Enhancing responsibility in financial regulation – critically examining the future of public–private governance: part II

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Part 1 of this paper argued that the financial services landscape is largely a decentralised regulatory space featuring two key players, the industry and the regulatory sector, and hence financial regulation is very much based on the relational paradigm between the two. It is also argued that contemporary models of governance that have shaped financial governance have allowed the industry to become the dominant provider of governance in many issue areas, and this has given rise to some concerns which have become apparent in the global financial crisis. The paper argued that although the relational paradigm between the regulatory sector and the industry may be more of a “background” issue rather than a frontline issue that relates to specific legislative or regulatory reform, this is an important and persistent paradigm in financial regulation. Section C of this paper, presented here, will look into specific areas of governance in the financial services landscape represented by eight models of governance mentioned in Part 1, and discuss the issues of governance from the perspective of the relational paradigm. Section D then concludes with some general observations.

C. Eight models in the governance of the financial services landscape

1. The no-regulation model

The first two models along the spectrum referred to in Section B relate to governance that is not chiefly provided by regulation, ie microcosmic self-regulation and trans- actional governance.

Prior to the global financial crisis, there have been significant areas of “no regulation” in the financial markets. One area of “no regulation” is the self-regulation of sophisticated investors in investment decisions. There is an almost accepted presumption in favour of no regulation for the activities of sophisticated investors, but it is questioned whether this view is based on a perception that is too microcosmic. The risks to sophisticated investors may not only be borne by themselves and but may also be borne by the savers of pension funds, for example. The freedom of these investors 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. This paper will, however, address three other areas in detail below: the over-the-counter (OTC) derivatives market, the offshore entity of hedge funds, and the providers of “certifier” products such as credit ratings, corporate governance and social responsibility ratings. We will discuss below how these issue areas are “governed”, the concerns highlighted in the global financial crisis and any implications from changes proposed to these governance models.

2. OTC derivatives transactions

OTC derivatives have come under scrutiny following the risk of default by US insurance giant AIG in credit default swaps in the financial crisis. That default was ultimately prevented by the bail-out undertaken 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 also 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 is 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 timeframes 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 has mitigated the risk of OTC derivative transactions to the extent that a “dis-integration” from exchange traded derivatives would occur.6

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 as a matter of 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:

“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.’”7

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. There have been two proposals to provide governance over the management of systemic risk in bilateral OTC derivatives trading. First, it is thought 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 Gerding8 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, eg 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 in the aftermath of the global financial crisis,9 and the Over-the-Counter Derivatives Markets Act 2009.10 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 that all standardised derivatives contracts be centrally cleared.11

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. Acharya12 has argued, based on 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.13

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.14 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 counterparts 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 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, which if not dealt with, could result in moral hazard.

One such principal-agent issue may be conflicting objectives that the central counterparty has to address, between keeping members happy 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 these organisations may be unwilling to take tough enforcement or discipline against their members. The mitigation of any potential agency problems is arguably key to delegating governance in derivatives markets to central counterparties. For example, the Financial Services Authority (FSA) arguably has oversight of the financial resources of central counterparties before giving them recognised status. However, as there are no clear bright lines as to continuing prudential management, this area may arguably have to be re-examined 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. 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 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 that would require all trade data in derivatives to be reported and disclosed. Such trade data would then be centrally stored in data repositories. In view of the role of systemic risk regulation chiefly undertaken by the European Systemic Risk Committee, such information could potentially feed into general prudential regulation.

The Systemic Risk Committee is supported by the work of three pan-EU regulators for banking, insurance and securities markets, which are currently networks of Member State regulators. Member State regulators are, however, also accountable to their financial stability councils in each Member State – eg the UK Council of Financial Stability comprises the Treasury, the Bank of England and the FSA. It may be questioned as to how information may be coherently processed and evaluated in this four-tiered structure, and the diversity in goals that may be brought to the table may be significant as well. The Systemic Risk Committee has the right to receive regular data reporting by the three pan-EU regulators, and the right to gain access to any necessary information. However, the information transmission, processing and aggregation between the three 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 level may need to be revisited to ascertain if the regulatory centre of influence is able to coherently monitor and mitigate any agency problem that is posed by reposing the governance of derivatives markets to central counterparties.

Finally, Stout has suggested the direct regulation of access to derivative trading, ie 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 derivatives trading in 2000, and basically required that derivatives trading would only be valid if based on an actual interest in the underlying subject matter of the derivatives transaction. In the absence of such an actual interest, a derivatives contract would be no different from a mere speculative transaction and would be outlawed. This could reduce the amount of derivatives 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 derivatives 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.

3. 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 has offered the following view of hedge funds:

“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 débâcle 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 from hedge fund failure are those that fall on the fund itself and 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.\(^{30}\)

Hedge funds present micro-type risks which affect the survival of a hedge fund itself, 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”\(^{31}\) 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 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 Maier\(^{32}\) 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 ring-fenced on trust.\(^{33}\)

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 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\(^{34}\) 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\(^{35}\) 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 aversion of systemic risk. In particular, as it is not easy to define a hedge fund, the Proposal for a Directive to Regulate Alternative Investment Fund Managers 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). This may capture non-UCIT\(^{36}\) funds that could be marketed to members of the public under FSA authorisation, and other miscellaneous collective investment schemes that could now legitimately operate in other Member States beyond the harmonised UCIT schemes. Although the Proposal has de minimis rules that exempts smaller collective investment funds in Member States from being captured, perhaps more consideration should be given to whether the scope of the Proposal can be designed to capture the regulation of risk and not the regulation of all non-UCIT fund management 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 disclosures 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.\(^{37}\) However, it might be questioned whether sophisticated investors in hedge funds should have more weapons at their disposal than the above. Sophisticated investors may often be subject to lock-in periods 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.\(^{38}\) This area may be revisited to see if it is necessary to create regulation to empower investors with 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. Further, smart regulation is enhanced by appropriate regulation to empower transactional parties such as investors and prime brokers, these actors could arguably function 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.\(^{39}\) 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, the blueprint in the Proposal that empowers and enhances their knowledge and informational capacity\(^{40}\) 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.41

Concerning 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.42 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 patterns of industry-wide risk and weaknesses.43 Besides disclosure, the Proposal also recommends certain prescriptive risk management measures such as the management of liquidity risk,44 and limitations that may be imposed on hedge fund investments in asset-backed securities.45 Perhaps the more prescriptive notions of risk management that contribute to the regulator’s governance of overall and systemic risk could be drafted in more general framework principles so that Commission legislation could in due course provide for specific measures if warranted so that public governance may 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.46 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 regulation 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,47 and improve informational transparency to them to support the transactional governance that they could provide.

However, where systemic risk issues are concerned, the lack of collective ownership of systemic risk issues as discussed earlier often means that regulatory governance is necessary to have oversight of this. The primary level of regulatory oversight lies with national regulators who register the funds, as information disclosure by funds would be made to them. However, systemic risk issues have to be addressed beyond the national level, especially in the interconnected markets of the EU. As mentioned earlier, at the EU level, three pan-EU regulators have the mandate to produce a harmonised rulebook and co-ordinate supervisory convergence, and they would report to the Systemic Risk Committee. The Systemic Risk Board has the power48 to issue non-legally binding warnings which would no doubt be highly persuasive, but it could be argued that Member States could distinguish high-level indications from their local conditions in deciding what weight to attach to such warnings. However, the combination of soft law from the Systemic Risk Committee and the hard law that can be issued by the pan-EU regulators49 may produce standards for the regulation of risk. This remains to be seen.

4. Self-certification by providers of “certifier” products

Investment products are often referred to as “credence goods”,50 and hence the market produces “certifier” products to help investors discern the quality of such credence goods. The purchasers of such certifier products are not, however, investors, but issuers, for the purposes of enhancing the attractiveness of their products. Credit ratings are intended to provide information on the creditworthiness of investment issuers, ratings on corporate governance provide information on how the agency problem in a corporation is managed, and social responsibility ratings and achievements provide information on the ethical, social and environmental reputations of the corporation. Certifier products potentially also include analysts’ recommendations to buy or sell, but this discussion will exclude the issues pertaining to analysts as the Markets in Financial Instruments Directive (MiFID) already provides direct regulation over certain aspects of research products. The Directive prohibits research analysts from receiving inducements to promise favourable research51 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.52

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, ie 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.53 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, ie investors who rely on the ratings.54 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 Nationally Recognized Statistical Rating Organization (NRSRO) Regulation and the International Organization of Securities Commissions (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, the “Governance Metric Index” by Governance Metrics International, and “The Corporate Library 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 the “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 probably 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. According to White, users’ desire for consistency of ratings across investment products helps to sustain market discipline in terms of information and the incentive for not-for-profit initiatives, but the oligarchic structure may be ameliorated by the range of methodologies to credit-rating agencies, but unlike any not-for-profit initiatives mentioned above designed to provide information to stakeholders for free. Hence, compared to corporate governance and social responsibility ratings, market discipline in terms of information and competition might be relatively weaker for credit-rating products.

Where market discipline is weak, suboptimal 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 remedies. One way out would be to regulate for an “investor-pay” model of credit ratings so that direct 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 either to mitigate the externalities that would arise, or else order that the externalities be borne by the rating agencies or issuers?

This paper submits 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 have pointed 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 argue that it is necessary 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, then the lack of evaluation would result in practical unaccountability.

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. 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.

The EU Regulation 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

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Conduct for Rating Agencies issued in 2004, now updated to incorporate more rigorous principles and stakeholder consciousness in rating complex structured products. Information disclosed to ESMA would be useful only if the regulator has expertise in critically appraising how rating systems should be designed and operated and is 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; if agencies collude with each other instead of compete with each other to deliver accurate ratings, then it is unlikely regulators that will be able to discern if accurate 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. In addition, 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 have a further platform allowing other stakeholder views to be submitted and stakeholder discussion sessions to be conducted.

Gerdinger has also suggested that regulator expertise in rating methodologies and standards can be enhanced via the development of open technical platforms. 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, and 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 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. 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 international soft law for a platform for open technical standards of credit ratings can perhaps 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.

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 how regulators could have in place expertise or capacity to monitor how the public goods are delivered, and to determine if they have been adequately delivered. 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.

5. 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 earlier, market-based governance can take place via various arrangements. There is an abundance of literature looking into the self-regulatory nature of some stock exchanges and the governance it provides over issuers and intermediaries. Although the US and Hong Kong are jurisdictions that still rely heavily on exchange governance, much less reliance is placed on exchanges in the UK and EU, and hence this section will not look into the potential “agency problem” 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;
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. This section will not deal with (c) as it has been dealt with above. This section 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.

This section 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. Access to detection and the capacity of such gatekeepers 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, corporate governance assurances. This part will argue that 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 be made accountable to regulators for the governance that has been delegated to them. However, this is not to suggest a bright-line distinction in the roles of gatekeepers, 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. It could be argued that accountants and lawyers could provide governance for the social good 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 on the part of 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 arguably a suboptimal 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: (i) as market-based services derived according to demand, such as consultancy work in internal systems and controls, corporate finance and acquisitions, and lawyers’ advisory and drafting services for transactions; (ii) as 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 to 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. Further, commentators have observed that in-house lawyers adopt the organisational identity of the corporation over individual ethical self-regulation or professional identity. 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. 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 the first type of 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 more 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.

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 and limited liability. Auditors are engaged in order to provide an assurance as to the accuracy of the mandatory reporting in order to maintain the legitimacy of the privilege of incorporation. 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 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?

It is suggested 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 that the audit process seeks to achieve. Power has argued 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, besides adherence to professional and technical standards in relation to the audit.

In relation to lawyers, Parker has suggested 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 social good. 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 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 below under “Meta-regulation”, as to the potential of compliance units to act as internal monitors in the regulatory space.

The US Sarbanes–Oxley Act 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 also required to report up the ladder to audit committees of companies if wrongdoing is suspected. These legal duties compel gatekeepers to provide governance over issuers. As a result, empirical evidence shows that the Big Four 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. 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 monitoring of such governance by regulators may have to take place through regulator engagement with professional bodies, developing common understandings and standards in achieving public goods, instead of a model of delegated governance supported by penalties. O’Connor has suggested that stakeholder involvement should be enrolled in order to monitor auditors in
achieving the social good of the audit. In particular, share-
holders may be given the right to appoint and remove
auditors and determine the remit of the audit.\textsuperscript{106}

Regulators arguably have a continuing role to 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
and gatekeepers is arguably a continuous learning process
and dialogue in respect of the public and social good that
can be delivered by the audit.\textsuperscript{107}

6. Soft law

In this section, I 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 impor-
tant not only in international financial governance but in
global governance generally.\textsuperscript{108} 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.\textsuperscript{109} 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 nego-
tiation, especially at an international level, as well as
modification and evolution.\textsuperscript{110}

Soft law is arguably an essential feature of the decentralised
realities of the regulatory space. The location of power,
expertise, capacity and influence in different entities within
the “regulatory space” means that much policymaking
would occur through the processes of negotiation and
dialogue.\textsuperscript{111} This is especially augmented at the international
level where policymaking is increasingly eclipsing merely
domestic regulatory solutions in the financial services land-
scape.\textsuperscript{112} As domestic regulatory solutions could be
undermined by regulatory arbitrage in this age of easy
migration of economic and financial activities, policymakers
recognise the importance of engaging in negotiation,
dialogue and co-ordination on an international level.\textsuperscript{113} Soft
law offers a platform for such engagement to take place as it
represents any commitment made to policies or decisions as
being reflexive,\textsuperscript{114} although the workability of such solutions
would often gradually become convincing and legalised in
states.\textsuperscript{115} 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 influ-
ence 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 forms epistemic communities\textsuperscript{116} to take leadership in the
framing of standards and soft law governing themselves.\textsuperscript{117}
Technocratic actors have been especially successful in stan-
dards and policy setting. According to Zaring and Redak,\textsuperscript{118}
international networks such as the Basel Committee are
based on a high respect for technocracy and are therefore
very successful in taking leadership over establishing the
standards of international prudential regulation. Tsingou has
also commented on how the OTC derivatives industry has
long made a case for self-regulation by producing techno-
cratic blueprints for self-regulation although policymakers
are now concerned about the size of the market and the
social risks of losses and fallouts from the market.\textsuperscript{119} Zaring,
however, sees IOSCO as relatively weaker in influence in
the setting of international standards as it is a network of
state regulators and is too concerned with political consider-
ations and diplomatic niceties and hence it has not been that
effective in leading international standard setting.\textsuperscript{120} 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 Proposal to regulate
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 standards
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 Arbi-
tration 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 standards setting.\textsuperscript{121} This
may be the reason why there has been extensive accep-
tance\textsuperscript{122} by states of the prudential regulation established in
Basel II Capital Accord, albeit giving elite banks much
autonomy in managing their own risks,\textsuperscript{123} such autonomy
now questioned and compelled to be limited after the onset
of the global financial crisis.\textsuperscript{124} Although many 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{125} The dominance of the industry has
led to the type of accountable 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 representa-
tion in the Basel II process are non-existent.\textsuperscript{126} Fransen and
Kolks have called for greater access and participation to be
available to stakeholder networks so that stakeholder
networks could be put in a position to monitor standards setting at the international level. Seidl describes international standards setting in soft law as a platform of “observeability”, 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. However, the dynamics of these entities depend largely on their bargaining power, rights of access, participation and critical scrutiny. Decentralized locations of influence may behave as self-interested entities in a game, focusing on the appropriation of power, or entities may take a neo-liberalist view that co-operation and co-ordination would secure optimal results. Perhaps in reality both sets of activities unfold. However, the dynamics of these entities depend largely on their bargaining power, rights of access, participation and critical scrutiny. Decentralized locations of influence may behave as self-interested entities in a game, focusing on the appropriation of power, or entities may take a neo-liberalist view that co-operation and co-ordination would secure optimal results.

Perhaps in reality both sets of driving forces exist to shape the dynamics amongst decentralized locations of influence in the regulatory space. 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 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 decentralized regulatory space at the international level so that standards 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 élite 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 (SEC).

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 are 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 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 Thiesen 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. Faure-Grimaud et al also agree 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. Has market discipline addressed any shirking? The Report of the Cadbury Committee 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.” (para 6.6)

However, 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, have reported that market participants and shareholders do not exert any market discipline on firms that do not comply or explain adequately. This may be due to a lack of conviction that corporate governance affects investment value at least in the short term, although the evidence of correlation seems stronger in the 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 made their discontent known of late. 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.  

However, as I have pointed out elsewhere, there is insistent policy leadership in the UK shaping the role of institutional shareholders to call 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, and the market will be responsible for dealing with deviations from the Code. It is arguable that policymakers 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. It remains arguable whether or not sound corporate governance is to be regarded as a public good; the debate is extensive and beyond the scope of this paper. However, empirical evidence suggests that sound corporate governance may be key to averting corporate disasters and losses in shareholder value. A number of commentators have suggested, albeit with hindsight, that corporate disasters such as Enron and Royal Ahold could have been averted if better corporate governance had been in place earlier. 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 policymakers 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 policymakers. For example, the French government has restricted bonuses that can be paid to bank executives where the bank is receiving government support; and the UK FSA 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 make apparent to a company 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, but the public good aspect of corporate governance would need to include the regulator. 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. Comply-or-explain arguably entails an ambivalent character that is not ideal in making it unequivocal whether a public good is sought to be delivered.

It remains an open question, however, as to whether corporate governance or aspects thereof would deliver any public good. The Walker Review of Corporate Governance in UK Banks 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 to shareholders. The Review, however, expects that the quality of explanations be improved and that shareholders engage actively in monitoring the comply-or-explain regime. The co-option of shareholders, particularly institutional shareholders, in the regulatory space has been a persistent aspect of policy. 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. Hence, it now seems shareholders will be asked 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, their accountability would lie to themselves in the investment value of their investee companies, and that would not be a measure of public good as such.

In respect of one particular issue, that of bankers’ remuneration, the Walker Review proposes legislation. 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 ownership over this aspect of corporate governance. The FSA is further bolstered by enforcement powers to intervene and invalidate remuneration clauses in banks’ transactions that may pose excessive risk.

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).

7. Meta-regulation and the “audit” model

This part discusses the two models known as “meta-regulation” and “audit”. Meta-regulation is firm-centric in nature as it is a regulatory approach based on leveraging on firm capacity and resources to provide permeability and accountability to external stakeholders and to meet the requirements of “compliance”. In financial regulation, this approach is seen in the MiFID and FSA’s SYSC Handbook 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, such as the delegated governance to auditors discussed earlier. This part will suggest how the audit model can assist regulators in meta-regulation.

Risk management has in any case always been part of corporate management anyway; how would the meta-regulation of risk management in financial institutions therefore differ from self-regulation by firms? The risk management of firms in general depends very much on the needs of particular firms, eg in order to reduce the cost of capital. The approach to risk management and even enterprise-wide risk management (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. 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 mentioned, meta-regulation aims to achieve a wider purpose of accountability to external stakeholders, such accountability being in part manifested as compliance with legal rules.

Hence, regulators’ interest in the meta-regulation of firm 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.

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. 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. Some minimum standards prescribed in the MiFID are that risks associated with confidentiality and storage of information and data, risks associated with business continuity when electronic systems 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, and remuneration policies. 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, liquidity risk, and group risk. Risk management also includes regular periodic reviews of the effectiveness and adequacy of the arrangements, policies, systems and procedures in place.

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, corporate governance including institution of audit committee, independent risk-assessment function in firms, and incorporation of 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 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 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 first to 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 systems and processes. The compliance function, for example, is arguably only concerned with legal compliance. 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 independent compliance function in firms to be an independent auditing unit that goes beyond legal compliance. Firms designing the compliance function could take the least costly and complex approach to instituting the compliance function.

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. The internal audit function is currently framed to support Board evaluation of internal controls, systems and processes under the Turnbull guidance. Hence, it is not required to be independent and is chiefly responsible for reporting to the Board. Further, Spira and Page 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. These proposals may supersede the FSA SYSC’s provision for an optional independent risk-evaluation function, 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. The internal gatekeepers’ role in risk management is intended to enhance firm capacity and assist senior management. As internal gatekeepers are not subject to a duty to report, whistleblowing 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 levered on firms’ capacity and resources to deliver regulatory/public goods, the firm arguably 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, ie “ritualism”. 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. 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 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 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 are 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 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?
Kaplan warn that delegation to private governance focusing on the documentation of processes is likely to risk omitting 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 result in cosmetic institutions.

Meta-regulators should ideally engage in their 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 regulators may defer to the firm’s expertise or judgement.

It is suggested that regulators may enhance their capacity in terms of knowledge and expertise in two ways. Regulators may complement the meta-regulation model with an “audit” model of regulation, ie co-opting third-party certifiers to engage in vetting, auditing and recommending on the adequacy of the regulated’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 ERM. Standards such as the balanced scorecard have been developed to enhance the effectiveness of Boards, and board evaluators could be in a position to assess the adequacy of the balanced scorecard adopted by Boards. Alternatively, there are other standards recommended for board evaluation, pertaining to 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 ERM, standards are being developed both in industry and academia in order to assess what appropriate systems and processes firms should have.

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 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 decentralised landscape of governance, and there is great potential, albeit there are difficulties in navigating this complex landscape. Regulators need constantly to 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 procedural standards; Grenstone has referred 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-opts the lender of last resort into transactional scrutiny of the banks’ liquidity positions, a form of smart regulation.

8. 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 Pruditioner 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 regulated sector 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 be co-opted to provide interpretive governance of rules. Regulators also rely on 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 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 decentralised 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 does 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 participation by other private entities such as civil litigants and their lawyers. I argue that 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 with the regulates in all four aspects of regulation. 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 at only a small fraction of the financial services sector, 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. 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’. 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 (SENSE?) 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, the FSA has stepped up enforcement, such as for non-disclosure and for market abuse. 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 recenter the exercise of powers, 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 co-operation and expertise of the regulated and maintaining the distance and authority of the regulator?

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 eight 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 probably strain 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 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. 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.

“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.”

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 be checked by “third-party interest groups.”

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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. Public interest groups then play a role in monitoring 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 perhaps the corporate social responsibility movement, allowing public interest groups and the media to expose and expressly discuss corporate practices in financial institutions. However, corporate social responsibility does not have the same status as envisaged in Ayres and Braithwaite’s model, i.e., giving the social responsibility advocates a place at the table with the regulated and regulator and being able to monitor both.\textsuperscript{243} It remains outside the legal realm, arguably in the realm of best practice, for the purposes of reputational enhancement or the business case.\textsuperscript{244}

Sabel and Dorf have suggested 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.\textsuperscript{245} I therefore suggest that not only is civil enforcement necessary to complement regulator-centred governance,\textsuperscript{247} but that the regulator should also be involved in 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 can 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 ante enforcement that exists alongside ex post regulator enforcement in an area where such enforcement is provided, an opportunity to reinforce both types of enforcement.\textsuperscript{256} 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 the public good and not acting for wealthy corporations, and such incentives have to relate to private gain for the lawyers’ efforts and involvement.\textsuperscript{257}

Perhaps such civil enforcement could be taken by institutional investors as well as individual investors. Such actions would not only be able to entail examination of the efficacy of disclosure regulation of securities products, but would be able to entail examination of the quality and efficacy of the actual disclosure among sophisticated parties exempted from mandatory disclosure. Empirical literature documented, long before the global financial crisis, 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 institutions. 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.\textsuperscript{258} 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 highlighted that investors were overly optimistic about the bundling of diverse obligations into the CDO, believing that such diversity inherently reduced risk. Such biases could have been detrimental to investor transactional controls over the sales of such products.\textsuperscript{259} As these transactions had been exempted from prospectus disclosure, being offered to sophisticated investors, there cannot be ex post regulator enforcement in an area where public protection has been removed. However, there is significant public interest in how institutions for the common saver become an important source of investment and finance in capital markets. 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.

**D. 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 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 these relational sub-optimalities.
(a) Regulators and policymakers need to focus on the articulation and achievement of regulatory goals and public goods.

In the centred landscape, it remains 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, undermines, or is contrary to them. As Underhill argues, “[g]overnance is also about objectives concerning the nomen 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 should have a role in ensuring that there is output legitimacy for the regulated’s governance.

Some governance assumed by regulated firms has to date allowed them to develop sub-optimal standards, as well as opaque and proprietary systems which have been inaccessible and hence un-evaluable by regulators, eg in relation to credit-rating agencies, the risk management of hedge funds, and the risks in the OTC derivatives trading market. This paper has also warned 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; otherwise, 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 should arguably include residual 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. Part C 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, eg 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 firms’ 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 centred landscape presents opportunities for aspects of governance to be supplied by the firm itself or by other actors in the landscape, 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 in adding to an “information revolution” in order for all participants in the regulatory space to co-ordinate, 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 the various interests and roles in governance – the public and stakeholders as consumer, taxpayer, client, citizen and interest champions, for example. The diversity in input from other actors in the regulatory space besides the regulated firms 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.”

Further, more international co-ordination and networking, perhaps led by regulators, 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 openness also compels all other participants, including regulators, to become observed and challenged, and this may prevent particular interest groups becoming too powerful, and may provide more compromised balances towards the delivery of common good and values. The movement towards greater participation and openness may face challenges from entities whose interests may lie in rent-seeking behaviour for their proprietary and technical expertise.

It can be argued that enhancing the evaluative or critical ability on the part of regulators may allow them to make quick and pre-emptive judgements that could damage innovation in the financial services industry. As argued in this paper, regulators need to step out of the old “capture by technocracy” mindset, and start 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 may invite representations by various interests. This is probably inevitable but the dynamics of diverse representation could unfold in a variety of ways as Trubek and Trubek have suggested, towards transformative 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 has argued 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 decentred 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 ESMA and national regulators. The Financial Stability Board is also taking the role in international co-ordination 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 decentred, and hence the consequences of actions taken by any one group of actors or stakeholders may have effects that are unanticipated. Regulators have to 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 co-ordination 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 have argued, 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 standards setting, supervisory and enforcement capabilities.

The variety of governance models discussed in Section C shows that the concept of governance in the financial services landscape has been evolving to align with the contemporary complexities of the decentred landscape and the sophistication of the financial services industry. However, as mentioned above, regulators need to reaffirm the importance of public goods such as the oversight of systemic risk, and to reorient 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 standards setting may be directed not only to the regulated industry, but to transactional parties to hedge funds, to the delegates and outsources 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 optimal behaviour and wider social good.

The future of governance in the financial services landscape lies in changes to the chemistry of the relational paradigm between the regulator and industry. In particular, regulators 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.

Senior Lecturer, University College London. This paper has been commissioned as part of the ECB Working Paper Series, but does not represent the views of the ECB in any way. All errors and omissions are mine.

1 SJ Choi, “Regulating Investors not Issuers: A Market-based Proposal” (2000) 88 California Law Review 2793. In this radical proposal to regulate investors, Choi was content to allow sophisticated investors the greatest amount of freedom to decide on investment decisions.

2 The EU Proposal for a Directive for Alternative Investment Fund Managers, however, suggests in Art 13 that regulators may have powers to limit the exposure of alternative investment funds to asset-backed securities.

3 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 F Partnoy, “ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?” (2002) at http://ssrn.com/abstract_id=293085.

4 JD Cummins, RD Philips and SD Smith, “Derivatives and Corporate Risk Management: Participation and Volume...
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6 Kroszner, ibid.


10 See esp s 113.


18 FSA Handbook REC 2.


23 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.


26 FS L’Habitant, Hedge Funds: Myths and Limits (Wiley Finance 2002), ch 4.

27 Bookstaber, supra n 13, 244.

28 D Frase, “Regulatory Creep and Convergence: Hedge Funds and the Regulators”, in I Cullen and H Parry (eds), Hedge Funds: Law and Regulation (London, Sweet & Maxwell, 2001), 17ff, arguing that the LTCCM débâcle has resulted in “regulatory creep” around hedge funds, such as the regulation of investor restriction and market abuse.

29 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 Paper on the Risks and Regulatory Engagement of Hedge Funds (DP05/04) available at http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf, pointing out the possibility of serious market disruptions from hedge fund liquidations and the risks to investor protection due to opacity in hedge fund operations.


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33 In the Matter of Lehman Brothers International (Europe) [2009] EWHC 2545 (Ch).
34 T Gilovich, D Griffin and D Kahneman (eds), Heuristics and Biases: The Psychology of Intuitive Judgment (Cambridge University Press, 2002); D Kahneman and A Tversky (eds), Choices, Values and Frames (Cambridge University Press, 2003).
36 Eg non-UCITs retail schemes see FSA COLL 1.2.
40 Also earlier proposed by the Hedge Fund Working Group (led by Sir Andrew Large), Hedge Fund Standards: Final Report (January 2008), largely based on information disclosure as a set of best practices.
41 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 (SDNY). Greater openness to civil actions in investment enforcement is seen in the HM Treasury, Reforming Financial Markets (6 July 2009).
42 Arts 20–24, the Proposal, supra n 37.
43 Fanto, for example, doubts that regulation of risk is possible based on the technical and subjective nature of risk information: J Fanto, “Financial Crisis Reforms: Maintaining the Status Quo?” paper presented at Centre for Commercial Law Conference, Queen Mary University of London, 11 December 2009.
44 Art 12, the Proposal, supra n 37.
45 Art 13, the Proposal, ibid.
49 To be endorsed as Commission legislation, see Art 7, ibid. Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority, September 2009.
52 FSA Handbook, COBS 12.3 and 12.4.
53 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 J Manns, “Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability” (2009) 87 North Carolina Law Review 1011.
55 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 R Daines, I Gow and D Larcker, “Rating the Ratings: How Good Are Commercial Governance Ratings?”, Arthur and Toni Rembe Rock Center for Corporate Governance, Stanford University (June 2008).
58 Manns, supra n 53 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.
60 CM Bruner, “States, Markets and Gatekeepers: Public–Private Economic Regimes in an Era of Economic Globalisation” (2009) 30 Michigan Journal of International Law 125; F 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 NR SRO 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/ecbpwp517.pdf.
61 Bruner, ibid.
62 Very unlikely, according to Spatt, supra n 54, although some intuition towards has been reported in the US.
64 JC Coffee and HA Sale, “Redesigning the SEC: Does the
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69 Rousseau, supra n 59, 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.


72 Art 22, ibid.

73 EF 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.


75 Gerding, supra n 73; J Braithwaite, Regulatory Capitalism (Cheltenham, Edward Elgar 2008), 4, 109ff.

76 D Asenova, M Beck and S Toms, “The Limits of Market-based Governance and Accountability – PFI Refinancing and the Resurgence of the Regulatory State”, University of York Working Paper No 35 (2007) 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.


79 Eg, 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 (November 2009).


86 Gunz and Gunz, supra n 83.


90 Such as audit or assurance services for corporate governance, see Fédération des Experts Comptables Européens, supra n 79.

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Carolina Journal of International Law and Commercial Regulation 725.


94 Humphrey, Loft and Woods, supra n 80.


97 Eg see Chiu, supra n 15.


99 Power, supra n 89, ch 6.

100 Ganuza and Gomez, supra n 93.

101 Art 6, MiFID Commission Directive.

102 C 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.

103 Art 8, MiFID Commission Directive.


107 JSF Wright and B Head, “Reconsidering Regulation and Governance Theory: A Learning Approach” (2009) 31 Law and Policy 192. J Braithwaite also considers dialogue, information exchange and learning to be key to the regulatory capitalism of today, see Braithwaite, supra n 75, 59.


114 AT Guzman and TL Meyer, “Explaining Soft Law” (2009) at http://ssrn.com/abstract=1353444; W Matthi and T 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 co-operation to find optimal solutions as well as to behave in a realist manner to achieve the maximisation of the state’s own interest.


118 Zaring, ibid; V Redak, “Risks, Ratings and Regulation: Towards a Reorganization of Credit via Basel II?”, in Mooschlechner et al supra n 116, 208.


120 Zaring, supra n 117, 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.

121 D 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 W Matthi and T Büthe, “Global Private Governance: Lessons from a National Model of Setting Standards in Accounting” (2004–05) 68 Law and Contemporary Problems 225.


126 Redak, supra n 118, 208.


130 S Lütz, “Political Economy Approach to Financial Reform”, in Mooschlechner et al, supra n 116, 34, arguing that political relations and concerns drive regulatory reform, and regulatory reform is not merely premised on economic and rational analyses.


133 Matthi and Büthe, supra n 121.


136 Faure-Grimaud et al, supra n 134.


142 Chiu, ibid, ch 2.


Final Report (26 November 2009), at para 1.5.

Para 5.7.

As discussed in Chiu, supra n 141.


Para 7.17.

“FSA Given Extra Clout to Punish City Crime”, The Financial Times 16 November 2009; FSA Code of Best Practice in Remuneration, which will harden into law with the Financial Services Bill 2009.


Arts 6 and 7, MiFID Commission Directive.

FSA Handbook SYSC 3.1, 6.1 and 7.1.

Power, supra n 89.


Acharya, supra n 12; Schwarz, supra n 7.

Art 7, MiFID Commission Directive and SYSC 7.1.


SYSC 3.2.

SYSC 7.1.

SYSC 11.

SYSC 12.


SYSC 3.2.15; 3.1.3.

SYSC 3.2.10.

SYSC 3.2.17.


Art 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.


Arts 6, 8 and 9, MiFID, SYSC 6.1, 6.2.

Such as Sargent, supra n 85.


Supported by S 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.

SYSC 6.1.


Art 8, MiFID, SYSC 6.2.


Spira and Page, supra n 180.


SYSC 3.2.10.

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.

Braithwaite, supra n 75, 140–56.

Para 6.5, 6.10, above.


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 J Braithwaite, “Meta Risk Management and Responsive Regulation for Tax System Integrity” (2003) 25 Law & Policy 1.

Levy and Kaplan, supra n 193, 438.
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Ibid.

FSA, Stress and Scenario Testing PS20/09, December 2009.


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


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, supra n 89 and Braithwaite, supra n 75, 140.

The possibility of greater co-ordination 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 Brummer, supra n 113.


M Greenstone, “Toward a Culture of Persistent Regulatory Experimentation and Evaluation” in Moss and Cisternino, supra n 199.


$ 9, 10, FSMA 2000.


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 HE Jackson and MJ Roe, “Public and Private Enforcement of Securities Laws: Resource-based Evidence” (2009) at http://www.law.harvard.edu/programs/olim_center/.


Eg Art 14, Market Abuse Directive; Art 51, MiFID; Art 25, Prospectus Directive; Art 28, Transparency Directive.

Chiu, supra n 213, ch 4.


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. M Woolders, E Cartwright and R 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” Department of Economics Working Paper, Vanderbilt University (2005). Also see the dilemmas and conflicts between regulators and regulated in financial


236 As discussed under Part I “Risk Regulation”, above.

237 Burch, supra n 235.

238 Balleisen and Eisner, supra n 231, 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.


240 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 Crane et al, supra n 193.


242 Discussed earlier under Part 2 “Responsive Regulation”.

243 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 Crane et al, supra n 193.


247 S 18 on collective proceedings, Financial Services Bill (UK, December 2009).

248 Burch, supra n 237.

249 Jackson and Roe, supra n 216; SJ Choi, “The Evidence on


252 Choi, supra n 249.

253 Jackson and Roe, supra n 216.

254 Burch, supra n 237.


257 Braithwaite, supra n 75, 65.


265 P Vieira da Cunha and M 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.”

266 Brummer, supra n 113, argues that regulatory coordination at the international level is fraught with incentitive problems and political dilemmas, but systemic risk may refooc regulators onto co-operation.


269 DM Trubek and LG Trubek, “New Governance and Legal Regulation: Complementarity, Rivalry, and Transformation” (2007) 13 Columbia Journal of European Law 1, arguing that stakeholder democracy can lead to coexistence 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 transformative evolution, for example, procedural coherence in governance co-ordination, development of minimum standands and collective problem solving.


271 Schwanz, supra n 7; Acharya, supra n 12.


273 Jackson and Roe, supra n 216..


275 Braithwaite, supra n 75, 15ff, explaining “restorative justice”.

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