; see also Günther and Randeria, *supra* note 68, at 56.

74 See Fuchs, *supra* note 50, at 43.

75 For a critical analysis of ISDA's arguments, see Lubben, 'Repeal the Safe Harbors', 18 *America Bankruptcy Institute Law Review* (2010) 319, at 326.

76 Böger, 'Close-Out Netting Provisions in Private International Law and International Insolvency Law (Part I)', 18 *Uniform Law Review* (2013) 232, at 234.

in individual parts or components'.[77] Such a 'broad-based breakdown in the functioning of the financial system'[78] can be alternatively defined as 'the risk that (i) an economic shock such as market or institutional failure triggers… either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility'.[79] In this context, contagion denotes 'the mechanism through which those shocks get propagated'.[80] It is generally assumed that in 'OTC derivatives markets, systemic risk arises largely due to counterparty credit risk'.[81] Thus, the rationale behind the systemic risk argument for close-out netting is that by reducing the counterparty risk of individual market participants, close-out netting also 'effectively reduces the risk of creating or increasing financial difficulties for counterparties caused by the inability of one of the market participants to meet its obligations, which in turn might lead to a succession of failures of other market participants (contagion effect/systemic risk)'.[82]

Although the systemic risk argument has been widely contested in economic[83] and legal literature,[84] this account of close-out netting has nevertheless 'nearly become a truism'[85] and has informed legislative reforms in several jurisdictions.[86] These reforms were necessary because close-out netting clauses 'contravene the *pari passu* principle'[87] common to several non-derogatory national insolvency laws. For this reason, ISDA lobbied for legal reforms on a global scale,[88] issuing a Model Netting Act as a blueprint for national reforms.[89] As a result, close-out netting

77 Kaufman and Scott, 'What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?', 7 *Independent Review* (2003) 371, at 371.

78 International Monetary Fund, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks* (2009), at 126.

79 Schwarcz, *supra* note 58, at 204. There is no single, generally agreed definition of systemic risk. See International Monetary Fund, *supra* note 78, at 113: '"Systemic risk" is a term that is widely used, but is difficult to define and quantify. Indeed, it is often viewed as a phenomenon that is there "when we see it", reflecting a sense of a broad-based breakdown in the functioning of the financial system, which is normally realized, ex post, by a large number of failures of FIs (usually banks). See also the definition proposed by the Group of Ten, *Report on Consolidation in the Financial Sector* (2001), at 126, available at http://www.bis.org/publ/gten05.pdf (last visited 21 April 2022). For a comparison of different definitions, see Kaufman and Scott, *supra* note 77. On systemic risk with respect to derivatives, see Bliss and Kaufman, 'Derivatives and Systemic Risk: Netting, Collateral, and Closeout', 2 *Journal of Financial Stability* (2006) 55; with respect to close-out netting, see Johnson, *supra* note 62, at 406ff.; Paech, *supra* note 20.

80 Utset, 'Complex Financial Institutions and Systemic Risk', 45 *Georgia Law Review* (2011) 779, at 792.

81 Baker, *supra* note 33, at 354.

82 Böger, *supra* note 76, at 234.

83 See, e.g., Bliss and Kaufman, *supra* note 79.

84 See, e.g., Johnson, *supra* note 62; Paech, *supra* note 20; Lubben, *supra* note 75.

85 Bliss and Kaufman, *supra* note 79, at 67.

86 On the recent alignment of German insolvency laws with ISDA close-out netting clauses, see, e.g., Horst, *supra* note 4, at 226ff.

87 Paech, *supra* note 20, at 857.

88 See, e.g., G. Tett, *Fool's Gold* (2009), at 39.

89 The 2018 Model Netting Act and Guide are available at http://www2.isda.org/functional-areas/legal-and-documentation/opinions/ (last visited 21 April 2022).

is now accepted in most jurisdictions that are home to leading OTC derivatives markets.[90]

It is important to note, however, that the effect of close-out netting is not to simply eliminate credit risk by netting the positions of the two parties to the ISDA Master. Generally, financial law cannot eliminate risk; it can only shift the risk between different entities.[91] The credit risk thus continues to exist. In this regard, economic studies have found that insolvency safe harbours transfer 'default risk from derivative counterparties to other claimholders, particularly creditors'.[92] In other words, the 'risk is shifted to non-financial counterparties, which alone have to bear the specific cost of bankruptcy'.[93] Hence, close-out netting redistributes the credit risk from the market participants to other actors outside these markets or – in situations where the cost of a bankruptcy is ultimately borne by the state – taxpayers in general.[94] In the case of Lehman Brothers, for example, studies found that 'Lehman's counterparties used the safe harbour provisions to terminate contracts when they stood to gain and to keep alive contracts when they were out-of-the-money'[95] and that therefore 'the settlement of Lehman's OTC derivatives claims may have resulted in significant losses to Lehman'.[96] Among other things, this would negatively affect other creditors of Lehman.[97] In the case of AIG, the existence of insolvency safe harbours was one of the reasons why a Chapter 11 petition was not filed.[98] As the Congressional Oversight Panel held, if AIG had filed for bankruptcy, CDS counterparties would have closed out their derivatives contracts, 'resulting in some level of disorder in the capital markets'.[99] Here, therefore, the potential effect of close-out netting led to massive state intervention using taxpayers' money. This redistribution of credit risk is the first distributive effect of OTC markets I want to highlight.

B *Speculation and Food Price Volatility*

A second type of distributive effect resulting from OTC derivatives trading relates to trade in food commodity derivatives.[100] The legal framework for OTC trading in food

[90] See Paech, *supra* note 20; Böger, *supra* note 76; Böger, 'Close-Out Netting Provisions in Private International Law and International Insolvency Law (Part II)', 18 *Uniform Law Review* (2014) 532; with regard to China, see Gao, 'Legal Pluralism and Isomorphism in Global Financial Regulation: The Case of OTC Derivative Counterparty Risk Regulation in China', 51 *George Washington International Law Review* (2019) 145.

[91] See J. Benjamin, *Financial Law* (2013), at 266.

[92] Bolton and Oehmke, *supra* note 62, at 2354.

[93] Paech, *supra* note 20, at 874.

[94] See Johnson, *supra* note 62, at 409f.

[95] Fleming and Sarkar, 'The Failure Resolution of Lehman Brothers', 20 *Economic Policy Review* (2014) 175, at 193.

[96] *Ibid.*

[97] See Schwarcz, *supra* note 55, at 717.

[98] See Lubben, *supra* note 75, at 320.

[99] Congressional Oversight Panel, '*The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy: Report*' (2010), at 63, available at https://www.gpo.gov/fdsys/pkg/CPRT-111JPRT56698/html/CPRT-111JPRT56698.htm (last visited 21 April 2022).

[100] See also Horst, 'Shareholder Activism for Human Rights? Aktienrechtliche Instrumente zur (mittelbaren) Durchsetzung von Menschenrechten auf den Finanzmärkten', in M. Krajewski and M. Saage-Maaß (eds), *Die Durchsetzung menschenrechtlicher Sorgfaltspflichten von Unternehmen: Zivilrechtliche Haftung und Berichterstattung als Steuerungsinstrumente* (2018) 203.

commodity derivatives comprises the ISDA Master and the 2005 ISDA Commodity Definitions. In a briefing note in 2010, the UN Special Rapporteur on the right to food, Olivier De Schutter, commented that '[a]t least 40 million people around the world were driven into hunger and deprivation as a result of the 2008 food price crisis'.[101] Yet economic literature is still divided over the influence OTC markets have on food prices.[102] The main reason for this seems to be that the test most commonly used to assess these effects – Granger causality[103] – produced mixed results.[104] Recent studies based on more refined methods, however, have found that, for certain foods, the effects of derivatives markets on prices can indeed be proven, at least for the period covering the food price crisis.[105] Furthermore, legal approaches have identified additional reasons for these effects.[106] All in all, there is agreement at least that food prices for certain food products around 2008 cannot be explained solely by reference to so-called market fundamentals[107] and that their increased volatility was due also to activity on OTC markets.[108] A large number of IOs have thus warned of the effects that OTC derivatives trading can have on food prices,[109] and Olivier De Schutter recommended significantly limiting OTC trading in derivatives on food because of the price increases.[110] These concerns led to important reforms in the regulatory framework for OTC trading in food commodities. In particular, the Dodd-Frank Act[111] and an EU directive[112]

[101] De Schutter, *supra* note 4.

[102] For an overview, see Williams, *supra* note 4.

[103] See Grosche, 'What Does Granger Causality Prove? A Critical Examination of the Interpretation of Granger Causality Results on Price Effects of Index Trading in Agricultural Commodity Markets', 65 *Journal of Agricultural Economics* (2014) 279; see also Gilbert and Pfuderer, 'The Role of Index Trading in Price Formation in the Grains and Oilseeds Markets', 65 *Journal of Agricultural Economics* (2014) 303, at 319: 'There is a large literature which claims that CIT [Commodity Index Trader] activity in agricultural futures markets has no price impact. … This literature largely relies on Granger-causality tests which fail to take account of positive correlation between CIT position changes and futures returns across the entire range of agricultural futures markets.' For a legal perspective, see Williams, 'Dodging Dodd-Frank: Excessive Speculation, Commodities Markets, and the Burden of Proof', 37 *Law & Policy* (2015) 119, at 134.

[104] See Chadwick, *supra* note 4, at 89.

[105] See Guilleminot, Ohana and Ohana, *supra* note 4, at 788, who come to the conclusion that 'index flows do have an impact on several agricultural prices at the weekly level'. See also Gilbert, *How to Understand High Food Prices, supra* note 4; Gilbert, *Speculative Influences on Commodity Futures Prices 2006–2008*, *supra* note 4. On increased price volatility, see also S. K. Roache, *What Explains the Rise in Food Price Volatility?* (2010) (IMF Working Paper WP/10/129), available at https://www.researchgate.net/publication/46433269_What_Explains_the_Rise_in_Food_Price_Volatility (last visited 21 April 2022).

[106] See Esmel, *supra* note 4; Gonzalez, *supra* note 4, at 66; Williams, *supra* note 4.

[107] See Esmel, *supra* note 4, at 509; Cochrane, Adams and Kunhibava, 'The Impact of Speculation on Global Food Accessibility and Food Security', 29 *Arab Law Quarterly* (2015) 76; UNCTAD, *Trade and Development Report, 2011: Post-Crisis Policy Challenges in the World Economy* (2011), at 111; see also Williams, *supra* note 103, at 125.

[108] See Horst, *supra* note 45; International Monetary Fund, *supra* note 5, at 70.

[109] Inter alia UNCTAD, *supra* note 107, at 111.

[110] De Schutter, *supra* note 4.

[111] Dodd-Frank, *supra* n. 27, § 737.

[112] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ 2014 L 173/349, Art. 57.

introduced position limits for some trading in commodity derivatives. However, ISDA successfully filed a lawsuit against the introduction of position limits under the Dodd-Frank Act,[113] and the position limits in Europe are net position limits that apply only to so-called economically equivalent OTC contracts.[114] Thus, whether these reforms in the United States and Europe will have a lasting impact of minimizing the risk of speculation with food prices is far from certain.[115] These effects of trading activities on the OTC derivatives markets on other sectors and third parties are the second type of effect of the OTC derivatives markets I want to highlight.

C *CDS and Sovereign Financing*

On 16 June 2014, the US Supreme Court decided that Argentina could not claim state immunity to escape its obligations towards bondholders. At a time when the country was experiencing a severe economic crisis, Argentina had tried to restructure its government bonds. Yet a small minority of hold-out creditors refused to accept any attempt by the state to reschedule its debt. As a result, Argentina was formally in default as of July 2014. This case sparked intense discussions over an international procedure for state insolvency[116] and the role of *pari passu* clauses.[117] Far less attention, however, has been paid to the fact that, following Argentina's default, the ISDA Determination Committee for the Americas declared a so-called failure to pay credit event with respect to sovereign credit default swaps (SCDSs)[118] on this class of Argentine bonds.[119] ISDA had already taken a similar decision with respect to Greek government bonds at the height of the Greek sovereign debt crisis in 2012.[120] As with food prices, economic studies come to quite different findings on the effects of SCDS markets in general.[121] That said, there seems at least to be agreement on the fact that prices of SCDSs can

[113] See *ISDA v. U.S. Commodity Futures Trading Commission*, 887 F. Supp. 2d 259 (D.D.C. 2012).

[114] See European Securities and Markets Authority, '*Opinion: Draft Regulatory Technical Standards on Methodology for Calculation and the Application of Position Limits for Commodity Derivatives Traded on Trading Venues and Economically Equivalent OTC Contracts* 2016), available at https://www.esma.europa.eu/sites/default/files/library/2016-668_opinion_on_draft_rts_21.pdf (last visited 21 April 2022).

[115] See Horst, *supra* note 4, at 111 ff.

[116] See, e.g., Paulus, 'Resolvenzrecht im Werden: NML Capital Ltd. Et. al. vs. Argentinien, 2. Runde', 46 *ZIP* (2013) 2190.

[117] See Cotterill, 'The Injunction Has Landed: The "Black Eagle", Pari Passu and Sovereign Debt Enforcement', 9 *Capital Markets Law Journal* (2014) 277; Chabot and Gulati, 'Santa Anna and his Black Eagle: The Origins of Pari Passu?', 9 *Capital Markets Law Journal* (2014) 216.

[118] SCDSs are credit default swaps involving government bonds.

[119] See ISDA, *ISDA Americas Credit Derivatives Determinations Committee: CDS Auction Relating to the Argentine Republic* (Press Release, 3 September 2014), available at https://www.isda.org/2014/09/03/isda-americas-credit-derivatives-determinations-committee-cds-auction-relating-to-the-argentine-republic/ (last visited 21 April 2022); see also Horst, *supra* note 45.

[120] See ISDA, *ISDA EMEA Determinations Committee: CDS Auction Relating to the Hellenic Republic* (Press Release, 19 March 2012), available at https://www.isda.org/2012/03/19/isda-emea-determinations-committee-cds-auction-relating-to-the-hellenic-republic/ (last visited 21 April 2022).

[121] Palladini and Portes, *supra* note 5; Coudert and Gex, *supra* note 5; Aktug, Vasconcellos and Bae, *supra* note 5; International Monetary Fund, *supra* note 5, at 57; Aizenman, Hutchison and Jinjarak, *supra* note 5; Calice, Chen and Williams, *supra* note 5.

deviate significantly from so-called market fundamentals. In this respect, the IMF's Global Financial Stability Report notes that 'during the height of the European debt crisis, SCDS (and government bond) spreads in more vulnerable European countries rose above the level that can be explained by the changes in the fundamental and market drivers considered in our model'.[122] Whether this also means that activities on the SCDS markets caused a significant rise in the borrowing costs for the European countries concerned is less clear, however. Relying on the Granger causality test,[123] the IMF found artificial increases of sovereign funding costs only for some countries and concluded that there was no evidence 'that, on average, increases in SCDS spreads generally increase the cost of sovereign bond funding'.[124] Other studies, however, have found that the borrowing costs of some countries can be affected by the SCDS markets.[125] They argue that – at least at times of financial crisis – activities on SCDS markets can indeed cause sovereign borrowing costs to rise significantly.[126] These findings are supported by studies suggesting that participants in SCDS markets may follow different economic rationales from bondholders. For example, owners of SCDSs may often have a greater economic interest in the default of the state concerned than in its financial stabilization.[127] This so-called empty creditor problem[128] may be a reason for strategically trying to prevent debt rescheduling.[129] Particularly with regard to the Argentinean case, the suspicion has been repeatedly expressed (although it has not been validated) that NML Capital and other plaintiffs challenging Argentina's debt rescheduling profited massively from Argentina's bankruptcy through SCDS contracts.[130] This is particularly concerning, because NML Capital's parent company, Elliott Management Corporation, was a voting non-dealer in the Determinations Committee (DC) for the Americas (i.e. a member of the institution that decided whether a credit event had occurred).[131] In this context, two human rights experts appointed by the UN Human Rights Council warned of the negative impact of so-called vulture funds[132] on the social, economic and cultural rights of the population.[133] This is also the reason for the

[122] International Monetary Fund, *supra* note 5, at 70.

[123] *Ibid.* For a critical account of the Granger causality test, see Grosche, *supra* note 103.

[124] International Monetary Fund, *supra* note 5, at 70.

[125] Palladini and Portes, *supra* note 5, at 24. Coudert and Gex, *supra* note 5.

[126] Delatte, Gex and López-Villavicencio, 'Has the CDS Market Influenced the Borrowing Cost of European Countries during the Sovereign Crisis?', 31 *Journal of International Money and Finance* (2012) 481.

[127] See Hemel, 'Empty Creditors and Debt Exchanges', 27 *Yale Journal on Regulation* (2010) 159, at 161.

[128] See Bolton and Oehmke, 'Credit Default Swaps and the Empty Creditor Problem', 24 *Review of Financial Studies* (2011) 2617; Juurikkala, 'Financial Engineering Meets Legal Alchemy: Decoding the Mystery of Credit Default Swaps', 19 *Fordham Journal of Corporate & Financial Law* (2014) 425, at 432.

[129] See UNCTAD, *Trade and Development Report, 2010: Employment, Globalization and Development* (2010), at 36.

[130] The source of the suspicion was the former Argentinian minister of economic affairs Axel Kicilloff; see Moses, Russo and Porzecanski, Argentine Bonds Decline as Default Triggers $ 1 Billion of Swaps (2 August 2014), available at http://www.bloomberg.com/news/articles/2014-08-01/argentina-default-triggers-1-billion-of-swaps-after-isda-ruling.

[131] See Horst, *supra* note 45.

[132] See Paulus, 'Geierfonds vor Gericht ausbremsen?' *ZRP* (2016) 146.

[133] UN Office of the High Commissioner for Human Rights, *Human Rights Impact Must Be Addressed in Vulture Fund Litigation – UN Experts* (Press Release, 27 November 2014), available at http://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=15354&LangID=E (last visited 21 April 2022).

EU short-selling regulation.[134] Furthermore, John Biggins and Colin Scott argue that decisions of ISDA DCs can be 'socially significant', because 'a DC decision can exert third party (distributional) implications for a range of stakeholders; including government actors'.[135] Thus, some economic studies suggest that activities on SCDS markets can raise the borrowing costs of countries and that, through its DCs, ISDA can also have a direct effect on the fiscal situation of a state.

4 Towards a Distributional Perspective in Transnational Law

In sum, then, we have seen that (i) the legal infrastructure of OTC derivatives markets relies on insolvency safe harbours such as those afforded by close-out netting, potentially shifting credit risk and the cost of bankruptcy to entities outside these markets; (ii) OTC derivatives trading can potentially affect food prices; and (iii) the SCDS market and individual ISDA decisions can have an impact on sovereign financing. These effects potentially have a profound impact on the living conditions of individuals and collectivities. What is more, the groups so affected are not participants in OTC markets. In fact, they have no relationship with either ISDA or the markets under its domination. Yet, these massive distributional effects of OTC markets and their legal infrastructure have often been overlooked. Although there was some analysis of this disregard for distributional aspects in critical legal studies literature in the 1980s,[136] they have been largely passed over in mainstream transnational legal scholarship. I will argue that this disregard for distributional aspects of transnational law has its roots in a specific understanding of the relationship between law and the economy. Using OTC derivatives markets as an example, I will show that this understanding (a) is grounded in a belief that law has only a facilitative role for market transactions; (b) essentially involves a doctrine of external effects, which fails to address the fundamental role that law plays in creating those effects; and (c) distinguishes between public and private law in such a way as to make it impossible to grasp the complex reality of multilayered transnational legal regulation.

A *The Constitutive Role of Law for OTC Markets*

The legal perspective on transnational financial markets has long been shaped by the efficient capital market hypothesis,[137] a concept deriving from the work of Eugene Fama.[138] According to this concept, prices on these markets generally 'fully reflect' all available information.[139] Some legal scholars have concluded from this that financial

[134] Juurikkala, 'Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis', 9 *European Company and Financial Law Review* (2012) 307.

[135] Biggins and Scott, 'Licensing the Gatekeeper? Public Pathways, Social Significance and the ISDA Credit Derivatives Determinations Committees', 6 *Transnational Legal Theory* (2015) 370, at 387.

[136] Kennedy, 'Cost-Benefit Analysis of Entitlement Problems: A Critique', 33 *Stanford Law Review* (1981) 387.

[137] See Gilson and Kraakman, 'The Mechanisms of Market Efficiency', 70 *Virginia Law Review* (1984) 549.

[138] Fama, *supra* note 3.

[139] *Ibid.*, at 383.

markets lead to an efficient allocation of invested capital and are therefore efficient.[140] This is because, under perfect conditions, a market equilibrium is by definition always pareto-efficient.[141] However, as suggested by John Maynard Keynes back in 1973, the behaviour of investors may differ from the behaviour of other economic actors.[142] Referring to Keynes, heterodox economist Hyman Minsky developed the financial instability hypothesis, arguing that financial markets are inherently unstable and prone to crisis.[143] Most remarkably, behavioural finance scholarship has contested this hypothesis, at least in part, 'both on theoretical and empirical grounds'.[144] It showed that there are several generalizable situations in which the behaviour of market participants deviates from the rational actor model.[145] This critique has at least to some extent changed the perspective of legal scholarship on OTC derivatives markets.[146] Thus far, however, this critique seldom extends to the fundamental issue of the relationship between law and economic processes as understood by mainstream legal thinking on financial markets. This legal understanding of the relationship between law and economic processes was shaped by foundational ideological debates.[147] Three fundamental premises can be considered essential to this understanding: (i) the autonomy of the economy; (ii) laissez-faire; and (iii) efficiency vs distribution.

(i) The understanding rests on the Smithian premise of the invisible hand, according to which the pursuit of self-interest 'naturally, or rather necessarily, leads [every individual] to prefer that employment which is most advantageous to the society'.[148] Together with a set of utilitarian principles such as Bentham's principle of utility,[149] this premise constituted a belief in the economy as an autonomous social sphere, 'a self-subsistent domain of freedom'.[150] Law is here considered always as an exogenous element to the (natural or anthropological) driving forces of the economy.

(ii) A welfarist interpretation of Smith's invisible hand further claims that, under conditions of ideal competition, any market equilibrium is pareto-optimal (first

[140] Gilson and Kraakman, *supra* note 137, at 554; for a critical analysis, see Awrey, *supra* note 12.

[141] This was the first fundamental theorem of welfare economics; see Feldman, 'Welfare Economics', in M. Vernengo, E. Perez Caldentey and B. J. Rosser Jr. (eds), *The New Palgrave Dictionary of Economics* (2019).

[142] He famously compared investment decisions to beauty contests; see Keynes, 'The General Theory of Employment Interest and Money', in *The Collected Writings of John Maynard Keynes* (1973), vol. VII, at 156.

[143] See H. P. Minsky, 'The Financial Instability Hypothesis' (1992) (Levy Economics Institute Working Paper No. 74), available at http://www.levyinstitute.org/pubs/wp74.pdf (last visited 1 May 2022).

[144] A. Shleifer, *Inefficient Markets* (2003), at 11.

[145] For an overview, see, e.g., Jolls, Sunstein and Thaler, 'A Behavioral Approach to Law and Economics', 50 *Stanford Law Review* (1998) 1471.

[146] Awrey, *supra* note 12.

[147] For an in-depth analysis, see Kjær, 'The Law of the Political Economy: An Introduction', in P. F. Kjær (ed.), *The Law of Political Economy: Transformation in the Function of Law* (2020) 1.

[148] Smith, 'An Inquiry into the Nature and Causes of the Wealth of Nations', in R. H. Campbell and A. S. Skinner (eds), *The Glasgow Edition of the Works and Correspondence of Adam Smith* (1976), vol. 1, bk IV. Ch. 2, at 454.

[149] J. Bentham, *An Introduction to the Principles of Morals and Legislation* (1789), Chap. 1.

[150] Purdy *et al.*, *supra* note 9, at 1795.

fundamental theorem of welfare economics).[151] From this, it is inferred that the function of law with respect to economic processes primarily consists in ensuring the free interplay of market forces. Although the invisible hand has been interpreted by some as implying that a laissez-faire approach towards the economy is the most appropriate, other interpretations have instead argued that the state should intervene to ensure conditions of perfect competition.[152] Under both interpretations, however, the nature of the market mechanism dictates the proper legal rules for regulating the economy – in other words, law plays a facilitative role in relation to economic processes.

(iii) Following on from this, some legal approaches consider that the problem of efficient allocation can and should be handled separately from its distributional consequences. Economic efficiency and equity are two separate issues according to this line of thought.[153] While such approaches are strongly contested in economic literature,[154] they have profoundly influenced legal views on the role of law with respect to distributional issues. The most prominent example is Louis Kaplow and Steven Shavell's claim that legal rules are concerned with efficiency and should not be used to redistribute wealth.[155] This conception of efficiency and equity is further underpinned by a liberal understanding of the rule of law as being incompatible with distributive aims.[156]

Taken together, these premises have had a lasting impact on the understanding of the role of law vis-à-vis economic processes.[157] A market is considered to be dominated by economic forces such as supply and demand, with these economic forces in principle being separate from the legal infrastructure of the particular market. The legal infrastructure can assist the market mechanism or it can disturb the efficiency of a market, but it will not affect the market mechanism itself, since the latter is seen as a purely economic phenomenon. Consequently, there is a tendency in international and transnational legal discourse to assess legal rules primarily in terms of their alleged facilitative role for markets. We can demonstrate this with respect to the discussion on close-out netting and systemic risk. We have seen that ISDA claims that close-out netting is necessary for the smooth functioning of derivatives markets, because it protects

[151] Feldman, *supra* note 141.

[152] This interpretation is often associated with ordoliberalism and the Freiburg School; see Hien and Joerges, 'Introduction', in C. Joerges and J. Hien (eds), *Ordoliberalism: Law and the Rule of Economics* (2018), 1; Biebricher, 'Ordoloberalism as a Variety of Neoliberalism', in C. Joerges and J. Hien (eds), *Ordoliberalism: Law and the Rule of Economics* (2018), 103.

[153] On the economic background, see K. J. Arrow, *Social Choice and Individual Values* (2nd ed., 1963); Bergson, 'A Reformulation of Certain Aspects of Welfare Economics', 52 *Quarterly Journal of Economics* (1938) 310; for an in-depth discussion, see Hockett, *supra* note 9.

[154] See, e.g., Ackerman, 'Still Dead After All These Years: Interpreting the Failure of General Equilibrium Theory', 9 *Journal of Economic Methodology* (2002) 119; Putterman, Roemer and Silvestre, 'Does Egalitarianism Have a Future?', 36 *Journal of Economic Literature* (1998) 861.

[155] Kaplow and Shavell, 'Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income', 23 *Journal of Legal Studies* (1994) 667.

[156] F. A. Hayek, *The Constitution of Liberty* (1997), at 231ff.

[157] For a recent discussion, see Purdy *et al.*, *supra* note 9.

individual market participants from incalculable counterparty risk, which in turn also reduces the systemic risk on these markets.[158] This rationale is the dominant view on close-out netting and has informed several legal reform processes.[159] While this line of argument correlates with the belief that legal rules serve chiefly to facilitate market-based economic transactions, it presupposes that an overall reduction in credit risk for market participants does in fact reduce a market's systemic risk. Yet, several studies have found that close-out netting can instead heavily contribute to a build-up of systemic risk on a market.[160] This has to do with the economic effects of close-out netting. Bliss and Kaufmann found that if close-out netting clauses were absent, '[t]he capital available to support gross credit risk exposures would far exceed to [*sic*] capital currently needed to support net exposures. Increasing the capital required to engage in derivatives dealing by a factor of 10 or more would materially alter the economics of derivatives markets'.[161]

It is therefore estimated that close-out netting reduces the need for collateral for transactions to roughly 15 per cent of the collateral needed without close-out netting.[162] Thus, close-out netting drastically reduces the capital required for taking positions on OTC derivatives markets.[163] That is to say, close-out netting profoundly affects the economic calculations and profit margins of these transactions. This means, however, that large segments of OTC trading and the risks associated with these transactions owe their existence to close-out netting.[164] The fact that it was only after close-out netting was introduced that OTC markets fully developed[165] testifies to the fundamental role of close-out netting for these markets. Close-out netting, then, is inseparably intertwined with the market mechanism, since it substantially affects the profitability of the transactions on the market. Thus, legal rules such as close-out netting do not so much facilitate the functioning of these markets; rather, they play a constitutive role, in that they shape the economic calculations of transactions and, thus, become an integral part of the market's structure.

Recognizing the constitutive role of seemingly technical legal rules also throws a new light on whether they are indeed economically necessary and politically desirable, for this constitutive role in creating OTC derivatives markets shows that the argument whereby close-out netting reduces systemic risk misses the point. Given close-out netting's constitutive role, the only markets on which it can conceivably reduce systemic risk are those created by its introduction. Without close-out netting, OTC markets would not have expanded to the point of building up considerable systemic risk.

[158] For a critical analysis of ISDA's arguments, see Lubben, *supra* note 75, at 326.

[159] See, e.g., the discussion on the recent alignment of German insolvency laws with the ISDA close-out netting clauses in Horst, *supra* note 4, at 226ff.

[160] Johnson, *supra* note 62, at 409; Fuchs, *supra* note 50, at 277; Schwarcz, *supra* note 55; Henkel, *supra* note 56, at 97.

[161] Bliss and Kaufman, *supra* note 79, at 67.

[162] Paech, 'Netting, Finanzmarktstabilität und Bankenrestrukturierung: Die Notwendigkeit eines internationalen zivilrechtlichen Standards zum Netting', 42 *WM* (2010) 1965, at 1966.

[163] Bolton and Oehmke, *supra* note 62.

[164] See Bliss and Kaufman, *supra* note 79, at 67.

[165] Horst, *supra* note 4, at 106ff.

Hence, rather than mitigating systemic risk, close-out netting fuels the build-up of systemic risk in OTC derivatives markets by providing a legal infrastructure that allows positions to be taken that do not fully account for the credit risk.[166] The argument that close-out netting may reduce systemic risk is therefore simply a case of begging the question: only systemic risk that the introduction of close-out netting has itself created can be reduced by close-out netting, if at all. What is more, recognizing this fact also changes the perspective on the distributional aspects of close-out netting. We have seen that the reallocation of counterparty risk via insolvency safe harbours substantially reduces costs in OTC derivatives trading. This means that market participants can enter into derivatives transactions without bearing the full counterparty risk. This counterparty risk has to be accounted for elsewhere. Thus, market participants gain the profits of these transactions without having to bear the full costs. In other words, insolvency safe harbours such as close-out netting redistribute wealth from those who bear the counterparty risk to participants in those markets (i.e. big banks and investment funds). In this respect, close-out netting is a striking example of socializing losses and privatizing profits.

To put it in more general terms, recognizing the constitutive role of law reveals the political choices engrained in the legal infrastructure of a market. This is a long-standing claim of critical legal scholars,[167] but it has recently acquired new momentum under the name of political economy of law.[168] While these critical approaches differ in many details, they all argue that law has not only a facilitative but also a constitutive role with respect to the market mechanism.[169] In so doing, they take up Karl Polanyis's hypothesis[170] of the embeddedness of markets and economic behaviour.[171] According to these approaches, a one-sided focus on efficiency tends to ignore the hegemonic nature, distributive effects and colonial legacies of the legal foundations of economic relations.[172] They rely on Keynsian,[173] Marxist, neo-Ricardian and so-called heterodox economic theories, among others, in examining the relationship between law and capitalism,[174] law and global inequality[175] and law and colonial exploitation.[176] Furthermore, this emphasis on the constitutive role of law

[166] Johnson, *supra* note 62, at 409.

[167] Kennedy, *supra* note 136; Hockett, *supra* note 9.

[168] Grewal and Purdy, *supra* note 9; D. S. Grewal, A. Kapczynski and J. Purdy, 'Law and Political Economy: Toward a Manifesto' (2017), available at https://lpeblog.org/2017/11/06/law-and-political-economy-toward-a-manifesto/ (last visited 1 May 2022).

[169] Purdy *et al.*, *supra* note 9; Grewal, 'The Laws of Capitalism' (book review), 128 *Harvard Law Review* (2014) 626; Deakin *et al.*, *supra* note 9.

[170] K. Polanyi, *The Great Transformation* (2nd ed., 2010).

[171] See also Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness', 91 *American Journal of Sociology* (1985) 481.

[172] See Hockett, *supra* note 9.

[173] See Listokin, 'Law and Macroeconomics as Aggregate Demand Externalities: An Application to Optimal Tort Law', 5 *Critical Analysis of Law* (2018) 60.

[174] See Grewal, *supra* note 169, at 652ff.

[175] See Pistor, *supra* note 7, at 175.

[176] See A. Anghie, *Imperialism, Sovereignty and the Making of International Law* (2008); S. Pahuja, *Decolonising International Law* (2012).

is accompanied by a fundamentally novel view of the core legal institutions for economic transactions, such as markets,[177] corporations,[178] contracts[179] and money.[180] Moreover, scholars have started to apply these insights to transnational law, pointing out 'that markets never exist "as such", but are legally constituted spheres of exercised power'.[181] As we have seen, this is particularly true of financial markets, which 'do not exist outside rules but are constituted by them'.[182]

B *Re-examining External Effects in Transnational Law*

The disregard of the constitutive role of law is linked to a specific understanding of external effects.[183] Pigou's book *The Economics of Welfare* is most often cited as the foundational work on the problem of external effects. In it, he defines external effects[184] as divergences between the marginal social net product[185] and the marginal private net product.[186] The Pigovean concept of external effects became a cornerstone of cost–benefit analysis,[187] according to which an external effect can be defined as 'a direct effect on another's profit or welfare arising as an incidental by-product of some other person's or firm's legitimate activity'.[188] But it was Ronald Coase, in his famous article 'The Problem of Social Cost', who added the most important building blocks for a legal understanding of external effects.[189] According to Coase, it is immaterial where the costs of an activity are initially placed, for 'the ultimate [economic] result (which maximises the value of production) is independent of the legal position if the pricing system is assumed to work without cost'.[190] In other words, 'if one assumes rationality, no transaction costs, and no legal impediments to bargaining, *all* misallocations of resources would be fully cured in the market by bargains'.[191] Coase concluded that 'there is no reason to suppose that government regulation is called for simply because

[177] See Deakin *et al.*, *supra* note 9; with respect to common pool resources, see Ostrom, 'Beyond Markets and States: Polycentric Governance of Complex Economic Systems', 100 *American Economic Review* (2010) 641; with respect to derivatives markets, see Awrey, *supra* note 12.

[178] G. Baars, *The Corporation, Law and Capitalism* (2019).

[179] See, e.g., Teubner, 'Die anonyme Matrix: Zu Menschenrechtsverletzungen durch "private" transnationale Akteure', 45 *Der Staat* (2006) 161; Grundmann and Renner, 'Vertrag und Dritter: Zwischen Privatrecht und Regulierung', 68 *JZ* (2013) 379.

[180] Feichtner, 'Public Law's Rationalization of the Legal Architecture of Money: What Might Legal Analysis of Money Become?', 17 *German Law Journal* (2016) 875; C. Desan, *Making Money* (2014).

[181] Zumbansen, *supra* note 10, at 123.

[182] Pistor, *supra* note 7, at 321.

[183] E. J. Mishan, *Cost-Benefit Analysis* (1975), at 109.

[184] A. C. Pigou, *The Economics of Welfare* (4th ed., 1932 [reprint 1960]), at 2.

[185] *Ibid.*.

[186] *Ibid.*.

[187] Mishan, *supra* note 183.

[188] *Ibid.*, at 117.

[189] Coase, 'The Problem of Social Cost', 3 *Journal of Law and Economics* (1960) 1, at 28.

[190] *Ibid.*, at 8; Coase, 'Notes on the Problem of Social Cost', in R. H. Coase, *The Firm, the Market, and the Law* (5th ed., 1992) 157, at 158.

[191] Calabresi, 'Transaction Costs, Resource Allocation and Liability Rules: A Comment', 11 *Journal of Law and Economics* (1968) 67, at 68.

the problem [of harmful effects] is not well handled by the market or the firm. … It is my belief that economists, and policy-makers generally, have tended to over-estimate the advantages which come from governmental regulation'.[192] Thus, Coase accepted that legal rules in the form of property rights are necessary for economic transactions, 'since without the establishment of this initial delimitation of rights there can be no market transactions to transfer and recombine them',[193] but he argued that we can disregard the initial setting of entitlements through legal rules, because they will not hinder efficient allocation. Coase's disregard of the initial setting of entitlements[194] and the specific normative content of the Coase theorem remain disputed, even within the law and economics discourse.[195] Moreover, there is continuing controversy in mainstream legal literature over the definition of externalities, the distinction between different types of externalities and the best way to deal with externalities. We can nonetheless identify in the Pigovean and Coasean account some basic assumptions on externalities that have shaped the dominant legal understanding of externalities.[196] On this view an externality is, by definition, a type of market failure, for an external effect leads to a non-pareto-efficient market outcome.[197] The law's task will be to internalize external costs so as to promote the efficiency of the market mechanism.[198] Depending on the approach taken to external effects, this can be achieved either through state intervention – e.g. taxation, subsidies, criminal or tort law – or by assigning property rights.

However, the financial crisis of 2007–2008 raised serious doubts about whether these basic assumptions concerning external effects adequately account for the effects of transnational financial markets. As we have seen, there is an ongoing debate on the question of whether food prices have been affected by trading in food commodity derivatives.[199] Furthermore, several studies have convincingly argued that in times of crisis SCDS trading can affect sovereign financing. We can again turn to close-out netting and credit risk to illustrate this point. We have seen that close-out netting can shift counterparty risk from the participants on OTC markets to creditors outside the market. Hence, counterparty risk is an external effect[200] that is produced

[192] Coase, *supra* note 189, at 18.

[193] *Ibid.*, at 8.

[194] Kennedy, *supra* note 136; Kennedy, 'Law-and-Economics from the Perspective of Critical Legal Studies', in P. Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (2008) 465.

[195] Medema and Zerbe, 'The Coase Theorem', in B. Bouckaert and G. De Geest (eds), *Encylopedia of Law and Economics*, vol. I, *The History and Methodology of Law and Economics* (2000) 836; Medema, 'Juris Prudence: Calabresi's Uneasy Relationship with the Coase Theorem', 77 *Law and Contemporary Problems* (2014) 65, at 66.

[196] See, e.g., R. H. Frank and E. Cartwright, *Microeconomics and Behaviour* (2016), at 546ff. On such an understanding in international law, see, e.g., E. A. Posner and A. O. Sykes, *Economic Foundations of International Law* (2013); J. P. Trachtman, *The Economic Structure of International Law* (2008).

[197] See, e.g., R. Cooter and T. S. Ulen, *Law and Economics* (6th ed., 2012), at 39; Verhoef, 'Externalities', in J. C. J. M. van den Bergh (ed.), *Handbook of Environmental and Resource Economics* (1999) 197, at 199ff.

[198] See, e.g., R. A. Posner, *Economic Analysis of Law* (6th ed., 2003), at 66.

[199] For an in-depth analysis of this issue, see Chadwick, *supra* note 4, at 84ff.

[200] Johnson, *supra* note 62, at 409.

by the specific contractual arrangements of the OTC market, and without close-out netting this market would not exist in its current shape. In other words, these external effects are created by the specific design of the legal infrastructure of a market. Thus, the law's constitutive role in relation to economic transactions means that externalities are not necessarily a type of market failure; more fundamentally, they can be the very product of a particular, legally constituted market mechanism. To sum up, it is not the failure of the OTC derivatives market but rather its smooth functioning that has produced these types of external effects. The legal infrastructure of OTC markets allows the taking of positions on food and agricultural products as well as on government bonds. The legal infrastructure makes sure that these derivative positions can be traded and secures the profits made through such trading, but it does not account for possible costs for third parties outside these markets. And this disregard of effects on third parties is an integral part of the infrastructure of OTC markets.

An understanding of external effects based on Pigovean and Coasean premises cannot account for these types of structural effects. It underestimates the extent to which the seemingly free interplay of economic forces is inherently shaped by arbitrary/political choices engrained in the legal infrastructure of financial markets. What is more, the tools capable of mitigating these types of externalities are not necessarily limited to those used to correct market failures. Rather, the question is whether and to what extent OTC derivatives markets in their current form are capable of securing the welfare of all affected groups. This perspective on externalities thus challenges, at a fundamental level, the belief that there is no alternative to the market mechanism for the distribution of resources. Of course, this does not necessarily mean that insolvency safe harbours should be done away with altogether,[201] or that OTC derivatives markets should be abolished. But their potential benefits need to be weighed against their potential problematic consequences. The legal infrastructure of OTC derivatives markets creates winners and losers, and the legal construction of external effects engrained in the legal infrastructure of transnational markets is one of the core distributional issues in transnational law.[202] It is therefore not enough to think of externalities only in terms of correcting a market failure via specific legal tools. A distributional perspective also needs to take account of the fact that markets as legally constituted institutions are a priori shaped by distributional choices engrained in their infrastructure.

C *Transnational Law Beyond the Delimitation of Public and Private*

The third explanation for the disregard of distributive aspects of transnational financial markets lies in a particular understanding of the contours of public and private law in relation to the regulation of economic interaction. Both Pigou and Coase seem to distinguish between two types of legal rules. The first consists of rules that are necessary to the free play of economic interaction. With reference to Adam Smith, Pigou

[201] Lubben, *supra* note 75.

[202] For an example of such an approach in the area of law and development, see Waked, 'Development Studies through the Lens of Critical Law and Economics: Efficiency and Redistribution Revisited in Market Structure Analyses in the South', 5 *Transnational Legal Theory* (2015) 649.

accepted that the free play of self-interest is always in principle limited by certain legal and social institutions.[203] Similarly, Coase assumed that the process of free bargaining presupposed that rights be in some way delimited, 'since without the establishment of this initial delimitation of rights there can be no market transactions to transfer and recombine them'.[204] The legal rules Coase and Pigou had in mind in this connection are what we would call 'private law'. In both accounts, however, we also find another set of legal rules. Pigou argued in favour of government intervention to correct failures in the free play of economic forces. Coase was more sceptical about such interventions, being of the view that they did not necessarily lead to greater market efficiency. Both, however, shared the idea that this second set of legal rules (public law) – the law a government may use to correct certain unwanted economic effects – is distinct from those rules that facilitate the free economic exchange. Thus, Pigou and Coase had a very specific understanding of private and public law. It developed into a line of legal thinking[205] that regarded private law as a set of economically neutral rules facilitating free bargaining processes and public law as inherently interventionist. It was also reflected in a particular conception of contracts in some legal literature.[206] Based on the premises of methodological individualism, this conception focused primarily on individual behavior.[207] According to this view, contracts are primarily the means by which private parties can freely negotiate economic transactions for purposes of overall economic efficiency,[208] for freedom of contract serves to maximize total welfare.[209] Accordingly, contractual networks such as the ISDA Master are viewed as nothing more than private bilateral agreements between parties. In line with this thinking on private and public law, most proposals to reform OTC derivatives markets after the financial crisis focused on proper prudential oversight and regulatory reform. In other words, the proposals were predominantly based on a public law rationale, according to which the 'unregulated' sectors of financial markets (such as OTC derivatives markets) were in need of greater and more rigorous oversight.[210]

These proposals are not without merit, for they increasingly focus on macroprudential concerns.[211] Still, they are limited in scope, as they do not fully address the

[203] Pigou, *supra* note 184, at 2.

[204] Coase, *supra* note 189, at 8.

[205] See, e.g., Hayek, 'Recht, Gesetz und Freiheit: Eine Neufassung der liberalen Grundsätze der Gerechtigkeit und der politischen Ökonomie', in A. Bosch, M. E. Streit, V. Vanberg and R. Veit (eds), *Gesammelte Schriften in deutscher Sprache* (4th ed., 2005) Part B, Volume 4, at 57ff and 135.

[206] For an overview, see Hermalin, Katz and Craswell, 'Contract Law', in A. M. Polinsky and S. Shavell (eds), *Handbook of Law and Economics*, vol. 1 (2007) 3; for a new and expanded theory of contract, see H. Dagan and M. Heller, *The Choice Theory of Contracts* (2017).

[207] For a critical view, see Ahdieh, 'Beyond Individualism in Law and Economics', 91 *Boston University Law Review* (2011) 43.

[208] See, e.g., Baird, 'Economics of Contract Law', in F. Parisi (ed.), *The Oxford Handbook of Law and Economics*, vol. 2 (2017) 3, at 17; A. Schwartz and R. E. Scott, 'Contract Theory and the Limits of Contract Law', 113 *Yale Law Journal* (2003) 541.

[209] For a critical discussion of this Coasean premise, see Hermalin, Katz and Craswell, *supra* note 206, at 24ff.

[210] For an overview of the reforms, see Kerkemeyer, *supra* note 24.

[211] Hockett, 'The Macroprudential Turn: From Institutional "Safety and Soundness" to Systematic "Financial Stability" in Financial Supervision', 9 *Virginia Law & Business Review* (2015) 201.

constitutive role and regulatory dimension of the existing legal infrastructure. We have seen that the legal infrastructure of OTC derivatives markets consists largely of a network of private bilateral contracts based on the ISDA Master as a framework agreement. Hence, the function of this contractual arrangement goes far beyond individual bargaining processes.[212] Rather, these contracts form the very foundation of OTC markets; they are market-making contracts.[213] This explains Katharina Pistor's claim that there is 'no such thing as "unregulated' financial markets, and deregulation is a misnomer … It signifies not the absence of regulation, but the implicit delegation of rule-making to different, typically non-state actors'.[214] Hence, OTC derivatives markets were never unregulated. They were regulated by a network of bilateral contractual arrangements. According to Robert Way, this 'regulatory function of private law is sometimes hidden because private law is often portrayed as primarily concerned with a facilitative function'.[215]

In the light of the financial crisis, however, more recent theoretical approaches to private law have started to challenge this reductionist conception of private law and contract as merely facilitative.[216] They argue that the function of contractual relations within financial markets cannot be reduced to bilateral agreements between private parties.[217] For transnational contractual networks,[218] such as the ISDA Master,[219] have massive structural effects.[220] This view of contracts takes into account philosophical and sociological approaches that have long emphasized the indirect consequences of (private) transactions[221] and the embeddedness of contractual relations in societal

[212] For an analysis of the role of ISDA and the contractual arrangement, see, e.g., Biggins and Scott, *supra* note 135; Biggins, *supra* note 38; Wielsch, 'Global Law's Toolbox: Private Regulation by Standards', 60 *American Journal of Comparative Law* (2012) 1075; Wielsch, 'Contract Interpretation Regimes', 81 *Modern Law Review* (2018) 958; Braithwaite, *supra* note 14; Horst, *supra* note 4, at 37ff.

[213] Morgan uses this term with respect to ISDA; see Morgan, 'Market Formation and Governance in International Financial Markets: The Case of OTC Derivatives', 61 *Human Relations* (2008) 637, at 646.

[214] Pistor, *supra* note 7, at 321.

[215] Wai, 'Transnational Liftoff and Juridical Touchdown: The Regulatory Function of Private International Law in an Era of Globalization', 40 *Columbia Journal of Transnational Law* (2002) 209, at 234.

[216] See, e.g., Dagan and Heller, *supra* note 206.

[217] Möslein, 'Contract Governance und Corporate Governance im Zusammenspiel: Lehren aus der Finanzkrise', 65 *JZ* (2010) 72, at 76; Ahdieh, *supra* note 207.

[218] Wielsch, *supra* note 212.

[219] Eidenmüller, 'Lex Mercatoria, the ISDA Master Agreement, and Ius Cogens: Comment on H. Collins, "Flipping Wreck: Lex Mercatoria on the Shoals of Ius Cogens"', in S. Grundmann, F. Möslein and K. Riesenhuber (eds), *Contract Governance*: *Dimensions in Law and Interdisciplinary Research* (2015) 407.; Braithwaite, *supra* note 14; Grundmann, 'Welche Einheit des Privatrechts? Von einer formalen zu einer inhaltlichen Konzeption des Privatrechts', in S. Grundmann, B. Haar and H. Merkt (eds), *Festschrift fur Klaus J. Hopt zum 70. Geburtstag am 24. August 2010*: *Unternehmen, Markt und Verantwortung* (2010) 61, at 84.

[220] Grundmann, *supra* note 219, at 84.

[221] This is Dewey's definition of public, which consists 'of all those who are affected by the indirect consequences of transactions to such an extent that it is deemed necessary to have those consequences systematically cared for'(J. Dewey, *The Public and Its Problems* (2012), at 48).

structures.[222] Thus, so-called private transnational legal rules and contractual networks often have a regulatory dimension with far-reaching distributive effects.[223] This understanding of contracts and private law is epitomized in new approaches to private law theory, which extend the essence of private law beyond the concept of private autonomy.[224] Thus, transnational contractual arrangements like the ISDA Master should not be dismissed as an issue between market participants. If a distributive perspective on transnational law is to properly apprehend the complexity of the transnational legal arrangements that distribute global wealth, then it must take account of elements of both public law and private.

5 The Way Ahead, or How to Deal with Distribution in Transnational Law?

So far, we have seen that law plays not just a facilitative but a constitutive role in relation to the economy and the market. In addition, the technical details of the legal infrastructure of transnational financial markets can have massive distributional consequences, as these rules distribute risk and create external effects. Furthermore, these effects cannot be understood with a public law rationale alone; the role of private law in constituting OTC markets must also be emphasized. A distributional approach to the legal infrastructure of OTC derivatives markets therefore needs to consider how these distributive elements can be accounted for.

A *Transnational Law and the Struggle for Legitimacy*

The starting point for such an endeavour is first to recognize that, despite some choice-of-law clauses and some touchdowns[225] in national laws, the legal infrastructure of OTC derivatives markets is not anchored in a single state legal system. Nor does this legal infrastructure correspond to the traditional understanding of sources of international law as listed in Article 38 of the ICJ Statute.[226] Due to 'ISDA's virtual monopoly on the production of rules for the OTC derivatives markets',[227] the legal regime is widely considered to be 'the paradigmatic example of a standard form contract that can be thought of as transnational law'.[228] Philip Jessup famously defined transnational law as 'all law which regulates actions or events that transcend national frontiers. Both public and private international law are included, as are other rules which do not wholly fit into such standard

[222] See Röhl, 'Über außervertragliche Voraussetzungen des Vertrages', in H. Schelsky, F. Kaulbach and W. Krawietz (eds), *Recht und Gesellschaft: Festschrift für Helmut Schelsky zum 65. Geburtstag* (1978) 435; more generally, Granovetter, *supra* note 171.

[223] Grundmann and Renner, *supra* note 179, at 380; Grundmann, *supra* note 219, at 84.

[224] S. Grundmann, H.-W. Micklitz and M. Renner, *New Private Law Theory* (2021).

[225] On the notions of liftoff and touchdown in transnational law, see Wai, *supra* note 215.

[226] For a discussion with respect to global law, see A. Fischer-Lescano, *Globalverfassung* (2005), at 55ff.

[227] Biggins and Scott, *supra* note 39, at 32.

[228] Braithwaite, *supra* note 14, at 784.

categories'.[229] However, there is no consensus on how the terms 'transnational law'[230] and 'transnational private rule-making'[231] are to be understood or defined.[232] Rather, there seem to be currently two fundamentally opposing views on transnational law. They are well illustrated by the notion of the independence or autonomy of transnational law. Critics of transnational law as an autonomous legal regime argue that transnational law ultimately remains dependent on state law,[233] because it is not an independent source of law, requires acceptance by state law[234] and relies on the 'coercive powers' of state law.[235] This means, for example, that ISDA 'as a private international association cannot sustain governance by itself'.[236] By contrast, those who believe in the independence of transnational law emphasize that transnational legal processes are not wholly determined by their touchdowns in national laws. That said, they acknowledge that autonomy does not signify the complete detachment of transnational regulatory arrangements from state norms. Drawing on systems theory approaches and the notion of autopoiesis,[237] they point out that autonomy here refers rather to the way in which a transnational legal regime interacts with state law and other legal systems.[238] That is, autonomy here means that transnational law reacts to the demands of other legal systems in accordance with internal, second-order rules.[239] These opposing views on the autonomy of transnational law are also reflected in the debate on the legitimacy of transnational rule-making processes. At a very general level, it is possible to distinguish between two kinds of approaches: universalist on the one hand and pluralist on the other.

[229] P. C. Jessup, *Transnational Law* (1956), at 2.

[230] See, e.g. Calliess and Maurer, 'Transnationales Recht: Eine Einleitung', in G.-P. Calliess (ed.), *Transnationales Recht: Stand und Perspektiven* (2014) 1.

[231] See Cafaggi, 'The Many Features of Transnational Private Rule-Making: Unexplored Relationships between Custom, Jura Mercatorum and Global Private Regulation', 36 *University of Pennsylvania Journal of International Law* (2015) 875.

[232] See, e.g., Zumbansen, 'Transnational Law, With and Beyond Jessup', in P. Zumbansen (ed.), *The Many Lives of Transnational Law: Critical Engagements with Jessup's Bold Proposal* (2020) 1.

[233] With respect to transnational financial law, see, e.g., Agasha, 'International Financial Law: Is the Law Really "International" and Is It "Law" Anyway?', 26 *Banking and Finance Law Review* (2011) 381, at 441; with respect to the Law Merchant, see Kadens, 'Order within Law, Variety within Custom: The Character of the Medieval Merchant Law', 5 *Chicago Journal of International Law* (2005) 39.

[234] See Michaels, 'Was ist nichtstaatliches Recht? Eine Einführung', in G.-P. Calliess (ed.), *Transnationales Recht: Stand und Perspektiven* (2014) 39, at 54.

[235] K. Pistor, 'Towards a Legal Theory of Finance' (2012) (ECGI Law Working Paper No. 196/2013; Columbia Law & Economics Working Paper No. 434), at 22, available at https://scholarship.law.columbia.edu/faculty_scholarship/2435/.

[236] Morgan, *supra* note 213, at 637.

[237] See Teubner, *Law as an Autopoietic System* (1993).

[238] For an analysis of the meaning of autonomy in relation to transnational law, see Horst, *supra* note 4, at 75ff.

[239] Fischer-Lescano and Teubner, *supra* note 10, at 43. This concept draws on Hart's distinction between primary rules of obligation and secondary rules of recognition; see H. L. A. Hart, *The Concept of Law* (3rd ed., 2012), at 91.

1 Universalist Approaches

It has long been argued in the context of global administrative law[240] and international public authority[241] that rule-making is increasingly shaped by hybrid configurations, such as investigations into the 'administration by private institutions with regulatory functions'[242] or the exercise of public authority by private actors.[243] Such arguments are informed by a universalist perspective which considers the publicness of transnational law as 'a necessary element in the concept of law under modern democratic conditions'.[244] For 'it is only the public itself – that is, a community and its institutions – that can define common interests'.[245] Hence, universalist approaches tend to propose forms of deliberative or representative democratic participation that are connected to or derived from national or international constituencies or communities.[246]

2 Pluralist Approaches

Transnational legal pluralism has a different take on the emergence of transnational law.[247] Drawing on, inter alia, Robert Cover's theory of jurisgenerative forces[248] and Eugen Ehrlich's concept of living law,[249] they argue that law has always been created in a variety of social contexts beyond the state.[250] Global[251] and transnational[252] legal pluralism therefore investigates plural forms of norm generation beyond state

[240] Kingsbury, Krisch and Stewart, 'The Emergence of Global Administrative Law', 68 *Law and Contemporary Problems* (2005) 15; Casini and Kingsbury, 'Global Administrative Law Dimensions of International Organizations Law', 6 *International Organizations Law Review* (2009) 319; Kingsbury, 'The Concept of "Law" in Global Administrative Law', 20 *European Journal of International Law* (2009) 23; Cassese, 'Is There a Global Administrative Law?', in A. von Bogdandy, J. Bernstorff, P. Dann, M. Goldmann and R. Wolfrum (eds), *The Exercise of Public Authority by International Institutions*: *Advancing International Institutional Law* (2010), 761.

[241] A. von Bogdandy and I. Venzke, *In wessen Namen?* (2014); Von Bogdandy, Dann and Goldmann, 'Developing the Publicness of Public International Law: Towards a Legal Framework for Global Governance Activities', 9 *German Law Journal* (2008) 1375; Bogdandy, Goldmann and Venzke, 'From Public International to International Public Law: Translating World Public Opinion into International Public Authority', 28 *European Journal of International Law* (2017) 115; Goldmann, 'A Matter of Perspective: Global Governance and the Distinction between Public and Private Authority (and Not Law)', 5 Global Constitutionalism (2016) 48; Goldmann, *Internationale öffentliche Gewalt* (2015).

[242] Kingsbury, Krisch and Stewart, *supra* note 240, at 20.

[243] Bogdandy, Goldmann and Venzke, *supra* note 241.

[244] Kingsbury, *supra* note 240, at 31.

[245] Bogdandy, Goldmann and Venzke, *supra* note 241, at 138.

[246] For a recent critical proposal concerning a concept of authority with respect to global law, see H. Lindahl, *Authority and the Globalisation of Inclusion and Exclusion* (2018).

[247] For an overview, see R. Seinecke, *Das Recht des Rechtspluralismus* (2015), at 201.

[248] Cover, 'Nomos and Narrative', in M. Minow (ed.), *Narrative, Violence, and the Law*: *The Essays of Robert Cover* (1992) 95, at 103.

[249] E. Ehrlich, *Grundlegung der Soziologie des Rechts* (4th ed., 1989), at 32.

[250] Fischer-Lescano and Teubner, 'Regime Collisions: The Vain Search for Legal Unity in the Fragmentation of Global Law', 25 *Michigan Journal of International Law* (2004) 999.

[251] Berman, 'Global Legal Pluralism', 80 *Southern California Law Review* (2007) 1155; Berman, 'Jurisgenerative Constitutionalism: Procedural Principles for Managing Global Legal Pluralism', 20 *Indiana Journal of Global Legal Studies* (2013) 665.

[252] Zumbansen, 'Transnational Legal Pluralism', 1 *Transnational Legal Theory* (2010) 141.

law, and in so doing refers to the autonomy of transnational law and processes of self-constitutionalization.[253] In contrast to universalist approaches, pluralists – inter alia taking into account postcolonial[254] and Third World approaches to international law[255] – therefore emphasize forms of counter-hegemonial participation that cannot be fully grasped in terms of a political community, as exemplified in law-making from below[256] and subaltern[257] forms of law creation.

B *Components of an Integrative Approach to Distribution in Transnational Law*

However contrasting the approaches of universalism and pluralism to the democratizing transnational rule-making processes may be, they share a common starting point insofar as they both acknowledge that such processes can have huge distributive consequences. Both approaches therefore concur in considering as fundamental to transnational law the problem that its rule can have effects on persons, communities and constituencies that are not involved in developing them.[258] With this in mind, my hypothesis is that these approaches should – at least with respect to the problem of distribution – be understood as complementing rather than contradicting each other. Neither increased oversight via state law and international agreements nor self-regulation and occupation of the system from within[259] can on their own establish proper democratic participation with respect to the distributional aspects of transnational law. Democratization of the legal infrastructure of transnational financial markets can be achieved only by combining universalist and pluralist types of democratic participation. Therefore while admitting that it is important not to overlook the role of political communities such as the state in relation to transnational law, it is equally important to recognize that transnationalization[260] affects the capacity of national parliaments to ensure democratic participation as well as the very notion of sovereignty.

The introduction of close-out netting is a case in point. As we have seen, it required adjustments to be made to some national insolvency laws. Yet, the involvement of national parliaments in the legal reforms should not be overestimated. In the parliamentary debates, the reforms were often justified by arguing that they simply brought

[253] Teubner, *Constitutional Fragments: Societal Constitutionalism and Globalization* (2012).

[254] See, e.g., Anghie, *supra* note 176.

[255] See, e.g., Chimni, 'Third World Approaches to International Law: A Manifesto', 8 *International Community Law Review* (2006) 3; Mutua, 'What Is TWAIL?', 94 *Proceedings of the Annual Meeting (American Society of International Law)* (2000) 31.

[256] B. de Sousa Santos and C. A. Rodríguez-Garavito (eds), *Law and Globalization from Below: Towards a Cosmopolitan Legality* (2005); B. de Sousa Santos, *Toward a New Legal Common Ssense* (2nd ed., 2012); Anghie, *supra* note 176.

[257] See G. C. Spivak, *Can the Subaltern Speak?* (2011).

[258] See, e.g., Cafaggi, *supra* note 231, at 935.

[259] Renner, 'Occupy the System! Societal Constitutionalism and Transnational Corporate Accounting', 20 *Indiana Journal of Global Legal Studies* (2013) 941.

[260] For a foundational study on transnationalization, see L. Viellechner, *Transnationalisierung des Rechts* (2013).

national laws into line with already existing usage in transnational financial markets and that failing to give legal recognition to these usages could have severe economic consequences. The distributional aspects of close-out netting were not discussed, however.[261] The introduction of close-out netting was therefore widely regarded as 'a significant example of market-driven high-impact international legal harmonization'[262] and ISDA had a crucial role in this process.[263] In other words, 'the legislative act by the state was but the last step of a regulatory reform process initiated by other forces'.[264] Thus, touchdowns in national law do not necessarily amount to meaningful democratic participation by national parliaments. What is more, the focus on national touchdowns generally tends to overlook the fact that not all jurisdictions are equal with respect to OTC derivatives markets. While, by virtue of choice-of-law clauses, this legal infrastructure relies predominantly on English and US (New York) law and interacts with EU regulations, it can afford to remain ignorant of most other national jurisdictions in the world. This is epitomized in the decision of ISDA with respect to SCDSs on Argentinian bonds. Here, the Argentinian legal system was simply irrelevant to this decision and Argentina could not intervene in this process. This means that national parliaments do not necessarily serve to cancel out hegemonic elements in transnational rule-making processes but can also perpetuate power asymmetries between constituencies. Thus, in the transnational sphere the concept of state sovereignty can no longer by itself ensure that a political community is subject only to those rules it has agreed upon.[265] Moreover, the expressions 'financial sovereignty' and 'monetary sovereignty'[266] are used to describe complex and hybrid relationships between private capital power and public regulatory power.[267] Private actors as well as states are involved in creating money, and 'the greatest challenge to monetary sovereignty does not emanate from other sovereigns. Rather, the challenge to sovereignty emanates from private money issuers'.[268] In short, transnational law is more than its touchdowns in national law, and international agreements and national constituencies cannot be the sole source of authority for transnational legal rules.

At the same time, a healthy scepticism towards transnational democratic processes of participation beyond the nation-state is equally well-founded. While ISDA claims to

[261] See Horst, *supra* note 4, at 226ff.

[262] Paech, *supra* note 20, at 18.

[263] Schwarcz and Sharon, 'The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependency Analysis', 71 *Washington and Lee Law Review* (2014) 1715.

[264] Günther and Randeria, *supra* note 68, at 58 [author's translation].

[265] For a critical account of sovereignty in the transnational sphere, see Volk, *supra* note 10; Volk, 'The Problem of Sovereignty in Globalized Times' *Law, Culture and the Humanities* (2019), available at https://doi.org/10.1177/1743872119828010.

[266] See Pistor, 'From Territorial to Monetary Sovereignty', 18 *Theoretical Inquiries in Law* (2017) 491; with respect to the EU and the ECB, see Kapadia, 'Europe and the Logic of Hierarchy', 41 *Journal of Comparative Economics* (2013) 436.

[267] C. Marazzi, *Sozialismus des Kapitals* (2012), at 138; J. Vogl, *Der Souveränitätseffekt* (2015), at 249f.; see also Pistor, *supra* note 266.

[268] Pistor, *supra* note 266, at 514.

be the 'most broadly-representative industry body',[269] this notion of representation focuses exclusively on market participants and, by design, does not encompass affected groups, such as the people affected by food price volatility. It is therefore telling that studies on the accountability of ISDA rule-making limit their understanding of accountability to proper representation of the market participants (sell-side and buy-side).[270] From a distributional perspective, ISDA is a hegemonic player that lobbies in the interest of OTC derivatives market participants. It is neither democratic nor representative in any politically meaningful way.[271] Thus, existing transnational law is often characterized by a severe lack of any kind of meaningful internal participatory elements or alternative forms of democratization.[272] The problem with pluralist concepts of legitimation is therefore that, thus far, the hegemonic nature of transnational financial law seems to have been rather impervious to participatory endeavours by affected groups or other stakeholders.

A distributional approach to transnational law therefore needs to integrate both universalist and pluralist elements in democratizing the distributional aspects of the transnational legal infrastructure. Such an integrative approach rests on the empirical findings that governance in transnational financial markets is 'multi-faceted and multi-levelled, bringing public and private, national and international together'.[273] Acknowledging this fundamental hybridity of transnational law, a distributional perspective needs to address (i) the multiplicity of sites of political decision-making; (ii) the plurality of forms in which political choices are articulated; and (iii) the variety of legal subject areas involved in shaping distributional choices.[274]

(i) The starting point for such an integrative approach is the finding that the current shape of the infrastructure of transnational financial markets is the result of political choices at national, international and transnational levels. This means that the 'struggle over a new foundation of legitimacy'[275] is not limited to a single setting; there is rather a plurality of locales and levels where distributional choices are made. Accordingly, a distributional approach needs to investigate potentials for democratizing distributional choices in all of these locales and at all levels of rule-making.

(ii) Furthermore, an integrative approach assumes that the means of democratizing distributional choices will be limited to neither universalist nor pluralist concepts of participation. For there is no single or exclusive way of politicizing

[269] See ISDA, 'OTC Derivatives Industry Governance: Structure' (2nd ed., 2010), at 3, available at https://www.isda.org/a/vGXEE/Industry-Governance.pdf (last visited 1 May 2022).

[270] See Borowicz, 'Private Power and International Law: The International Swaps and Derivatives Association', 8 *European Journal of Legal Studies* (2015) 46.

[271] See, e.g., Carruthers, 'Financialization and the Institutional Foundations of the New Capitalism', 13 *Socio-Economic Review* (2015) 379, at 389; with respect to DCs, see Biggins and Scott, *supra* note 135.

[272] See, e.g., Cutler, *supra* note 10.

[273] Morgan, *supra* note 213, at 657; see also Baker, *supra* note 16, at 1360.

[274] This is the programme of Teubner's societal constitutionalism; see Teubner, *supra* note 253, at 121f.

[275] Zumbansen, *supra* note 252, at 184.

transnational law.[276] Rather, the politicization of distributional choices will take different forms with respect to locales and levels of rule-making, ranging from formal parliamentary processes to various kinds of transnational protest and civil disobedience.[277] These diverse forms interact with and complement each other.

(iii) Finally, this means that a distributional approach looks at distributional choices in all fields of law. Distributional elements are engrained in public regulatory law as well as an in private law, corporate law, securities law, bankruptcy law and also in private contractual arrangements such as supply chains, framework-agreements, intra-group contracts and the like. Distributional choices are the result of the interplay of national touchdowns, international agreements and transnational arrangements.

C *Three Examples of Politicization of the Distributional Aspects of OTC Derivatives Markets*

Seen from this distributional perspective, the current debate on the reform of OTC derivatives markets presents an ambiguous picture: on the one hand, a number of macroprudential reforms introduced significant changes to OTC derivatives markets in the aftermath of the financial crisis, in particular EMIR in Europe and Dodd-Frank in the US.[278] These reforms introduced, inter alia, new clearing obligations,[279] margin requirements[280] and reporting obligations,[281] as well as position limits for some trading in commodity derivatives,[282] and have restricted certain trading in SCDSs.[283] Taken together, these regulatory reforms highlight that the legal infrastructure of OTC derivatives markets can in fact be altered by the political processes of parliamentary democracy. On the other hand, these reforms have left the foundational structure of OTC derivatives markets largely untouched. OTC derivatives markets remain a network of private bilateral agreements dominated by ISDA, a private organization. This led Claire Cutler to conclude that 'the private regulation of OTC derivatives seems to be somewhat immune to contesting social forces' and that '[i]ts contestation requires a more general re-evaluation of financialization of the global political economy, which does not yet appear to be on the radar'.[284] Against this background, a distributional

[276] Teubner, 'Quod omnes tangit: Transnationale Verfassungen ohne Demokratie?', 57 *Der Staat* (2018) 171, at 184ff.; Teubner, *supra* note 253.

[277] Horst, *supra* note 4, at 157.

[278] See above at Section 2.A; for an overview, see Kerkemeyer, *supra* note 24.

[279] See above at Section 2.A.

[280] On non-centrally cleared derivatives, see BCBS and IOSC, *supra* note 32.

[281] See EMIR, *supra* note 28, Art. 9.

[282] For Europe, see Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, OJ 2014 L 173/349, Art. 57; see also Dodd-Frank Act, s. 737. As mentioned above, however, ISDA successfully filed a lawsuit against the introduction of position limits under Dodd-Frank; see *ISDA v. U.S. Commodity Futures Trading Commission*, 887 F. Supp. 2d 259 (D.D.C. 2012).

[283] Regulation (EU) No. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short-selling and certain aspects of credit default swaps, OJ 2012 L 86/1.

[284] Cutler, *supra* note 10, at 95.

approach can help to shed light on possible forms of contestation of private rule-making in OTC derivatives markets that are often overlooked in a debate that is still primarily focused on traditional forms of regulatory oversight. To illustrate this, I will conclude by highlighting three ways in which the legal infrastructure of OTC derivatives markets and the distributional choices engrained therein have been contested in recent years.

1 State Intervention Beyond Regulation

An initial way of contesting private rule-making in OTC derivatives markets is through state intervention in the legal infrastructure that does not take the form of regulatory reform. In this regard, Katharina Pistor[285] pointed out that, in a coordinated effort under the auspices of the FSB,[286] several states negotiated with ISDA to issue the so-called ISDA 2015 Universal Resolution Stay Protocol.[287] This protocol, together with subsequent protocols such as the ISDA 2016 Resolution Stay Jurisdictional Modular Protocol,[288] makes sure that certain contractual rights such as close-out netting can be exercised only after a stay period of up to 48 hours.[289] Thus, in this case, states pressured ISDA, via the FSB, to release a protocol that amends the contractual infrastructure of the OTC markets. Pistor rightly observed that '[t]he fact that sovereign states had to co-opt a private business association… to achieve their regulatory goals, indicates the extent to which states have lost control over the governance of global finance'.[290] However, this also shows that states still possess the power to amend private rules on OTC derivatives markets, at least if they are willing to do so and are not acting alone. That is to say, ISDA's successful attempts to lobby for the amendment of several national legal rules are not a one-way street. States can also successfully pressure ISDA into amending its contractual infrastructure to reflect national laws.

2 Self-Constitutionalization of Transnational Legal Regimes

A second way of contesting private rule-making in OTC derivatives markets has to do with the understanding of the nature of transnational law itself. While some authors mostly focus on the fact that ISDA is a private organization that lobbies in the interests of its members,[291] Anelise Riles showed that, 'whatever the reasons for ISDA's original creation, by now it is no longer just the political tool of a small group of insiders in New York and London – it is also a constellation of durable material and institutional practices engaged in by people and institutions very far away indeed from those

[285] Pistor, *supra* note 7, at 150 ff.

[286] D. Ruddigkeit, *Das Financial Stability Board in der internationalen Finanzarchitektur* (2011) (*Beiträge zum transnationalen Wirtschaftsrecht*, No. 111).

[287] ISDA, *ISDA 2015 Universal Resolution Stay Protocol*, available at http://assets.isda.org/media/ac6b533f-3/5a7c32f8-pdf/ (last visited 1 May 2022).

[288] ISDA, *ISDA 2016 Resolution Stay Jurisdictional Modular Protocol*, available at http://assets.isda.org/media/f253b540-95/83d17e3d-pdf/ (last visited 1 May 2022).

[289] Pistor, *supra* note 7, at 150.

[290] *Ibid.*, at 152.

[291] See, e.g., Tett, *supra* note 88.

original insiders'.[292] This observation is in accord with Gunther Teubner's notion of self-constitutionalization of transnational legal regimes,[293] according to which transnational legal regimes have a tendency to emancipate themselves 'from the original agreement of their founding members'.[294] This means that the legal infrastructure of OTC derivatives markets may be shaped by ISDA, but the evolution of the legal regime is also influenced by the pressure of other regimes, stakeholders and practices that cannot simply be reduced to the will of a single institution. Here, the development of CCPs is illustrative. While CCPs have recently been incorporated into national regulatory reforms,[295] they evolved as 'a privately owned and operated risk management mechanism'.[296] Thus, even though there are several links with state-based law, transnational usages form the legal foundation for the operation of CCPs.[297] Against this background, the introduction of CCPs is not simply the result of a state-based regulatory reform, nor is it merely the outcome of a plan of ISDA members. The development of CCPs is rather the result of demands for risk management tools for OTC transactions from various stakeholders both inside and outside OTC derivatives markets and of pressure from various groups, organizations and states. In this sense, the introduction of CCPs shows that transnational legal regimes also have the potential to internally adapt their legal infrastructure to minimize potentially harmful effects such as the build-up of systemic risk.

3 Human Rights and Finance

The third example for (re-)politicizing the distributional consequences of the legal infrastructure of transnational financial markets is a specific strand in the human rights and finance debate.[298] Proposing 'a "macro" or "systemic" approach to the relationship between global finance and human rights that looks at the interaction between the structures, processes, and dynamics of international finance and the capacity of states to secure broad-based human rights protection',[299] Dowell-Jones and Kinley investigate 'the broader impact of the financial system on economic structures and performance, which affects the socioeconomic rights of people on an increasingly global scale'.[300] In doing so, they show that the fundamental doctrinal question in the human rights and finance discourse of whether and to what extent certain human rights instruments contain directly binding obligations for private entities is often of

[292] Riles, *supra* note 21, at 242.

[293] Teubner, *supra* note 253, at 42ff; Teubner, 'Self-Constitutionalizing TNCs? On the Linkage of "Private" and "Public" Corporate Codes of Conduct', 18 *Indiana Journal of Global Legal Studies* (2011) 617.

[294] Teubner, *supra* note 253, at 55.

[295] See above at Section 2. A.

[296] Braithwaite, *supra* note 31, at 87.

[297] Chamorro-Courtland, *supra* note 25.

[298] Kinley, *supra* note 298; Dowell-Jones and Kinley, *supra* note 53; D. H. Kinley, *Artful Dodgers: Banks and Their Human Rights Responsibilities* (2017) (Sydney Law School Legal Studies Research Paper No. 17/17), available at http://ssrn.com/abstract=2926215 (last visited 1 May 2022).

[299] Dowell-Jones and Kinley, *supra* note 53, at 188.

[300] *Ibid.*

rather hypothetical importance.[301] We can demonstrate this with reference to the responsibility to respect[302] formulated in Principle No. 11 of the UN Guiding Principles on Business and Human Rights (UNGP).[303] John Ruggie argued that the responsibility to respect is a 'transnational social norm',[304] which exists '"over and above" all applicable legal requirements; and it applies irrespective of what states do or do not do'.[305] Yet, this contested issue of the legal nature and bindingness of Principle 11 of the UNGP risks concealing the fact that several legal obligations for private entities concerning the human rights of third parties have been enshrined in national laws in recent years. The legal nature and binding force of these national laws are not in question. Human rights due diligence is a case in point. Principle No. 17 of the UNGP details the duty of companies to conduct human rights due diligence (HRDD). HRDD obligations have recently been integrated into national corporate and securities laws. A prominent example is the EU CSR Directive[306] on non-financial reporting.[307] Effects on human rights are explicitly covered by these non-financial statements.[308] As we have seen, there are reasons to believe that the food price crisis of 2008 was exacerbated by trading in food derivatives, which could also affect 'the right of everyone to an adequate standard of living… including adequate food' and 'the fundamental right of everyone to be free from hunger' affirmed in Article 11 ICCESCR,[309] as the right to food encompasses economic as well as physical accessibility to food.[310] A massive rise in food prices exacerbated by trading in food derivatives can therefore potentially negatively affect the right to food. Accordingly, this potential impact of OTC derivatives trading on food prices is subject to the non-financial reporting obligation imposed under German law, and this obligation is backed up by certain administrative fines and even penal provisions. In addition, certain shareholder resolutions can be

[301] See Horst, *supra* note 4, at 195 ff.

[302] See Shemberg, 'New Global Standards for Business and Human Rights', 13 *Business Law International* (2012) 27, at 30.

[303] J. Ruggie, *Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework* (2011) (Report of the Special Representative of the Secretary General on the issue of human rights and transnational corporations and other business enterprises). See also Shemberg, *supra* note 302.

[304] Ruggie and Sherman, 'The Concept of "Due Diligence" in the UN Guiding Principles on Business and Human Rights: A Reply to Jonathan Bonnitcha and Robert McCorquodale', 28 *European Journal of International Law* (2017) 921, at 923.

[305] *Ibid.*, at 924.

[306] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ 2014 L 330/1.

[307] The Directive has, for example, been transposed into German law as Gesetz zur Stärkung der nichtfinanziellen Berichterstattung der Unternehmen in ihren Lage- und Konzerlageberichten (CSR-Richtlinie-Umsetzungsgesetz), 11 April 2017 (BGBl. I 2017 Nr. 20, 18 April 2017, p. 804).

[308] See, e.g., German Commercial Code (HGB), § 289c (2) 4.

[309] On the right to food, see, e.g., M. Ssenyonjo, *Economic, Social and Cultural Rights in International Law* (2016), at 473; B. Saul, D. Kinley and J. Mowbray, *The International Covenant on Economic, Social and Cultural Rights* (2014), at 867.

[310] CESCR, General Comment No. 12: The right to adequate food, UN Doc. E/C.12/1999/5, 12 May 1999, para. 13; Ssenyonjo, *supra* note 309, at 480.

challenged if the non-financial statement is incorrect, thereby potentially allowing instruments of securities law and capital markets law to be used to enforce human rights.[311] In sum, non-financial reporting requirements with respect to human rights potentially politicize national corporate and securities laws by making distributional aspects such as the effects of trading in food commodity derivatives an issue for corporate governance.

Thus, from a distributional perspective, there are several potential avenues for politicizing specific distributional consequences of the legal infrastructure of OTC derivatives markets. However, these examples seem to be rather incremental and limited in nature. Yet, as Katharina Pistor and Claire Cutler have pointed out, incremental reforms of aspects of the legal infrastructure of global finance can also initiate broader transformative changes. The seemingly negligible and rather technical reform to abolish insolvency safe harbours such as close-out netting would in fact, as we have seen, 'materially alter the economics of derivatives markets'.[312] Therefore, we should not underestimate the potential of incremental change to politicize the distributional effects of transnational law.

[311] See Safraty, 'Human Rights Meets Securities Regulation', 54 *Virginia Journal of International Law* (2014) 97.

[312] Bliss and Kaufman, *supra* note 79, at 67.