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**IS THE KING NAKED? JUDICIAL GOVERNANCE AS A RESPONSE TO
MARKET AND STATE FAILURES
THE POLISH TOXIC CURRENCY OPTIONS CASE**

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COMMENTS AND SUGGESTIONS ARE MOST WELCOMED)

1. Introduction

The purpose of the proposed paper is to scrutinize the soundness of the so-called “judicial governance” regarded as an alternative to both market mechanism and political process. It seems that the recent economic crisis requires a differentiated response. Different markets have been affected by different types of market failure. In the US the deregulatory policy on the OTC derivatives has resulted with the over-exposure towards risk and created very good conditions for excessive speculation with credit derivatives (especially credit default swaps-CDS), leading to fluidity problems and gradually affecting the whole banking and financial market. Additionally the crises had an immense impact on other markets, where the toxic financial instruments such as the CDS-styled derivatives and collateralized debt obligations (CDOs) have not even been treaded.

The problem of the Polish toxic currency options case, being a direct result of the current financial crises and market instability is to be analyzed against that background. Thus the paper will concentrate on a typical market failure case having a huge impact on economic performance, analyzing feasible alternatives to market transactions such as direct government/legislative intervention and judicial process. The problem has obvious international consequences. The Polish courts and the Polish government operate as a part of a wider multilevel inter-governmental governance structure of the European Union. Additionally the Bilateral Investment Treaties protect private investors from nearly 60 countries against many potential regulative actions of the Polish government. The multilevel legal and institutional structure creates some

biases and paradoxes. The question arises whether and how they can effectively be managed by the multilevel judicial structure on both national and international levels.

2. The concept of the judicial governance in case of the market failure, radical change and uncertainty

The comparative institutional analysis (Komesar 2005) suggests three potential types of remedies being deployed in case of the so called market failure.

A) The market. Parties may insure against unpredictable events on the market. This strategy is strictly connected with the general equilibrium theorem and the concept of the complete contract (contingent contract claim), concerning all possible states of affair. Within the economic literature it has been suggested by e.g. K. Arrow. The economic theory of complete contingency contract is however seriously weakened by the assumption about the existence of the transaction costs. If transaction costs are high enough then it is not profitable for a party to spend resources on filling the gaps in contract. How the gap is to be filled ex post it is no longer the problem of market governance, given the fact, that in majority of cases it is up to the court how to fill the gaps in incomplete contracts. Hence the market solution under the assumption of positive transaction costs is effectively being transformed into the problem of judicial governance.

B) The government. Given the fact that the existence of transaction costs leads to gaps in contract the state could effectively prevent the ex post construction of contracts. The typical instrument then is just a set of the default rules which operate if not bargained out by the parties. The stronger regulatory instrument is the set of mandatory rules set out in case of a typical market failure e.g. information asymmetry.

C) The court. It is commonly believed that courts should supplement the market in case of high transaction costs. According to Ronald Coase: “when the market transactions are so costly as to make it difficult to change the arrangement of rights established by the law (...) the courts directly influence economic activity. It would therefore seem desirable that the courts should understand the economic consequence of their decisions and should (...) take these consequences into account when making their decisions.” (Coase 1960). Courts typically intervene also in case of the market failure such as fraud, duress of deceit (Cooter Ulen 1998). According to R. Posner: “Economic analysis reveals no grounds other than fraud, incapacity, and duress (the last narrowly defined) for allowing a party to repudiate the bargain that he made in entering into the contract.” (Posner 1992). Consequently even gross inequalities between parties resulting from the difference in bargaining skill are justified. Nevertheless some legal doctrines as unconscionability, exploitation of the weaker party, etc. may play some role especially in civil law countries. The question arises whether judges are prepared to solve the problem of allocation and distribution of resources under the assumption about the presence of uncertainty, risk and bounded rationality. This part of judicial practice seems to be criticized by many authors (Komesar 1996, 2001, Vermeule 2006).

Within this context three economic models of judicial governance could be distinguished:

-The Posnerian model: courts should adopt the same position as the markets- the market transaction is the first best. Courts should thus adopt the "market mimicking" strategy, aligning their judgments with potential (virtual) market solution. Thus judicial governance becomes a perfect substitute for market (Posner 1972, 1989, 1992, 2005).

-The Coasian model: judicial governance is perceived as residual allocative framework within the high transaction costs environment (Normative Coase theorem). Additionally judges successfully apply distributive schemes enhancing, at least in the common law, the overall efficiency of law, accordingly with the so called efficiency of the common law hypothesis. The certainty of legal position sets out the limits of the efficiency enhancing strategy. In other words: courts under some assumptions could be an institutional alternative to market, but they are not ideal substitutes. Moreover the costs of judicial governance should also be taken into account (Coase 1960).

-The Calabresian model is based on the assumption that different values should be preserved by the judiciary. Hence the axiological pluralism becomes the background of judicial activity. Judicial governance differs from market a serious way. The decisions are left for the court exactly because of the fact that courts have to take different values into account. The market solution is not adequate in many cases, because of the fact that market is not perfect (market failure model). Fairness, justice (distributional effects) and efficiency should be equally taken into account (Calabresi 1972, 1982).

Certainly the problem of judicial governance might be scrutinized on a much broader basis. In the XIX century courts in the US started to establish and implement the common law doctrine against speculation. Courts thus became forerunners of the antispeculative policy adopted later on by statutory law, when the whole bunch of statutes has been adopted, encapsulating *Future Trading Act 1921* and *Grain Futures Act (1922)* *Commodities Exchange Act 1936*, regulating commodity futures, and *Securities Exchange Act 1934* being a core of anti-speculative financial law. Even in the UK where the statutory provisions seem to play an important role in regulating derivatives, the ultimate application of statutory provisions rested upon courts.

The legal definition of a wagering had been proposed by Hawkins J. in *Carlill v. Carbolic Smoke Ball Co.* [1892] 2 Q.B. 484, 490-491. "a wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and the other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties." In this way the famous English case *Universal Stock Exchange Ltd v. Strachan* [1896] AC 166 set out the English doctrine of gaming transactions, thus substituting sec. 18 of the Gaming Act 1845, which stated: "All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void; and no suit shall be brought or maintained in any court of law or equity for recovering any sum of money or valuable thing alleged to be won upon any wager".

The same could be said about some peculiar aspects of derivatives treated on the stock exchange, such as the binding force of broker's commercial custom and its force for the principal (*Nickalls v. Merry*, L.R. 7 H.L. 530, *Robinson v. Mollett*, L.R. 7 H.L. 802). The nature of the unenforceable wagering contract has been endorsed in *Earl of Ellesmere v. Wallace* [1929] 2 Ch. 1. Additionally the function of derivative transaction has been analysed in some cases such as *Metelmann v. N.B.R* (1984), where it has been stated that derivatives may also serve as an efficient tool to mitigate loss due to the change of price (Ch. Lloyd's Report 1/1984, p. 614). Likewise in more recent cases under the FSA 1986 the courts tried to identify the legal nature of derivative transactions or to analyse the problems of legal capacity to enter the sophisticated derivative transaction. This was necessary due to the vagueness of some provisions of the FSA. (*City Index v. Leslie* [1991] AC 98). More recently judicial decisions set out the legal status of many derivative transactions; in *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996) the legal nature of certain interest rate swaps has been defined as contracts, not securities. Moreover the judgment in *Caiola v. Citibank*, 137 F. Supp. 2d 362, 364-65 (S.D.N.Y. Apr. 2, 2001) had impact on the evaluation of the legal status of the so called soft law regulations issued by International Swap and Derivatives Association for the OTC derivative transactions. The court held that certain provisions of the ISDA Master Agreement could have prevailed over the statutory provisions of the Securities Exchange Act.

But what does the interplay between the statutory regulation and judicial intervention show us? It seems that courts are residual lawmakers: (in case of market failure and state (legislation/administration) failure. Courts intervene as the "interstitial legislators". In this highly complex derivative cases - what is the background of their decisions since even recently judicial interventions play an important role in the regulatory framework?

The question is to be addressed in reference to the case of the Polish currency toxic options. Since 2008 over 10000 Polish companies engaged in contracts designed to protect them from a stronger Polish currency zloty. The main economic reason for this strategy was the fact that the value of the Euros they earned from selling goods and services in Europe was continuously decreasing for last 5 years. However the unexpected collapse of the Polish currency since September has left many of them in painful positions. The Financial Supervision Authority (FSA), Poland's financial agency, estimates that at least 99 Warsaw Stock Exchange-listed companies concluded the option deals last summer. Many relatively small private firms have been exposed as well. The FSA estimates the hedges could cost these companies an estimated 15bn PLN (€3.3bn), if closed at today's exchange rate. Many analysts believe however that the losses could grow much higher if the zloty continues to weaken. The currency has lost nearly 30% of its value against the euro since July 2008. About 1500 firms may go bankrupt in case of performance of the option currency contracts.

Both macro and micro effects are discernible. On the macro level the rise of unemployment and bankruptcy of nearly 2000 firms plus massive loss of the bigger, including the biggest companies will have an impact on the whole national economy. On the micro level the relationship between banks and investors are not clear since many banks acted as financial advisors breaching their fiduciary duties. In many cases the information on risk exposure has not been disclosed. Many contracts contain hidden provisions of suffer serious formal defects.

Under those conditions two questions will be addressed:

1. Is the case of Polish currency toxic options a market or government failure?

2. If it is the real market failure, how should the government and the judiciary respond to the disastrous economic consequences of those contracts for a group of business entities?

As to the first question, there seems to be no unanimously accepted answer. Each contract should thus be scrutinized on an individual basis. This requires the control by the courts. In fact the majority of loss suffering disappointed companies has brought claims against banks, submitting for resolution or invalidation of those option contracts. How are the courts going to deal with those highly specialized financial transactions still remains unknown. One of the possible solutions is to adopt the position, that those contracts as bets or contracts for differences were valid but not enforceable. Generally however there is no sensible solution on the level of national contract law, regulated by the Polish Civil Code.

The other option may be contemplated, namely the general legislation rendering the majority if not all option contracts void or voidable, depending of the version of the bill. Three bills have been prepared so far but there is no political consensus as to which one of them should be implemented.

However this is not the whole picture. Since 2004 Poland is a member of the EU. In 2006 the European Council adopted the EU's *Markets in Financial Instruments Directive* (MiFID), stipulating minimum requirements of the protection of individual unsophisticated investors. The implementation of the directive would have solved the problem of toxic options provided the contracts were fraudulent or unbalanced. In other terms, if the option contracts had constituted the typical case of the market failure, the problem would have been solved by the implementation of the directive. The Polish government failed to adopt the directive however, thus acting in breach of the EC law.

The potential consequence of this will be that the individuals whose rights protected by the EU legislation suffered loss, could claim compensation from the Polish government. This could be prevented by the national courts applying the non-implemented directive while resolving the disputes between banks and investors.

The consequence of that could also be very serious since Poland signed about 60 Bilateral Mutual Investment Protection treaties. Those treaties protect investors (resp. banks from those countries against the appropriation). It seems that the definition of the expropriation is very broad and still being extended in jurisprudence of the arbitration tribunals, thus leading to the compensation from the Polish government in cases where the courts or the government would resolve those option contracts. It has been proved in the case of Czech Republic that potential compensation could amount the sum of loss, i.e. about € 3 bn.

How should courts operate under those circumstances? Which model of judicial governance would be the best fitting? The question remains which of those models fit best the contemporary complex structure of multilevel legal systems. It seems that the model of multilevel international judicial governance based on Coasian approach to judiciary could provide with feasible solution under the assumption that the political process cannot provide with an adequate remedy to the market failure (Stone Sweet 2000, 2008; Hirshl 2004; Halberstam 2007).

Those findings could be proved within a light of Sen's concept of normative evaluation and legal analogues in a multilevel global system (Sen 1982, 2001, 2002, 2006). In one of his papers A. Sen has correctly observed that that social sciences are predominantly based on the

legal contractual paradigm (cf. J. Rawls' theory of justice, T. Scanlon's contractualism, K. Binmore's natural justice). Additionally he proposed to concentrate on the competitive idea derived from the Smithian "Impartial Spectator" paradigm, when he observed:

"The basic idea is pithily put by Smith in *The Theory of Moral Sentiments*, in the context of judging one's own conduct, as the requirement to Reexamine it as we imagine an impartial spectator would examine it," or as he elaborated in a later edition of the same book: "to examine our own conduct as we imagine any other fair and impartial spectator would examine it. (...) However, the impartial spectator as a judgmental device has some important differences from the framework that emerges from the analogy with a legal contract. While the contractarian approach attempts to eliminate the influence of vested interests by imagining a contract - in the original position - in which people are unaware of their own exact identities and thus of their own special interests, the Smithian approach of the impartial spectator tries to do this through examining how things would look to a "fair and impartial spectator." (*Normative Evaluation and Legal Analogues*, Amartya Sen 2006).

Thus the competitive paradigm is marked by the triadic relationship, which characterizes arbitration and adjudication. The idea is based on the concept of impartiality, objectivity and fairness. Those ideals are not attainable within the world shaped by normative frameworks based on the contractarian paradigm. However it does not necessarily mean that there are not attainable at all and that the whole idea of impartiality is too idealistic to be useful in real life. It seems that impartiality, objectivity and fairness are still basic normative presuppositions of any adjudicative process. The legal process should be at least to some extent imbued with those values, corresponding with the idea of Smithian impartial spectator. The question remains whether such a model of the judicial governance and judicial regulative framework does fit the complex regulatory environment such as financial market and derivative regulation.

3. The notion of legal and economic evolution

Two factors shifted derivatives from disregarded set of gambling practices to highly regarded set of financial transactions (contracts or securities respectively): market of risk, i.e. tradeability (previously non-existing market and economic aspect) and enforceability (legal aspect). Therefore, it should be stressed that path dependence and historical development of private law assumes the notion of evolution. There are three basic levels of such evolution regarding derivatives: firstly, apparent legal evolution from anti-speculative to pro-derivative approach (Cooter 1996, Kang 1996). Secondly, the evolution of economic theory concerning derivatives: from Keynes' scepticism through Arrows' enthusiasm to Stiglitz's and Hirshleifer's realism. Thirdly, on the level of law and economics the issue arises whether derivative law and massive stock and future exchange regulation leads to ZTC micro worlds and global market of markets.

Within the evolution process a specific drive towards dualism might be observed: regulated futures, stock and commodity exchange (with almost no litigation, due to technical regulations; deposits, clearing house, licenses, etc.) or sophisticated conventions (OTC market) are present on this market rather than typical contracts. The derivative OTC markets are

regulated by soft law enforced in non-jurisdictional way (Cooter and Kornhauser 1980). Is this process a herald of disappearance of traditional private law? At this point some theories of legal evolution might be useful (Hayek, Teubner 1993).

It seems that the evolution is a discernible process albeit not decisive as an explanatory tool. Firstly, in order to draw any interesting conclusion from the evolutionary based analysis it is necessary to specify the direction of development or just a vector of that process. The question arises whether the evolution of derivatives regulation is at all possible or meaningful. There are two basic problems concerning this question. Firstly, it is doubtful that the evolution of derivative market can be automatically explained in terms of financial innovation, the growth of market or the other similar data. Secondly, since it is unclear which derivatives are economically profitable or simply useful from the perspective of wealth maximization, it is not clear which type of regulation, (liberal or restrictive) is better off. This contention does not have to lead to the attitude of skepticism. The skepticism should rather be controlled and moderated by the analytical approach which carefully distinguishes between the impossible and the difficult.

4. The legal origin hypothesis and derivatives regulation

The paper of La Porta, Lopez de Silanes, Shleifer and Vishny stipulates that a 'legal origin' in form of either common law or civil law has different effect in relation to the protection of shareholders interests. According to the paper the regulation shaped within the common law legal systems creates better conditions for the protection of shareholder's interests in comparison with the civil law systems. Concurringly companies in common law systems could have developed much faster, having the better access to financial resources (La Porta *et al.*, 1998). Sometimes the legal origin hypothesis is being elaborated further and said to contain two substantial claims: the "law matters" claim and the "legal origins" claim (Armour *et al.*, 2008). According to the "law matters" claim, legal rules create the institutional framework for the market economy, establishing property rights (Barzel 1997) and enforcing contracts (Hermelin *et al.* 2007). Legal rules and their enforcement by the state could thus indirectly influence the economic output (Coase 1959, 1960), attracting investors by safeguarding their potential returns.

Therefore the quality of regulation plays an important economic role, even if transaction costs are relatively low (Coase 1960, 1988). Additionally, the "legal origins" claim states that the quality of laws varies depending on the fact that the legal system belongs either of the common law or to the civil law legal family. The common law is said to establish legal rules which would be superior in terms of shareholders protection and thus creating better conditions for the rapid growth of firms. The reason for that contention is not clear, although it is generally claimed that the common law as a judge-made law is more flexible and prone to be adapted to changing circumstances. Additionally, it is claimed that judicial independence creates a very good safeguard against the anomalies of political process, so often penetrating the statutory lawmaking process. The anomalies of the lawmaking process are supposed to influence civil law systems, leading to wasteful results due to the influence of interest groups. Additionally the civil law is said to be more 'rigid'. The question remains whether the same could be said about the difference between civil law and common law regulatory regimes on derivatives.

In this context it is instructive to mention the traditional legal doctrine opposing speculation in reference to derivatives known as the common law rules against contracts for differences in American law (e.g. *Irwin v. Williar* 110 U.S. 499 (1884)). The doctrine is based on

the assumption that the speculative transactions are inherently bad from the moral point of view and put into the jeopardy both the people affected by gambling practices and the whole society as well, as it has been stipulated in the whole line of cases. In *Irwin v. Willar* 110 U.S. 510 Justice Matthews lucidly compared the position of the American common law on contracts for differences with English statutory law on wagering, observing that: “In England, it is held that the contracts, although wagers, were not void at common law, and that the statute has not made them illegal, but only non-enforceable (*Thacker v. Hardy, ubi supra*), while generally, in this country, all wagering contracts are held to be illegal and void as against public policy; *Dickson's Ex'r v. Thomas*, 97 Pa. St. 278; *Gregory v. Wendell*, 40 Mich. 432; *Lyon v. Culbertson*, 83 Ill. 33; *Melchert v. Amer. Union Tel. co.* 3 McCrary, 521; S. C. 11 Fed. Rep. 193, and note; *Barnard v. Backhaus*, 52 Wis. 593; [S. C. 9 N. W. Rep. 595;] *Kingsbury v. Kirwan*, 77 N. Y. 612; *Story v. Salomon*, 71 N. Y. 420; *Love v. Harvey*, 114 Mass. 80.”

Additionally the doctrine against contracts for differences had from the beginning been based on the assumption that the profit gained by the speculator was unjust. Later on this approach found some echo in economic theory, since such an ethical theory was delivered by F.B. Hawley as a theory of entrepreneurship perceived as risk bearing. F. Knight regarded such profit as rather unjust and related to massive losses (Knight 1921). However it is the moral theory which seems to have been a fundament of the earliest anti-speculative regulations (Schwark 1990).

Meanwhile the British and American legislation embraces statutory rules endorsed by *Future Trading Act 1921*, *Grain Futures Act 1922*, *Securities Exchange Act 1934*, *Commodities Exchange Act 1936*, *The Commodity Futures Trading Commission Act 1974*. In the US and the UK the so called “antigambling legislation” has been adopted to the economic needs beginning with *Bernard's Act 1733*, through the sec. 18 *Gaming Act 1845* and sec. 1 *Gaming Act 1892*, and sec. 5 of the *Gambling Act 2005* regarding contracts for differences as unenforceable. The application of the rule based on *Universal Stock Exchange Ltd v. Stracham* [1896] AC 166 in recent cases under the *FSA 1986* e.g. by Lord Donaldson MR in *City Index v. Leslie* [1991] AC 98 testifies that the statutory law was much more flexible and served as a vehicle of institutional and regulatory change. Moreover it seems that the traditional common law was unable to initiate the process of liberalisation.

The change of the attitude towards derivatives which took part in late 70-s and 80-s resulted with massive deregulation and limitation of the previously enforced antispeculative laws, as it could be reflected by the British legislation dealing with derivatives and contracts for differences as a specified investments: sec. 63 *FSA 1986*, Par. 7-9 Sch. 1 to *FSA 1986*, sec. 412 *FSMA 2000*, art. 83-85 *FSMA 2000 (Regulated Activities) Order 2001*, *FSMA 2000 (Gaming Contracts) Order 2001* and exempting derivatives from the scope of regulation of sec. 5 of *The Gambling Act 2005*.

A very similar transformation took place in civil law jurisdictions, where the XIX century cautious approach to contracts for differences has been substituted with a much more liberal one. The attitude of German and French law should also be mentioned; in particular the notion of the so-called *Börsentermingeschäft* in German law on stock exchanges in *Börsengesetz vom 16. Juli 2007* (BGBl. I S. 1330, 1351), and in § 2 Abs. 2 Nr. 2 of the *Wertpapierhandelsgesetz vom 9. September 1998* (BGBl. I S. 2708, as amended by the art. 3 des Gesetzes vom 20. März 2009 (BGBl. I S. 607) as well as earlier regulations such as *Börsengesetz vom 22 Juni 1896 (RGLB 157)*, § 53 of the amendment of 1908 (RGBl 215/BGBl III 4110-1), §§ 50, 53, 57, 58 of *Gesetz*

zur Änderung des Börsengesetzes 11.07.1989, BGBl I, within the context of §§ 763 and 764 BGB (including judiciary approach; e.g. BGHZ 93, 307, BGHZ 88,144,146) and the concept of financial futures (*les contrats financiers à terme*) in French law and legal writing (Medjaoui 1996, Valette 1991, Nayer & Brochard 1990).

The French anti-speculative approach had been reflected by the enactment of the *Law nr 1885-03-28 of 28.03.1885* “sur les marchés à terme”, according to which the unauthorized transactions have fallen within the scope of the art. 1965 of the Civil Code, stipulating *a contrario* the unenforceability of such transactions: “Tous marchés à terme sur effets publics et autres sur valeurs mobilières, denrées ou marchandises ainsi que tous marchés sur taux d’intérêt, sur indices ou sur devises sont reconnus légaux. Nul ne peut, pour se soustraire aux obligations qui en résultent, se prévaloir de l’article 1965 du code civil, lors même qu’ils se résoudraient par le paiement d’une simple différence.” The regulation has not been changed until 1996 (art 93 of the *Law nr 96-597 du 02.06.1996* “de modernisation des activités financières”). According to the current regulation encapsulated within the art. L211-1 III of the CMF, as Amended by the *Ordonnance nr 2009-15 of 08.01.2009*, derivatives are treated as the so-called financial contracts: “Les contrats financiers, également dénommés ‘instruments financiers à terme’, sont les contrats à terme qui figurent sur une liste fixée par décret”. Nonetheless those transactions which are not mentioned within the decree are no longer “financial contracts” within the meaning of the 2009 Act. This point should be especially stressed within the context of the Article L211-35 of CMF, which states: “Nul ne peut, pour se soustraire aux obligations qui résultent de contrats financiers, se prévaloir de l’article 1965 du code civil, alors même que ces opérations se résoudraient par le paiement d’une simple différence”. It is worth mentioning that the regulation has been introduced by the *Ordonnance n°2009-15 du 8 janvier 2009* - art. 1.

According to the law’s origin hypothesis the common law regulation should be more flexible. It could only be said that the brief sketch of the evolution of the anti-speculative laws proves the opposite, the main vehicle of change being statutory law and the common law being often even an obstacle towards liberalization. Moreover, there is no evidence that the civil law jurisdictions adopted significantly different attitude towards derivatives. The difference lies rather in the style of regulation and the institutional regime. In Germany the general legislation was enforced for the long time directly by the courts. The same could be said about France and the UK in XIX and the first half of XX century. Moreover there was virtually no difference of the scope of regulation. All anti-speculative laws having been established in the second half of the XIX century were essentially similar, reflecting the same attitude towards speculation: the general enforceability of contracts for differences was balanced with the exemption clauses concerning organized stock exchanges. Thus the presently called OTC derivatives became unenforceable.

This (European) approach could be contrasted with the American common law which took much more rigid approach, as it has been endorsed by the Supreme Court in in *Irwin v. Willar* 110 U.S. 508-509 (1884), where the doctrine against contracts for differences had been affirmed in following way: “The generally accepted doctrine in this country is, as stated by Mr. Benjamin, that a contract for the sale of goods to be delivered at a future day is valid, even though the seller has not the goods, nor any other means of getting them than to go into the market and buy them; but such a contract is only valid when the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer; and if, under guise of such a contract, the real intent be merely to speculate in the rise or fall of prices, and the

goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void. And this is now the law in England by force of the statute of 8 & 9 Vict. c. 109, § 18, altering the common law in that respect. Benj. Sales, §§ 541, 542, and notes to 4th Amer. Ed. by Bennett.”

Nevertheless, the hostility of judges toward derivatives does not seem to be a peculiar feature of the XIX century American common law. The British judges also seem to be rather reluctant to promote freedom of contract where the suspicion of speculative transaction looms in the horizon. It is quite instructive how judges comment on the merits of derivative instrument under the shadow of statutory regime which thoroughly authorizes those transactions. One of the most striking examples of this judicial attitude towards the financial innovations has been purported by Lord Donaldson MR, who observed: “In the common coin of political life it is not uncommon to encounter condemnation of "City speculators." It is not for me as a judge to join in that debate, but the day to day working of the markets form part of the background to this dispute and have to be taken into consideration. (...) Clearly this system would not work if all dealers in the market took the same view as to future movements in prices and equally clearly the more people there are dealing in the market, the greater the opportunity for a diversity of view. So it comes about that the intervention of "speculators" from outside the market is not wholly unwelcome and indeed may in some circumstances contribute towards the achievement of the real objective of the market, although in some circumstances they can unsettle a market in no one's interests other than their own.” (*City Index v. Leslie* [1991] AC 98). The examined problem concerned the question whether the transaction constituted the investments within the meaning of section 1(1) of the FSA 1986, given the fact that the plaintiff had already been found "authorized person" for carrying out investment business for the purposes of the Financial Services Act 1986.

In this context one may examine the question: either the liberalization of the derivative market is inefficient from the economic standpoint or the judge-made law falls short in terms of flexibility and production of economically efficient rules. Assuming that the evolution of derivative market is efficient and that the financial innovations meet important economic needs such as the increase of fluidity, spread of information and dispersing risk, it seems that the law's origin hypothesis does not work in the context of derivative regulation. Moreover, the differences between the American and British approaches and regulatory techniques create a source of puzzlement for the potential adherents of the law's origin hypothesis. It is not clear to what extent the law's origin matters since both systems finally arrive to very different conclusions adopting strikingly different regulatory regimes. Moreover, the discrepancy between the American and English regulatory approach is additionally paired with the significant similarity between the English, French and German regulations. In all of these European jurisdictions the regulatory framework seems to be at least analogical, if not the same.

The anti-speculative, restrictive regulations were established by statutory instruments and supplemented by traditional private law. In France and Germany the regulation restricted the doctrine of the freedom of contract. It had been issued in a form of the provision of the civil code. In England the Gaming Act 1845 played a similar role, influencing the common law doctrine of enforceability of contracts. Additionally, all relevant European legal systems adopted the same regulatory instrument: contract for differences were generally unenforceable but valid and certainly not illegal. On the other hand, those transactions entered into on the stock exchange were generally exempted from the anti-speculative regulations.

Nevertheless, it may be beneficial to assume that this evidence is not conclusive and that the American approach finally favored the most efficient regulatory regime. This could be possible under the assumption that the economic theory regards derivatives as instruments with the power of putting the market in jeopardy. Therefore, even though it had been true, the restrictive regulatory approach should be flexible enough to react to the evolution of the economic theory pertaining to the economic function of derivatives. Meanwhile it should be stressed that the basic framework of the American derivative regulation remained virtually untouched for almost one hundred years. It seems however that the difference between the American style and European styled regulation is conceptually too broad to be useful. Still, the regulatory regime seems to respond to the economic proviso at least to some extent.

5. The “incomplete law” hypothesis and derivatives’ regulation

The fundamental assumption purported by K. Pistor and Ch. Xu (Pistor & Xu 2002, 2003) is that firstly, law is in general inherently incomplete and secondly, that the incomplete system cannot be effectively enforced. The power to interpret existing law, to adapt it to changing circumstances and to extend its application to new cases is thus called ‘residual lawmaking power’. According to the “incompleteness of law” theory, residual lawmaking powers may be conferred to the legislature, courts, or regulators. Hence depending on the identity of the residual lawmaker, the regulatory regime could be legislator-oriented, judicially-oriented or administrative-oriented.

While analyzing the development of financial law between XIX and XX century, the authors come to the conclusion that the legal evolution leads from the judicially- or legislator-oriented regulatory frameworks to the more developed forms in which the administrative agencies have the last say. This hypothesis is illustrated by the parallel development of the English, American and German financial law, leading all jurisdictions towards the paramount influence of specialized administrative agencies, playing crucial and double role of residual lawmakers and ultimate enforcing agencies at the same time. Both common law systems with the paramount role of judge-made law and civil law countries, where the statutory enactments responded to the problem of incomplete law, tend to develop the specialized agencies.

It has been suggested that the regulatory powers of either private or public regulatory agents developed faster in common law jurisdictions such as the US and the UK than in Germany. This could be an effect of both faster development of financial markets and relatively greater incompleteness of law in those countries. Nevertheless it seems that the incompleteness thesis leads to two claims. According to the positive claim all jurisdictions, under some assumptions such as the growth of financial market, economic growth and industrialization, tend to create the specialized regulatory agencies. The normative claim suggests that such a development is the optimal path of evolution. The regulatory agencies could effectively match the alleged incompleteness of law as the most flexible lawmakers and at the same time they could join the lawmaking function with the supervision and proactive enforcement of the relevant regulation.

It seems that even if the “incompleteness of law theory” applies to the financial regulations concerning market for shares and shareholder capital, for various reasons it is not necessarily an adequate instrument to be used within the development of derivatives. Firstly, it does not capture the fundamental difference between the stock exchange traded derivatives and

the OTC derivatives. Secondly, the smooth evolution from judge-made or statutory rules to the sophisticated regulatory frameworks administered by specialized regulatory agencies is questionable. There are two reasons for this criticism: firstly, there is no integral regulatory regime for all derivative instruments in majority of jurisdictions, the regulation being based on a patchwork of security regulators, stock exchange supervision, and judicial enforcement in case of the OTC contracts, the sole existence of integrated regulator and supervisor being nothing more than either a political and regulatory challenge or a mere wishful thinking. This line of reasoning is albeit not conclusive. It surely undermines the positive claim while remaining the normative claim unattached. Analytically it could be possible that the derivative market as a whole has not yet reached the stage already attained by the regulation on financial securities.

The more disruptive conclusions may be drawn from the closer scrutiny of the American path breaking history of derivative regulation. Once again the American experience seems to produce a counteracting effect. The very short story of the US derivative's regulatory framework reads as follows. In the beginning was the word or concept called "unrestricted freedom of contract". This lasted until the middle twenties of the XX century. Later on the massive regulation made world better off, for the financial world has been dramatically tortured by the glooms of great depression.

The whole structure of federal agencies has been established as the offspring of the New Deal policy. The regulatory powers over derivatives have been divided between the Stock Exchange Commission and the Commodity Future Commission. Those agencies regulated, supervised and enforced restrictive anti-speculative laws: Then the trend to the liberalization came in 1970's, the derivatives still being generally regulated by the CEA with the growing list of exemptions issued by the *Commodity Futures Trading Commission* (CFTC). In general all 'contracts for future delivery' were either exchange-traded or void. Thus the OTC market existed only within the scope of the CFTC exemptions, concerning basic OTC transactions. Such a regulatory framework lasted to the year 2000, when the US congress passed the *Commodity Futures Modernization Act* (CFMA) deregulating the OTC derivatives by virtue of exemption from the application of CEA and the regulatory power of the CFTC. According to the sec. 2 d 1 of the CFMA parties who are "eligible contract participants" to any individually negotiated derivative contract on any commodity are excluded from the application of the CEA. Moreover sec. 2 d 2 stipulates that the CEA is generally not applicable at all to those transactions. The only exception to that is the set of provisions concerning fraud and manipulation of market price, which means that the scope of regulation is limited to fraud and price manipulation.

Thus the statutory law provided with deregulation and incapacity of the existing agencies. At the same time such a deregulatory approach created some doubts concerning the existence of any regulatory framework for the OTC derivatives. The underlying assumption might have been such that the very statues of the "eligible contract participants" would create a sufficient regulatory safeguard, since the requirement for ECP's would have selected only the sophisticated professional market participants (US financial institutions, non-US regulated insurance companies and banks and their US branches and agencies, participants acting as brokers, agents, investment advisers or fiduciaries) and natural persons with more than 5,000,000\$ in assets who enter into the related transactions for risk management purposes. In effect the CFMA acted as a double sword: it either excluded some markets participants from any supervisory regime as in case of eligible natural persons or shifted that task to other agencies, already supervising some categories of financial institutions. The move to defragmentation and decentralization of the

supervision may be regarded as striking if compared to the British FSMA 2000, which adopted the opposite approach, creating a single integrating supervising agency, i.e. FSA.

The brief look at the American deregulatory reform justifies some skepticism toward any theory of linear legal evolution, especially in a form of the “incomplete law theory”. It seems that there is no determinism as far as the alleged evolution of the financial regulations is concerned. Thus the step back is not excluded and the sound theory of legal evolution should take it into account. Additionally, in reference to the “incomplete law theory” it should be observed that in the majority of jurisdictions the regulating and enforcing agencies do not in fact have the last say, taking the powers of judicial control of the administrative actions into account. In the majority of cases the administrative decision could be overruled by the court. Hence, the judicial control plays an increasingly important role, creating a counterbalance to the growth of the so-called “regulatory state”. It is not certain however whether does it mean that there is no legal evolution and the regulatory regimes may not fruitfully be analyzed against any evolutionary background.

6. The “normative uncertainty” hypothesis and three models of derivatives’ regulation

The problem with any coherent legal theory of derivative regulation is that such a theory is always depending on the economic theory. Since there is no coherent normative economic theory of derivatives, it is very difficult to expect lawyers to provide with any coherent legal theory as well. Is the whole effort doomed to failure then? It seems that the economic function of derivatives is somehow paradoxical. The neoclassical economics regards derivatives as the necessary instrument providing not only liquidity or risk spreading, but enabling the existence of the perfectly competitive market, since without derivatives there is no possibility to meet one of the core requirements of the General Equilibrium Theorem - the complete or contingent contract claim, according to which there should be the market for any possible state of affairs.

The paradox lies however in a fact, that derivatives work efficiently within a perfect competitive market structure, whose existence is conditioned upon the effective work of derivatives. As R. Coase observed many years ago, economists very often behave as if we lived in an ideal world of zero transaction costs, or to put it differently, within a world of perfect competitive market economy. Unfortunately not all derivative markets are perfectly competitive and arguably there are not always zero transaction cost worlds. The sheer fact is that derivative markets are diversified, since it is very difficult to analyze derivatives as such. Certainly an optimal regulation concerns well institutionalized stock exchanges. This is not to say that there is no place for the OTC derivatives - the question should be raised however how to minimize the possible market failures on the OTC derivatives markets. Additionally the dynamic growth of financial innovation does not facilitate the regulatory task. The question remains how to combine innovation with security under the conditions of uncertainty (the normative uncertainty hypothesis).

The normative theory of regulation would favor “dynamic efficiency” and the capability to adopt the regulation to changing circumstances rather than fixed regulatory approach, concentrated on one particular purpose. The future regulatory frameworks will have to be responsive and multi-purposive. This is especially important given the fact that the regulators lack a solid normative economic theory, thus are regulating under uncertainty. If the regulation should be multi-purposive, reflexive and adequate in a sense that it maintains the balance

between restrictive and liberal attitudes, then three different kinds of regulatory frameworks could possibly be distinguished:

- 1) transaction-oriented regulation (e.g. contract for differences - both statutory and judge-made law, as in the UK: statutory consequences of the gambling act set out in judicial decisions; common law on contracts for differences);
- 2) institution-oriented regulation (the institutional regulation as in FSA 1986 - stock exchange regulator (might be private), commodities, OTC, securities, banking system, etc.);
- 3) market-oriented regulation (the need for integrated supervision in form of the *FSMA 2000*, *MiFID 2006*, probably the future US regulation).

It seems that the evolution of the regulatory regimes could usefully be analyzed against the above distinction between transactions-oriented, institution-oriented and market-oriented regulations. The enactment of the *FSMA 2000* could thus be described as move from institution- (stock exchange oriented *FSA 1986*) to a new, market-oriented regulatory framework. That framework does not concentrate on a particular institution, embracing the whole spectrum of agents, transactions, markets and institution. The exhaustive scope of regulation has been combined with the creation of the integrated supervisor (FSA), but the existence of such a single supervision does not necessarily belong to the essential characteristics of the market-oriented regulations.

At the same time the enactment of the *Commodity Futures Modernization Act 2000* could be perceived as a step back from the institution-oriented CEA regulation to the transaction-oriented one, with the definition of the derivative transaction becoming a crucial element of the regulatory regime and virtually establishing the boundaries and scope of the potential regulation. Alternatively the same fact, namely the passage of the *Commodity Futures Modernization Act*, could be perceived as market-oriented deregulation, since in fact it created the whole complex of the unregulated OTC derivative market, exempted from any supervision.

The British and American approaches can thus be usefully contrasted. The *FSMA* adopted liberal approach toward OTC derivatives accompanied by the extensive supervision. The regulation could therefore be responsive and complete. On the other hand the American regulation created the heavily regulated patchwork with a huge unregulated sector of the market. It could be concluded that the *CFMA 2000* generally focuses on the regulation of products and markets, whereas under the British *FSMA* the market-oriented nature of regulation concentrates on information standards and customer protection. As a result all potential derivative transactions are organized and supervised. There is for example no restriction for the natural person being unsophisticated and unauthorized party to enter highly sophisticated derivative transaction, provided the product is offered by the authorized person complying with all consumer protection requirements. The *FSMA* as a market-oriented regulation contains the principle of segmentation, based on the assumption, that the access to the financial market should be open and at the same time the participants should be covered by different levels and intensity of regulatory instruments, beginning with the authorization requirements for the business institutions and ending with the consumer and credit protection rules in case of physical, unauthorized persons. As such the regulation essentially aims at the creation of the biggest possible market characterized by the highest prudential standards.

7. Conclusion

It seems then that the market oriented model of regulation has not accidentally been adopted by the European Commission (*MiFID 2006*) and many other jurisdictions including Germany, France and Poland (*Financial Services Act 2005*). Additionally the move in the same direction has already been announced by the US Secretary of the Treasury, Timothy F. Geithner, who characterized the awaited American derivative regulation as: “(1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.” (*the letter from the Secretary of the Treasury Timothy F. Geithner to Senator Harry Reid, May 13 2009*).

Taking the unusual and diversified evolution of derivatives market into account, two lessons should possibly be remembered. Firstly, the financial crisis proved that R. Coase was right, when he wrote, that: “if the traditional markets of the past have diminished in importance, new markets have emerged in recent times of comparable importance in our modern economy. I refer to commodity exchanges and stock exchanges. (...) All exchanges regulate in great detail the activities of those who trade in these markets (the times at which transactions can be made, what can be traded, the responsibilities of the parties, the terms of settlement of disputes and impose sanctions against those who infringe the rules of the exchange. It is not without significance that these exchanges, often used by economists as examples of a perfect market and perfect competition, are markets in which transactions are highly regulated. It suggests, I think correctly, that for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed”. The second problem concerns the diversity of regulatory approaches. It seems that the deregulated American market for derivatives, especially for credit derivatives such as credit default swap’s (CDS), created a regulatory externality, hence the more coordinated regulatory activity would be recommended, albeit there is not much institutional space for such coordination, and certainly the global summits are not the best way to deal with regulatory problems.