Introduction

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The recent history of financial markets suggests that financial crises are recurring more frequently, that traditional regulatory controls have failed to control risk, including systemic risk, and that legal and regulatory reforms are necessary to control the huge social costs that can be imposed on the economy and society by excessive financial risk-taking. Regulation must become more adaptive. One of the important lessons of the global financial crisis is that the effective regulation and supervision of financial markets requires continuous adaptation of rules and supervisory practices as the markets themselves evolve: the nature of the instruments traded, the efficacy of institutional structures and the degree to which national and international markets are integrated, for example, must all be reflected in regulatory and supervisory systems. In the past decade the speed of change has accelerated and has had wide-reaching effects on global markets. This was particularly evident in how the risks that were growing in the US sub-prime mortgage market just prior to the outbreak of the crisis in 2007 were transmitted via the structured finance markets to European banks and to other investors globally.

Law and regulation, both ‘on the books’, in terms of regulatory design, and ‘in action’, in terms of supervisory practices and enforcement, were notably deficient in responding to changes to financial markets over the global financial crisis. Private law and public law were both implicated. Weaknesses in private law and contracting frameworks, such as the model contracts governing the vast over-the-counter derivatives market, and in the corporate law doctrine of separate legal personality, which allowed banks to shift massive risks to shell corporations to evade regulatory controls, were exacerbated by prudential regulation frameworks that allowed process-based regulations, such as Basel II, to eviscerate prudential controls and put the global financial system at risk. Legal and regulatory frameworks had an overriding – and disproportionate – focus on reducing transaction costs between market participants, so that they could enter into an increasing array of complex transactions with the expectation of greater returns. But these transactions also carried greater risks, most of

which have been externalised, or shifted on to society at large. Regulation and private contracting essentially permitted private parties to reap huge gains from private risk-taking while, at the same time, socializing the losses.

But reform is not easy. An extensive 'law and finance' literature already charts the troublesome and contested relationship between law and financial market development and the uncertainties as to which rules matter and why they do. Massive reform, on an international scale, and with potentially unhelpful influences, including international dynamics in the form of efforts to control the emerging international rule book, institutional competition as domestic institutional structures are reformed, and the risk of group-think, is all the more challenging. As is well known, regulatory reform in the wake of crisis can also suffer from over-reaction as regulators and politicians are gripped by the imperative to 'do something'. The financial crisis has also sharply exposed the difficulties regulation faces in capturing dynamic risks, in crafting appropriate rules and, in particular, in supporting innovative, flexible and imaginative supervisory practices. Even over the relatively short time frame of the current reform movement the nature of systemic risk, for example, has remained contested. Product regulation, to take another example, has come in and out of the regulatory focus as a means for addressing the risks that retail investors face in complex markets; the UK Financial Services Authority's initial reaction post-crisis to difficulties in the retail structured products markets was to focus on distribution; it has since focused more closely on product regulation. Similarly, in the US, initial efforts to require regulatory approval of 'plain vanilla' consumer finance products did not acquire traction.

The theme of this book, accordingly, is law reform in the financial markets. It relies heavily, of course, on the global financial crisis as a rich case study, although not all contributions address the crisis, with some considering the theme of law reform and markets more generally. It seeks to contribute to the global financial crisis literature by ranging across public and private law frameworks, and by using different theoretical, doctrinal and contextual approaches to examine the main weaknesses in the public and private law frameworks for controlling excessive financial risk-taking. Its major theme is law reform, however, and so it adopts a remedial as well as a diagnostic approach and examines the particular areas of financial market law reform that are necessary to build a more efficient financial system with enhanced social welfare.

The volume consists of contributions that were initially presented in 2009 at the W.G. Hart Legal Workshop at the Institute of Advanced Legal Studies, University of London, which addressed the theme of 'Law Reform and the Financial Markets'. The conference's theme was forward-looking

in addressing what role law reform can play in building more robust and vibrant financial markets. The workshop was generously supported by the Institute of Advanced Legal Studies, Cambridge Finance, and the ESRC's World Economy & Finance Research Programme. It opened with a plenary lecture by Sean Hagan, General Counsel of the IMF, chaired by London School of Economics and Political Science Director Sir Howard Davies. A series of plenary sessions followed, during which a range of distinguished speakers from the international academic, regulatory (the Bank for International Settlements, BaFin (the German supervisor), CONSOB (the Italian market supervisor), the European Commission, the US Federal Deposit Insurance Corporation, the UK Financial Services Authority, and the Swiss National Bank were all represented) and practitioner communities debated the financial crisis and law reform. The complexities of legal intervention in the financial markets and the related economics and finance issues were discussed in panel sessions over the following two days, with participants including representatives of the Federal Reserve Bank of Chicago and legal practitioners who had brought actions against certain issuers of complex structured finance products. The workshop was characterized by wide-ranging and stimulating debate on a range of issues of central importance to the current international reform movement, including how best to redesign regulation, the international dimension of regulation and the role of private law in financial markets.

This volume reflects the contributions at the conference but it is also designed to reflect the first wave of law reform driven by the global financial crisis, where possible. Most of the chapters reflect developments as at November/December 2010, and so cover, for example, the Dodd-Frank Act 2010, the ongoing UK reforms to the institutional structure of regulation and supervision and the EU sovereign debt crisis. As such, the book aims to consider emerging themes from the 'post-crisis world', as it were. As is traditional with the Hart Workshop, the volume also combines the contributions of established scholars with those from newer, 'early career' scholars.

The book is divided into four parts: I) Redesigning Financial Regulation, II) The Challenges of Capital Market Law Reform, III) Consumer and Depositor Protection, and IV) The Role of the Lender of Last Resort and EU Sovereign Debt Restructuring.

Although much initial attention focused on the broadly-cast reform 'road maps' produced by, *inter alia*, the G20 and the EU's European Council, the global financial crisis has raised law reform issues of great substantive and technical detail. The EU's efforts to capture the risks of alternative investment funds (particularly hedge funds), and to manage the difficult political and market interests generated by hedge fund regulation,

have, for example, led to a harmonizing measure of great technical detail and complexity being adopted by the EU in late 2010. Efforts to capture systemic risk, identify the optimum design for regulatory capital, and recalibrate accounting standards have also preoccupied policymakers nationally, regionally and in the major international fora, including the Financial Stability Board, the Basel Committee and the International Accounting Standards Board. The vast reach of the behemoth Dodd-Frank Act across all sectors of financial market regulation is leading to a new US rule book that has major implications for all market sectors.

But in all this, the very large questions that the crisis has generated with respect to the role of law and supervision must not be overlooked in the ‘rush to regulate’. Part I accordingly considers the wider design issues raised by financial regulation. Chapter 1, by Professor Julia Black, who presented one of the workshop’s plenary lectures, opens the part by examining one of the core questions that the crisis has prompted: the fate of principles-based regulation (PBR). As Professor Black notes, prior to the financial crisis ‘new governance’ techniques of financial regulation received close and positive attention from scholars and from exponents of ‘smart’ regulation, and so their performance over and since the financial crisis merits close review. She focuses in particular on PBR, a prominent member of the family of ‘smart’ governance techniques that, along with risk-based regulation, reliance on internal management and controls, and market-based regulation, has suffered some reputational damage and has become associated with prejudicial ‘light touch’ regulation. Professor Black examines the nature of PBR, including how it operates formally and substantively and in different regulatory settings, and charts the recent change in its fortunes. Prior to the financial crisis, not only were the merits of PBR much lauded by regulator and regulatee, but PBR also became an instrument of international regulatory competition. The fall, however, was sharp and steep, particularly in the UK, reflecting a wider shift in the dominant economic and political philosophies away from a reliance on the ability of markets to self-correct and the belief that regulation should be ‘light touch’. Professor Black suggests that the future of PBR is mixed; the current emphasis on prescriptive rule-making limits the reach of PBR, for example, but PBR remains important at the international level. She concludes by warning that, while the financial crisis tested the effectiveness of a wide range of regulatory techniques and institutional structures, including traditional rule-based intervention, it is the weaknesses that the crisis exposed in PBR and in other techniques of ‘new governance’ that should prompt the greatest thought, not least given the support new governance enjoyed prior to the crisis.

Professor Nicholas Dorn argues in Chapter 2 for more democratic accountability in financial regulation and rejects many of the conventional theories (such as convergence theory) that have justified the independence of central banks, financial supervisors and other technical experts who oversee financial market operations. He discusses how convergence in regulatory practices arises from international regulatory networking among national authorities possessed of technical expertise, and suggests that this has undermined effective regulation by insulating regulators and other technical specialists from the moral and social questions prompted by regulation. He applies the work of social theorists such as Pierre Bourdieu, whose theories recognized the tension between cultural capital and economic capital. Most financial regulatory models in market economies lean heavily in favour of the economic capital model, which relies on market models and on forms of technical knowledge developed by private interests. But it often leads to socially undesirable outcomes because it does not reflect the broader values of society, and its governing institutions may not be democratically accountable. He concludes that regulatory reforms have not struck the right balance because they continue to rely on a technical one-dimensional knowledge base for financial market regulation that threatens the broader economic and social values of society. Only by establishing democratically accountable regulatory frameworks can regulators hope to achieve the public good of systemic stability.

The global financial crisis, unlike the earlier Enron-era equity market crisis, originated in the credit rather than the capital markets. But it exposed the risks of silo-based regulation and the extent to which credit and securities markets are interdependent. Capital/securities market regulation has been a subsidiary concern of the reform movement, but it has, nonetheless, been the subject of an important range of reforms, and is the subject of Part II. This part opens with Professor Emiliós Avgouleas's discussion of the vexed issue of short sale regulation in Chapter 3. He dismisses the view of many policymakers that short selling leads to increased volatility and financial instability, examining the large number of studies on the market impact of the prohibitions on short sales over the financial crisis. He suggests that the huge falls in the price of financial stocks, which prompted the prohibitions, were more the result of a rational reaction to bad news, funding pressures, and irrational loss aversion, fuelled by herding behaviour, and less the result of short selling itself. The focus of short sales regulation should therefore be to protect against market irrationality and to assist rational traders in moving quickly (through short sales) to protect their positions against the arrival of bad news. But care must be taken to ensure that short sales are not used to perpetrate market abuse. He suggests that these objectives can

be achieved by means of enhanced disclosure requirements and a sophisticated circuit breaker system. Professor Avgouleas also calls for better international coordination and criticizes recent reforms and reform proposals from the US SEC, the EU Commission, and EU Member States as obstructing international convergence. The wider lesson is that law reform should be restrained and based on limited controls, such as, in the short-selling context, tailored disclosure requirements. The prohibitions on short selling over the crisis stand as a cautionary lesson for law reform as they seem to have adversely affected liquidity and pricing efficiency in the securities concerned and to have damaged the market's informational efficiency.

The structured product market emerged as one of the most problematic capital market sectors in the wake of the crisis – both for professional and retail investors. The questions for law reform raised by this product sector are reflected in Chapter 4, which examines, from a private law perspective, what causes of action might be possible for investors seeking damages against issuers and third party banks who are involved in the sale of structured finance products. The authors (Professor Michael Dempster, Dr Elena Medova and Julian Roberts) provide an analysis of these issues from a theory of finance perspective. They argue that the *caveat emptor* defence asserted by defendant issuers and banks against claimants who are presumed to be sophisticated (such as institutional investors, pension funds and local city and state governments) may not protect defendants against private law claims. In particular, it may not be sufficient for issuers and banks to have their non-retail clients sign a release against any claims (except those related to fraud) relating to the sale of risky financial products when the products themselves are so risky, from a statistical point of view, that there is very little, if any, chance of recovery. The authors review the recent case law in the US, the UK and Germany and show that the German courts have been more receptive to private law claims in this area, based on the German Civil Code's principles of good faith and negligence. The authors suggest that UK and US courts might depart from a strict application of the *caveat emptor* doctrine in wholesale securities markets to permit more claims to be reviewed based on these principles.

The difficulties generated by private causes of action with respect to claims of mis-selling are also raised in Chapter 5, albeit in the context of the fast-developing regulatory regime that underpins China's capital market. In a wide-ranging examination of the capital market law reform process in China, Dr Sanzhu Zhu argues that one of the most serious problems facing China's capital markets authority, and the Chinese courts, since the emergence of China's capital market, has been how best

to tackle various forms of securities fraud in order to protect the interests of investors and to maintain the integrity of China's securities market. This chapter examines in particular the role played by the people's courts in investors' civil compensation claims arising from false statements made on the securities market. Dr Zhu's examination demonstrates the importance of a supportive and accommodating court, with a set of appropriate judicial rules and procedures, to investor protection and the development of securities markets. Dr Zhu argues that the limited role played by the people's courts and the restrictive procedures adopted by the Supreme People's Court suggest that, despite the progress made by the courts in accommodating these types of action, the people's courts are constrained by external as well as internal factors, including resource restrictions and wider concerns about social stability, which may limit further legal reform in this area. The chapter concludes, however, that the legal, regulatory and judicial changes in China over the last few decades have enabled it to achieve sustainable growth levels in its capital markets. The chapter also demonstrates the importance of the embedding of the rule of law in its capital markets to the development of China's markets and to its overall economic development.

Corporate governance-related reforms have emerged as a major theme of the current law reform movement, with corporate governance techniques becoming a key device for supporting better risk management by financial institutions. The EU, for example, has laid down a gauntlet internationally in the form of the high and prescriptive standards that now apply to executive pay in financial institutions under the Capital Requirements Directive III (2010). Efforts are also being made to engage institutional investors more actively as monitors of risk-taking by boards, as reflected in the reforms to shareholder voting on pay that the Dodd-Frank Act 2010 has introduced in the US. The debate concerning shareholder engagement is a long-standing one, however, which pre-dates the crisis. Shareholder voting has, for example, for some time been a concern of the EU, which regards the ease with which cross-border shareholders can vote as a key element of its efforts to construct a deep, liquid and efficient securities market. In Chapter 6, Agata Waclawik-Wejman examines recent developments in the EU legal framework governing cross-border shareholder voting and how voting procedures and safeguards are being strengthened in the intermediated securities environment. The chapter focuses on the technical legal problems that arise where securities are held in cross-border intermediated settlement systems, and the conflicts that can arise between different legal concepts across the EU and that hinder law reform. The chapter also examines the Shareholder Rights Directive, which came into force in 2009, and how it aims to improve communica-

tions between issuers and shareholders and strengthen cross-border shareholders' voting rights. The chapter concludes with an overview of the most important initiatives on the removal of the remaining legal barriers to the exercise of voting rights in the EU and considers the reforms that remain necessary if an efficient framework for the cross-border exercise of voting rights in Europe is to be achieved.

The earliest phases of the global financial crisis reform agenda saw the retail investor and the consumer of financial services largely overlooked as policy attention focused on the management of systemic risk and the stabilization of markets. This omission reflects a wider weakness in financial regulation; the consumer financial services markets can be overlooked, including in scholarship and as new tools are developed for examining financial regulation. The insights of the extensive law and finance scholarship in the capital markets field, for example, have not been used to explore weaknesses in consumer market regulation, although the findings of behavioural finance are increasingly shedding a sharp light on design failures in consumer regulation. Governance difficulties also beset the consumer sector; the difficulties the consumer interest faces in accessing policy debates and the law-making process on financial market regulation are well known. More recently, however, law reform has focused more closely on the consumer interest. The passage of the Dodd-Frank Act 2010, for example, saw heated discussion on what would become the new Consumer Financial Protection Bureau and on the scope of its powers, particularly with respect to the authorization of products.

Part III accordingly addresses issues relating to consumer and depositor protection. It opens with Chapter 7, in which Professor Iain Ramsay and Professor Toni Williams explore the implications of the influential neo-liberal approach to consumer credit regulation, based on 'availability and safety', which is promoted by the World Bank, in particular. The chapter examines how this influential model, which assumes that consumers can act as agents of market discipline, makes it difficult to design consumer credit regulation that is fair and distributionally progressive. Using this model, the chapter considers the public regulation of consumer credit markets more generally, including recent developments under the Dodd-Frank Act 2010 and the establishment of the Consumer Financial Protection Bureau, with respect to the UK FSA's 'Treating Customers Fairly' supervisory model, and relating to the institutional reorganization of supervision and regulation in the UK. The authors conclude that there are limits on the ability of consumers to exert discipline on credit markets and, in particular, that financial literacy remains a relatively untested method for 'upskilling' consumers. They suggest that regulation

of the supply side remains crucial for achieving fairness, and call for an outcomes-based approach to the regulation of products and product marketing. They point, however, to the limitations of intervention, warning that, while regulation may promise greater safety, and may lead to slightly lower prices and greater choice for lower income consumers, it does not prevent the poor from paying more than middle income consumers for credit, and call for efforts to promote affordable access to credit for low income consumers.

In Chapter 8, Philip Morris explores the particular issues raised by deposit protection in the specific context of the Crown Dependency jurisdictions and with particular reference to international competitiveness. The Isle of Man has operated a deposit protection scheme since 1991 (which has been triggered on two occasions), whilst Guernsey has recently enacted a scheme with distinctive features and Jersey adopted a revised guarantee scheme that became operational in 2009. He examines how these jurisdictions are competing for new financial business in light of the global crisis, and how this dynamic has shaped and influenced the development of their policies and regulatory objectives regarding deposit guarantee schemes.

Part IV addresses the systemic stability risks that have dominated law reform discussions. In Chapter 9, Professor Christian Johnson addresses the legal reforms adopted by the US Congress to enhance the Federal Reserve's ability to provide liquidity to financial institutions during periods of crisis or loss of investor confidence. During the crisis, the Board of Governors of the Federal Reserve System, through the Federal Reserve Bank of New York and other Federal Reserve Banks, embarked upon a series of unparalleled and unprecedented actions, repeatedly injecting massive volumes of liquidity into the US credit markets. Some of the most innovative approaches occurred during the extraordinarily volatile months of September and October 2008. Measured in the tens and hundreds of billions of dollars, all of the actions were bold and innovative, and raised controversial issues regarding the Federal Reserve's authority to act under such circumstances. The chapter provides a thorough review of the Federal Reserve's statutory and regulatory authority as a lender of last resort and discusses how Congress has enhanced its authority under recent legislation, including the Dodd-Frank Act, to allow it to achieve more fully its regulatory and oversight objectives.

The book concludes with Chapter 10, in which Professor Kern Alexander examines the issues raised by law reform in the context of the EU sovereign debt markets. The financial crisis has led to a dramatic reshaping of EU financial market regulation, of the relationship between the Member States and the EU, and of the institutional structures that

support EU financial market regulation. Chief among the reforms is the establishment of the new European System of Financial Supervision, which is based on local operational supervision by domestic supervisors and on coordination through four new EU authorities, who are endowed with a range of new supervisory and rule-making powers. In January 2011, three new supervisory authorities, the European Securities and Markets Authority, the European Insurance and Occupational Pensions Authority and the European Banking Authority, were established, together with the new European Systemic Risk Board (ESRB). Although it remains to be seen, the new Authorities and the ESRB should make considerable progress in enhancing prudential supervision and with respect to the surveillance of systemic risk. The European Central Bank, however, has also played a critical role in stabilizing EU markets. Since August 2007, the scale of the ECB's operation to inject liquidity into the EU financial system has been unprecedented in size and scope. It has also been remarkably smooth. The Bank's focus has been on preserving stability in the euro money markets and on supporting the integrity of the EU financial markets. The smooth operation owes much to the competency of the ECB, but also to a more relaxed approach to acceptable collateral than the Bank of England or US Federal Reserve require. But despite the ECB's success in providing exceptional liquidity support to eurozone banks and sovereigns, the eurozone and the EU institutions have not made sufficient progress in redesigning the crisis management procedures of EU Member States and central banks, and in reforming central banks' 'lender of last resort' function, especially in the eurozone.

Professor Alexander addresses some of these issues as they relate to the EU sovereign debt crisis and to how a more harmonized, but decentralized, legal regime governing sovereign bond contracts can achieve more efficiency and stability in EU sovereign debt markets. Over the recent sovereign debt crisis, the EU has not had a legal or formal institutional framework to resolve a sovereign debt default or restructuring. The Greek crisis and the growing sovereign debt problems of other EU states raise important questions about whether EU policymakers should establish a formalized institutional process across the EU to promote more orderly sovereign debt restructurings. Professor Alexander also analyses a number of corollary questions concerning how such a process could work without undermining market discipline; what powers, if any, should be allocated to the EU institutions to oversee sovereign debt restructurings; what set of principles should guide policymakers in devising such an institutional framework; and whether this could help indebted countries avoid a damaging loss of investor confidence and destabilizing market volatility.

Overall, the book seeks to examine the theme of law reform from a range of different theoretical perspectives, with respect to public and private law, and across a variety of jurisdictions and market sectors.

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