



City Research Online

City, University of London Institutional Repository

Citation: Pagliari, S. (2012). Who governs finance? The shifting public-private divide in the regulation of derivatives, rating agencies and hedge funds. *European Law Journal*, 18(1), pp. 44-61. doi: 10.1111/j.1468-0386.2011.00585.x

This is the unspecified version of the paper.

This version of the publication may differ from the final published version.

Permanent repository link: <https://openaccess.city.ac.uk/id/eprint/2574/>

Link to published version: <https://doi.org/10.1111/j.1468-0386.2011.00585.x>

Copyright: City Research Online aims to make research outputs of City, University of London available to a wider audience. Copyright and Moral Rights remain with the author(s) and/or copyright holders. URLs from City Research Online may be freely distributed and linked to.

Reuse: Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge. Provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way.

City Research Online:

<http://openaccess.city.ac.uk/>

publications@city.ac.uk

WHO GOVERNS FINANCE?

THE SHIFTING PUBLIC-PRIVATE DIVIDE IN THE REGULATION OF DERIVATIVES, RATING AGENCIES, AND HEDGE FUNDS¹

European Law Journal (forthcoming)

Stefano Pagliari

Ph.D. Candidate, Balsillie School of International Affairs, University of Waterloo
Fellow in International Political Economy, London School of Economics

ABSTRACT

The division of responsibilities in the regulation and supervision of financial markets between ‘public’ regulatory agencies and ‘private’ market actors is not fixed, but it has radically changed across time. This paper argues that the financial crisis of 2007-09 has triggered the latest turn in the ‘public-private’ divide in the regulation of finance. Focusing in particular on the extensive reforms that have been introduced internationally in the regulation of OTC derivatives, credit rating agencies, and hedge funds, this paper argues that the response to the financial crisis has brought to a halt the reliance on self-regulation and market discipline as primary regulatory mechanisms that had characterized the approach of regulators prior to the crisis. However, while public regulatory agencies have consolidated in their hands the authority to regulate and oversee markets previously left outside their regulatory oversight, the content and the purpose of their regulatory intervention continue to present significant element of continuity with the pre-crisis regulatory paradigm.

¹ The author would like to thank for their valuable comments and suggestions Eric Helleiner, Brett Kocher, Troy Lundblad, Francis Snyder, and all the participants to the the 8th WISH Conference ‘The Visible Hand’ - European and Global Perspectives on Financial Market Regulation and Economic Governance. 26-27 February 2010, Angers, France. An earlier draft of this paper has also been presented at the ESCR Conference ‘Finance In Question/Finance In Crisis’, University of Manchester, UK, 12-14 April 2010.

I. Introduction

Who governs the global financial markets? Most debates on the regulation of financial markets are informed by the implicit assumption that a clear division of roles exists between ‘regulators’ and a ‘regulatees’. The responsibility to regulate and oversee the activities of private market actors is often described as naturally falling in the hands of the state, which delegates this function to regulatory agencies often coordinating their regulatory policies at the international level. Contrary to this perception, the division of responsibilities in the regulation and supervision of financial markets between ‘public’ regulatory agencies and ‘private’ market actors (hereinafter public-private divide) is not fixed, but it has radically changed across historical periods, countries, and financial sectors.

This paper argues that the global financial crisis, which erupted in the summer of 2007 from the US housing market, has triggered the latest significant turn in the public-private divide in regulation of finance. The crisis has spurred heated debates among regulators, lawmakers, and financial industry representatives over the gaps that have been revealed in the international financial regulatory architecture.² A second issue of contention has been whether these gaps should be addressed through the intervention of public regulators or whether the private sector should be given first the opportunity to correct its own mistakes. What has been the impact of the financial crisis on how the responsibility to regulate and oversee financial markets is divided between public regulatory agencies and private market actors?

By examining the extensive reforms in the regulation of OTC derivatives, credit rating agencies, and hedge funds that have been coordinated at the international level, the argument presented in this paper is that the crisis has halted the shift in the public-private divide that had taken place over the previous fifteen years or so. During that period, international and European regulatory bodies opposed measures to bring OTC derivatives markets, credit rating agencies, and hedge funds within the perimeter of their regulatory oversight. Instead, they preferred to shift important regulatory functions to private market

² For a review see E. Helleiner & S. Pagliari, 'Crisis and the Reform of International Financial Regulation', in E. Helleiner, S. Pagliari, and H. Zimmermann (eds), *Global Finance in Crisis. The Politics of International Regulatory Change* (Routledge, 2009).

actors, granting a public policy role to industry-driven self-regulatory measures, and directing the ‘visible hand’ of regulation to the purpose of harness the ‘invisible hand’ of market discipline.

This shift in the public-private divide had attracted the attention of numerous scholars, who have investigated its origins. While presenting different explanations, most of these works shared the tendency to regard the delegation of regulatory responsibility to private market actors in finance as a rising trend. The possibility that this trend could be reversed and public regulatory authorities could in the future seize back the authority they had delegate to the markets was only rarely discussed.³

To the surprise of many observers, the financial crisis of 2007-2009 has led international regulatory authorities to endorse measures to bring under the regulatory oversight of public regulators markets and institutions that had been left outside of their jurisdiction. Public regulatory agencies in Europe, US, and elsewhere have taken upon themselves the task of monitoring and sanctioning the implementation of financial standards that had been left to the market discipline. They have questioned the capacity of voluntary self-regulatory measures to address the regulatory gaps revealed by the crisis and often replaced them with mandatory regulatory requirements.

In order to put this change in the proper context, this essay will start by analyzing in Section II the evolution of the public-private divide in the regulation of global finance from a historical perspective, focusing in particular on the regulatory paradigm that has emerged since the 1990s. Section III will move instead to the extensive regulatory reforms that have been triggered by the global financial crisis of 2007-09, focusing in particular on three cases: OTC derivatives markets, credit rating agencies, and hedge funds.⁴ While the regulatory response to global financial crisis could be regarded as one of the most dramatic turning point in public-private divide in the regulation of finance since the 1930s, this represents in many cases primarily a shift in the location of the rule-making authority - from private market actors to public regulatory agencies – rather than

³ Important exceptions are L. Pauly, 'Global finance, political authority, and the problem of legitimation', in R. Hall & T. Biersteker (eds), *The Emergence of Private Authority in Global Governance* (Cambridge University Press, 2003); D. Mügge, 'Private-Public Puzzles: Interfirm competition and transnational private regulation', (2006) 11 *New Political Economy*.

⁴ The regulatory initiatives described in this paper are updated to September 2010.

in the content and purpose of regulation. The conclusion to this paper will thus argue that the purpose and content of the regulatory intervention presents significant element of continuity with the pre-crisis regulatory model, and a paradigmatic change in the purpose of regulatory intervention has yet to appear.

II. Before the crisis: the new paradigm in the regulation of finance

A The public-private divide from a historical perspective

From a historical perspective, the involvement of state actors in the regulation and supervision of financial markets is quite a recent development. The rules that initially brought order to international transactions found their origin in the so-called *lex mercatoria*, the customs of those merchants who were the first to provide credit within and across the borders of the emerging nation-states. These rules were enforced through the threat of ostracism from the merchant community and of boycotting of all future trades. The predominance of private rule-making in the regulation of finance endured and reached its height during the ‘first wave of globalisation’ at the end of the XIXth and early XXth century. At this time, both the most important financial centre in the world (London) and its emerging challenger (New York) maintained powerful self-governing corporatist institutions, such as the London Stock Exchange, the Corporation of Lloyds, and the New York Stock Exchange. Self-regulatory arrangements also governed other corners of the financial system, like commercial bank clearinghouses, payments and securities settlement systems, and interbank deposit markets.⁵

It is only after the First World War and the Great Depression that the governments in the most industrialized countries widened their intervention in the regulation of finance. During this period, governments intervened to place restrictions on the activities of financial market participants (eg Glass-Steagall Act of 1933 restricting the freedom of US

⁵ J. Braithwaite & P. Drahos, *Global Business Regulation* (Cambridge University Press 2000); C. Cutler, *Private Power and Global Authority: Transnational Merchant Law in the Global Political Economy* (Cambridge University Press 2003).

banks to operate in the securities markets) and to create new domestic regulatory institutions (eg creation of the Securities and Exchange Commission to oversee self-regulatory organizations, such as stock exchanges).⁶

These reforms represent a watershed in the public-private divide, as states took upon themselves the task of preventing the disruptive effects demonstrated by currency and banking crises of the Great Depression. Nonetheless, private market actors were not completely stripped away of their regulatory functions. According to Moran, the reconstruction of the financial systems in the United States and the United Kingdom after the Wall Street Crash of 1929 relied on an extensive network of self-regulatory organizations, in particular in the regulation of securities markets and stock exchanges, which were granted by the state the license to govern their activities through a 'charter' defining their duties and rights.⁷

As several scholars have argued,⁸ the fifteen years or so preceding the financial crisis of 2007-09 have witnessed a partial 'return to the past', as the division of regulatory functions between 'public' regulatory agencies and 'private' market actors shifted in favour of the latter.

While from an historical perspective self-regulation had been the norm in sectors such as securities markets and stock exchanges, in the years preceding the crisis self-regulatory initiatives were institutionalized into a larger number of financial sectors. For instance, industry self-regulatory initiatives from the main derivatives dealers have provided the legal background against which the growing volumes of transactions have flourished outside of regulated exchanges, also known as 'over the counter' markets. After the collapse of the US hedge fund Long-Term Capital Management in 1998, self-regulatory measures adopted by hedge fund groups and by their bank counterparties have become the most important regulatory mechanism to reduce the systemic risk posed by the industry. In the case of rating agencies, while the Credit Rating Agency Reform Act of

⁶ M. Moran, *The Politics of the Financial Revolution: the USA, UK, and Japan* (McMillan 1991) 28.

⁷ *ibid.*, 15-23; For self-regulation in securities markets see S. Gadinis & H. Jackson, 'Markets as Regulators: a Survey', (2007) 80 *Southern California Law Review*.

⁸ See in particular E. Tsingou, 'Policy preferences in financial governance: public-private dynamics and the prevalence of market-based arrangements in the banking industry', (2004) CSGR Working Paper No. 131/04; G. Underhill & X. Zhang, 'Setting the rules: private power, political underpinnings, and legitimacy in global monetary and financial governance', (2008) 84 *International Affairs*.

2006 put an end to the self-regulatory status of the industry in the United States, they continued to remain self-regulated in Europe and elsewhere.

Moreover, what differentiated these self-regulatory initiatives from those in place since the 1930s in countries such as the UK and US was their transnational dimension. Underpinning this shift of self-regulation from a national to transnational dimension was the emergence at the global level of a restricted number of transnational financial industry associations composed of internationally-oriented firms or high-profile individuals capable of drafting voluntary self-regulatory initiatives whose scope transcended the national boundaries.⁹ In the case of OTC derivatives, crucial self-regulatory initiatives have been developed by the International Swaps and Derivatives Association (ISDA), and other industry groups such as Futures Industry Association, the Emerging Markets Traders Association, the Derivatives Policy Group, and a private organization/think tank such as the G30.¹⁰ Groups such as the Managed Funds Association, Alternative Investment Funds Associations, and Hedge Fund Standards Board have taken the lead in developing self-regulatory mechanisms for hedge fund managers, while their bank counterparties have coalesced into the Counterparty Risk Management Policy Group.

While these developments at the turn of the century have enhanced the importance of private rule-making in governing global financial markets to an extent not seen since the 'first wave of globalization' that preceded the Great Depression, it would be misleading to regard this shift in the public-private divide as simply a 'return to the past'.¹¹

Instead, there is a fundamental difference between the self-regulation in international finance during the 'first wave of globalization' and the 'second wave of globalization'. While the former preceded the rise of state-based regulation, the revived importance of self-regulation in the latter has taken place against a background of international

⁹ T. Porter, 'The Significance of Changes in Private-Sector Associational Activity in Global Finance for the Problem of Inclusion and Exclusion', in P. Mooslechner, et al. (eds), *The Political Economy of Financial Market Regulation. The Dynamics of Inclusion and Exclusion* (Edward Elgar, 2006).

¹⁰ E. Tsingou, 'The Governance of OTC Derivatives Markets', in P. Mooslechner, et al. (eds), *The Political Economy of Financial Market Regulation. The Dynamics of Inclusion and Exclusion* (Edward Elgar, 2006); W. Coleman, 'Governing Global Finance: Financial derivatives, liberal states and transformative capacity', in L. Weiss (ed), *States in the Global Economy - Bringing Domestic Institutions Back In* (Cambridge University Press, 2003).

¹¹ See also E. Helleiner & S. Pagliari, 'Between the Storms: Patterns in Global Financial Governance, 2001-07', in G. Underhill, J. Blom, and D. Mügge (eds), *Global Financial Integration Thirty Years On. From Reform to Crisis* (Cambridge University Press, 2010).

regulatory agencies that had been created by states since the 1970s to coordinate their domestic regulatory policies.

B A new paradigm in the regulation of finance

The shift in the public-private divide in the years preceding the global financial crisis has been the outcome of two complementary sets of policy choices taken by state actors.

First, in the period preceding the crisis public regulatory authorities have in some cases refrained from extending the perimeter of their regulatory oversight and to claim regulatory power over innovative markets and instruments. When different episodes of financial instability in the 1990s and early 2000s put OTC derivatives markets, hedge funds, and credit rating agencies on the agenda of international regulatory bodies, the recommendations released by these bodies did not seek to put in the hands of public regulatory authorities the responsibility to regulate and supervise these markets and institutions.

In the case of derivatives, the recommendations released by the Basel Committee and the International Organisation of Securities Commissions (IOSCO) in 1994, after several corporate scandals involving the use of derivatives, endorsed only a very limited involvement of regulators over the part of market remaining outside of regulated exchanges.¹² While in Europe a comprehensive regulation of OTC derivatives never emerged, the US Congress went even further, introducing in 2000 a legislation to exempt many kinds of derivatives from federal oversight.¹³

A similar outcome characterized the regulation of hedge funds and credit rating agencies. When hedge funds entered the regulatory agenda after the collapse of the US-based fund Long-Term Capital Management in 1998, European and US authorities comprising the

¹² IOSCO, 'Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms', (Technical Committee, International Organization of Securities Commissions, July 1994); Basel Committee on Banking Supervision, 'Risk Managements Guidelines for Derivatives', (Bank for International Settlements, July 1994). For an analysis, see E. Tsingou, 'The Governance of OTC Derivatives Markets', *op. cit* n.10.

¹³ G. Tett, *Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe* (Simon & Schuster 2009).

Financial Stability Forum discussed but ultimately failed to agree on the desirability of directly regulating and supervising these investment vehicles.¹⁴

Credit rating agencies were brought in the international regulatory agenda by the collapse of Enron in 2001. In response to this scandal, the International Organisation of Securities Commissions (IOSCO) drafted in 2004 a set of best practices for rating agencies to uphold, without openly recommending national regulatory authorities to take responsibility for enforce compliance with these rules.¹⁵ Whereas in the United States Congress forced this task upon regulators through the Credit Rating Agency Reform Act of 2006, in Europe the securities regulators and the European Commission rejected the hypothesis of following a similar path and introducing a mandatory 'European Registration Scheme'. They decided instead to leave the industry outside of the scope of their direct regulatory oversight.¹⁶

The decision to allow OTC derivatives, rating agencies, and hedge funds to continue to operate outside the public regulatory umbrella was frequently justified by regulatory authorities on the ground that market actors in OTC derivatives markets or investing in hedge funds were sufficiently wealthy and sophisticated. Extending the public regulatory oversight over these markets was described as generating moral hazard, inducing investors to reduce their due diligence, stifling innovation and increasing compliance costs.

However, it would be a mistake to equate this trend as simply a process of deregulation. On the contrary, the fifteen years that preceded the financial crisis of 2007-09 coincided with a proliferation of codes of best practices and other regulatory initiatives drafted by international regulatory bodies.

It is thus important to highlight a second set of policy choices that informed the pre-crisis shift in the public-private divide, that is, a shift in the purpose and content of regulation

¹⁴ FSF, 'Report of the Working Group on Highly Leveraged Institutions' (Financial Stability Forum, April 2000). For an analysis see P. Robotti, 'Mapping the regulatory debate on hedge funds: a political analysis', FMG Discussion Paper (Financial Markets Group at the London School of Economics, 2006); B. Eichengreen, 'Governing Global Financial Markets: International Responses to the Hedge Funds Problem', in M. Khaler & D. Lake (eds), *Governance in a Global Economy* (Princeton University Press, 2003).

¹⁵ IOSCO, 'Code of Conduct Fundamentals for Credit Rating Agencies' (Technical Committee of the International Organization of Securities Commissions, December 2004).

¹⁶ European Commission, 'Communication from the Commission on Credit Rating Agencies, 2006/C 59/02' (2006).

away from directly regulating what market participants could and could not do through orders and prohibitions, towards seeking to harness the ‘invisible hand’ of markets in support of their regulatory objectives.

Informing this shift was the view expressed in particular by the Federal Reserve in the US that the capacity of public regulatory authorities to regulate effectively innovative markets was constrained by their complexity and innovative nature of these markets. At the same time, several regulators and economists argued that these constraints in the public regulatory power could be mitigated by leveraging the same market forces.¹⁷ While the discipline imposed by regulators was described as ‘rule-based, episodic, bureaucratic and slow to change’, market discipline was described as ‘forward-looking and inherently flexible and adaptive ... continuous, impersonal and non-bureaucratic’,¹⁸ capable of preserving financial stability without stifling innovation or posing unnecessary costs that could damage the competitiveness of financial firms.

Two strategies have been pursued during this period by regulatory authorities to harness market forces in support of their regulatory. First, international regulatory bodies have frequently sought to take advantage of the supposed greater flexibility and sensitivity to market developments of industry self-regulation by providing their seal of approval to the codes of best practices drafted by financial industry associations and incorporating them into their international regulatory initiatives. Moreover in those cases where industry-driven initiatives were inadequate or non-existing, they have not hesitated to solicit industry groups to revise the existing self-regulatory initiatives or to draft new ones, often relying on the threat of introducing formal regulation in the case the private sector had failed to meet regulators’ expectations. For instance, the report published by the FSF on the regulation of hedge funds called upon the hedge fund industry to draft a set of sound practices to improve risk management, internal controls, and disclosure of relevant information to their counterparties. In 2007 the FSF renewed its calls on the hedge fund industry to review the existing sound practice benchmarks for hedge fund managers in

¹⁷ For an example, see P. Hamalainen, et al., 'A Framework for Market Discipline in Bank Regulatory Design', (2005) 32 *Journal of Business Finance & Accounting*; B. Bernanke, 'Financial Regulation and the Invisible Hand', Speech at New York University Law School, (Federal Reserve, 2007).

¹⁸ R. Herring, 'How Can the Invisible Hand Strengthen Prudential Supervision? and how can prudential supervision strengthen the invisible hand?', in V. Borio, et al. (eds), *Market discipline across countries* (MIT Press, 2004).

the light of expectations set out by regulators and market participants.¹⁹ In the case of credit rating agencies, IOSCO relied on the voluntary incorporation by rating agencies into their own internal self-regulatory schemes of its international codes of conduct for rating agencies.

International regulatory bodies have also sought to leverage the self-regulatory skills of financial actors in support of their policy objectives also at the firm-level. Traditional command and control policies seeking to correct market failures by ensuring the compliance with standardized norms of behavior have ceded ground to regulatory policies granting a greater degree of freedom and flexibility to the operations of private market actors in order to promote their self-regulatory capabilities and encourage financial innovation.²⁰ This shift has been documented by several scholars who have studied the evolution of the international capital requirement regime for banking institutions set by Basel Committee.²¹ While the first 1988 Basel Capital Agreement established a rigid relationship between banks' exposures and the amount of reserve capital they were required to put aside, the Basel II Agreement completed in 2004 allowed the most sophisticated banks to use their own data and risk-management schemes to determine their risk exposure and the amount of reserve capital they were required to retain.

In a similar way, the guidelines drafted by the Basel Committee and IOSCO on OTC derivatives markets sought to assist national authorities in promoting sound risk management practices for market actors involved in these markets. The FSF put at the core of its recommendations the attempt to promote stronger risk management by hedge funds and to strengthen credit risk assessment, exposure measurement methodologies, and collateral procedures from hedge funds' counterparties. IOSCO's code of conduct for credit rating agencies also focused on strengthening the capacity of rating agencies to manage the conflicts of interest involved in the rating business.

Second, international regulatory bodies have not relied on market actors uniquely as rule-

¹⁹ FSF, 'Update of the FSF Report on Highly Leveraged Institutions', (Financial Stability Forum, May 2007).

²⁰ T. Strulik, 'Knowledge Politics in the Field of Global Finance? The Emergence of a Cognitive Approach in Banking Supervision', (2006) CSGR Working Paper No. 195/06; M. Power, 'The invention of operational risk', (2005) 12 *Review of International Political Economy*.

²¹ D. Tarullo, *Banking on Basel: the future of international financial regulation* (Peterson Institute for International Economics 2008).

makers, but also as monitoring and disciplining devices. International regulatory have frequently relied on the capacity of markets to monitor changes in a financial firms activities by replacing standardized regulatory requirements with market-based measures of value and risk (e.g. security prices, credit ratings). In particular, the ratings published by commercial credit rating agencies came to be incorporated in several important regulatory initiatives, such as in the determination of capital requirements for banking institutions under the Basel II agreement, the determination of eligible investments or asset concentrations, or the measurement of credit risk associated with certain securities.²² Beyond this indirect market monitoring function, regulators have also relied on the direct market influence of private counterparties to penalize excessive risk-taking without the need for an intervention by supervisors, simply by virtue of changing their investment decisions.²³

Therefore, at the same time as they were scaling back the extent of their regulatory oversight, regulators have actively used their ‘visible hand’ to create an environment conducive for private counterparties to perform this monitoring and steering function. The primary mechanism to achieve this goal has been the imposition upon financial firms of disclosure requirements to enhance the transparency of certain markets.²⁴ Disclosure requirements have been a central piece in the toolkit of financial regulators since the first half of the XXth century. However in the fifteen years preceding the crisis their use has increasingly gone beyond the prevention of frauds and abuses in securities markets, and they have increasingly been employed in the context of prudential regulatory policies to reinforce financial stability.²⁵

The elevation of ‘market discipline’ in the Basel II Agreement as a ‘third pillar’ besides capital requirements and supervisory policies represents an example of the prominent role that market pressures have come to play as a monitoring and enforcement mechanism in

²² For a review of the use of credit ratings in regulatory policies see Basel Committee on Banking Supervision & Joint Forum, *Stocktaking on the use of credit ratings* (Bank for International Settlements, June 2009).

²³ For a review, see M. Flannery, 'The Faces of "Market Discipline"', (2001) 20 *Journal of Financial Services Research*.

²⁴ P. Hamalainen, et al., 'A Framework for Market Discipline in Bank Regulatory Design', (2005) 32 *Journal of Business Finance & Accounting*, 2005; E. Tsingou, 'Policy preferences in financial governance...', *op cit* n. 8; R. Herring, 'How Can the Invisible Hand Strengthen Prudential Supervision? and how can prudential supervision strengthen the invisible hand?', *op cit* n.18.

²⁵ E. Avgouleas, 'The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform ', (2009) 6 *European Company and Financial Law Review*.

international regulatory policies.²⁶ However, prior to the crisis market discipline has occupied an even more central part in the international regulatory policies designed to regulate rating agencies, hedge funds, and OTC derivatives markets. For instance, IOSCO required rating agencies to disclose publicly how they had incorporated its 'Code of Conduct Fundamentals for Credit Rating Agencies' into their internal guidelines and explain any deviation from it in order to allow the users of ratings to monitor the implementation of these international best practices and punish those agencies not complying with international best practices. Also in the case of hedge funds, the approach advanced by the FSF and adopted in Europe and in the US was based on the principle that the task of monitoring hedge funds' activities should not be performed by regulators, but rather by hedge funds' investors and prime-brokers, who were described as having stronger incentives to monitor hedge funds' positions and greater resources than those available to regulators. The recommendations released by the FSF thus focused on strengthening the disclosure of information regarding hedge funds' activities to their private counterparties, rather than the private reporting of this information to the supervisory authorities.

In sum, the shift in the public-private divide that has emerged in international finance prior to the last financial crisis should be regarded not simply as an example of deregulation, but rather the emergence of a new regulatory paradigm. Andrew Crockett, former General Manager of the Bank for International Settlements, has argued that a 'paradigm shift' has occurred in the approach taken by financial regulators, who are increasingly attempting 'to work with, rather than against, the grain of market forces' in their approach to the regulation of financial markets.²⁷ The former Chairman Tommaso Padoa-Schioppa talked instead of the emergence of 'market-friendly regulation'.²⁸

This trend is in line with the growing importance that self-regulation and other market-based regulatory solutions have gained in the 'global administrative law'²⁹ emerging to

²⁶ J. Caruana, 'The importance of transparency and market discipline approaches in the New Capital Accord', Keynote Speech at the Market Discipline Conference (Federal Reserve Bank of Chicago and BIS, November Discipline Conference 2003).

²⁷ A. Crockett, 'Market Discipline and Financial Stability', (2002) 26 *Journal of Banking and Finance*,

²⁸ T. Padoa-Schioppa, 'Market-friendly Regulation of Banks: An International Perspective', in D. Duwendag (ed), *Szenarien der Europäischen Währungsunion und der Bankenregulierung* (Duncker & Humblot, 1997).

²⁹ B. Kingsbury, N. Krisch, R. Stewart, 'The emergence of global administrative law', (2005) 15 *Law and Contemporary Problems*; R. Hall & T. Biersteker, *The Emergence of Private Authority in Global Governance*

address the consequences of globalization in different areas. Despite, this trend has frequently been interpreted as a death knell for the state, this view is misleading. As several authors have more recently acknowledged, the development of self-regulation in the global economy has frequently taken place ‘in the shadow of public power’.³⁰ As this section has argued, also in the case of global financial regulation the enhanced power of private market actors in setting and enforcing the rules governing finance rested on a set of policy choices by state actors in the main countries. As the analysis of the changes brought by the financial crisis of 2007-09 in the next section will demonstrate, these same public actors also held the keys for reversing this trend and seizing back the regulatory responsibilities they had delegated to markets.

III. After the crisis: The reassertion of public regulation

In the years preceding the crisis, several scholars have provided different hypotheses to explain the origin of this shift in the relation between public and private actors in the governance of financial markets described above. Several authors argued that this delegation of regulatory responsibilities to the markets reflected the growing constraints posed by financial globalization and innovation upon the capacity of public actors to effectively govern financial markets.³¹ Others raised the attention towards the central role played by American and British regulatory authorities in shaping the international agenda and their interest in leaving their firms dominating world markets free from the burdensome regulatory measures.³² Some authors identified the origin of this shift in the preferences of financial industry groups, and their capacity to capture the regulatory

(Cambridge University Press 2003); M. Barr & G. Miller, 'Global Administrative Law: The View from Basel', (2006) 17 *The European Journal of International Law*.

³⁰ A. Newman & D. Bach, 'Self-Regulatory Trajectories in the Shadow of Public Power: Resolving Digital Dilemmas in Europe and the U.S. ', (2004) 17 *Governance: An International Journal of Policy, Administration, and Institutions*; F. Scharpf, *Games Real Actors Play. Actor-Centered Institutionalism in Policy Research* (Westview Press 1997). V. Haufler, *A Public Role for the Private Sector: Industry Self-Regulation in a Global Economy* (Carnegie Endowment for International Peace 2001).

³¹ P. Cerny, 'The dynamics of financial globalization: Technology, market structure, and policy response', (1994) 27 *Policy Sciences*; W. Mattli, 'Public and Private Governance in Setting International Standards', in M. Khaler & D. Lake (eds), *Governance in a Global Economy* (Princeton University Press, 2003).

³² B. Eichengreen, 'Governing Global Financial Markets: International Responses to the Hedge Funds Problem' *op cit* n.14.

process not only at the national level but also at the transnational level.³³ Finally, for others this capture was primarily ideological, and it reflected the influence within the international regulatory community – in particular the Federal Reserve headed by Alan Greenspan and the British Financial Services Authority - of an ideational consensus stressing the efficient and rational nature of financial markets.³⁴

While pointing in the direction of different causal explanations, most of these interpretations tended to describe the shift in the public-private divide as a structural change in the evolution of financial markets, unlikely to be reversed in the future. Among the few exceptions was Louis Pauly who argued forcefully in 2003 that the delegation of regulatory authority to private market actors in the global economy remained a fleeting phenomenon. According to Pauly, public authority would likely reassert control over what they had delegated to private actors in the case of a financial crisis or a phenomenon seriously delegitimizing market mechanisms.³⁵

This possibility has manifested itself in a dramatic fashion during the global financial crisis of 2007-2009. This event has shaken the political foundations that underpinned the pre-crisis delegation of regulatory responsibilities to the private sector and unleashed political dynamics different from those faced by the pre-crisis literature. In particular, the use of taxpayers' money in support of financial institutions has triggered an unprecedented politicization of financial regulatory politics. This has shifted the centre of the action away from those regulatory agencies that before the crisis remained more prone to be captured by the financial industry and raised the profile of elected policymakers who faced now strong electoral incentives to demonstrate to their electorate

³³ D. Mügge, 'Private-Public Puzzles...' *op cit* n. 3; G. Underhill & X. Zhang, 'Setting the rules...' *op cit* n.8; J. Bhagwati, 'The Capital Myth: The Difference between Trade in Widgets and Dollars', (1998) 77 *Foreign Affairs*.

³⁴ FSA, 'Turner Review: A regulatory response to the global banking crisis' (Financial Services Authority, 2009); A. Greenspan, *The Age of Turbulence: Adventures in a New World* (Penguin Press 2007); Eleni Tsingou, 'The role of policy communities in global financial governance: a critical examination of the Group of Thirty', in T. Strulik & H. Wilke (eds), *Towards a Cognitive Mode in Global Finance* (University of Chicago Press, 2007).

³⁵ Louis W. Pauly, 'Global finance, political authority, and the problem of legitimation', *op cit*, n.3. Another important exception D. Mügge, 'Private-Public Puzzles...' *op cit* n.3.

their commitment to not lead crucial regulatory responsibilities in the hands of those same private market actors that had contributed to the crisis.³⁶

The rest of this paper will analyze how these largely unprecedented political dynamics had the effect of reversing the shift in the public-private divide that took place since the 1990s in the international regulation of OTC derivatives, credit rating agencies, and hedge funds. These cases show that while the initial recommendations released by the G20, the Financial Stability Forum/Board and the International Organisation of Securities Commissions continued to focus on self-regulation and market-discipline as primary regulatory mechanisms, these international bodies have come to depart from the pre-crisis regulatory paradigm by placing these three markets and institutions firmly under the regulatory oversight of public regulatory authorities.

A *OTC Derivatives*

During the period preceding the crisis regulatory authorities in the US, Europe, and in the international standard-setting bodies had refrained from advocating an expansion in the perimeter of their regulatory oversight to incorporate the growing portion of derivatives traded over-the-counter (OTC), despite the fact that the size of these markets came to overshadow exchange-traded derivatives.³⁷ Instead, regulatory authorities expressed significant confidence in the operational infrastructure created on a self-regulatory basis by the main market participants gathered in the International Swaps and Derivatives Association. However, when the financial crisis erupted in 2007, it quickly became clear that this infrastructure had not kept pace with the explosion in the complexity of these instruments and the surging trading volumes.³⁸

The way these regulatory deficiencies were initially addressed presents significant similarities with the pre-crisis regulatory paradigm. Instead of requesting the power to directly address these regulatory gaps, US regulatory authorities under the leadership of

³⁶ E. Helleiner & S. Pagliari, 'The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance', in E. Helleiner, S. Pagliari, and H. Zimmermann. (eds), *Global Finance in Crisis. The Politics of International Regulatory Change* (Routledge, 2009).

³⁷ A notable exception has been the Commodity Futures Trading Commission headed by Brooksley Born, who called for the regulation of OTC derivatives in 1999.

³⁸ For an early warning, see PWG, 'Policy Statement on Financial Market Developments' (President's Working Group on Financial Markets, March 2008).

the Federal Reserve Bank of New York, in coordination with their main European counterparts convened the main derivatives markets participants in a series of closed-door meetings and presented specific requests to be met through further self-regulatory steps.³⁹

Derivatives markets participants have been rapid in responding to the detailed requests coming from regulators. Since March 2008, they have committed to increase the standardization and enhance the processing of derivatives traded over-the-counter, improve collateral management, report all credit derivatives to a central 'trade repository', reduce the volume of outstanding credit derivatives trades by tearing up contracts that have essentially opposite positions over the same risk, increase the certainty and transparency of a settlement process following a corporate default or another 'credit event' by 'hardwiring' an auction-based settlement mechanism into standard derivatives contracts (Big Bang Protocol).

Most importantly, when the collapse of Lehman Brothers demonstrated the systemic effects of the collapse of a major counterparty in the derivatives markets, regulators urged market participants to mitigate the counterparty risk in OTC derivatives transactions by redirecting these flows through central counterparties where bilateral trades could be cleared. While in the US regulators quickly achieved the commitment by the main dealers eager to avoid more formal regulation, in Europe the relation between public authorities and private market actors has been more difficult. The European Commission was able to achieve the commitment by the major derivative dealers to clear derivatives through a central counterparty located in Europe only by threatening to impose higher capital requirements on derivatives not processed through a European clearing house.⁴⁰

Despite the fact that the regulatory changes in OTC derivatives markets during the first two years of the crisis were as extensive as those occurred in the entire previous decade, it is important to note that these reforms remained voluntary and self-regulatory in nature, with the role of public authorities confined to steering these industry-driven initiatives through carrots and sticks.

³⁹ The correspondence between the NY Federal Reserve and the derivatives markets participants is available on the website of the New York Federal Reserve Bank: http://www.newyorkfed.org/newsevents/otc_derivative.html.

⁴⁰ C. McCreedy, 'Address by Commissioner Charlie McCreedy at the EP Committee on Economic and Monetary Affairs', (European Commission, February 2009).

It was only after the bankruptcy of Lehman Brothers in September 2008 and the bailout of the insurance giant AIG that the European Commission and the US Treasury departed from the first-pillar of the pre-crisis regulatory paradigm by introducing comprehensive regulatory plans to bring the regulation and supervision of OTC derivative markets firmly under the regulatory oversight of public regulatory agencies. The European Commission described this as a ‘paradigm shift ... away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly’.⁴¹

At the core of these regulatory initiatives was the attempt to shift derivative markets from predominantly OTC bilateral transactions, where regulators have little to no oversight, to more centralised clearinghouses or trading platforms under the oversight of financial regulators and subject to binding regulatory requirements. In the first stage of the crisis, regulators saw their role as simply that of ‘encouraging’ this step, often through the threat of formal legislation. At the first G20 leaders summit in Washington in November 2008 the G20 leaders asked regulators to ‘*insist* that market participants support exchange traded or electronic trading platforms for CDS contracts’.⁴² However, since the collapse of Lehman Brothers most public regulatory authorities in Europe and in the US have announced their support for making central clearing and exchange trading mandatory for standardized OTC contracts. At the Pittsburgh summit in September 2009, G20 leaders stated more categorically that ‘all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.’⁴³

While this represents a significant expansion in the intervention of regulators in these markets, the use of the ‘visible hand’ of regulation did not go as far as many

⁴¹ European Commission, ‘Ensuring efficient, safe and sound derivatives markets: Future policy actions . Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions, and the European Central Bank’ (European Commission, Internal Market and Services DG, October 2009). For the US Treasury see US Treasury, ‘Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation’, (Department of the Treasury, June 2009).

⁴² G20, ‘Declaration of the summit on Financial Markets and the World Economy’ (Group of Twenty, November 2008); E. Helleiner, ‘Reining in the market: Global Governance and the Regulation of Derivatives’, in D. Claes & C. Henrik Knutsen (eds), *Governing the Global Economy* (Routledge, 2010).

⁴³ G20, ‘Leaders’ Statement: The Pittsburgh Summit’, (Group of Twenty, April 2009).

policymakers and commentators have advocated. For instance, instead of mandating the trading onto exchanges of all derivatives contracts, the US and European regulatory plans continue to allow ‘non-standardized’ derivatives to be traded over-the-counter. At the same time, they seek to enhance the information available on these markets by mandating the reporting of all OTC contracts to trade repositories, and they impose higher prudential requirements for counterparties in non-centrally cleared derivatives transactions in order to create incentives to migrate of OTC derivatives onto central clearinghouses and exchanges. Moreover, both the US Congress and the European Commission plan have introduced significant exemptions from mandatory clearing and exchange trading for many of those corporate end-users that use OTC derivatives to hedge their commercial risk, after intense lobbying from these same market players.

During the Greek debt crisis several policymakers have also called for the banning of so-called ‘naked’ credit default swaps, where the buyer of the credit insurance does not own the underlying asset on which the credit insurance was purchased. However, this kind of proposal has not been incorporated into the US and European regulatory plans, which have not gone as far as posing limits to the kind of derivatives could be traded.

In sum, while the regulatory response to the financial crisis has consolidated in the hands of public regulatory agencies in Europe and elsewhere the authority to regulate OTC derivatives markets and channeled a significant portion of these markets through central clearinghouses, they have been wary of expanding their regulatory intervention to the extent that it significantly curtail these markets, or limit the access of corporate end-users to OTC derivatives markets.

B Credit Rating Agencies

The financial crisis of 2007-09 has also brought the regulation of credit rating agencies back under the spotlight. The immediate acknowledgment of how rating agencies had severely underestimated the risks attached to mortgage back securities and other structured finance products led IOSCO to amend in 2008 its ‘Code of Conduct

Fundamentals for Credit Rating Agencies’.⁴⁴ Similarly to the first set of best practices drafted in 2004, the amended Code of Conduct remained non-binding, relying on ratings agencies to voluntarily incorporate these recommendations into their individual codes of conduct, and on discipline imposed by the users of ratings as the unique mechanism to ensure compliance.

However, the reliance on market discipline and self-regulation progressively came under severe criticisms throughout 2008. Primarily, it was European policymakers who led the charge, with the Internal Market Commissioner Charlie McCreevy defining the IOSCO Code of Conduct a ‘toothless wonder’.⁴⁵ In a public consultation launched in 2008 on the regulation of rating agencies, the European Commission argued that the oligopolistic structure of the rating agencies’ market did not allow market participants to switch to other rating providers, thus making it ‘highly unlikely that market pressure alone is sufficient to discipline the CRAs to change their conduct.’⁴⁶ The Commission also dismissed the different self-regulatory measures taken by different rating agencies, arguing that ‘most of these have not been robust and or stringent enough to cope with the severe problems and restore the confidence in the markets’, while still lacking a credible enforcement mechanism.⁴⁷

The crisis has thus gradually shifted the responsibility to monitor and enforce compliance with the IOSCO code of conduct from market pressures to the hands of public regulatory authorities. At the Washington Summit on November 2008, G20 leaders asked regulators to ‘review credit rating agencies’ adoption of the standards and mechanisms for monitoring compliance’.⁴⁸ IOSCO supported this goal by developing a ‘common monitoring module’ to assist supervisors in monitoring compliance with its Code of

⁴⁴ IOSCO, ‘Code of Conduct Fundamentals for Credit Rating Agencies. Revised version’ (Technical Committee of the International Organization of Securities Commissions, May 2008).

⁴⁵ C. McCreevy, ‘Regulating in a Global Market’, Inaugural Global Financial Services Centre Conference, (European Commission, June 2008).

⁴⁶ European Commission, ‘Commission Staff Working Document accompanying the Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies. Impact Assessment’ (Brussels, European Commission, November 2008).

⁴⁷ European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies’ (Brussels, European Commission, November 2008).

⁴⁸ G20, ‘Declaration of the summit on Financial Markets and the World Economy’, (Group of Twenty, November 2008).

Conduct,⁴⁹ and endorsed the creation of colleges of regulators or bilateral regulatory arrangements that could help regulators in the supervision of the largest CRAs that operate across borders.⁵⁰

While these measures sought strengthen the capacity of public authorities to monitor the self-regulatory measures taken by rating agencies to incorporate the IOSCO Code of Conduct into their internal practices, IOSCO did not place public authorities in charge of directly regulating rating agencies and sanctioning non-compliance. This approach was openly criticized at the international level by the G20. The G20 Working Group on 'Enhancing Sound Regulation and Strengthening Transparency' that was convened after the Washington Summit presented in March 2009 an explicit criticism of the self-regulatory status of credit rating agencies: 'a self-regulatory framework does not appear sufficient to ensure compliance with the IOSCO Code ... Effective supervision requires surveillance of CRAs' activities and, where necessary, enforcement of rules applying to CRAs'.⁵¹

G20 leaders took another step towards increasing the role of financial regulators in the regulation of rating agencies when at the Washington Summit they requested credit rating agencies that provide public ratings to be registered.⁵² The significance of this shift in the public-private divide was acknowledged also by IOSCO, which stated in May 2010, 'a consensus emerged that the IOSCO CRA Code, as an industry code that promoted CRAs to implement internal controls and processes designed to give effect to the IOSCO CRA Principles, should be supplemented with regulation of CRAs by national competent authorities.'⁵³

⁴⁹ IOSCO, 'IOSCO urges greater international coordination in the oversight of credit rating agencies' (International Organization of Securities Commissions, September 2008). See also IOSCO, 'IOSCO announces next steps on Credit Rating Agencies' (International Organization of Securities Commissions, July 2008).

⁵⁰ IOSCO, 'International Cooperation in Oversight of Credit Rating Agencies. Note.' (Technical Committee of the International Organization of Securities Commissions, March 2009).

⁵¹ G20 Working Group 1, 'Final Report on Enhancing Sound Regulation and Strengthening Transparency', (G20 Working Group 1, March 2009).

⁵² G20, 'Declaration of the summit on Financial Markets and the World Economy', (G20, November 2008).

⁵³ IOSCO, 'Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies. Consultation Report', (Technical Committee of the International Organization of Securities Commissions, May 2010).

While regulators in the US had already been granted this authority by the CRA Reform Act of 2006, this was not the case in Europe and other jurisdictions. The European Commission has reestablished a regulatory level playing field with the US by introducing in 2008 a comprehensive regulatory framework requiring all rating agencies issuing ratings intended for use for regulatory purposes by financial institutions in the EU to register with European regulators.⁵⁴ Other countries such as Japan, South Korea, and Australia have followed the European lead and announced the introduction of similar regulatory frameworks placing in the hands of securities regulators the authority to impose regulatory requirements upon rating monitoring their implementation, and sanctioning episodes of non-compliance.⁵⁵

At the same time, a deeper analysis of the content of the regulation introduced in Europe and the amendment to the existing regulation introduced in the United States demonstrates significant elements of continuity with the pre-crisis regulatory approach. For instance, despite the fact that the crisis has revealed significant shortcomings in the methodologies employed by rating agencies in rating structured finance products, both the regulatory proposals presented in the US and Europe have refrained from placing public regulators in charge of monitoring and validating the methodologies employed by rating agencies, defining which instruments could be rated and which level of due diligence should be conducted on the assets underlying a rating, or to second guess the performance of their ratings. Instead, regulators have remained wary that such measures would put them in the position to validate the operation of rating agencies, creating moral hazard and exacerbating over-reliance on ratings. They have thus addressed this issue primarily by requesting rating agencies to provide to the market more information regarding their ratings' historical performance, the assumptions and methodologies, the level of due diligence on the assets underlying a structured finance product they rate, as well as to differentiate ratings for structured finance products from ratings for corporate and sovereign bonds. These disclosure requirements were designed to assist market

⁵⁴ European Commission, 'Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies', (European Commission, November 2008). For an analysis of the EC regulation see Sarah Peiyee Woo, "Stress before Consumption: A Proposal to Reform Agency Ratings", paper presented at the 8th WISH Conference, Angers, (February 26-27 2010).

⁵⁵ FSB, 'Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability. Report of the Financial Stability Board to G20 Leaders' (Financial Stability Board, September 2009).

participants in understanding the limitations and implication of ratings and conduct ‘what if’ analyses. The legislation passed by the US Congress (Wall Street Reform and Consumer Protection Act of 2010) has also departed from the principle that the ratings should be granted protection from lawsuits under the First Amendment of the US Constitution, and introduced a provision that would make it easier for investors sue rating agencies.

Also the approach pursued in the US and Europe to address the conflicts of interest deriving from the fact that rating agencies are paid by the issuers of the security they are rating presents a strong continuity with the market-based regulatory paradigm that emerged prior to the crisis. Regulators have sought to mitigate the conflicts of interests in the rating business by introducing an additional set of disclosure requirements regarding their conflicts of interests, the policies in place to manage these conflicts of interests, and the preliminary ratings obtained from a credit rating agency prior to selecting a firm to conduct a rating in order to prevent issuers from ‘shopping’ among multiple agencies in search for the highest rating. These disclosure requirements were strengthened by prohibitions, such as barring analysts from engaging on advisory services and making recommendations regarding the design of structured finance products they rate, and from participating in fee discussions with issuers, and by limited internal governance requirements (e.g. rotation arrangements for analysts, composition of their boards of directors). However, regulators in Europe and in the US have not severed the link between raters and issuers. Proposals presented in the US to create a public ‘rating clearinghouse’ that would sever the direct link between agencies and issuers of structured products, or in Europe to create a public ‘European rating agency’ had not much success beyond simply calls for further study on the viability of such wholesale changes in the way rating agencies are funded. Instead, as the US Treasury stated, the role of public regulators that emerges from these regulations is not ‘to prescribe allowable business models in the free market’, but rather ‘to make it simple for investors to understand the conflicts in any rating that they read and allow them to make their own judgment of its relevance to their investment decision’.⁵⁶

⁵⁶ US Treasury, ‘Assistant Secretary for Financial Institutions Michael S. Barr. Written Testimony. Senate Committee on Banking, Housing, and Urban Affairs’, (Senate Committee on Banking, Housing, and Urban Affairs, August 2009).

An important sign of discontinuity from the pre-crisis regulatory paradigm comes from the attempt of regulators to use their authority to reduce the excessive reliance on ratings by market actors as a replacement for adequate risk analysis and risk-management. Before the crisis ratings were frequently hard-wired in the existing regulatory framework through numerous references to credit ratings in regulatory requirements guiding different market actors. In order to lessen undue reliance on ratings, the SEC has removed references to credit ratings in different parts of securities laws. The European Commission has published a consultation report regarding the ‘policy options to address the problem of excessive reliance on credit ratings’.⁵⁷ At the international level, the G20 has asked the Basel Committee to correct the incentives arising from the use in the Basel II agreement of external ratings or other market-based measures of value and risk, such value-at-risk (VaR) estimates,⁵⁸ thus reversing the reliance on market-based measures of price and risk in regulation that had characterized the regulatory paradigm prior to the crisis.

C Hedge Funds

Similarly to the case of OTC derivatives and rating agencies described above, the outbreak of the crisis did not initially undermine the support for industry-driven codes of best practices and market-based regulatory solutions that had characterized the regulation of hedge funds since the collapse of Long-Term Capital Management in 1998. On the contrary, at the outset of the crisis the major European leaders all gave their seal of approval to the self-regulatory initiatives drafted by a group of London-based hedge funds (Hedge Fund Standards Board), including the German government that had traditionally been the most vocal in calling for directly regulating these investment vehicles.⁵⁹ In the US, federal regulatory agencies took upon themselves the task of

⁵⁷ European Commission, ‘Consultation document: Policy options to address the problem of excessive reliance on ratings’, (European Commission, July 2008).

⁵⁸ G20, ‘Declaration on Strengthening the Financial System’ (Group of Twenty, April 2009).

⁵⁹ N. Sarkozy, et al., ‘International Economic Situation. Joint declaration of M.Nicolas Sarkozy, President of the French Republic, M. Gordon Brown, British Prime Minister, Ms Angela Merkel, German Chancellor, M. Romano Prodi, Italian Prime Minister, and M. Jose Manuel Barroso, President of the European Commission’ (January 2008).

creating two advisory groups formed respectively by hedge funds managers and investors with the mandate of creating a private sector-driven set of best practices.⁶⁰

When hedge funds reached the international agenda for the first time in the middle of the crisis at the G20 Washington Summit, the G20 leaders reached out to the same hedge fund bodies that had already developed codes of best practices, asking them to ‘bring forward proposals for a set of unified best practices’. The role of public authorities as envisioned by the G20 was limited to ‘assess[ing] the adequacy of these proposals’.⁶¹ As in the case of past episodes of financial instability, these calls from regulators have triggered the reaction from major hedge funds groups, which have committed to fostering convergence between different industry best practices and delivering to the FSB a set of harmonised Principles of Best Practices for Hedge Fund Managers on 24 June 2009.⁶²

However, these self-regulatory steps taken by the hedge fund industry have generated only lukewarm reactions from public authorities. Securities regulators gathered within IOSCO have raised doubts about the effectiveness of industry codes of best practices as a substitute for direct regulation. First, IOSCO argued that the adoption by hedge fund managers of these industry codes of best practices had remained low, as demonstrated by a survey showing that only less than 10% of British hedge funds managers were prepared to sign up to the standards drafted by the HFWG,⁶³ and there has been no demand by investors of these hedge funds to adopt the standards. Second, IOSCO denounced the variety of different industry standards covering different issues and the lack of a globally consistent solution. Third, IOSCO argued that there were ‘still open questions’ regarding the enforceability of such codes either by regulators or industry associations’.⁶⁴

While in the past industry-driven initiatives were successful in deflecting the threat of more stringent regulation, this time the outcome was different. When the G20 leaders met at London Summit on April 2009, they abandoned the long-standing international support

⁶⁰ PWG, 'PWG Announces Private Sector Groups to Address Market Issues for Private Pools of Capital' (President's Working Group on Financial Markets, September 2007).

⁶¹ G20, 'Declaration of the summit on Financial Markets and the World Economy', (Group of Twenty, November 2008).

⁶² AIMA, 'AIMA Position Paper on the European Commission's Draft Directive on Alternative Investment Fund Managers (AIFMs)', (Alternative Investment Managers Association, October 2009).

⁶³ Kinetic Partners, 'Press release: UK Hedge Funds Uncommitted to Adopting Best Practice Standards', (17 November 2008)

⁶⁴ IOSCO, 'Hedge Funds Oversight: Final Report' (Technical Committee of the International Organization of Securities Commissions, June 2009). 7

for self-regulation in the hedge fund industry and announced that ‘hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively’.⁶⁵ Building upon this international commitment, the European Commission presented in April 2009 a directive (Alternative Investment Fund Managers Directive) requiring hedge fund managers to seek authorization with a national regulator and be subject to reporting, governance, and risk management requirements in order to operate in Europe.⁶⁶ A similar shift from self-regulation to direct regulation has taken place in the US, where Wall Street Reform and Consumer Protection Act of 2010 has removed those exemptions from the Investment Advisers Act of 1940 that allowed advisers to hedge funds to avoid registering with the Securities and Exchange Commission.

By mandating the registration of hedge funds managers with a national regulatory authority and requiring them to disclose appropriate information on an ongoing basis, these regulatory plans represent a significant departure from the pre-crisis regulatory paradigm and they place firmly in the hands of public authorities the primary responsibility to regulate and supervise hedge funds’ activities. However, the regulation that has emerged could be better described as ‘enhanced oversight’ of hedge funds managers than a ‘granular approach’ to closely regulating and constraining their investment activities.⁶⁷

Similarly to the pre-crisis paradigm, at the core of the emerging regulation of hedge funds there is the attempt to enhance the level of transparency in the industry. The regulatory plans presented by the European Commission and US Treasury require hedge fund managers to provide information regarding the identity of their funds, their internal governance arrangements and key service providers, as well as their trading activities, including information on the principal markets and instruments in which they trade, their principal exposures and concentrations, the use of short-selling, the overall level of

⁶⁵ G20, 'Declaration on Strengthening the Financial System', (Group of Twenty, April 2009).

⁶⁶ European Commission, 'Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC ', (European Commission, April 2009).

⁶⁷ Richard Baker, president of the Managed Funds Association, quoted in Marcy Gordon, ‘Hedge fund industry accepts Obama oversight plan, but seeks more details, assured privacy’ (Associated Press, 31 March 2009)

leverage. While before the crisis these disclosure requirements were targeted exclusively to the markets in order to enhance market discipline, disclosure requirements are now meant to assist the same regulatory authorities to police hedge funds and to identify market abuses (eg insider trading and market manipulation), as well as to assess the systemic risk they pose to the financial system.

The approach emerging from the crisis to the regulation of hedge funds also extends the visible hand of regulatory agencies to influence the internal organization and operational conduct of the funds. Hedge fund managers operating in Europe and in the US would have to comply to various regulatory requirements regarding their internal policies to manage conflicts of interest, asset safekeeping and valuation arrangements, risk-management mechanisms, and remuneration.

However, these regulatory frameworks have been cautious in extending the ‘visible hand’ of regulators as far as interfering with hedge funds’ market activities. While some Continental European authorities called for the imposition of prudential regulatory requirements similar to those imposed upon banks, the US regulatory plan includes neither the introduction of capital requirements nor of a cap on leverage for non-systemically relevant hedge funds. The cap on hedge funds’ leverage that was introduced in the directive initially presented by the European Commission was later removed from the text, and European authorities retain the power to limit the level of leverage only under exceptional circumstances. Moreover, none of the regulatory initiatives described above impose restrictions on the capacity of hedge fund managers to employ short-selling techniques or to their use of derivatives, nor they impose any position or concentration limits. In sum, similarly to the pre-crisis regulatory paradigm, these regulatory proposals continue to regard the discipline imposed by the banks that provide hedge funds with credit as the primary line of defense to constrain excessive leverage and risk-taking in hedge funds’ activities. At the same time, it must be remarked how both in Europe and in the US regulators have now been granted the statutory authority to intervene and impose restrictions on hedge funds’ activities in those situations where market discipline fails and hedge funds come to pose systemic risk to the stability of the financial system as a whole.

IV. Conclusion

Scholars and policymakers have frequently drawn parallels between the global financial crisis of 2007-2009 and the Wall Street crash of 1929. Both shocks came after a decade of financial innovation and enthusiasm in the financial markets, and imposed a hefty toll on the world economy. This paper has suggested that another parallel could be found in the regulatory response. Both financial shocks have led public authorities to increase their involvement in the regulation of financial markets and significantly altered the divide between public regulatory agencies and private market actors.

The regulatory initiatives described in this paper represent a significant departure from the regulatory approach that gained prominence in the decade or so prior to the crisis. During this period, regulators refrained from extending the perimeter of their regulatory oversight over OTC derivatives, rating agencies, and hedge funds. The crisis has reversed this position. By mandating the registration of hedge fund managers and rating agencies whose ratings are used for regulatory purposes, by shifting a large part of derivatives contracts traded bilaterally into regulated central counterparties, and by imposing regulatory requirements upon market actors engaging in transactions over-the-counter, the commitments made at the international level within transgovernmental regulatory bodies such as FSF/B and IOSCO, or a leaders forum such as the G20 clearly placed in the hand of public actors the authority to set standards governing these three markets and institutions.

Another significant departure from the pre-crisis regulatory paradigm comes from the very limited endorsement given to self-regulatory initiatives designed by financial industry groups as a legitimate substitute for regulatory initiatives set and enforced by public regulatory agencies. This is not to say that the self-regulatory steps taken by the key market participants did not leave a mark over the regulatory response to the crisis. For instance, the operational infrastructures that support the OTC derivatives markets continue to be primarily the product of self-regulatory efforts developed under the aegis of the International Swaps and Derivatives Association. In other areas, the emerging public regulation has built upon self-regulatory measures already introduced voluntarily by market participants. However, public regulatory agencies made these measures

mandatory and backed them up with the coercive authority of the state. In general, while elements of self-regulation remain in the regulation of these sectors, they now sit on top, rather than replace, a regulatory framework set and enforced by public regulatory agencies.

From this perspective, the reassertion of public regulation over a large number of markets and institutions that remained outside of the public regulatory umbrella represents the most significant turning point in the way responsibilities to regulate financial markets are divided between public and private actors since the 1930s. At the same time, several commentators have downplayed the significance of some of these changes. These have been described as simply tweaking at the margin, without fundamentally altering the purpose of the intervention of public actors in the regulation of market activities and the relation between public and private market actors.

Indeed, the analysis presented above provides some support to this skeptical interpretation. When we analyze how public regulators have used their newly acquired regulatory authority to address the market failures highlighted by the crisis in these three areas, there are several elements of continuity with the pre-crisis regulatory paradigm. During the crisis we have seen regulators significantly reduce the degree of discretion enjoyed by the regulated private market actors. At the same time, market discipline and industry self-regulation remain important components in the attempt to re-regulate OTC derivatives markets, hedge funds, and credit rating agencies.

A close analysis of these regulatory measures shows that the kind of shift along the public-private divide triggered by the financial crisis of 2007-09 is very different from the one that followed the Wall Street Crash of 1929. In response to the Wall Street crash of 1929, public authorities in the major industrialized countries extended the use of the visible hand of regulation to prohibit some of the financial instruments created before the crisis, to restrict the freedom of banks to operate in the securities industry, and to discourage financial innovation. In response to the global financial crisis of 2007-09, public authorities have been wary of subduing or restricting the access to certain markets and products, often justifying this choice with the costs that such forms of regulation would pose upon the broader economy. The invisible hand of market discipline remains

thus an important ally in the attempt to re-regulate OTC derivatives markets, hedge funds, and credit rating agencies.

In sum, while the global financial crisis of 2007-09 has significantly altered the public-private divide in the regulation of OTC derivatives, rating agencies, and hedge funds, this shift pertains more to the consolidation of the authority to regulate and oversee these markets and institutions in the hands of public regulatory than a change in the purpose and content of their regulatory intervention. At the time of writing, a paradigm change in the regulation of finance similar to the one that followed the Wall Street crash of 1929 does not seem be on the horizon.