What is finance for?
A functional framework for finance and law

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INTRODUCTION

“Banking”, the 3rd Lord Rothschild apparently once remarked, “consists of facilitating the movement of money from Point A, where it is, to Point B, where it is needed.” One might imagine that his Lordship uttered these words in a sort of understated way, which would contrast his description all the better with his family’s legendary achievements in the realm of banking during the 19th century. In fact, the Rothschild’s business model did not consist in the kind of deposit banking we may associate with the simple and unexciting task of moving money from Point A to Point B. Rather, the Rothschild’s finance activities covered the ground of what we would now term investment banking. Most notably they were engaged as market-making investors on the bond market. While already at the time such financial operations resulted in a vast and sophisticated business, we came to see new terms to represent its complexity in recent years—like currency swaps, credit derivatives or equity options. With this development came a new formula of what finance was apparently doing for society: “the financial sector is to dampen the effects of risk by reallocating it efficiently to parties that can bear risks the most easily.” In contrast to the notion that banks will move money from Point A to Point B, this description is much more elusive; for what does it mean that the financial sector is a function of efficient risk allocation? A decade after the global financial crisis such proposition should be seen at least as incomplete. Indeed, a central feature of the crisis was that at its peak in Autumn 2008 no more money was moving from Point A to Point B and that state sponsored institutions had to step in to facilitate this need. Thus, reducing finance to a matter of risk allocation would yet be another understatement.

So what is finance for? The crisis provided a context in which this question became salient and a chance to hope for some fresh answers. The paper seeks to trace this post-crisis discussion from a law and finance perspective. The argument consists of three main parts. First, the paper analyses how the crisis lead to rethink the function of finance, with a special focus on prominent policy reports of the time. I will argue that the discussion suggests a distinction between a material and formal approach to finance, which each cast the function of finance in a distinct way. The aim will be to describe these two approaches and to explain how they frame our

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2 Other financial activities of the Rothschild’s business included foreign exchange dealing and arbitrage, private banking services for an exclusive circle of customers, and industrial investment (ibid., 6).
thinking about finance, the operations of the financial system, and the policy decisions on finance and its regulation. These “framing effects” of a material and formal approach to finance are at the centre of the functional framework that we aim to develop. For the current debate on finance, this framework proposes two things: first, to use the material/formal distinction as an analytical tool to assess financial policy and to understand how the financial system works. Its second input then is to argue for a more material approach to finance. A more material approach to finance is to complement and challenge its formal counterpart that is currently dominating economic scholarship. In particular, a material view argues against the tendency of the formal approach: to put finance in a social vacuum, rather than to connect it to particular social needs; to think about the financial system as it is, rather than how it should be; and to turn finance into a matter for economic experts only, rather than embedding it more broadly in the academic and public discourse.

The second part, extends the proposal towards finance and law. If we analyse the functions of finance with the material/formal distinction and take a more material approach to finance, what were the consequences for the law? Can a material view translate into a legal framework and what are the challenges of such a translation process? The second part will approach these questions through a case study. Illustration for a material approach to finance we find in the Kay Review of UK Equity Markets, while the legal counterpart is represented in the review on Fiduciary Duties of Investment Intermediaries, which the Law Commission prepared for the English government upon recommendation in the Kay Review.\textsuperscript{5} The case study shows both how the functional framework we envisage can translate into the law, while at the same time crucial input from a material approach may be lost in translation. Losses can partially be explained as a matter of legal rationality and technicality. Yet an important further reason is the “politics of translation”: the process of translating a financial policy proposal into law is subject to a public debate in which different interest groups share in; in particular, also market interest groups that rely for their argument on a formal approach to finance.

The third part, approaches the questions of the second part in a more systematic, theoretical way: for finance we established in the first part a distinction between a material and formal approach. That distinction builds the core of a functional framework of finance. Is it now possible to extend the material/formal distinction to the legal sphere to arrive at a framework that allows for a cross-cut analysis of finance and law? To answer this question, we revisit Max Weber’s concept of formal and material rationality, which introduces the material/formal distinction to observe the varieties of rationality across law and the economy.\textsuperscript{6} In a next step, we then use Weber’s insights to analyse three questions about finance and law: are knowledge transfers between finance and law possible at all?; how do different combinations of material


\textsuperscript{6} In English, it is perhaps more common to refer to Weber’s distinction between formal and material rationality as formal and substantive rationality. In this paper, I prefer to use the term “material”, which stays closer to the German original (materiale Rationalität). In the same vein, I will speak of a formal and material approach to finance.
and formal approaches affect the interaction between finance and law?; and how does the material/formal distinction integrate the politics of finance and law? Answering these questions will provide us with the first part of a functional framework of finance and law. Its second part will consist in some key themes for “a more material law of finance”. A more material law of finance considers the question how a legal system would look like that responds to a more material approach to finance. The paper thus concludes with canvassing some ideas about the legal structure and strategy of a material law of finance.

I. The functions of finance

A. Two parables

What has finance ever done for us? In the wake of the global financial crisis, this might be how some have questioned the financial system. Finance and development scholars might answer them with a parable. Consider an entrepreneur who has an idea for producing a new airplane engine that would reduce fuel consumption considerably. Developing the idea will require extensive further research and testing, and this requires capital. While he is confident about his business venture, he still is reluctant to risk all his live savings for it. Also he needs some funds readily available to support his daughter’s university education. A bank loan will allow him to match these different needs: he can access capital, diversify his risk, and retain some liquidity for other purposes. So the bank mobilizes the savings of many individual savers whom our entrepreneur could not afford to ask individually to fund his project. Those savers, on the other hand, would themselves not be well positioned to assess whether the engine project actually is a promising undertaking and whether our entrepreneur is the right person to carry it out. Intermediating between the two, the bank can solve these difficulties for it will collect the necessary information on the engine project and monitor its further development to make sure that the project is worthwhile for each party. There is considerable empirical evidence that finance promotes economic development in the way the parable suggests. And one can easily imagine positive spillover effects: the engine project will create jobs and provide a source of income for other individuals and businesses; if successful, there will be a tax benefit for the state, what contributes to funding public expenditures, etc.

Yet there exist different, much less favourable parables of finance too. Remarkably, some are told by economists who would agree with the tale thus far. So the problem must be that we yet miss some important information about how financial markets work today. We can glimpse this other side of finance if we adjust the parable as follows. Suppose that our entre-

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preneur is not quite a start-up engineer. Rather he runs a successful aeronautical business corporation and could easily fund the project for a new airplane engine with profits he retained from earlier years. Nevertheless, he decides to finance his latest business idea by taking his firm to the stock market. Offering shares to the public allows him to cash in on his initial investment and to fill the company’s coffers with even more cash. The new controlling shareholders of the company do not understand much about engineering, yet about asset management. They decide that the firm’s liquidity must be put to good use and transform its treasury unit into a profit centre that invests on the global financial markets. Profits from the firm’s core business are soon left behind. Some investors who buy the firm’s shares on the stock exchange of course still naively assume that they are allocating capital to a renown player in a valuable industry, while in fact they are investing into an in-house bank. Meanwhile, market pressures to increase shareholder value and the profit centre’s traders, enticed by their bonuses for earlier profits, lead the firm to take ever more risk in derivate positions. At last, spectacular losses bring the firm to the brink of collapse, demanding eventually for a state sponsored bailout to save the jobs in the industry. Today, the financial patterns and processes visible in this parable are often referred to as “financialisation”. And also here we find a growing body of empirical scholarship suggesting that this is more than just a parable.10

B. Modelling the functions of finance

1) Finance for society

True to their nature the two parables omit much detail. Still they provide a way to frame the discussion following the global financial crisis. After this event, the question about the function of finance would start naturally with the second parable. Why should it make sense for a firm to raise equity in the capital markets if it does not need funding for its core business, but rather turns towards finance, puts its core business at undue risk and makes it a state liability? To adapt the scenario to the financial crisis: why should it make sense that banks engage in an ever more complex web of transactions between themselves, which even their own risk models fail to fathom, if this necessitates bailouts to protect their core business?11 Responding to this issue, post-crisis commentators indeed invoked a functional perspective on finance. As a matter of principle, the Stiglitz Report, for instance, holds: “In any case, any strategy for restructuring the financial system needs to focus on the functions which the financial system should be providing and take due account of the repeated failures in recent decades.”12 Following this

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11 It should be remembered that there were also financialised industry corporations that ran into trouble during the crisis and had to be bailed out, most notably General Motors and Chrysler (see Timothy Sturgeon, Johannes van Biesbroeck, “Crisis and Protection in the Automotive Industry”, World Bank: Policy Research Working Paper 5060, 16-18).

line of argument, others helpfully reminded us that finance derives from the Latin word *finis*, meaning “goal” or “end”, thereby arguing that finance should not be seen as more than a means to an end:

Finance does not embody a goal. Finance is not about “making money” per se. It is a “functional” science in that it exists to support other goals—those of the society. The better aligned a society’s financial institutions are with its goals and ideals, the stronger and more successful the society will be. If its mechanisms fail, finance has the power to subvert such goals, as it did in the subprime mortgage market of the past decade.\(^{13}\)

So importantly, the functional link is modelled here as “finance for society”, not as “finance for finance”. The goals, which finance is to support, are then said to originate in us: “They reflect our interests in careers, hopes for our families, ambitions for our businesses, aspirations for our culture, and ideals for our society….”\(^{14}\) In line with this, policy considerations for financial institutions and instruments are focussed on “social needs” such as “mortgages that help individuals manage risks of home ownership better, student loans with lower transaction costs, banking the un-banked, or insuring the uninsured.”\(^{15}\) This financial policy corresponds with the more general view of “a market economy that performs its social functions well in the longer term.”\(^{16}\) Obviously, this particular functional perspective on finance brings us back to the first parable in which finance is positively associated with the benefits of economic growth. Yet it is crucial to realise that the scope of social goals and needs in the above comments are considerably wider than economic growth *tout court*. In a nutshell, “finance for society” means not simply “finance for the economy”.

2) Two approaches to finance: material and formal

Linking finance to society is, however, merely a start for modelling the functions of finance. It remains open how to transform such an approach into more technical functions. The discussion following the financial crisis suggests that there exist two basic approaches leading, perhaps, towards “finance for society”, a material and a formal one. I will consider them each in turn. In the material approach to finance, we find the financial functions still closely related to social and individual needs. An explication of this approach interprets the technical role of finance therefore as follows:

Finance can contribute to society and the economy in four principled ways. First, the payments system is the means by which we receive wages and salaries, and buy the goods and services we need; the same payments system enables business to contribute to these purposes. Second, finance matches lenders with

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14 Shiller, *ibid*.


16 *Ibid.*, 96. This market perspective also informs the Kay Review, *supra* note 5.
borrowers, helping to direct savings to their most effective uses. Third, finance enables us to manage our personal finances across our lifetimes and between generations. Fourth, finance helps both individuals and businesses to manage the risks inevitably associated with everyday life and economic activity.\textsuperscript{17}

So in a material approach, finance remains visibly embedded in society and the economy. Its existence relates to particular needs of individuals and businesses: receiving wages, buying goods, managing particular risks and household finances, etc. The perspective on financial markets, accordingly, is one that links back to the needs of market users, rather than market participants. As a corollary, the quality of financial activities and the utility of financial innovation is measured by the degree to which they advance the four basic functions for market users: making payments, allocating capital, managing personal finances, and handling risk. More technical market functions like liquidity, transparency, or price discovery through trading (i.e. the process by which information becomes embedded in market prices) are considered as intermediate steps towards these basic goals.\textsuperscript{18}

In the formal approach to finance, on the other hand, the discussion takes a much more technical turn towards financial markets. The emphasis lies on market functions and failures. Starting point to enquire into finance are not particular social needs but the first theorem of welfare economics suggesting that supply, demand, and competition will usually lead to socially beneficial outcomes. If the outcomes prove puzzling the analysis proceeds in three steps. First, it must be established how supply and demand really operate. Second, there might be a market failure that explains the puzzle (an externality, public good, natural monopoly, asymmetric information situation or a missing market). Third, the puzzle might be due to a government failure, i.e. a consequence of flawed laws or regulations, either unintended or the result of regulatory capture. The corollary is that only once these three steps are well understood in theory and evidence, one can diagnose a socially undesirable outcome and start to think about how to improve matters.\textsuperscript{19} Because the starting point are not particular social needs of market users, the formal approach tends to focus on what market participants are doing and to leave it there if a puzzle remains either unnoticed or unresolved. The overall outlook on finance can differ fundamentally from the material approach and appear rather detached from economic and daily life:

Markets in financial securities are set up, and exist, almost entirely to be markets for information trading, and high-frequency “liquidity provision,” that we find hard to fathom. They are not really markets for the securities themselves. We could easily handle individuals’ lifetime saving and dissaving needs, and firms’ need to issue and retire equity, with orders-of-magnitude less volume, in much sleepier bank-like institutions. Yes, we could each avoid being the negative-alpha part of price discovery by only buying index

\textsuperscript{17} Kay, supra note 13, 6. In the same vein, Independent Commission on Banking (ICB), Final Report (September 2011), 7 (hereinafter cited as the “Vickers Report”, after Sir John Vickers, chair of the ICB); also similar Stiglitz Report, supra note 12, 57-58.

\textsuperscript{18} See Kay, ibid., 5; Kay Review, supra note 5, 9, 30.

funds. It’s a bit of a puzzle that we don’t. It’s also a good thing we don’t, or there would be no traders making prices efficient.\textsuperscript{20}

The effect of framing finance in either a material or formal approach thus appears to be quite significant. We can illustrate this further by revisiting the parables briefly. A material view would in the first parable start with our entrepreneur’s engine project, including its potential benefits of reducing fuel consumption, and emphasise how finance channels savings into fresh investments that promise to be of value. It will also notice the entrepreneur’s financial household needs relating to his daughter’s education and the possibility that a bank loan will allow him to manage the business risk involved in the engine project. The payments system, finally, will accompany the project and personal finances of our entrepreneur all the way. In the second parable, the payments system remains of continuous importance for the aeronautical firm and its activities, be they financial or related to its core business. However, a material approach will question whether capital allocation still is directing the savings of the corporation to most effective use: instead of using those savings to invest into the new engine project, the company raises more cash by going public and then turns to invest on the financial markets while running its core business as a sideline. Certainly, the increase in trading volume will bring liquidity to the market, further price discovery in the securities traded, and provide profit opportunities for the firm’s traders and for those who are passing on the money further down the investment chain. Thus, capital allocation might be effective from a market participants’ perspective, yet whether it is so for market users is questionable for at least two reasons. First, investors who are buying shares in our firm are not allocating their savings to the company’s engine and other projects as they may think. Rather, they are investing into an in-house bank. Second, the firm’s activity on the financial markets disrupts rather than enhances the performance in its core business.

The formal view, on the other hand, will in the first parable seek to understand why there is a demand for the bank’s services. A suitable explanation would be that banking intermediation will make the lending process more efficient for it reduces transaction costs: the entrepreneur could not afford the search costs for collecting the capital for his project. Further, his lower credit standing might increase the cost of capital as compared with the interest he would pay for a bank loan. For the individual savers, the costs for gathering the necessary information about whether the project is promising and the entrepreneur capable and trustworthy will likely be prohibitive as well. Moreover, the bank will reduce the costs by monitoring the further development of the project. Thus, effectively, the savers replace their trust in the entrepreneur by their trust in the bank. Of course, this might produce “agency costs” for savers if they cannot trust the bank to act in their interest. To keep the lending process efficient, it must therefore be ensured that the bank has the right incentives to perform its monitoring function in the savers’ interests.\textsuperscript{21} As regards the second parable, a formal approach suggests that if a corporation is willing to go public in order to raise additional, albeit presumably unnecessary capital, this

\textsuperscript{20} Cochrane, \textit{ibid.}, 44.

might well be socially beneficial. It must only be ensured that the process is subject to supply and demand in a competitive market. Moreover, if securities markets are not about the securities themselves but rather about price discovery through trading, then, more trading volume will benefit this process. Better “price signals” from the market will enhance capital allocation. Higher levels of market activity will also raise liquidity for market participants. Financial innovations, like the derivatives our firm invests into, must likewise be socially beneficial if the market accepts them. Derivative products tailored to the “risk appetite” of individual market players will allow to spread risk across markets to those who can bear it most efficiently. At last, if some retail investor thinks to allocate capital to a particular industry while actually funding an in-house bank, this is simply a market failure due to investor irrationality against which regulation will be of little help. The more central question is how to stabilise the financial system so that it can perform its market functions efficiently and without tax payer support.\(^{22}\)

C. Finance for finance

Finance is a means to support social goals. That was the starting point in both the material and formal approach to finance for modelling its technical functions. Both approaches thus started from a “finance for society” perspective. Introducing and illustrating the two approaches has so far just demonstrated potential “framing effects”: the powerful capacity to lead the discussion into a particular direction of financial policy and practice. Existence and importance of such framing effects are not unknown to the economic discourse. They were famously noted by John Maynard Keynes at the time of the Great Depression:

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves exempt from any intellectual influence, are usually the slaves of some defunct economist.\(^{23}\)

The global financial crisis and its aftermath suggest that Keynes was correct on both: the principle that intellectual frameworks matter and that this is not always well understood. Accordingly, some post-crisis commentators deemed it necessary to restate the point. Under the heading “ideas matter”, we read in the Stiglitz Report:

> To too large an extent before the crisis, a dominant orthodoxy prevailed—a set of ideas that proved wanting. If the world was to move into a robust recovery and prevent a recurrence, a broader set of ideas had to be given serious consideration.\(^{24}\)

The “orthodoxy” dominant before the crisis and the “broader set of ideas” needed corresponds to what is called here the formal and material approach to finance, respectively. We have seen that a formal approach can result in an understanding of finance, which is quite detached from

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\(^{22}\) Cochrane, supra note 19, 48 and passim.


the particular needs of everyday life and ordinary businesses. Finance becomes an abstract concept and market for promoting liquidity, efficiency, price discovery, risk sharing, etc. This notion of finance correlates with a state of affairs in which the functional link between finance (on the one hand) and society and the economy (on the other) is impaired. In such situation, finance turns into a self-referential system that uncouples itself from society and primarily works for the profit of those who are running it. Adair Turner, former chairman of the UK’s Financial Services Authority (FSA), described the situation as follows:

There is no clear evidence that the growth in the scale and complexity of the financial system in the rich developed world over the last 20 to 30 years has driven increased growth or stability, and it is possible for financial activity to extract rents from the real economy rather than to deliver economic value. Financial innovation and deepening may in some ways and under some circumstances foster economic value creation, but that needs to be illustrated at the level of specific effects: it cannot be asserted a priori or on the basis of top level analysis.  

Recent empirical work for the US shows that since the 1980s intra-financial lending indeed rose sharply, while a diminishing share of credit has gone to the real economy. The interconnectedness in the financial system reached a historical high immediately before the financial crisis and appears to remain on a similar level in the years since. Lending between financial institutions accounts now for nearly half of all financial sector lending. Further studies on the matter, moreover, provide evidence that this increased intra-financial lending seems not to promote financial efficiency, but instead to divert capital from financing real investments in order to extract rents along the intermediation chain: “increased intra-financial lending does not lead to greater risk sharing, more useful liquidity and higher investment; rather it appears to lead to lower real investment, suggesting a capital diversion and rent extraction role for intra-financial lending.” So what this empirical work describes is a state of affairs in which finance, for the better part, exists for the sake of finance. In this “finance for finance” world the notion conveyed by the first parable that banking is about financing business and enhancing economic growth moves into an idyllic distance: “Anyone who supposes that financing business is the primary function of banking is mistaken.” In a world where the “overwhelmingly dominant element in the balance sheets of banks today are the claims financial institutions have against each other”, parable two is closer to the mark.

It is now crucial to see more clearly how a “finance for finance” reality comes to correlate with a formal approach to finance. The context of financial innovation offers a suitable and

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28 Kay, supra note 13, 190; detailing the flows through the deposit channel for the UK, US, France, and Germany in 2014 (ibid., 189). What bank’s are actually lending for is also discussed in Turner, supra note 25, 22-30.
29 Kay, ibid., 190; detailing the intra-financial lending for the UK, US, France, and Germany in 2014 (ibid., 189).
important example to illustrate this. After the financial crisis, a particular question as to the role of financial innovation was whether complex forms of securitisation and derivatives would actually deliver value added or rather serve the financial industry to increase its own profits. On this question, Adair Turner gave a first-hand description of how regulators pre-crisis were reading financial innovations through the lenses of the formal approach. Starting with the first welfare theorem—as it was stated by Arrow and Debreu—regulators assumed that a competitive equilibrium is efficient and hence will lead to socially beneficial results. A competitive equilibrium requires, among other things, that markets are “complete”. For financial markets this means that markets must be such that each desired contract can be concluded. Innovative finance contracts will therefore complete markets because they allow investors to meet their desired combination of risk, return, and liquidity more precisely. Thus, complex securitisation and related derivatives allowing for more tailored combinations of risk, return, and liquidity must deliver value added and hence be socially beneficial.\textsuperscript{30}

In theory these benefits of “market completion” follow axiomatically from the Arrow Debreu theorem, and in the pre-crisis years many regulators, and certainly the FSA, were highly susceptible to this argument by axiom. We were philosophically inclined to accept that if innovation created new markets and products that must be beneficial and that if regulation stymied innovation that must be bad.

Yet the benefits of market completion do not follow axiomatically and the overall welfare results of new financial products may well be negative.\textsuperscript{31} Today it is, of course, well known that one negative impact of complex securitisation and derivatives was that they contributed to systemic risk in the financial sector.\textsuperscript{32} However, to assess the value added by such products one cannot simply focus on system stability, as Turner goes on to explain. One must also account for the fact that complex financial products were to “a non-trivial proportion” driven by tax and capital arbitrage. They were designed to reduce tax payments or capital requirements without reducing inherent risk. Thus, even if those innovative products would not have created systemic risk and generated private return, they were “socially useless” because they did not deliver “economic value at the collective social level”.\textsuperscript{33} So then we can see how analysing financial innovation in the formal approach feeds back into a finance for finance reality: the

\textsuperscript{30} Turner, \textit{ibid.}, 33 (including the following quote); cf. supra (text accompanying) notes 19 and 22.


\textsuperscript{32} It was not so before the crisis. A paper like the one of Raghuram Rajan who famously raised the issue at the Jackson Hole Symposium in 2005 was not well received at the time (see Raghuram Rajan, “Has Financial Development made the World Riskier?”, NBER Working Paper Series, Working Paper 11728 (November 2005); on the background story, see e.g. Kay, \textit{supra} note 13, 56-58).

\textsuperscript{33} Turner, \textit{supra} note 25, 33. For worse, tax and regulatory arbitrage mean to socialise loss, while privatising the profits flowing from them, as John Kay explains: “Fiscal arbitrage is a means of taking money out of the pockets of the public and transferring it to advisers, traders and the firms that employ it. With regulatory arbitrage, the loser is the potential beneficiary of the regulation. If the regulation is useless, as may often be the case, the costs of regulatory arbitrage simply represent a transfer from the operating profits of the business to the financial professionals who make the arbitrage possible. If the regulation would have benefited customers, or protected taxpayers or other firms from potential loss, then these customers or taxpayers are losers from the efforts to avoid regulation.” (Kay, \textit{supra} note 13, 123) For a similarly critical view on the role of financial innovation, see Stiglitz Report, \textit{supra} note 12, 77, 197-98.
formal approach allows product innovations, which are not designed for market users but rather for extracting rents along the intermediation chain, to enter the market without much regulatory scrutiny. The formal approach’s ideality and the “finance for finance” reality go hand in hand. Recalling Keynes’s dictum on the intellectual influence of “defunct economists”, Turner summarises the framing effects of a formal approach to finance as follows:

But the bigger danger may be that reasonably intellectual men and women who play key policy making roles can be over-influenced by the predominant conventional wisdom of the current generation of academic economists. Certainly in the UK Financial Services Authority, the idea that greater market liquidity is in almost all cases beneficial, that financial innovation was to be encouraged because it expanded investor and issuer choice, and that regulatory interventions can only be justified if specific market imperfections can be identified, formed key elements in our institutional DNA in the years ahead of the crisis.  

D. Finance: a more material approach?

The studies on intra-financial lending, which we have reviewed, provide little reason to believe that the financial system changed fundamentally in the years since the global financial crisis. “Finance for finance” still remains an economic and political reality. The same holds for the intellectual framework underpinning the financial economy. While the Great Depression lead to a paradigm shift in economic thinking, recent linguistic research established that nothing similar seems to have occurred in economic scholarship since the last crisis. The main findings of this bibliometric study are as follows. By and large, the crisis is rationalised within the existing concepts of mainstream economics. In this account, the financial crisis boils down to a sudden dry-up in liquidity, which links back to misperceived risks resulting from opaque, short-term funding techniques—such as complex securitisation and related derivatives. The mainstream literature manages to explain the crisis as an exogenous systemic shock, rather than the result of an intrinsic instability of modern financial capitalism. Thereby the central tenet that (financial) markets are efficient and equilibrating in principle remains unquestioned for it assimilates the idea of extraneous shocks. Since the crisis is framed in standard concepts, there is no need for mainstream economics to discuss the event in light of more long-term secular trends, like increasing inequality and distributional concerns, rising levels of debt and leverage in the financial system, and trends in financial regulation. Economic reasoning on the crisis

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34 Turner, supra note 25, 15 (emphasis added).
36 Ernest Aigner, Matthias Aistleitner, Florentin Glötzl, Jakob Kapeller, “The Focus of Academic Economics: Before and After the Crisis”, Institute for New Economic Thinking, Working Paper 75 (May 2018). The study deploys a text corpus of over 440,000 articles published between 1956 and 2016, a sample of 400 top-cited papers before and after the crisis, and a list of thirty influential books on financial and economic crisis (including authors like Keynes, Schumpeter, Marx, Polanyi, Friedman, and Hayek).
37 Cf. supra text accompanying note 4.
essentially sticks to its “standard terms of rationality, risk, asymmetric information and efficiency”. In other words, what we called here the formal approach to finance remains firmly entrenched in the post-crisis economic discourse. This suggests the following interpretation of the current state of affairs: the “finance for society” approach, which we can glimpse from part of the economic discourse after the crisis, is an ideal, while what we got with our current system is a “finance for finance” reality supported by a formal model of finance. The solution following from this seems obvious: if we wish to work towards our ideal of “finance for society”, a vital element of our efforts must be to shift from a formal to a material approach of finance. My overall argument in this section indeed suggests “a more material approach” to finance. Yet it must be advanced cautiously for this approach neither means simply to drop the formal for a material approach nor to synthesise the two.

At first glance, of course, choosing the material approach seems straightforward: in the wake of the crisis, the formal approach may seem like the path of vice ending in a “finance for finance” impasse, while the material alternative signs the path of virtue leading to “finance for society”. In fact, this alternative is quite misleading for it overlooks that the two approaches overlap in two crucial features: purpose and technicality. Let us consider them each in turn. *Purpose* links to the question how finance relates to society on a principled level: is it finance for society, finance for the economy or finance for finance? When being confronted with the abstract, technical jargon of the formal approach—such as liquidity, transaction costs, risk, efficiency, price discovery (not to speak of the sophisticated mathematics underpinning it)—, one might be tempted to conclude that a formal approach is little more than an ideology of modern financial capitalism. The formal approach furthers the “false consciousness” that finance is a good thing. However, that is far too simple a view. Arguing in a formal approach precisely becomes a problem because, as we have seen, it shares its starting point with the material one: “finance for society”. Certainly, the framing in the formal approach is quite particular as it starts its analysis with the first theorem of welfare economics. Nevertheless, the aim is to arrive at “socially beneficial arrangements”. It cannot be assumed a priori that a formal approach aims at finance for the sake of itself. Rejecting the formal approach for this reason will only confirm the suspicion that one rejects with it what one does not understand. The difficulty with arguments drawing on a formal setting thus lies elsewhere and is much more troubling. It consists in that it is not quite clear at which point such arguments turn into a finance for finance ideology. The aim to work towards socially beneficial results might be sincere or simply make an argument superficially attractive—as we witnessed it in the context

38 Aigner and others, supra note 36, 22.
39 See supra text accompanying note 19.
40 A typical reaction is Cochrane, supra note 19, 30: “I don’t understand it’ doesn’t mean ‘it’s bad,’ or ‘regulation will improve it.’ And since that attitude pervades policy analysis in general and financial regulation in particular, economists do the world a disservice if we echo it.”
of financial innovation.\textsuperscript{41} Again, Turner’s analysis on the function and size of banking illustrates the intricacies of the formal approach very well. To be sure, Turner is critical about where a formal approach to finance can lead to. Still, on several features of modern finance, which we associate here with formal finance, he concludes that they might be valuable “up to a point”, while it remains uncertain where to draw the line.\textsuperscript{42} On the issue, for instance, whether liquidity that results from position-taking (or as some would say, speculation) is value added at the social level, he summarises:

Has all the increased trading activity of the last 30 years delivered economic value via lower transaction costs and more efficient and liquid markets, or has it generated harmful volatility and enabled market traders to extract economic rent? My answer is that I don’t know the precise balance of these possible positives and negatives, because there are many issues of complex theory and empirical analysis not yet resolved and very difficult to resolve.\textsuperscript{43}

Such an assessment should caution against seeing a material and formal approach to finance as easy alternatives. Moreover, there is the second overlap between the two approaches that confirms this result: \textit{technicality}. We saw that the material approach ties finance closely to particular needs of individuals and businesses, whereas the formal one is always at risk to lose touch with these social and economic realities, subjecting them to market rationality and mathematical formulas. Against this background, the danger is to romanticise the material view as the one going back to what is tried, tested, and tangible in finance and to posit the formal view as embodying the realm of a cold, scientific rationality and technicality. This opposition is now particularly misleading about the material approach. Finance is a functional science also when it serves particular social needs and therefore a material approach must as well spell out finance’s \textit{technical} functions—which indeed it does, as we have noted earlier. According to the material approach, finance can contribute to society in four principled ways: facilitating payments, allocating capital, managing household wealth, and handling risk.\textsuperscript{44} The alternative thus consists not in a technical and a non-technical approach to finance, but in how such technicality is framed. The prospect of embracing a material approach to finance and completely dropping the formal approach, which dominates mainstream economics today, seems promising at first sight. On closer inspection, however, such an extreme solution has little to commend itself because it glosses over the significant overlap between the two approaches and hence wrongly promises clear cut answers where in practice much is left to sensible argument from both sides. A material approach that is too confident about its own position only risks to turn from being a critical opponent of the economic mainstream into an ideological discourse itself—and that is never a virtue.

\textsuperscript{41} See supra text accompanying note 30.
\textsuperscript{42} See Turner, supra note 25, 7 (“it does not follow that further financial deepening (i.e. a growing level of private sector credit and bank money relative to GDP) is limitlessly value creative”; “Market liquidity delivers economic value up to a point, but not limitlessly.”).
\textsuperscript{43} Turner, \textit{ibid.}, 40.
\textsuperscript{44} See supra text accompanying note 17.
A more promising option may seem to synthesise the two approaches into an overarching framework of finance and society. Would that not be the best of both worlds? Attempts to arrive at an integrated model of finance exist. Some, for instance, are working towards a synthesis in expanding a formal approach based on neo-classical economics with the perspectives of new institutional and behavioural economics. Others are taking an even more holistic approach, constructing a framework of finance in society, which draws on neoclassical and heterodox economics, political and social theory. Such synthesised frameworks of finance have their merits. For present purposes, however, a synthesis would be besides the point. The analytical value comes from having the material/formal distinction in place. In the tradition of Max Weber, the material and formal approach serve as “ideal types”. They are not fixed, complete descriptions of financial functions, rather they allow us to make the latent framing in different approaches to finance explicit, sometimes even within the same text. Thus, the essence about differentiating between a formal and material approach to finance is the dialectical tension that comes with the distinction. The tension between the two approaches challenges us on each specific issue of modern finance to check whether we are moving towards “finance for society” or “finance for finance”. This requires illustration:

The global financial crisis is well known to have been a systemic crisis. When the investment bank Lehman Brothers filed for bankruptcy in Autumn 2008 the global financial system tottered on the brink of collapse and the state had to come to the rescue. In the wake of the crisis, great intellectual effort was therefore spent on how to design a financial system that controls the hazards of systemic risk and avoids bailouts. The discussions on new capital and

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45 Robert Merton, Zvi Bodie, “Design of Financial Systems: Towards a Synthesis of Function and Structure”, *Journal of Investment Management* 3 (2005), 1-23. An important question, which must be at least mentioned briefly here, is whether a synthesis that starts from a neo-classical and hence formal approach transforms into a material approach to finance when it integrates a neo-institutional perspective. The question is delicate for the following reason: it is well known that new institutional economics started with differentiating itself from the neo-classical tradition, famously pioneered by the work of Ronald Coase and his transaction costs approach (see e.g. Ronald Coase, “The Problem of Social Cost”, *The Journal of Law & Economics* 3 (1960), 15-19). However, one can make a good case that Coase’s work is ambivalent as regards its stance towards the neo-classical heritage. It has been argued that his key concept of transaction costs did in fact not fundamentally challenge the neo-classical tradition, but to the contrary provided a means to defend it and expand its influence (see David Campbell, Sol Picciotto, “Exploring the Interaction between Law and Economics: The Limits of Formalism”, *Legal Studies* 18 (1998), 249-278. A similar case can be made for the update of neo-classical with behavioural economics—see, ibid., 276). The ambivalence that characterises the concept of transaction costs and the support it provides for the neo-classical framework is the reason why explanations of financial functions that draw on the transaction costs approach have been associated with the formal framework in this paper (see *supra* text accompanying note 21; cf. Merton and Bodie, *ibid.*, 6). Nevertheless, it should be noted that an approach that basis its analysis on concepts like information asymmetries, agency costs, etc. must not necessarily lead into a “finance for finance” perspective (good examples are notably the Stiglitz Report, *supra* note 12 and the Kay Review, *supra* note 5).


47 On the concept of ideal type, see *infra* text accompanying note 183.

48 The Stiglitz Report, *supra* note 12, for instance, clearly tends towards a material approach, yet it still emphasises a transaction costs approach what infuses a formal element into its analysis.
liquidity requirements for banks, with a particular concern for systemically important institutions, is a prime example for these efforts. Another is the initiative to clear more derivatives through exchanges or the creation of numerous regulatory authorities and bodies, which supervise financial stability at the local and global level. All this is certainly of great importance. But framing matters. A formal approach will see those efforts as reactions to particular market and regulatory failures before the crisis. The main welfare concern will be the social costs associated with another systemic breakdown: “The social cost question remains how to create a financial system that is not prone to runs, crashes, and bailouts, even if that costs a few percentage points of GDP.” 49 In short, the focus lies on the welfare implications of the stability of the financial system, not of the financial system itself. That is one blind spot a more material approach to finance seeks to uncover. To be sure, a material approach will likewise take a keen interest in how to create a stable financial system. Yet it will also ask what kind of system it is that we are stabilising: is it one that serves particular needs of households and businesses or rather itself; is the system promoting “finance for society” or “finance for finance”? A material approach has therefore a more fundamental takeaway from the Lehman collapse than the task to ponder over system stability:

Lehman was not, in any ordinary sense of the phrase, a business of economic importance. If it was a systematically important financial institution, it was not an important financial institution. The business provided no services to the real economy that were not available elsewhere, and few services to the real economy at all. The company was badly run and operated primarily for the benefit of its own staff, especially its most senior executives. 50

The example shows, a material approach is not to dispose of the technical issues of the formal one. It is a challenge about how to contextualise the technical functions of finance and their regulation within a “finance for society” framework. This challenge potentially arises with any particular question on modern finance. It is an ongoing challenge and its analytical sting is lost if we synthesise the material/formal distinction into an (apparent) “super theory” of finance. That we cannot resolve the tension between the two approaches is far from being an intellectual shortcoming. Just the opposite: to have the tension in place is the very point of making these different discursive approaches explicit. If we recommend “a more material approach” to finance this is therefore what it means: confronting the “finance for finance” reality of the current financial industry with the simple question: “What is it all for?” 51 On a particular issue, say high-frequency trading, the answer may then take a more material or formal approach. The formal approach insists: “The social question for high-frequency trading—like all of finance, really—is whether it screws up markets or makes them more efficient and ‘liquid.’” 52 The going-in position for the material approach is instead: “People who applaud traders for providing

49 Cochrane, supra note 19, 48.
50 Kay, supra note 13, 277.
51 We owe this key question to Kay, ibid. (the question is invoked throughout his book).
52 Cochrane, ibid., 45 (the sentence is all the more telling as the author advances a view that is not uncritical about the question whether high-frequency trading is socially beneficial).
liquidity to markets are often saying little more than that trading facilitates trading—an observation which is true, but of very little general interest.\footnote{Kay, supra note 13, 94.} The question “What is it all for?” hence marks the spot from where the dialectic between a formal and material approach unfolds and the challenge of a more material approach sets in.

“What is it all for?” is at the same time an elegant umbrella formula for a functional approach to finance. It bundles the perspectives that finance can serve society, the economy or itself. Thus, the question leads us to see that \textit{all three} perspectives are \textit{functional} perspectives. It is of some importance to realise this. Some commentators critically observe that rent extraction has become a defining feature of present day finance. They explain this feature notably with information asymmetries between investors and financial intermediaries, which result from innovative, complex financial products. It is then suggested that capturing rent through financial innovation should be seen as “dysfunctional finance”.\footnote{Paul Woolley, “Why are financial markets so inefficient and exploitative—and a suggested remedy”, in Adair Turner and others, \textit{The Future of Finance: The LSE Report} (London School of Economics and Political Science, 2010), 123.} If one considers the phenomenon from a “finance for society” perspective that might be so. However, from a “finance for finance” perspective there is nothing dysfunctional about information asymmetries that allow market participants extracting rent along the intermediation chain to the detriment of market users. This is exactly what the complexity and size of intra-financial lending should achieve: “The proliferation of poorly understood complexity in the financial sector was intentional: complex products were a source of profit, and these products would have been less rewarding for the sellers if they had been better understood by the buyers.”\footnote{Kay, supra note 13, 137. In a similar vein, Andrew Haldane, Simon Brennan, Vasileios Madouros, “What is the contribution of the financial sector: Miracle or mirage?”, in Adair Turner and others, \textit{The Future of Finance: The LSE Report} (London School of Economics and Political Science, 2010), 106 (arguing that “risk illusion”, which makes banking \textit{appear} to be profitable, “is there by design”). The insight that financial innovation functions for the participants of financial markets, rather than its users provides a link to a supply-side theory of financial innovation—on which see Dan Awey, “Toward a supply-side theory of financial innovation”, \textit{Journal of Comparative Economics} 41 (2013), 401-419.} To understand rent seeking in the financial sector as dysfunctional is therefore quite an understatement. A more material approach to finance starting from the leading functional question “What is it all for?” will be stricter on this point: “finance for finance” is perfectly functional, for some. So again it appears that a material approach to finance uncovers blind spots and initiates a discussion where the formal approach remains silent. In order to formulate the programme of a material approach more systematically, we must therefore ask: what are the blind spots of formal finance and how do they arise?

The vantage point, which comes with the \textit{distinction} between a material and formal view, allows us to uncover the logical structure behind the blind spots of formal finance. As we know by now: the formal approach reasons from markets to market failures. It skips the question of how finance links back to particular social needs for it trusts that (financial) markets are in principle efficient and lead to socially beneficial outcomes. The logical priority of markets so
conceived has three important implications. First, it places financial markets into a social vacuum. If one can presume that financial markets will enhance social welfare, it is unnecessary to enquire any further to what social ends finance shall be a means. The essential functional link between finance and society is thereby significantly weakened. It rests on the formal presumption that financial markets will get it eventually right. (The success of market economies over central planning will, of course, be readily at hand to justify this presumption.) Second, the markets first approach introduces a bias towards the financial markets that already exist. The presumption that financial markets promote economic growth and social welfare justifies to leave them as they are until one can identify puzzling results. (The concept of market failure is key in producing this status quo bias. It dispels any doubt about the priority of markets because any formalist can argue: “Naturally, we are aware that markets are not perfectly efficient. In fact, no one seriously believes that any longer. There might well exist a market (or regulatory) failure, which for sure must be addressed to restore the magic of the invisible hand.” In other words, the concept of market failure functions also as a discursive means to defend the logical priority of markets, may this be intended or not.) Third, introducing the priority of markets on the basis of neoclassical welfare economics casts the functions and functioning of financial markets as an economic matter. Whether financial markets work or fail becomes a discussion in which those have the upper hand who defined the relevant language game in the first place: economic experts versed in a formal approach to finance. Long-term secular trends, like increasing levels of debt and intra-financial lending and their distributive effects, drop out of the picture.

A material approach to finance systematically challenges the logical priority of (financial) markets and each of its implications: social vacuum, status quo bias, and expert privilege. Before going through each of these points, it might be helpful to briefly remind in some key words what this programme does not mean: advocating central planning, disputing the importance of price signals for capital allocation or the importance of economic expertise in modern finance. Even so, a material approach will question, first, the notion that we need not think in terms of specific social goals what finance should do for us because we can leave such thinking to the wisdom of the market. A material approach therefore aims to embed finance into the social and cultural context of particular aspirations, interests, hopes, and needs of individuals and their businesses. On a more technical level, it sets out a range of basic functions against which we

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56 Cf. supra text accompanying note 13.
57 Cochrane, whom we take here as the main proxy for the formal approach, indeed alludes to the idea: “Hayek and the failure of planning should teach us a little modesty…” (Cochrane, supra note 19, 30). Our main proxy for the material approach provides the following comment on the matter: “Both supporters of the market system and its critics have failed to recognise that the trading floor of the investment bank is not the epitome of the market economy but an excrescence from it. Observers on both left and right have mistakenly regarded the process of financialisation in Western economies as part of the success of these Western economies in competition with the centrally placed regimes of eastern Europe.” (Kay, supra note 13, 301-02)
58 Cf. supra text accompanying note 36.
59 Cf. supra text accompanying note 13.
can measure the quality and utility of particular financial activities. Do they help end users of finance to make payments, allocate capital, manage their personal finances, and control risk?\(^{60}\) The importance of such a list of financial functions lies not in being exhaustive, rather than to provide a framework that makes the discussion on finance more grounded than in a purely formal approach. Second, as the material approach does not submit to the logical sequence of market and market failure, it becomes an ongoing issue whether the financial system as it stands amounts to “finance for society” or “finance for finance”. Where the formal approach does not find a market dysfunctionality or identify a market failure that would justify intervention, the functional approach of the material perspective is broader: even a stable and smooth financial system, which causes no systemic crisis, can be run primarily for the benefit of those who are working within the system rather than for the real economy. The yardstick of a material approach hence is not the financial system as it stands, but the one we wish to have. Third, in the material approach, finance becomes integrated into a particular social, economic, and cultural context, rather than simply starting from a market presumption. The broader framing makes it clear that finance, its functions and functioning is by far not just a narrow technical matter that belongs into the hands of economic experts. As a first consequence, the perspective of finance research becomes broader as well. The formal approach rationalised the subprime crisis in terms of liquidity, asymmetric information, risk allocation. A material approach asks different questions about housing finance, however. As regards the subprime crisis it may ask: why did financial firms make loans to people who had no income, no jobs, and no assets?\(^{61}\) And the central question to judge success and failure of a system of housing finance more generally becomes: do we have the houses we need, in the locations where they are needed, and are the houses well matched to the needs of the people who live in them?\(^{62}\) That broader basis for finance not only highlights the importance of other disciplines that contribute to the debate: political and social theory, economic sociology, and financial history—to name just a few. A further important consequence of a more material approach finally is: to frame the technicality of finance in a more democratic way. It makes finance more accessible to the uninitiated and, importantly, requires formal explanations to justify themselves in the sense that they must be able to link back to real needs of people and businesses.

II. Kay’s fiduciary principle: success or lost in translation?

If one was to take a more material approach to finance what were the consequences for financial regulation? A lawyer might grasp the relevance for rethinking regulation along these lines from the pre-crisis experience in which financial regulation was embedded in the formal approach. In its battle for market share with New York before the crisis, London, so it is often said, was

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\(^{60}\) Cf. *supra* text accompanying note 17.


in for a “light touch” approach to financial regulation. True, to a significant extent the notion of “light touch” never did match with the actual regulatory practice of UK’s Financial Services Authority. Still, Adair Turner acknowledged that the FSA’s regulatory and supervisory approach before the crisis was based on an understanding: that markets are in general self correcting and market discipline more effective than regulation or supervisory oversight; that risk management was better placed and assessed with the risk models of market participants; and that customer protection is best ensured not through direct regulatory intervention, but through transparent, unfettered wholesale markets and rules of conduct. Thus, those comments show again that the FSA’s regulatory approach before the crisis was firmly grounded in a formal approach to finance.

How would financial regulation change, then, if framed in a material approach to finance; and can such a material approach translate into legal analysis at all? We will consider these questions from a more theoretical viewpoint in the third part of the paper. To prepare for this discussion, this second part investigates a particular incident of interplay between “material finance” and law. In 2012, economist John Kay published his review UK Equity Markets and Long-Term Decision Making. It is the result of a year-long, in-depth study with extensive access to market sources and professionals from the finance industry. The review had been commissioned by the British Government to assess whether the equity markets in the UK perform their core purposes. This provided an ideal platform for Kay to introduce a key distinction of the material approach: that financial markets should be there to meet the needs of market users, rather than market participants. The core purposes of equity markets are to enhance the performance of businesses and enable savers to benefit from them through returns to direct and indirect ownership of shares. Kay concluded that UK equity markets meet those purposes not as effectively as they should. One particular remedy he recommended for improving the situation was to apply the legal concept of fiduciary all along the investment chain. The Govern-

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64 See Black, ibid., 18; Turner Review, supra note 12, 86.
65 Turner Review, ibid., 87-88.
66 See also supra text accompanying note 34.
67 Kay Review, supra note 5.
68 The terms of reference stated the aim of the Kay Review as follows: “To examine the mechanisms of corporate control and accountability provided by UK equity markets and their impact on the long term competitive performance of UK businesses, and to make recommendations.” (see Department for Business, Innovation and Skills (BIS), The Kay Review: Terms of Reference (June 2011)).
69 Kay Review, supra note 5, 9 and passim; cf. supra text accompanying note 18. Kay’s later writings, most notably his path-breaking book Other People’s Money, profited very substantially from his work on the Kay Review (on the intertextual relation, see Kay, supra note 13, 311). Thus, the review established the empirical and theoretical basis for Kay’s later, more elaborated functional approach to finance, which we identify here with the material approach.
ment accepted this recommendation and instructed the Law Commission to undertake a review.\textsuperscript{70} In 2014, the Law Commission issued its final report on \textit{Fiduciary Duties of Investment Intermediaries}.

As regards the procedural background, it is important to note that both reviews allowed for making comments and submitting evidence from interest groups and specialists at several stages of the review process. The Kay Review started with a call for evidence, which results were then incorporated into an interim report.\textsuperscript{71} The interim report was again open to public feedback before the final report was produced. The Law Commission launched its project with a pre-consultation phase setting out the project and seeking initial views. On this basis, it produced a consultation paper of considerable length,\textsuperscript{72} which was submitted to the public for additional input before finalising the review. The UK Government, finally, was there to initiate the reviews via its Department for Business, Innovation and Skills (BIS). It further steered the process by setting the terms of reference for both reviews. That meant in particular to answer and interpret the recommendations of the Kay Review and to define the scope of review for the Law Commission. A crucial final step in the process, as we will see, was for the Government to answer the recommendations of the Law Commission’s final report. We find these answers laid out in a comprehensive progress report on the implementation of the Kay Review.\textsuperscript{73} It appears from this brief procedural description that our case study allows us to illustrate the process of translating a material approach to finance into law as a multipartite and multi-layered social interaction. It involves not simply an economic and a legal perspective represented in the two main reports, the Kay Review and the Law Commission’s review, respectively. The Government, interest groups, and financial specialists play an important role in intermediating and influencing whether and how translation occurs.

The presentation of the case study will be as follows: in a first step, I will introduce how the legal concept of fiduciary features in the Kay Review. It must be clarified what role fiduciary duties were meant to play in an economic analysis of equity markets that are to serve businesses and savers. After the economic rational for the fiduciary principle has been established, we can analyse, in the next step, how the concept of fiduciary was interpreted by the Government and subsequently by the Law Commission as regards financial intermediation. In this second step, the main focus is on the Law Commission’s final report, which also contains statements of different interest groups and specialists, illustrating the political struggle that runs along the translation process. A close reading of the Law Commission’s final report shows the technical subtleties that often decide whether a material approach to fiduciary duties carries over from economics into the legal realm. The case study concludes with a third step, commenting the

\textsuperscript{70} See Department for Business, Innovation and Skills (BIS), \textit{Ensuring Equity Markets Support Long-Term Growth. The Government Response to the Kay Review} (November 2012), 8-9, 26.


\textsuperscript{73} See Department for Business, Innovation and Skills (BIS), \textit{Building a Culture of Long-Term Equity Investment. Implementation of the Kay Review: Progress Report} (October 2014), 28-32.
translation process and drawing some lessons for the potential of a material approach to finance to frame the law of finance.

A. The fiduciary principle in the Kay Review

The Kay Review envisions equity markets that function for the benefit of market users (savers and businesses), rather than market participants. This is however quite different from how these markets are working today. The main problem Kay identifies is short-termism in the chain of intermediation: asset managers, who are now the dominant players on the equity markets, are concerned with trading to “meet the numbers” on a short-term basis, rather than looking out for businesses that will prove of value long-term. This focus on trading is underpinned by economic theory suggesting that the share price reflects the value of a particular business. Trading that leads to price discovery thus leads to value discovery and thereby ensures that capital is allocated most efficiently. A focus on market price hence is necessary, but also sufficient. What matters for traders (and the trading algorithms they deploy) in this market environment is not to assess, monitor or even enhance the value of a business idea, but to correctly guess the short-term movement of market prices—or rather: to guess what others are guessing that prices will be; and, of course, guessing what others are guessing that others are guessing, etc. Thus, return on this market is generated by outwitting others’ guesses. However, competition among asset managers who are measuring their performance relative to each other is inherently a zero sum game: returns to investors (savers), taken as a whole, can be enhanced only by improving the performance of the corporate sector as a whole. Competition of asset managers who are trying to outperform each other can add nothing to the value of companies and hence nothing to the overall return of savers. Rather, the net profits of trading activity made by market participants are in aggregate a cost to investors.

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74 For the realm of business, Kay describes short-termism more broadly as follows: “In business, short-termism occurs when companies invest too little, either in the physical assets of the business or in the intangibles which are generally the source of their competitive advantage—their reputation, their capacity for innovation, and in the skills and capabilities of their employees.” (Kay Review, supra note 5, 14).


76 Kay invokes at this point Keynes’ famous comparison of financial investment with: “those newspaper competitions in which the competitors have to pick out the six prettiest faces from 100 photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which to the best of one’s judgment are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligence to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.” (Keynes, supra note 23; cf. Kay Review, supra note 5, 40)

Against short-termism in equity investment, Kay suggests a range of measures to enhance long-term value investment. He submits that financial activity on equity markets should not focus on trading shares, but on investing in particular businesses. Asset managers should consequently aim at making an impact on the corporate sector through investment research, selecting and monitoring projects that are worth undertaking in the long-run. In this framework, the financial intermediaries who are active on the equity markets thus become the mentor of listed companies in which they choose to invest and the stewards for savers as the ultimate economic beneficiaries. Such culture of stewardship in the equity investment chain is very different from a trading culture based on anonymous relationships between market participants who engage in a price guessing competition. The most important links in the investment chain so conceived exist between companies and their directors, between the asset managers and the companies in which they invest, and between asset managers and asset holders, such as pension funds and trusts, which are acting as agents on behalf of savers as the ultimate beneficiaries. Thus, the basic idea is to structure the investment chain in a way that all the intermediaries are aligned with the goals of promoting valuable long-term businesses, which shall in turn benefit the end investors. According to Kay, a central element to realise this idea for equity investment is to rebuilt each link in the chain as a trust relationship:

This Review adopts as a basic premise the belief that the investment chain will work best if those who invest funds in equity markets have trust and confidence in the agents with which they place the funds and if the companies which list on equity markets have respect for those who rely on their earnings and cash flow to generate returns on their savings and security in their retirement. If the relationship between companies and savers is mediated through a series of intermediaries, as it normally is, trust and respect between companies and savers can be achieved only if this mutuality of trust and respect is reproduced throughout the investment chain.

It is against this conceptual background that the legal concept of fiduciary comes into play. To properly understand the role Kay sees for fiduciary duties in the investment chain, we must however be more specific about his notion of “trust and respect” on which his idea of stewardship ultimately rest. Kay considers trust as an “ethos” that constitutes the principle mechanism to address information asymmetries and misaligned incentives along the investment chain. He envisages a “culture of trust” that is furthered and supported by government and its agencies as well as by financial intermediaries. Given this cultural understanding of trust, it comes as no surprise when Kay comments that trust and respect could not be established by regulation. Regulation could, however, provide a framework that encourages trust and punishes its breach. Overall, the review therefore favours the development of good practice standards over detailed regulation of market behaviour: “Such definition of good practice would set out principles rather than prescribe behaviour or business models, and would allow flexibility to

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78 Kay Review, ibid., 11, 42, 44, 88.
79 Ibid., 48, 87.
80 Ibid., 45.
81 Ibid., 45, 47.
individual circumstances and for change over time.”82 The review then sets out a list of principles, which company directors, asset managers, and asset holders should adopt and develop. On the translation of such principles into law through courts and regulatory authorities, Kay remarks:

We do not believe the principles set out in these [good practice] statements should be translated into specific regulatory requirements. However, we do envisage that Regulators will also endorse these principles, consider to what extent existing regulatory requirements may prevent their adoption, and seek to align existing guidance and codes of practice with them.83

The process, which the Kay Review intends to foster trust along the investment chain hence is practice driven and principles based, yet with government agencies and courts to incentivise and guide the development. The way how Kay formulates his fiduciary principle is now exactly matched to this approach.84 His starting point is that: “Trust in an investment chain will be as strong as the trust in the weakest link of that investment chain.”85 Kay goes on to briefly restate the concept of fiduciary duty as created in common law, highlighting the core fiduciary duties of loyalty and prudence. This provides the basis for making the link between economic analysis and law eventually explicit: “The Review does not believe that there could be any sound basis for placing trust in an intermediary who does not recognise these duties of loyalty and prudence….”86 Fiduciary duties hence are understood as a vital condition of trust in the investment chain. Taken together with the premise that trust in the investment chain is as strong as the trust in its weakest link, the corollary is that: “Regulatory obligations in the equity chain should be raised to fiduciary standards.”87 Kay, finally, adds two important technical points of law to safeguard the approach. First, fiduciary obligations should not be capable of being contractually overridden and, second, they should apply independently of the classification of the client as a professional, wholesale or retail investor.88 Significantly, Kay explains the second point of law by linking it directly to the material focus on market users:

We consider that these observations remain true even, or perhaps especially, when savers use intermediaries to undertake investment on their behalf; in other words, the fiduciary obligation is not relieved by the identification of the immediate client as a professional or wholesale investor. The economic interest in all monies in the investment chain lies with savers, and it is to the interests of these savers that the legal and

82 Ibid., 47.
83 Ibid.; cf. ibid., 49 (“Good practice statements would not be binding in legal or regulatory terms, but ... it is likely that regulatory authorities and the Courts would have regard to them.”)
84 The match between the economic model and the regulatory approach in the Kay Review is systematic, as Kay explains: “The recommendations in this report have two strands. In the long-term, we seek a new model of equity investment, sustained by a new regulatory philosophy.” (ibid., 88)
85 Ibid., 65.
86 Ibid., 66.
87 Ibid., 65.
88 Ibid., 67.
regulatory responsibilities of equity investment intermediaries must be directed. ... Caveat emptor is not a concept compatible with an equity investment chain based on trust and stewardship.\(^9^9\)

In Kay’s overall concept of long-term equity investment for the benefits of market users, the fiduciary principle is therefore best understood as a legal means to incentivise and reinforce trust relationships along the investment chain. Through the concept of fiduciary, the law may contribute to building an equity investment chain that embodies an ethos and culture of trust throughout the chain.\(^9^0\) Kay’s principle of stewardship, which is central to his idea of long-term investment and essentially rests on trust and respect, is hence matched with the legal principle of fiduciary. That is how the Kay Review basically contextualises and understands the fiduciary principle. And it is on this basic understanding that the following discussion of its interpretation through the UK Government and the Law Commission will focus.\(^9^1\)

B. Translating Kay’s fiduciary principle

1) Intermezzo: the Government’s response to the Kay Review

Kay’s idea of stewardship and his objective to rebuild the equity investment chain based on trust relationships received support from the Government. In its response to the Kay Review, the Government, however, pointed out that the term “fiduciary” had led to a great deal of discussion since the review had been published: while some interpreted the term in a strict legal sense, others took it to describe a more general duty of care.\(^9^2\) In order to clarify that “these standards should apply universally”, the Government chose to avoid the term “fiduciary” and decided to restate Kay’s fiduciary principle as follows:

All participants in the equity investment chain should act:

- in good faith;
- in the best long-term interests of their clients or beneficiaries;
- in line with generally prevailing standards of decent behaviour.

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\(^9^9\) Ibid., 66. The discussion on client classification goes back to the early days of modern financial regulation in the UK. An attempt to step up protection for professional investors had already been made in the Gower Report, which provided the basis for the regulatory reforms in the 1980s. Gower’s recommendations on this issue were, however, not accepted by Government (see L.C.B. Gower, Review of Investor Protection, Report: Part I, Cmnd. 9125 (HMSO, 1984), 34-38; Department of Trade and Industry, Financial Services in the United Kingdom. A New Framework for Investor Protection, Cmnd. 9432 (HMSO, 1985), 11-12).

\(^9^0\) In later writings, Kay has developed this into an argument for a “just culture” in finance, for which he relies on practices in the airline industry (see Kay, supra note 13, 238).

\(^9^1\) Besides the fundamental link between stewardship, trust, and fiduciary, the Kay Review also discusses and recommends to consider and clarify more particular issues connected to fiduciary duties, notably: the personal scope of fiduciary duties; disclosure of investment costs; the inclusion of environmental and social goals into investment decisions; and the practice and profits related to stock lending (see Kay Review, supra note 5, 13 (Recommendations 7-10), 66-69).

\(^9^2\) See BIS, supra note 70, 8-9 (including the following quotes).
This means ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.

These obligations should be independent of the classification of the client.

They should not be contractually overridden.93

Driven by the concern to make fiduciary standards universally applicable, the Government’s restatement is very much in line with Kay’s basic concept. Next, the Government took another important step to secure a broad discussion on the issue in defining the terms of reference for the Law Commission. Initially, the enquiry, which Kay recommended for the Law Commission to undertake, only comprised “to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.”94 Yet the Government’s final terms of reference instructed the Law Commission with a broad mandate to research the scope and effect of fiduciary duties along the investment chain and to identify if any changes were needed.95 Besides its mandate to the Law Commission, the Government also asked the financial regulatory authorities FSA and FCA to review to what extent current regulatory rules would align with its reformulated fiduciary principle. In particular, the regulators were called on to consider the issues of conflicts of interest and contractual mechanisms to limit the obligations of financial intermediaries.96

2) The Law Commission’s review: Fiduciary Duties of Investment Intermediaries

The Law Commission’s review on fiduciary duties in the investment chain, comprising the consultation paper and final report, provides a formidable resource for anyone who wishes to explore the interaction between law and finance. This is especially so because the review includes a detailed description of the existing market practice and analyses in technical detail how the law applies to it.97 Thus, one can indeed closely follow the translation of the economic

93 Compare this with the original formula for the fiduciary principle in the Kay review: “All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client’s interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.” (Kay Review, supra note 5, 12)

94 The Law Commission restated the Government’s terms of reference briefly as follows: “(1) To investigate how fiduciary duties currently apply to investment intermediaries and those who provide advice and services to them. (2) To clarify how far those who invest on behalf of others may take account of factors such as social and environmental impact and ethical standards. (3) To consult relevant stakeholders. (4) To evaluate whether fiduciary duties (as established in law or as applied in practice) are conducive to investment strategies in the best interests of the ultimate beneficiaries. We are asked to carry out this evaluation against a list of factors, balancing different objectives, including encouraging long-term investment strategies and requiring a balance of risk and benefit. (5) To identify areas where changes are needed.” (see Law Commission, supra note 72, 6-7; for the Government’s full terms of reference see ibid., 251-52)

95 See BIS, supra note 70, 24.

96 For the description of market practice, see Law Commission, supra note 72, Ch. 2 and 3.
issues flagged in the Kay Review into a legal framework. The focus of the review lies on pensions because the Law Commission considers pension schemes a crucial investment vehicle for market users (savers) and an area where savers are particularly vulnerable to the failure of financial markets. The focus on pensions is also due to the issue raised by the Kay Review how far the law allows and requires pension fund trustees to account for environmental and social goals in their investment decisions.98 Issues relating to pensions and their special legislation thus cover a substantial part of the review.99 Yet the review also considers more generally the duties the current law sets out along the investment chain and whether there is a need for reform.100 For the purpose of illustrating the process of translating Kay’s fiduciary principle into law it will be sufficient to focus on these more general parts. The presentation will proceed in three steps. To give an impression of the legal technicality involved in the translation process, I will first briefly recapitulate how the Law Commission describes fiduciary duties within the legal framework. The second step, then, summarises the findings of the Commission on how the current law applies fiduciary duties along the investment chain and on whether this matches with the policy aims identified in the Kay Review. In the third step, we finally consider the reform ideas, which the Law Commission proposed to meet the objectives of Kay’s fiduciary principle. The presentation of the three steps thus follows the key words: legal framework, application, reform.

Legal Framework—From a legal point of view, the concept of fiduciary involves two basic questions: to whom does the concept apply and what is its content? On the first question, the Kay Review draws on an earlier paper of the Law Commission, which describes a fiduciary relationship as one in which there is “discretion, power to act and vulnerability”.101 These three factors for testing whether a fiduciary relationship arises are still mentioned in the recent review, though the Commission now considers them only as indicators that feed into a new key test to establish a fiduciary position. This new key test for applying fiduciary standards is said to be: “whether there is a legitimate expectation that one party will act in another’s interest.”102 It is obvious that such a test makes the question whether fiduciary duties apply uncertain (on the one hand) and keeps the concept flexible and open (on the other).103 As regards the question about the content of fiduciary duties, Kay had emphasised the duty of loyalty and prudence.104 In a similar vein, the Law Commission characterises the duty of loyalty as the distinguishing duty of a fiduciary. It continues to elaborate on the content of this duty of loyalty under two main themes: a fiduciary should not compromise its fiduciary duty with other duties or interests

98 See Law Commission, supra note 5, 7.
99 Ibid., Ch. 4-9.
100 Ibid., Ch. 10-11.
101 Kay Review, supra note 5, 65; for the original source see Law Commission, Fiduciary Duties and Regulatory Rules, Consultation Paper No 124 (HMSO, 1992), 30.
102 Ibid., supra note 5, 38.
103 Ibid.
104 See supra text accompanying note 86.
(“no conflict rule”); and a fiduciary must not make unauthorised profit (“no profit rule”). Potential conflicts with these rules may, however, in both situations be resolved by proper authorisation.¹⁰⁵ We recall that one of Kay’s technical inputs was that fiduciary standards should not be capable of being contractually overridden; and so also the Law Commission discusses in some detail how fiduciary duties may be modified by agreement. It notably emphasises that the courts will take the contract as the starting point and mould fiduciary duties according to the nature of the relationship between the parties and the facts of the case.¹⁰⁶ In sum, it appears that also as regards its content, the concept of fiduciary is both: “extremely flexible but also inherently uncertain.”¹⁰⁷

The Kay Review singles out fiduciary duties as the legal concept for promoting trust relationships in the investment chain. We have seen that this suggestion is well founded and fitting within Kay’s overall approach. From a legal perspective, however, it is quite impossible to know whether fiduciary duties are suitable, or even necessary, for the task if they are not put in context. Consequently, the Law Commission maps the legal context of fiduciary duties, starting with a list of the basic legal sources that are relevant for governing financial markets. Potentially relevant rules will arise from four different sources: agreements by the parties; regulatory rules by the Financial Conduct Authority (FCA); special legislation (e.g. on pensions, unfair contract terms, misrepresentation); and “judge-made” law setting out particular duties in case law (e.g. on contract and tort). Fiduciary duties belong to the last category.¹⁰⁸ Already this condensed catalogue of legal sources provides a glance at the massive legal complexity the investment chain entails. Analysing the legal constraints under which a particular financial intermediary operates must always run the gamut of these four sources. And a claim against an intermediary in the investment chain will regularly allege a variety of causes of action: breach of contract, misrepresentation, negligence, and perhaps a breach of fiduciary duties.¹⁰⁹ In the overall legal framework, the Law Commission therefore describes fiduciary duties as sitting “alongside the other statutory, equitable and common law duties”, or as operating “in the background of other duties.”¹¹⁰ The Commission suggests to understand fiduciary duties as “‘legal polyfilla,’ moulding themselves flexibly around other legal structures, and sometimes plugging the gaps.”¹¹¹ The flexible and uncertain character of the fiduciary concept and the complex legal framework governing financial markets—of which fiduciary duties form just one element—make it sufficiently clear that translating Kay’s fiduciary principle into law is anything

¹⁰⁵ Law Commission, supra note 5, 38-40.
¹⁰⁶ Ibid., 43-45.
¹⁰⁷ Law Commission, supra note 72, 244.
¹⁰⁸ See Law Commission, supra note 5, 31-32. Moreover, fiduciary duties are not the only duties to define how one should act in the interest of another. Besides elaborating on the scope of fiduciary duties, the Law Commission therefore also extended its analysis to duties attaching to the exercise of power and duties of care that arise in the law of contract, tort, and trust (see ibid., 46-60).
¹⁰⁹ Ibid., 183.
¹¹⁰ Ibid., 34 and 183, respectively.
¹¹¹ Ibid., 31.
but straightforward. A finely balanced economic proposal meets here with a sophisticated legal framework that sifts and sorts this proposal according to its own technical rationality and standards.

Application—The Law Commission proceeds to apply the current law on fiduciary duties to the investment chain. In the consultation paper, the Commission described the complex chains of intermediation that exist between savers as the ultimate beneficiaries and the listed companies in which they are invested. In a pension focus, the intermediaries active in the investment chain are, besides the pensions schemes themselves, investment advisers, investment managers, actuaries, brokers, and custodians.\textsuperscript{112} The Commission considers systematically: (i) to which of these intermediaries fiduciary duties apply; (ii) the content of such fiduciary duties; and (iii) to whom those duties are owed. We remind Kay’s policy proposal that was: regulatory obligations throughout the equity chain should be raised to fiduciary standards, they should not be capable of being contractually overridden, and they should be directed towards end-users and therefore also apply between professional investors if they are part of the chain.\textsuperscript{113} The Commission’s analysis at this point hence becomes a touchstone of whether Kay’s fiduciary principle may translate into operative legal practice. On all three questions (i)-(iii), the Commission’s conclusions are sobering—though they will hardly surprise anyone who is familiar with the way English common law thinks. (i) It is already unclear whether fiduciary duties apply as matter of principle to the intermediaries mentioned. At no link in the chain the Commission finds such duties with any certainty. While for investment advisors, managers, and actuaries the status as fiduciary is rather likely, it is the opposite for custodians who regularly have a contractual relationship only with professional investors and not with end-users; and brokerage comes to lie somewhere in between. Thus, under current law there exists no fiduciary standard throughout the investment chain.\textsuperscript{114} When it comes to the content of fiduciary duties (ii), the Commission notes that courts will take a “contract first” approach and especially between professional investors be reluctant to apply fiduciary duties. Those duties hence remain unprotected against being contractually overridden. Moreover, the standards courts apply tend to mirror regulatory requirements: if an intermediary complied with regulatory rules, courts will be slow to find liability. In line with this, client classifications set out in FCA rules do matter for courts and they tend to interpret fiduciary duties in light of such rules rather than independent of them.\textsuperscript{115} As to the question to whom duties are owed (iii), courts focus on the immediate relationships in the chain and are cautious to impose duties between parties who

\textsuperscript{112} Law Commission, supra note 72, Ch. 3.
\textsuperscript{113} See supra text accompanying note 87.
\textsuperscript{114} Law Commission, supra note 5, 186-94.
\textsuperscript{115} Ibid., 194-202.
Reform—In line with its mandate and given the unfavourable results under current law, the Law Commission considered whether there was a need for reforming fiduciary duties. To begin with, it evaluated the options of reforming the law through codification and case law, respectively, and rejected both. As regards case law, the Commission noted “major difficulties in relying on ‘judge-made’ law to control complex and fast-moving financial markets.” Its main concerns were the following. First, judges could only decide the cases brought before them and in practice very few cases were brought. Moreover, those most vulnerable to poor practice in financial markets would likely be the least able to litigate their case. Second, judges could set new standards only after (often long after) the event, when it was too late to prevent the practice retrospectively. Instead, courts could only provide financial redress. And the Commission adds: “Large compensation payments can introduce further disruptions to the market, adding to cost and risk.” Finally, the Commission stated in a more general way: “The principles set out in the Kay Review are so far removed from the courts’ interpretation of fiduciary duties that we do not think that it is possible to create the first from the second.” Also for the the idea to reform the law of fiduciary through codification, the Commission showed little sympathy. It repeated again that: “fiduciary duties are difficult to define and inherently flexible. This is one of their essential characteristics: they form the background to other more definite duties, allowing the courts to intervene where the interests of justice require it.” So apparently, the concern was that flexibility, which serves the interests of justice, was lost if the law of fiduciary was codified. Furthermore, the Commission submitted that “any attempt to change fiduciary duties through legislation would result in new uncertainties and could have unintended consequences in other areas.” As a result, the Commission’s position on codifying fiduciary duties can therefore be summarised: codification costs the benefits of flexibility for receiving the disbenefits of increased uncertainty. Clearly, that is not a bargain.

Against this background, the Law Commission came up with a rather ingenious third reform idea. In its consultation paper, it submitted the proposal that instead of case law or codification, consideration should be given to a new statutory cause of action. More specifically, the Law Commission sought views on whether to extend the right to sue based on section 138D of the Financial Services and Markets Acts 2000 (FSMA). The Commission summarised its idea in the final report as follows. The right to sue as established by paragraph (2) of 138 FSMA reads:

A contravention by an authorised person of a rule made by the FCA is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty. (emphasis added)

116 Ibid., 202-204.
117 Ibid., 205.
118 The Law Commission’s position as presented hereinafter is laid out ibid., 206-07 (including all quotations).
119 See Law Commission, supra note 72, 245.
Yet according to current practice, this right is extremely limited for two reasons. First, it only applies to private persons, which must be individuals or corporations that are not conducting business of any kind. Case law held that dealing on financial markets amounts to conducting business and hence interprets the concept of a private person narrowly. Second, not all rules made by the FCA are actionable. Excluded as a cause of action are notably the FCA Principles of Business. Those principles include the following standards, which the Commission deemed “highly relevant” for the fiduciary standards envisaged by the Kay Review:120

(1) A firm must pay due regard to the interests of its customers and treat them fairly (Principle 6). (2) A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client (Principle 8). (3) A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement (Principle 9).

In the consultation paper, the Commission sought views on the question whether section 138D should be extended to enable businesses to sue and to enable actions on the basis of the FCA Principles of Business.121 The Commission’s arguments for the extension were that it thought an extended right to sue “would go a long way towards providing investors with a cause of action for losses caused by breaches of the ‘fiduciary’ standards set out in the Kay Review.”122 In particular, the Commission had envisaged a right which could not be contractually overridden. Moreover, it argued that such a right would be independent of a contractual relationship and hence allow end-users to sue a financial intermediary higher up in the investment chain with whom they only entertained an indirect relationship. Finally, an extended right to sue could, in the Commission’s opinion, supplement the work of regulators by private enforcement and provide a greater deterrent to bad behaviour. On the downside, the Commission noted that civil litigation may not necessarily prevent misbehaviour and was inherently uncertain, costly, and slow. It also thought that while an extended right to sue would not extend existing duties, it would take enforcement out of the regulator’s control. Yet, especially the Commission feared that the “effect of any such change would be uncertain and potentially disruptive. It would add substantially to costs in the chain, including insurance and legal costs.”123 At the time of consultation, the Commission’s going-in position was therefore that there should be no statutory extension of rights to sue within financial markets.124

As one would expect, the consultation process brought arguments for and against the reform of section 138D FSMA in order to extend the existing right to sue. Arguing in favour of the extension, one academic commentator contributed the observation that an extension would not extend duties, but only their enforcement and further argued that the courts should be more involved in setting standards for the financial sector:

120 Law Commission, supra note 5, 208 (including the following quote).
121 Law Commission, supra note 72, 246.
122 Law Commission, supra note 5, 209.
123 Ibid., 209-10.
124 Law Commission, supra note 72, 246.
There is also an argument to be made that the courts have for too long been sidelined in setting standards of conduct in the financial sector and that there is no reason in principle why the financial sector should be treated differently from other areas of commerce where the courts are involved in setting fiduciary standards (e.g. agency, partnership, companies).\(^\text{125}\)

On the other side, the Commission noted that most consultees were against extending the existing right to sue: “Many felt that the existing position was adequate and that the case for an extension had not been made.” In particular, the Commission summarised the feedback from investment intermediaries to the effect “that any extension would be disruptive and lead to added costs, which would be passed to the ultimate beneficiaries.”\(^\text{126}\) It illustrated this position with the following statements:

Re-fitting the rule-book for the purpose suggested not only would seem a massive endeavour, it likely would create new causes of action not contemplated in existing law, which in turn might introduce significant uncertainty and costs without desired benefits to investors or to the market. [BNY Mellon]

Our view is that the increased litigation risks, and consequential costs, will lead to higher costs being passed down the investment chain, and ultimately to the detriment of beneficiaries. [Association of Consulting Actuaries]

This proposal (if adopted) would create the risk of multiple and/or speculative lawsuits which could place unnecessary costs and risks on service providers and which might lead in turn to more expensive and unnecessarily risk averse services for end investors/pension members. [HSBC Securities Services]\(^\text{127}\)

On the balance, the Law Commission’s position on the matter remained unchanged.\(^\text{128}\) It noted that an extension of section 138D was “extremely controversial, with most financial intermediaries opposed to the change.” Against this background, the Commission did “not feel able to recommend such a change at this stage.” It was nevertheless keen to restate its opinion “that the extension might go some way towards implementing the sort of changes envisaged by the Kay Review”, adding that it was “possible that a limited extension, subject to suitable defences, could be implemented without undue costs.” Importantly, the Commission thus did not make a specific recommendation to introduce or further consider a new statutory right to sue, yet concluded: “Given the controversy involved, the issue is one for Government. If the Government were sympathetic to this change, we think that the issue would merit further research and debate.” So what did Government think?

3) Finale: the Government’s progress report on the Kay Review

Shortly after the Law Commission’s final report, the Government published its own report, presenting systematically the progress that had been made on the agenda set out in the Kay Review. The report devotes a special part to the progress made in building trust relationships and aligning incentives throughout the investment chain.\(^\text{129}\) The Law Commission’s review on

\(^{125}\) Law Commission, supra note 5, 210-11 (the argument is from Iain MacNeil).

\(^{126}\) Ibid., 211.

\(^{127}\) Ibid., 211-12.

\(^{128}\) The Law Commission’s conclusion as presented hereinafter is laid out ibid., 212-13 (including all quotations).

\(^{129}\) See BIS, supra note 73, Part C.
fiduciary duties is considered comprehensively and the progress on specific recommendations is explained one by one. Yet as the Law Commission did not make a specific recommendation as regards a statutory right to sue, one looks in vain for a progress report on that particular issue. Interestingly, the table in which the Government set out its answers contains a further category besides the recommendations for “additional findings”. However, the Government’s response under this category only considers the regulation of investment consultants and does not mention the debate surrounding section 138D FSMA. Given the fact that the Law Commission described the debate on a new statutory right to sue as “extremely controversial” and flagged the issue as “one for Government”, it is somewhat surprising that the Government did not at least rank the issue as an “additional finding” and clarify whether it would be—as the Law Commission put it—, “sympathetic to this change”. On the basis of the Government’s own report, one is forced to conclude that it was not.

C. Kay’s fiduciary principle: a comment on its translation

1) The success of a lost principle

Kay’s fiduciary principle is meant to be a legal means of fostering trust relationships along the equity investment chain. It should contribute to a culture of trust and stewardship on equity markets in which companies and financial intermediaries align their market practice with the interests of savers. In its review, the Law Commission analysed whether the current law of fiduciary provides a basis for a fiduciary principle so conceived. Its conclusion was, as we have seen, that fiduciary duties “do not appear to be an effective means of achieving Professor Kay’s policy aims.” Also on the field of law reform, the result was unfavourable. Though the Law Commission considered various options for reforming fiduciary duties—codification, case law, and a statutory right to sue—, it did not support any specific reform proposal. Eventually, all three reform options failed. Must we therefore conclude that Kay’s fiduciary principle was completely lost in translation? Not quite. The plain results of its translation may be sobering, still when properly contextualised the impact of Kay’s fiduciary principle is more nuanced. We must remember that we focussed our case study on the core of Kay’s reflections on fiduciary duties and considered the Law Commission’s study from this angle. We have not presented the Law Commission’s numerous recommendations that resulted from Kay’s further queries when elaborating on fiduciary duties, in particular his issues with stock lending and intermediated shareholding, and his recommendation that the Law Commission should clarify whether environmental and social goals can be included in investment decisions of pension fund trustees.

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130 Ibid., 32.
131 Law Commission, supra note 5, 205.
132 See supra text accompanying notes 118 and 128.
133 See Law Commission, supra note 5, 218-27 (stock lending); 227-38 (intermediated shareholding), Ch. 7 (factors in pension trust investment); cf. Kay Review, supra note 5, 68-69. Kay’s recommendation to review the factors relevant in pension trust investment was arguably the most successful one as it was followed by a
Moreover, we recall that the Government not only instructed the Law Commission to reflect on the legal significance of Kay’s fiduciary approach. The FCA reviewed the matter from a regulatory point of view and reported that its standards would be in line with Kay’s fiduciary principle as it was reformulated by Government.\footnote{See BIS, supra note 73, 33-34.} If we consider this wider context of the debate, we therefore cannot say that the translation of Kay’s fiduciary principle into law was without notable effect.

Yet an intense debate and some success on specific policy points should not make us believe that Kay’s fiduciary principle was effectively translated into the legal framework as a matter of principle. To recall the Law Commission’s verdict for the current law: fiduciary duties do not apply throughout the investment chain, and where they apply they are subject to contractual modification, especially between professional parties. Kay’s idea to have fiduciary standards in place to support trust and respect also at the weakest link of the chain does not reflect in these findings.\footnote{See supra text accompanying notes 113-116 and 85, respectively.} Moreover, the FCA’s reassurance that its current regulatory principles would match Kay’s standards offers no compelling reason to think otherwise. The debate on extending the right to sue in section 138D of the FSMA is revealing on this point. To begin with, the Law Commission was explicit that this particular reform idea took a regulatory approach to the matter, so the reform idea at least overlaps with the FCA’s regulatory domain.\footnote{“We said that if there were a desire to impose duties on all intermediaries in the investment chain to act fairly, we would need to consider a new statutory cause of action—such as extending rights to sue for breach of statutory duty under section 138D of the Financial Services and Markets Act 2000 (FSMA). We also note the Government’s response to the Kay Review. This implicitly considered that Kay Principles should be achieved through regulation rather than law reform when it asked the FCA to consider to what extent current regulatory rules in this area align with the principle it set out.” (Law Commission, supra note 5, 207))} More importantly, however, the Law Commission’s idea of approaching the reform in the domain of regulation rather than the law of fiduciary was, as we have seen, not meant to to add new duties along the investment chain, but “only” to extend their enforcement.\footnote{See supra text accompanying note 123.} The reform idea was not to introduce new regulatory principles. Thus, it cannot be the gist of the matter that the FCA thereafter confirmed those principles to be in line with Kay’s policy objectives. That last point was, as a matter of principle, already made by the Law Commission in stating that some of the FCA Principles of Business were “highly relevant to the ‘fiduciary standards’ set out in the Kay Review”.\footnote{Law Commission, supra note 5, 208.} What made the Commission’s reform idea “extremely controversial” seems therefore not to have been the FCA principles as such, but rather the combination of those principles with the institutional framework of courts.\footnote{Also the Government’s response to the Kay Review corroborates this view of things as it mentions that its reformulated Kay fiduciary principle enjoyed “industry-wide support” (see BIS, supra note 70, 24).} The overall picture that emerges from this is therefore: whether Kay’s fiduciary principle translates into law, as a matter of principle,
is not decided by the question whether the FCA Principles of Business correspond to Kay’s standards. That correspondence is only a necessary, but not a sufficient condition of the translation. What apparently makes the difference is in whose hands enforcement is placed: whether it is the regulators or the courts to police those principles. Seen like this, the issue of extending the right to sue in section 138D of the FSMA indeed becomes a key moment in the translation process. The Law Commission seemed quite aware of this as it mentions just after its rejection of this reform proposal: “However, we are conscious that the extension [of section 138D] might go some way towards implementing the sort of changes envisaged by the Kay Review.”\textsuperscript{140} So if Kay’s fiduciary principle eventually did not make it through the translation process, the next question naturally is: why so? An answer to this question must include at least two aspects: the technicalities and politics of translation.

2) Technicalities of translation

From a technical point of view, the first problem of translation might have been that the Law Commission did not correctly understand Kay’s proposal. Yet there is little in the review that suggests a misunderstanding. As we pointed out, the Law Commission was well aware of how the current law and its reform relate to the basic policy aims set out in the Kay Review.\textsuperscript{141} For the more general question about whether a material approach to finance can translate into law this contains an important lesson: it does not seem that economic and legal analysis are hermetically sealed off from one another so that there could be no meaningful attempt of translation in the first place. So the problem was not that Kay’s idea did not catch on with the Law Commission. What one can question, however, are the Law Commission’s technical arguments on how and why not to translate Kay’s fiduciary principle through law reform. On this matter, the heart of the problem is that the Commission seems to overlook that such a translation consists in a particular combination of norm structure and institutional framework, which is responsive to the context of finance: it must be principles based and hence inherently flexible and inevitably uncertain, on the one hand, and the courts must realise their institutional competence, on the other hand, that they can use this flexibility and uncertainty to incentivise and guide a dynamic market practice. The Law Commission considers (almost) all elements of the equation: principles, flexibility, uncertainty, courts, incentives, guidance, market context. Yet the way it analyses and puts these elements together when presenting the three reform options—codification, case law, right to sue—, remains open to challenge or requires at least clarification. We will discuss this accordingly.

Codification—To transform his idea of stewardship, Kay favoured a principles over a rule based approach because it “would allow flexibility to individual circumstances and for change over time.”\textsuperscript{142} Kay’s fiduciary principle consequently mirrors his more general emphasis on

\textsuperscript{140} Law Commission, supra note 5, 213.
\textsuperscript{141} See supra text accompanying notes 117 and 122.
\textsuperscript{142} Kay Review, supra note 5, 47; cf. supra text accompanying note 82.
principles in the realm of law and regulation to guide decision making on dynamic financial markets. Also the Law Commission noticed that the character of fiduciary duties as “‘a flexible set of principles’ to guide decision making” was for Kay “part of their appeal.”\textsuperscript{143} We have seen as well, that the Commission links this flexibility of fiduciary principles implicitly with the institutional framework: “fiduciary duties are … inherently flexible. … allowing the courts to intervene where the interests of justice require it.”\textsuperscript{144} Against this argumentative background, one can coherently argue against codifying fiduciary duties if codification means more detailed rules that would reduce the flexibility of a principle that courts require in the interests of justice. The Law Commission’s next argument that any reform through legislation would “result in new uncertainties and could have unintended consequences in other areas”\textsuperscript{145} implies, however, a certain tension for it changes from flexibility to its flipside: uncertainty. While it is correct to say that codifying fiduciary duties would add new uncertainty to this area of the law, one must also say that uncertainty is what makes those principles work in the first place—in a principles based approach, uncertainty and flexibility are two sides of the same coin. Allowing the courts to intervene based on fiduciary principles therefore means to accept uncertainty as a mode of governance and provides courts with the institutional discretion to make use of it. If the approach is that courts can use fiduciary principles in the interests of justice, then it would be inconsistent to value flexibility and loathe uncertainty. Uncertainty rather takes on a constructive role.\textsuperscript{146} Putting the matter this way opens new perspectives on how to map a principles based approach onto the context of finance. We can illustrate this while discussing the Law Commission’s next reform option.

Case law—Against relying on case law in the context of finance, the Law Commission alluded to difficulties for case law to control “complex and fast-moving financial markets”, essentially arguing that: (i) few cases were brought and, if so, (ii) unlikely by those vulnerable to poor practice; (iii) courts could only provide financial redress after the event, what is potentially disruptive to the market, adding to cost and risk.\textsuperscript{147} None of this is compelling.

(i) The notion that case law is inapt to control complex and dynamic financial markets because few cases are brought is only convincing if one imagines that case law was the single legal source to rely on. Yet that cannot be the argumentative basis for the Law Commission which does an excellent job in mapping the different legal sources governing financial markets today. Fiduciary duties contribute one legal element to the complex edifice of financial law

\textsuperscript{143} Law Commission, supra note 72, 61.
\textsuperscript{144} Law Commission, supra note 5, 206 (emphasis added); cf. supra text accompanying note 118.
\textsuperscript{145} Ibid., 207.
\textsuperscript{146} In the aftermath of the financial crisis, the idea of “constructive ambiguity and uncertainty” has been particularly influential for dealing with moral hazard issues related to public bailouts; see e.g. The de Larosière Group, The High-Level Group on Financial Supervision in the EU (February 2009), 33 (often referred to as the “Larosière Report”, after Jacques de Larosière, chair of the Group).
\textsuperscript{147} See supra text accompanying note 118.
and regulation; they are not meant to replace it—though they might be an important pillar.\textsuperscript{148} Also in Kay’s original proposal, fiduciary duties are just law’s contribution for promoting trust along the investment chain, but not the basis of trust.\textsuperscript{149} If the Law Commission elaborates on the limits of judge-made duties for financial governance that fiduciary duties “are not a silver bullet which will slay the evils of short-termism or narrow self-interests”,\textsuperscript{150} one can only say: certainly, except that they were never meant to be a silver bullet. Yet reframed as a contributory element, the context of dynamic financial markets rather makes an argument for relying on fiduciary principles even if few cases are brought. Kay argues for a principles based approach because it can adapt over time; a feature that is essential for being responsive to the dynamic practice of financial markets. Combining their adaptive quality with the insight that fiduciary principles institutionalise uncertainty as a mode of governance an important feature of fiduciary duties to govern the investment chain comes in sight: intermediaries that operate under the uncertainty of such principles are incentivised to integrate a material approach to finance already at the time when they are developing their new market practice, not just when a particular practice is challenged in court. Financial intermediaries must account for the risk that comes with such “principled uncertainty” and hence anticipate how courts may understand principles like loyalty, good faith, or fair treatment in the perspective of market users.\textsuperscript{151} There need not be much case law to incentivise market practice in this way, the crucial point rather is a strong institutional backing of fiduciary principles through the courts. Only if it is likely that courts will make effective use of the flexibility provided by fiduciary duties, intermediaries are constructively incentivised to account for the interests of market users ex ante, and not simply to rationalise them ex post during litigation.

(ii) The Law Commission’s concern that case law is no effective means to protect those most vulnerable to poor practice in financial markets is understandable. Still the measure for assessing Kay’s fiduciary principle should be his overall concept and in this retail investors are merely a part of the story, albeit an important one. For Kay a crucial function of fiduciary duties would have been to operate also between professional investors if they are a link in the equity investment chain.\textsuperscript{152} In that case they would also, for instance, protect pension funds. On the one hand, those professional investors surely have the capacity to mount a legal challenge against another professional up or down the chain. On the other hand, another phenomenon that became better known through the financial crisis is that also professional investors can be

\footnotesize{\textsuperscript{148} For the third reform option (right to sue), the Law Commission, however, especially highlights its contributory character: “Extending rights to sue would supplement the work of regulators by providing an alternative form of enforcement. … This form of ‘additional enforcement’ could provide a greater deterrent to bad behaviour.” (Law Commission, supra note 5, 209 (emphasis added))
\textsuperscript{149} See supra text accompanying note 81.
\textsuperscript{150} Law Commission, supra note 5, 9.
\textsuperscript{151} For the different standards, see supra text accompanying notes 86 (loyalty), 93 (good faith), 120 (fair treatment).
\textsuperscript{152} See supra text accompanying note 88.}
the victims of mis-selling practices.\textsuperscript{153} Looking at things from a material approach to finance we then realise: if mis-selling hits a pension fund the economic loss is ultimately born by savers at the end of the chain. The corollary is that there is a case to be made for having fiduciary duties in place between professional investors who certainly have the means for seeking redress in court proceedings.

(iii) That courts only can deal with cases retrospectively is, as we have already noted, not an argument against their effects as precedent for future cases.\textsuperscript{154} Of relevance can therefore merely be the Law Commission’s argument that financial redress may be disruptive to the market, adding to cost and risk. What to think of this argument is easy to see if one uses the material/formal distinction we developed earlier.\textsuperscript{155} The Commission, no doubt unconsciously, lends here its support to the formal approach of finance: the focus of protection is the market, not the market user, and also the added costs and risk fit neatly into the formalist ideal to have legal rules in place which ensure legal certainty and thereby low transaction costs along the investment chain.\textsuperscript{156} The particular difficulty with such arguments we have considered in detail and it suffices to restate the main point: they are plausible at first glance and therefore stop the reflection where the material approach would go further and ask the inconvenient question: “What is it all for?”\textsuperscript{157} Whom should equity markets ultimately serve and, if it is market users, how should we arrange legal protection and distribute legal risks along the chain? Should we allocate the risks of financial redress, by default, with market participants or with the end-users of financial markets? How we answer this last question greatly influences how much weight we give to an argument on the market effects of a particular legal solution, which remains—unless there exists clear empirical evidence—nothing more than a hunch.

Right to sue—Against the idea to establish a new statutory right to sue, the Law Commission argued that civil litigation may not necessarily prevent misbehaviour and was inherently uncertain, costly, and slow.\textsuperscript{158} Again, these arguments were only decisive if one imagined fiduciary duties as the silver bullet, rather than a contributory legal feature in governing finance. And also the next reason does not add a new type of argument to those we discussed already. The Law Commission considered the effects of a new right to sue to be “uncertain and potentially disruptive”, adding “substantially to costs in the chain”.\textsuperscript{159} That argument simply is the formal approach of finance reloaded; it just has been discussed for the second reform option (case law) and so there is no need to consider it again. However, there is an additional tension in the Law


\textsuperscript{154} Cf. supra text accompanying note 151.

\textsuperscript{155} See supra text accompanying note 48.

\textsuperscript{156} Cf. supra text accompanying note 21 and in note 45.

\textsuperscript{157} See supra text accompanying notes 40 and 51.

\textsuperscript{158} See supra text accompanying note 123.

\textsuperscript{159} Law Commission, supra note 5, 210; cf. supra text accompanying note 123.
Commission’s argument while presenting its third reform option, the extension of section 138D of the FSMA.

The ingenuity of the third reform option lies in altering the rules of the specific context from which the problem arises, viz. to amend financial regulation, rather than the law of fiduciary. A reform so specified reduces the need to worry about unintended consequences in other areas of the law considerably. As we have seen, the extension of the right to sue in section 138D of the FSMA consisted in including businesses as “private persons” and elevating FCA Principles of Business to a cause for action.\(^{160}\) The second extension hence turns the reform option into a principles based approach. The content of the right to sue becomes flexible and uncertain at the same time. Just as fiduciary principles, the third reform option therefore relies on uncertainty as a mode of governance. The combination of norm structure and institutional framework is the same as in the second reform option (case law) and it therefore maps equally well onto the context of dynamic financial markets: the extension of section 138D of the FSMA stands for a principles and court based approach, which allows courts to incentivise and guide a dynamic market context.\(^{161}\)

Against this background, the Law Commission seems to misunderstand its own reform proposal on a crucial point when concluding the discussion on an extended right to sue with the comforting words: “It is possible that a limited extension, subject to suitable defences, could be implemented without undue costs.”\(^{162}\) As a principles based approach, a right to sue cannot be limited in a way that would remove the “principled uncertainty” the Law Commission tends to associate with market disruptions, costs, and risk along the investment chain.\(^{163}\) This uncertainty is an essential part of the technical combination we find in the idea to extend section 138D of the FSMA: it is a specific right to sue insofar as it focusses on the context of financial markets, yet as regards its substance this right to sue is just as flexible and uncertain as an approach that relies on fiduciary principles. So if the Law Commission argues that an extended right to sue would not extend existing duties, but only their enforcement,\(^{164}\) that is simply an understatement: because the reform approach relates to regulatory principles, it potentially does open the possibilities for courts to set new standards. It might have been the potential effects of this very combination of principles and courts, which made the discussion on extending section 138D “extremely controversial”.

\(^{160}\) See supra text accompanying note 120.
\(^{161}\) Cf. supra text accompanying note 151.
\(^{162}\) Law Commission, supra note 5, 213; cf. supra text accompanying note 128.
\(^{163}\) See supra text accompanying notes 151, 147 and 159.
\(^{164}\) “The extended rights to sue would not extend the obligations of financial intermediaries: it would only apply where rules had been breached.” (Law Commission, supra note 5, 209; cf. supra text accompanying note 123)
3) Politics of translation

The Law Commission does not develop its reform proposals in splendid isolation. As our case study shows, the process is a dynamic exchange of arguments, involving a wide range of specialists and interest groups. For the project on fiduciary duties of investment intermediaries, the Government also explicitly required the Law Commission to seek the views of relevant stakeholders.\(^{165}\) The process of translating a specific policy proposal like Kay’s fiduciary principle into law hence is political in the sense that it becomes a matter of discursive power to influence the process towards a particular outcome. The debate on extending section 138D of the FSMA offers a textbook example of these politics of translation. Usually, those politics of translation are summarised under the term “regulatory capture”, expressing the “tendency to see issues through the eyes of the industry rather than its customers.”\(^{166}\) It has been said that regulatory capture is a “much over-used phrase … which obscures as much as it reveals.”\(^{167}\) Indeed, there exists a tendency to assume that just mentioning this term would suffice to explain the, in fact, complex phenomenon of how processes of regulating financial markets are influenced by the financial industry. It is therefore important to be more specific and to trace moments of capture in specific cases. Framing effects, for instance, which we described for a formal approach to finance, are perhaps better understood as “intellectual capture”.\(^{168}\) We will now try to explicate the political aspects of the translation process in our case study. This will allow us to highlight and better understand the subtle mechanisms behind the politics of translation and the framing effects coming with a particular approach to finance.

When describing and commenting the reform idea to establish a new right to sue, we have seen that from the start the Law Commission’s argument leans towards a formal approach of finance. The Commission’s going-in position in the consultation paper is to reject such a right because “it would be uncertain and potentially disruptive. It would add substantially to costs in the chain, including insurance and legal costs.”\(^{169}\) During the consultation phase, there are of course some who take a more material approach, arguing for a more pronounced position of the courts in setting standards for financial markets. In stating that there is “no reason in principle why the financial sector should be treated differently from other areas of commerce where the courts are involved in setting fiduciary standards”,\(^{170}\) one consultee advances a conviction of a material approach to finance, which we have not considered so far. And that conviction is: finance is not special.\(^{171}\)

\(^{165}\) See supra note 95.
\(^{166}\) Kay Review, supra note 5, 47.
\(^{168}\) The term is ascribed to Adair Turner (see Kay, supra note 13, 303).
\(^{169}\) Law Commission, supra note 72, 246; cf. supra text accompanying notes 155 and 159.
\(^{170}\) See supra text accompanying note 125.
\(^{171}\) Kay, supra note 13, 5 (“But finance is not special, and our willingness to accept uncritically the proposition that finance has a unique status has done much damage”).
Finance is a business like any other, and should be judged by reference to the same principles—the same tools of analysis, the same metrics of value—that we apply to other industries, such as railways, or retailing or electricity supply. … The perspective that views finance as just another business invites us to ask “What is finance for?” … What needs does the industry serve, viewed from the perspective of market users, rather than market participants?172

Yet as the debate on implementing fiduciary standards via a new right to sue starts on “formal grounds”, it takes apparently little to do away with the notion that finance is not special. All that financial intermediaries opposed to the reform must do in the consultation process is to reiterate the formalist argument that: “any extension would be disruptive and lead to added costs, which would be passed to the ultimate beneficiaries.”173 This argument of intermediaries is shrewd indeed for it innocently portrays their opposition as being in the best interest of market users, rather than simply fending off an uncomfortable reform proposal. We do not suspect that the Law Commission was not aware of the business interests informing the position of intermediaries and was naively buying into such a facile argument. Nevertheless, one cannot overlook the fact that the Commission’s final position is fairly close to the one advanced by financial intermediaries opposed to the reform. At the very least, the opposing formal argument was sufficiently strong to let the Commission conclude:

There are arguments to be made both for and against an extension of section 138D. We accept that the effects of the change are uncertain. It could be disruptive and add to costs, while encouraging defensive rather than beneficial behaviour. It is also extremely controversial, with most financial intermediaries opposed to the change. We do not feel able to recommend such a change at this stage.174

The victory for intermediaries to get away without a specific recommendation from the Law Commission appears to have been of some importance. Even if the Commission informally recommends the issue as “one for Government”, the Government was not really challenged to follow up on the controversy. Its progress report on the Kay Review remains, as we have seen, silent on the matter.175 What this teaches us for the translations process and its politics in general is that we must consider how the framing of a particular issue links up with implicit and explicit procedural mechanisms, in this case with the explicit mechanism of whether or not the debate ends in a specific recommendation. An example for an implicit mechanism, on the other hand, we find in the following sentence in which the Law Commission summarised the feedback from those opposed to the reform: “Many felt that the existing position was adequate and that the case for an extension had not been made.”176 The notion that “the case for an extension had not been made” implies a status quo bias for the existing legal framework. We have already analysed the status quo bias for the formal approach to finance, which rests on the presumption for market solutions and the concept of market failure.177 Here we find the legal equivalent: if

172 Ibid.
173 Thus is the Law Commission’s summary of the financial intermediaries’ position, see supra text accompanying note 126.
174 Law Commission, supra note 5, 212; cf. supra text accompanying note 128.
175 See supra text accompanying note 129.
176 Law Commission, supra note 5, 211; cf. supra text accompanying note 126.
177 See supra text accompanying note 57.
the existing legal framework aligns with the interests of market participants and the argument for reform starts from a formal approach, then it needs little for the existing legal framework to prevail. So the mechanism implicitly at work here is the one of a presumption against the material approach: the burden of proof lies with those who wish to argue for extending the right to sue. Such procedural mechanisms are important features of the politics of translation. In a subtle way, they steer the discussion towards a particular outcome.

III. Finance and law: a functional framework

In the first part, we identified a material and formal approach to finance. We noticed in passing that the difference could have been put in other words. Some commentators spoke, for instance, of an “orthodoxy” and a “broader set of ideas” instead of a formal and material approach. Another terminology could have been the distinction between neo-classical and heterodox economics. If we chose to speak of a material and formal approach that was to emphasise the point that the question what finance is for should not exclusively be framed as an economic matter: a more material approach to finance integrates more perspectives than just an economic one. Yet perhaps even more importantly, the distinction between a material and formal approach is useful because it replicates in the legal domain: as there is a formal and material approach to finance, there is a formal and material approach to law. The material/formal distinction thus cuts across different domains and for this reason it is the more important distinction than the others just mentioned. We will discuss now first how the material/formal distinction is conceptualised for law and the economy (A). This discussion will serve us as the basis for, subsequently, elaborating on the material/formal distinction from a law and finance perspective (B), what provides the essential part of the functional framework for finance and law this third part seeks to develop. The paper closes with some final remarks on a more material law of finance (C).

A. Varieties of rationality: material and formal

The idea to use the material/formal distinction for a cross-cut analysis of law and the economy goes back to the work of Max Weber. In the fragments of his posthumously published texts, which we know today as Economy and Society, the distinction plays an important role in a general theory of rationalisation of Western society. Weber thought that modern social life was marked by a shift from community to society: social relationships are no longer based on communities to which one feels to belong, but on impersonal relationships that are motivated by individual interests. Individuals thus need to define their interests and correlate them with the interests of others, a process that Weber refers to as rationalisation. Weber’s “grand narrative” hence is one of modern life’s rationalisation and consociation (Vergesellschaftung).
There is one field of social action that provides Weber with the archetype to observe these processes of rationalisation and consociation: the market. A market allows its participants to deal with one another on an impersonal basis. One can focus on the commodity and its price rather than the person at the other end of the bargain. This is especially so where the market reaches the stage of a “free” market, for where the market is left to itself, the bonds of fraternal ethics which operate in a community do no longer hold. Communal norms and considerations hence do not hinder to rationalise market processes according to the self interest of market participants. The constraints on this market society rather becomes a “rational legality” which implies most notably that one does not go back on what was once formally promised.182

Weber’s description of market behaviour offers a glimpse at the wider social processes of rationalisation and consociation he has in mind and it provides us with the basis for explaining his distinction between formal and material rationality within his analysis of economic action and the law. To begin with, we must remind ourselves that these two kinds of rationality serve Weber as ideal types. They do not suggest a particular empirical explanation, for instance that human action is exclusively or even predominantly rational, rather than coloured by tradition or emotion. So ideal types are ideals indeed in that they do not reflect reality, though they are being constructed based on empirical observations. Weber explicitly states that ideal types would be nothing more than methodological tools to understand a particular aspect of social life. The notion of economic theory, for instance, that individuals are acting out of rational self-interest, rather than tradition, error or affect is according to Weber one such ideal type of human action, which is in fact rather unrealistic.183 Unfortunately, the pragmatic and methodological character of ideal types is not always well understood and this taints their explanatory power. The rational actors in economic theory are a prime example that shows both: the extraordinary analytical power of ideal types and the danger that they are taken to reflect humans as they are. Weber himself was well aware of this problem and cautioned against it: “That there is obviously a danger of rationalistic interpretations where they are out of place is thereby not to be denied. All experience unfortunately confirms the existence of this danger.”184 We will now present Weber’s ideal types of formal and material rationality for the economy and law, respectively.

Economy—Weber describes economic action that is formally rational with a clear key word: computation. Formally rational is economic behaviour that directs its task to make provisions by numbers and computations. More specifically, the most rational way to guide economic action—from a formal, technical point of view—is to assess and compute in monetary terms. A monetary computation (Geldrechnung) comprises costs, earnings, the market situation, goods and their availability (etc.), all assessed and expressed in monetary terms. A special kind

182 Ibid., 382-83. Weber sees this formal legality—in the context of this passage—insofar guaranteed as market participants share an interest in continuing their dealings in the future. Modern social theory would speak of “reputational bonds” between “repeat players”.

183 Ibid., 2-3, 10.

of such a monetary computation is for Weber the one that applies to businesses. Businesses, which are taking a rational course of economic action, are calculating in capital terms (Kapitalrechnung). The basic features of such a capital calculation are the balance sheet, the profit and loss statement, and capital risk. Most important, however, is the return on capital employed (Kapitalrentabilität). Return on capital employed provides the essential business imperative: “The estimated return, which is established through calculation, directs any single measure of a rational business.”\(^{185}\) It follows that any economic action, which does not align with this formal business imperative, will be judged as irrational. Irrational are therefore interests in a business, which do not primarily support its sustained long-term profitability. Rent-seeking shareholders and speculators, for instance, who seek private gain in a business advance such irrational interests and are for Weber simply: “one more specific material irrationality of the modern economic order” and “one source of what the modern market economy knows as the phenomenon of ‘crisis’…”\(^{186}\)

While Weber’s central term for formal rationality in economic action is calculation, the way he discusses its material counterpart suggests a quite different key word: distribution. Materially rational is an economic action that measures its distributive effects among a group of people against some evaluative premise. What provides the basis of such evaluation is, according to Weber, “particularly vague” and he therefore readily concludes that the concept of material rationality is vague too. In its essence, he defines the concept of material rationality negatively: the defining feature of a material approach to economic action is that it does not content itself with the fact that economic calculations are in place, even if they may be formally rational and technically adequate. For a material approach the measure of rational economic action is not expressed in numbers. The standards for evaluating rationality in a material sense are instead “ethical, political, utilitarian, hedonic, corporative, egalitarian or some other kind of claims”\(^{187}\). Weber brings this material rationality in sharp contrast to its formal counterpart. Formal rationality of economic action, which may express itself in the most elaborated calculations, remains in case of free markets “absolutely indifferent” against any kind of “material postulates”. The rationality of a formal approach is therefore limited as a matter of principle: “It is indeed of purely formal character. … formal rationality of monetary computation as such says nothing about the kind of material distribution of economic goods. This distribution always needs specific discussion.”\(^{188}\)

\(^{185}\) Weber, supra note 180, 44-45, 48-49.

\(^{186}\) Ibid., 79. Weber notes, however, that speculation and rational business calculation are naturally difficult to set apart (ibid., 92).

\(^{187}\) Ibid., 44-45. The standards of material rationality are, according to Weber, “in principle unlimited” (ibid., 45).

\(^{188}\) Ibid., 59. If one considers his historical situation, it is of course interesting if Weber (ibid.) nevertheless remarks: “According to the experience of the last decades, formal and material rationality coincide to a relatively high degree”, if one sees the standard of rationality in “a certain minimum of material provision for a maximum number of people”. The reasons for this coincidence, Weber finds “in the kind of incentives, which put in motion the kind of economically directed social action that alone is appropriate to monetary computation.” The incentives Weber has in mind for a market economy are “material or non-material, individual interests” (ibid., 119), yet ultimately he considers the “the pursuit of income” (ibid., 120) as the essential motivation for
Law—What are the standards Weber develops for a material and formal rationality of law? It is difficult to convey his sense of formal legal rationality, although or perhaps because his discussion recommends the following key word for it: logic. Another clue is that Weber follows a clear historical paradigm: private law scholarship of 19th century Germany, which reached in his opinion “the highest degree of methodological and logical rationality”.

Weber summarises the postulates of this academic tradition and so we get a good grasp of Weber’s notion of formal legal rationality, if we present some of these postulates and enrich them with his further observations. The essential aspects of law’s formal rationality can thus be described as follows. A legal decision should apply abstract legal propositions to a particular set of facts. Legal propositions are to begin with established through logical analysis and generalisation of particular cases. Abstract legal propositions are then synthesised into legal institutions and principles, which determine what of social life is legally relevant. Finally, all legal propositions must be rationalised and arranged into a system that is logically clear and coherent. Once established, this logical system provides—as a matter of principle—a solution for every particular legal problem: for each set of facts, it is possible to deduce logically a decision from the system’s abstract legal propositions.

Formal legal thinking hence develops “its particular logical rationality” (logische Eigengesetzlichkeit). The flipside of this particular rationality is that what cannot be rationally “constructed” within legal concepts will be dismissed as “legally irrelevant”. Weber notes the “rational-systematic” and “little vivid” character of academic legal thinking, which can emancipate the law considerably from the “daily needs” of law’s particular interest groups. Practical interests in the law may be annihilated by the “power of unfettered, purely logical demands of legal scholarship”.

Weber defines his notion of material legal rationality again negatively to its formal complement. So a legal decision that rests on a material standard will not be logically deduced from abstract legal propositions. Material legal thinking draws on other standards for arriving at its decisions: ethical or utilitarian imperatives, pragmatic reasons or political principles. The key word for law’s material rationality hence is not logic, yet we may say: correctness. A legal decision must confirm with some accepted social standards, which are not mere logical abstractions. The standards for law’s material rationality are consequently vague—just as we have seen it for economic action following a material approach. Some material standards we find in Weber’s treatise are justice, human dignity, good faith, bonos mores, market practice, economic action. In line with this, he considers dynamic income streams, like business profit (or in our time: bonuses) to revolutionise economic action, while any kind of fixed income will further conservative tendencies in the economy (ibid., 121).

Ibid., 397.

For the original postulates, see ibid.

Ibid., 395-97.

Ibid., 506. Bernhard Windscheid, a representative scholar of the time, famously drew the conclusion: the lawyer as such is “not concerned with ethical, political or economic considerations” (Bernhard Windscheid, “Die Aufgaben der Rechtswissenschaft”, in his Gesammelte Reden und Abhandlungen (Leipzig, 1904), 101.

Ibid., 459—one may ponder whether this problem has returned in economic scholarship in the 20th century.

Ibid., 397.
and also utilitarian or economic considerations which particular interest groups read into legal propositions. Now again, we have to consider the sharp contrast Weber draws between material and formal rationality. As we have mentioned already, any kind of such material standards is something that escapes the formal view: lawyers cannot “think” them through in their own legal terms and hence they do not exist from a legal point of view. “Expectations” of private interest groups towards the law will therefore again and again be “thoroughly disappointed” for the logical perspective of formal law will consider all these material standards simply as “irrational.” It is therefore not too surprising if Weber concludes that “the precision of legal work, as it expresses itself in the courts’ reasoning, will be lowered quite significantly if sociological and economical or ethical reasons take the place of legal concepts.”

**Economy and Law**—Weber organises his varieties of rationality along the material/formal distinction that cuts across the domains of law and the economy. We consequently receive a matrix of four rationalities which we described with the key words: calculation (formal/economic), logic (formal/law), distribution (material/economic), and correctness (material/law). There are subtle variations, yet clearly there is also some affinity between formal and material rationality across fields: calculation goes well with logic, and the same holds for distribution and correctness if the underpinning material standard is the same (e.g. justice) or at least similar (e.g. equality and justice). As we have seen, Weber’s general theme is the rationalisation and consociation of modern life, which he discovers archetypically in market processes. If market processes are a driving force of rationalisation, an important question then is how this will affect other social rationalities, law in particular. This the question we will consider now. To begin with, Weber emphasises that law “by no means only guarantees economic, but all different kinds of interests”. He notably mentions: personal security; ideal goods, such as one’s honour; political, clerical, familial or other positions of authority; and all sorts of social privileges, which neither are economic nor are desired for mere economic reasons. Nevertheless, Weber maintains that law “directly serves economic interests on the largest scale” and that, if there seems or actually is no direct link, “economic interests belong to the most powerful factors to influence lawmaking.”

Weber now draws a straight line between formal economic and formal legal rationality. Among the requirements, Weber considers necessary for reaching the “highest level of formal rationality” in a firm’s business calculations, we find: “formal rational administration and formal rational law”. The functioning of the administrative and legal order must be “completely

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197 On Weber’s further types of social action, see *ibid.*, 12.
198 See *supra* text accompanying note 181.
certain” and all agreements should be “reliably” and “purely formally” warranted by the political power. The correlate of this first requirement is what Weber calls: “material economic freedom of contract”. This second requirement means that there should be no substantive regulations on consumption, procurement, and pricing or any other restrictions on what the parties can freely agree to be the terms of their bargain.201 Thus, we can see how for Weber formal economic rationality depends on formal rational law (first requirement) and the absence of material standards in law (second requirement). More specifically, we observe the overlap of the formal rationalities of law and the economy in Weber’s notion of predictability. To understand this, it is important to remember that the German word for predictability (Berechenbarkeit) also connotes certainty and calculability. Naturally, “predictability”—in the sense of predictability, calculability, and certainty—is of “pivotal importance” for “optimal business calculations”, as Weber puts it.202 For law, on the other hand, Weber explains that law’s formal rationalisation implies an “increasing predictability of … the administration of justice”; such predictability is “one of the most important prerequisites” for capitalistic businesses, “which of course need legal certainty of transactions” (juristische Verkehrssicherheit).203 In a similar vein, Weber notes in a different passage that “the speed of modern business transactions requires a promptly and predictably functioning legal system” and that, as he goes on to explain, “the universal predominance of market consociation requires … a functioning of the law which is calculable according to rational rules.”204

The picture that emerges from this is that formal economic rationality relies significantly on law’s formal rationality because the latter guarantees to hold parties to their bargain and does so in a system that is predictable, calculable, and reliable. While this is straightforward, the link between economic interests and law’s formal rationality is not. As a matter of principle, we already know the reason for this: economic interests may appeal to material standards (e.g. market practice, good faith) and therefore be at odds with the logical calculations of a formal legal system. Law’s “particular logical rationality” will time and again thwart attempts to translate material interests into formal legal concepts.205 Nevertheless, against the background of an increasing significance of market transactions, Weber suggests that it will usually be market participants to initiate a rationalisation of legal rules. Yet this would not necessarily mean to rationalise the law in its formal qualities.206 For instance, with the market growing in size and importance, market participants will increasingly wish to rely on market practice and basic

201 Ibid., 94.
202 “Die außerordentliche Bedeutung optimaler Berechenbarkeit als Grundlage optimaler Kapitalrechnung wird uns in der Erörterung der soziologischen Bedingungen der Wirtschaft stets neu entgegentreten.” (Ibid., 48-49)
The context of this passage suggests all three meanings of Berechenbarkeit: predictability, calculability, and certainty.
203 Ibid., 505.
204 Ibid., 198.
205 For Weber, the formal qualities of the law only “indirectly” depend on “general economic and social conditions”. Of “direct” relevance he considers “intra-legal” factors, in particular the way how legal professionals, notably judges and lawyers, reason. Weber shows therefore a keen interest in legal education (see ibid., 456).
206 Ibid., 455-56.
standards of loyalty because they require the “ethical minimum” embodied in these standards to supplement the rule of “caveat emptor” and to run their transactions efficiently. If the law rationalises its practice according to such market standards, it will therefore “accommodate powerful interests”. However, rationalisation along such material standards will not be conducive to law’s formal qualities. As regards the interplay between law and the economy, Weber hence concludes: “In any case, the development of law’s formal qualities therefore displays peculiar contradictory features.” The law is “strictly formal” as long as the “certainty of business transactions” requires it. In the interest of business, modern law will at the same time be “anti-formal” when it refers to “market practice” in the sense of an “ethical minimum” of decent behaviour.  

B. Cutting across finance and law

A functional framework for finance and law must cut across different fields. In the first part, we have looked into the economic discourse for its answers on the question about the function of finance. We suggested to use the material/formal distinction to differentiate between two ways of framing the purpose of finance in modern society. The second part probed into the question whether a material approach to finance would carry over into the legal realm through a case study. We hence applied a practical perspective to observe the transfer of knowledge between finance and law. With Weber’s distinction between material and formal rationality, we have now a more systematic, theoretical perspective to assess how formal and material approaches to finance interact with law.

Of course, Weber’s distinction between formal and material rationality in economic action does not simply overlap with the material and formal approach we discussed for finance. It is rather that Weber’s discussion allows us to sharpen our framework. The emphasis of a formal approach to finance on market processes, efficiency, and mathematically elaborated economics falls squarely within Weber’s idea of a rationalising economy relying on business calculations and free markets. The interests of participants and users in financial markets require, however, some refinement. We have seen that for Weber rent-seeking, speculation, and other material private interests of market participants tend to conflict with the formal rationality of a business. Crisis may be the consequence. In that sense, Weber’s material/formal distinction offers a pathology of formal finance: if participants in financial markets advance their own material interests through the financial system, the system turns irrational. On the other hand, of course, the same analysis applies if we take the social interests of market users to be the material standard. Thus, from a different perspective, we learn again that a formal and material approach to finance are not simple alternatives, one being rational the other irrational. Yet if we keep in mind that Weber’s ideal types are not simple equivalents of the material/formal approach to finance, there is a case to be made that his cross-cut analysis of economic and legal rationality

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207 Ibid., 506-07.
208 Ibid., 512.
209 Cf. supra text accompanying note 44.
is quite useful to elucidate the interaction between the legal system and a functional approach to finance—in particular as regards the question whether and how we may promote a more material approach to finance through legal means.

1) Epistemology: knowledge transfers between finance and law

If we aspire to translate a material approach to finance into law the first question is whether this is possible as a matter of principle. Weber’s typology of social rationality offers us a useful perspective here. The worry might be that the way how law and finance reason is so different that any attempt to communicate policy matters between the two is futile. We may think that the rationalities of law and finance are incommensurable and understanding between the two fields therefore impossible. One could understand Weber’s notion of law’s formal rationality to suggest such an extreme case. Formal law develops its own particular logical rationality and dismisses anything that is alien to it as legally irrelevant. What the lawyer cannot think does not exist.\(^{210}\) Our case study provides helpful illustration that fears about such a principled incommensurability are unwarranted. The Law Commission well understood the economic policy concerns of the Kay Review and was also able to explain whether and how those policies can be translated into the law. Thus, Kay’s fiduciary principle was not lost in translation because of some principled rationality conflict that would block any attempt of meaningful communication between finance and law.

In fact, Weber’s description of the material/formal distinction provides us with a more realistic and differentiated view on the matter. First, we should remember that his formal rationality of the law is an ideal type that serves to analyse reality, not to represent reality. The other point is that formal rationality must be understood in tandem and in tension with material rationality. So if an ideal formal legal system rejects economic considerations, it does not follow that the legal system in reality will do so. We have seen that Weber at no point suggests that economic interests could not effectively influence how the law evolves. Quite to the contrary, Weber argues that “economic interests belong to the most powerful factors to influence lawmaking”\(^{211}\). Weber’s argument is therefore not one of incommensurable rationalities between law and the economy. His argument is that formal rationality implies a style of legal thinking that works against an attempt to introduce economic policy arguments. Translating such material arguments into law is therefore not impossible, as a matter of principle, but uncertain and contingent. Claims to the contrary are either a theoretical exaggeration or the result of a formal approach to finance, which considers finance as the special domain of economic experts, which no one else can understand.\(^{212}\)

We can illustrate the point on apparent epistemological limitations once more with our case study. According to the Law Commission, it was not possible to construct Kay’s policy concerns in the legal concept of fiduciary as it is presently understood by the courts. What the law

\(^{210}\) See supra text accompanying note 192.

\(^{211}\) See supra text accompanying note 200.

\(^{212}\) Cf. supra text accompanying notes 58 and 61.
cannot construct in its concepts is, in line with a formal perspective, legally irrelevant. Yet irrelevant does not mean that Kay’s economic arguments were not understood. The problem was that the existent legal structure did not allow the translation. Moreover, Kay anticipated the legal technicalities in his proposal and suggested in particular that fiduciary standards should not be capable of being contractually overridden and independent of client classifications.\textsuperscript{213} Kay’s recommendations thus included to adjust the legal structure in order to meet his policy concerns. The Law Commission also picked up these specific legal suggestions and elaborated on possible reform options. We analysed this part of the translation process in detail and raised a number of concerns about the Law Commission’s argument,\textsuperscript{214} yet none suggested that the Law Commission misunderstood Kay’s proposal on a fundamental level.

2) Finance and law: combinations of material and formal approaches

That there is a chance for meaningful communication between finance and law does not mean that this would be straightforward. Whether an attempt of translation is successful is uncertain and contingent. We saw in our case study how a finely balanced economic proposal met with a sophisticated legal framework that sifts and sorts this proposal according to its own technical rationality and standards.\textsuperscript{215} This is in line with Weber’s argument that law’s “particular logical rationality” may well impede, alter or hinder to harness the law for particular purposes of economic policy. The more general question then is how the different possible combinations of material and formal approaches to law and finance would affect their interaction. Theoretically there are four of these combinations, which we can pinpoint as follows: (i) formal finance and formal law, (ii) material finance and material law, (iii) formal finance and material law, (iv) material finance and formal law. On way to approach these combinations evidently is to go through them one by one. Another way is to emphasise the methodological principle that underlies this part of the framework: the dialectical tension between the material/formal distinction. While presenting the formal and material approach to finance we highlighted that the important thing is to have the distinction in place: the tension between the material and formal pole allows for questioning the mainstream discourse of finance.\textsuperscript{216} From Weber we learn that we can extend this methodological principle across finance and law. We ask for instance: how does a formal approach to law hinder the translation of a material approach to finance? Instead of going through all the combinations one by one, I will focus my comments hereinafter on some specific observations that follow from combining formal and material perspectives on finance and law.

Our case study covers a material approach to finance which should be translated into law. We can hence analyse how the translation process on the legal side reaches out to formal and material arguments and to what effect. Kay’s fiduciary principle represents an economic policy

\textsuperscript{213} See supra text accompanying note 87.
\textsuperscript{214} See supra text accompanying notes 142-164.
\textsuperscript{215} See supra text accompanying note 111.
\textsuperscript{216} See supra text accompanying note 48.
proposal that promotes user interests in equity markets. The law should be aligned with this particular *material* standard to assess the correctness of legal decisions. During the translation process, the legal terms that should carry this material standard vary: fiduciary, duty of care, good faith, fair treatment. All of these concepts, however, are of principled character: they are flexible and uncertain, and consequently cannot be put into a clear set of logical rules. In other words, they resist formal rationalisation. Now we saw that for the current law, the Law Commission did not find a way to construct Kay’s fiduciary principle from the court’s approach to fiduciary duties. The key arguments were: the court’s do not apply fiduciary standards at every link in the investment chain, notably not between professional investors; as regards the content of fiduciary duties, the courts take a “contract first” approach and, moreover, they tend to mirror regulatory requirements, notably client classifications. So are these arguments, which block Kay’s material approach to finance, of formal character? The answer reveals Weber’s “contradictory features” of modern legal rationality. A “contract first” approach is indeed a corner stone of formal legal rationality for it holds parties to their bargain. One shall not go back on what one formally promised. Such an approach makes the law for the parties predictable, calculable, and reliable for it offers them the possibility to design their legal relationship in minute detail and having it backed by the state and its courts. Such a contract first approach will be in tension with material interests of participants and users of financial markets. Yet for market participants, the interest in materialising standards of loyalty throughout the investment chain will, as a rule, only carry so far as they wish to rely on a market practice that ensures an “ethical minimum” of decent behaviour—beyond this minimum “caveat emptor” prevails. This balance between formal and material interests of market participants is formalised in regulatory rules on client classifications for such rules make the law predictable on this point. Thus, we can conclude: for the current law, Kay’s material approach to finance was substantially defeated by rules reflecting a formal legal rationality tailored to the material needs of market participants.

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217 Cf. *supra* note 151.

218 See *supra* text accompanying note 208.

219 Weber may have underestimated the significance of contractual design for the formal rationality of law and therefore misjudged the formal rationality of English law. To be sure, he noticed the relevance of freedom of contract, formally understood, for formal business calculations (see *supra* text accompanying note 201). On the other hand, he tied his ideal of formal legal rationality closely to 19th century German legal scholarship (see *supra* text accompanying note 189). With this not quite universal standard in mind, it is not astonishing that Weber had no high opinion of English law’s rationality: although he considered the judiciary of the king’s courts to be “strictly formal” (*Weber, supra* note 180, 471) and recognized some formalism in the doctrine of precedent, he still called the English administration of justice “extremely irrational” (*ibid.*, 510). Of course, Weber never had come to see what a “contract first” approach means in today’s modern business law practice, which heavily relies on English common law and stands for contracts that are systematically much more sophisticated than their civilian counterparts. For a recent discussion on Weber’s perspective on English law, see Martin Flohr, *Rechtsdogmatik in England* (Tübingen, 2017), 1-9.

220 A formal approach to contract will not notice that the possibilities to define the substance of the contract will in fact be very different, depending in particular on the parties relative bargaining power (the point will be elaborated below, see *infra* text accompanying note 233).
Kay’s fiduciary standards, which he advanced in the interest of market users, went considerably above an “ethical minimum” approach in the investment chain. He explicitly set out to challenge “caveat emptor”, which he deemed incompatible a concept for an equity investment chain based on trust and stewardship. On the matter of market practice for decent behaviour, Kay’s fiduciary principle would have tilted the balance towards the interests of market users. Moreover, as a principles based approach Kay’s reform approach collided with the formal ideal of a predictable law. All reform options, which should transform Kays’ material approach to finance into law—codification, case law, right to sue—, had therefore a difficult stance from the start. Again we can consider how the arguments against these reform options map onto the material/formal distinction. The argument against codification was that it would reduce legal flexibility required in the interests of the material standard of justice at the price of increasing uncertainty of the law of fiduciary. Codification was thus irrational on both accounts: material and formal. For case law, one argument was that financial redress may be disruptive to the market, adding to cost and risk. A similar concern was advanced against a new statutory right to sue, which effects were considered uncertain and potentially disruptive, adding to costs in the investment chain. We associated these considerations with a formal approach to finance. Yet, they also harmonise well with a formal rationality in law and the economy more generally. Courts that grant financial redress based on legal principles cut against the central tenet of formal rationality in both areas: predictability. Legal rules, on the other hand, which ensure legal certainty contribute to stable business calculations for they make risk, costs, and profits calculable. Such formal rationalisation suits well with the interests of financial intermediaries who wish to maintain a financial system that serves their own material interests. As a result, the example shows how a formal approach to finance overlaps with formal rationality in law and the economy. Unsurprisingly, it is difficult to argue against the formal status quo of the legal system.

It is not, of course, that the law and regulation of financial markets would only consider the material interests of market participants. We remember that in our case study the regulatory authorities confirmed that its rules would be in line with Kay’s fiduciary principle as restated by the Government. In the states that were affected by the financial crisis the law regulating the financial industry saw in general a significant materialisation in the interest of market users and taxpayers. Stricter rules, for instance, on conflicts of interest and on suitability standards for selling investment products or increased transparency requirements on investment costs should enhance protection of retail investors. In the interest of taxpayers, regulators sought to ensure the stability of the financial system. So there is considerable material rationality within the current legal framework, which is said to benefit market users and the public. We

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221 See supra text accompanying note 89.
222 See supra text accompanying notes 118 and 123.
223 On the formal legal status quo, see supra text accompanying note 218.
224 See supra text accompanying 134.
can put now these material aspects of financial law, on the one hand, against the material and formal approach to finance, on the other. If we apply the material/formal distinction in this way, we add an important analytical layer to the discourse of finance and its regulation, which brings us back to the issue of system stability we discussed in the first part. We argued that a material approach to finance will take a keen interest in how to construct a stable financial system, yet it will further consider what kind of financial system it is that we seek to stabilise: is it one that furthers “finance for society” or a “finance for finance” reality? The critical point that follows for the materialisation of law is: between (well-intended) regulation that aims to protect retail investors or to ensure a stable financial system, on the one hand, and the effects of such regulation, on the other, may exist a functional mismatch: regulation might function to stabilise a system that functions for the sake of itself. Investor protection rules that allow for a steady stream of funds into the financial system are conducive to a system that is built for the interests of market participants who seek to extract rents along the investment chain. The same query arises from regulations on financial stability. A materialisation of financial law must therefore not necessarily be in line with a material approach to finance. Kay’s fiduciary principle serves as an excellent example where a material approach to finance matches with the materialisation of the law: fiduciary duties were meant to achieve a structural change in the financial system because they were to apply throughout the investment chain. The systemic effects are here fully in view, while for investor protection rules that only cover the relationship between the end users and the first link in the intermediation chain the critical question remains: does this not simply allow to keep running a financial system that quantitatively and qualitatively works for the interest of market participants?

3) Politics of finance and law

The framework for law and finance we have outlined so far starts from a functional analysis of finance, differentiating between a material and formal approach. We mapped this functional framework onto Weber’s ideal types of rational economic and legal action. The result is an analytical framework that uses the material/formal distinction to cut across finance and law. We have tested the framework in the previous paragraphs, relying on our case study of the Kay Review for illustration. The case of the Kay Review suggests that knowledge transfers between economic and legal analysis are possible, yet subject to a complex interaction between formal and material approaches to finance and the economy, on the one hand, and to law, on the other. Our case study has yet another important lesson for the question whether economic policies translate into legal terms: the politics of translation. So where are the politics in a framework that operates with the material/formal distinction to analyse law and finance? The answer is that the material/formal distinction itself is political or, to put the matter differently, that it is

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226 See supra text accompanying note 49.
227 The argument has its antecedents in social theory, see e.g. Claus Offe, Strukturprobleme des kapitalistischen Staates (Frankfurt, 2015) (1972), 71; and more recently, Christoph Menke, Kritik der Rechte (Frankfurt, 2015), 294.
underpinned by politics. Politics is implied in the concepts of material and formal rationality in Weber and in the divide between a material and formal approach to finance. So far we have only hinted at this political issue when we stated that a more material approach to finance would not simply be an “economic” proposal and when we traced the political struggle that accompanied the translation of Kay’s fiduciary principle.\(^{228}\) We must now be more specific.

We introduced the distinction between a material and formal approach to finance to map the post-crisis discourse on the functions of finance. We noticed that both approaches overlap in their ultimate purpose, which we called “finance for society”. However, we saw considerable differences in how the two approaches elaborate on finance’s technical functions, which are meant to transform a “finance for society” goal. A material approach sees finance as a function of particular needs of businesses and individuals. A formal approach understands finance as an appendix to market and welfare economics. Framing the matter in one or the other way is not politically neutral for it implies a statement on the balance of power on financial markets. The material approach puts the interests of markets users first, whereas the formal approach puts the market first and thereby favours those who can make best use of it—at least until someone, perhaps, discovers a market failure.\(^ {229}\) We have seen that on “financialised” financial markets the power resides with market participants, not with its users. It is this balance of power that a material approach sets out to change. The matter thus is highly political and we saw the tensions play out in our case study. While Kay’s fiduciary principle initially found support from the Government, its further translation into law was not only subject to law’s particular logical rationality: the translation process revealed also a clash between those promoting the interests of market users and those representing market participants. We followed this conflict of interest closely for the debate on a new statutory right to sue.\(^{230}\)

In Weber’s use of the material/formal distinction, the political character is obvious in the concept of material rationality. We can glance this from the key words which we selected to pinpoint material rationality in the economic and legal sphere: distribution and correctness; for it is of course unclear and disputed what the relevant standard for distribution in an economy and for a correct legal decision should be. If Weber consciously choses to leave these standards open he already implies them as contested. Indeed, for the material standards of economic action he explicitly points out that they are “in principle unlimited” and that the distribution of economic goods is “subject to discussion” from a material point of view.\(^{231}\) But also for legal rationality it is clear that Weber has conflicting material interests in mind. We have illustrated this with our case study in which the interests of users and participants in financial markets called for a different legal standard of businesses loyalty.\(^{232}\) Importantly, however, Weber does not restrict the political implications to the realm of material rationality. In a famous passage

\(^{228}\) See supra text accompanying notes 62 and 165.

\(^{229}\) On the status quo bias that comes with the concept of market failure, see supra text accompanying note 57.

\(^{230}\) See supra text accompanying note 138.

\(^{231}\) Weber, supra note 180, 45, 59.

\(^{232}\) See supra text accompanying note 221.
of Economy and Society he elaborates on the political effects of formal rationality, more specifically, of a formal approach to the freedom of contract. We have seen already how Weber links a formal freedom of contract, which holds parties to their bargain and remains unconstrained by material legal standards, to the formal rationality of business calculations. Now he goes on to explain that the “formal possibilities” to enter into agreements of any form and substance would by no means ensure that these possibilities would in fact be open to everyone. The main result of a formal freedom of contract is, according to Weber, rather that it provides legally unconstrained possibilities for those with power and cunning “to use the market as a means to obtain power over others”. Individuals, whose economic position allows them to use formally free markets to obtain power over others, Weber calls “market interest groups” or, more pronounced, “market power interest groups” (Marktmachtinteressenten). It is above all them who are interested in a legal system that: “lays down legal propositions, which create types of enforceable agreements, that are formally up for everyone’s free use, yet in fact accessible only to the haves and thus, as a result, support their and only their autonomy and positions of power.”

Weber’s analysis lucidly uncovers the politics of a formal approach to markets and their underpinning legal institutions. On a superficial level they appear politically neutral. Everyone can join the market; everyone can enter into an agreement—for neither prices nor law discriminate. Even better, under the conditions of contractual free play on competitive markets, the invisible hand will guide everything to the best possible result for the many, not just the few. Yet the political, legal, and economic power structures of today’s financialised financial markets have in fact little to do with the “lovely idea of reconciliation of interests or the invisible hand of mundane provenance. As markets of all markets, financial markets became the scenes of an event, in which the flagrant release of financial economic forces combines itself with the consequent build-up of strict relationships of dependence.” That underscores our point that the distinction between a formal and material approach to finance is political indeed. The logical priority of the market, which underlies the formal approach to finance, is not politically neutral. And neither is a formal law of contract. Formal rationality in law and finance prioritises “market interest groups” (Weber) or “market participants” (Kay) who can use and have used financial markets to establish, fortify, and defend a “finance for finance” reality by power and cunning. The political foundation of the distinction does not decide the argument between a formal and material approach, and it also does not commend to replace a formal by a material approach. Yet the political implications of formal finance do lend considerable support to a more material approach to finance.

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233 See supra text accompanying note 201.
234 Weber, supra note 180, 439.
235 Ibid., 385, 439.
236 Ibid., 439.
237 Joseph Vogl, Der Souveränitätseffekt (Zürich, 2015), 235.
C. A more material law of finance

On the basis of the framework we put together so far, would it be possible to devise “a more material law of finance”—a law that responds to the more material approach to finance? The task for such an approach to law is not primarily concerned with the legislator, although there are important initiatives that precisely aim to transform the law in line with a more material approach to finance. The task here can also not be to follow the functions of finance into the details of financial regulation, important a this may be. The case study on the Kay Review shows well that when we try to translate a particular economic policy proposal into law, the devil is often in the detail. The task we can meaningfully undertake in this final part of the paper is, however, to briefly outline some proposals of legal structure and strategy, which are relevant to orientate a more material law of finance. Central to the discussion are three key words: principles, institutions, and legal reasoning.

1) Principles

A more material law of finance is one that emphasises principles. Foregrounding principles does not necessarily mean that rules are not important to govern modern financial markets. The Law Commission, for instance, sees it as a matter of getting the balance right: “For all the frustration with a compliance culture, we think that both principle and detail are needed in a system which is to be sufficiently responsive to market change.” Moreover, an emphasis on principles does not guarantee the translation process, as our case study illustrates. And still, principles—like fiduciary duties, good faith or fair treatment—provide an essential feature to financial regulation: flexibility. The main theme, I wish to explore here is how to interpret this “principled flexibility” in the context of a more material law of finance. I suggest three things are of considerable importance in this respect:

First, flexibility helps with issues that connect to law’s “particular logical rationality”: the legal system filters and rearranges an economic policy proposal according to its own rationality and technicality. A certain extra-legal input—like Kay’s fiduciary principle—will stimulate a complex legal framework and require a detailed analysis whether the law matches with the extra-legal idea. Principles allow here to smooth out the edges of the translation process: their inherently flexible norm structure permits to align the intra-legal processes with the extra-legal policies. The flexible character of principles works, in other words, against a formalistic legal logic that would hinder an attempt to translate the “spirit” of a material approach to finance into the formal letter of the law.

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238 Besides the Kay Review, *supra* note 5, such an approach informs also the Vickers Report, *supra* note 17: the Vickers Report aims, among other things, at a structural reform of the banking sector, which tries to separate banking services that are material to the real economy from others that are not.


240 See *supra* text accompanying note 215.
Second, flexibility enables courts and regulators to cope with the dynamics of financial markets. One characteristic that financial markets share with capitalist markets is their dynamic quality: market players have an interest in getting an edge over their competitors, which allows them to make profits and extract rents that would not be available to them if market discipline would work normally. Fernand Braudel saw therefore capitalism as the system of the “counter market” (contre-marché). Interestingly, Braudel associates such counter markets with “long trade chains between production and consumption” and notes that “the longer these chains become, the more likely they escape the usual rules and controls”. As regards the individual characteristics of capitalists, which are able to outflank the market, he remarks: “These capitalists were superior to all others in information, intelligence and culture.” It does not take much to see that this description fits all too well with modern financial markets and their long and complex chains of intermediation, on which some intermediaries are much better informed and equipped to deal than others. Especially financial innovations, which occur mainly in investment banking and fund management, create an opacity of modern finance that allows the creators of these innovations to circumvent the discipline of open markets and regulation. Thus, the economic incentives to get “the edge” entices to play the rules, rather than to play by the rules. Already Weber observed: “The inclination to give up economic chances, only to act legally, naturally are modest where not a strong convention disapproves of the circumvention of formal law …. Especially in the economic sphere, circumventions of a statute can be easily concealed.” As regards finance, the same dynamics and tendencies have been more recently described under the term of “regulatory arbitrage”. A formalised law of detailed regulatory rules stands here against the strong incentives of sophisticated financial market participants to work around them. The usual attempt to counteract these circumventions with more detailed rules is ultimately futile because no rule-maker can contemplate all possible ways how future market practices will evade the new regulation and because market participants have a steady


242 Braudel, ibid., 52.

243 Ibid., 55.

244 Kay describes that the financial intermediaries who enjoy “the Edge” on today’s financial markets are most notably investment banks (see Kay, supra note 13, 114-18).

245 Woolley, supra note 54, 130.

246 Weber, supra note 180, 197. Contemporary economic sociologists confirm the observation: “although rules and regulations are vital for the functioning of markets as they establish trust by protecting market participants from asymmetric information, it is in the nature of capitalist competition that profit-seekers will try to evade or circumvent them. Illegal or sublegal just as innovative trading—the two often being the same—tend to be more profitable, due to being riskier, than trading in the usual paths.” (Wolfgang Streeck, How Will Capitalism End? (London, 2016), 207)

economic interest to continue with their circumventions. To avoid the regulatory dialectic of regulation, circumvention, re-regulation, circumvention (etc.), legal principles are a useful instrument. They infuse the necessary flexibility into the legal framework to cover also those financial practices, constructions, and innovations, which legislators, regulators, and courts cannot foresee in advance.

Third, flexibility should be seen in direct connection with uncertainty. It is common to value flexibility, as for instance the Law Commission does when it notes that flexibility serves the interests of justice. Legal uncertainty, on the other hand, usually gets a much less favourable evaluation. Weber’s idea of formal rationality offers an explanation why so: legal uncertainty reduces the predictability that is needed for rational business calculations, and on financial markets where even milliseconds make a difference these days, the interests of market participants in legal certainty will be significant indeed. It is therefore not surprising if the Law Commission was particularly susceptible to arguments of legal certainty. To avoid that legal certainty becomes an argument that eclipses a material approach to finance without being questioned, it is therefore quite important to reframe the argument on flexibility and justice. It must be clear that in a principles based approach flexibility and uncertainty are two sides of the same coin. Uncertainty also has a positive side—which we call flexibility—from which it cannot be separated. Therefore, we argued that taking a principles based approach would mean to accept uncertainty as a mode of governance and we described this mode of governance to the effect that intermediaries operating under the uncertainty of legal principles are incentivised to integrate a more material approach to finance already at the time when they are developing their new market practice, and not only when a particular practice is challenged in court. The importance of this last argument can now be seen more clearly against the dynamics of financial markets and regulatory arbitrage: in a market context where the incentives of market participants are set to circumvent formal legal rules, there is an argument to be made that “principled uncertainty” provides incentives against such circumventions. If some market participants decide to create financial innovations for arbitrage purposes, it is ultimately them who can judge and hence must bear the risk of legal uncertainty.

2) Institutions

A more material law of finance is one that emphasises institutions. If the “inclination to give up economic chances, only to act legally, naturally are modest where not a strong convention disapproves of the circumvention of formal law”, legal institutions are there to incentivise and support such a convention. In our case study, we examined whether courts can and should


\[249\] Law Commission, supra note 5, 206.

\[250\] See supra text accompanying note 151.

\[251\] Weber, supra note 180, 197.
fulfil *part* of this institutional role. Our overall argument was that courts have a meaningful role to play. While one should not expect that courts would provide an ultimate solution to change behaviour on financial markets, they still can incentivise market practice. A principles based approach to finance will be necessary, but not sufficient. Crucial is the *combination* of norm structure and institutions to make a difference: only if it is likely that courts will make effective use of the flexibility provided by legal principles, financial market players are constructively incentivised to account for the interests of market *users* ex ante, and not simply to rationalise them ex post during litigation.\(^{252}\) Thus, the strategy of installing courts for governing financial markets significantly depends on their institutional self-understanding. There are three crucial points on how to frame the institutional role of the courts.

The first argument is the conviction of a material approach to finance that “finance is not special”.\(^ {253}\) A material approach argues against considering finance as a special field of market practice that is accessible only to the initiated, i.e. economic and regulatory experts. The financial industry has to comply with the same standards as any other industry and the courts should therefore not be less willing to interfere where standards of market behaviour are deplorable. Our case study on the Kay Review, moreover, suggests that financial intermediaries may fear the intervention by courts considerably more than by regulatory authorities.\(^ {254}\) Practical experience supports the view that the question who is in charge of enforcement does connect to the problem of regulatory capture. Of course, this is not to say that financial regulators would be necessarily tame in their enforcement. Still, compliance with regulatory rules and principles is something that is often negotiated between regulatory authorities and market participants. Thus, “intellectual capture” becomes an issue.\(^ {255}\) Courts, on the other hand, are not involved with the “daily business” of financial market participants; they enter the stage in pathological cases. This could be turned into an argument against courts, stating that they do not have the necessary expertise in market practice to deal with finance cases. However, once it is realised that finance is not special, distance from market practice can actually be appreciated as an advantage: courts may be more critical of a practice that market participants and regulators would consider legitimate already because it is market practice.

The second argument explaining why courts should reconsider their role as regards financial markets is the dynamics of these markets. The Law Commission saw “major difficulties in relying on ‘judge-made’ law to control complex and fast-moving financial markets”.\(^ {256}\) While finance will not be unique in its dynamic character as an industry, its dynamic features nevertheless provide an argument to involve the courts. We noted already how the dynamics of financial markets will again and again result in regulatory arbitrage—in particular where detailed, formal rules are in place. An attempt to cope with these dynamics through ever more

\(^{252}\) See *supra* text accompanying note 151.
\(^{253}\) See *supra* text accompanying note 171.
\(^{254}\) See *supra* text accompanying note 139.
\(^{255}\) Cf. *supra* text accompanying note 168.
\(^{256}\) Law Commission, *supra* note 5, 206; see *supra* text accompanying notes 118 and 147.
detailed rules is futile—for there will always be another way to achieve a certain economic result.257 A legal system that is adapted to such a market context must therefore be itself dynamic. Legal principles are part of such a dynamic legal structure, yet they are not sufficient; they will not provide a strong incentive against regulatory arbitrage ex ante, if it is not clear that courts and regulators will use them ex post to assess the latest financial innovation. We have seen that courts may be reluctant to avail themselves of the discretion inherent in legal principles because they see them in conflict with legal certainty.258 The crucial point for the judicial self-understanding therefore is that the dynamic context of financial markets provides a special argument that justifies to govern with principled uncertainty. If neither the legislator, nor regulators, nor courts can devise a set of rules that would cover every possible variation of future financial practices, it is legitimate for courts to use principles that allocate the legal risk of uncertainty with market participants.259

The third argument in favour of courts considers an institutional missing link. We recall the Law Commission’s concern that only few finance cases are brought and hence the courts would have little opportunity to engage in standard setting for financial markets.260 Considering the issues with regulatory arbitrage it would of course be completely illusory to rely on case law for updating financial market law on a detailed level. What is already a problem for regulatory authorities surely is beyond the capacities of courts. Yet the argument we have presented here is a different one. Governing by “principled uncertainty” is akin to govern by remote control: courts provide the principles and the incentives, not the rules. We argued that little cases were needed for setting out principles that create the right incentives for market players. Who, however, will implement the spirit of these principles into the daily practices of financial intermediaries? The missing link we have in mind for this task are business lawyers. While courts are at the centre of the legal system from where they provide impulses to the economy, lawyers are located on the periphery of the system where they continuously match market practice with legal rules and principles.261 Lawyers hence are a crucial link to advise on whether the latest financial innovation, for instance, complies with the spirit of a legal principle that a court laid down in a particular precedent.262 Of course, some lawyers are to a great extent economically

257 Merton gives an example that illustrates the point clearly: to take a leveraged position in the Standard and Poor’s 500 stock market index, he lists no less than eleven possibilities—which are not meant to be exhaustive (see Robert Merton, “Financial Innovation and the Management and Regulation of Financial Institutions”, Journal of Banking & Finance 19 (1995), 474).
258 Cf. supra text accompanying note 249.
259 The Stiglitz Report argues in a similar vein: “The fact that firms are always inventing ways of circumventing regulations means that governments have to view regulation as a dynamic process and provides an argument for legal frameworks that give regulators wide latitude to respond to the public interest.” (Stiglitz Report, supra note 12, 83)
260 See supra text accompanying note 147.
262 The following article of a City lawyer, published shortly after the opening of the London International Financial Futures Exchange (LIFFE), provides a suitable example: Patrick Daniels, “The legal consideration in futures contracts”, International Financial Law Review (1983), 26 (the article’s header reads: “LIFFE is barely six months old. The English courts contain precedents under which their contracts operate”).

dependent on market participants and, in a specific case, lawyers must represent their client’s interests (one could speak of “economic” and “institutional” capture, respectively). Nevertheless, there are notably two important aspects working against this capture by economic interests. First, it is part of a lawyer’s duty of care that she must advise objectively on the legal risks of a particular business practice. Second, lawyers reason in a particular way, as we now have repeatedly pointed out, and that ensures that not every fanciful idea of regulatory arbitrage will pass their scrutiny.

3) Legal reasoning

The material law of finance is one that emphasises legal reasoning. This emphasis comes with the conviction that framing matters. Our core distinction for a functional framework of finance and law is the material/formal distinction. As this distinction cuts across law and finance, so do the framing effects that the framework makes explicit. For economic thinking, we recalled Keynes’s statement about the power of ideas, which conveys the issue of framing effects in a general way. More specifically, we have then illustrated the framing effects of a formal approach to finance with the example of financial innovation. The case of the Kay Review, subsequently, presented the chance to see how a material approach to finance would reframe the discussion on the legal concept of fiduciary. We realised conflicts between such a material approach to finance and a formal approach to law: formal arguments drawing on legal certainty have a strong appeal and can push the discussion quickly into a particular direction. Consequently, we therefore tried to reframe the notion of legal uncertainty when we explained its constructive, positive side. Such reframing is an attempt to avoid that legal certainty becomes an argument that eclipses a material approach to finance without being questioned in the process of legal reasoning that translates a particular approach to finance. Liquidity and market completion are ideas with a potentially similar framing effect for both areas, economic and legal thinking. All these examples suggest that framing matters, greatly. As one leading scholar of argumentation theory puts it: “the success or failure of individual argumentations depends almost entirely on this concept [of the frame].”

How frameworks and framing effects relate to legal reasoning is not yet well understood; though the hermeneutic tradition in legal methodology can be seen as an important contribution, building on the concept of prejudice (Vorverständnis). Also, the notion of “intellectual capture” hints at these problems. Another important concept that belongs here is the one of presumption. We have integrated the concept of presumption when commenting on the logical

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263 See supra text accompanying notes 192, 195 and 205.
264 See supra text following note 29.
265 See supra text accompanying note 222.
266 See supra text accompanying notes 249 and 163.
267 Cf. supra text accompanying notes 30 and 34.
270 See supra text accompanying note 168.
priority of markets in the formal approach to finance. It has been clearly stated how the presumption for market solutions suggested a particular regulatory philosophy that prevailed before the financial crisis, viz. “that the market in its native state brought the highest benefits to society, and the ecological balance of the self-adjusting market environment was not to be tinkered with unless convincing proof was offered otherwise (presumption of beneficence absent compelling proof of hazard).” Turner’s observations, which we have quoted earlier, are a variation on the same theme: “in the UK Financial Services Authority, the idea … that regulatory interventions can only be justified if specific market imperfections can be identified, formed [a key element] in our institutional DNA in the years ahead of the crisis.” In this context belongs also Turner’s statement on the issue whether liquidity, which results from position-taking, is value added at the social level. He said that he would not know the precise balance of the positive and negatives on this issue as there remain many open empirical and theoretical questions. A formal approach to finance would leave market and regulatory practice as they are until these questions are resolved. Turner, however, was prepared to shift the burden of proof: “in setting trading book capital requirements for commercial and investment banks, we should shift from a bias in favour of liquidity to a bias to conservatism.” In a similar vein, we suggested during the case study that speculations about the market effects of a particular legal solution should not be given too much weight, unless there is clear evidence to the contrary. We also noted an implicit presumption that follows from a status quo bias towards the existing legal system. It is an important part of a material law of finance to make implicit presumptions in the discourse on finance and its regulation visible, and to see whether we should align the burden of proof that follows from them with a more material approach to finance.

Issues with “intellectual capture” and argumentative presumptions should be seen as part of the framing effects that are at work in legal reasoning, and the significance of framing for legal reasoning should be explored and stated systematically. As lawyers can learn from Keynes and the philosophical theory of argumentation, the significance of intellectual frameworks can hardly be overstated. Frame structures are not just something that one brings to a particular argument, for instance a prejudice for a material or a formal approach to finance. Frames are not located before or besides the argumentative process but occur within it “as the always relevant and potentially movable boundary between the subjective and objective content of the

271 See supra text accompanying note 56.
273 Turner, supra note 25, 15; cf. supra text accompanying note 34.
274 See supra text accompanying note 43.
275 Cf. supra text accompanying note 19.
276 Turner, supra note 25, 41.
277 See supra text accompanying note 157.
278 See supra text accompanying note 176.
issues in question.”279 One important element of dealing with frame structures is to make them explicit. This is what we have tried to do in this paper from a law and finance perspective. The core structure of our framework is, as will be clear by now, the material/formal distinction that allows us to bridge the fields of finance and law. It is a peculiarity of the framework we propose that it does not seek to replace a formal approach of finance with a material one—as tempting that might be in the financialised world we are living in. We assume the framework to be more powerful if the tension between the material and formal approach remains in place,280 so that we arrive at a framework that will in some sense integrate its own framing effects. That banking consists in moving money from Point A, where it is, to Point B, where it is needed—as Lord Rothschild submitted—could be a nice formulation of a material approach to finance. It would be an understatement nevertheless, just as finance is not simply a function of efficient risk allocation expressed in mathematical formulas. Also for the realm of legal reasoning, we prefer to rely on the dialectical tension between material and formal arguments, even if on the balance, we favour a more material approach to finance and the law of finance.

279 Wohlrapp, supra note 162, 175.
280 See supra text accompanying notes 48 and 216.