Enhancing Responsibility in Financial Regulation – Critically Examining the Future of Public – Private Governance

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2009/10
Abstract

This paper will be published as an article in two issues of the Law and Financial Markets Review (Oxford: Hart Publishing, 2010). Section 1 of the article argues that “financial regulation” is essentially a decentred regulatory space. A regulatory space refers to a landscape where a variety of actors and interest groups may have resources, capacity and ability to exert influence over the governance of issue areas in the landscape. Where the financial services landscape is concerned, the regulatory space is dominated by the industry and regulatory agencies, giving rise to governance driven by industry interests and objectives as well as public interest. Section 2 of the article then provides a literature review of modern governance and regulation theories to show how “public-private” models in governance have been developed in contemporary theory and practice. Section 3 draws on the literature review to discuss specific areas in financial regulation represented by different models of “public-private governance” and critically examines the nature of “public-private governance” in the context of the global financial crisis. Section 4 argues that “public-private governance” in financial regulation has given rise to problems of unaccountability, agency and capture, and some suggestions are made in relation to the dynamics of the “public-private governance” going forward.

1. The Nature of Governance in the Financial Services Landscape

Modern financial regulation, following international financial liberalisation and deregulation in many nation states, may be characterised as follows: the prevalence of the legitimacy of market based solutions as a form of governance; the recognition of the limitations of state-based regulation in favour of internationalised governance and the acceptance of internationalised governance as a dynamic and participative process that could be termed as a “regulatory space”.¹

With globalisation and financial liberalisation,² the growth of the global investment economy and the power of private entities have led to financialisation³ - often explained as the dominance of financial services and products in global wealth creation, and the empowerment of private entities

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¹ Term first used in Colin Scott, “Analysing Regulatory Space: Fragmented Resources and Institutional Design” (2001) Public Law 329. The “regulatory space” is a metaphor used to describe the idea that resources and information are often dispersed and fragmented among a group of constituents that are interested in an area of governance, and hence the exercise of powers of governance or regulation may actually be dispersed rather than concentrated in the hands of the government.

² An account of financial liberalisation may be found in John Williamson and Molly Mahar, A Review of Financial Liberalization (World Bank, Washington, 1998).

³ Gerard A Epstein (ed), Financialisation and the World Economy (Cheltenham: Edward Elgar 2006), esp at chapter 1 “Introduction”.

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involved in this economy. Financialisation is characterised by deregulation\(^4\) in financial services and markets, and the rise in power of non-public and state based entities involved in standard setting, supervision and securing compliance.\(^5\) This phenomenon also sets the backdrop for the ideological movement from liberal political economy to neo-liberalism, and the predominance of economic theories of regulation.\(^6\) The market itself would be regarded as the first port of call for solving problems generated in the market.\(^7\) Globalisation has often been described as the precursor to a gradual phenomenon of denationisation or de-statistation,\(^8\) and the rise of non-state actors to lead in the real governance of various internationally connected issues. Such non-state actors could be international organisations or networks of policy-makers, technocrats or members of the industry,\(^9\) or powerful financial institutions themselves.\(^10\) Financialisation has not only transferred wealth and

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resources to the global financial sector but has also allowed the financial sector to become a credible player in designing the governance and infrastructure surrounding its activities.\textsuperscript{11} Such governance often results in outputs of “law”,\textsuperscript{12} from legalisation such as under the World Trade Organisation\textsuperscript{13} to more pluralistic forms of soft law.\textsuperscript{14} The sources of what may be termed “law” have become more varied, as private sector participants have increasingly produced “codes” and other outputs of governance and regulation that have a norm-like character.\textsuperscript{15} The plurality of the nature of law and governance is a consequence of the plurality in participation in the “regulatory space”. “Public-private governance” is a form of new governance encompassing a range of public and private actors, competence, resources and centres of influence and power.\textsuperscript{16}

Public-private governance in the financial services industry is situated in a “decentred” regulatory space. Black argues that decentred regulation is premised on five preconditions, namely complexity, fragmentation, interdependencies, ungovernability and the rejection of a clear private-public

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\textsuperscript{12} Judith Goldstein, Miles Kahler, Robert O’Keohane and Anne-Marie Slaughter, “Introduction to Legalisation and World Politics” (2000) 54 International Organisation 385, defining legalisation as a process increasing state participation in multilateral arrangements that would increasingly commit them to formulate clear and dependable norms which would either become hard or soft law. The form of “strong” legalisation such as found in the WTO arrangements are discussed in Sol Picciotto, “The WTO’s Appellate Body: Legal Formalism as a Legitimation of Global Governance” (2005) 18 Governance 477. Less “strong” forms of legalisation often manifest in various forms of soft law.


\textsuperscript{14} Orly Lobel, “The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought” (2004-5) 89 Minnesota Law Rev 342 where governance becomes a shared process where different public and private actors may contribute towards, and regulators may act more as facilitators than prescribers.


“Complexity” refers to the nature of problems that may need to be governed. “Fragmentation” refers to the fragmentation of knowledge, resources, and capacity for control, much like the analysis of the “regulatory space”. “Interdependencies” refers to the dynamics between the participants in the regulatory space, co-producing and co-enforcing norms of governance. “Ungovernability” refers to the autonomy and unpredictability of actor behaviour in the regulatory space, which will pose challenges to assumptions made by regulatory authorities. In a decentred landscape, there is, some argue, no public-private distinction as all participants contribute to and influence governance. The decentred analysis has frequently been applied to financial regulation.

The era of decentred regulation or governance gives rise to access, participation, multipartite representation, the sharing of tasks and responsibility, credible private ordering, collaboration with regulators, discourse and mutual accountability, shared problem-solving and synergy. However, commentators have pointed out that the problems of multiple centres of influence and governance also produce a chaotic “market for regulation” where participants in the regulatory space compete with each other, engage in arbitrage and become subject to coordination dilemmas. Further, lack of coordination in decentred landscapes then results in protracted dialogue and “learning” and this may cause ambiguity in the objectives that are to be achieved (which may not be the focus of decentred regulation anyway). Contemporary regulatory theories arguably sustain the decentred analysis by constructing models that proceduralise governance i.e. that deal with the processes that take place within the regulatory space, so that the governance framework in its decentred condition may be supported by the establishment of internal order/coherence and/or transparency or democracy.


19 Orly Lobel, “The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought” (2004-5) 89 Minnesota Law Rev 342; Shann Turnbull, “Self Regulation” (1997), article presented at International Conference on Socio-Economics, Montreal, arguing that where there are diverse centers of information, expertise and resources, power is fragmented and issues are complex, and hence, governance has to be provided in part by ground-up private sector locations.


21 John SF Wright and Brian Head, “Reconsidering Regulation and Governance Theory: A Learning Approach” (2009) 31 Law and Policy 192 in which decentred regulation is regarded as part of the post-structuralist ideology.

On the other hand, it is not entirely true that public regulatory governance as a distinct form of governance has become irrelevant in the financial services landscape. Regulators arguably remain unique in the regulatory space, and are representations of perspectives of “public interest” or “public good” (in the economic sense of public goods that are not supplied for failure of collective action on the part of the market). The “public” character of regulators in the regulatory space is arguably distinct, and this is conceptually sustainable even if the regulatory space is decentralised.

Donahue asks “[g]overnance and markets... tend to be tangled with each other...”, but “does engaging the market offer the most promising blueprint for accountability in the pursuit of particular public goals?” Goodhart et al have also argued that there is a place for “regulation” in governing the activities of the financial services sector where market failures and public goods such as systemic stability are concerned. There is an acknowledgement that concerns such as “public goods” would still likely be addressed by the type of governance that is characterised by public interest, and would articulate values and objectives of a communitarian character. Such “public” governance, as argued by Donahue is based on a form of “extensive accountability” to a variety of stakeholders, in furthering a variety of different “mandates”. This is different from “intensive accountability” represented by market-based governance which seeks rather single-mindedly market efficiency and individual wealth creation. Hence, there is a unique role for “regulation” as a form of public governance.

mention is made of global governance as a “deliberative polyarchy” where decision-making and learning takes place in a continuous dialogue and deliberation.


27 Although the authors tend to be cautious about the role of public regulation as optimal governance in financial markets, see Charles Goodhart, Philip Hartmann, David Llewellyn, Lilian Rojas-Suarez and Steven Weisbrod, Financial Regulation: Why, How and Where Now? (London: Routledge 1998) at 3-4.


29 “Regulation” may be defined as a phenomenon that seeks to provide a sustained and focused approach to modify the behaviour of the subjects of regulation, so that compliance may be secured according to the standards and goals in such regulation, see P Selznick: “Focusing Organizational Research on Regulation”, in R.G. Noll (ed.), Regulatory Policy and the Social Sciences (Berkeley, University of California Press, 1985) at 363-
Further, Levi-Faur argues that the economic society rests on the bedrock of regulation, a phenomenon known as “regulatory capitalism”. Regulatory capitalism refers to the existence of governance frameworks that shape economic functioning and the protection of certain political or social values, representing a landscape where economic functions and needs are facilitated, and distributive or social goals are also being pursued. Braithwaite supports this by arguing that it is a myth that the laissez-faire nature of markets have been allowed to flourish as such in the ideology of neoliberalism and deregulation. In fact, he argues that the public character of governance continues to exist extensively and has evolved into a form of regulatory capitalism. Regulators continue to define governance over businesses in competition policy and laws, laws relating to health, safety and product quality. Empirical research has also pointed out that citizens’ acceptance of the level of risk associated with any economic or social activity is directly correlated with the level of institutional trust, and hence, the presence of the “public character” of regulatory governance as an institution underpinning the investment economy is necessary to facilitate acceptance of private investment risks and participation in the investment economy.

Further, the global financial crisis has brought the “public-private” distinction back into discussion. Although the crisis is a failure of private market institutions and the market, the response from most nation states hit by the financial crisis has been not only to activate the central bank’s capacity as lender of last resort to a number of large and significant global financial institutions, but taxpayers’ money has been directly injected into ailing banks to rebuild their balance sheets, and governments have intervened to effect banking rescues by compelling certain corporate mergers and acquisitions. Hence, recourse to “external” measures beyond the market would put into doubt the self-sufficiency of private market-based governance. The trailing social costs and effects of the


31 John Braithwaite, Regulatory Capitalism (Cheltenham: Edward Elgar 2008) at 4-29.


33 Although contemporary literature has doubted the continued relevance of the lender of last resort, eg see Steven Lawrence Bailey, “New Zealand’s Alternative Approach to Banking Supervision” (1998) 3 Yearbook of International Financial and Economic Law 393. But see Xavier Friexas, Bruno M Parigi and Jean-Charles Rochet, “The Lender of Last Resort: A 21st Century Approach” ECB Working Article No 298 (2003), arguing that the facility of the lender of last resort is relevant although it needs to evolve.

34 Lloyds/HBOS and RBS in the UK, Fortis in Belgium, The Netherlands and Luxembourg.

35 Bank of America and Merrill Lynch, and Washington Mutual, Lloyds TSB in the UK with HBOS.
crisis, as manifested in the real economy of many countries, call for an acknowledgement of a need for governance over the financial services industry that involves some “public” values and objectives and the type of “extensive accountability” referred to in Donahue’s arguments mentioned above.

Further, the legal harmonisation in the EU’s financial services law as part of the movement to create an integrated market for financial services and products, rests heavily on identifying regulatory leadership and empowering the regulatory role to bring about coordinated standard-setting, supervision and enforcement. The “public” character of governance deals not only with public goods and objectives and extensive accountability, but the public policy of fostering an integrated internal market.

The article has attempted to present an overall picture of the governance of the financial services industry- on the one hand decentred, populated by resourceful, competent and powerful industry participants, and on the other hand consisting also of agencies of authority that have a public character, whether state-based, regional (such as EU committees) or international (such as IOSCO). The relative lack of direct influence of stakeholder groups such as consumers in this regulatory space arguably means that the governance in the financial services landscape is essentially a public-private governance, which could be defined as a sharing and morphing together of competence between actors of a public and private character, in addressing regulatory concerns and problems. The key feature of the public-private governance is the relational paradigm between the actors of a public character, dominantly regulators (whether EU or state-based) and the private sector, and this paradigm characterises the nature of financial regulation and governance. For example, public-private governance may be represented in regulatory approaches such as meta-regulation, smart regulation, soft law and responsive regulation. These regulatory models reflect the changing role of regulators not as platforms of authority, but as participants in a relational paradigm with the industry in providing governance over the financial services landscape.

**The Relational Paradigm – The Regulator and the Industry**

In 1998, Goodhart et al published *Financial Regulation- Why, How and Where Now*[^38] to shed light on this relational paradigm. This remains an important book that has taken stock of the realities of financial regulation up to the 1990s and consolidated a vision of the workings and mechanics of financial regulation as a relational paradigm- an open-ended relational contract between the regulator and regulated. The authors argue that it is practically impossible to intrude in an extensive regulatory manner into the highly innovative working of the financial services industry, but it remains important that the regulator is able to pursue and provide certain necessary public goods such as systemic stability and to address market failures. Hence, the authors also contend that the


[^37]: For example the Hague Institute of International Law established by the Dutch government is a public-private governance network harnessing competence of the private and government sector in addressing issues in international law.

nature of financial regulation will become a relational outworking between regulator and industry in terms of specific “bonding” commitments by the industry to conduct itself and to achieve certain outcomes acceptable to the regulator. The article agrees that this relational paradigm will remain dominant in the financial services landscape, but one of the key problems in this paradigm is the relative weakness of other stakeholders as will be explained.\(^\text{39}\)

The risk-based approach to supervision of the UK’s Financial Services Authority (“FSA”), \(^\text{40}\) although not a relational contract between regulator and regulated, is heavily based on a relational paradigm. The risk-based approach to financial regulation has also been accepted in many other countries, such as Australia and parts of Canada.\(^\text{41}\) Risk-based regulation is a modern compromise between the acknowledgement of the realities of the decentralised regulatory space and the limitations of the regulators, and the role of regulation in providing public goods. Risk-based regulation seeks to define the regulator’s responsibility within the parameters of economic resources, efficiency and cost-benefit analyses.

Risk-based regulation is often interpreted as a preventative or pre-emptive regulatory approach,\(^\text{42}\) whereby the private and social risks of financial activities are measured, adjusted and assessed so as to inform the regulator of the appropriate regulatory approach to take with respect to a firm or the industry in general, having regard to the regulator’s resources.\(^\text{43}\) The FSA has been committed to risk-based regulation since its establishment in 2000.\(^\text{44}\) Although the intention of risk-based

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\(^\text{39}\) See Section 3, in Part 2 of this article, forthcoming.


\(^\text{41}\) Julia Black, The Development of Risk-based Regulation in Financial Services: Canada, the UK and Australia- a Research Report (London: ECRC Centre for the Analysis of Risk and Regulation, LSE 2004).

\(^\text{42}\) Jonathan B Wiener, “Whose Precaution After All? A Comment On The Comparison And Evolution Of Risk Regulatory Systems”(2003) 13 Duke J. Comp. & Int’l L. 207; Sidney A Shapiro and Robert L Glicksman, Risk Regulation at Risk (Stanford U Press 2003) where the concept of preventative regulation based on risk is defended against charges of excessive social cost and paternalism. In the liberal tradition of America, risk-based regulation may be seen as being paternalistic, communitarian and quite against the grain of individualism and laissez-faire, against which Shapiro and Glicksman defended risk-based regulation as a pragmatic and socially useful approach. In the UK however, the same risk-based approach is actually seen as a move of retreat from the social state. See Better Regulation Task Force, Alternatives to Regulation, and Risk, Responsibility and Regulation, infra.

\(^\text{43}\) A detailed examination of what risks are identified, how risks are adjusted to “net” levels after considering firms’ mitigation approaches, how regulators decide if particular risks ought to be addressed in regulation or supervision and the impact of regulation on firm activities, is presented in Julia Black, The Development of Risk-based Regulation in Financial Services: Canada, the UK and Australia- a Research Report (London: ECRC Centre for the Analysis of Risk and Regulation, LSE 2004).

\(^\text{44}\) See speech by Michael Foot, FSA, at http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2000/sp69.shtml. The historical context of strong self-regulation in the financial services industry prior to the establishment of the FSA may be important to the adoption of risk-based regulation, which promises proportionality and a relational paradigm in the FSA’s approach. For some history, see Julia Black, Rules and Regulators (Oxford: Clarendon 1998) at chs 2 and 3. This
regulation is to ensure that regulatory attention and resources may be prioritised in an efficient manner to address the riskiest issues that may affect the delivery of regulatory goals, Black has also critically commented that risk-based regulation could be used to redefine blame and the parameters of accountability. A risk-based approach in regulation could allow regulators to carry out uneven levels of supervision depending on the risk profiles of firms, and hence allocate resources according to those priorities. This may legitimate any perception of regulatory shortfall involving firms that are regarded to be “safer” by regulators. However, if the risk profiles of firms are in any way mistaken at any given time, then the FSA may run the risk of allocating insufficient resources to manage unperceived risks. It is arguable that the global financial crisis that hit two of the UK’s largest high street banks i.e. Halifax Bank of Scotland and the Royal Bank of Scotland in late 2008/early 2009 could be due to the misperception of either bank’s health under the risk-based regulatory framework. In 2006, the then-Chairman of the FSA, Callum McCarthy identified about 1,500 firms that were subject to medium-to-high risk-based supervision, which entailed the FSA’s regular visits and continuous monitoring. The rest of the industry, some 28,349 firms, were subject to low risk supervision, which meant compliance with reporting requirements established under FSA rules. Most of the financial services industry then was arguably subject to a form of self-certifying discipline.

In a risk-based regulatory approach, the regulator constructs the risk profile of the regulated and that provides the blueprint for how the regulator supervises the regulated. The spectrum below shows the varying degrees of closeness in a regulator-regulated relationship in a risk-based approach to regulation.

is also the general thrust of public regulation in the millennium, see Stephen Bundred, “The Future of Regulation in the Public Sector” (2006) 26 Public Money and Management 181.


46 The risk profile of a firm may take between 1-3 years to be constructed and it is uncertain how periodic reviews may be carried out by the regulator, see Stuart Bazley and Andrew Haynes, Financial Services Authority Regulation and Risk-based Compliance (London: Tottel Publishing 2006) at 4.30.

47 Most representations to the Regulatory Reform Select Committee of the Parliament after the onset of the financial crisis seemed to agree that the application of risk-based regulation by the FSA had been faulty but the approach itself remained valid. See “The Implications of the Financial Crisis for Regulation” (20 Aug 2009) at http://www.publications.parliament.uk/pa/cm200809/cmselec/cmderg/329/32906.htm#n35. Kern Alexander also commented that the risk-based approach to regulation had been faulty for its failure to consider systemic risk in its risk profiling, see “Principles v. Rules in Financial Regulation: Re-assessing the Balance in the Credit Crisis” (2009) 10 European Business Organisations Law Review 169.

48 Bazley and Haynes argues that risk-based regulation relies heavily on enhancing the internal compliance and risk management processes within firms, see Bazley and Haynes, Financial Services Authority Regulation (op cit) at 4.46ff.
If the risk profile of a regulated entity is “low-risk”, greater reliance may be placed upon the regulated’s submission of data and reporting, amounting to a form of self-certification by the regulated. The relationship is characterised by trust and paradoxically, distance. Further down the spectrum would be more intensive regulator monitoring or supervision to steer aberrant conduct into line, ie greater distrust and scrutiny but closeness in intensity. The main challenges for the regulator in the risk-based approach are that:

(a) The relational distance between the regulator and regulated in low risk firms could amount to a longer term “delegation” to the regulated to monitor itself, and such delegation may entail agency problems in due course. If the construction of the risk profile of a firm is based on faulty assumptions, then such an agency problem may become augmented over time.

(b) The relational closeness between the regulator and regulated in more intensive monitoring may actually result in a bias towards decreased enforcement over time.

In an earlier work, I have discussed how the relational paradigm of risk-based regulation may affect the discharge of legal duties of regulated financial investment intermediaries. I have specifically drawn attention to the possibility that the relational paradigm in risk-based supervision may allow room for investment intermediaries to adjust and change sub-optimal practices through dialogue and negotiation with the regulator, and this process would render it inappropriate for bright line pronouncements (especially judicial ones) to be made that the regulated has fallen below a particular standard of care or breached a rule. Risk-based regulation also allows issues with the regulated to be first pursued within a relational paradigm, perhaps by moving from a medium supervisory level to a high-medium or high level, and hence, this relational paradigm may indirectly encourage less resort to enforcement, leaving governance issues internalised in the relational paradigm. Although the relational outworking could encourage more effective change of behaviour, it could also mask shirking by firms and create opacity as to how firms are monitored. Although policy-makers are keen to distinguish between risk-based regulation and the now-discredited light-touch regulation carried out by the FSA, it could be argued that the nature of

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risk-based regulation lends itself to an atmosphere of relational outworking between regulator and regulated, which has led to an enforcement deficit. In sum, risk-based regulation may fail to take into account of its relational side risks—the risks of being too far or too close to the regulated. Further, the relational paradigm of financial regulation in this area has gradually eclipsed jurisprudence in civil actions as being an important source of governance.

The twin themes of being too far and too close to the industry will remain dominant as we examine contemporary governance models in the literature review, and specific models in financial regulation. In the context of the global financial crisis, it will be argued that issues in the relational paradigm have been persistent although they are more of “background” rather than front line problems. However, background problems could have exacerbated frontline problems. For example, the UK Turner Review has acknowledged how key beliefs in market efficiency may have been important in contributing to the financial crisis—background beliefs affecting frontline regulation and governance. This article however does not amount to a simplistic call for re-regulation but an examination of how the relational paradigm in the governance of the financial services industry may be re-oriented so that the nature of governance in the financial services landscape may be able to reflect common values of responsibility and sustainability.

Section 2 will provide a literature review of contemporary perspectives of governance, much of which have influenced the governance in the decentred financial services landscape. Section 3 will then show how the contemporary models of governance have shaped specific areas of financial regulation. I will look at specific areas of financial regulation as conceptualised in 8 models derived from the contemporary perspectives in governance. Discussion of the 8 models of financial regulation will arguably show that the governance of the financial services landscape is dominated by relational problems including over-reliance by regulators on industry governance, and the agency problem where public goods or regulatory goals have been delegated to the industry. Section 4 will draw out some broader observations from the examination in Section 3 and will argue that regulators need to address the relational sub-optimalities in the public-private governance of the financial services industry in order to develop overall governance.

2. The Concepts of Contemporary Governance

This Section will discuss concepts of governance generally and will present a literature review of the concepts of self-regulation, market-based governance, meta-regulation, smart regulation and responsive regulation. These will further form the rubric of the 8 models of financial governance discussed in Section 3. Contemporary perspectives in governance are based on the underlying theme of common values such as caring for one’s fellow man, normativity, fairness, participation and transparency.

53 FSA, The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009) at p88 which acknowledged that the FSA’s approach in relational outworking with firms was not aggressive enough and a more intrusive and systemic approach is now needed.


55 Yochai Benkler, “From Greenspan’s Despair to Obama’s Hope: The Scientific Basis of Cooperation as Principles of Regulation” in David Moss and John Cisternino eds, New Perspectives on Regulation (The Tobin Project, 2009), arguing for the reaffirmation of common values such as caring for one’s fellow man, normativity, fairness, participation and transparency.
that boundaries in governance such as private and public are continuously being challenged, and this is certainly present in the governance landscape for financial services.

**Self-Regulation**

On a basic level, self-regulation falls within the sphere of personal autonomy in which private activities or ordering may take place. Psychologists define self-regulation as behaviour controlled by internal guidance,\(^5^6\) often based on perceptions of utility, goals, emotions or constitution.\(^5^7\) Hence, the Better Regulation Task Force suggests that often “no intervention”, leaving to the good sense of personal self-regulation, is a better alternative to regulation even where risks may be perceived.\(^5^8\) Self-regulation in the microcosmic sense is typically represented in the leaving to the individual to determine an appropriate course of action, such as leaving to sophisticated investors’ good sense to govern their own investments. For example, a sophisticated individual making a decision to purchase an investment product is self-regulatory. Limitations are imposed on retail investor access to certain investment products such as the Qualified Investors’ Collective Investment Schemes regulated by the UK FSA\(^5^9\) or participation in funds managed by Alternative Investment Funds proposed to be regulated by the EU.\(^6^0\) By and large, the microcosm of a sophisticated investor’s decision is largely at will, and this has also allowed sophisticated investors such as banks and financial institutions to own large quantities of complex assets such as collateralised debt obligations whose liquidity has always remained a paradox.\(^6^1\)

**Responsibilisation**

Self-regulation in the microcosmic sense may also be complemented by responsibilisation on the part of financial product investors or consumers. Responsibilisation refers to the enhancement of awareness of personal responsibility on the part of investors or consumers for their choices and in

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\(^5^7\) Maya Tamir, Chi-Yue Chiu and James J Gross, “Business or Pleasure: Utilitarian versus Hedonistic Considerations in Emotion Regulation” (2007) 7 Emotion 546 on utility, and see Vohs and Baumeister, *Handbook, ibid.*


\(^5^9\) FSA Handbook COLL 8.


finding solutions for their investment or financial problems.\textsuperscript{62} This is often purported to be achieved by improving financial literacy and education.\textsuperscript{63}

However, responsibilisation is principally appropriate where investors can govern their own choices and decisions and where information asymmetry and inequality in bargaining power do not occur. Where investors and consumers may not be able to differentiate between lemons and peaches in a reliable manner, responsibilisation would only entail the privatisation of losses.\textsuperscript{64} Schürz also argues that for the abjectly impoverished in the US, for example, financial literacy education has not made much headway in either imparting knowledge, understanding or application.\textsuperscript{65} Even if responsibilisation empowers individuals to seek private benefit in an informed and empowered manner, it is individualistic in nature and does not address the wider issues of public and collective goods such as collective information and action.\textsuperscript{66} It will be argued in Section 3 that the empowerment of stakeholders as a collective force and as assisting regulators could be important in re-orienting the relational paradigm between the regulator and industry, but this will be beyond the sense of responsibilisation for individual choice as discussed above.\textsuperscript{67}

**Transactional Governance**

Transactional governance refers to contractually established rules, rights and obligations that provide governance over behaviour. Williamson opines that bilateral private ordering could involve parties in providing “good order and workable arrangements”.\textsuperscript{68} De Minico describes the private transactional paradigm as an autopoietic and self-referential system of self-regulation.\textsuperscript{69} This means that participants to the transactional paradigm see themselves as actively making the rules by which


\textsuperscript{63} Toni Williams, “Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services” (2009) 29 Law and Policy 226; www.moneymadeclear.gov.uk, which is the FSA’s website for improving consumer financial awareness according to its objective in s3, FSMA 2000.

\textsuperscript{64} Williams “Empowerment” (2009), above.


\textsuperscript{66} Above.


they bind themselves as they navigate the dynamics of bargaining and negotiation with their counterparties. The transactional paradigm emerges from the bottom-up, and is self-referential as the paradigm functions without the need for external intervention. Many commentators would agree that many transactional rules in finance, particularly in international finance have developed in relational paradigms of transactions, and those that are regarded as popular or efficient have become standardised, creating a body of transactional private law that governs international financial transactions.70

However, transactional governance may have certain limitations. First, although transactional standardisation may provide certainty and efficiency, it may contribute to snowballing of risks (perhaps systemic risk) if it is subsequently realised that certain transactional rules are flawed.71 The relational paradigm in transactional governance could be myopic as to wider communitarian effects. This could be seen in the use of derivatives for risk management purposes. Derivatives are used to hedge, a key element of risk management for the real economy as well as the investment economy, and many derivative transactions are carried out over-the-counter in the interests of low cost and speed.72 The International Swaps and Derivatives Association has over the years overseen the rise of standardisation in derivative transactions.73 However, in the wake of the financial crisis, the sharp rise in counterparty risk in OTC markets after the collapse of Lehman Brothers in September 2008 have resulted in the snowballing of losses in derivative markets and the intensification of the financial crisis.74 Policy-makers globally are now concerned as to whether the volume of unregulated OTC derivative trades would pose systemic risks in the future.75 The proposals to bring the OTC derivatives market within a regulatory/governance framework will be discussed in Section 3.


73 For eg, the ISDA Master Agreement 2002.


Second, transactional standardisation provides a form of governance that facilitates transactions, but may not provide a blueprint for dealing with failures and externalities. Partnoy argues that in a transactional paradigm, participants will each look after their selfish interests even if they perceive problems that may occur to other participants. Opportunistic behaviour may occur, participants in the market may pass risk onto the next available participant and when trouble occurs, collective action is not likely. Coase’s seminal article on the “Problem of Social Cost” argues that externalities can be managed within transactional contexts, and stakeholders can enter into the transactional paradigm to exert bargaining power. Hence, *ex ante* provisions of regulatory governance may not be necessary or efficient. However, where derivatives trading is concerned, the participants are heterogenous, diffuse and international, the externalities may be dispersed and borderless. The relational connection arguably breaks down for transactional governance to arise. Hence, there would be a gap in addressing externalities that arise in such a context.

**Smart Regulation**

An extended form of transactional governance may lie in “smart regulation”. Gunningham and Sinclair propose that smart regulation involves levering on the expertise, interests and resources of second and third parties in the regulatory space to act as “surrogate” regulators, and this therefore provides a range of policy instruments and instrument mixes for addressing any governance issue. Smart regulation encompasses a partnership between first, second and third party stakeholders, certifiers, gatekeepers and regulators.

In terms of levering on parties in the “regulatory space”, whether counterparties, stakeholders, certifiers or gatekeepers, the increased diversity in participation may introduce checks and balances in the regulatory space, and improve the legitimacy of such governance. However, there may be challenges in seeking coordination and reconciliation between regulatory goals and the private interests pursued by these entities. Further, the key vulnerability of the smart regulation model is that too much trust and reliance may be placed on “surrogate regulators” such that they are no longer regarded as instrumental in a fabric of regulatory design- regulators simply choose the path of the least resistance and allow the surrogate regulators to provide the entire rubric of regulation or governance.

**Market based Governance**

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78 Op cit.


The “Market” is classically understood to be based on the freedom of participation and exercise of will by individuals in their own self-interest, but it has developed into an institution, a model and even a collective entity which today, may be arguably providing a form of “governance”, a collective good over and above individual private goods exchanged in a market context. Market-based governance may be described as “[the motivation] of private interests to further public good”. This could mean allowing the activities of participants in the market to provide solutions to problems that may be generated by the market itself, such as (a) transactional solutions evolved into standardised ones, (b) the aggregation of market participants’ incentives to provide discipline and monitoring, (c) using market-based institutions such as stock exchanges to provide discipline, (d) allowing “governance” goods such as certification goods to flourish in a market for such goods, (e) using market concepts to refashion the supply of public goods or services, (f) outsourcing to the market functions that may have been carried on by the government, or (g) seeking private investment into partnerships with the government in providing quasi-public services such as healthcare or education. “Market-based governance” is very much in sync with the decentred regulatory space which sees the amorphous collective entity of the “market” as being a source of governance. Shamir argues

85 Such as how credit rating agencies have been used to provide information regarding issuers’ credit-worthiness, using stock exchange membership to provide discipline to members, the role of trade associations for the financial industry, and the role of the corporate governance industry.
86 Such as credit, corporate governance, social responsibility ratings.
88 Chs 2, 5 and 6, Donahue and Nye eds, Market-Based Governance (2002), above.
89 Above, also see D Asenova, M Beck, & S Toms, “The Limits of Market-Based Governance and Accountability - PFI Refinancing and the Resurgence of the Regulatory State” (2007) University of York Working article number 35.
that market-based governance allows information to be discovered from the market, innovations to take place, providing a reflexive form of governance that is derived from and feeds back into the open and porous nature of the market itself and into society in general.  

(a) Market-based Standardisation as Self-regulation

The market may be able to generate standards of behaviour that could provide self-regulation and arguably a form of collective or social good. This could be a standardisation process, sometimes led by trade or industry associations or international associations or networks, or could be a market for standards itself. Supply side and demand side factors would play out to determine the evolution of standards or a market for standards. Supply side factors may include the perception by industry participants that self-regulatory standards would stave off more costly regulatory intervention, the interest in industry participants in developing technocratic standards that would be appropriate to industry needs, and competitive pressures amongst market participants in producing standards of credible self-regulation where there are also demand side pressures for such generation. On the demand side, it may be argued that self-regulatory standards generated by the market are well regarded, usually relevant to the technocratic issues at hand, and perceived to be more persuasive and inspire compliance to a greater extent than externally imposed regulatory standards. In financial regulation, many self-regulatory standards have been generated as a form of standardisation, and this is largely due to the leadership of organisations such as trade and industry associations or international organisations, associations or networks. Examples of such standards


94 Peer pressure racing to the top may be seen as an effective market force that compels financial institutions to adopt best behaviour, see Michael D Pfarrer, Ken G Smith, Kathryn M Bartol, Dmitry M Khanin and Xiaomeng Zhang, “Institutional Influences on Voluntary Disclosure” (2005) at http://mba.tuck.dartmouth.edu/mechanisms/pages/Articles/Pfarrer.pdf, an empirical study that shows that mimicking practices in the industry is often an important driver for change in behaviour in financial institutions, in this case, on restatement of earnings.


may be the Basel I and II capital adequacy standards led by the Basel Committee. Faerman et al also argue that regulators seek out the industry to come up with industry standards or solutions as they are generally recognised to have more expertise and resources, providing more convincing leadership in complex technocratic issues.

However, standards such as the Basel II capital adequacy standards have been criticised to be open-ended and imprecise, pandering to the needs of flexibility and self-interest of financial institutions. Roubini has pointed out how the open-endedness of the standards served the interest of risk-taking executives in financial institutions, instead of the good of public interest.

Where market-generated standards are not standardised, but rather subject to a market for standards itself, competitive pressures may produce a race to the top or a race to the bottom. Commentators refer to the “gaming efforts of corporations” as a natural tendency when subject to forces of regulation or pressures for self-regulation, in attaining standards of a cosmetic and minimal character that entails least cost to the corporations. This is a race to the bottom. Gerding has also suggested that where financial institutions could develop their own standards, in the case of risk management under the Basel II open-ended mandate, the market for standards did not produce a race to the top. Each financial institution protected the secrets of its proprietary risk management system, and this actually subverted any open competition amongst alternative systems. The risk management systems developed by each financial institution were technologically and scientifically limited, and tolerated sub-optimalities and faults in the safety of remaining opaque.

(b) The Aggregation of Market Participants’ Disciplining Incentives


Where financial regulation is concerned, many commentators have suggested that market-based governance can take the form of market discipline by market participants who have a stake in shaping the behaviour of others, i.e., that certain market participants that have something to lose may be incentivised to ensure that other connected participants behave in such a way that may avert losses. The discipline provided by these participants may in turn provide a general discipline towards socially good behaviour. Commentators have suggested that large equity or bond holders in financial institutions, and subordinated debt holders may be particularly well-disposed to carry out such market discipline. This also seems to find consensus with policy makers, especially in the UK.

Further, perhaps shareholders and creditors of financial institutions could provide a form of market-based governance over firm behaviour? In the recent financial crisis, much critique has been levied against shareholders of failed banks in the UK acting as “absentee landlords” or “ownerless corporations”. However, commentators have suggested that shareholders are likely to act as monitors only if the equity stake is sufficiently large. On the other hand, empirical literature has suggested that shareholders with large stakes in financial institutions are more likely to encourage management to engage in excessive risk-taking activity, in order to drive earnings up for shareholders’ short-term interests. Hence, there are opposing possibilities as to how shareholder monitoring may develop as a form of governance. Further, empirical literature also provides interesting findings as to the effectiveness of shareholder or public forms of activist monitoring against corporations. Calveras, Ganuza and Llobet argue that where a minority group of activists are relied on to provide monitoring against corporations in, for example, corporate social

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105 Hector Sants, CEO of the FSA, speaking to the Financial Times in “FSA Chief Lambasts Uncritical Investors”, Financial Times (11 March 2009).

106 Paul Myners, “We need More Responsible Corporate Ownership”, Financial Times (11 Oct 2009). The Review of Corporate Governance in UK Banks (Nov 2009) by Sir David Walker intends to boost stewardship responsibility on the part of institutional shareholders most of whom hold only minority stakes in major UK banks and financial institutions. It remains to be seen if such policy leadership can actually motivate greater gatekeeping by shareholders.


responsibility, regulators will overestimate the effectiveness of such market-based governance and provide regulation at a socially sub-optimal level. Hence, the unintended consequences flowing from market-based governance may have to be examined carefully. That said, there continues to be a significant amount of emphasis in the UK placed on institutional shareholders to monitor financial institutions more carefully.\footnote{110} I have elsewhere argued that although institutional shareholders in the UK are motivated highly by policy leadership and the work of proxy voting agencies to engage with their investee corporations, significant challenges remain for them in engaging in activism and, in particular, collective activism.\footnote{111} Further, the evidence of better financial performance from shareholder activism in corporate governance or social performance is still arguable,\footnote{112} and hence the purely financial motivations for shareholder activism may remain equivocal for some time.

In general, Donahue argues that the incentives of private participants are often geared towards the maximising of private interests, or profit-seeking behaviour. This is fundamentally different from the nature of regulatory governance which is characterised by multiple objectives and yardsticks in evaluation of progress and achievement. Hence, the working out of market participants’ behaviour as a form of governance may not always be aligned with the achievement of collective good or regulatory objectives.\footnote{113}

(c) Market-Based Self Regulation in the Form of Self-Regulatory Organisations or Associations

Market-based self-regulatory organisations may exist in the form of trade and voluntary associations, either domestic or networked and international. The market itself may also be a self-

\footnote{110} HM Treasury, Reforming Financial Markets (July 2009); David Walker, A Review of Corporate Governance in UK Banks and other Entities in the Financial Services Industry (Nov 2009).


\footnote{113} Ch 1, Donahue and Nye eds, Market Based Governance (2002) op cit.
regulatory organisation, such as the stock market which produces rules for product issuers whose securities are being traded on the market, and rules for the intermediaries accessing and using the market.

The governance provided by self-regulatory organisations may be in the form of standards as mentioned above, coupled with a sense of quality assurance, and discipline or enforcement through membership. Discipline or enforcement could be levied by way of membership denial, exclusions, withdrawals, suspensions limitations of privileges or access, reputational discipline or even punitive gestures.\(^{114}\)

Although membership of a trade association with standards and best practices may provide a form of governance as quality assurance, empirical literature suggests that industry often sees membership with a trade association as a way of camouflaging firms’ sub-optimal behaviour.\(^{115}\) For voluntary membership with self-regulatory organisations, firms that “behave badly” are generally more enthusiastic embracers of trade association membership, in the hope that the membership will provide a cloak of credibility for them. Firms may or may not actually improve their behaviour but they believe that they would less likely be targeted by regulators as they are shielded behind the credibility of trade association membership. Further, where the self-regulatory organisation may be in competition with other self-regulatory organisations, it is uncertain if the standards and extent of discipline or enforcement would be a race to the top or a race to the bottom. Some empirical literature suggests a possibility of racing to the top, as self-regulatory organisations may care about reputation, and members themselves value the reputation associated with membership.\(^{116}\) Some literature, such as those dealing with stock markets, suggests otherwise. Commentators are of the view that competitive forces compel stock markets to seek private interests such as profit maximisation over public interest, and this interest would be aligned with the private interest maximisation of its members. Hence, stock markets are unlikely to be effective self-regulatory organisations in disciplining against member abuses or sub-optimal behaviour.\(^{117}\) However, can one argue that investors may be able to make their demand pressures known by withdrawal from less reputable markets, and hence that there are still incentives for markets to align themselves with investor interests?

Lima and Errázuriz\(^ {118}\) argue that although there would be investor pressures to demand that a self-regulated stock exchange be vigilant in supervision and credible in enforcement, the extent of


discipline stock exchanges are engaged in would depend largely on what the public already perceives or knows about the quality of the stock market. Where the public already trusts or perceives the stock market favourably, the lack of enforcement or discipline will not give rise to doubt about the quality of discipline or enforcement. In fact, the occurrence of discipline or enforcement may decrease the level of favourable perception, giving the market no incentive to be vigilant or to carry out enforcement. However, where the public has no particular perception of the quality of the market’s discipline or enforcement, then the public is unable to tell if the lack of discipline or enforcement is due to low vigilance or, in fact, effective policing so that no scandal has erupted. DeMarzo et al also argue that stock markets are more likely to use a carrot instead of stick approach to discipline and enforcement. This is because a carrot approach is less costly in terms of relational cost and administration. A stick approach may be preferred by investors but the threat of withdrawal may be a loss for stock markets, and hence they will tend towards the choosing lower cost discipline or enforcement. This would mean that enforcement or discipline is usually carried out in a friendly, unthreatening and perhaps not necessarily effective manner. In sum, empirical literature shows that stock markets may not be disciplined by demand side pressures to undertake discipline or enforcement against issuers or members, as such actions may have no effect or the opposite effect on how the market is perceived on the demand side. Further, empirical literature also shows that in general, self-regulatory organisations tend to rely on merely reputational effects to discipline their members, and even where discipline is pursued the enforcement may be very lenient.

What about particular designated self-regulatory organisations that demand compulsory membership? Would the governance provided by such organisations be more credible or effective? Economists argue that self-regulatory organisations tend to serve the interests of their members, and members’ needs and interests generally feed into the design of organisation rules and standards, as the self-regulatory organisations see their members’ needs and interests, not users’ interests, as the “demand side” for its rules. The history of self-regulatory organisations in the UK under the Financial Services Act 1986 has generally been acknowledged not to be terribly effective in protecting investors. Besides, the credibility of self-regulatory organisations providing governance and discipline could be in doubt as these organisations may first run into the problem of not being accepted by the industry as legitimate, and may secondly not be perceived by the public as credible, as they often do not need to be subject to transparency and accountability to the public. On the first problem, compulsory self-regulatory organisations may have to overcome dissidents within the industry and provide a set of norms that can be bought into by all. This may involve a challenging process, and compromises that are made may not always reflect the governance necessary for


consumer or investor protection. For the second problem, transparency and procedures to involve public participation and accountability often help in improving the perceived legitimacy of such non-state organisations, as the governance provided by self-regulatory organisations behind closed doors may not be seen as credible. Hence, the procedural legitimacy of such self-regulatory organisations could be improved, but Koppell suggests that this does not substitute for the efficacy of rules and enforcement, which remains a weak point in the governance provided by self-regulatory organisations.

(d) The Market for Governance Products

The market may provide sub-markets for governance products such as ratings and gatekeeping services to facilitate the investment market itself. Market demand for third party verification and reputational certification is found in relation to the evaluation of issuer products, such as an underwriter’s reputational involvement, credit ratings and analyst recommendations. Increasingly, where social responsible investing is important, the corporate governance and social responsibility ratings of the issuer may be crucial to the marketability of an investment product. Such third party verification or reputational certification is thus a commodity demanded for and supplied by the marketplace, but could provide a form of quality assurance to investors. Gatekeepers such as auditors and lawyers however perform a different function, as their involvement is generally demanded by issuers and financial institutions for compliance purposes, and as such, the market in these services may arguably have arisen as a result of regulatory imposition.

Taking the first group of gatekeepers whose reputational output may also provide a form of quality assurance, could this output be regarded as a type of market-based governance? Jessop opines that the capitalistic notion of commodification refers to putting a quantifiable value on all goods and services. Thus, reputational verification and quality assurance type services in the financial sector are also commodified and appeal to the demand for reputational output or services in an informationally asymmetric market. If we perceive reputational output as offering a form of market-based governance, it may be argued that we are expecting these services to provide a form of quality assurance that can amount to a form of investor protection. Although this “non-value” based consequence may result, in the recent financial crisis, it may be queried as to whether reputational output such as a credit rating has served that purpose. Reputational output such as credit ratings has been subject to information asymmetry, sub-optimal assumptions and models and the lack of

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123 Steven Bernstein and Benjamin Cashore, “Can non-state global governance be legitimate? An analytical framework” (2007) 1 Regulation and Governance 347.


125 Ibid.


127 This lies behind the European Commission’s proposal to require registration, disclosure and supervision of rating agencies in the EU, by CESR, see European Commission, Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies (2008), as accepted by the Council.
independence on the part of the reputational provider. The lack of independence and potential conflicts of interest have been identified not only to affect credit rating agencies but also research analysts. If the reputational output is not reliable, then instead of adding to information efficiency in the market, the reputational output would have performed the opposite function. Jessop also argues that the commodification of market-based services encourages a “value perception” of these services instead of their “non-value” purposes or effects, and hence, providers of reputational output look to the interests of those that provide its revenues, i.e., mainly issuers, and may be less concerned with the investors who are users of the reputational product, and the wider purposes of social good. The hope that such market-based reputational output may also serve the purposes of investor protection may be misplaced.

The next group of gatekeepers who may provide some form of market-based governance are entities involved in corporate transactions who professionally verify certain disclosures made by the corporations, such as auditors, underwriters and lawyers. It could be argued that the professional verification provides a form of assurance for market participants, and hence a form of investor protection.

Auditors have been heavily criticised for the failure to detect Enron’s fraudulent financial statements, causing significant investor losses after the collapse of the company. Although the auditors in that case have been compromised, it is questionable as to whether auditors generally provide a governance function for public good. Auditors have argued that their auditing function is defined by professional discipline and contract, and possibly would not amount to the type of governance required for detection and policing corporate wrongdoing. However, as Section 3

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135 Most empirical literature doubt that detection is that easy. T Bell, S Szykowny, and J Willingham, *Assessing the Likelihood of Fraudulent Financial Reporting: A Cascaded Logit Approach*. KPMG Peat Marwick, Montvale,
will argue, the “governance” role of auditors has been largely minimalised as regulators have ceased to perceive the audit as a delegated form of governance and regulators may not further check on the quality of the audit or subject it to question. It will be argued that there is a need to re-orient the importance of third party stakeholders and gatekeepers such as auditors in the relational paradigm between the regulator and industry.

As for underwriters of public offers, Choi argues that they are naturally placed to provide informational signalling to the market as they are involved in certifying the financial position of the companies they are underwriting. Lawyers are also often regarded as gatekeepers in two senses: external transactional counsel may be able to detect matters that are amiss, and internal in-house counsel may be able to act as whistleblowers. The US Sarbanes-Oxley Act 2002 has placed some faith in lawyers acting as gatekeepers, and compels in-house counsel to report up the ladder if they discover matters that may be amiss. In-house counsel could also act as whistleblowers under the enhanced whistleblower protection regime in the Act. A caveat suggested here is that although whistleblowing may be an important source of information for regulatory enforcement, the social legitimacy of whistleblowing has always been questioned. As for external lawyers, they may act in transactions on an ad hoc basis and may not have enough corporate information or access to the

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138 Stephen Choi, ‘Market Lessons For Gatekeepers’ (1998) 92 Northwestern University Law Review 916. Choi provides a market-based proposal for regulators to compel more disclosure on the part of underwriters so that they may become a market for certifiers for investors. Investors can then make discerned judgments as to the quality of such certification, and be able to rely on the information signals provided by such certifiers in choosing whether or not to subscribe for particular securities. This proposal thus introduces regulation of certifiers in order to overcome information asymmetries between investors and certifiers.

139 Section 607, Sarbanes-Oxley Act 2002.

140 Although that remains a challenging call, as whistleblowers often find that their turning against the corporation severely affects their legitimacy even if the matter raised is in public interest. KR Sawyer, J Jackson and M Holub, “The Necessary Illegitimacy of the Whistleblower” at SSRN, at http://articles.ssrn.com/sol3/articles.cfm?abstract_id=917316.

senior management of the corporation to act as its monitors.\footnote{142} Gatekeepers will be discussed in greater detail in Section 3.

\textit{(e) Market Concepts in the Delivery of Public/Regulatory Goods}

Next, we proceed to discuss if the utilisation of market concepts to fashion the provision of regulatory or public goods, is effective. Risk based regulation, as discussed above, is very much a manifestation of market-based perspectives being infused into the provision of regulatory or public goods.\footnote{143} However, Donahue explains that regulatory governance is “extensive” in nature, serving multiple goals and the attainment of goals could be measured in many ways. But the market is “intensive” in nature, as there is usually a single-minded focus on the part of market participants to seek profits and minimise cost. Hence, some forms of market-based governance may be a way of “engineering into public undertakings a greater degree of intensive accountability that typifies markets”\footnote{144} There is, however, a fundamental tension between the extensive nature of governance and the intensive nature of the market. Existing literature on outsourcing\footnote{145} and public-private financing projects\footnote{146} may provide evidence of such tension, although this article will not discuss these in detail (i.e. points (f) and (g) above).

Section 3 will discuss in particular the delegation of governance to credit rating agencies and auditors in achieving public/regulatory goals, and will highlight that market-based governance is highly attractive when expertise is perceived to be credible and to be relied upon. But such expertise may, as Donahue suggests, not be entirely amenable to serving public/regulatory goals. Where trust in expertise becomes unquestioning, a situation of “capture by technocracy” can occur, and market based governance may not achieve public/regulatory goods and may also be unaccountable.

\textit{Shared Governance}

We next turn to a number of regulatory paradigms where, although leadership is provided by regulation, the regulated may be co-opted to provide governance within discretionary parameters. Where regulatory provision is made to provide governance over an issue, it may not be able to capture all of the situations that it should govern, and hence, many regulatory provisions would be

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\begin{itemize}
  \item \textsuperscript{142} E Burger, ‘Who is the Corporation’s Lawyer?’ (2005) 107 West Virginia Law Review 711.
  \item \textsuperscript{144} Ch1, Donahue and Nye eds, \textit{Market-Based Governance} (2002) at 7.
  \item \textsuperscript{145} This author has earlier discussed how “outsourcing” may work in providing the public good of consolidated stock market information under the EU Markets in Financial Instruments Directive 2006, see Iris H-Y Chiu, “Delegated Regulatory Administration in EU Securities Regulation” (2006) 40 International Lawyer 737 and citations therein.
  \item \textsuperscript{146} The article will not go into detail into PFIs, generally see Darrin Grimsey and Mervyn K Lewis, \textit{Public Private Partnerships: The Worldwide Revolution in Infrastructure Provision and Project Finance} (Cheltenham: Edward Elgar 2007).
\end{itemize}
“open-textured”. Some regulatory provisions may be more “open-textured” than others, giving a degree of discretion to the regulated to implement or interpret the regulatory requirement. In this Section, we will deal with the open-textured forms of regulatory governance which in reality produce forms of delegated and outsourced governance to the regulated. Regulation typically provides for certain principles to be adhered to, or certain outcomes to be achieved, but there is flexibility in how the regulated may “comply”. Such flexibility in compliance co-opts the regulated in co-designing their compliance. There may be a few manifestations of such “flexibility”, in spite of the existence of a regulatory framework. One is “enforced self-regulation”, where the self-regulatory devices discussed above may be subject to customised regimes for regulatory intervention, such as the relational contract envisaged by Goodhart et al. Second is “meta-regulation” which provides regulation with the role of activating the internal capacity for the regulated to self-regulate and create outcomes aligned with regulatory objectives, and finally, a possible reliance on ethical evolutions in the conduct of business which may have become attractive now that “business ethics” has become increasingly important in business management education.

**Enforced Self-Regulation**

Ayres and Braithwaite propose that the regulated should be subject to a form of self-regulation that harnesses the benefits of the reflexivity, innovation and commitment inherent in self-regulation and avoids the disadvantages of cosmetic compliance, ineffective enforcement and sub-optimal rules. This is enforced self-regulation where both the regulator and regulated play an active role in designing and ensuring compliance. Enforced self-regulation allows the regulated to set out the rules by which it is bound. The regulator vets and approves those rules in accordance with minimum standards and regulatory objectives. The regulator is then entitled to inspect the regulated to see if compliance is taking place and is able to enforce against the regulated where the rules are breached. Enforced self-regulation may also include appointing an in-house compliance unit to report on non-compliance with the firm’s tailor-made rules. Ayres and Braithwaite identified a number of pros and cons in this approach but concluded that the approach offers a balance between credible rule-making and securing compliance, and introducing flexibility and innovation to meet business needs. In *Financial Regulation: Why, How and Where Now* Goodhart et al see the potential of sophisticated financial institutions being able to design rules they would be committed to be bound by and regulators having a greater role in inspection and enforcement. Norton has also commented

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on the regulatory adoption of the Basel II Capital Accord as being of the type of enforced self-regulation designed by elite banks.\(^\text{153}\)

Although enforced self-regulation may in theory overcome some of the weaknesses of mere self-regulation, in that the regulator is involved to provide supervision and enforcement, would the regulator’s supervision and enforcement be mere smoke and mirrors? Norton points out the fact that regulators are often too ill-resourced and ill-equipped to make meaningful assessments of the adequacy and appropriateness of the regulated’s own design,\(^\text{154}\) particularly when such designs may be tailored to subjective needs and shrouded in technical mysteries. Empirical literature also points out that there are gaps between the regulator and regulated in communication and expertise, where enforced self-regulation is in place (in Italy regarding risk management for banks).\(^\text{155}\) The lack of sufficient understanding and matching critical capacity on the part of the regulator could create a situation where the regulator may give the benefit of the doubt to the industry if it does not sufficiently understand in order to be able to critically evaluate. This could produce a “capture by technocracy”, where the regulator may relegate the enforced self-regulatory model, to one more like a self-regulatory model. Further, many financial institutions also actually adopt similar models competitors adopt, and such models need not really reflect the institution’s risk or needs, and hence it becomes even more difficult to judge models that may appear to be popular and supported by the majority of the technocracy.\(^\text{156}\)

**Meta-Regulation**

“Meta-regulation” refers to a regulatory approach which empowers and enhances the capacity of corporations to self-regulate, but connects “the private justice of the internal management system” to the “public justice of accountability”.\(^\text{157}\) Parker proposes that such capacity to self-regulate may be enhanced by value orientation, management commitment, the acquisition of skills and knowledge and the design of internal processes and systems. The “self-regulation” of each microcosm should then be accountable to regulators and stakeholders in order to achieve not just “compliance” but responsibility towards the democratic polity. Parker envisages that “meta-regulation” would improve the permeability of the corporation to public accountability.\(^\text{158}\)

This approach may be manifest in the emphasis placed on corporate governance, risk management, ethical business management and even corporate social responsibility- encouraging corporations to


\(^{154}\) Above.


\(^{158}\) Parker, *The Open Corporation* (2000), above.
improve and self-reflect from the inside. The meta-regulation of risk management in financial institutions is in particular, a key feature of financial regulation in the EU and the UK. The Markets in Financial Instruments Directive provides for broad principles of organisational soundness, the establishment of a compliance function, risk management systems, internal audit, and the responsibility of senior management for compliance generally. These cannot be excessively prescribed as regulators are not in a position to micro-manage firms, and hence, these represent a meta-regulatory approach where regulators expect certain internal measures to be in place in firms, and the regulators’ role is to monitor the performance of such measures. Some commentators have lauded this approach as being reflexive and cost-effective, and likely to entail more permanent solutions that would be viewed as convincing for firms.

Parker suggests that the monitoring role of the regulator may be carried out in two aspects ie an outcomes approach and a process approach. The first means that regulators look at what is achieved in terms of the firm’s behaviour, and as long as the regulator’s objectives are met, the process of achieving them is left to the regulated to determine. This is similar to the principles-based approach taken by the FSA. However, as with the enforced self-regulation model, where the firm’s designs are subjective and technical, the performance of the designs may be difficult to evaluate. Under the meta-regulatory approach, there is also a risk of “capture by technocracy”. The process approach means that regulators would also look critically at the systems and processes that the regulated has put into place and may review such arrangements with the regulated. Parker has pointed out the dangers of leaving to the regulated to define the processes for compliance- the regulated can design processes to enhance cosmetic compliance and pass blame from senior management to weak and vulnerable employees when things go wrong. Further, Parker and Braithwaite both point out that it is essential for firms to have sufficient resources and capacity for self-reflection to design optimal systems, and that the regulator must not be evading the difficulty of supervising firms by latching onto meta-regulation. Where the regulator may not be well-equipped to discern outcomes or satisfactory processes, the regulator would in effect have delegated to the regulated not only to self-


163 Above at 144.

regulate processes, but also to define the goals to be achieved. This would in fact be no different from pure self-regulation.  

Meta-regulation is likely to continue as an important feature in the shared governance framework. This is probably underscored by the emphasis business management professionals and consultants place on the future of risk management, particularly Enterprise-wide Risk Management (ERM). ERM is an approach that attempts to consolidate and integrate the risks faced by firms and the processes used by firms to manage those risks. Firms therefore become microcosmic centers of self-control, identifying, pooling together and strategising with respect to the risks and opportunities to which the firm is open. ERM is described by Power as a tool for self-governance for the entire organisation of the firm, although he is sceptical if ERM will consist only of systems and processes that are designed to provide compliance and box-ticking comfort without true engagement with the risks facing the corporation, ranging from financial to social, reputational and strategic risks. Further, ERM may be said to be based on an extension of the audit framework, as its practice is closely linked to instituting systems in an organisation that capture data and provide audit trails. This may be due to the support of mainly accounting consultants who are professionally involved in developing ERM. More will be discussed in Section 3 of the specific issues in financial regulation that are governed by meta-regulation.

In sum, meta-regulation risks not being capable of evaluation by regulators, if they are “captured by technocracy” and find it difficult to judge the performance of the firm’s systems and designs. In this respect, shared governance such as meta-regulation that allows and entails reliance upon the internal expertise of firms may create a presumed legitimacy. An excessive emphasis on process

165 As pointed out by Parker in relation to the meta-regulation of corporate social responsibility issues, see Christine Parker, “Meta-Regulation: Legal Accountability for Corporate Social Responsibility?” in Doreen McBarnet, Aurora Voiculescu and Tom Campbell (eds), The New Corporate Accountability: Corporate Social Responsibility and the Law (Cambridge University Press, 2007), chp 8.


170 Rene M Stultz, “Rethinking Risk Management” in Donald H Chew ed, Corporate Risk Management (NY: Columbia Business School 2008) at 119 where it is said that “the primary goal of risk management is to eliminate the possibilities of costly lower-tail outcomes”.

and learning may produce a continuous dance in process rituals\textsuperscript{172} without giving rise to public goods and social outcomes. Further, meta-regulation may also be seen as an excessively microcosmic approach to regulation. It offers no particular insight as to the collective effects of firm self-regulation and issues of social risk or communitarian concerns, or systemic risk. Morgan suggests that meta-regulation is often premised upon the language of economic efficiency and the technocratic expertise of the firm itself, and this discourse risks eclipsing the bigger picture of redistributive issues, social rights and justice.\textsuperscript{173}

**Ethical Self-regulation**

“Business ethics” has become a staple discipline in business management education and is arguably crystallising into a body of values and standards for behaviour within a for-profit organisation.\textsuperscript{174} Could the existence of “business ethics” become a credible form of self-regulation or meta-regulation?

In a narrow sense, ethics may relate to the prevention of fraud or other anti-social and detrimental behaviour that may inflict organisational and social costs. Seen in that light, ethical self-regulation would include risk management, social responsibility in the sense of prevention or mitigation of externalities, and corporate governance.\textsuperscript{175} Ethics may also relate to “proactively” adding to social good, such as community participation and volunteering, related to the perspective of the corporation as a social institution being socially responsible and accountable.\textsuperscript{176}

Ethics has been defined as an *internal regulatory map* that leads to self-regulation, i.e. that individuals or the organisation have a coherent moral awareness, make moral judgments, may be driven to act by moral motivations and hence produce moral behaviour.\textsuperscript{177} However, the motivation towards ethical behaviour may also be rational, such as for the management of reputation or image,

\textsuperscript{172} These may be network “games” where entities in the network may spend time and effort influencing their capacity and communication in the network, and using extensive resources towards that end. The network may hence become an end in itself. See Erik-Hans Klijn, Joop Kopperjan and Katrien Termeer, “Managing Networks in the Public Sector” (1995) 73 Public Administration 437.


Hendry argues that we live in a bimoral society where both the pursuit of individual wealth and social good are equally lauded and hence where choices may have to be made between the two, individuals and institutions are often placed in a difficult and challenging situation. Internal dispositions towards moral behaviour are often challenged by countervailing forces, such as rational calculations in game scenarios, organisational indifference, or the market perceptions of the value of such behaviour. Hence, whether ethical dispositions may become a potent self-regulatory force or not would depend on the interplay of internal dilemmas, incentives and perceptions of the individual or organisation. Commentators have argued that it may be possible to provide “direction” for ethical self-regulation through pre-determined goals, i.e. “goal setting” could be effective for self-regulation to take place. However, it is also discovered that although goal-setting may help in driving self-regulation, it is susceptible to being redefined by the individual or organisation, and could also allow self-congratulatory behaviour, complacency and slack once the “goal” is perceived to be attained. On a governance level, could ethical self-regulation be reliable in producing a consistent pattern of self-regulatory behaviour in a firm, and an even pattern of behaviour across the industry?

Nevertheless, there is also literature suggesting that “ethics” as a self-regulatory force is often not self-induced, but follows the occurrence of a crisis, whether on an organisational or market level. A crisis often triggers the effect of “flinging far from equilibrium” for an organisation or entity, and in seeking to restore or redefine fundamental identity, reliance is placed on ethical reform to learn...
from the crisis.186 Crises are “push factors” towards a re-examination of ethical culture (or the lack thereof) and a rejuvenation of ethical consciousness.187 The global financial crisis may thus provide a context for re-examination as to the potency of ethical self-regulation as a form of self-governance by firm and industry. However, the self-regulatory potency of ethics is still questionable. To what extent are ethical references representative of change? Is recourse to “ethics” a flavour of the moment in response to crisis management? Will ethics have a permanent appeal for businesses?188 It is also arguable that ethical questions are often asked only with the benefit of hindsight, i.e. that pointing to the lack of ethical behaviour as an important factor leading to crisis usually takes place after the fact.189 Hence, on an ex ante basis, it could not be ascertained how far ethical behaviour would have prevented or mitigated any crisis, and this lack of ex ante proof of the value of ethical behaviour may undermine the self-regulatory potency of “ethics”. In sum, the various internal motivations towards or away from ethical self-regulation and the lack of ex ante correlation between ethical self-regulation and the prevention of crises are key factors in considering the place of ethical self-regulation in any aspect of financial regulation.

**Regulator-led Governance: Regulation**

“Regulation” may be defined as a phenomenon that seeks to provide a sustained and focused approach to modify the behaviour of the subjects of regulation, so that compliance may be secured according to the standards and goals in such regulation.190 This perspective sees regulatory control rights as being vested in the public authorities, in order to achieve predetermined regulatory goals. Hence, “regulation” is a form of governance with public character as discussed earlier, largely exercised through the rights of control in standard setting, supervision and enforcement.

Regulatory control may range from facilitative regulation, such as default provisions in law that could be adapted by the regulated, viz various provisions in company law; constitutive regulation that sets out parameters, frameworks and structures as to how power may be exercised or activities may be carried out, such as mandatory disclosure regulation for investment and securities products;
and regulative regulation that prescribes behaviour. Mandatory disclosure regulation is widely used in financial regulation. Its nature and rationale have been well canvassed in extensive academic literature. Regulative command-and-control type regulation is still prevalent in financial regulation, particularly in dealing with certain aspects of legal duties imposed on financial intermediaries, and in regulation dealing with market abuse.

Regulatory control is heavily attenuated with industry input in contemporary financial regulation. The industry is often asked to input into the policy making and standard setting process, the market may be asked to assist in surveillance, and responsive and risk-based regulation shows that enforcement is no longer a straightforward and polarised event between the regulator and industry. “Responsive regulation” was proposed by Ayres and Braithwaite in their classic book explaining that enforcement should not be looked at simplistically as a tit-for-tat strategy which regulators impose when non-compliance is detected. Rather, a pyramid of enforcement options should be devised to encourage long term compliance with the spirit of regulation. Regulators should generally start with informal persuasion and warnings in order to encourage future commitment towards compliance, escalating the severity of enforcement as the severity of the case merits. This allows regulators to put in place a graduated deterrence model that achieves social control with proportionate cost. Baldwin and Black further argue that there is potential to extend the responsive regulation model into a “really responsive” model, understanding the firm’s contextual, industry-based and cultural factors in compliance deficits. It is arguable that the risk-based regulation model adopted by the UK Financial Services Authority is an extension of the pyramid of enforcement, putting emphasis on proportionate regulatory intervention. The need for proportionate regulatory intervention is not only due to the lack of regulatory resources to use a big stick for every transgression, but also due to ideological and political acceptance of a “proportionate” and not invincible role of the state.

Modern regulation has evolved to become more participative, especially in relation to the industry, and restraint from overregulation stems from the perception of regulation as costly, stifling innovation and subject to public choice. However, one of the key issues in the global financial

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crisis is the management of systemic risk, particularly, the regulation of systemic risk. As the specific studies into OTC derivatives markets and hedge funds will show later, systemic risk management suffers from a collective action problem and is arguably a public good.\textsuperscript{197} Hence, the role of regulation of systemic risk may remind us of visions of social objectives\textsuperscript{198} and public good\textsuperscript{199} that are the representations of the concept of what essentially is “regulation”.\textsuperscript{200}

This review of governance models will form the rubric of the 8 models of governance in the financial services landscape along a spectrum as follows:

| No regulation-transactional governance | No regulation-self certification | Self regulatory organisation, inc market governance | Soft Law, External standards, comply or explain | Regulatory standards, meta-regulation | Regulatory standards, audit | Regulatory standards, adjudication/responsive regulation | Regulatory standards, strict liability |

The graph represents a linear spectrum, showing from left to right, a decreasing amount of private or self- governance, and an increasing amount of external or public regulation. All of the above models along the spectrum can be found in financial regulation, whether in the EU or internationally. Each model of governance arguably encapsulates the relational paradigm of regulators and the industry in different degrees of partnership or interdependence as a result of different policy, efficiency or political factors. The article does not delve too much into how these models of interdependence have come to be, but will critically examine selected areas of governance in the financial services landscape represented by the models. The critical examination will flesh out specific issues in relation to each specific area of governance discussed. However, the article also intends to suggest that the fundamental issues in the nature of governance in these models are as follows:


Models of governance in the financial services landscape are largely decentralised and shared, as in the models discussed in the literature review, but it is arguably the industry that has become overly dominant in this landscape.

The models of contemporary governance are susceptible to the problem of regulator “capture by technocracy”, and has resulted in the lack of accountability and checks and balances.

The marginalisation of the regulator and other stakeholders in the landscape needs to be addressed.

The contemporary models of governance do not sufficiently address issues of collective needs or public good such as systemic risk, whose ownership arguably falls to the regulator.

I will now discuss the 8 models of governance in the diagram above and selected areas of substantive law or governance in financial services represented by the models.

3. Eight Models in the Governance of the Financial Services Landscape

No Regulation Model

The first two models along the spectrum refer to governance that is not chiefly provided by regulation ie microcosmic self-regulation and transactional governance.

Prior to the global financial crisis, there have been significant areas of “no regulation” in the financial markets. An example of a microcosmic area of self-regulation is the self-regulation of sophisticated investors in investment decisions. The Markets in Financial Instruments Directive obliges investment advisers to categorise clients into retail, sophisticated or eligible counterparties. Investment advisers are placed under lesser obligations to be responsible for the suitability or appropriateness of investment products where sophisticated investors are concerned, and eligible counterparties such as financial institutions themselves would have the complete freedom to decide their investments with no external adviser being held to account for those decisions. The freedom of many financial institutions to purchase complex asset-backed securities which have turned out to be toxic may raise the question of whether the freedom in respect of investor choice or product design should be curtailed. The Turner Review in the UK has also left this question open. Three areas of discussion will now be made: the OTC derivatives market, the offshore entity of hedge funds, and the providers of “certifier” products such as credit ratings, corporate governance, social responsibility ratings. The next Sections will discuss how these issue areas are “governed”, the concerns highlighted in the global financial crisis and any implications from changes proposed to these governance models.

OTC Derivatives Transactions

201 Article 24.
203 Chapter 3.1(ii), The Turner Review (2009), op cit.
OTC (over-the-counter) derivatives have come under scrutiny following the risk of default by American insurance giant AIG in credit default swaps in the financial crisis. The looming default was ultimately prevented by the bail-out granted by the US Treasury. Derivative transactions are not subject to product regulation in the leading jurisdictions of financial regulation such as the US and the UK, but the financial institutions dealing with them are generally subject to regulatory supervision under financial or corporate regulation. Derivative trading is generally regarded as part and parcel of the financial risk management not only of financial institutions but of corporations in general, although some empirical research shows that corporations also use derivatives not only to hedge but to add value. Although Enron is an extreme and spectacular failure of speculation in derivatives, it cannot be ruled out that some extent of derivative speculation goes on in corporate life.

Exchange-traded derivatives are not subject to product regulation as they have developed into standard forms, and exchanges act as central counterparties to all such derivative transactions. Hence, the credit risk of such transactions are passed to the exchange, and the exchange manages risk of default through risk monitoring, centralised loss-sharing mechanisms, collateral and margin policies, netting and settlement facilities and controlled accessibility to the exchange by membership. For example, LCH Clearnet was able to resolve the defaults by Lehman Brothers after the investment bank collapsed in September 2008, by using the collateral posted by Lehman and the loss sharing arrangements in place.

Bilateral OTC derivatives are generally tailor-made to suit the purposes of counterparties and are therefore less standardised. They are settled bilaterally, which means that counterparties will have to bear the credit risk of each other, and this could be augmented as the settlement time frames of derivatives could be long, and could vary, and could also have many periodic runs. In order to mitigate the risk of bilateral OTC derivatives, the International Swaps and Derivatives Association (ISDA) has developed a Master Agreement to standardise certain terms such as collateral policies, netting of open positions and how counterparty credit risk should be evaluated. Many OTC derivatives are based on the ISDA Master Agreement. Further, Kroszner is of the view that developments such as the ISDA Master Agreement, the availability of credit ratings made by rating agencies such as Standard and Poor’s or Moody’s, and better risk management technology overall

204 Partnoy points out the difficulties in regulating derivative “products” directly, as rules often give rise to more opportunities for arbitrage and unintended consequences, and risk being too prescriptive. See Frank Partnoy, “ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?” (2002) at http://ssrn.com/abstract_id=293085.


has mitigated the risk of OTC derivative transactions to the extent that a “dis-integration” from exchange traded derivatives would occur.\textsuperscript{207}

In the wake of the financial crisis, thought is being given as to the risks that derivative trading poses to the financial systems of the world. In particular, bilateral OTC derivative trading is highlighted to attract concern as a heavily exposed counterparty such as AIG could pose systemic risk, in addition to the credit risk borne by counterparties. As Schwarz points out,\textsuperscript{208}

\begin{quote}
Without regulation, the externalities caused by systemic risk would not be prevented or internalized because the motivation of market participants “is to protect themselves but not the system as a whole .... No firm ... has an incentive to limit its risk taking in order to reduce the danger of contagion for other firms.”
\end{quote}

Left to transactional governance between counterparties in a bilateral OTC derivatives contract, neither party would take ownership of the systemic risk that could entail from the overall exposure either party may have. The leading recommendation in the US and EU is that the market-based governance provided by exchange-traded derivatives could mitigate the systemic risk in bilateral OTC derivatives trading, through standardisation and oversight by central counterparties. Blair and Gerding\textsuperscript{209} argue that the central counterparty mitigates credit risk and is able to provide orderly resolutions upon default, thus mitigating systemic risk. Further, they also argue that central counterparties are ideal data repositories that can show up excessive exposures, highlight risk and bring in prudential monitoring by the central counterparty to exert discipline, for example, by requiring more collateral. The information collected by the central counterparty may also highlight industry trends, and whether firms have similar exposures, and how these exposures may affect systemic risk. Hence, Blair and Gerding are of the view that moving OTC derivative trading to be exchange traded would be a step in the right direction. This is also to be the position in the US Treasury White Paper on reforms required post the global financial crisis,\textsuperscript{210} and the Over-the-Counter Derivatives Markets Act 2009.\textsuperscript{211} Although the European Commission has not proposed that all derivatives trading should become concentrated on exchange, it proposes to encourage exchange trading by levying higher capital charges on bilateral transactions, and to mandate all standardised derivatives contracts to be centrally cleared.\textsuperscript{212}


\textsuperscript{210} US Department of the Treasury White Paper, A New Foundation: Rebuilding Financial Supervision and Regulation (March 2009).

\textsuperscript{211} See esp s113.

In essence, the issue of systemic risk is the key driver for thoughts behind reforming the basically transactional governance that exists in bilateral OTC derivatives transactions. The transactional governance between counterparties supported by the ISDA Master Agreement is not regarded as sufficient, as transactional governance by its nature deals with the microcosm of the transacting parties and the risks attaching to those parties only. Transactional governance is arguably unable to deal with systemic risk such as caused by multiple similar exposures by other firms in the market. Acharya\textsuperscript{213} argues from empirical evidence that financial institutions deliberately take similar risks although they are aware that the multiplication effects of risk materialising would cause systemic effects through the financial system. This is because financial institutions see that the chances of them being bailed out would increase in the event of joint failures than in the event of individual failures. This seems to suggest that private market institutions do not inherently see themselves as the ultimate owners of the responsibility for mitigating systemic risk. Bookstaber’s analysis of derivatives such as portfolio insurance in the 1980s would go as far as to say that the nature of some derivatives is such that when analysed in a microcosm, the hedge looks sensible, but on a macro level, the adoption of the same hedge across the industry would itself be responsible for triggering systemic effects in losses that would multiply and cascade across similar transactions.\textsuperscript{214}

However, under the reform proposed in the US and the EU, reliance would be placed on market-based governance supplied by the central counterparty. This also means that reliance is placed on the central counterparty not only to take ownership of the responsibility for credit risk in each transaction but also the systemic risk of the patterns and volume of derivatives trading as a whole. Culp argues that substituting bilateral transactional governance for central counterparty governance may not be ideal as the exercise merely offloads risk onto the central counterparty. Although the central counterparties have been robust and resilient thus far, they have existed in a framework of competition with the market for bilateral transactions. The removal of that diversity could create a significant burden on central counterparties, and if central counterparties fail, the effects could be systemically catastrophic.\textsuperscript{215} However, central counterparties have extensive experience in managing risk, and hence the risk of central counterparties failing may be small.

Nevertheless, if the concentration of derivatives trading on exchange becomes significant, central counterparties can be too big to fail. This may mean that reliance on central counterparties may have to be underlined by government support, as a form of lender of the last resort. Hence, addressing systemic risk may require the participation of public governance, and such participation could be in the form of underwriting the robustness of private market institutions such as central counterparties. If central counterparties dominate in governing derivatives transactions in good times, but public governance is envisaged to have a role in bad times, then there may arguably be an


\textsuperscript{215}Christopher L Culp, “The Treasury Department’s Proposed Regulation of OTC Derivatives Clearing and Settlement” (2009) at \url{http://ssrn.com/abstract=1430576}. Further, if central counterparties become too big to fail, then another problem in moral hazard may be created.
effective delegation of governance to central counterparties for achieving public goods such as financial stability. Delegation of governance raises the relational issues of accountability and agency,\(^\text{216}\) which if not dealt with, could result in moral hazard.\(^\text{217}\)

One such principal-agent issue may be conflicting objectives that the central counterparty has to address, between satisfying its members and taking tough measures to manage risks. Lima et al and De Marzo et al, as discussed earlier, have highlighted the tendency of self-regulating organisations to maintain harmonious relationships with members and hence may be unwilling to take tough enforcement or discipline against them.\(^\text{218}\) The mitigation of any potential agency problems is arguably key to delegating governance in derivatives markets to central counterparties.

In the UK, the FSA arguably has oversight of the financial resources of central counterparties before giving them recognised status.\(^\text{219}\) However, as there are no clear bright lines as to continuing prudential management, this area may arguably have to be relooked if central counterparties are to become more important as a source of governance in the OTC derivatives market. In the EU, the Settlement Finality Directive already provides for the harmonisation of approaches in the EU markets to protect settlement and netting carried out by clearing houses and central counterparties from domestic insolvency proceedings, and the Financial Collateral Arrangements Directive provides for the recognition of a range of possible collateral, the processes for realisation of collateral when necessary, and the adoption of close-out netting for the transfer of collateral even upon the onset of a participant’s insolvency.\(^\text{220}\) In addition to the above, perhaps it should be considered whether the prudential regulation of central counterparties should be continuing and harmonised to ensure that


\(^{219}\) FSA Handbook REC 2.

systemic risk may be managed when the volumes of trades mandated through central counterparties increase.

In addition to enrolling central counterparties to provide governance over derivatives trading, the US and EU are also adopting a post-trade transparency approach\(^{221}\) that would require all trade data in derivatives to be reported and disclosed. Such trade data would then be centrally stored in data repositories. As the EU embarks on systemic risk regulation for the internal market, with the leadership of the European Securities Markets Authority, European Banking Authority and European Insurance and Occupational Pensions Authority,\(^{222}\) accountable to the European Systemic Risk Board,\(^{223}\) such information could potentially feed into general prudential regulation undertaken at the EU level.

The European Systemic Risk Board (“ESRB”) is supported by the work of 3 pan-European regulators for banking, insurance and securities markets, who are currently networks of member state regulators. Member state regulators are however also accountable to their respective governmental authorities in respect of systemic risk, such as the UK Council of Financial Stability that comprises the Treasury, Bank of England and FSA. It is queried as to how information may be coherently processed and evaluated in this multi-tiered structure, and the diversity in goals that may be brought to the table may be significant as well.\(^{224}\) The ESRB has a right to have regular data reporting by the 3 pan-EU regulators, and the right to gain access to any necessary information.\(^{225}\) However, the information transmission, processing and aggregation between the 3 pan-EU regulators and national regulators, and within national frameworks may still need to be worked out. The complex structure for overseeing systemic risk at the EU may need to be revisited to ascertain if systemically relevant information could be effectively discerned and analysed. The potentially voluminous disclosure of post-trade data would have to be put to effective study and use, in a coherent and coordinated manner.

\(^{221}\) S113(4), s114, Over-the-Counter Derivatives Markets Act 2009; CESR, “Commission Consultation Document on the possible initiatives to enhance the resilience of OTC Derivatives Markets” (14 Sep 2009).


\(^{223}\) Proposal for a regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB), Sep 2009.


\(^{225}\) Arts 14 and 15, Regulation Of The European Parliament And Of The Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board.
Finally, Stout suggests the direct regulation of access to derivative trading, i.e. transactions in breach of the rule against difference contracts should be void. The “rule against difference” was in force in the US until the liberalisation of derivative trading in 2000, and basically required that derivative trading would only be valid if based on an actual interest in the underlying subject matter of the derivative transaction. In the absence of such an actual interest, a derivative contract would be no different from a mere speculative transaction and would be outlawed. This could reduce the amount of derivative trading being carried out, cutting down the amount of “socially useless” activity in the financial services sector. Lord Turner’s suggestion that risky and “socially useless” activities may attract higher tax could be taken in the same vein as Stout’s suggestion. Shrinking the volume of speculative derivative trading may actually be a way to preserve erstwhile transactional governance in OTC derivatives trading, as the systemic risk may be abated with a smaller sector, lower volumes and lower impact resulting from risky exposures. However, it would probably be unrealistic to turn the wheels of time backwards.

**Hedge Funds**

Hedge funds carry out a range of complex investment strategies to “generate absolute returns” and some take on significant risk such as leverage in that process. Bookstaber offers a view of hedge funds, viz:

“The hedge fund/alternative investments moniker is a description of what an investment fund is not, rather than what it is. The universe of alternative investments is just that: the universe. It encompasses all possible investment vehicles and all possible investment strategies minus the traditional investment funds and vehicles.”

Bookstaber is of the view that “traditional investment funds and vehicles” are regarded as mainstream only because they have been defined in scope by regulation, and are hence a subset of the wider world of investment. To regulate hedge funds would be tantamount to regulating the investment activity itself in total. Prior to the global financial crisis, although many recall the debacle of Long Term Capital Management in 1998, there are mixed views as to whether hedge funds should be subject to some extent of regulatory supervision. After all, the losses that may entail

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227 “Financial Services Authority chairman backs tax on 'socially useless' banks”, The Guardian (27 Aug 2009), quoting Lord Turner’s remarks in an interview with a current affairs magazine, Prospect.

228 F S L’Habitant, Hedge Funds: Myths and Limits (Wiley Finance 2002) at chapter 4.

229 Bookstaber, Markets, Hedge Funds and The Perils (2007), op cit at 244.

230 Dick Frase, “Regulatory Creep and Convergence: Hedge Funds and the Regulators” in Iain Cullen and Helen Parry eds, Hedge Funds: Law and Regulation (London: Sweet & Maxwell 2001) at 17ff, arguing that the LTCM debacle has resulted in “regulatory creep” around hedge funds, such as the regulation of investor restriction and market abuse.

231 The Report of the Alternative Investment Expert Group to the DG Internal Market (European Commission, July 2006)at para 1.3 quite clearly arguing that hedge funds should be left unregulated, and the FSA, Discussion
from hedge fund failure are those that fall on the fund itself and their usually sophisticated investors. However, the concern now is that institutions such as pension funds also invest in hedge funds and hence investment losses may also be social losses. Further, the volumes under hedge fund management have grown and hence failures of funds may pose a systemic risk if cascades of failures result.232

Hedge funds present micro-type risks affecting the survival of the fund, to macro-type systemic risk that could affect the industry and related institutions. For micro-type risks, it is perhaps worth considering the room for hedge fund counterparties to exert transactional governance to mitigate those risks. This is because the equivalent sophistication on both sides may provide “good working order”233 in transactional governance. Banks financing hedge funds are in a position to monitor credit risk, and prime brokers may be in a position to mitigate fund exposures to market risk by collateral and margin requirements. Prime brokers generally perform the services of execution, custodianship, clearing and settlement and securities lending against collateral. They are intimately connected with hedge fund activities and could be in a position to monitor the risks of hedge funds.

King and Maier234 argue that left on their own, although prime brokers have the ability to impose certain controls and undertake monitoring of hedge fund risks, they are unlikely to do so as the competition in the market entails incentives to race to the bottom in order to attract hedge fund engagement. They argue that regulation should be increased for prime brokers, so that direct regulation over prime brokers could provide indirect governance over hedge funds through transactional controls that prime brokers would have to implement. Such transactional controls could relate to prudential monitoring of hedge fund exposures, and could relate to margin and collateral posting and leverage ratios. The irony in the recent global financial crisis is that, instead of perceived risky hedge funds falling out and causing systemic risk, Lehman Brothers was the prime broker that fell, resulting in controversies as to whether hedge fund assets held in Lehman accounts at the time of the filing for bankruptcy would be ringfenced on trust.235

Investors in hedge funds may also be in a position to monitor the fund’s market and operational risks. In the smart regulation model, hedge fund activities are carried out in a web of many interacting actors that could supply governance to mitigate the risks of hedge fund activities. However, it could be argued that although the theoretical smart regulation model would co-opt these actors in the “regulatory space” as “surrogate regulators”, the faith in them could be


235 In the Matter of Lehman Brothers International (Europe) [2009] EWHC 2545 (Ch).
misplaced. These “surrogate regulators” can fail when they are overly optimistic, riding on market bubbles and behaving in an irrational manner, or where prime brokers are concerned, racing to the bottom in a competitive market to be engaged by hedge funds. When “surrogate regulators” in the market succumb to the heuristics and biases\textsuperscript{236} of bounded rationality, banks may offer excessive leverage, prime brokers may be lenient with margin discipline and investors may not ask for sufficient accountability.

The European Commission’s proposal\textsuperscript{237} to directly regulate alternative investment funds including hedge funds and private equity funds may however exert more control than is necessary for the purposes of public good ie the mitigation of systemic risk. As it is not easy to define a hedge fund, the Proposal for a Directive to Regulate Alternative Investment Fund Managers\textsuperscript{238} covers all alternative funds that are not within the scope of UCITS (undertakings in collective investments relating to transferable securities, which can be offered on a passport under home country control in the EU\textsuperscript{239}). This may capture non-UCITs\textsuperscript{240} funds that could be marketed to members of the public under FSA authorisation, and other miscellaneous collective investment schemes that can now legitimately operate in other Member States beyond the harmonised UCITs schemes. Although the Proposal has \textit{de minimis} rules that exempts smaller collective investment funds in Member States from being captured, perhaps more consideration may be given as to whether the scope of the Proposal can be designed to capture the regulation of risk and not the regulation of all non-UCITs funds managing above a certain volume.

That said, the Proposal has a few notable features. The Proposal arguably provides a mixture of micro-regulation of hedge fund risks, and macro-regulation of the type of systemic risk that hedge funds may pose. On micro-regulation of hedge fund risks, the Proposal arguably strengthens the position of investors in hedge funds, and this could empower them as monitors of hedge funds in the smart regulatory space. Investors could benefit from the duties imposed on fund managers to treat them fairly and act in their best interests, and investors would receive annual and periodic disclosure protecting their interests and rights over issues such as the integrity and independence of valuation, termination terms and rights, hedge fund investment policies and strategies, risk management and profile.\textsuperscript{241} However, it is queried if sophisticated investors in hedge funds should have more arsenal than the above. Sophisticated investors may often be subject to lock-in periods


\textsuperscript{238} 29 April 2009.


\textsuperscript{240} For example, non-UCITs retail schemes see FSA COLL 1.2.

\textsuperscript{241} Arts 9, 10, 15-17, 19 and 20 of the Proposal, op cit.
and limitations of withdrawals, and such provisions may greatly undermine their ability to exert
discipline on hedge funds. However, it may also be argued that readiness to “exit” is not necessarily
an optimal disciplinary strategy, and that the exercise of “voice” may achieve a dimension beyond
the mere market force of the invisible hand. This area may be revisited to see if it is necessary for
regulation to empower investors in exit rights in order to enhance their monitoring of hedge funds.

Further, although not in the Proposal, the UK recommendations in best practices for hedge funds
made in the Large report suggest that specific disclosures on risk profiles and management, and
valuation policies be disclosed to prime brokers, so that prime brokers may be kept in the loop of
monitoring hedge funds’ levels of exposures. Hence, the smart regulatory model may be enhanced
by appropriate regulation to empower transactional parties such as investors and prime brokers, as
these actors could act as “surrogate regulators”.

The strength of transactional governance lies in its bottom-up nature. Contracting parties are
intricately involved in addressing issues and can provide solutions in a reflexive and innovative
manner. Where contracting parties may have equivalent amounts of sophistication such as hedge
funds, prime brokers and the sophisticated investors in hedge funds such as institutional investors,
regulatory provisions that empower and enhance their knowledge and informational capacity could be important to the micro-governance of hedge funds. Perhaps the transactional governance that could be provided by investors over hedge funds could further be supported by the availability of joined civil actions by investors against hedge funds for fraud, breaches of contractual duties or duties of care, diligence and trust.

On the macro-level of overseeing the risks the hedge fund industry may pose to the overall financial
market, the Proposal empowers regulators to receive key information regarding risk management,
profiles, leverage, short selling and other such information regularly from hedge funds. Information is likely to be key to the management of systemic risk by regulators. However, there is a need to meaningfully process, understand and use the information received in ascertaining the

243 Hedge Fund Working Group (led by Sir Andrew Large), Hedge Fund Standards: Final Report (Jan 2008).
245 Also earlier proposed by the Hedge Fund Working Group (led by Sir Andrew Large), Hedge Fund Standards: Final Report (Jan 2008), largely based on information disclosure as a set of best practices.
246 The hedge funds of failed US investment bank Bear Stearns have been sued by numerous investors including Barclays, Barclays, PLC v. Bear Stearns Asset Mgmt. Inc., et al., No. 07-CV-1140 (S.D.N.Y.). Greater openness to civil actions in investment enforcement is seen in the HM Treasury, Reforming Financial Markets (6 July 2009).
247 Arts 20-24, the Proposal, op cit.
patterns of industry wide risk and weaknesses. Besides disclosure, the Proposal also recommends certain prescriptive risk management measures such as the management of liquidity risk. The Proposal also intends to impose limitations on hedge fund investments in respect of risky investment decisions such as in relation to asset-backed securities. However, it is queried if such specific prescriptions could be drafted as more general framework principles so that Commission legislation could in due course provide for specific measures. This would allow the public governance of systemic risk to develop in an incremental and informed way.

It may be argued that the imposition of direct regulation inevitably undermines transactional solutions, as regulation has the effect of replacing and centralising transaction costs and removes the impetus towards private solutions. This may arguably stifle innovation in transactional governance that prime brokers and investors could exert for accountability. However, as King and Maier have pointed out, enhanced regulatory empowerment of the “surrogate” regulators in the smart regulatory model may be necessary in order for them to act at all. In addressing micro-type risk concerns, transactional governance in particular should be encouraged. Perhaps the Proposal should also empower prime brokers as proposed in the UK Large Report, and to improve informational transparency to them to support transactional governance that could be provided by them.

However, where systemic risk issues are concerned, the lack of collective ownership of systemic risk issues often means that regulatory governance is necessary. The Proposal’s template for disclosure and possible specific prescriptions into investment activity where systemic risk issues loom large represent an appropriate scope for public governance. It would however be important that the Proposal is not anti-gold-plating and that Member States may be able to introduce measures specific to their concerns. The key challenge in the management of systemic risk in the EU would lie in the coordination between national and EU levels of governance. The primary level of regulatory oversight lies with national regulators who register the funds, and continuing information disclosure by funds would be made to them. But systemic risk issues likely have to be addressed beyond the national level, especially in the interconnected markets of the EU. It remains to be seen if the multi-tiered structure in the EU dealing with systemic risk information and coordinating governance action would be effective.

A multi-tiered structure in dealing with systemic risk issues could be effective as ground-level information may be ascertained by national regulators and be transmitted to pan-European

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248 Fanto for example doubts that regulation of risk is possible based on the technical and subjective nature of risk information, James Fanto, “Financial Crisis Reforms: Maintaining the Status Quo?” paper presented at Centre for Commercial Law Conference, Queen Mary University of London, 11 Dec 2009.

249 Art 12, the Proposal, op cit.

250 Art 13, the Proposal, op cit.


authorities and the Systemic Risk Board. On the other hand, national regulators could filter out information they choose to disregard, and seemingly irrelevant or local information which might prove to be important upon hindsight. The potential for coordination and economies of scale in processing local and cross-border information is immense, but the potential for conflict of goals is equally so, as national governments with political concerns may be involved in systemic risk governance with the national regulators. Moreover, Member States do not necessarily desire coordinated action if such action encompasses risks to the autonomy of any particular Member State in dealing with what it may perceive to be issues of national concern. The autonomy of Member States also faces another challenge - the pan-European authorities in banking, securities, insurance and occupational pensions are mandated to produce hard law that would secure convergent technical standards and supervisory approaches in Member States. Although these authorities are heavily underpinned by the network of national regulators, the institutionalisation of management and hierarchy in the authorities entail the independence of the authorities from the networks. Further, the Systemic Risk Board has the power to issue non-legally binding warnings which would no doubt be highly persuasive, although it could be arguable that Member States could distinguish high-level indications from the Board, from their local conditions, in deciding what weight to attach to such warnings. It remains to be seen if the combination of soft law from the ESRB and the hard law that can be issued by the pan-EU regulators may produce an overall EU level governance for the regulation of risk, and how this may work with national management of systemic risk.

Self-Certification by Providers of “Certifier” Products

Investment products are often referred to as “credence goods”, and hence the market produces “certifier” products to help investors discern the quality of such credence goods. The purchasers of such certifier products are however not investors, but issuers, for the purposes of enhancing the attractiveness of their products. Credit ratings are intended to provide information on the credit-worthiness of investment issuers, ratings on corporate governance provide information on how the agency problem in a corporation is managed, social responsibility ratings and achievements provide information on the ethical, social and environmental reputations of the corporation. Certifier

253 The UK Council of Financial Stability would include the Treasury as representative of the government.

254 To be endorsed as Commission legislation, see Art 7, and 11-15, Regulation Of The European Parliament And Of The Council establishing a European Securities and Markets Authority, Sep 2009.

255 Art 25(1)(b), Regulation Of The European Parliament And Of The Council establishing a European Securities and Markets Authority, Sep 2009, for example.

256 For example, Art 4, 25 of the above Regulation setting out the institutional structure, and Art 3 giving the Authority separate legal personality, and Arts 6-24 dealing with the tasks and responsibilities of the Authority and its powers.

257 Art 16, Regulation Of The European Parliament And Of The Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, Sep 2009.

products potentially also include analyst recommendations to buy or sell, but this discussion will exclude the issues pertaining to analysts as the Markets in Financial Instruments Directive already provides direct regulation over certain aspects of research products. The Directive prohibits research analysts from receiving inducements to promise favourable research and the FSA Handbook further requires that research must be labelled as non-independent if conflicts of interests are involved, and that dissemination of research must be done fairly including highlighting the existence of conflicts of interests.

There has hitherto been no need for the certifier products themselves to be regulated, in respect of the processes giving rise to them, and the soundness or integrity of these processes. It is not suggested that this is therefore a regulatory gap. Products released into a marketplace are subject fundamentally to market discipline, i.e. that the market could itself test the accuracy of such products and user feedback may affect issuer demand and provide a form of market discipline for certifier products. However, market discipline would only be effective if there is competition in the supply of the products, and information is supplied to the market to help in discerning the quality of the products. In the market for credit ratings, there is an effective international oligarchy of Standard & Poor’s, Moody’s and Fitch. Further, the competition on the demand side for ratings comes from issuers, and issuers would shop for the most favourable rating. These demand-led forces do not encourage credit rating agencies to issue ratings to benefit their stakeholders, i.e. investors who rely on the ratings. Hence, the competition actually produces a race to the bottom rather than a race to the top to meet stakeholders’ needs. Further, there is also information asymmetry between the users of the ratings and the rating agencies, although the US “NRSRO” Regulation and the IOSCO Code of Fundamental Best Practices for Credit Rating Agencies provide for disclosures to be made of rating methodologies and management of conflicts of interest. These disclosures may not provide sufficient insight for users to discern if a rating is in substance “accurate”. The accuracy or otherwise of a rating may only be settled after an investor has taken a risk with the purchase of an investment and either made a gain or suffered a loss. Although there are market imperfections in terms of rating agencies’ incentives and the situation of information asymmetry, those alone have not warranted regulatory intrusion into governing the supply and quality of certifier products.

Where corporate governance ratings are concerned, there is a greater number of players including the “Corporate Governance Quotient” by the Institutional Shareholder Services (ISS) and RiskMetrics Group, Governance Metric Index by Governance Metrics International, and The Corporate Library.

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259 Articles 24-5, MiFID Commission Directive.


261 Many argue that the US SEC’s regulation to register only established and tested credit ratings agencies created further barriers to entry for competitors, protecting the incumbents’ oligarchy, see Regulation on “Nationally Recognised Statistical Rating Organisation” (2006), and Jeffrey Manns, “Rating Risk After The Subprime Mortgage Crisis: A User Fee Approach For Rating Agency Accountability” (2009) 87 North Carolina Law Review 1011.

Ratings by The Corporate Library (founded by Robert Monks, an avid activist investor in the US). Social responsibility ratings are provided by leaders such as the Socrates Database managed by Kinder, Lydenberg, Domini Research & Analytics (KLD) and Intangible Value Ratings provided by RiskMetrics. It remains to be seen whether the market for such ratings would be dominated by issuers as well, and the incentives driving the provision of these services would then be similarly affected by issuer demand. Corporate governance and social responsibility rating services however exist alongside other not-for-profit initiatives such as the Sunday Times Best 100 Companies to Work For, and World’s Most Ethical Companies (Ethisphere). Thus, these initiatives may be able to provide some balance in the landscape so that issuer domination on the demand side would not necessarily produce a race to the bottom, and stakeholder needs may be met by aggregating the information available to the market from rating providers and not-for-profit initiatives.

Another factor that aggravates the lack of healthy competition in the market for certifier products is the fact that the market is likely subject to network effects, i.e. that the more use is of made of the product, the appeal to the market of such products increases and more users are attracted to the product. As White explains, users’ desire for consistency of ratings across investment products helps to sustain reliance on the few incumbents in the credit rating market. The market for corporate governance and social responsibility ratings also consists of a few incumbents, but the oligarchic structure may be ameliorated by the range of not-for-profit initiatives mentioned above designed to provide information to stakeholders for free. Hence, compared to corporate governance and social responsibility ratings, perhaps market discipline in terms of information and competition would be relatively weaker for credit rating products.

Where market discipline is weak, sub-optimal rating products may be provided on the market and the externalities may be occasioned to stakeholders who use the ratings. In the absence of contractual redress between investor-users of the rating products and the rating agencies, stakeholders may have considerable difficulties in exerting discipline upon rating agencies through civil enforcement. It remains to be seen how CalPERS’ suit will fare against all three rating agencies in the US for erroneous top ratings given to toxic structured securities products based on subprime mortgages. Stakeholder discipline through judicial redress is likely to be costly and ad hoc. The externalities would in essence be mistaken investment choices and hence investment losses. On a certain level, it is not that different from a consumer who has relied on a Which? Magazine review and bought an electrical appliance that subsequently does not turn out to last. Risk of consumption loss may be regarded as a private risk to be mitigated by private diligence or private law redress. One way out would be to regulate for an “investor-pays” model of credit ratings so that direct

263 Although some empirical research queries as to whether the ratings are of any predictive value as to existing and future performance, and whether the ratings actually correlate with the governance findings behind them, see Robert Daines, Ian Gow, and David Larcker, “Rating the Ratings: How Good Are Commercial Governance Ratings?”, Arthur and Toni Rembe Rock Center for Corporate Governance, Stanford University (June 2008).


accountability can be constructed between rating agencies and users. However, Rousseau is of the view that this may preclude some users from being able to access ratings information. Or should there be regulation to either mitigate the externalities that would arise, or else order that the externalities be borne by the rating agencies or issuers?

This paper suggests that regulation to mitigate the externalities that mistaken ratings would cause to stakeholders who rely on them becomes necessary when ratings are not merely a private good, but also a public good. Bruner and Partnoy point out that regulators have prematurely given their seal of approval to credit rating products and have integrated credit ratings into their regulatory schemes. Hence, the issue with credit ratings is that they are no longer merely certifier products for the market, they are certifier products that regulators have bought into, for example, in order to work out the required level of minimum capital in financial institutions. This has not happened yet with corporate governance and social responsibility ratings. Regulatory approval without further checks has obliterated market discipline for credit rating products, as the market is no longer being asked to ascertain accuracy. The market assumes accuracy due to regulatory approval, but regulatory approval itself may have been unfounded. It remains open to regulators to retreat from such product endorsement and leave the credit rating market to be disciplined by user preferences and litigation. In the alternative, if regulators need to continue relying on rating products, then regulators may arguably have to develop yardsticks by which to evaluate the credibility of such products. Arguably, regulatory monitoring would be needed as if the production of public goods has been outsourced and the lack of evaluation would result in practical unaccountability.

266 Manns, “Rating Risk” (2009), op cit argues that an aggregated user-fee model can be implemented, to be administered by the regulator, and such a model could allow users to sue ratings agencies and for the regulator to decide the thresholds for any action.


268 Christopher M Bruner, “States, Markets and Gatekeepers: Public-Private Economic Regimes in an Era of Economic Globalisation” (2009) 30 Michigan Journal of International Law 125; Frank Partnoy, 'The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies' (1999) 77 Washington University Law Quarterly 619. For example, Regulation AB provides that historical performance disclosure can be omitted for offering of Asset-backed securities if such as “investment grade” with reference to an NRSRO rating. Hence, ratings from recognised credit ratings agencies may be used as proxies for traditional disclosure regulation. Further, the Basel II Capital Accord prior to the financial crisis recommended that minimum capital requirements for banks be implemented with reliance upon credit ratings issued for the assets banks hold, as a part of the “standardised” approach, see eg P van Roy, “Credit Ratings and the Standardised Approach to Credit Risk in Basel II”, European Central Bank Working Paper 2005 at http://www.ecb.int/pub/pdf/scpwps/ecbwp517.pdf.

269 Bruner, above.

270 Very unlikely, according to Spatt (2009), above, although some intimation towards has been reported in the US.

Prior to the global financial crisis, regulators all over the world have “outsourced” the development of rating methodologies to credit rating agencies, but unlike any outsourcing partnership between the public and private sectors, regulators have not assumed any oversight or monitoring over the development of rating products, relying on the reputation of the giant incumbents.272 The financial crisis has shown up the weakness of this self-regulatory model of certifier products. Rating agencies have not applied ethical self-regulation to provide the most credible ratings, and have instead succumbed to issuers’ demands and have not prioritised their user stakeholders’ interests.273

The EU Regulation274 to regulate credit rating agencies envisages that the European Securities Markets Authority (“ESMA”) would have to approve of rating agencies and monitor their operations, and that rating agencies should be subject to periodic disclosure of their key methodologies, assumptions, conflicts of interests and remuneration policies. A similar approach has been found in IOSCO’s Code of Conduct for Rating Agencies issued in 2004, now updated to incorporate more rigorous principles and accountability to stakeholder in rating complex structured products.275 Information disclosed to ESMA would be useful only if the regulator has expertise in critically appraising how ratings systems should be designed and operated and be able to test the performance of these systems in delivering accurate ratings. There may be a gap between having systems and procedures that actually deliver credible and reliable ratings and having systems and procedures that look adequate and intelligent enough to the regulator. Regulators have to avoid succumbing to the acceptance of processes adopted by the regulated, and need to be in a position to test the performance of these systems and determine if the regulatory good is delivered.

Stolper argues that it is inherently very difficult for regulators to detect whether optimal and accurate ratings have been delivered by agencies, and if agencies collude with each other instead of compete with each other to deliver accurate ratings, then regulators will unlikely discern if accurate

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ratings have been delivered. Further, there is the issue of whether the regulatory regime will now be regarded as tantamount to underwriting the quality of the rating product.

It is not insurmountable for ESMA to develop actual critical expertise in vetting rating agencies’ methodologies and findings. In areas of regulation over medicines for example, regulator approval more or less warrants the quality and safety of use for such products and such guarantees are only possible because the regulator has developed matching expertise with the industry. There is some justification for ESMA developing the capacity to vet the information submitted by rating agencies and to evaluate the quality of the rating product. Besides, ESMA has been tasked to develop technical standards in its establishing legislation.

In developing ESMA’s technical, knowledge and informational expertise, ESMA is rightly expanding its relational paradigm to include stakeholders, so that its relational paradigm would not be dominated by the industry. The enrolment of stakeholders allows diverse input into knowledge and capacity building, as well as critical views and input. The diversity of views ESMA is exposed to could help develop greater critical capacity in evaluating the rating agencies’ performance. However, it is submitted that the Stakeholders Group should not be of closed membership, and should facilitate a platform allowing other stakeholder views to be submitted and stakeholder discussion sessions to be conducted.

Gerding also suggests that regulator expertise in rating methodologies and standards can be enhanced via the development of open technical standards for rating products. This argument borrows from the idea of “open source” in software developments that open participation in information pooling and technical development by any interested party can help shape and build a robust product. The ethics in open source lies in no one being able to claim proprietary rights over such product. However, unlike the ethos in “open-source”, rating agencies are unlikely to give away their proprietary systems voluntarily and regulation may be needed to compel the establishment of that open platform. Forster argues that the chief difficulty in discerning the reliability of ratings lies


277 Rousseau, “Regulating Credit Rating Agencies” (2009), op cit argues that governments should perhaps have direct input and control over the ratings methodology and process, but this paper suggests that moral hazard may entail from reliance on the government stamp of approval, and this puts undue burden on governments to get the ratings “right”, which could be very difficult for complex assets.


279 Art 7, Regulation Of The European Parliament And Of The Council establishing a European Securities and Markets Authority, Sep 2009.

280 Art 22, above.

281 Art 22, Regulation for the European Securities Markets Authority, op cit, which envisages a closed group of 30 members selected for a term of two and a half years and may only be re-selected for an additional term.

282 Erik F Gerding, “Code, Crash and Open Source” (2009) 84 Washington Law Review 127, arguing that the technical systems and methodology used by ratings agencies should become open source rather than proprietary as opaque systems hide flaws and increase risk.
in the opacity of the standards and methodologies used to achieve the ratings. By using economic analysis, Forster shows that if certain minimum standards for ratings can be made open, perhaps at the international level, this would offer significant improvements in regulatory efficacy and user reliance, leading to increases in social good.283 Opening up the technical standards and methodologies in ratings is likely to meet with opposition by the industry as their rent-seeking behaviour would be affected, even if economic rents have been sought based on flawed systems they have used.

That is not to say that developing open technical platforms to enhance the informational capacity of regulators and stakeholders should not be encouraged. This is an area where perhaps international soft law for a platform for open technical standards of credit ratings can be developed, so that the industry and stakeholders may both be involved in fashioning and evaluating the technical methodologies and standards to be used. This would require the industry to develop value added services beyond the use of proprietary methodologies to issue rating products. The development of open technical standards may be key to enhancing the regulator’s competency in evaluating the quality of the certification.284

The main issue with credit rating agencies is that ratings have become a quasi-public good and governance over the rating process has been outsourced to the industry without practical accountability, as regulators are unable to evaluate the ratings which have been subject to opaque and proprietary processes. The way forward is for regulators to have in place expertise or capacity to monitor how the public goods are delivered, and to determine if they have been adequately delivered.285 Regulator expertise and capacity may be further enhanced by facilitating open information flows and technical standard development at the international level, although this would not likely be welcomed by the industry.

**Market-Based Governance**

The next two models along the spectrum refer to a form of governance that is “self-regulatory” plus some external form of discipline in the market. As suggested in the literature review in Section 2, market-based governance can take place via various arrangements. There is an abundance of literature looking into the nature of stock exchanges and the governance it provides over issuers and intermediaries.286 Although the US and Hong Kong are jurisdictions that still rely heavily on exchange

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285 D Asenova, M Beck, & S Toms, “The Limits of Market-Based Governance and Accountability - PFI Refinancing and the Resurgence of the Regulatory State” (2007) University of York Working paper number 35 argues that making the outsourcee accountable in private-public partnerships such as the Private Financing Initiative, is one of the main challenges in making the partnership work.

governance, much less reliance is placed on exchanges in the UK and EU, and hence this Section will not look into the potential “agency problems” that may exist where delegated governance is made to stock exchanges. In this Section, I have decided to look at whether “gatekeepers” may provide a form of market-based discipline in the financial services landscape. “Gatekeepers” are a broad range of third parties who may be:

(a) Transactionally connected with firms, such as auditors and lawyers;

(b) Involved in reputational verification of firms’ disclosures or activities such as auditors, underwriters, rating agencies and stock exchanges;

(c) Involved in evaluation but not necessarily reputational verification, of disclosures by firms, such as research analysts, stock exchanges, credit, corporate governance and social responsibility rating agencies.287

Gatekeepers are generally discrete groups with either professional or specialised expertise, and their involvement with a firm may provide a form of “surrogate regulation” envisaged in the smart regulation model, although there may be no conscious perception that gatekeepers have been delegated or outsourced with aspects of governance. The following will not deal with (c) as has been dealt with above. I will argue that regulators have perhaps missed perceiving that there is an element of delegation in some aspects of gatekeepers’ governance and there are significant agency problems in gatekeepers’ governance providing public/regulatory goods.

The following will focus on auditors and lawyers. Auditors and lawyers are regarded as gatekeepers as they are often able to gain access to intimate firm information, and hence may be in a position to uncover wrongdoing and disconcerting signals such as excessive risk. Gatekeepers’ potential access to detection and their capacity to apply a critical mind are the attributes that allow us to ascribe governance capacity to these gatekeepers. Gatekeepers could provide a form of governance over issuers for investors through audit, assurance and professional verification, some of which may be regulatory goods, such as the annual audit of company accounts, others may be market goods desired by issuers such as consulting and corporate governance assurances.288 Although gatekeepers could provide a form of governance as part of their market-based services to clients, the imposition of this social good aspect upon gatekeepers’ market-based services may be difficult and inappropriate. However, where the market for gatekeepers’ services or functions has been created by regulation, then gatekeepers could arguably be made accountable to regulators for the governance that has been delegated to them. However, this is not to suggest a bright line distinction

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288 For example, the accounting profession is considering offering audits or assurances of corporate governance statements made by companies, see Fédération des Experts Comptables Européens, Discussion Paper for Auditor’s Role Regarding Providing Assurance on Corporate Governance Statements (Nov 2009).
in the various roles of gatekeepers undertake for their clients, and regulators and professional bodies need to engage each other in greater exchange over gatekeepers’ roles.

Where accountants and lawyers are transactionally connected with issuers, accountants may be able to flag up wrongdoing, and increasingly, even signs of excessive risk that could become systemically important, and lawyers may also be able to detect non-compliance or creative compliance by their clients. However, it is arguable that accountants and lawyers could provide governance for the social good only if professional discipline or regulatory liability compels them to choose social good above client loyalty at all times. Hamdani has argued that gatekeepers such as auditors and lawyers will only be incentivised to consciously monitor their clients if some form of liability is imposed on them to do so. As negligence liability is costly to prove, strict liability is the least costly way of co-opting responsibility for monitoring by these gatekeepers. However, the imposition of strict liability may be disproportionately costly if it is difficult for gatekeepers to screen their clients perfectly. This is likely a sub-optimal way of enrolling gatekeepers into the regulatory space, and does not take into account of the value added innovations gatekeepers have brought to businesses and the development of gatekeepers as a business industry itself. It is proposed that gatekeeper functions may be looked at in two respects: one, gatekeepers’ services as market-based services derived according to demand, such as aspects of consultancy work unrelated to compliance, corporate finance and acquisitions, and lawyers’ advisory and drafting services for transactions. The second type of gatekeeper services would be based on a market created by regulatory requirements, ie audit services provided by accountants or compliance services provided by lawyers.

For gatekeeper services of the first type, gatekeepers may gain significant proximity into corporate and business affairs and may be able to detect wrongdoing and excessive risk. However, accountants engaged in consulting and advisory work are often placed under duties of confidentiality, and the professional mantra of lawyers is that they see themselves as fiduciaries of their clients and not “trustees” of stakeholders. Although the capacity of these gatekeepers puts them in a position that could be influential for governance purposes, the imposition of governance objectives upon their work poses challenges in terms of conflict of purpose. If regulators establish a whistleblowing regime or even impose a whistleblowing duty, professionals may find it difficult to comply with that


as the social legitimacy of whistleblowing is still not well-established, and whistleblowing professionals may find their lives as professionals cut short rather than enhanced.293 Further, commentators have observed that in-house lawyers adopt the organisational identity of the corporation over individual ethical self-regulation or professional identity.294 Even external counsel appointed to represent corporations in specific transactions can be captured by their clients depending on how the counsel views the relationship with the client and how important the client may be to the firm.295 Hence, whistleblowing regimes may not be able to overcome those inherent perceptions and biases.

Accountants and lawyers owe duties in private contract although their professional capacities and expertise lend themselves to being seen as surrogate regulators in the regulatory space. It is proposed that where accountants and lawyers are transactionally connected with their clients in respect of market-based services mentioned above, the private contractual nature of those arrangements should prima facie be preserved. Intervention by regulators in these areas would likely entail unintended consequences such as the creative avoidance of regulatory objectives through opaque means of rendering services. Such intervention may not enhance the monitoring capacity of these gatekeepers and may promote collusions between gatekeepers and clients through creative and opaque forms. However, this is an area which regulators should have dialogue and information exchange with professional bodies in order to build up understanding into how professionals may have a role in governance in the regulatory space. Cunningham also advocates a model to introduce carrots to induce gatekeepers to pay attention to the social good of their activities. This model allows rewards to be paid for gatekeepers to whistleblow on their clients. Cunningham is of the view that firms could contract to pay gatekeepers extra if wrongdoing is uncovered, as the lack of uncovering of such wrongdoing would boost firm reputation and hence there is something in it for firms to enter into such bargains. Gatekeepers can be prevented from having perverse incentives to earn those rewards if regulation makes it mandatory for gatekeepers to work in teams from different firms, hence checking each other’s behaviour.296

As for gatekeeper work of the second type ie that the market for gatekeepers’ work such as audit or compliance, has arisen because of regulatory requirements, it is proposed that gatekeepers in those capacities should be perceived as having been delegated a role in governance in the regulatory space, and regulators should address the agency problems this entails.


Villiers points out that the fundamental basis underlying issuers’ corporate reporting is their accountability in exchange for the privilege of incorporation, limited liability and corporate finance. Auditors are engaged in order to provide an assurance as to the accuracy of the mandatory reporting required of corporations. Hence, auditors’ transactional relationship with their clients is not merely a private market contract for services. The market for audit contracts has arisen because of regulatory provision to co-opt the professional services of auditors to provide inspection and verification of corporations. Viewed in that light, independent auditing is a delegated form of regulatory administration in ensuring accuracy in corporate disclosure, and hence is expected to assist in the delivery of public/regulatory goods. This may provide a legitimate basis for us to regard auditors as gatekeepers whose role is to provide governance via the audit, although the same argument may be less convincing in cases of voluntary audits or assurances which would be market-based products.

However, Markham argues that auditors in the US are required to certify a sample of financial statements produced by firms as in compliance with the Generally Accepted Accounting Principles (US) and hence auditors are not to be taken as warranting financial soundness or policing corporate fraud. This may arguably be different from the auditors’ duty to certify that a firm’s financial statements are “true and fair” in the UK. But does the audit entail all of the implications of detection of wrongdoing and policing of an issuer? Some commentators have argued that it is not technically easy for auditors to detect wrongdoing, or to value complex financial assets held by


299 Such as audit or assurance services for corporate governance see Fédération des Experts Comptables Européens, Discussion Paper for Auditor’s Role Regarding Providing Assurance on Corporate Governance Statements (Nov 2009).


firms in order to evaluate the level of financial risk. Empirical evidence has shown that because it is not always easy for auditors to screen the quality of their clients, auditors rely on proxy factors such as the corporate governance of the firm in deciding whether the audit may be complex and hence the level of audit fees to charge. Empirical research by Ganuza and Gomez also shows that it is difficult for courts and regulators to discern if gatekeepers have actually discharged diligence in monitoring for wrongdoing or excessive risk. Gatekeepers could adduce evidence of processes and data trails to insist that they have taken all care and it is difficult to prove otherwise. In such circumstances, what is the level of public good that can be expected to be delivered by audit?

I have elsewhere argued that in a model of delegated regulatory administration, agency problems may entail. Coffee and others have argued that the public interest aspect of the audit has been lost on the auditing profession as manifested in the Enron saga. Auditors have used the auditing opportunities as channels for non-audit business and have commodified the audit. Hence, there is a role for regulators to define the social good sought to be achieved in the audit process. Power argues that regulators should not necessarily accept the gatekeeper’s verdict as the final say. This would be tantamount to forgoing any supervisory oversight upon delegation. The agency problem could be addressed by radically subjecting the profession to account to a regulatory agency, as is the case in the US with the Public Accounting Standards Oversight Board. In the EU, perhaps regulators could engage with professional bodies, in defining or fostering the standards of accountability for audits, besides the profession’s general adherence to professional and technical standards.

In relation to lawyers, Parker suggests that where lawyers take on the role of “compliance institution” in firms, especially in financial services firms, this role is different from being an in-house counsel or legal advisor. The compliance institution is established by regulation and hence the role of such an outfit is defined in accordance with regulatory objectives and can be fashioned to achieve

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303 Humphrey, Loft and Woods (2009), op cit.


306 For example, see Iris H-Y Chiu “Delegated Regulatory Administration in EU Securities Regulation” (2007) 40 International Lawyer 737.


308 Ch6, The Audit Society (1999), op cit.


310 Article 6, MiFID Commission Directive.
The compliance professional may thus be regarded as a delegate in monitoring compliance and wrong-doing, supplying the governance envisaged in the smart regulation model. However, although the compliance function envisaged in the MiFID\(^\text{312}\) is to be independent, it is framed as an outfit to support senior management, not as intelligence provider to regulators. This issue will be addressed in detail under “Meta-regulation” shortly, as to the potential of compliance units to act as internal monitors in the regulatory space.

The US Sarbanes-Oxley Act 2002 has moved towards enrolling auditors and lawyers as gatekeepers by subjecting them to regulatory oversight in place of self-regulatory discipline by professional bodies. Lawyers are required to report up the ladder to audit committees of companies if wrongdoing is suspected.\(^\text{313}\) These legal duties compel gatekeepers to provide governance over issuers. As a result, empirical evidence shows that the Big 4 audit firms tend to decline riskier business so that the gatekeepers with the most capacity avoid having to encounter governance challenges of detecting wrongdoing or fraud.\(^\text{314}\) Hence, gatekeepers may shy away from a governance role if the threat of regulatory liability looms. It is proposed that although the audit and compliance markets have arisen due to regulatory requirements and hence they could be regarded as delegated forms of governance, the harnessing of governance potential by auditors and lawyers needs to be more fully developed. Regulators need to engage with professional bodies, developing common understandings and standards in achieving public goods, instead of a model of delegated governance supported only by penalties. O’Connor also suggests that stakeholder involvement should be enrolled in order to monitor auditors in achieving the social good of the audit. In particular, shareholders may be given the right to appoint and remove auditors and determine the remit of the audit.\(^\text{315}\)

Regulators have a continuing role to engage with and monitor their delegate gatekeepers, but it is submitted that such monitoring should not be based on a system of strict liability as this may in fact chill gatekeepers from taking on the governance role. The relational paradigm between regulators

\(^{311}\) Christine Parker, “The Ethics of Advising on Regulatory Compliance: Autonomy or Independence?” (2000) 28 Journal of Business Ethics 339, arguing that the independence of such outfits is key to enhancing the embrace of ethical values and social good.

\(^{312}\) Art 8, MiFID Commission Directive.


and gatekeepers is arguably a continuous learning process so that gatekeepers’ market and business roles and their governance roles may co-evolve.  

**Soft Law**

In this section, I will examine the nature and efficacy of soft law as external standards that may provide governance but are not legally binding. Soft law has become increasingly important not only in international financial governance but in global governance generally. Soft law represents a range of measures, instruments and standards that may not have the attributes of traditional law made under the auspices of a state, and in Abbott and Snidal’s conceptualisation, is “soft” as it lacks one or more of the characteristics of hard law. Hard law obligations are defined as obligations which have been fashioned with precision and whose interpretation and adjudication is delegated to a third party, using defined processes. However Meyer does not strictly agree with Abbott and Snidal’s conceptualisation of soft law and prefers to view soft law as distinguished from mere policy or politics as it intends to secure a binding effect although there is more flexibility in dealing with deviations. Soft law is different from hard law as it essentially accommodates negotiation, especially at an international level, as well as modification and evolution.

Soft law is an essential feature of the decentered realities of the regulatory space. The location of power, expertise, capacity and influence in different entities within the “regulatory space” means that much policy making would occur through the processes of negotiation and dialogue. This is especially augmented at the international level where policy-making is increasingly eclipsing merely domestic regulatory solutions in the financial services landscape. As domestic regulatory solutions could be undermined by regulatory arbitrage in this age of easy migration of economic and financial activities, policy makers recognise the importance of engaging in negotiation, dialogue and

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316 John SF Wright and Brian Head, “Reconsidering Regulation and Governance Theory: A Learning Approach” (2009) 31 Law and Policy 192. John Braithwaite also considers dialogue, information exchange and learning to be key to the regulatory capitalism of today, see Braithwaite, *Regulatory Capitalism* (2008), op cit at 59.


coordination on an international level. Soft law offers a platform for such engagement to take place as it represents any commitment made to policies or decisions as being reflexive, although the workability of such solutions could become convincing and legalised in states. Soft law is undeniably important in the present landscape of international financial regulation, but a few key challenges remain.

As argued earlier, the two dominant locations of influence in the decentralised regulatory space of financial services are regulatory agencies and the industry. The industry wields great power in influencing the soft law outcomes. This is especially so where the industry has technocratic expertise and form epistemic communities to take leadership in the framing of standards and soft law governing themselves. Technocratic actors have been especially successful in standard and policy setting. Zaring and Redak comment that international networks such as the Basel Committee is based on a high respect for technocracy and is therefore very successful in taking leadership over establishing the standards of international prudential regulation. Tsingou also comments on how the OTC derivatives industry has made a case for self-regulation for a long time by producing


323 Andrew T Guzman and Timothy L Meyer, “Explaining Soft Law” (2009) at http://ssrn.com/abstract=1353444; Walter Mattli and Tim Büthe, “Setting International Standards: Technological Rationality or Primacy of Power” (2003) 56 World Politics 1 arguing that soft law allows states to balance the needs of international coordination to find optimal solutions as well as to behave in a realist manner to achieve the maximisation of the state’s own interest.


technocratic blueprints for self-regulation although policy-makers are now concerned about the size of the market and the social risks of losses and fallouts from the market.\textsuperscript{329} Zaring however sees IOSCO (the International Organisation of Securities Commissions) as relatively weaker in influence in the setting of international standards as it is a network of state regulators and argues that the IOSCO is too concerned with political considerations and diplomatic niceties, and hence it has not been that effective in leading international standard setting.\textsuperscript{330} An example would be the lack of enthusiastic acceptance or legalisation of IOSCO’s Code of Fundamental Practices for Credit Rating Agencies issued in 2004, which has only now become a useful benchmark in the EU Regulation for credit rating agencies. In terms of industry-led technocratic networks, the International Accounting Standards Board, a network representing the industry has become very successful in taking leadership over technocratic standard setting, not to mention other industry-led international networks such as the International Chamber of Commerce which has led in producing standards such as the ICC Arbitration Rules and the Uniform Customs and Practice for Documentary Credits, and the International Capital Markets Association which has issued a definitive set of rules dealing with Eurobonds.

The decentralised locations of influence in the regulatory space are not equal in power. Much deference is given to technocratic expertise and such expertise is often regarded as legitimate in leading international standard setting.\textsuperscript{331} This may be the reason why there has been extensive acceptance\textsuperscript{332} by states of the prudential regulation established in Basel II Capital Accord, albeit giving elite banks much autonomy in managing their own risks,\textsuperscript{333} such autonomy now questioned and compelled to be limited after the onset of the global financial crisis.\textsuperscript{334} Although many


\textsuperscript{330} Zaring, “Three Challenges” (2009), above, arguing that IOSCO has only established a few sets of standards such as prospectus requirements for cross-border listings, but the influence of IOSCO is not as great as the Basel Committee for example.

\textsuperscript{331} Dieter Kerwer, “Rules that Many Use: Standards and Global Regulation” (2005) 18 Governance 611, arguing that although technocratic expertise is a strong indication of legitimacy in influence and the exercise of power, the standards set are often done in an opaque and non-inclusive manner, and there is no thought given as to how the standards may be enforced. See also Walter Mattli and Tim Büthe, “Global Private Governance: Lessons from a National Model of Setting Standards in Accounting” (2004-5) 68 Law and Contemporary Problems 225.


technocratic standards appear credible and enjoy widespread support, there is a risk that technocratic centres of influence may be disproportionately powerful in the regulatory space. An issue that needs to be addressed is that the regulatory space may have become too inclusive of technocratic experts and industry interests, and exclusive of stakeholder participation to bring to the table concerns of a more social or redistributive nature.\textsuperscript{335} The dominance of the industry has led to the type of unaccountable outsourcing of governance discussed earlier in relation to credit rating agencies. This may be largely attributable to a form of “technocratic capture” of regulators by the industry, regulators relying on the industry’s governance as legitimated by superior levels of technical expertise.

It has been argued that labour and consumer representation in the Basel II process are non-existent.\textsuperscript{336} Fransen and Kolks call for greater access and participation to be available to stakeholder networks so that stakeholder networks could be put in a position to monitor standard setting at the international level.\textsuperscript{337} Seidl describes international standard setting in soft law as a platform of “observeabiliy”, a platform that allows many interested entities to observe the dynamics of other entities, and to move in to fill in gaps or create gaps as the dynamics unfolds.\textsuperscript{338} However, the dynamics of these entities depend largely on their bargaining power, rights of access, participation and critical scrutiny. Decentred locations of influence may behave as self-interested entities in a game, focussing on the appropriation of power, or entities may take a neoliberalist view that cooperation and coordination would secure optimal results.\textsuperscript{339} Perhaps in reality both sets of driving forces exist to shape the dynamics amongst decentred locations of influence in the regulatory space.\textsuperscript{340} Turnbull is of the view that it is necessary to empower the different centres of influence in the regulatory space so that all entities can check and monitor each other and can communicate and


\textsuperscript{340} Susanne Lütz, “Political Economy Approach to Financial Reform” in Peter Mooschlechner, Helene Schuberth and Beat Weber eds, \textit{The Political Economy of Financial Market Regulation} (Cheltenham: Edward Elgar 2006) at 34, arguing that political relations and concerns drive regulatory reform, and regulatory reform is not merely premised on economic and rational analyses.
negotiate on an even level in order to generate decision-making that fully takes into account of the complexities and needs of the regulatory space.  

Stakeholder access and participation may also enhance the quality and process of problem solving. In this respect, this paper submits that it is important to empower diverse representation, such as stakeholder representation in the centred regulatory space at the international level so that standard setting and the development of soft law at the international level may be carried out under more critical scrutiny and in an environment allowing for more meaningful participation, approximating a more democratic framework. Many technocratic standards issued at the international level have become legalised in states, such as the Basel Capital II Accord standards and the International Accounting Standards, both adopted as law in the EU. However, commentators warn that the legalisation of these standards may mean a wholesale endorsement of technocratic or elite governance without requiring the same level of accountability that would be required of governments and state bodies. Government representation and stakeholder representation should be given at least observer status in industry-led international networks which produce soft law. Perhaps the Basel Committee should also be subject to some scrutiny outside of the narrow circle of central bankers that constitute its membership. It is noted that in January 2009 the IASB has voluntarily subjected itself to a Monitoring Board consisting of IOSCO and the US Securities Exchange Commission.

The above has discussed the key challenge of expanding the relational paradigm between regulators and industry to include more diverse participation by stakeholders. This may improve the input aspect of standard setting and the quality of the standards themselves at the international level. The next key challenge for soft law is the output aspect—how the standards are used and applied, and the efficacy of the standards. Standards such as Corporate Governance codes, are subject to a comply or explain regime and not formally legalised. There are some commonly accepted reasons for adopting a comply-or-explain regime for various pieces of soft law. The voluntary nature of the standards may make them adaptable to specific needs, and avoids burdensome prescription for corporations. Further, the soft law status of the standards may mean that amendments to these standards can be made quickly and easily to reflect the changing times and needs. The comply or explain regime is also intended to provide a testing ground for how standards may work in practice. These benefits of the reflexive nature of the comply-or-explain regime may be harnessed if the market is able to evaluate the application of these standards. If the voluntary nature of the

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341 Shaan Turnbull, “Governing the Management of Complexity” (2003), paper presented at 19th EGOS Colloquium, European Group for Organisational Studies, Copenhagen;

342 Daniel Durrant, “Burying Globally, Acting Locally: Control and Co-Option In Nuclear Waste Management” (2007) 34 Science and Public Policy 515 on an example of how stakeholder competition, co-option, communication and coalition can provide solutions to nuclear waste management.


standards results in shirking, or the lack of market discipline, then the comply-or-explain regime may only serve to expose and perpetuate a market failure.

The comply-or-explain regime faces two key problems. One is market failure, ie shirking by the industry to which the standards are meant to apply, and that the shirking is not addressed by market discipline; and secondly, the issue of whether comply-or-explain is appropriate if the application of the standards is meant to deliver a public good.

In terms of market failure, empirical evidence shows that shirking is rather prevalent. For example, Andres and Thiessen surveyed German corporations subject to the comply-or-explain regime in respect of the Corporate Governance code and found that firms may comply more or less depending on their financial performance and explanations are hardly given for non-compliance as firms prefer to fall outside of the radar. 345 Faure-Grimaud et al also found that in the UK, where a comply-or-explain regime applies to the Combined Code of Corporate Governance, non-compliant firms are appalling in their explanations for deviation if explanations are given at all, although the rate of compliance has increased over the years. 346 Have shareholders exerted any market discipline? The Report of the Cadbury Committee 347 in 1992 stated that:

Shareholders have delegated many of their responsibilities as owners to the directors who act as their stewards. It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use this power. While they cannot be involved in the direction and management of their company, they can insist on a high standard of corporate governance and good governance. (at para 6.6, Cadbury Report)

The market discipline from shareholders has been arguably slow and not quite effective. Market discipline could exist in the form of exit, ie where shareholders sell shares in response to poor governance and hence the price of company shares may provide an indication of market discipline. MacNeil and Li, in surveying the market response in the form of share price changes to non-compliance with the UK Combined Code of Corporate Governance, reports that market participants and shareholders do not exert any market discipline on firms that do not comply or explain adequately. 348 This may be due to a lack of conviction that corporate governance affects investment value at least in the short term 349 although the evidence of correlation seems stronger in the


348 Ian MacNeil and Xiao Li, ““Comply or Explain”: market discipline and non-compliance with the Combined Code” (2006) 14 Corporate Governance 286.

medium to long term. This uncertainty in perceiving the value of adherence to corporate governance codes may account for the weak market discipline in “enforcing” the codes. Market discipline can also exist in the form of “voice” ie by engagement or voting in order to make shareholder views on poor governance known to the company. Institutional shareholders are assisted by the proxy voting industry in making voting decisions and have engaged in some activism. However, it remains to be seen if such engagement is effective in “spirit” and not merely a box-ticking and narrow-minded application of the Combined Code.

I have argued elsewhere that there is insistent policy leadership in the UK calling upon institutional shareholders to ask management to account and to ensure that sound governance is in place. This arguably goes beyond exhorting institutional shareholders to exert market discipline. If the Combined Code is a platform upon which market practices and discipline should develop, then it should be shaped by market forces, including the lukewarm market reactions documented in empirical research mentioned above. It is arguable that policy-makers do not see the comply-or-explain regime for best practices in corporate governance in the UK as merely a platform for the market to shape its wishes. There is arguably an aspect of a desirable social good or public good that may be delivered from compliance with the Code. For example, empirical evidence suggests that sound corporate governance may be key to averting corporate disasters and losses in shareholder value. A number of commentators suggest, albeit with hindsight, that corporate disasters such as Enron and Royal Ahold could have been averted if better corporate governance were earlier in place. Although such ex post analyses do not positively prove that sound corporate governance would likely contribute to corporate survival, these studies contribute towards the perspective that sound corporate governance could be advocated for the possible prevention of corporate disasters, which not only lead to losses in shareholder value but also social losses for stakeholders such as employees, suppliers and the wider community. Further, in the recent global financial crisis, many policy-makers view remuneration structures in firms that encourage excessive risk taking in


investment activities to be important in contributing to bank failure and systemic risk. However, on the other hand, it can be argued that preventing the occasional social loss from bad apples does not necessarily mean the governance structure of every corporation should now be subject to accountability to the public or community at large.

Certain limited corporate governance issues such as remuneration policies at banks may be issues of public interest, as failed governance may result in externalities of a scale that exceed those from corporate collapses in other industries. This is now increasingly being accepted by policy-makers. For example, the French government has tightened bonuses that could be paid to bank executives where the bank is receiving government support, and the UK Financial Services Authority has published A Code of Remuneration Practices for banks and financial institutions. However, corporate governance straddles the internal-external and public-private paradigms. It is on the one hand concerned with internal policies, culture, risk management and accountability to shareholders, but on the other hand, failures of governance may contribute to corporate failures having wide social effects.

If corporate governance or aspects of it may be public goods, then the comply-or-explain regime is arguably inappropriate and inadequate to ensure the supply of the public good. This is because “comply-or-explain” does not represent to companies that public good is relevant to its corporate governance arrangements. The relational paradigm in a comply-or-explain regime is between the company and its shareholders. “Comply-or-explain” may favour individualised approaches as long as they can be well explained and accountability is prima facie to shareholders. But if the adherence to the Combined Code is intended to deliver a public good that entails from well-governed companies, then “comply-or-explain” should be accountable to the regulator as well. But if the quality of explanations is not monitored and there is no prescription as to the quality of explanations, then there is no mechanism to oversee that alternative supplies of corporate governance by deviating firms will maintain the level of public good. This would mean that some firms for some reason can opt not to supply the public good, or affect the overall level of supply of the public good.

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London, 31 January 2009


explain arguably entails an ambivalent character that is not ideal in making it unequivocal if a public good is sought to be delivered.

However, it remains an open question as to whether corporate governance or aspects of which would deliver any public good. The Walker Review of Corporate Governance in UK Banks 359 states that

“There is nonetheless an important concentricity between public policy objectives and the interests of shareholders. This relates respectively to the “downside” protection of shareholders as a responsibility of their boards and, in the case of the financial regulator, the central bank and the Treasury, their attentiveness to the public interest more widely, including the potentially unlimited liability of taxpayers.”

This articulation of the social importance of corporate governance may underlie the approach in the Walker Review as inching closer to regarding more aspects of corporate governance as capable of delivering public goods. However, there is still a difficult balance and the Walker Review is unwilling to depart from the comply-or-explain regime of the Code which premises accountability primarily to shareholders. The Review however expects that the quality of explanations should be improved and that shareholders should engage actively in monitoring the comply-or-explain regime.360 The co-option of shareholders, particularly institutional shareholders in the regulatory space has been persistent in policy.361 This is in nature a form of delegated governance towards public/social good if the link is made between corporate governance and public good. Walker has argued that the limited liability of shareholders is a privilege whose social legitimacy also depends on the exercise of stewardship by shareholders.362 Hence, it now seems that accountability will now be asked of shareholders to show how they have managed the accountability of their investee companies. Are shareholders now delegated with the governance of ensuring that the public good of sound corporate governance is delivered? Even if they are, to whom are they accountable? Would it be the accountability of the investment manager to the engaging pension fund, or the accountability of the pension fund to its diffuse beneficiaries? Who would be able to judge the measure of public good in shareholder activism for sound corporate governance?

In respect of one particular issue, that of bankers’ remuneration, the Walker review however proposes that bankers’ remuneration issues be legislated.363 The FSA Code of Remuneration Practices has also taken a first step to address this issue, defining the remuneration structures of financial institutions as affecting public interest since social losses following from financial institution failure may be massive. These steps arguably move us toward accepting that remuneration structures in financial institutions affect the level of public good, and hence increased regulatory

359 Final report (26 Nov 2009), at para 1.5.

360 Para 5.7.


363 Para 7.17.
ownership over this aspect of corporate governance may be developed. The FSA is further bolstered by enforcement powers to intervene and invalidate remuneration clauses in banks’ transactions that may pose excessive risk.364

Signs and signals relating to the growing public nature of corporate governance may ultimately mean that certain comply-or-explain structures may have to give way to meta-regulatory structures where accountability to the regulator would be directly established (although the difficulties in this approach will be detailed shortly).

Meta-Regulation and the “Audit” Model

In this part, discussion will be made as to the two models represented as “Meta-regulation” and “audit”. Meta-regulation is firm-centric in nature as it is a regulatory approach that leverages on firm capacity and resources to provide permeability and accountability to external stakeholders and to meet the requirements of “compliance”.365 In financial regulation, this approach is seen in the MiFID366 and FSA’s SYSC Handbook367 in dealing with the risk management of financial institutions including instituting internal audit and independent compliance functions. As for the “audit” aspect, this is defined widely as including any evaluative or monitoring process undertaken by a third party to assist the regulator,368 such as the delegated governance to auditors discussed earlier. This Section will suggest how the audit model can assist regulators in meta-regulation.

Risk management has always been part of corporate management anyway, and hence, how would the meta-regulation of risk management in financial institutions differ from self-regulation by firms? The risk management of firms in general depends very much on the needs of particular firms, for example in order to reduce the cost of capital.369 The approach to risk management and even Enterprise-wide Risk Management (thereafter “ERM”) is documented in practice to be very much based on the particular needs of each business, or even each business line in a firm.370 Hence, risk management by a firm has always been self-regulatory in nature as rooted in a firm’s own incentives to survive and succeed. Meta-regulation of firms’ risk management should therefore be distinguished from self-regulation by firms, or otherwise it would be devoid of meaning. As Parker has earlier mentioned, meta-regulation is for achieving a wider purpose of accountability to external

366 Arts 6 and 7, MiFID Commission Directive.
367 FSA Handbook SYSC 3.1, 6.1 and 7.1.
stakeholders, such accountability being in part manifested as compliance with legal rules. Hence, regulators' interest in the meta-regulation of risk management should be for the purpose of achieving regulatory/public goods, such as requiring firms to take measures to mitigate systemic type risks. As argued earlier, individual firms are not likely to take ownership of systemic risk and in fact banks often have the tendency to behave in a manner that exacerbates systemic risk in the name of individual risk management.371

Meta-regulation in the MiFID and the FSA’s SYSC Handbook is in the form of prescribing that firms put in place adequate risk management policies and procedures to “identify, manage, monitor and report” risks.372 Such policies, procedures and systems are dependent on the nature, scale and complexity of the business, the diversity of its operations, the volume and size of its transactions and the degree of risk associated with each area of operation.373 Some minimum standards prescribed in the MiFID are that risks associated with confidentiality and storage of information and data, risks associated with business continuity where electronic systems may malfunction, and risks associated with financial data integrity such as accounting policies and procedures, must be managed. The FSA SYSC Handbook provides a further list of areas where risk management must occur: delegation and supervision systems between senior personnel and employees in the firm, the identification of money laundering activities, legal compliance, corporate governance, the assessment of employee suitability, remuneration policies.374 Banks, building societies and investment firms are further asked to manage specific risks such as counterparty risk, market risk, interest rate risk, operational risk and residual risk,375 liquidity risk376 and group risk.377 Risk management also includes regular periodic reviews of the effectiveness and adequacy of the arrangements, policies, systems and procedures in place.378

There is some discretion as to the design of the risk management systems and procedures in each firm but both the MiFID and the FSA Handbook provide guidelines for the types of systems or procedures that are desirable or optional: internal audit,379 corporate governance including institution of an audit committee,380 independent risk assessment function,381 and incorporation of

374 SYSC 3.2.
375 SYSC 7.1.
376 SYSC 11.
377 SYSC 12.
378 Art 5(S), MiFID Commission Directive, FSA SYSC 7.1.
380 SYSC 3.2.15, 3.1.3.
risk management into business strategy. However, an independent compliance function, the accountability of senior management and systems for ensuring the suitability, honesty and competence of employees are mandatory and must be put in place. There therefore seems to be a minimal tier of prescribed risk processes and a second tier of optional risk processes depending on the nature, size and complexity of the business. In the UK, the Walker Review is likely to add to the mandatory list for listed banks and major insurers: the institution of a separate Risk Committee at Board level and the institution of a Chief Risk Officer having independence and equivalent status with senior management. The audit and compliance functions are accountable to senior management, although the proposed Chief Risk Officer would have a direct line to the chairman of the Board’s Risk Committee.

Regulators who adopt meta-regulation should arguably avoid relying solely on the internal “gatekeepers” such as the internal audit, compliance or risk evaluation functions to discharge the satisfactory evaluation of a firm’s risk management. The “internal regulatory space” is likely subject to issues of organisational identity, conflict or collusion of goals and other incentives and cultures that affect individual and departmental motivations. Spira and Page argue that internal risk management involves a wide array of concerns and techniques, and hence, different departments in a firm could develop pockets of power in relation to particular risk management issues and techniques, and produce a competing environment in the “internal regulatory space”. Further, as internal gatekeepers are intended to support senior management, it would be rather incompatible with their organisational and legal role to see them as being accountable to regulators or the wider community. Moreover, to frame their accountability outside of the organisation would require regulators to first set standards as to their eligibility and qualifications so that they may be in a position to have some independent expertise to make substantive evaluations of risk management.

381 SYSC 3.2.10.
382 SYSC 3.2.17.
384 Article 9, MiFID Commission Directive and SYSC 3.2.2-3.2.5, 3.2.11-3.2.12 support this by requiring effective supervision and delegation systems, and reporting to senior management.
387 Art 6, 8 and 9, MiFID, SYSC 6.1, 6.2.
391 Supported by Stephen Ward, “Exploring the Role of the Corporate Risk Manager” (2001) 3 Risk Management 7, arguing that the role of corporate risk management is highly susceptible to various interpretations.
systems and processes. The compliance function for example, is arguably only concerned with legal compliance.\textsuperscript{392} Although Parker argues that the compliance units of many firms see themselves not merely as monitors of legal compliance but as auditors of the firm’s ethical and social responsibility behaviour, there is potential but no mandate to develop the compliance function in firms to be an independent auditing unit that goes beyond legal compliance.\textsuperscript{393} Firms designing the compliance function could take the least costly and complex approach to its institution and structure.

As for the optional “internal audit” function, an internal audit department could provide substantive evaluation of a firm’s processes and systems as envisaged in the MiFID and SYSC.\textsuperscript{394} The internal audit function is currently framed to support Board evaluation of internal controls, systems and processes under the Turnbull guidance.\textsuperscript{395} Hence, it is not required to be independent and is chiefly responsible for reporting to the Board. Further, Spira and Page\textsuperscript{396} warn that if the internal audit function is in fact outsourced, then the incentives of the “internal audit” may be skewed towards value adding and maintaining continuity of business from the client instead of gatekeeping the client.

The Chief Risk Officer proposed in the UK Walker Review is to be an independent function with direct accountability to the Chairman of the Board’s Risk Committee. This function is intended to have a more general overview of business strategy and risks and should focus on prudential management of the listed bank’s risks. The Risk Committee supported by the Chief Risk Officer would have to report annually in a separate document in the annual report, and hence these internal gatekeepers may be perceived to have some form of accountability to shareholders.\textsuperscript{397} These proposals may supersede the FSA SYSC’s provision for an optional independent risk evaluation function,\textsuperscript{398} although the latter may remain optional for smaller financial institutions where the institution of the CRO may not apply. The “independent risk evaluation function” in SYSC again defines such a function to assist the senior management, although it is meant to be independently staffed and resourced. By and large, the range of internal gatekeepers as part of risk management, are intended to enhance firm capacity and assist senior management. As internal gatekeepers are

\begin{footnotesize}
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\item \textsuperscript{392} SYSC 6.1.
\item \textsuperscript{394} Art 8, MiFID, SYSC 6.2.
\item \textsuperscript{396} Laura Spira and Michael Page, “Risk Management: The Reinvention of Internal Control and the Changing Role of Internal Audit” (2003) 16 Accounting Auditing and Accountability Journal 640.
\item \textsuperscript{397} Recommendations 23, 24, Walker Review Final Report.
\item \textsuperscript{398} SYSC 3.2.10.
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not subject to a duty to report, whistleblow\textsuperscript{399} or otherwise be accountable to regulators, regulators should be prepared to evaluate the performance of internal risk management functions rather than to accept the discharge of these processes as sufficient to demonstrate sound risk management.

As meta-regulation levers on firms’ capacity and resources to deliver regulatory/public goods, the firm should be co-opted in a proportionate manner to meet certain benchmarks for the delivery of the regulatory/public goods. The challenge for regulators is to be able to define the public goods to be delivered in the meta-regulatory process so that firms may not perceive meta-regulation as allowing creative compliance that regulators cannot evaluate or as allowing firms to provide evidence of compliance just by having a list of processes and policies in place—i.e. “ritualism”.\textsuperscript{400} The FSA Handbook has identified a list of risks that banks, building societies and investment firms must manage, and the Walker Review has specifically identified that risk management focuses on prudential risk management.\textsuperscript{401} The identification of the particular risks that regulators are concerned about has not been particularly evident in the MiFID and its supporting legislation. It is arguably imperative that regulators need to identify the objectives and goals of the meta-regulatory approach as this is what distinguishes meta-regulation as having a “regulatory” and not self-regulatory effect. Regulators may also need to move away from identifying firm-specific risks which are no different from the risk management a firm would carry out for itself anyway, to identifying those risks that firms have to manage in order to add to regulatory/public good. In addition to prudential risk management, perhaps risk to consumer loss, stakeholder risk and even social responsibility risk\textsuperscript{402} could be added. Further, systemic risk beyond microscopic prudential risk could also be identified as a specific regulatory goal in this meta-regulatory approach. Ideally this should also be done at the EU level so that the meta-regulatory approaches may be consistent and do not encourage regulatory arbitrage.

Meta-regulation should pertain to the identification of risks that need to be managed as a matter for delivering regulatory/public goods beyond the risk management specific to the business, success or survival of the firm. Firms should also understand that the risk management required of them under the meta-regulatory approach goes beyond mere firm needs. Levy and Kaplan argue that “[t]he embrace of corporate capacity has been fuelled by a growing concern at an international “governance” deficit…. [d]espite the need for more global coordination, states have tended to

\textsuperscript{399} SYSC 18 specifically provides for protection from retaliation for any worker in a financial institution, if whistleblowing is done with respect to risk management issues, SYSC 18 is of general application and does not specifically relate to any connection between the regulator and internal gatekeepers nor does it impose a duty on anyone to whistleblow.

\textsuperscript{400} John Braithwaite, Regulatory Capitalism (Cheltenham: Edward Elgar 2008) at 140-156.

\textsuperscript{401} Paras 6.5, 6.10, above.

\textsuperscript{402} Beth Kytle and John Gerard Ruggie, “Corporate Social Responsibility as Risk Management- A Model for Multinationals” (2005), Corporate Social Responsibility Initiative Working Paper No 10, John F Kennedy School of Government, Harvard University, arguing that CSR risks and stakeholder risks are social losses upon materialisation.
restrict their roles”. If the embrace of corporate capacity in meta-regulation becomes unquestioning, then regulators may forget to assess the outcomes of meta-regulation. Firms are co-opted in designing appropriate processes and systems for themselves and may be tempted to provide the least costly systems in order to achieve “compliance”. This may not always be sufficient to meet the needs of the regulatory/public goods. Further, what is “compliance”? Is it the existence of processes and systems evidenced by the adequacy of thought addressed to them, or is it an assessment by the regulator of substantive adequacy and the likelihood to achieve the regulatory/public goods desired? Levy and Kaplan warn that delegation to private governance focussing on the documentation of processes is likely to risk forgetting the assessment of outcomes. The approach to the regulatory implementation of the Basel II Capital Accord has shown that regulators have not satisfied themselves as to the sufficiency and effectiveness of flexible prudential management by financial institutions. This would allow processes to become a proxy for delivery of the public goods, and therefore an end in themselves to be achieved. Further, the perception by firms that they would be evaluated based on the existence of processes rather than by the performance of the processes would lead to incentives for least costly design and cosmetic institutions.

Meta-regulators should ideally engage in own evaluations of the performance of processes, but as Coglianese and Kagan suggest, this requires knowledge and capacity building on the part of regulators, and the more diverse the industry may be, the more challenging it would be for regulators to identify what may be substantively adequate. The FSA, in line with the Financial Stability Board’s recommendations have included stress-testing as part of firm risk management. Such stress testing would be both carried out by the firm and regulator in selected firms. Where stress-testing is internally managed, this is arguably another layer of meta-regulation. But where regulator stress-testing may be carried out, there is potential for this to become evaluative of performance rather than of processes. However, the issue with meta-regulation is that it is not easy for regulators to test and predict the performance of risk management under hypothetical situations, and hence there may be a temptation to be captured by firm expertise.

It is suggested that regulators may enhance their capacity in knowledge and expertise in 2 ways. Regulators may complement the meta-regulation model with an “audit” model of regulation, viz co-

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404 Although Braithwaite argues that the regulators must ascertain that firm resources are sufficient to design processes and systems to deliver the regulatory/public goods, see John Braithwaite, “Meta Risk Management and Responsive Regulation for Tax System Integrity” (2003) 25 Law & Policy 1.


407 above.

408 FSA, Stress and Scenario Testing PS20/09, Dec 2009.
opting third party certifiers to engage in vetting, auditing and recommending on the adequacy of the regulated firm’s designs and systems. Such third party certifiers could be private entities or agencies involved in Board evaluation, remuneration solutions, and advisory services for risk management and enterprise-wide risk management. Standards such as the balanced scorecard has been developed for enhancing the effectiveness of Boards, and board evaluators could be in a position to assess the adequacy of the balanced scorecard adopted by Boards and their effectiveness. In the alternative, there are other standards recommended for board evaluation, pertaining to the Board dynamics, teamwork, accountability, quality of decision-making and leadership and visionary steering. Remuneration consultants are perhaps less reliable as their methodologies are based on surveys in the peer group in similar industries and often act for an executive appointee in contractual negotiations. However, the Walker Review has identified the possibility that remuneration consultants could act as third party certifiers on the basis of their voluntary submission to a Code of Best Practice. On risk management, especially enterprise risk management, standards are being developed both in industry and academia in order to assess what the benchmarks of appropriate systems and processes for firms may be.

It is submitted that regulators can learn from third party certifiers, although co-opting them may be a form of delegated governance, and regulators would need to address potential agency problems in

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412 Eg http://www.independentremuneration.co.uk/independent-remuneration-solutions.html.


this “delegation” of governance. It has also been suggested earlier that the learning process for regulators may be enhanced by allowing diverse stakeholder input into the regulatory policy process in order to introduce alternative and critical views. Regulatory networks at the international level could also facilitate and promote the development of open procedural and technical standards for risk management.

Meta-regulation is very much at the heart of the centred landscape of governance, and there is great potential albeit difficulties in navigating this complex landscape. Regulators need to constantly review the achievements of the regulatory/public goods in this complex regulatory space and ensure the accountability of the industry even if the industry has superior technical expertise.

In this process, regulators and the industry may both be engaged in learning and experimentation of technical and processual standards, and Greenstone refers to this as “persistent regulatory experimentation”, allowing the governance process to become evolutionary through experimentation, learning and review. For example, the FSA has recently enhanced its prescriptions for managing liquidity risk, and personnel incentives risk stemming from remuneration arrangements, although such changes were triggered by the global financial crisis. The new liquidity requirements now encourage more recourse to be made to the Bank of England or European Central Bank for liquidity turnover in order to reduce the stigma of approaching the lender of last resort. This encourages constant internal review of the liquidity buffers and positions in a bank, a form of meta-regulation, as well as co-opting the lender of last resort into transactional scrutiny of the banks’ liquidity positions, a form of smart regulation.

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415 If third party audit becomes itself a ritual of comfort and not intended to uncover any discomfort, then there is no ownership of the evaluation of regulatory outcomes, see Power, The Audit Society (1999), and Braithwaite, Regulatory Capitalism (2009) at 140.

416 The possibility of greater coordination and convergence in international networks notably government led “clubs” such as the G-20 has been augmented since the global financial crisis and the rise of the importance of systemic risk as a regulatory concern. See Chris Brummer, “Post-American Securities Regulation” (2010) California Law Rev forthcoming, at http://ssrn.com/abstract=1441508


419 Michael Greenstone, “Toward a Culture of Persistent Regulatory Experimentation and Evaluation” in David Moss and John Cisternino eds, New Perspectives in Regulation (The Tobin Project 2009).


Regulation

The final two models are regulator-centred models, where the source, interpretation, supervision and enforcement of laws or regulations are in the regulators’ hands. However, even in regulator-centred models, there may be significant industry input in any one of the four aspects of regulation mentioned above. The FSA consults its Consumer and Practitioner Panels and also publicly for changes proposed to its policies and rules, and the ESMA is now required to consult its Stakeholders Group. Hence, diverse input feeds into policy and rule making. On the interpretation of rules, Black argues that the community of regulated firms is an interpretive community whose engagement in dialogue and exchange with regulators entails a process of interpretive development of rules. Where regulation is subject to litigation and adjudication, lawyers, experts, judges and tribunals may also be co-opted to provide interpretive governance of rules.

Regulators also need industry input to secure supervision or compliance. Financial regulators often rely on imposing duties upon markets to report and monitor suspicious activities so that the regulator may take action against market abuse. The risk-based regulation model also means that public-private negotiations, dialogue and exchanges in the supervisory process would likely precede any enforcement, and models in responsive regulation may be used to encourage compliance without polarising the regulator-regulated relationship.

There are also regulatory regimes which are designed in such a way that bright lines for compliance or enforcement are more easily ascertained and where liability is often strict liability for ease of proof and enforcement. This is represented by the last model along the spectrum. An example would be the mandatory disclosure regimes administered by the regulator in relation to investment products, market and trade transparency. Further, traditional command-and-control regimes


424 Section 9, 10, FSMA 2000.

425 Article 22, Regulation for a European Securities Markets Authority 2009.


427 For eg Arts 26 and 43 of the MiFID require electronic trading platforms and stock exchanges to monitor that their users comply with laws relating to market abuse. Further, Jackson and Roe argue that in policing and enforcing against insider trading, public enforcement relying on market detection and surveillance is undoubtedly superior to any private monitoring of the market, see Howell E Jackson and Mark J Roe, “Public and Private Enforcement of Securities Laws: Resource-based Evidence” (2009) at http://www.law.harvard.edu/programs/olin_center/.


exist where there is perceived to be public interest in fairness and justice, such as market abuse. This paper will not revisit the well-trodden literature explaining or exploring the rationales for mandatory disclosure and for regulating market abuse. The characteristic of regulator-centred governance that this paper focuses on is the extent and efficacy of “regulatory control” in this decentred landscape of financial regulation.

The EU has moved in the direction of recommending most enforcement by regulators to be in the form of administrative penalties. This may be in the interest of harmonising enforcement approaches in EU securities and financial regulation, but would concentrate the power of prosecutor and judge in the hands of the regulator. This in turn shapes the nature of the relational paradigm between the regulator and industry as mainly a regulator-regulated relationship, and as involving less of other entities such as civil litigants and their lawyers. I argue that the potential marginalisation of other stakeholders such as criminal and civil enforcement is not ideal, as this allows the regulated to become an excessively significant entity in the regulator’s perceived regulatory space.

In the FSA’s example, prior to the global financial crisis, the FSA maintained a high degree of public-private partnership in all aspects of regulation discussed above. This is arguably a response to the fears articulated with respect to the powers and accountability of the FSA at its establishment in 2000. The FSA has adopted a risk-based approach to regulation, targeting intensive supervision to

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433 Ch4, Chiu, Regulatory Convergence (2008), op cit.


435 The number of players in a game theory setting influence the behaviour of strategically motivated entities seeking to modify behaviour according to the perceived behaviour of another. Myrna Wooders, Edward Cartwright and Reinhard Selten argue that multiple players in a game setting often entail conformity with majority actions although individual actions would have been different. See “Behavioural Conformity in Games with Many Players” (2005, Dept of Economics Working Paper, Vanderbilt University). Also see the dilemmas and conflicts between regulators and regulated in financial regulation, Fiona Haines and David Gurney, “The Shadows of the Law: Contemporary Approaches to Regulation and the Problem of Regulatory Conflict” (2003) 25 Law and Policy 354.

only a small fraction of the financial services sector,\textsuperscript{437} and a light-touch approach to enforcement. Rider argues that the FSA had been anxious to maintain a good relationship with the industry and was reluctant to move away from the old self-regulatory regime.\textsuperscript{438} However, the close relationship between regulator and regulated has caused the regulator to adopt market beliefs and values, resulting in a light-touch approach, as acknowledged in The Turner Review.\textsuperscript{439} The recruitment of staff from the private sector, and the overall philosophy of belief in and engagement with the private sector may have resulted in forms of capture\textsuperscript{440} over the FSA in taking the light-touch regulatory approach. Contrary to what the public feared regarding the power of the FSA, the problem that has arisen in the financial crisis is its lack of exercise of powers. With the onset of the financial crisis and the acknowledgement of supervisory inadequacy of Northern Rock,\textsuperscript{441} the FSA has stepped up enforcement, such as for non-disclosure and for market abuse.\textsuperscript{442} However it is submitted that although crises often have the potential to allow reframing of the exercise of powers in a “regulatory space” and regulators could re-centre the exercise of powers,\textsuperscript{443} regulators have to consider the implications this may now have on their relationship with the regulated. Abrupt polarisation from the industry may also affect frank and open information exchange in the supervisory process, or the process of input in the design of policies and rules. But can we strike a balance between co-opting the cooperation and expertise of the regulated and maintaining the distance and authority of the regulator?\textsuperscript{444}

\textsuperscript{437} As discussed under Part I “Risk Regulation”, above.


\textsuperscript{439} Turner Review, op cit at 87-88, referring to the FSA’s belief in the self-correcting nature of markers, the self-remedying effects of transparency, and senior management’s incentives and capacity to address problems resulting in a form of light-touch regulation which is unaggressive and arguably hands-off


\textsuperscript{441} FSA, The Supervision of Northern Rock: A Lessons Learned Review (March 2008).

\textsuperscript{442} Eg Lloyd v Financial Services Authority [2009] UKFSM FSM069 (09 July 2009), where the non-implementation of systems to capture trade data and non-reporting of such data resulted in a £9 million fine, the £2.54 million fine on Barclays for the same failure in transaction reporting; FSA’s prosecution against Uberoi and Uberoi for insider dealing (4 Nov 2009), FSA’s fine on Mark Lockwood for failing to detect and prevent a suspicious client transaction amounting to insider dealing (2 Sep 2009), the FSA’s prosecution of directors at iSoft for overstating revenues (7 Jan 2010) and other censures and fines in relation to broker misrepresentation or fraud.


\textsuperscript{444} It is argued that all regulatory relationships have a social strain that encourages flexibility, experimentation, dialogue and bonding and the achievement of meaningful controls. This is flanked by an instrumental strain that supports the legitimacy of exercise of power. The balance is a delicate one between the social strain and instrumental strain to encourage control and compliance, and to minimise opportunism and antagonism.
One consistent argument advanced in this paper across the various governance models is that there is a need to mitigate the dominance of the industry in the relational paradigm between the regulator and industry across the 8 governance models. One way this may be done is by enrolling expertise beyond the regulator, such as market participants and stakeholders, and international networks. Regulator-centred models of governance that are underlined by administrative enforcement often place too much emphasis on the relationship between the regulator and regulated, and changes in the relational paradigm could affect regulatory outcomes greatly.

Further, the emphasis on administrative sanctions may place excessive reliance on regulator enforcement to provide the public goods of investor protection and financial stability. This would likely put strain on the regulator’s capacity and resources, create issues of accountability and create a regulatory governance that may not be best informed. It is submitted that regulator-centred governance should be complemented by stakeholder and wider community involvement surrounding regulatory governance. This involves greater stakeholder participation and access to provide input, as discussed earlier in relation to the development of knowledge and standards with David I Gilliland and Kenneth C Manning, “When Do Firms Conform to Regulatory Control? The Effect of Control Processes on Compliance and Opportunism” (2002) 21 Journal of Public Policy and Marketing 319.

“External Experts Help FSA Probe Banks”, The Financial Times (3 Jan 2010). In particular, Deloitte & Touche’s review of companies flagged up breaches of financial reporting by iSoft, whose directors now face criminal prosecution for making misleading financial statements to perpetuate market abuse.

Edward J Balleisen and Marc Eisner, “The Promise and Pitfalls of Co-Regulation: How Governments Can Draw on Private Governance for Public Purpose” in David Moss and John Cisternino eds, New Perspectives in Regulation (The Tobin Project 2009) describes this essential private-private partnership as co-regulation which must be based on monitoring any governance delegated to private entities and the ascertainment of commitment to wider good and reputational values on the part of the private entities.


Perhaps this accounts for the blame placed on the FSA for the failure of Northern Rock and the UK banking crisis, as well as the blame placed on the US SEC for the US subprime and banking crisis and the fund management frauds involving Madoff and Stanford, see Jill E Fisch, “Top Cop or Regulatory Flop? The SEC at 75” (2009) 95 Virginia Law Review 785; John C Coffee and Hilary A Sale, “Redesigning the SEC: Does the Treasury have a Better Idea?” (2009) 95 Virginia Law Review 707.

respect to regulating credit rating agencies and the meta-regulation of risk management. Further widening stakeholder participation also refers to civil enforcement by investors and consumers, and perhaps even stakeholders.\textsuperscript{450} I have earlier argued that as investment intermediaries’ duties to their clients become increasingly framed by regulatory rules and accountability to the regulator, there is a corresponding lack in defining how these developments may relate to accountability and responsibility to the individual aggrieved investor.\textsuperscript{451} I argued\textsuperscript{452} that:

“The principles-based approach to governing financial investment intermediaries may arguably provide a dynamic environment where net risks may be assessed at an ongoing level, and the governance input by the regulator may be adjusted. This will allow regulation to move away from a static environment... Both the regulator and regulated may benefit from this dynamic framework..., and the regulated may be allowed to carry out a discourse with the regulator in delivering the regulatory outcomes collaboratively with regulatory oversight and/or intervention.”\textsuperscript{453}

The standard of care investment intermediaries may owe to individual clients would be “contextualised” in the supervisory process. But this should not completely substitute any civil enforcement by investors as a form of governance. As Ayres and Braithwaite have suggested, agencies could often be checked by “Third Party Interest Groups.”\textsuperscript{454} Third Party Interest Groups are public interest groups that can monitor the regulator-regulated relationship where such relationship involves frequent dialogue and exposure, entailing the risk of corruption and regulatory capture. Ayres and Braithwaite argue that regulatory relationships that are ongoing and involve regular contact could give rise to corruption and capture within the regulatory outfit. PIGs then play a role to monitor the regulated and the regulator, and should have a role in calling both to account, hence preventing corruption and capture. The closest we have is possibly the movement of corporate social responsibility, allowing public interest groups and the media to expose and expressly discuss the corporate practices in financial institutions. However, corporate social responsibility does not have the same status as envisaged in Ayres and Braithwaites’ model, ie giving the social responsibility advocates a place at the table with the regulated and regulator and being able to monitor both.\textsuperscript{455} It remains outside the legal realm, arguably in the realm of best practice, for the purposes of reputational enhancement or the business case.\textsuperscript{456}

\textsuperscript{450} John Braithwaite, \textit{Regulatory Capitalism} (2009) at 79, in particular, p82 where it is stated that “qui tam [which means people who sue for both individual and communal interests] in effect networks whistleblowers, with law firms, state regulators and prosecutors, extending the intelligence, evidence gathering and litigation capabilities of the state in big, difficult cases.”

\textsuperscript{451} Chiu, “The Nature of” (2008), op cit.


\textsuperscript{454} Discussed earlier under Part 2 “Responsive Regulation”.

\textsuperscript{455} We are still at the stage of debating the theoretical justifications for corporate social responsibility, and relying on firms to take initiatives in being socially responsible or sustainable. The development of guidelines to measure social performance is still work in progress, see generally Andrew Crane, Abigail McWilliams, Dirk
Sabel and Dorf also suggest that the role of administrative agencies in modern democratic constitutionalism is to facilitate learning and exchange and joint problem solving for citizens and markets, and hence agencies provide standards as benchmarks to facilitate and incentivise learning and rolling of best practices, and enforcement against obstructive behaviour against the participative and open process. Salamon has also proposed that modern regulation is collaborative and co-opting in nature. I therefore suggest not only that civil enforcement be necessary to complement regulator-centred governance but that the regulator also be involved in the civil enforcement so that a platform of mutual exchange and learning can exist for complementary governance in the regulatory space.

The co-option of civil enforcement has been significant in the US. Investors could start class proceedings (largely against issuers) and are assisted by an attorney under a contingency-funded arrangement. This model of civil enforcement arguably allows an ex-post form of regulation by looking at actual consequences of the ex ante regulation and firm behaviour. It allows individuals to be compensated, and empirical literature has documented a corresponding decrease in the cost of equity and increase in market liquidity as a result of civil enforcement that exists alongside regulators’ public enforcement. However, commentators warn against the proliferation of frivolous suits, the tendency to target large firms for bounty-hunter enforcement, the incentives

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459 S18 on collective proceedings, Financial Services Bill (UK, Dec 2009).


of attorneys to profit from the litigation, and the danger of treating civil enforcement as being more important than public enforcement which reinforces public goods. However, the adjudication process will co-opt counsel, experts and judges to provide jurisprudence on legal duties and obligations and the public good of investor protection. This provides interpretive feedback for the regulator and policy-makers in evaluating the efficacy and design of regulation as well. To mitigate the ills associated with civil enforcement, Rose and Coffee have argued that the regulator can have oversight of, input into, or institute an approval machinery to control frivolous and unmeritorious claims. This co-opts the regulator into the civil enforcement landscape, and could mutually reinforce both types of enforcement. Moreover, Braithwaite, quoting Bucy, supports the contingency-fee funding model as essential to empowering private litigation, as there must be incentives to co-opt lawyers into acting for public good and not acting for wealthy corporations, and such incentives have to relate to private gain for the lawyers’ efforts and involvement.

Perhaps civil enforcement could be taken by institutional investors as well, where appropriate. Such actions would allow courts to examine the efficacy of disclosure regulation of securities products, and where securities products have been sold to sophisticated investors under exemptions from mandatory disclosure, civil enforcement would allow courts to examine the actual quality of the unregulated disclosure and to define the duties of providers of investment products in common law. Empirical literature has documented way before the global financial crisis of a paradox in the market for complex securities products such as collateralised debt obligations frequently sold among financial institutions and to sophisticated investors such as pension funds. These securities products were often accompanied by opacity and paucity in disclosure but the market was oblivious and liquidity remained in spite of poor disclosure. Although it could be explained that the hedging of these products against credit default swaps and the high ratings given by rating agencies served as proxies for disclosure and risk management, academic literature has long highlighted that investors have been overly optimistic about the bundling of diverse obligations into the CDO, believing that such diversity inherently reduces risk. Transactional governance between sophisticated parties in

464 Choi, “The Evidence” (2004), op cit,


466 Burch “Securities Class Actions” (2008), op cit.


469 Braithwaite, Regulatory Capitalism (2008) at 65.

this context has been weak or non-existent. As these transactions have been exempted from prospectus disclosure, being offered to sophisticated investors, there cannot be ex post regulator enforcement. However, there is significant public interest in the investment activities of sophisticated institutions as many of these manage savings of the common people. If easier and cost-effective access to civil enforcement is provided, an opportunity to examine the transactional defects and issues could arise in adjudication and any jurisprudence provided can inform regulators as to whether any rethinking needs to be done in respect of the nature of disclosure regulation for investment products in the wholesale market.

4. General Observations and Conclusions

The regulatory space in financial regulation has become decentred, and the importance of the relational paradigm between regulators and industry is likely to remain a staple phenomenon. In this decentred landscape, some key challenges going forward would be how the relational paradigm, which has become dominated by the industry should be adjusted so that the regulator may be able to address the issues of agency and capture. In particular, as regulator reliance, delegation and capture is largely attributed to the technical expertise claimed by the industry, the relational paradigm should arguably expand to include other gatekeepers, certifiers, professionals and stakeholders in order to mitigate the relational sub-optimalities.

(a) Regulators and policy-makers need to focus on the articulation and achievement of regulatory goals and public goods.

In the decentred landscape, it is important for regulators to ascertain how self-regulatory and market-based initiatives work in relation to the delivery of regulatory goals and public goods. Regulators need to address the needs of public goods and regulatory goals in the financial services landscape, and critically determine if the governance of the industry contributes to, undermines or is contrary to them. As Underhill argues, “[g]overnance is also about objectives concerning the norms underpinning the broader social and political stability without which markets are unable to function,” and hence, the performance of governance assumed by the regulated should be evaluated, and regulators have a role in ensuring that there is output legitimacy for the self-regulatory and market-based governance.

Some governance assumed by the regulated has to date allowed the regulated to develop sub-optimal standards, as well as opaque and proprietary systems which have been inaccessible and hence un-evaluable by regulators, for example in relation to credit rating agencies, the risk management of hedge funds, and the risks in the OTC derivatives trading market. The paper also warns of potential tendencies in the meta-regulation of risk management in financial institutions in general. Where governance led by the regulated may result in opacity and practical


unaccountability, regulators should arguably be able to challenge those with the values and objectives of regulatory governance, or else, the public character of regulatory governance would be subsumed, and how the industry governs itself would dominate the “governance” of the industry. The relational paradigm between regulators and regulated going forward, should arguably include enhanced evaluation and supervision by the regulator in aspects of industry governance that is intended to deliver regulatory/public goods. As Levi-Faur and Braithwaite have pointed out, regulatory capitalism exists because markets are essentially out of control, hence, regulators remain responsible for the articulation of regulatory goals and public goods such as the mitigation of systemic risk and to develop the evaluative ability to determine if these are delivered. Section 3 has discussed how regulator evaluation should be enhanced in respect of the role of central counterparties in OTC derivatives trading, the regulation of credit rating agencies, and of gatekeepers such as the audit and compliance functions.

In order to develop regulators’ ability to supervise and evaluate the performance of industry governance, the EU is taking the right step forward in demanding more transparency from the industry, for example, from alternative investment funds in terms of risk management, and from credit rating agencies in terms of methodologies and assumptions. Transparency and access to the regulated’s processes and systems is the first step to informational and knowledge building for the regulator. But the regulator must still develop critical and evaluative expertise, as will be discussed below.

(b) Where the decentred landscape presents opportunities for aspects of governance to be supplied by the firm itself or by the regulated, regulators should remain aware as to what extent reliance on such governance to deliver public/regulatory goods may be warranted, and regulators should arguably be responsible for overseeing the delivery of public/regulatory goods.

As mentioned, increased transparency and reporting to the regulator is a first step to allowing the regulator to learn and understand the actual workings of the regulated’s expertise. Further, other actors, such as stakeholders and gatekeepers in the regulatory space may be involved to add to an “information revolution” in order for all participants in the regulatory space to coordinate, contest and navigate towards comprehensive and meaningful governance. Regulators need to enrol and maintain dialogue with gatekeepers, certifiers, and stakeholders in the regulatory space, through regulatory supervision, informal dialogue or information exchange and learning in general. Widening participation in governance is generally agreed by governance theorists to be the way forward, to take into account of the various interests and roles in governance- the public and stakeholders as


consumer, taxpayer, client, citizen and interest champions, for example.\textsuperscript{476} The diversity in input from other actors in the regulatory space besides the regulated would assist in developing more critical perspectives and evaluative ability on the part of regulators. As da Cunha and Junho Pena suggest, “[participation] is an instrument for negotiating divergent interests; it does not eliminate losses but makes them transparent and acceptable.”\textsuperscript{477}

Further, more international coordination and networking, perhaps led by regulators,\textsuperscript{478} could generate more open standards of governance and compliance. Compelling the industry to open up more technical systems and standards may start a platform for the fashioning of more robust blueprints and standards. General open-ness also compels all other participants including regulators, to become observed and challenged, and this may mitigate particular interest groups becoming too powerful, and may provide more compromised balances towards the delivery of common good and values.\textsuperscript{479} The movement towards greater participation and open-ness may however likely face challenges from entities whose interests may lie in rent-seeking behaviour for their proprietary and technical expertise, or aggressive interest groups.

It may be argued that enhancing the evaluative or critical ability on the part of regulators may allow them to make quick and pre-emptive judgments that could damage the innovations in the financial services industry.\textsuperscript{480} As argued in this paper, regulators need to step out of the hitherto “capture by technocracy” and are only starting to bridge the informational gap between them and the industry. Fears by the industry that regulators would become risk-averse and extreme are not entirely unfounded, but it is suggested, not entirely imminent. The enrolment of diversity in stakeholder participation in the regulatory space may bring a balanced slate of views to assist regulators. This will make the regulatory space more dynamic and various interest representations may become invited. This is probably inevitable but the dynamics of diverse representation could unfold in a variety of


\textsuperscript{477} Paulo Vieira da Cunha and Maria Valeria Junho Pena, “The Limits and Merits of Participation” World Bank Research Paper 1996. However, the authors argue that participation is likely to lead to problem solving if it is based on already shared common values. “Questions about participation cannot avoid the issue of political power, local power, populism, and representation. They cannot avoid issues of moral pluralism (the variety of ways in which people could value their lives) or cultural diversity. They cannot dismiss the ways in which people can be blocked from better lives by the beliefs of their cultures. They cannot avoid the pressure that a dominant group may exert to forge solutions that are morally unacceptable.”

\textsuperscript{478} Brummer “Post-American” (2010), op cit, argues that regulatory coordination at the international level is fraught with incentive problems and political dilemmas, but systemic risk may refocus regulators onto cooperation.


ways as Trubek and Trubek have suggested, towards transformatory governance, a form of collective problem solving with compromises in transparent minimum standards.

Regulators should also empower civil enforcement by investors against issuers and perhaps also investment advisers. These groups are motivated by different incentives, and could be a source of intelligence for regulators, and also exercise some monitoring over the activities of the regulated. Unger also argues that as financialisation has moved the governance of financial markets from domestic governments to international governance, such governance should not merely be a platform for seizure of representative power by interest groups. The values that have evolved in establishing the legitimacy of governments such as democracy, accountability, participation, and checks and balances need to feed into governance frameworks as well. Hence, regulators should ensure widening participation by gatekeepers, certifiers and stakeholders in order to support the information revolution and introduce balance to the power landscape in the decentered regulatory space.

(c) Regulators need to develop expertise in and responsibility for policies that may identify and manage systemic risk.

As earlier mentioned, a number of commentators have argued that the management of systemic risk is a public good that is not likely to be supplied by the market. Regulators are perhaps best placed to take on the responsibility of identifying and managing systemic risk. Not all asset bubbles or massive leverage may result in systemic risk, but it is imperative for regulators to develop research and increased expertise in identifying the emergence of such risks and trends. The taking of ownership of systemic risk issues is gathering pace in the EU, with the establishment of a European Systemic Risk Committee which would work with the pan-European regulators and national regulators. The Financial Stability Board is also taking the role in international coordination to frame guidelines for the assessment of systemically risky and important matters in the financial services landscape. The FSB’s guidelines may be a step forward to determine the indicators of systemic risk, but these should be further evaluated, reviewed and developed. The financial services landscape is not only innovative but decentered, and hence the consequences of actions taken by any one group of actors or stakeholders may have effects that are unanticipated. Regulators have to

481 “New Governance & Legal Regulation: Complementarity, Rivalry, and Transformation” (2007) 13 Columbia Journal of European Law 1, arguing that stakeholder democracy can led to co-existence of public and private forms of governance that complement each other, meaning that different strands of governance have different objectives and do not merge, or rivalry between the strands of governance, but these dynamics may lead to transformatory evolution, for example, procedural coherence in governance coordination, development of minimum standards and collective problem solving.


develop expertise in seeking out relevant information not only from the regulated, but also from other actors in the financial services landscape such as gatekeepers, certifiers, professionals and stakeholders, and in applying the indicators of systemic risk to such information. This likely requires enhanced capacity, learning and coordination on the part of regulators worldwide.

(d) Regulators must be prepared to countenance the much more complex job of regulation in a decentred and globally-connected landscape. As Jackson and Roe argue, there is great value in public enforcement in the achievement of regulatory goals and public goods, regulators should be more and better resourced to develop standard setting, supervisory and enforcement capabilities.

The variety of governance models discussed in Section 3 shows that the concept of governance in the financial services landscape has been evolving to match up with the contemporary complexities of the decentred landscape and the sophistication of the financial services industry. However, as mentioned above in (a), regulators need to reaffirm the importance of public goods such as the oversight of systemic risk, and to re-orient the relational sub-optimalities in public-private governance, and to assert certain forms of appropriate control in the regulatory space, whether via standard setting, supervision or enforcement. Regulatory standard setting may be directed not only to the regulated industry, but to transactional parties to hedge funds, to the delegates and outsourcees of governance, and to third party certifiers such as rating agencies. Supervision may involve communication and experimentation, as well as evaluation and exercise of authority. Enforcement may include not only deterrence, but a more comprehensive sense of justice that restores to optimal behaviour and wider social good.

The future of governance in the financial services landscape would lie in changes to the chemistry of the relational paradigm between the regulator and industry. In particular regulators should have a unique role to uphold public good and regulatory governance and should assume greater critical evaluation of the governance provided by the industry. This paper argues that this is not tantamount to a form of simplistic re-regulation as the regulator is not assuming all forms of control over the industry where it is impractical to do so. Rather, regulators should enhance their responsibility through informational enhancement, knowledge and capacity building, learning and evaluation, and co-opt a variety of participation in the financial services landscape particularly from stakeholders and investors in civil enforcement. Enhancing the responsibility of the regulator, may be the fundamental change in governance that is required.


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