Introduction*

Among the many profound consequences of the tumultuous events of 2008 and 2009, not the least has been the corrosive loss of confidence in the system of regulation that supposedly protected the world's financial system against the risk of sudden panic and collapse. Like the Fukushima disaster of 2011, the controls in place experienced repeated, multiple failures in the face of an unexpected shock. And as in the case of Fukushima, the system came perilously close to a catastrophic meltdown. The after effects of both disasters linger on as this book is written: in the case of Fukushima, a decades-long problem of clean-up and rehabilitation; in the case of the global financial crisis, a period of recession, distress in sovereign debt markets, and political instability.

Looking back, we can see some of the factors that contributed to the disasters. Fukushima happened as a result of inadequate backup systems for cooling in the event of power failure. As for the financial crisis, the causes are still being debated. Probably one of the culprits was the US Federal Reserve's accommodative monetary policy during the mid-2000s, which flooded world financial markets with liquidity and thereby sparked a credit bubble in housing and other assets. Other factors included tax changes in the United States which increased the benefits of home ownership; legal innovation which contributed to the spectacular increase in the volume of mortgage-backed securities and credit default swaps; the failure of rating agencies to properly assess the default risk of securities tied to house values; accounting rules which exacerbated the freezing up of market liquidity; compensation systems for senior executives which incentivized excessive risk-taking; political factors in the United States that encouraged an inappropriate level of subprime mortgage lending; and a general atmosphere of complacency and overconfidence among governments, market actors, and the public at large which fed off of the illusion of ever-increasing prosperity and skyrocketing house values. The concatenation of these and other factors created a 'perfect storm' for markets – an interconnected series of events and conditions which, while rare, is also exceedingly costly and dangerous.

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In the wake of this disaster, policymakers, commentators and analysts have gone back to first principles. Ideas once relegated to economists' ivory towers have emerged as actual policies: contingent capital securities for banking firms; 'living wills' for systematically important institutions; agencies charged with monitoring and managing systematic risk; quantitative easing of monetary policy; centralized markets for credit default swaps; consolidation of fiscal discipline across national boundaries; and much else besides.

One of the most important elements in this process of re-thinking and re-invention is the question of the proper allocation of regulatory authority. Who should be responsible for ensuring that financial markets function safely and honestly and that they direct capital to socially useful projects? An easy answer is that the government should perform this task; but a moment's reflection suggests that reliance on the government alone is not a desirable approach to the problem. Systems of command-and-control have not worked well in any country where they have been seriously employed. On the other hand, the pat solution of free-market economics also is no panacea. Markets, however beneficial, are also subject to imperfections and abuse. Regulation is needed to rein in impetuous market forces and direct them to socially valuable purposes. The exquisitely delicate problem of regulatory design is to identify and implement the optimal mix of public and private regulation and control.

This problem is complicated by the following factor, which has only recently been recognized as one of the most important issues in the theory of regulation. Regulation need not be implemented by 'government' as traditionally understood – by elected or appointed public officials wielding a monopoly over the use of force. Certainly government officials are a principal means for carrying out the regulatory task, but regulation can also take place in the private sector. Private actors can be enlisted – deputized, as it were – to carry out some of the tasks traditionally assigned to governments.

There are multiple benefits of enlisting private actors for the enforcement process. Among other things, private actors have superior knowledge about their own operations and the industries in which they operate; are well equipped to monitor their employees and agents; have capacities to impose sanctions which would be unavailable to the government; add another set of eyes and ears and a different perspective on the issues; and face different funding capacities and budget constraints.

On the other hand, there are also significant downsides to private enforcement. The incentives of private actors are unlikely to be perfectly aligned with those of the public; the introduction of yet another enforcement agent can add complexity and costs to the regulatory process; and the presence of private regulators may induce an inappropriate attitude of laxness in the government sector – among other problems.

Assuming that private regulation and enforcement are desirable, moreover, there is also the delicate issue of how that regulation should be structured. Should the process be localized within regulated firms, extended into an industry-wide self-regulatory organization, or implemented in a quasi-public partnership between private and public actors? And what form should private regulation and enforcement take – purely private sanctions; non-binding recommendations for best practices; private rules enforced by government agents; or some other arrangement? These questions of design illustrate that the institution of private regulation and enforcement, like the basic choice between regulation and markets, involves a subtle set of trade-offs of costs and benefits.

STRUCTURE OF THIS BOOK

This book focuses on those tradeoffs, weighed and assessed across a variety of segments of the financial services industry. Chapter 1 provides an introduction and overview to the methodologies of private regulation and enforcement in the United States financial services sector. This chapter highlights the flowering of intra-firm processes and procedures that serve regulatory and enforcement functions. Important among these are the growth in power and influence of corporate in-house attorneys; the establishment of quasi-independent compliance offices; the increased importance of the internal audit function and board-level audit committees staffed by independent directors; and the development of techniques and methodologies of risk management and the elevation of the risk management function through the establishment of specialized risk offices headed by Chief Risk Officers. The chapter identifies ways in which, under American law, the private sector provides government-like enforcement services through activities such as standard-setting or promulgation of 'best practices', as well as through self-regulatory organizations operating under varying degrees of governmental control. Also important in the mix – at least in the United States – is the influence of private litigation, which can impose substantial liabilities on companies, and which can, to some extent, serve a governmental purpose of distributing compensation to persons harmed by corporate malfeasance. The chapter assesses the legitimacy, independence, efficacy and accountability of these private enforcement mechanisms in the context of an overall regulatory mix including both public and private actors.

Chapter 2 provides a window into one of the most important – and poorly understood – financial instruments of the modern era: the credit default swap (CDS). The chapter analyzes from a general perspective over-the-counter (OTC) derivatives, focusing on the CDS market before and after the financial turmoil, paying specific attention to the role of private regulation and enforcement. CDSs offer significant social benefits, by allowing firms a better ability to manage and control risk and by facilitating more accurate pricing of credit risk, but also pose new risks for the financial system in the form of moral hazard and systemic risk.

CDSs fit nicely into the theme of private regulation and enforcement because the principal regulator of CDS contracts is the International Swaps and Derivatives Association (ISDA), a private standard-setting body composed principally of major participants in the market. The global financial crisis imposed severe stress on this framework because – rightly or wrongly – CDSs were widely blamed for contributing to the financial turmoil of 2008–2009. New regulations adopted in the wake of the crisis imposed stricter government regulation on what had previously been an essentially unregulated market. The chapter illustrates how the ISDA participated in the development of a new framework to govern CDS transactions, and thereby remained a principal force for regulation and enforcement in this important area of modern finance. These developments allow for an analysis of the legitimacy, efficacy, independence and accountability of private regulation and enforcement in the context of the market for credit derivative instruments.

Chapter 3 concerns the burgeoning field of microfinance: procedures and institutions for directing credit, through grassroots, market-based mechanisms, to disadvantaged or traditionally underserved communities. The lack of access to credit markets has long been considered a principal impediment to economic development and improvement in income and wealth inequalities. Microfinance is a means for potentially rectifying some of these disadvantages and inequalities. The chapter identifies the most important discipline mechanisms for microfinance, involving, besides public regulation, funding instruments (such as peer-to-peer platforms, socially responsible lending policies, and microfinance investment vehicles), as well as a wide variety of institutions and networks, seeking various objectives, which operate in the microfinance space. Because microfinance is such a new and rapidly developing feature of world financial markets, it is an interesting sector in which to observe the complex structure of regulation and enforcement, offering unexplored opportunities of experimenting and studying different combinations of public/private forms of interaction and levels of regulation. Here, as elsewhere, the financial crisis, coupled with related crises and scandals specific to the microfinance field, has created an opportunity to critically re-examine the role of public and private powers, with an eye to many relevant and sometimes conflicting factors and values, including the legitimacy and accountability of regulators, effectiveness of the rules (costs included), access to financial services, equality, minimization of systemic risk, consumer protection, and other values.

Chapter 4 addresses the technically complex but extraordinarily important issues surrounding the processes for settling financial transactions. The chapter considers, in particular, how public and private actors are working to develop efficient mechanisms for small-scale international funds transfers. Most important in this respect is the creation, in 2007, of the International Payments Framework (IPF), established by most important payment systems and internationally active banks. The purpose of IPF – which grew out of an earlier initiative for European integration in payments, the Single Euro Payments Area (SEPA), is to define standards and an operating framework for simplifying low-value, non-urgent cross-border credit transfers. The chapter outlines the potential of this framework to evolve into an integrating framework for retail payments across the world, and assesses the development along the dimensions of legitimacy, accountability, quality, and independence.

Chapter 5 addresses another crucial issue for the architecture of modern finance: the development of a coordinated and transparent system of accounting standards. This chapter focuses on the International Accounting Standards Board (IASB), an organization founded by professional accountants in 1973 to develop policies and procedures for harmonizing accounting standards across the globe. The IASB has had remarkable success: its standards have been adopted in Australia, Brazil, the European Union, Russia, South Africa, and to some extent the United States, among other countries. As in the case of some other forms of private regulation, the standards promulgated by the IASB have come, in a sense, from the 'ground up'. They were not promulgated by any governmental body or even any single rulemaking at a given time. Instead, they evolved in a cooperative and consultative process that included, prominently, representatives of major accounting firms that maintain offices – and expertise – in many different countries. The international standard-setting process worked closely with standard-setting organizations at the national level, such as – in the United States – the Emerging Issues Task Force. The IASB's main responsibility is to prepare and issue preliminary exposure drafts and International Financial Reporting Standards (IFRS). Much of the important work of the IASB is undertaken by the IFRS Interpretations Committee, which interprets the application of the IASB's standards and provides guidance on financial issues not addressed by the IASB's standards. The important work of the IASB raises obvious concerns about accountability and legitimacy, since this body reports to no governmental supervisor – concerns that are addressed in the closing pages of this chapter. The chapter also considers the quality of the IASB's work, with reference both to its standard-setting regime and to the standards that it has issued.

Chapter 6 describes perhaps the most prominent – and most important – initiative in banking markets since the late 1980s – the development and promulgation of guidelines by the Basel Committee on Banking Supervision. The Basel Committee is comprised of regulators and central bankers, and thus can be considered an aspect of governmental rather than private regulation. However, the Basel Committee's operations are effectively similar to those of private regulation and enforcement in certain respects. The committee itself has no formal governmental role; its function is to develop and promulgate 'guidelines' – recommendations for best practice – which in themselves have no force of law. The guidelines become effective, legally, only when adopted and enforced within the context of a country's domestic banking regulation. Moreover, the guidelines themselves give considerable scope for self-regulation, since they rely heavily on internal modeling, processes and risk assessments by the financial institutions that they are designed to regulate. The chapter offers a detailed examination of two aspects in which the Basel process relies on self-regulation by banks subject to its strictures: the Basel Accords' Internal Rating Based Approach to credit risk and the Advanced Measurement Approach to operational risk. In addition describing the regulatory regime of public-private ordering the chapter examines the ways in which these recommendations were designed, implemented and enforced, with special reference to the assessment dimensions of legitimacy, quality, accountability, and independence.

FINANCIAL MARKET GOVERNANCE AND TRANSNATIONAL PRIVATE REGULATION: LOOKING FORWARD

This book is part of a broader project concerning the role of private actors in transnational regulation. The project focuses on four dimensions: legitimacy, quality, effectiveness and enforcement, across many areas and sectors from financial markets to consumer protection, from corporate social responsibility to food safety. It examines the different forms of transnational private regulation (TPR), their successes and failures, and their relationship with both global and domestic public regulation.[1]

[1] Fabrizio Cafaggi (2011) 'New Foundations of Transnational Private Regulation', *Journal of Law and Society*, **38** (1), 20.

The main objective is to define a descriptive comparative matrix that can provide illustrations of different patterns in transnational regulatory arrangements primarily reflecting the interaction between public institutions and private organizations. The preliminary results of the research show that new forms of interaction between private transnational actors like the ISDA, IASB, IPF, and public, formal and informal institutions are taking place. For example the work of the International Organization of Securities Commissions (IOSCO) both in the general area of principles of securities regulation and in more specific areas like the recent regulation on financial market infrastructures (FMI) constitutes a vivid illustration of the interplay between technical standardization and new models of financial regulation with new relationships between public and private regulatory bodies.[2]

Within financial markets the most important changes after the crisis have occurred within the public sphere, involving both domestic regulatory models and transnational forms of coordination between regulators. New tasks have been assigned to the Financial Stability Board (FSB) and to the IMF. The private sphere, on the other hand, is changing primarily under the pressure of global and local public regulation, addressing both accountability and effectiveness shortcomings. The crisis has highlighted how local regulatory failures can turn into global downfalls. Interdependences of the financial risk, due to market integration, increasing capital trade but also to the specificity of financial risk spreading, have called for radical reform of the governance system with a new and stronger role of the FSB implementing political mandates coming from G20.[3] The FSB has not been the only institution gaining power from the crisis; clearly the role of IMF has become paramount especially when the financial crisis has generated consequences for financial stability and the separation between financial stability policy and financial regulation has partly faded away. Even if the separation between the two dimensions still has strong institutional implications on who does what, they have become

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[2] IOSCO-CPSS (April 2012), 'Principles for Financial Market Infrastructures', available at http://www.bis.org/publ/cpss101a.pdf (accessed 8 August 2012).

[3] See, for example, the G20 mandate to address shadow banking: FSB (October 2011), 'Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board', available at http://www.financialstabilityboard.org/publications/r_111027a.pdf (accessed 8 August 2012), and FSB (April 2012) 'Strengthening the Oversight and Regulation of Shadow Banking Progress Report to G20 Ministers and Governors', available at http://www.financialstabilityboard.org/publications/r_120420c.pdf (accessed 8 August 2012).

so intertwined that coordination is a necessary pillar of financial global governance.

The crisis has also showed the existence of a plurality of financial systems, reflecting different regulatory practices in financial regulation, well beyond the conventional juxtaposition between the Anglo-American and the German-Japanese models. The 2008 crisis was primarily borne by US and European investors and taxpayers while emerging economies were able to avoid most of the negative impact and, in some instances, have even benefitted from the crisis, given the high level of liquidity they disposed of out of the trade surplus. Only several years later did the exporting-led economies start suffering the consequences of the economic crisis following the financial one. This will have an impact on the new equilibria in regulatory design. Not only do differences emerge across regional financial systems, but also, as the contributions to the book show, within the financial system the various sectors follow different logics in allocating regulatory power and in defining the regulatory relationship between regulators and regulated. For example, information regulation affects the flow that goes from borrowers to lenders and influences the duration of lending contracts, their content, and their modes enforcement.[4] Local differences in financial regulation have an impact on the policies of foreign investors and in particular on foreign direct investment (FDI).[5]

Hence we observe two apparently contradictory phenomena: increasing global interdependence in risk assessment and management, and the persisting importance of differences in regulatory cultures between mature and emerging economies and within each of them. How should these two factors, driving in opposite directions, be reconciled? The main lesson is that global governance of financial markets calls for global institutions to be able to coordinate and internalize local diversities determined by public but also by private regulatory cultures. The references to macro-prudential oversight, for instance, should not ignore the remarkable differences existing in the relationships between regulators and regulated in old and new economies. There is no reason to believe that market integration will significantly reduce these differences given the importance of politics and culture in designing responses to the crisis. The European current

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[4] Raghuram Rajan (2010) *Fault Lines, How Hidden Fractures Still Threaten the World Economy*, Princeton, NJ: Princeton University Press, pp. 11–12.

[5] The importance of local jurisdictions has been explicitly recognized in the Financial Stability Board's articulation of the general principles: FSB (October 2011) 'Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board', available at http://www.financialstabilityboard.org/publications/r_111027a.pdf (accessed 8 August 2012).

situation represents a vivid illustration of how the local political dimension influences global governance well beyond continental boundaries.

The second dimension is related to the effects of the crisis and its consequences for regulatory governance both at the local and global levels. Shifting from actors to effects allows seeing hidden consequences of regulatory actions or inactions that often translate into negative externalities to be paid by third parties, for example taxpayers, consumers, and employees.[6] Taxpayers all over the world, but in particular in the US and Europe, have been asked to contribute substantively to the mitigation of the consequences of the financial crisis, and have paid a significant price for the regulatory failures. New forms of governance require that risk is priced adequately and that negative externalities coming from regulatory failures, including the consequences of violations committed by regulated entities, are fully internalized in the regulatory scheme.

The third conclusion worth highlighting concerns the variations of regulatory strategies and instruments within sectors. The growing importance of technical standardization underlines the increasing role of the International Organization for Standardization (ISO) and the redefinition of the boundaries between different types of standards.[7] The same regulated entities – the banks for example – are exposed to very different regulatory models depending on the financial products they deal with and the markets they operate since domestic regulations maintain wide variations. Private regulation clearly has shown its limits in some of the investigated areas. The example of derivatives and that of payments show major shortcomings in terms of both accountability and effectiveness of private regulatory regimes and the governance responses required by public regulators to preserve regulatory legitimacy. In one case, at least at the EU level, the difficulties encountered by private regulators have pushed the EU to change strategy in order to pursue the objective of a uniform payment system.[8] In the other case – derivatives – the balance between global and local regulation has been redesigned but the ISDA continues to exercise an important and leading role.

Some final words concern the enforcement of transnational financial private regulation. Enforcement remains primarily decentralized in the public domain, with different allocations of power between regulators

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[6] Katharina Pistor (2012) 'Real vs. Imagined Financial Markets: The Regulatory Challenge', *The Selected Works of Katharina Pistor*, available at http://works.bepress.com/katharina_pistor/12 (accessed 8 August 2012).

[7] Tim Büthe and Walter Mattli (2011) *The New Global Rulers: The Privatization of Regulation in the World Economy*, Princeton, NJ: Princeton University Press.

[8] Regulation (EU) No 260/2012, 2012 O.J. (L 94), p. 22.

and courts across countries. In some legal systems domestic courts play a leading role while in others primacy of regulators is the rule. Lack of coordination among local enforcers may undermine common regulatory policies. The specificity of financial rules should require appropriate coordination mechanisms between courts and regulators enforcing the same rules. Private regulators in the financial markets, unlike in other sectors seem to have played so far a relatively minor role in enforcement but are likely to become stronger if new specialized institutions emerge.[9]

Despite its large variations across different domains, the area of financial markets can usefully be seen as a laboratory for regulatory innovation and provide new approaches to the public/private interplay and new forms of relationships between regulators, regulated, and beneficiaries.

[9] Geoffrey P. Miller, (2012) 'Financial Private Regulation and Enforcement', in Fabrizio Cafaggi (ed.), *The Enforcement of Transnational Regulation*, Cheltenham, UK and Northampton, MA, USA: Edward Elgar Publishing, pp. 263–78.