The geography of investment management contracts: the UK, Europe and the global financial services industry

Gordon L Clark and Ashby H B Monk+, Smith School of Enterprise and the Environment, University of Oxford, Hinshelwood Road, Oxford OX1 3QY, UK and Faculty of Business and Economics, Monash University, Caulfield VIC 3142, Australia; +Global Projects Center, Faculty of Civil and Environmental Engineering, Stanford University, Palo Alto, CA 94305-4121, USA.

Contact. gordon.clark@ouce.ox.ac.uk; amonk@stanford.edu

Abstract. Contract is crucial for governing the relationships between asset owners and the many types of agents that underpin the production of financial services. We distinguish between discrete contracts for financial services and investment management contracts that are better described as relational in the sense that they are open-ended and subject to renegotiation between the parties. Emphasis is placed upon the significance of risk and uncertainty in financial markets and the ways in which the parties to contracts adapt to these conditions. This provides the backdrop for understanding three different types of contractual arrangements apparent in the investment management industry, bringing to the fore the significance of the choice-of-jurisdiction when writing contracts for investment services. We explain how and why the UK is a favoured destination for European institutions just as offshore jurisdictions, such as the Cayman Islands, may be the favoured 'home' jurisdictions for certain types of UK and global investment managers. At the heart of the relationship between asset owners and asset managers is the power of these parties when choosing the type of contract and the jurisdiction which is the favoured location for formalising these relationships.

Keywords. Contract, governance, investment management, jurisdiction, performance

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Introduction

Financial institutions vary by size, function, and jurisdiction-of-origin. The social science literature tends to focus upon banking institutions, distinguishing, for example, between whole countries and their legal traditions in terms of the status attributed to banks relative to markets (see Thakor 1996; La Porta et al. 1998; Dore 2000). Another type of financial institution is less studied: 'beneficial' institutions, such as pension funds, insurance companies, sovereign wealth funds, and endowments, whose purpose it is to underwrite or insure the welfare of participants or related rights-holders (Davis and Steil 2001). Worldwide, these institutions account for approximately $18 trillion in assets invested on behalf of more than a billion people (*Investment & Pensions Europe,* June 30th 2012). In some cases, the ownership or sponsorship of a fund is its distinguishing attribute. In many cases, however, this is less important than the fact that the nominated or notional beneficiaries of these institutions have no voice in their governance. These institutions tend to be self-governing, albeit subject to mandated rules of behaviour and standards of performance (Hawley and Williams 2000).

Agency relationships dominate the financial services industry (Black 1992). Financial institutions acting on behalf of beneficiaries might contract out the formulation of investment strategy which, in turn, involves the purchase of investment management services (e.g. from an asset manager) with the flows of assets coordinated by fee-for-service custodians. An agent might be charged with the responsibility of collecting and presenting information on the performance of investment managers (e.g. a pension consultant). Yet other agents might be charged with the responsibility of reconciling that information against client expectations and industry benchmarks (e.g. auditors and accountants) (see Clark 2000). In order to bypass this chain of agents, some funds have sought to bring functions in-house. Whereas the outsourcing of financial services relies upon governing chain of commercial agreements between institutions, the in-sourcing of financial services relies upon the coordination of employment contracts. Neither type of contract is likely perfect: employees can shirk their responsibilities while external providers can hold clients hostage by exploiting their reliance on the proffered services (as suggested by Trebilcock 1993 amongst others).

In this paper, we focus upon the contractual relations between beneficial financial institutions and their service providers, emphasising the form and functions of contractual agreements with investment management providers. We explain how and why these contracts are quite different from the contracts that bind together firms and suppliers in commodity producing industries. Many contracts for investment management services can be terminated-at-will. Nonetheless, they are used to provide frameworks for governing relationships in the context of risk and uncertainty rather than being simply instruments to manage the supply of services. We explain how and why the jurisdiction in which these contracts are written matters to parties on both sides of the market. This is especially significant for the UK and Europe and elsewhere. Jurisdiction selection is explained by reference to financial institutions' need for legal certainty or at least procedural fairness. In some instances, the choice-of-jurisdiction can be explained by suppliers' interest in discounting their accountability to clients.

There is an extensive literature on offshore financial centres, especially those that shelter the financial services industry from tax liabilities (see Wójcik 2012). This is important (Wainwright 2011). However, offshore centres have other significant roles especially as regards the governance of contractual relationships in the financial services industry. Explicating how and why this is the case is one contribution of the paper. Following Clark and Monk (2013a, 2013b), we articulate the conceptual building blocks needed to understand the role of contracts in the investment management industry. Our analytical strategy is grounded in a particular market environment. Risk and uncertainty are pervasive aspects of financial markets and are arguably deeply embedded in the contractual relationships that bring together financial institutions and their suppliers. Likewise, we suggest that the geography of contract is important, with jurisdictions like the UK (London specifically) serving as the bridge-point between geographically dispersed financial institutions and centralised market providers. In these ways our approach is more akin to Macauley's (1963, 1985) sociology of contractual relations and Bathelt and Glückler's (2011) relational economic geography than standard treatments of contract. We are more concerned with models of contract in the financial services industry than the neoclassical theory of optimal contracting (compare Bolton and Dewatripont 2005).

In the next section, we begin with the standard model of contract, noting its underlying principles and the differences between so-called discrete contracts and relational contracts. This logic is complicated by the real world of financial markets and the financial services industry, as risk and uncertainty tempers expectations of service providers' diligence in realising agreed objectives. To illustrate, we compare the nature and performance of contracts in commodity producing industries against the financial services industry. Taking the argument a step further, we suggest that many financial institutions treat contract as a desirable thing in itself and as a framework for governing relationships over time and space. In these ways, contract plays a complex and not entirely consistent role in the financial services industry. This is illustrated by reference to the demand and supply of contract by jurisdiction, suggesting that the choice-of-jurisdiction is a significant aspect of the European and global financial services industry. In conclusion, implications are drawn for the governance of contractual relationships in the context of the 'relational turn' in economic geography.

Before proceeding, it is important to comment briefly on the exposition of our argument and the limits of our research. In large part, this paper is an exercise in abstraction consistent with related work in economic geography; see Scott (1986) on transaction costs, Storper and Venables (2004) on face-to-face contact, and Bathelt and Glückler (2011) on relational economic geography. This strategy provides way of articulating the relevance of contractual frameworks applicable to a specific industry, its institutional formations, and its geographical footprint (along the lines developed by Clark and Monk 2013a, 2013b). There has been less research on the structure and management of nonbanking financial institutions than is the case of commodity-producing industries that have extensive global footprints (see Durand and Wrigley 2009 on the global retailing industry). At the same time, it is important to acknowledge that this paper is a contribution to the growing research programme in economic geography and cognate disciplines about the nature and significance of the financial services industry, advanced business services, and related institutional formations of policy and governance. See Coe et al. (2013), Faulconbridge and Muzio (2009), French et al. (2011), Maurer (2008), and Wójcik (2012).

However, this paper is distinctive in that our discussion of contractual frameworks is necessarily abstract because private contracts are proprietary documents. These documents are subject to confidentially clauses designed to limit third-party disclosure of the form and terms and conditions of agreed contracts. In a number of instances, we have encountered situations where disclosure of contractual terms and conditions has been strictly limited even *within* organisations between functions. Is not surprising, therefore, that most studies of contract in the social sciences, including economics, sociology, and management studies do not disclose the sites of fieldwork, the nature and content of the documents analysed, or the parties involved.[1] So, for example, Macauley's (1963, 1985) and Macneil's (1985) seminal studies of the practice of contract make no mention of specific contracts, their terms and conditions, and who was involved. Empirical research on contract tends to rely upon US court cases which lay bare the issues, the arguments, and the points of dispute; even

[1] /. For an exception, see Argyres et al. (2007) who report on a case study of the evolution of contract-making in the US IT industry between an unidentified company and its service providers (also not identified). This study has the virtue of making time an explicit consideration in a wider theoretical treatment of the design and development of private contracts.

here, however, court opinions do not report the substance of the contracts in dispute. These documents are not available for public viewing, even if one was to visit the particular court in which the dispute was heard.

As a consequence, the ways in which contractual relationships in the industry are portrayed in this paper should be treated as provisional rather than definitive. While we have conducted interviews, read documents, and compared different types of contractual frameworks across asset classes, different kinds of financial institutions (public and private pension funds, sovereign wealth funds etc), and service providers across the UK and Europe, and the United States, we are not able to violate the shackles of confidentiality.[2] On the basis of this research, we would suggest that the shackles of confidentiality tend to advantage the provider side of the market in that many clients have neither the legal resources nor the information at hand with which to challenge the terms and conditions of proffered contracts. As many legal scholars have noted, at base, the ideal of contract is a chimera where the practice of contract involves the exercise of power (see Shiffrin 2007). As indicated here, the choice-of-jurisdiction in relation to the exercise of contract can be intimately related to the relative powers of the contractual parties.

The Nature of Contract

Bolton and Dewatripont (2005) and Posner (2003) begin their expositions of bilateral contracts with two self-interested parties who have more to gain from forging a transaction and carrying it through than acting separately. Bolton and Dewatripont assume that both parties are means-and-ends rational and seek to maximise their respective utilities. Explaining the significance of contract, Bolton and Dewatripont suggest that risk and uncertainty can complicate the realisation of planned transactions between well-intentioned individuals. Less analytically, Posner demonstrates that the time involved between making a commitment and realising its completion can provide parties opportunities to engage in gamesmanship. This type of behaviour may harm one or both of those involved or, worse, undercut the willingness of others to make similar commitments.

Whereas individuals can get by on a "cash-and-carry basis", Posner contends that society as a whole benefits from the "good-faith performance" of past commitments. Indeed, the modern economy, based as it is on the division of labour and the specialisation of tasks and functions, trade and exchange, and networks of collaboration is only possible if commitments to exchange in the future are honoured (even in their breach). Posner (2003, 94-95) argues "the fundamental function of contract law … is to deter people from behaving opportunistically towards their contracting parties in order to encourage the optimal timing of economic activity and (the same point) obviate costly self-protective measures." In a related statement, Bolton and Dewatripont (2005, 3) note that their exposition presupposes the existence of "a well-functioning legal system." They assume that "contracting parties do not need to worry about whether the courts are able or willing to enforce the terms of the (agreed) contract precisely." Posner is not nearly as sanguine.

Bilateral contracts have certain characteristics. Parties undertaking these contracts are assumed to do so from unencumbered positions, allowing them to negotiate the best deal without concern for the past. It is also assumed that the costs of contracting are small relative to the benefits to be had from contracting, not just in absolute terms (for each and every contract) but also in relative terms (comparing one contract to another). If circumstances change such that the original terms and

[2] /. In a related paper, we used freedom of information (FoI) rights and privileges to request disclosure of the contracts written by US state and local governments with investment management and financial service providers. In many states, FoI deliberately excludes these contracts from public view. This has led to remarkable differences between public institutions (even in the same jurisdiction) in the form and substance of contracts. See Clark and Monk (2013c).

conditions become unduly onerous on one or both parties, it is assumed there are mechanisms available to renegotiate those terms and conditions. This may include compensation for parties that relied on the original terms and conditions. The efficiency of bilateral contracts depends on the clarity of terms and conditions, especially as regards what counts as the appropriate measures of performance of both parties to the contract. Bilateral contracts are assumed 'complete' in that upon termination there are no residual claims to be adjudicated or interests to be reconciled.

For Bolton and Dewatripont and for Posner, the virtues of contract can only be realised if there are independent bodies to adjudicate between the competing claims of self-interested parties. This is not meant to imply that each and every contract is subject to the force of law. Rather, it is the existence of a system of adjudication, mediation, and enforcement that provides both parties incentives to carry through on their commitments. To the extent that the legal system is an effective and reliable adjudicator of contractual disputes, parties to contracts seeking to avoid the costs of adjudication are likely to self-regulate their behaviour in ways consistent with societal expectations. In this respect, bilateral contracts are instruments for facilitating the efficient realisation of transactions between parties. As Posner observes, contract is more often than not a legal document which has its origins not just in the intentions of the parties concerned, but also in the legal apparatus of the state.

Whereas much of contract theory presupposes that the object of analysis is the bilateral contract, attention has shifted towards relational contracts that are, by definition, incomplete in three ways. First, these types of contracts may extend into time without a specified or required date of termination. Second, the terms and conditions of contracts may be subject to revision and renegotiation over time as circumstances change and as parties seek to rebalance separate and mutual benefits <u>within</u> the contract. Third, these types of contracts may be a means of economising on the search costs associated with finding other parties who may or may not provide complementary services. In this respect, relational contracts are a means of governing economic and financial relationships rather than being simply an instrument that opens and closes at certain dates and times based upon *a priori* defined costs and benefits (as implied by Coase 1937).

By contrast, discrete contracts provide a start date and a termination date as well as an explicit accounting of the costs and benefits to be shared between the contracting parties. If underwritten by social norms and conventions like the moral obligations associated with making a promise, there need not be any ambiguity as to realizing the expected benefits of such contracts, and the role of law in ensuring that those expectations are, as much as possible, met. Relational contracts are more complex and multifaceted. Without a specific termination date, there are periodic reviews of the costs and benefits of remaining with the contract, balancing progress to date in meeting desired objectives against the costs of breaking with the contract and the search costs associated with finding other contractual partners. Consequently, relational contracts are judged successful to the extent to which they cope with and enable parties to adapt to changing circumstances.

Financial Institutions and Financial Markets

To understand the nature and governance of contractual relations between asset owners and asset managers, it is important to establish the relevant contextual variables that give rise to observed behaviour. Whereas much of the discussion about contract in law and economics eschews contextual variables, economic geographers emphasise the interaction between theoretical principles and context suggesting that observed outcomes are best understood at the intersection between these elements of theory and practice (see Bathelt and Glückler 2011). It is notable that cognitive science makes a similar move when explaining observed behaviour: cognitive predisposition is mediated by the environment in which people make decisions and provides for wide variation in plausible behaviour (Clark 2013). There are four factors crucial to understanding the nature and scope of contracting in financial institutions and markets.

Chains of providers

The financial institutions that are the objects of our research are beneficial institutions in that they act on behalf of absent owners or silent beneficiaries. Attempts have been made to engage principals so as to encourage involvement and direct expression of their interests. However, most principals are neophytes when it comes to understanding and giving voice to their long-term financial interests. Corporate officers and trustees act in their stead subject to common law and statutory requirements as to the exercise of authority and responsibility. Corporate officers and trustees normally do not have high-level financial skills, notwithstanding their responsibilities (Clark and Monk 2013a). As such, they typically delegate responsibility to others inside and outside of the institution for realising the investment objectives of the institution, and hence the interests of beneficiaries. These agents are accorded deference for their domain-specific skills and expertise (Clark 2007).

In large part, fiduciaries are the nexus joining the interests of beneficiaries with the skills and expertise of agents. Typically, they report to beneficiaries on an annual basis the status of their entitlements, the financial standing of the institution, and the circumstances affecting their current and expected welfare. Agents report on their performance to fiduciaries on a more regular basis (perhaps monthly, often quarterly, and certainly annually). Performance criteria are normally established by contract; more often than not, performance criteria are part and parcel of the norms and conventions of the financial services industry and include, for example, appropriate third-party measures of relative performance against industry benchmarks. In many cases, fiduciaries employ other agents to certify the integrity and quality of reported performance measures. Fiduciaries may also employ agents to collect performance data from a wide range of industry providers so as to provide reference points against which to evaluate stated performance. These agents and others are elements of complex networks of service providers governed by contract.

Structure of the industry

Financial institutions owe their headquarter locations, if not their sites of operation, to the entity or entities that represent beneficiaries. Their corporate officers and trustees are typically located at some distance from major financial centres and the handful of global financial markets that dominate international financial stocks and flows. By contrast, most agents co-locate in national financial centres and have a significant presence in global financial markets. Electronic networks sustain the routine communication between (dispersed) financial institutions and their (centralised) agents, as well as the collection and distribution of financial assets to the myriad of agents located in the major financial centres. In Clark and Monk (2013b), we provide an explanation of how beneficiaries, fiduciaries, and agents are electronically linked together over time and space.

At the global level, the financial services industry is dominated by multinational firms. Economies of scale and scope reinforce the complementarities between tasks and functions so as to enable the provision of products and services with appropriate market-facing characteristics (see Clark 2002). In London and New York, small providers co-locate with the large providers, operating at the margins of service provision amenable to innovation and development (such as hedge funds). In major continental European centres, large banking institutions – being more often than not, national 'champions'–tend to dominate the provision of financial services. Their size and significance is such that intermediation is limited, with many tasks and functions held internally rather than out-sourced. Market density is less than anticipated on the basis of 'local' assets under management (AuM). This has implications for the site and process of contracting (see Gilson et al. 2012). London and New

York are hosts to a remarkable depth and range of financial service providers, offering products, services, and organisational forms not otherwise available in national financial centres.

Products sought and produced
Manufacturing industries produce material goods. Financial institutions deliver services: they contract with investment managers to produce a target rate of return on assets invested. The target rate of return may be specific to an asset class, a certain (industry or geographic) segment of an asset class, and the style or strategy of investment. The target rate of return may be accompanied by limits imposed on risk exposure and the holdings of certain securities within agreed asset classes. Typically, investment managers report performance against either an absolute return target or a relative return target measured against industry norms and benchmarks (Clark 2000). Investment managers require a minimum volume of assets to manage, base fees on AuM, and shy away from performance-related compensation (aside from certain classes of alternative investments).

Elsewhere, the financial production process is explained by reference to the resources or strategic assets of investment firms. These include the talent and skills of portfolio managers, the process of decision-making, and the information infrastructure that supports judgement, authority, and action (Clark and Monk 2013a). Typically, contracts written between financial institutions and investment managers are open-ended in that investment managers are expected to invest according to the target rate of return until the client indicates a wish to change strategy and/or terminate the agreement. In part, this is due to the fact that the target rate of return is set against expected liabilities, which can extend far into the future (10, 20, even 50 years). The transaction costs involved in assessing performance, deciding to change managers, and hiring replacement managers (or re-allocating AuM to existing managers) are significant for small and large financial institutions.

By convention, both parties can terminate these contracts with a couple of days, a week, or perhaps a month's notice. However, some investment managers, particularly those in illiquid asset classes like infrastructure, require clients to commit assets over the long term, utilising lock-in provisions and penalty clauses for early termination so as to deter financial institutions from switching assets between managers should performance fall short of expectations. In many cases, target rates of return allow for a specified range of returns around a central point. To the extent that target rates of return are set with respect to industry benchmarks, the interests of financial institutions and investment managers may diverge when, for example, managers meet their benchmarked target rates of return in a declining market. In any event, many 'manage' returns so as to maintain good relations with their clients even if that means adapting or dramatically shifting their investment activities and transactions to meet return targets at specific dates.

Product and financial markets
The target rate of return is produced by investment managers in national and global financial markets. But there is considerable variety in the structure, performance, and management of stock markets around the world (Wójcik 2011). Furthermore, it is evident that there is a hierarchy of financial markets such that regional markets tend to follow national markets, and national markets either lead or follow global markets depending upon their place in the 24-hour trading clock (Clark and Thrift 2005). Some markets are more efficient in terms of price formation and disclosure than others. Here, there are four crucial issues.

- First, developed markets oscillate between periods of relative calm (where expectations tend to be met and encourage further trading) and moments of turmoil and disruption (where expectations are often not met and, as a consequence, either encourage higher levels of turnover or encourage investors to sit out market turmoil in the hope of re-entering when expectations are more settled).

- Second, financial markets are non-stationary in the sense that momentum carries forward market participants, their expectations, and their plans for the future. Market participants adapt their expectations against observed and expected conditions such that markets hardly ever go backwards and, more often than not, go forwards (Lo 2011). As such, risk models that approximate current market conditions are vulnerable to unanticipated shifts in market conditions and expectations such that these models can become self-defeating.

- Third, the repeated process of producing the rate of return does not necessarily lead to a closer-and-closer approximation of the 'target'. The production process depends upon anticipating market movements and others' reactions to more or less commonly-observed information. Unanticipated shifts in market sentiment and behaviour as well as exogenous shocks are common (Shleifer 2000). Noise can radically affect the skills and expertise of managers that were better than average in previous periods (compare with Gertler 2003 and Levitt et al. 2012).

- Fourth, herding is a reasonable defensive strategy in that if the target rate of return is benchmarked against market performance, following market sentiment is a way of approximating clients' expectations even if this type of behaviour reinforces systemic shocks.

Investor strategy
We distinguish two kinds of investing: one kind is deliberate and based on skills and expertise with respect to target rates of return, while the other is essentially gambling on the path of market sentiment. Unfortunately for clients, it is often difficult to distinguish one from the other especially if there appears to be some randomness in the period-to-period sequence of returns reported to clients. Investment managers may reap the benefits of having a certain stock of skills and expertise and decision protocols that map onto (current) market momentum. But past success can promote an illusion of skill, ignoring the underlying properties of financial markets (Kahneman 2011). In this respect, clients may incorrectly attribute skill and expertise to investment managers, reinforcing commitment by increasing their allocation of AuM. When events turn against investment managers, it may be difficult to identify the causes of shortfalls in performance.

Contract – Form, Functions, and Performance
For some theorists, historical differences between nations' institutions are enough to distinguish between Anglo-American, continental European, East Asian, and Latin American regimes or systems of states and markets (Greif 2006; see also the literature spawned by Hall and Soskice 2001 on the 'varieties of capitalism'). For yet others, differences in institutional form are less significant than their functionality when nation-states and major corporations respond to global financial imperatives (see Clark and Wójcik 2007; Dixon 2012). For others, form is less significant than substance in that the former is deemed a 'shell' given life by the specifics or issues that take it into the world of practice (Kennedy 1976). In this section, it is argued that form is very important and valued as a thing in itself. So too are the functions of contract and how it is governed. Both are important in understanding the performance of contractual relationships between financial institutions and agents and the choice of jurisdiction in which to locate contract.

Form
Summers (2006, 5) suggests that a "form-oriented mode of analysis" should focus upon the units of a legal system, emphasising their purposes, constituent features, and organisational structure. A unit can be distinguished in terms of its resources and its boundaries. He noted that units must be seen in relation to "the legal system as a whole." Crucially, he suggested legal procedures, rules, and regulations almost always come after the formation of legal systems and units. As is widely acknowledged, Anglo-American legal systems combine vestiges of English common law, of which

contract law is a constituent element, and statutes that represent the scope and significance of the regulatory state through the 20th century (Calabresi 1982). For centuries, English courts 'regulated' the nature and scope of private contracts on a case-by-case basis. Through the 20th century, contract law was formalised in statute in terms of both its scope and its necessary ingredients.

Contract embodies certain features and characteristics that are intrinsically valuable. Riles (2011, 3) observed that when the US government rescued AIG in the depths of the global financial crisis, the one thing that was deemed sacrosanct was the "rule of law" (maintaining the integrity and enforceability of collateral contracts). The significance of contract could be attributed to its functionality (see below). However, the point made by Riles is that whereas functionality can be measured and gauged in terms of its efficacy, the significance attributed by policy makers to contract as an institution meant that policies that might have discounted the value of contractual commitments were simply not considered. She also observes that the global financial services industry values UK (England and Wales) and US contract law far higher than the contract law of other jurisdictions. This is despite the fact that the majority of financial transactions and agency agreements originate in far-off jurisdictions.[3]

Being a constituent element or unit in Anglo-American legal systems, contract is expressed in validated documents. Financial contracts come in a variety of shapes and sizes as befitting the specific interests and circumstances of the parties to contract. However, it is apparent that the financial services industry and its associated professional bodies have encouraged the adoption of standard contractual models and templates. Standardisation simplifies negotiation and agreement, encourages the formation of shared expectations and commitments, and economises on transaction costs. It also facilitates agency relationships with external providers and, ultimately, deepens the market for financial services. Furthermore, standardisation provides legal advisers and the consultants that manage the process of evaluating potential agents, a ready-made 'independent' basis for assessing the proffered contractual terms and conditions. Nonetheless, there is a market for standardisation with various providers competing for dominance (compare Gilson et al. 2012).

Functions

Posner (2003, 98) summarises the functions of contract as follows: "(1) to prevent opportunism, (2) to interpolate efficient terms, (3) to prevent avoidable mistakes in the contracting process, (4) to allocate risk to the superior risk bearer, and (5) to reduce the costs of resolving contract disputes." These functions have a behavioural element, a procedural benefit, and an overarching economic benefit relevant to the parties concerned as well as society as a whole (e.g., to allocate risk to parties that are best able to bear those risks). In the financial services industry, standard investment management agreements (IMAs) cover a wide variety of asset classes and are intended to prevent opportunism and reduce the costs of resolving *ex-post* contractual disputes. As such, IMAs are used to regulate the relationship between parties, relying upon the agreement to structure any subsequent negotiation. Note, however, investment managers rarely bear the costs of poor investment performance directly; poor performance can, however, prompt clients to terminate their IMAs.

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[3]/. There are various legal regimes around the world, based upon quite different principles and historical traditions. La Porta et al. (1998) argue that English common law regimes are more consistent with the imperatives driving global financial markets than many other types of regimes (notably continental European traditions). By their account, the global financial services industry gravitates to jurisdictions that rely upon English common law, avoiding (when given a choice) other more restrictive or inflexible regimes. Our argument is consistent with this thesis although we do not believe that the map of legal regimes is necessarily determinate of the nature and scope of global financial markets (see Clark and Wójcik 2007).

In the financial services industry, the narrative accompanying contract is used to define what is covered by the agreement, the terms used in the agreement, and the procedures whereby the agreement is implemented (start date, notice of termination, and expectations as regards to continuity). Quite literally, contract is a means of performing an agreement between parties. Contracts for financial services can be extensive in scope, and quite demanding in terms of the expertise needed to understand clause by clause. The standard UK IMA runs 60 to 70 pages in length and requires side-letters to clarify points subject to interpretation. However, some principals and some agents are content with short, simple, and relatively open IMAs, leaving the meaning and interpretation of the agreement to the parties concerned on an ongoing basis. In this respect, contracts serve as frameworks for relationships with service providers that stretch over time and space.

IMAs normally specify the fees involved in managing allocated assets, varying by asset class and style of investment. However, these agreements are less precise when it comes to specifying the 'service' provided by investment managers and the criteria to be used when determining whether performance has met agreed targets. As noted above, risk and uncertainty are ever-present features of global financial markets. In this regard, contracts can be seen as instruments designed to forestall overreaction to unexpected events in financial markets, thereby promoting a longer-term view of the significance of individual events in relation to market volatility. Notwithstanding the fact that most IMAs allow for termination at will, the transaction costs involved in exercising those rights are significant, especially if switching between providers becomes a customary response to short-term events. Even so, it is widely assumed that clients switch between providers more often than is justified by trends in manager and market performance (Kay Review 2012).

Performance

By convention, contract is 'performed' in the financial services industry in three different ways. First, clients are sent quarterly reports on investment performance referencing the appropriate benchmarks and risk protocols. Second, annual visits to the client by the fund manager provide an opportunity for justifying investment performance and prospects. Third, the fund manager may solicit representatives of the client and other clients to attend conferences which set out new research and investment programmes. Here, fund managers seek to bypass other agents like investment consultants. The default option is continuity of the relationship. Breakpoints in the relationship appear when there is evidence of systematic negative (relative) performance over time, or where there are indications that the fund manager's narrative as to the chosen investment strategy, its conception and implementation, and its place in the world relative to other fund managers lacks coherence or plausibility.

Fundamentally, contracts are an important way service providers sustain their businesses. Given increasing returns to scale, the fact that company-specific compensation is often tied to the volume of AuM, and the benefits of liquidity for portfolio managers when seeking to manage returns against benchmarks, continuity of client commitment is a necessary if not sufficient condition for success. Large short-term inflows and outflows of assets can rapidly increase processing costs and disrupt risk and return strategies for whole asset classes and across asset classes in financial institutions. In these circumstances, many investment managers have an interest in writing IMAs so as to dampen client switching while giving their portfolio managers time to recover their short-term positions against the relevant benchmarks if necessary. Contract is 'performed' in a manner consistent with the separate as well as shared interests of clients and managers.

Governance and Choice-of-Jurisdiction

In this section, we bring the discussion of contractual form, function and performance to bear on the choice-of-jurisdiction. We show that the choice-of-jurisdiction can play an important role in governing contractual relationships. We concentrate on three strategic options: *in situ* or default contracting, choosing to contract in London, and choosing to contract in an offshore jurisdiction.

In Situ or Default Contracting

Ethnographies of financial institutions note that the structure of the industry is taken for granted by market participants (see O'Barr and Conley 1992; Abolafia 1996; Riles 2011). In a similar fashion, economic theorists take for granted the existence of well-functioning legal systems (see Bolton and Dewatripont 2005). One indication of the significance of the commonplace in the global financial services industry is the ready acceptance of standardised IMAs. As noted above, these agreements find favour on both sides of the market and are often legitimated by agents that have an interest in certifying the status of these agreements. These agreements are not 'official' in the sense of being mandated by government but originate with industry associations, professional bodies, and consulting companies. Given the importance of a relatively small number of multinational law firms in the global financial services industry, it is not surprising that similar IMAs are to be found around the world including the UK and Europe, North America, Australia, and Hong Kong (Beaverstock 2004).[4]

Standard IMAs reference the asset class or classes and the investment style of the mandate and summarise the objectives of the mandate and the fees charged by the manager. If the target rate of return is identified, it is set within the context of a relevant benchmark, an acceptable band around that benchmark, and the time period over which performance is to be judged. Accompanying these schedules are documents on issues such as custody, securities lending, risks, etc. Also included are statements about how redemptions might be made, the notice period required in exercising redemption, and caveats on redemptions such as when markets are "disrupted". Parties to these contracts agree not to disclose terms and conditions without the express permission of the other party. As for disputes about performance, standard IMAs typically set out a dispute resolution process which can include the investment manager's head of compliance, industry-based dispute resolution systems (national and international), and, in the UK, the Financial Ombudsman Scheme.

However, care should be taken not to exaggerate the significance of standardised IMAs. In some corners of the market of investment services, notably hedge funds, clients are confronted by complex contracts that lack the transparency and disclosure typical of standard IMAs. Clients are challenged to either accept these types of contracts or incur the transaction costs involved in negotiating line-by-line and provision by provision the proffered terms and conditions. For many clients, reliant upon fee-for-service external legal advisors, the transaction costs involved can be a significant constraint on the willingness of parties to negotiate. As a result, these providers may produce a type of 'standardised' contract that does not carry the approval of the relevant industry associations and professional bodies but nonetheless is 'accepted' industry practice. The willingness of clients to accept these types of contracts in niche segments of the market is often legitimated by claims of superior financial performance.

Contracting in London

There are many accounts of London's domination of the European financial services industry (e.g. see Clark 2002 and Faulconbridge et al. 2007). London provides a 'deep' marketplace for the services needed to function in global financial markets; it casts a significant shadow over Europe's financial centres. As anticipated by Gilson et al. (2012), London provides off-the-shelf standardised

[4]/. See also Faulconbridge's (2008) work on the structure and management of multinational law firms. He suggests that the diffusion of templates and their sequential revision and re-calibration to fit changing circumstances is aided by the interchange of legal professionals within and between these global companies.

contracts for a wide range of financial services. Standardised contracts often come with the approval of relevant industry associations and professional bodies, the advice of consultants and law firms, and the tacit approval of the UK financial regulator (notwithstanding the exceptions noted above). When coming to London to purchase financial services including investment management, European financial institutions rely upon the experience and expertise of London-based institutions. Reliance is reinforced by low transaction costs and claims of accepted convention legitimated by practice (often not available at home).[5]

By writing contracts in London, or by writing contracts that require settlement in London, purchasers of financial services rely upon the form and functions of UK law. Whereas it is easy enough to understand the functionality of the legal system, the formal properties of UK law are desirable in their own right. In part, this is because of the independence of the UK judiciary and the equitable status attributed to claimants in the legal system. Its reputation for adjudicating disputes on the merits of the issues provides claimants confidence that their interests will be respected even if they should not win.[6] Furthermore, there are close consultative arrangements between the City of London, the Bank of England, and financial regulators such that events or cases that would render adjudication problematic are used to fine-tune the relevant supervisory processes (McCormick 2010). Finance, law, and geography are bound together in ways that sustain the status of London in the global financial services industry (in much the same way that Delaware dominates the US market for corporate governance; see Gilson et al. 2012).

It should be emphasised, however, that there are few contractual disputes that find their way to the Ombudsman and the alternative dispute resolution processes. There are three possible explanations for this fact. First, parties that use the standard IMA believe provisions for governing contractual relationships are fair and equitable. Second, the transparent nature of the judicial system carries with it the prospect of reputational damage should investment managers violate the norms and conventions associated with the implementation and execution of such agreements. Third, the widespread reliance upon London as the site through which to contract with financial service providers is such that it provides clients the opportunity to legitimate decision-making even if mistakes are made in the governance of those contractual relationships.

Contracting in Offshore Jurisdictions

In the previous section, we explained why London is a desirable jurisdiction for financial institutions from continental Europe and beyond to write contracts with global financial service providers. It is apparent, however, that UK and European financial institutions also write contracts in jurisdictions

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[5]/. It is not uncommon for asset owners to seek advice from legal advisors on the industry status of various types of contracts, relying upon the norms and conventions in the industry to justify acceptance of terms of conditions that would not be thought acceptable in other jurisdictions or industries. This practice is consistent with the history of contract law and the deference shown to the terms and conditions of contracts willingly undertaken by parties to private contracts (see Eisenberg 1998).

[6]/. There have been few UK instances of a contractual dispute over investment management coming to open court. The most celebrated case is Unilever Superannuation Trustees Ltd v Mercury Asset Management (circa 2000) which was settled just prior to the start of proceedings. A recent case (2012) involved a UK fund manager and a group of its clients. The latter charged the former with changing the composition of its investment product beyond that allowed by the contract. The court held in favour of the fund manager. This case was exceptional, and may have harmed the reputation of the fund manager more than the claimed variation in investment strategy damaged the substantive interests of the plaintiffs. See Certain Ltd Partners in Henderson PFI Secondary Fund II LLP (A Firm) v Henderson PFI Secondary Fund II LP (A Firm) [2012] EWHC 3259 (Comm).

beyond the reach of the courts of England and Wales. For example, Dublin and Luxembourg are financial centres specialising in certain types of financial services providing tax-related advantages for both principals and agents. In this section, we are less concerned with European tax havens than offshore jurisdictions such as the Cayman Islands (see also Wainwright 2011 and Wójcik 2012). Jurisdictions like the Cayman Island enable financial service providers like hedge funds opportunities for writing contracts with distinctive governance characteristics.[7]

One difference between UK IMAs and the contracts offered in offshore locations is their simplicity. Investors are typically offered an application form to purchase shares in a notionally self-governing fund *administered* by agents located in those jurisdictions but *managed* by agents located in London. Application forms include provisions for the legal status of applicants, enabling fund administrators the opportunity to exclude certain institutional investors likely to demand greater transparency and accountability. According to the size of the investment, applicants are offered different classes of shares, some of which have voting rights. In many cases, the goals and objectives of the fund are very broad and emphasise the style of investment. There may be little detail as to the expected exposure to certain asset classes, target rates of return, risk budgets, and relevant benchmarks against which to judge performance. In some cases, clients have the right to sell their shares back to the fund (subject to terms and conditions). In other cases, clients must agree to long-term lock-in provisions and the commitment of further assets over specified periods of time whatever the performance of the manager.

In many cases, applicants are informed that the fund administrator and its agents have discretion over all matters pertaining to its administration, management, and investment strategies. In some cases, applicants are provided a fund Prospectus and notice that the Articles of Association of the fund are available upon request. If applicants purchase voting shares, they may be permitted to attend the annual general meeting of the fund held in the offshore jurisdiction. However, the power to appoint directors to the fund, set the agenda for annual general meetings, and purchase services from other agents typically reside with the fund administrator. The fund, its custodian, its legal adviser, its auditor, and its investment manager are notionally separate legal entities. And yet, when deciding whether or not to invest in the fund, financial institutions interested in investing in these entities normally receive presentations from the London-based investment manager. Whether by management and/or ownership, the offshore fund and its London-based investment service providers are intimately related (Wainwright 2011).[8]

This contract could be cast as a relational contract in that it binds the parties together over the long term. As well, in a formal sense, it has a governance structure allowing for the representation of client interests. Whether or not clients hold voting shares and exercise their powers through the Articles of Association normally depends on whether clients are willing and able to meet the threshold of investment required to claim voting rights and whether clients are willing and able to

[7]/. Clients are often not aware of the tax benefits that accrue to financial service providers (and especially their principals) providing funds domiciled in offshore jurisdictions. Associated with these arrangements are back-office processing and compliance operations the costs of which (local wages, office space charges, and telecommunication fees) are much lower than found in London and New York. These benefits are often emphasised in 'beauty-parades'.

[8]/. It may be that investment managers are better able to their shelter fund-related earnings from UK and US tax authorities in offshore jurisdictions using local rules and regulations pertaining to the treatment of such earnings to delay or discount reported earnings. This can benefit the principals of such funds and their investment managers and spill over to employees via the payment of bonuses etc. This type of arrangement may be less attractive to large, diversified investment managers where ownership is diverse and not involved in the management of the institution.

exercise those rights. The costs involved in exercising voting rights in far-off jurisdictions are significant, considering these types of investment vehicles are normally small components in most institutions' overall investment strategies. Consequently, it is not surprising that these contracts default to being purchasing agreements that have little in the way of effective governance procedures. Here, form is an empty shell. Its functionality in terms of promised returns is the primary decision variable as to whether to enter into such a 'relationship'.

The Map of Contract

In the previous discussion, we brought together the form and functions of contracts that bind together asset owners and asset managers, showing that form matters (the laws of England and Wales) and function matters (being a mechanism for governing the relationships between these rather different organisations). At one level, the standard IMA has many properties consistent with a bilateral contract. It provides both parties the opportunity to terminate at will any contract for investment services, requiring very little in terms of advance notice of termination. The standard IMA also provides considerable detail in terms of the costs of services, the relevant benchmarks against which to evaluate performance, and reasonable boundaries on the asset classes and instruments deemed consistent with the investment mandate. However, we have argued that the standard IMA is actually a relational rather than a discrete contract and, as such, it seeks to govern the relationship between parties, recognising that the objectives of these contracts can extend far into the future. The distinction between discrete and relational contracts is harder to sustain in practice than often recognised (Kimel 2007).

In this respect, the standard IMA functions as a relational contract in that it dampens opportunism, limits overreaction to short-term events, and provides investment managers with a timeframe through which to demonstrate skill and expertise. If, as Kahneman (2011) contends, investment management promotes an illusion of skill, treating bilateral contracts as relational contracts allows asset owners a chance to judge service providers against competing options. Knowing this is the case, investment managers seek to dampen short-term volatility in returns, while guarding against trends in longer-term performance that fall short of the relevant benchmarks. By this logic, parties to IMAs understand the game played on both sides of the agreement and willingly accept the rules of the game. Continuity of contract is oftentimes explained in terms of inertia (a behavioural predisposition). In a similar manner, continuity of contract is explained here by reference to the advantages of maintaining relationships given the problems associated with assigning cause and effect in the context of market risk and uncertainty.

By this assessment, both sides of the market have an interest in converging on a standard or accepted form of contract. This is made possible by industry groups and professions who have a vested interest in facilitating or deepening the market for financial services—in the absence of a widely accepted form of contract, it is more than likely that institutions would tend to avoid the transaction costs involved in designing, negotiating, and executing bespoke agreements. In these circumstances, the largest institutions would likely substitute contracts for financial services with employment contracts for personnel employed by these institutions to produce these services internal to the organisation (Clark and Monk 2013a). Intermediation is made possible by the standardisation of contract and, most importantly, the ready acceptance of one jurisdiction as the reference point for industry standards. We contend that the supply of, and demand for, UK contract law is a crucial ingredient in explaining the European map of the financial services industry and the geographical patterns of intermediation.

We have also sought to show that contract can vary by jurisdiction such that offshore financial centres can offer governance regimes that are quite different to that which dominates the investment management industry of the UK and Europe. Financial institutions willingly accept a form of investment contract that effectively denies them an active voice in its governance. This type of contract appears to be relational in that it binds the parties together over the long term with, in some cases, limits on withdrawal and mandatory periods of lock-in. And yet, notwithstanding the formalities associated with the governance of this type of arrangement, few investors have powers consistent with the effective governance of this type of arrangement. In effect, this type of arrangement is more consistent with a bilateral contract than it is consistent with the theory of relational contracting. Parties to these types of arrangements know full-well the differences between standard IMAs and the types of agreements that are found in these offshore jurisdictions.

Even if investors have rights in terms of the governance of these types of arrangements, these rights are very difficult to activate and carry through on a consistent basis. Why, then, do investors agree to terms that seem to violate the notional advantages of relational contracts? Here, there are three explanations. In the first instance, investors may come to believe that the standard IMA is a means of 'client capture' rather than being, as oftentimes assumed, an equitable self-governing instrument. Investment management companies find refuge in these types of agreements, being a mechanism through which to 'manage' clients' expectations. This is especially important when asset owners have neither the time nor the resources to actively engage investment managers on issues that directly benefit their interests. In the second instance, the standard IMA is, in any event, validated by the industry as a whole such that re-writing these agreements can be a very expensive proposition without any certainty as to its likely consequences (cost-effective, superior rates of return).

There is, perhaps, a third less obvious explanation. The existence of alternatives to the standard IMA and related expectations regarding its governance and execution are often strategic elements in the on-going search by asset owners for influence over the costs and benefits of contradicting with the global financial services industry. In many investment portfolios, offshore providers running with asymmetric bilateral investment management contracts are relatively small components of institutions' investment programmes. So, for example, the types of investment strategies pursued by hedge funds based in offshore jurisdictions are often different from those provided by the global investment houses that utilise the standard IMA across asset classes (bonds, equities, etc.). There is a subtle and often unacknowledged connection between the investment strategies pursued by those entities that require clients to sign up to asymmetric bilateral contracts and the entities that provide standard investment services. It is the existence of 'alternative' investment managers based in offshore jurisdictions that asset owners use in their attempts to impose discipline upon the larger providers in the global financial services industry.

Conclusions

Understanding the governance and management of financial institutions is one element of a comprehensive explanation of the global financial industry. How financial institutions are managed, how their geographical scope is sustained, and how they are governed in relation to the network of service providers within and across markets are vital topics in our research programme (Clark and Monk 2013a, 2013b). Here, we have extended the analytical framework to the nature and governance of contractual relationships in the industry with particular reference to the place of London in the European market for financial services. In part, this paper is about the design and functional performance of different types of contractual forms (bilateral and relational contracts). It is also about the special place of offshore jurisdictions in the market for financial services relative to continental Europe and London. Wójcik (2012) suggests these offshore jurisdictions provide 'action spaces' for financial leverage and arbitrage. In this paper we have also pinpointed offshore jurisdictions as strategic elements in the governance of the contractual relations between asset owners and asset managers.

At one level, our conception of contract is quite conventional: it is the means by which financial institutions govern their relationships with the financial services industry. As such, it is argued that the form of contract is an important element in framing the relationships between these parties and has a number of important dimensions including its place in the institutional framework of the state. As such, the form of contract, its design and documentation, and the proper ways in which these instruments are executed are reliant upon the legal edifice. We also show that contract has a number of important functions, including binding parties together over time and space in the context of financial market risk and uncertainty. Contract governs opportunism and the possibility that agents may exploit asset owners because the latter are unable to systematically discriminate between managers who are 'lucky' as opposed to 'skilled' in realising rate of return objectives. So as to illustrate the ways in which these types of contracts are performed, we focus upon three different strategies: *in situ* contracting, contracting in London, and contracting in offshore centres like the Cayman Islands.

Our 'geography of contract' resonates with recent initiatives in economic geography that emphasise the relational aspects of economies and societies (see Bathelt and Glückler 2011). It is rather different from neoclassical economic models of contract that emphasise the role of contract as the means of realising intended transactions, and more recent theoretical treatments of contract that emphasise bilateral contracting over relational contracts (Bolton and Dewatripont 2005). In our analysis, the sharp differences sometimes attributed to bilateral and relational contracts are less important than how they perform as governing devices designed to sustain relationships. By emphasising governance we have discounted contract as the embodiment of moral obligation or commitment, a thread of argument evident amongst legal scholars (see Fried 1981; Kimel 2005). Nonetheless, it is apparent that the nature and performance of financial contracts are embedded in social and political formations (nation-states). Here, we have argued that form alone is insufficient to explain the use of contract as a means of governing commercial relationships over time and space (see also Dixon 2012; compare La Porta et al. 1998).

Two implications follow from our analysis. One has to do with the ongoing debate about the significance of London for the global financial services industry. In some quarters, London casts an unwelcome shadow over continental Europe suborning domestic financial institutions into what some commentators disparage as casino capitalism (Sinn 2010). On the other side of the Atlantic, commentators rail against the continuing importance of London for international financial transactions. By our account, London thrives because of the density of market intermediaries found in the city (compared to the major financial centres of continental Europe) and the fact that these services are available in a jurisdiction that offers accepted contractual terms and conditions underpinned by a judicial apparatus which promises adjudication on its merits (if need be). The fact that there are so few cases brought to court about the performance of contracts for financial services suggests that the form, functions, and performance of these contracts is thoroughly internalised into customary practice.

Our analysis of contracts in the investment management industry also pinpointed significant shortcomings in customary practice. The standard IMA carries with it certain advantages and disadvantages; it is a means of economising on transaction costs, relying upon familiarity and broad acceptance to gloss-over the fact that it can be a mechanism for holding hostage clients who have neither the resources nor the sophistication to rewrite contracts in their interests. Being a mechanism for governing relationships, the standard IMA tends to reinforce past commitment in circumstances where expert judgement may reasonably call for a reassessment of its terms and conditions in the light of the performance of suppliers. On the other side of the market, simplified contracts are offered by providers that require levels of deference and delegation that clients would otherwise reject if suggested by major multinational service providers. That these rather different, even competing, forms of contract coexist in London, and are available to local, European, and international clients suggests that customary practice is contested (albeit obliquely).

Between 'capture' and 'coexistence' is the strategic use of contract by clients so as to manage their service providers. To do so may involve, for example, discounting standard IMAs and forsaking the simplified contracts of offshore providers in favour of bespoke contracts that explicitly serve the interests of clients rather than clinging to the assumption that the parties to financial contracts are notionally equal 'partners' in the process of investment management. Here, of course, financial institutions may face significant barriers in realising their ambitions to strategically manage contract. Few institutions have the resources necessary to design bespoke contracts, and even fewer institutions have the resources necessary to oversee their implementation and compliance. One way forward may be for financial institutions to claim control over the design of contract, pushing aside industry sponsored standard IMAs in favour of common contracts that fit certain types of financial institutions and certain types of financial products.

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