Freedom of Contract and Financial Stability– Introductory Remarks

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This issue of the European Business Organization Law Review is devoted to fundamental questions arising from the close interplay between contractual freedom and market stability as have become particularly clear throughout the financial crisis of 2008/09. Ultimately, they go back to the relation between law and finance, as it has been at issue for quite some time now and has only recently been put into a new institution-based framework in the Legal Theory of Finance (LTF),¹ which forms the basis of this research endeavour.

1 Legal Foundations of Financial Markets–Institutional Context

The assumption of an interaction between contracts and market stability requires first of all a clarification of the underlying institutional understanding of the role of law in financial markets. LTF looks at law as endogenous to financial markets, implying its institution-building role and highlighting this by referring to the ‘legal

¹ Pistor (2013). For the roots of the controversy about the relation between law and finance cf. La Porta et al. (1998), Pistor et al. (2002), Roe (2003), Roe and Siegel (2011), Beck et al. (2003). For a collection of the essential contributions. Cf. Deakin and Pistor (2012).

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construction of financial markets'.² This has been a very familiar way to look at law and product markets, as becomes clear in antitrust analysis where it is often a private contract that constrains competition. Still, there seems to be something special about the interrelation between private contracts and financial markets which may call this institutional correlation into question.

At first sight, the legal construction of financial markets appears to be a truism. As becomes particularly clear in the securities markets, it is by force of law that parties can enter into securities purchase agreements and purchase agreements on financial products that accommodate their specific needs for corporate finance, thus creating tradeable assets whose vindication solely relies on law. This not only applies to the long-standing case of over-the-counter (OTC) derivatives, as evidenced by their enforceability fostered by regulation, which becomes particularly clear from the implications for the resulting regulatory competition.³

1.1 Private Creation of Money by Structured Finance Products

One more recent case in point involves structured finance products, such as asset-backed securities, that had increasingly been gaining in importance up until the financial crisis of 2008/09.⁴ After having been looked at as an exogenous determinant aiming at the reduction of transaction costs, the law in its formative role for the structuring of asset-backed securities came into focus throughout the crisis.⁵ The success of a securitisation transaction is based on the legal separation of the special purpose vehicle (SPV) from the originator, thus ensuring bankruptcy remoteness of the SPV, so that the originator can be certain to have its illiquid debt removed from its balance sheet in return for an increase of liquid funds.⁶ Hand in hand with this bankruptcy remoteness necessarily comes the role of an SPV to provide 'money market funding for capital market lending'.⁷

This opens up a wider perspective on shadow banking, not only as a circumvention strategy of banks with respect to their regulatory burdens, but also as something close to a 'parallel system of private money creation'.⁸ It sheds light on the maturity transformation of shadow banks outside the regulated depository sector, so that broader monetary implications are not unlikely.⁹ Unlike regular banks, these private entities, including, among others, asset-backed commercial paper (ABCP) conduits, in particular SPVs, money market mutual funds and repo-financed credit funds, are not subject to the requirements that are key to the banking safety net, such as capital requirements and strict portfolio limitations.¹⁰ Financial

² Pistor (2013), at pp. 317–318.

³ For the example of regulatory competition between the US and the UK industry, see Weber (2016), at pp. 79–80.

⁴ For this shift in perspective, cf. Bonavita (2016), at pp. 29–30.

⁵ e.g., *ibid.*, at 29–35; Pistor (2013).

⁶ For details, cf. Bonavita (2016), at pp. 28–35.

⁷ Mehrling et al. (2013), at p. 2.

⁸ Ricks (2011), at p. 744. For the broader context, cf. Bonavita (2016), at pp. 29–31.

⁹ Ricks (2011).

¹⁰ *Ibid.*, at p. 744.

instability inevitably results, as became especially clear throughout the financial crisis when this liquidity based on short-term funding made government bail-out measures necessary—at the expense of taxpayers.¹¹

Apparently, the application of quite a few of these measures requires the suspension of legal commitments captured by another characteristic of law vis-à-vis finance according to LTF, i.e., its elasticity.¹² The latter makes legal rigidity dependent on the hierarchical status of the addressee of the norm within the system. Whereas market participants at the apex of the system benefitted from the elasticity of law throughout the crisis, those at the periphery had to face illiquidity, default and exit.¹³ These distributive repercussions of the elasticity of law have recently been replicated with respect to asset-backed securities, which now qualify as eligible collateral under the newly amended ECB Monetary Policy Guidelines, even if only rated triple-B as opposed to triple-A before.¹⁴ Access to the discount window, the crucial standing credit facilities maintained by central banks, is however only granted to commercial banks. Even though ECB monetary policy has moved from discount window lending to open market operations, the list of ECB-eligible collateral applies all the same.¹⁵ In any case, the elasticity of collateral guidelines mentioned above which lowers the eligibility requirements for ECB collateral benefits only those market players that have access to the resulting liquidity. The apex of this system is populated by banks, which turn out to be not only the beneficiaries of the underlying elasticity of law but also the recipients of the thereby privately created money.¹⁶

1.2 Contracts and Political Power

1.2.1 Sovereign Debt Restructuring on the Basis of *Pari Passu* Clauses

Another example where the clash of the needs for financial stability and political power may be reflected by the elasticity of law is the field of sovereign debt restructuring and the underlying contracts. In fact, one way to persuade potential creditors of sovereign debt of the unlikelihood of the threat of a later cessation of payments following a restructuring was considered to be the inclusion of a *pari passu* clause in the underlying contract. Such a clause would stand in the way of selective payment of restructuring participants and of other techniques to encourage bondholders to assent to a restructuring proposal. At the same time, however, this seemed to play out the other way around in *NML Capital, Ltd. v. Republic of*

¹¹ For an overview of the various measures of the US government from summer 2007 to summer 2008, ranging, e.g., from negotiations to establish a Master Liquidity Enhancement Conduit, to the establishment of the Term Auction Facility and the Primary Dealer Credit Facility, cf. Adrian and Ashcraft (2012), at pp. 26–38; for an illustration using the example of the government bail-out of AIG, see Pistor (2013), at p. 318.

¹² Pistor (2013), at pp. 320–321.

¹³ For more detail, *ibid.*, at p. 320.

¹⁴ Bonavita (2016), at p. 36.

¹⁵ Tarkka (2009), at pp. 34–61.

¹⁶ For these redistributive effects, see also Bonavita (2016), at p. 35.

Argentina,¹⁷ where Argentina passed the Lock Law, thus trying to avoid any resumption of negotiations with holdouts. Instead of adhering to a narrow interpretation of the *pari passu* clause to the effect that it would only prohibit formal subordination, the Second Circuit Court of Appeals went so far as to rely on a broader interpretation of the clause, i.e., it did not allow Argentina to pay other bondholders without paying the holdouts.¹⁸ Such a broad, ‘elastic’ interpretation thus results in differential payments to creditors and ultimately undercuts promising and fruitful restructuring practices.¹⁹ On a larger scale, this may pose a risk to financial stability as a public good. Looking at numerous and certainly varied cases in the past, ranging from the Third World Debt Crisis of the 1980s involving governments in Latin America, Africa, Asia and Eastern Europe, to the eurozone crisis,²⁰ it becomes quite clear that these barriers work against states and debtors on the periphery as opposed to the holdout creditors located at the apex. Again, elasticity of the law turns out to be a function of the addressee’s closeness to the apex.

1.2.2 Collective Action Clauses (CACs) as Safety Valves

At the same time, the Argentine court tried to meet these possible objections regarding a potential increase of holdout litigation resulting from its decision by referring to collective action clauses (CACs) as a way ‘to effectively eliminate the possibility of holdout litigation’.²¹ A CAC can pave the way for a super-majority of bondholders to approve a restructuring proposal, binding the dissenters, thus changing the repayment terms of the bond and making it applicable to all bondholders.²² It can therefore fulfil the function of safety valve. Such safety valves are especially called for in cases of a significant change of circumstances with respect to the distribution of risk that cannot be reasonably expected to be accepted by one of the parties, as illustrated by the example of the case law of the German Federal Court of Justice regarding the frustration of private contracts at the time of the hyperinflation in the 1920s and their necessary adjustment.²³

In order to be able to achieve their aspired goals of furthering an effective restructuring process, safety valves have to be carefully designed and therefore the balance between the individual veto right of a single bondholder and the effective restructuring as a public good has to be struck with a sense of proportion.²⁴ The design of traditional CACs goes back to English practice in 1879 and displays some shortcomings. These are closely connected to the aforementioned necessary balance, because in case of a relatively small outstanding amount of bond a

¹⁷ 727 F.3d 230 (2d Cir. 2013), cert. denied, 134 S. Ct. 2819 (2014).

¹⁸ *NML Capital, Ltd. v. Republic of Argentina*, (2d Cir. Oct. 26, 2012) (Nos. 12-105), at p. 18.

¹⁹ Weidemaier (2013), at p. 6.

²⁰ For an account of banking crises, cf. Gelper (2014).

²¹ *NML Capital, Ltd. v. Republic of Argentina*, (2d Cir. Oct. 26, 2012) (Nos. 12-105), at p. 27.

²² For overviews, cf. Buchheit and Gulati (2011), Drake (2014).

²³ Pistor (2013), at p. 329.

²⁴ On the importance of design of safety valves, Pistor (2013), at p. 329.

creditor can relatively easily block the necessary majority vote and thus undermine any restructuring and renegotiation.²⁵ In contrast, New York law bonds first required unanimous consent for any amendment of the payment terms and only in 2003 started to shift to a 75 % vote requirement, which up until then had only been provided for under English law.²⁶ Looking at this market-like evolution of contract clauses, one might tend to assume an effect of CACs on prices, increasing costs for borrowers that are seemingly prepared to enter into restructuring. Empirical studies point in either direction.²⁷ The perception of market participants may however differ in that higher borrowing costs are feared in emerging markets as a result of the use of CACs.²⁸

In the absence of a CAC, the threat of default may pose its own risk. In view of such a development and public discussion about a sovereign's capacity to pay its debt, distressed-debt investors will come in and buy this sovereign's debt on the secondary market. As opposed to corporate distressed-debt investors that at times may actually promote the efficient reorganisation of the respective corporation, the so-called sovereign vulture funds' interests differ from those of the sovereign because their presence leads to the holdout problems described above, thus making effective restructuring impossible.²⁹ This may indeed be another reason why CACs seem even less beneficial because these funds will be incentivised to purchase enough of the outstanding debt to be able to block any restructuring from going forward.

As indicated by the third party submission in *NML v. Argentina*, this deadlock may only be overcome when parties are involved that are not immediate parties to the bond issuance itself, but only to an agreement with the issuer, i.e., the trustee, who is an agent or fiduciary of the bondholders (and not the sovereign issuer) and with whom all enforcement rights are vested.³⁰ A court injunction against the sovereign debtor now risks having de facto binding effects on the trustee, compelling it not only to pay but also to possibly violate its fiduciary duties to the bondholders. It is true that parts of the US Trust Indenture Act and in particular its Sect. 316(b), which prohibits any reduction in the amounts due a bondholder without that bondholder's consent, do not apply to sovereigns. However, considering that the precedent created on the basis of the Trust Indenture Act has been followed by New York-law sovereign bond documentation, the trustee's fiduciary duties could serve as safety valves to overcome the deadlock and strike a

²⁵ For details, cf. Buchheit and Gulati (2011).

²⁶ Bradley and Gulati (2013), at p. 5. For a brief overview of the historical development, cf. Drake (2014), at pp. 144–148.

²⁷ Finding no or little pricing effects of CACs, Petas and Rahman (1999), Becker et al. (2003) and Weinschelbaum and Wynne (2005); finding a lower cost of capital, especially for below-investment grade bonds, Bradley and Gulati (2013); finding little impact on the cost of capital for the highest rated issuers and the lowest rated issuers, but a reduction of the cost of capital for those in the middle range, Bardozzetti and Dottori (2014).

²⁸ Gelpert and Gulati (2013) and Pistor (2013), at p. 324.

²⁹ For an evaluation of the advantages and disadvantages of sovereign vulture funds, see Muse-Fisher (2014), at pp. 1684–1685.

³⁰ Overview at Varottil (2011), at p. 231; Pustovit (2016), at p. 63.

balance between individual contractual rights and the bondholders' interest in restructuring.³¹ In order to actually overcome the impasse, first the true challenge has to be met: this safety valve has to be carefully designed and, in addition, the institutions that will further shape this design have to be designated. Especially the latter question raises the all-too-well-known alternative between a market solution and regulation that remains to be further explored. The long-lasting debate over default fiduciary duties in the context of business associations as well as the looming threat of political lobbying in the case of regulation pushed by private organisations show that there is no easy solution.³²

2 Market Discipline and Financial Stability

2.1 The Position of Central Counterparties (CCPs) as Intermediaries

This political aspect is one of the key issues of the regulation of the OTC derivatives market and in particular of the mandatory clearing of OTC derivatives via a central counterparty.³³ Contrary to legislators' statements, it is highly contested whether mandatory clearing is in fact an efficient regulatory measure to combat systemic risk. The extensive exchange of arguments pro and con CCPs in the OTC derivatives market sheds light on underlying trade-offs to be made resulting from the inherent financial instability of the financial system.³⁴ The question is not how to eliminate this instability, but how to determine and realise its optimal level.

In the case of CCPs this raises particular questions not because CCPs pose, by themselves, a systemic risk, but because of their position as highly systemically important entities. Again, the problem arises how to design safety valves in order to deal with the interdependencies and interconnectedness of these intermediaries. One well-known legal instrument to address problems of growth and market power resulting from network effects is antitrust law. However, its application to CCPs leads to quite a few challenging questions. First of all, the key determination of whether CCPs have market power may be difficult to make because of the problems of market definition and the scope for market entry. What is more, even in the absence of direct price control, it goes without saying that the wide range of regulation governing CCPs, whose assessment has been very controversial, has an impact on their market power.³⁵ The importance of regulation for market power

³¹ For the evolution of debt contracts in the shadow of the US Trust Indenture Act, see Eichengreen and Mody (2000), at pp. 6–7. For the proposition to bring to bear fiduciary duties to overcome the deadlock, see Pustovit (2016), at pp. 65–66.

³² For the debate on default fiduciary duties, cf., e.g., Widener University (2013), for the problems of the complex interactions between public legislators and influential transnational private trade associations at the example of the International Swaps and Derivatives Association (ISDA), see Biggins and Scott (2012).

³³ For an overview of central counterparty clearing and its regulatory development, see Weber (2016), at pp. 81–82. For a brief historical background with respect to the US, see Kroszner (2006).

³⁴ Pistor (2013), at p. 316. For an overview of the arguments, cf. Weber (2016), at pp. 82–92.

³⁵ Schönenberger and Schmiedel (2005), at pp. 28–31.

becomes quite clear when considering, for example, its effect on market access in terms of interoperability.³⁶ Thus, market power depends on governance as provided for by the legislator, hence it is politically determined.

This is why governance infrastructure has had noticeable effects and has received wide attention, as recently illustrated by the European Market Infrastructure Regulation (EMIR), mandating and implementing equal access in, e.g., its Articles 8, 40, 51 and 78.³⁷ Even though EMIR aims for transparency in the derivatives markets, mitigation of systemic risk and protection against market abuse³⁸ (e.g., in its Article 7 para. 1 it provides for clearing contracts on a ‘non-discriminatory and transparent basis’), the status of market infrastructure institutions as such at the same time raises challenges of its own. The downside of their status is the concentration of systemic risk outside the banking system, effectively turning CCPs into systemically important financial institutions (SIFIs) by regulatory fiat.³⁹ As a result, applying corporate governance and bank solutions to CCPs as the point of departure for regulatory intervention does not seem to be too far-fetched.⁴⁰

This, of course, cannot eliminate the crucial difference, namely, the lack of conventional capital on the part of CCPs, which are confronted with high and hardly predictable price volatility. Therefore, the question of how to limit taxpayer bail-out with respect to CCPs has to be addressed by looking for rationales for loss-sharing. One proposition is based on the notion of social responsibility, calling for liability of financial actors that participate in the relevant markets.⁴¹ Another way to arrive at more effective loss-sharing among CCPs, clearing members and derivative end-users could be to rethink the ownership and governance structure of CCPs and to introduce user-ownership.⁴² Again, as is the case with all of these solutions, the hierarchy of financial claims results from the legislator’s fiat. It may arguably come at a great cost, though, because end-user ownership (and liability) may have severe effects on other financial market actors, such as insurance companies, pension funds, etc., so that the actual problem of systemic importance is not overcome but only emerges at another level. Hence, the issue of bail-out is far from resolved. Instead, the need for a loss-absorption mechanism seems to be greater than ever.

2.2 The Design of Contingent Convertible Instruments (CoCos) as Loss-Absorption Mechanism

On a larger scale, the tension between market discipline and financial stability became particularly clear throughout the global financial crisis in the form of the

³⁶ Lee (2011), at pp. 40–41, 58–60; pointing in the same direction, Weber (2016), at pp. 86–87.

³⁷ 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 OJ 2012 L 201/1.

³⁸ Consideration 7 of Regulation (EU) No 648/2012, *ibid*.

³⁹ Singh (2014).

⁴⁰ For similar implications, cf. Lee (2011), at p. 256.

⁴¹ Weber (2016), at pp. 96–99.

⁴² Bank of England (2010), at p. 56.

too-big-to-fail phenomenon.⁴³ For fear of contagion and material adverse effects on the entire financial system and other sectors, the disciplining effect of insolvency of systemically important financial institutions was eliminated by government bail-out, imposing significant costs on the taxpayer. According to the Legal Theory of Finance, this appears as another instance of elasticity of law dependent on the hierarchical status of its beneficiaries within the system.⁴⁴ In order to ensure monitoring by shareholders and creditors and to offer alternative loss-absorption mechanisms, the EU Bank Recovery and Resolution Directive provides, in its Articles 43 and 44, for the bail-in tool, which allows conversion of debt to equity and the writing down of liabilities.⁴⁵

From a policy perspective, this raises the question of whether, in the case of contingent capital, contractual or regulatory enforcement is the more suitable way to implement such a bail-in tool. It is quite apparent that neither solution is without its faults. Especially the design of the trigger highlights the difficulty of both, in the case of contractual enforcement, potential liability questions with respect to the exercise of directors' discretion, and in the case of regulatory enforcement, the well-known risk of regulatory failure.⁴⁶ In order to avoid these shortcomings, the regulator paved the way for a loss-absorption mechanism under the minimum capital requirements of Basel III, which may be able to incorporate the strengths of both previously mentioned tools—the contractual and the regulatory enforcement of the bail-in mechanism.⁴⁷ Initially the Basel Committee on Banking Supervision favoured an increase in core capital for banks. In Basel III this increase was not implemented on the basis of common equity only, but other financial instruments may now also absorb losses.⁴⁸

This option offers opportunities, but raises questions at the same time. In order to achieve an optimal level of market discipline and financial stability, the respective financial instruments have to rely on a well-balanced contractual design that has to particularly account for specific dimensions highlighting the trade-off to be made, such as the type of trigger event—whether market-based or based on regulatory discretion, on the level of capital to trigger the CoCos, or on the underlying loss-absorption mechanism—, conversion or write-down of the debt. A closer look may show that cautious contractual arrangements with resulting gradualism of the loss-

⁴³ Hellwig (2009).

⁴⁴ See above Sect. 1.2 as well as Pistor (2013), at pp. 320–321.

⁴⁵ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance, OJ 2014 L 173/190; for an overview and critical assessment, cf. Avgouleas and Goodhart (2014), at pp. 17–27; Biljanovska (2016), at pp. 108–112.

⁴⁶ Bates and Gleeson (2011), at pp. 269–270.

⁴⁷ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance, OJ 2013 L 176/1.

⁴⁸ For details, cf. Biljanovska (2016), at pp. 119–120.

absorption mechanism will be better able to reconcile the conflicting goals. Only under these circumstances can one be sure that there will be room to take account of change. The danger that the full force of law may bring down the system as suggested by the Legal Theory of Finance seems to be smaller, since the law-finance paradox cannot fully unfold.⁴⁹ Under these conditions, contingent capital instruments may serve as safety valves in order to take account of an uncertain future and to bridge the abyss between market discipline and financial stability.

3 Different LTF Perspectives on Financial Stability

3.1 The Impact of Basel III on Competition in the Banking Sector

Basel III has also been targeted against procyclical effects, hence working against financial stability, at macro level, in addition to allowing contingent capital instruments as loss-absorption mechanisms. For this purpose, it has strengthened capital conservation on the basis of higher standards regarding quality and quantity of minimum capital requirements for banks and by introducing a countercyclical buffer that imposes an additional time-varying capital requirement of 0–2.5 % of risk weighted assets (RWA).⁵⁰

There is empirical evidence that Basel III has an impact on competition in the banking sector.⁵¹ As a result of Basel II, the larger banks opted for model-based regulation and implemented an extensive risk management system, whereas small banks remained under the standard approach and were then required to hold relatively higher capital charges for their asset positions. With the increase in complexity in Basel III has come an increase in this competitive effect, possibly further strengthening the competitive advantage of larger banks and leading to further consolidation in the banking sector to the detriment of small and medium-sized financial institutions.⁵² From the perspective of LTF, it could be concluded that this is evidence of the legal construction of finance, which, however, differs from the exemplary way in which law constructs financial markets, as has been shown above at the example of asset-backed securities.⁵³ In this latter case, it is the legal construction drafted by market participants and not the regulator that constructs finance.⁵⁴ In contrast, Basel III is based on legislative action. Its ‘constructive’ effect with respect to financial markets results from its incentive effect on bank behaviour, but is not, by itself, an immediate integral component of the financial market.

⁴⁹ For the law-finance paradox, cf. Pistor (2013), at p. 323.

⁵⁰ For details of the related regulatory framework in Basel III, cf. Amorello (2016), at pp. 151–153.

⁵¹ Behn et al. (2014a) and (b).

⁵² For details, cf. Amorello (2016), at pp. 155–164.

⁵³ For this approach, *ibid.*, at pp. 153–155.

⁵⁴ Pistor (2013), at pp. 317–318.

3.2 The Legal Construction of Financial Markets in China

In a similar vein, it can be shown at the example of the evolution of trust law in China that LTF might apply differently to transition economies.⁵⁵ Ambiguities of the Trust Law 2001 in China are maintained by Chinese regulators and courts in order not to disturb the delicate balance between market practice, the public interest in developing the market, and the requirements of the law. The conventional wisdom with respect to innovation finance on the basis of private equity aims to identify the best suited form of business association, which, most typically, is the limited partnership or the limited company.⁵⁶ This, in turn, goes back to a transaction cost-based line of reasoning. Under this approach, innovation finance is closely linked with freedom of contract and resulting innovative forms of corporate contracts.

Drawing on an LTF-based explanation for the generation of innovation finance within the corporate law framework, one has to take a slightly different approach towards the law-finance paradox mentioned above. There clearly is a paradoxical relationship between law enforcement and the stability of financial markets here, since if the Trust Law 2001 had been fully enforced from the beginning, instability might have been introduced into the market if investors had been disincentivised, leading to a falling supply of liquidity for supporting China's new financial infrastructure. On the other hand, the paradoxical relationship between law and finance might appear in a very different light, specifically with regard to the introduction of new laws in emerging and transitional markets. This is because it is not only the full enforcement of simple contract law that leads to market instability, but also full enforcement of the amalgam of trust law, more specifically property law. This could be considered as a reason why current market practice relates more closely to earlier versions of contract law rather than to trust or property law.⁵⁷ Another case in point is the practice of absolute payment that ensures full payment to investors even in case of underperformance, which, in its effects, comes close to creating beneficial rights for investors and therefore amounts to a guarantee equivalent to that of trust property.⁵⁸ At the same time, this reverse direction of effect of the law-finance paradox results from the different stage of development of the financial market in question. The trust industry in China is still in the making, so that markets whose stability may be at stake have yet to evolve. The full force of law is not only suspended to take account of fundamental circumstances that would bring down the system, but also because the suspension of the law is part of the evolutionary process of law itself. It is the law that constructs the financial markets in China.

⁵⁵ See Hsu (2016).

⁵⁶ Haar (2008), at pp. 143–144.

⁵⁷ Hsu (2016), at pp. 181–183.

⁵⁸ Ibid, at pp. 189–191.

4 Conclusion

This *tour d'horizon* of contracts in financial markets highlights the explanatory power of the Legal Theory of Finance in various respects. Structured finance products, securitisation techniques and resulting private money creation are cases in point to show that financial markets are legally constructed and do not exist independently of law, such as contracts and the private and public rules governing them. The *pari passu* clauses and their application then show the differential application of these legal rules according to the hierarchical status of the respective market participant, and reveal the resulting danger of deadlock of sovereign debt restructuring. At the same time, the latter may create a need for a safety valve in order to eliminate the possibility of holdout litigation. Two legal instruments to achieve this could be CACs and fiduciary duties of the trustee towards the bondholders. This need to ensure that safety valves fulfil their purpose can also be framed as the need to resolve the tension between market discipline and financial stability, which lies at the heart of the law-finance paradox. This trade-off has proved relevant for the regulation of the OTC derivatives market and the related question of effective loss-sharing among CCPs, clearing members and derivative end-users. Apart from the concept of ownership, which may have to be rethought for this purpose, this issue raises the question of another loss-absorption mechanism. The same holds true for the conceptualisation of the minimum capital requirements of Basel III that allow financial instruments other than common equity to absorb losses. It goes without saying that these instruments have to be designed as cautious contractual arrangements with corresponding gradualism of the loss-absorption mechanism so that the safety valves will be able to function. In addition to this dimension, Basel III is characterised by a resulting effect on competition in the banking sector. Thus, this regulation has been strongly shaping financial markets by creating corresponding incentives. Legal construction in this case results from behaviour instigated by law, but not immediately from law itself. Such a variance in the application of LTF to financial contracts can also be illustrated by the evolution of trust law in China. It is true that the evolution of trust law has helped to prevent market instability with the help of suspension of the law as suggested by the law-finance paradox. The latter, however, typically operates to keep such legally constructed financial markets intact. Trust law in China, in contrast, constitutes the legal construction without an underlying additional infrastructure of legal rules. It is the law in finance.

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