ANNELISE RILES, *Collateral Knowledge: Legal Reasoning in the Global Financial Markets*

University of Chicago Press, Chicago and London, 2011,
xii, 295 pages. $27.50 ISBN: 9780226719337

''We are not the lowest, most disrespected lawyers in the bank who only perform the clerical task of filling in the blanks in ISDA* forms. We are actually the vanguard of users of subtle and sophisticated legal knowledge and techniques that form the backbone of the global financial system and ensure financial stability."

[Caption for an imaginary cartoon showing an unimpressive back office with a desk occupied by equally unimpressive-looking swap documentation personnel]

The above imaginary cartoon caption (perhaps from a Dilbert comic strip) humorously encapsulates an important theme of Annelise Riles' book, Collateral Knowledge: Legal Reasoning in the Global Financial Markets. This ambitious book wants us to think about global financial markets in a new way. It sets out to challenge a popular, fundamental assumption that underlies much of the discussion of the legal regulation of financial services to date: that there is a clear dichotomy between public governmental regulation and private market activity.

In particular, Riles questions the assumption, especially widespread and popular in the United States prior to the 2008 financial crisis and often seen as an integral part of a successful U.S. postindustrial model, that private ordering by markets is innately superior to bureaucratic reasoning since it occurs in real time and is conducted by private market experts with greater legitimacy and experience (p. 157). This view, associated especially with the Austrian school of economists such as Hayek and von Mises, is often utilized by free market conservatives to oppose governmental regulation of markets. However, Riles views governmental regulation and private market activity as not being opposed to each other. Going beyond the obvious point that laws and regulations are necessary for the enforcement of private contracts, Riles asserts that government and private actions do not compete or serve as substitutes, but rather use similar legal techniques for governance and act in collaboration to support the global financial system. She thus wishes to turn the discussion of global financial regulation in a direction that is *more technical* and *more political* (p. 223, emphasis in original).

* ISDA stands for International Swap Dealers Association (*the eds.*)

Riles agrees that globalization has led to an emphasis on private action over government regulation. However, she also notes that the favored method of analysis has shifted from economics, with rational actors and incentive systems, to law, with accountability, transparency, and the rule of law (p. 8). She is equally skeptical of broad generalizations of the rule of law crowd such as "transparency." Instead, she looks for new questions about markets and a new theory of law and markets that is "close to the ground" (p. 14) without relying on such "motherhood and apple pie" generalizations.

Riles focuses on the use of collateral in swap transactions to demonstrate how legal thought shapes markets and the importance of legal knowledge as a technique of private governance. The reality of global financial governance is a "*routinized but highly compartmentalized set of knowledge practices*" (p. 33, emphasis in original), many with a technical legal character, that occur among large, private financial institutions—a kind of private regulation. The importance of such private governance techniques is too often ignored, Riles argues, in discussions of global financial regulation.

Rather than debate primarily on a broad theoretical level, Riles argues her point on the important role of the techniques of private regulation by utilizing her background in anthropology to delve deeply into the actual workings of collateral in swap transactions. She focuses, in particular, on the working of the "low level" back office legal specialists in banks who document such transactions. This ethnographic approach finds that contrary to our image of law clerks mechanically "filling in the blanks" on standardized forms, the legal knowledge and technique utilized to document these transactions constitute a significant private form of regulation. She draws a parallel between legal knowledge and collateral, noting that legal knowledge, like collateral, is on the sidelines but always working to sustain markets (p. 20).

Riles' field research and two major case studies both involve financial markets and regulation in Japan, focusing specifically on legal issues relating to collateral in swap transactions. Collateral is required for many swap transactions because it provides a partial guarantee of payment. Banks and corporations enter into swap agreements with large financial institutions. These agreements are often "side deals" designed to hedge some specific risk that occurs in the "main" transaction, such as interest rate risk, foreign currency exchange risk, or, more recently, default risk with respect to the bond or other debt of a third-party issuer.[1] Any risk of default on the swap contract itself adds unwanted, additional risk and defeats the original purpose of using the swap solely to hedge some specific risk arising from the "main" transaction.

Some forms of hedging, such as futures contracts, are traded on exchanges where all of the participants are required to maintain adequate capital and are otherwise regulated.

1 Swaps and other hedging transactions are widely referred to as derivatives since the payments under these agreements are generally based on, or "derived" from, a separate index or asset that is related to the risk that is to be hedged. In addition, derivatives are used to place "one-way" bets without any "main" transaction in order to speculate on price movements of an asset or index.

However, swaps, which are often longer term and customized, and therefore may well be more desirable, are private ("over-the-counter" or "OTC") transactions. Accordingly, the use of collateral, together with the rules (swap code) and forms provided by an industry group of large financial institutions that are major swap dealers (the International Swap Dealers Association or "ISDA") have been critical to the rapid development of the swaps market.

Riles' first case study deals with the "netting" of collateral under the ISDA rules and forms. Since large financial institutions have many agreements with the same counterparty, it is extremely burdensome to supply separate collateral for each agreement. Netting allows the cancelling out of mutual obligations and one party to provide a relatively small amount of "net" collateral owed under the agreements as a whole. Chapter 2 and also Chapter 5 deal with efforts in Japan to assure largely foreign financial institutions acting as counterparties to Japanese banks that this ISDA provision would, in fact, be enforceable under Japanese law. Action in Japan involved a progression from administrative guidance to legal opinions to the enactment of a netting law (in 1998) to conform Japanese law to market practice. Although supporters of the netting law often portrayed it as a triumph of economics and markets over law (pp. 207-9), Riles instead views the netting law, with its "hollow core" to be filled in later by bureaucrats, as a clever use of legal form to show Japan's conformity with modern, global markets and to protect Japan from pressure for greater "transparency" (pp. 214-6). Riles also emphasizes the ongoing collaborative aspect between government bureaucrats and private legal specialists (pp. 97-8) and the similarity in legal techniques used by both groups.

The second case study (Chapter 4) focuses on efforts by the Bank of Japan to conform the settlement system for daily interbank transactions to high-paced market practices, i.e. change a system where settlement occurred once at the end of each day (and which had the potential of leading to a system-wide panic if any major bank failed to settle) to a "real-time" settlement system. The real-time system had its own liquidity issues, however, as banks would need access to the funds necessary for ongoing settlement (p. 161). Implementation of this new system involved a practice whereby the market participants and regulators agreed to act as if each transaction was settled in the proper order so as to minimize liquidity issues (p. 179). Riles cites use of this "placeholder" or legal fiction by the Bank of Japan as an example of how government can use the technique of such legal fictions as effectively as can private actors (p. 180) such as ISDA and banks (e.g., swap market participants treating ISDA's rules on collateral as binding despite uncertainties over how such rules might actually be enforced in a variety of jurisdictions).

The book is of special interest to students of Japanese law, and not solely, or even primarily, because of these two case studies. Rather, Riles' discussion, particularly in Chapter 3, has important implications for fundamental issues that remain controversial in Japan concerning the role of law and administration in financial services—an area that remains subject to both overly broad generalizations and popular perceptions that color, and sometimes overwhelm, thoughtful analysis.

These issues include the following. Is Japan an economic and financial "failure" due to its lack of implementation of the rhetoric of reform despite the availability of the "successful" model of a primary role for private markets offered by the U.S. post-industrial model? More specifically, have efforts to reform financial regulation in Japan, as exemplified by Japan's "Big Bang" program of financial deregulation, floundered because bureaucrats were ultimately unwilling to give up control, exercised in the past by means of administrative guidance, and defer to market practices? And perhaps most fundamentally, is it correct to clearly distinguish between *ex ante* and *ex post* regulatory styles in Japan (i.e., informal administrative guidance versus legal interpretation of rules and enforcement) in the financial services area?

For some time Japan was singled out as a failure among advanced industrial societies. One important reason is Japan's prolonged period of low economic growth. Just as high economic growth during Japan's boom years led to an oversimplified view of Japan as having well-conceived, consistent, and fully implemented economic policies,[2] low growth has produced an equally oversimplified view of failure. Ironically, two myths that were often cited as causes of Japan's prior success—bureaucratic omnipotence and cultural advantages—have now morphed into bureaucratic incompetence and cultural handicaps that are given as reasons for its failure.

The ascendance of a Hayekian view of the superiority of private markets in conjunction with the perceived success of financial deregulation in the United States has underpinned this view of Japan as a failure. Much of the thrust of Riles' book is to challenge this Hayekian view and go beyond what she views as a false dichotomy between government regulation and "free" market activity. This task was made easier following the 2008 financial crisis, as Japan is no longer singled out as a failure. It is now apparent that many advanced countries, including the United States and much of Europe, face similar problems relating to low economic growth, aging societies with rising social welfare payments, and increasing government debt. In addition, the proposed solutions—aggressive fiscal policies that continue to increase national debt and aggressive, non-traditional, monetary policies such as zero interest rates and quantitative easing—are similar to those utilized in Japan despite their lack of clear success to date.[3]

How about the charge that financial regulators in Japan are unwilling to give up traditional practices of administrative guidance, and even if "law on the books" changes the reality of heavy-handed regulation of financial services does not? Here, Riles' "on the ground" approach is very helpful in addressing this generalization. She finds that the

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2 L. HEIN, Growth Versus Success: Japan's Economic Policy in Historical Perspective, in Gordon (ed.) Postwar Japan as History (London 1993) 99.

3 For an early article noting the relevance of Japan's aggressive monetary policies for declining conditions in the United States, see J. BULLARD, Seven Faces of "The Peril". Federal Reserve Bank of St. Louis Review (Sept.-Oct. 2010) 1.

bureaucratic mindset in Japan did, in fact, substantially change. Japanese bureaucrats were not merely going through the motions; they accepted the idea that benefits could be obtained through the development of private capital markets and open competition among market participants. In fact, their aim, according to Riles, was nothing less than remaking Japanese financial institutions and their management into rational market actors (pp. 22, 40).

The results appear to be disappointing. Although it would be unfair to judge the results of this deregulation effort simply by Japan's economic growth rate, it does not appear that Japan's financial system entered a new age of market competition. One factor may be an exaggerated view of the positive effect of Hayekian markets and the benefits of financial deregulation. I would also posit that although the government made substantial efforts to deregulate, the banks and other financial institutions that were supposed to seize new competitive opportunities and provide the benefits of a newly efficient market did not perform their role effectively. The reasons include a combination of poor market conditions (including a bad economy and weak demand for financial products) and the persistence of traditional relationship banking practices that were low risk, but low return.[4]

The final, and to me the most interesting point for Japanese regulatory practice, is Riles' reexamination of the supposedly clear distinction between administrative guidance and "transparent" banking regulation. Riles' suggested close interaction between the governmental and private sectors and similarity in their legal techniques occurs in the United States as well. From my own perspective as a former practicing attorney in New York who represented Japanese banks before U.S. financial regulators, I find it is no easy matter to compare financial regulatory systems or to clearly distinguish between administrative guidance and transparency in banking regulation. In every system banks are the most highly regulated industry due to the potentially catastrophic impact of any failure of the banking system on the underlying economy. Banks are accordingly subject to extensive prudential regulation and "guidance."[5] And regulators regularly rely on the

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4 See B.E. ARONSON, Reassessing Japan's Big Bang: Twenty Years of Financial Regulatory Reform, in Gerteis and George (eds.) Japan Since 1945: From Postwar to Post-Bubble (2013) 165, 173-7. This book chapter is based on research conducted as a Visiting Scholar at the Bank of Japan in 2010.

5 This additional scrutiny of banks results in a closer, more ongoing relationship—and a greater degree of informality and administrative "guidance"—than in other industries. In every system bank regulators possess strong licensing powers and, even more importantly, possess the "nuclear weapon" of the legal authority to obtain a cease and desist order for a violation of a vague standard such as "unsafe and unsound banking practices." This provides the regulators with very strong negotiating power and incentivizes regulated banks to heed the regulators' suggestions. In addition, banks are subject to annual on-site examinations that are guided by voluminous bank examination manuals. Bank regulators can emphasize any issue they like (at least to a degree) by simply including it in the bank examination manual or placing it on another relevant checklist.

banks themselves to investigate their own problems (i.e., a bank hiring reputable law firms and accounting firms to undertake investigations requested by the regulators).

Foreign bankers in New York who complained about vague rules and the informal guidance of regulators were equally, if not more, unhappy when the Federal Reserve embarked on a new initiative for transparency in enforcement in the mid-to-late 1990s. It meant that foreign banks could be subject to the embarrassment of formal, publicly announced enforcement actions without prior notice or an opportunity to "fix" the problem with regulators informally. Similarly, recent complaints by foreign bankers in Tokyo about Japan's Financial Services Agency, including new informal controls despite formal deregulation, difficulty in communications and lack of trust, would also be consistent with a change from administrative guidance to a "transparent" regulatory style.[6]

This intriguing book left me pondering two questions. First, can we fully equate Riles' focus on collateral in swap agreements with regulation of financial institutions generally? Swap agreements may represent a special case in that ISDA is an unusually strong and successful private industry group. Not only has it made detailed swap code rules and forms as a kind of private law, it has been successful, for example, in having virtually all of the major industrialized countries amend their bankruptcy laws to protect and favor the position of swap counterparties in the event of bankruptcy. This is not the typical situation for most lines of business (or areas of regulation) within the financial services industry. ISDA is limited to a relatively small number of large financial institutions who are able to regulate a series of private transactions with each other, not establish the equivalent of private regulation for all banks and certainly not for the general public.[7]

Second, having artfully made the point that private regulation is important and not in opposition to government regulation, where do we proceed from here? The trend since the 2008 financial crisis has been one of re-regulation due to the perceived failure of private markets; in particular, AIG collapsed and triggered a financial crisis due precisely to the functioning of the system of collateral in swap transactions (i.e., due to its declining positions as the "insurer" of bonds of various issuers under credit default swaps, AIG was unable to provide the huge amounts of collateral it owed and required government rescue). Riles makes the point that following 2008 we remain stuck debating in terms of the same old public-private dichotomy and we need, perhaps more than ever, to move beyond it. But how can we utilize Riles' insight and foster and better organize the collaborative contributions of public and private regulation in the real world?

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6 B.E. ARONSON, *supra* note 4, 172.

7 However, the public impact of such private bank regulation has become readily apparent. The rapid expansion of derivatives and their role in the 2008 financial crisis made them a controversial topic for re-regulation under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and other initiatives.

Such caveats regarding real world implementation do not in the least detract from Riles' fundamental insight: there is not a black and white dichotomy between public and private regulation or *ex ante* and *ex post* regulation, and we need to develop more nuanced approaches. Riles succeeds admirably in her stated goal to "open up new questions" (p. 13) and to develop a new theory of law and markets. She ably provides the latter based on her examination of everyday legal knowledge and techniques that may form the basis of a collaborative "public-private" form of regulation of large financial institutions. Her book is a major contribution and will serve as an excellent starting part to the post-2008 discussion of the regulation of global financial markets in a complex and volatile world.

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