Looking past consensus to implementation: a growing international consensus on the need for capital markets regulatory reform masks tough questions about implementing such reforms†

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Key points

- As the global credit crisis continues to evolve, a general consensus is emerging both as to its causes and the necessity of comprehensive and effective regulatory reform.
- This article discusses the various reports and proposals put forth by the USA, European and global entities, including the UK FSA, European Commission, G20 and various US regulators.
- Particular consideration is given to the difficult issues associated with implementation of these reforms underlying this high-level consensus, including methods of regulating the shadow banking sector, the introduction of a systemic risk regulator and the problems posed by identifying systemic risk as well as the enforcement and standardization of regulatory reforms.
- This article also examines the vital role that international agencies, such as the Financial Stability Board, the International Monetary Fund, the World Bank and the Basel Committee on Banking Supervision could play in effectively coordinating and improving national regulatory efforts.

Our special issue is timely and important. The sudden and serious downturn in the world economy and the perceived weaknesses of the existing regulatory structures in key markets have led to calls for major reforms. This special issue of the *Capital Markets Law Journal* explores the causes of the current crisis, reviews the various proposals to reform our markets and identifies some additional key issues that must be resolved.

The current market crisis has prompted a series of reports assessing the causes of the crisis and proposing regulatory reforms. Some of the more thoughtful of these reports include the Group of 30 (G30) Report, co-chaired by Paul Volker, setting forth principles for regulation of financial institutions;[1] a US Government

† Opinion and thought in this area continues to evolve rapidly. By the time this article is published, new proposals and ideas will surely have emerged. Accordingly, this article speaks as of 26 May 2009.

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1 Group of Thirty, Working Group on Financial Reform, 'Financial Reform: A Framework for Financial Stability' (15 January 2009) <http://www.group30.org/pubs/reformreport.pdf> accessed 26 May 2009 (hereinafter 'G30 financial reform').

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Accountability Office (GAO) report reviewing what happened in the USA and assessing the weaknesses of the US regulatory structure;[2] the de Larosière report, reviewing and recommending changes in the EU regulatory structure;[3] the UK Financial Services Authority's Turner Review, assessing the UK and, to a lesser extent, the EU regulatory structure;[4] reports by working groups appointed by the Group of Twenty (G20) after its meeting in November in Washington; and the Committee on Capital Markets Regulation (CCMR) reports recommending significant changes in the US regulatory structure.[5] The recommendations in these reports influenced the statement issued by the G20 following its April meeting in London, as well as the two accompanying Declarations, which reflect the broad consensus derived from and reflected in these reports.

From these reports has emerged a general consensus, both as to the causes of the current crisis and the regulatory reforms needed. Two critical points of agreement have been reached by key observers, including the G20. First, in implementing regulatory reforms, individual nations will not cede national sovereignty to existing or new international regulatory agencies.[6] Rather, national regulators will be responsible for implementing recommended reforms and international standards, as well as supervision and oversight of national markets. Second, all systemically important institutions, instruments and markets should be regulated, preferably under the umbrella of a consolidated supervisor in each jurisdiction. But, as we shall see, consensus has yet to be reached on the details of implementing the desired reforms or what powers and responsibilities a consolidated supervisor should have. Parallel introduction of key reforms in various national markets to implement whatever global reforms are agreed upon will require close cooperation among countries and regulators to achieve the desired convergence and to avoid undue interference with the conduct of cross-border business. However, as we shall discuss, there are some troubling signs that such coordination is not occurring as much as one would like in such key areas as regulation of derivatives, credit rating agencies, short selling and securitizations, and resolution of failing institutions, among others.

In this article, I give an overview of the consensus that has emerged from these reports and discuss some of the issues yet to be resolved. Subsequent articles in this special issue

2 US Government Accountability Office, Report to Congressional Addressees, 'Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System' (January 2009) <http://www.gao.gov/new.items/d09216.pdf> accessed 26 May 2009 (hereinafter 'GAO Report').

3 The de Larosière Group, 'The High-Level Group on Financial Supervisions in the EU' (25 February 2009) <http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf> accessed 26 May 2009 (hereinafter 'de Larosière Report').

4 Financial Services Authority, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (March 2009) <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> accessed 26 May 2009.

5 See, Committee on Capital Markets Regulation, 'The Global Financial Crisis: A Plan for Regulatory Reform' (May 2009) <http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf> accessed 26 May 2009 (hereinafter 'CCMR's Plan for Regulatory Reform'); Committee on Capital Markets Regulation, 'Committee on Capital Markets Regulation Recommendations for Reorganizing the U.S. Financial Regulatory Structure' (14 January 2009) <http://www.capmktsreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf> accessed 26 May 2009.

6 See, The Group of Twenty, 'The Global Plan for Recovery and Reform' (2 April 2009) <http://www.g20.org/Documents/final-communique.pdf> 3, accessed 26 May 2009 (hereinafter 'G20 Global Plan'); Turner Review (n 4) 99; de Larosière (n 3) 47; G20 (n 5) 3.

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examine in more detail some of the key proposals and critical decisions that will have to be made in implementing regulatory reforms.

1. The emerging consensus on the causes of the current market crisis

There seems to be a growing consensus that the following contributed to the current crisis.[7] First, an unusual convergence of macro-economic conditions: significant trade imbalances, in particular between China and the oil exporting countries and the USA and the EU; extremely high liquidity and low interest rates. Second, market participants came to believe that an increasing technical sophistication fundamentally reduced market risk. Coupled with a period of market euphoria, a prevailing mindset emerged that encouraged credit and asset inflation, notably in housing, which led to a significant increase in the aggregate mortgage debt outstanding even though there was only a marginal increase in the number of households. Third, the existing national regulatory architectures lacked the ability to oversee and react to these developments and had a series of gaps in connection with the regulation of financial institutions. Notably, regulatory gaps permitted the expansion of entities functioning as shadow banks, financial entities performing bank-like economic functions but that existed outside the reach of bank regulators. The entities held assets that became equivalent to those held within regulated entities, but, in many cases, with higher leveraged coupled with a reliance on short-term funding. Furthermore, national regulators and regulatory regimes were poorly coordinated, preventing regulators from properly supervising cross-border financial institutions. Fourth, in the opinion of many, the prudential rules governing markets were flawed, particularly with respect to capital and liquidity. Notably, while Basel II was a good example of international cooperation and an improvement on Basel I, it has large elements of pro-cyclicality in its approach to capital adequacy computations.[8] Fifth, a belief that the markets were efficient and would discipline key players, resulting in a self-correction of any excesses. What was not appreciated was the overriding influence of the herd instinct in an ebullient market producing exceptional returns for some. Sixth, an over-reliance on rating agencies, both by investors and regulators, especially with respect to structured products developed in connection with the securitization of mortgages, student loans and credit cards, and in particular collateralized debt obligations. Investors especially accepted and relied on investment grade ratings of structured products without appreciating the complexities of the instruments purchased

7 See, 'Delivering intensive supervision and credible deterrence', Speech by Hector Sants, Chief Executive, Financial Services Authority, The Reuters Newsmaker event (12 March 2009) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml> accessed 26 May 2009; Bradley Gans, 'Regulatory Implications of the Global Financial Crisis' Working Paper Series No. 102, Goethe University Institute of Law & Finance (28 April 2009) <http://www.ilf-frankfurt.de/uploads/media/ILF_WP_102.pdf> accessed 26 May 2009; Turner (n 4) 11–47; de Larosière (n 3) 7–12; GAO (n 2) 16–47.

8 Pro-cyclicality refers to regulatory requirements or standards that amplify the effects of an underlying business cycle, increasing gains in good markets but exacerbating losses in down markets.

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or the risks involved. Ultimately, no one performed the necessary due diligence on these products. Similarly, to the extent that financial institutions retained some of the risks involved in the creation of these complex products (eg, by holding the super senior tranche of collateralized debt obligations), there was a failure of oversight by both regulators and boards of directors with respect to assessing the adequacy of the risk models being used by management to assess exposure to these products. Furthermore, the packaging and repackaging of assets and asset-backed securities magnified the affects of underlying market movements, as exemplified by the rapid implosion of AAA-rated CDOs as US housing prices fell. Finally, a universal consensus that the compensation structures within financial institutions were flawed and not subject to sufficiently rigorous oversight by boards of directors or compensation committees.

As noted by Turner, among others, these causes contributed to a series of proximate drivers that led to the crisis: significant leverage, too great a dependence by the market on increasingly exotic forms of securitization coupled with short-term wholesale funding, a collective underestimation of risk and a willingness by some investors, including financial institutions, to take excessive risk in the search for yield in a low interest rate environment.

2. Proposed regulatory reforms

Effective regulation of institutions, instruments and markets that are systemically important is the key policy objective identified by the G20 Statement in London.[9] Some regulatory initiatives will touch on more than one area. For example, regulation of derivatives will involve regulatory changes that will affect both the instruments themselves and how they clear and settle in the market. Others will focus principally on markets. In this section, I first discuss the market issues and then address the issues in which the two are intertwined.

Reform of market regulations

Short selling, which is thought by many to have contributed to the instability surrounding many financial institutions, has been the focus of many regulators around the world. Confidence in a financial institution as a counterparty and as a holder of cash and securities is critical, and sudden and precipitous declines in market prices of an institution's outstanding securities can cause customers to withdraw cash or refuse to deal with the institution as a counterparty because of the fear of insolvency. Often, the sudden declines in stock prices of financial institutions were accompanied by significant short selling, including naked short selling, which was seen to exacerbate volatility and which led to calls by leaders of those institutions, among others, to ban or curb

9 See, G20 (n 5) 3.

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the practice. In addition, there were allegations that short sellers also spread false rumours in the market, which contributed to the decline in stock prices.

Initially, some regulators simply banned short selling with respect to equity securities of financial institutions.[10] Some commentators felt that this was an overreaction. Notably, when an International Organization of Securities Commissions (IOSCO) task force considered the issue of appropriate short selling regulation, it did not call for a ban on short selling. Rather it announced four key principles to guide the regulation of short selling activities: controls should be implemented to reduce or minimize the potential adverse affects on the orderly and efficient functioning and stability of financial markets; a reporting regime should provide timely information to the market or market regulators; an effective compliance and enforcement system should be developed; and appropriate exceptions should be allowed for certain types of transactions to promote efficient market functionality and development.[11] The US Securities and Exchange Commission (SEC), which has been under pressure to review its regulation of short selling in general and, in particular, to reinstitute the uptick rule or a comparable rule to slow the decline in prices to which short selling can contribute, recently issued short sale rules for comment.[12] Other regulators have mandated disclosure of short positions in excess of a small amount—in the UK, 0.25 per cent of issued and outstanding shares—in order to alert both regulators and market participants and allow greater scrutiny of the activities of short sellers.[13]

Regulators attempting to regulate short selling will have to decide whether to regulate short selling generally or only with respect to financial institutions. If the latter, identifying the institutions whose securities would be covered by short selling restrictions will be critical. In addition, regulators will have to decide whether regulation should apply only to shares of securities or also apply to derivative contracts that can create a synthetic short position in a security. In addressing these issues, regulators must bear in mind

10 In the USA, both naked and covered short selling was temporarily banned and disclosure of short positions in excess of 0.25 per cent was mandated. Securities and Exchange Commission, Press Release, 'SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets' (19 September 2008) <http://www.sec.gov/news/press/2008/2008-211.htm> accessed 26 May 2009. Similarly, the UK banned net short positions and required similar disclosure. Financial Services Authority, 'FSA Statement on Short Positions in Financial Stocks' (18 September 2008) <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml> accessed 26 May 2009. Twenty-three other countries, including France, Germany, Ireland, Italy, Korea, Japan, Luxembourg, the Netherlands, Russia and Switzerland, imposed restrictions or prohibitions on short selling.

11 Technical Committee of the International Organization of Securities Commissions, *Hedge Funds Oversight Consultation Report, OICU-IOSCO* 7 (March 2009) <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf> accessed 26 May 2009.

12 In general terms, the uptick rule permitted short sales to be executed only (i) at a price higher than the last quoted price or (ii) at the last quoted price if such price was higher than the immediately prior price. The uptick rule was repealed in 2007 by regulation SHO and Rule 10a-1 (8 April 2009) <http://www.sec.gov/rules/final/2007/34-55970.pdf>. On 26 May 2009, the SEC published for comment proposed rules reimplementing the uptick or similar rule. Securities and Exchange Commission, 'SEC Seeks Comments on Short Sale Price Test and Circuit Breaker Restrictions' (8 April 2009) <http://www.sec.gov/news/press/2009/2009-76.htm> accessed 26 May 2009.

13 See, Financial Services Authority, Press Release, 'Financial Services Authority statement on short positions in financial stocks' (18 September 2008) <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml> accessed 26 May 2009; Financial Services Authority Short Selling (no. 2) Instrument 2008 <http://www.fsa.gov.uk/pubs/handbook/instrument2_2008_50.pdf> accessed 26 May 2009.

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the significant support for the role of short selling in making markets efficient and that IOSCO has not endorsed a short selling prohibition.[14]

Derivatives and the derivatives market

Almost all commentators agree that the derivatives market must be regulated, especially the market for credit default swaps, whose volume exploded recently and that is principally an over-the-counter market (as opposed to an exchange traded one). Indeed, it was direct exposure to credit default swap counter parties, without a clearinghouse interposed as an intermediary, that caused the Board of Governors of the Federal Reserve System (FRB) to decide that it must intervene to prevent American International Group, Inc. (AIG) from defaulting when its ratings were downgraded. Without a central counterparty, like a clearinghouse, AIG's default would have caused billions of losses at its counterparties.

There is strong consensus around the regulation of both the structure of the derivatives market and the instruments themselves. First, wherever possible, central clearing counterparties should be interposed between end users to reduce systemic risk. Second, limits should be placed on either the types of instruments permitted or to whom they can be sold. Third, there should be increased transparency of outstanding positions.[15]

There is a growing view that requiring market participants to use central clearing parties will enhance the liquidity in and transparency of derivative markets and that such clearing parties will reduce risk by managing the collateral requirements of, and the netting of position among, clearing members.[16] Central clearing requires standardization of contracts; however, a not insignificant percentage of the over-the-counter derivative contracts are bespoke, though the estimates of percentages vary.[17] Thus, the role of bespoke derivative contracts, their regulatory treatment and whether bespoke contracts can be cleared through a clearing entity must be addressed. If bespoke contracts cannot be centrally cleared, regulators should consider whether counterparties should have increased capital requirements to address the systemic risk that bespoke contracts directly between counterparties pose. Moreover, if each market creates clearing entities, regulators in markets other than that where the clearing entity is located must consider whether to allow transactions with counterparties in their jurisdiction that are not cleared by clearing entities subject to their jurisdiction. The EU has announced that it will require use of a European clearing entity with respect to all derivatives that reference an EU-incorporated

14 See Securities Exchange Act Release No. 29278 (7 June 1991), 56 FR 27289 (13 June 1991); E Boehmer and J Wu (Julie), 'Short Selling and the Informational Efficiency of Prices' (8 January 2009) <http://ssrn.com/abstract=972620> accessed 26 May 2009). See also, Securities and Exchange Commission, Amendments to Regulation SHO: Proposed Rule, Release No. 34-59748, 17 CFR Part 242, 9.

15 Turner (n 4) 82; de Larosiere (n 3) 94; G20, *Declaration on Strengthening the Financial System* (2 April 2009) <http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf> 3, accessed 26 May 2009 (hereinafter 'G20 Declaration').

16 See, IOSCO Consultation Report, *Unregulated Financial Markets and Products* (May 2009) <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD290.pdf> 27, accessed 26 May 2009.

17 Current efforts to clear Credit Default Swap (CDS) contracts focus on index CDS and, eventually, standardized single name CDS. It is unclear whether all CDS can be sufficiently standardized to enable clearing.

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entity and that are offered to counterparties in the EU.[18] The USA seems intent on allowing multiple clearing entities to compete irrespective of the place of incorporation of the referenced entity.[19] It would perhaps be more sensible if one or two international clearing facilities subject to appropriate oversight were established, with interconnection to permit enhanced netting.[20]

Unfortunately, the regulatory debate in some jurisdictions is being fuelled by the perception that many derivative contracts are simply gambling contracts, because neither counterparty is required to have an interest in the underlying instrument to which the derivative relates. Indeed, there are some proposals in the USA that would treat credit derivatives as insurance contracts and require that any purchaser of protection have an exposure to the underlying instrument to which the derivative relates.[21] Such proposals ignore the key role that credit derivatives play in risk management and as an alternative to trading in the underlying instruments.

Another aspect of regulating derivatives in the USA is a call, by Secretary Geithner, among others, to revisit the reforms implemented by the Commodities Futures Modernization Act of 2000 (CFMA).[22] Prior to the passage of the CFMA, it was unclear

18 In his address to the European Parliament's Committee on Economic and Monetary Affairs, Commissioner Charlie McCreevy urged the EP to adopt rules requiring the use of a European clearing house for certain CDS trades. See, Charlie McCreevy, 'Address by Commissioner Charlie McCreevy at the EP Committee on Economic and Monetary Affairs' (3 February 2009) <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/34&format=HTML&aged=0&language=EN&guiLanguage=en> accessed 26 May 2009. Subsequently, the CDS dealers voluntarily committed to clearing these CDS trades in a European clearinghouse, a proposal that Commissioner McCreevy found acceptable. See, Letter to Commissioner Charlie McCreevy, dated 17 February 2009, regarding 'Industry commitment to the European Commission regarding Central Counterparty Clearing of Credit Default Swaps in Europe' <http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2009_02_17_isda_letter_en.pdf> accessed 26 May 2009; Press Release, 'Commissioner Charlie McCreevy welcomes Industry Commitment to EU Central Counterparty for CDS' MEMO/09/77 (19 February 2009) <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/77&format=HTML&aged=0&language=EN&guiLanguage=en> accessed 26 May 2009.

19 Federal Reserve Board Press Release, 4 March 2009, announcing its approval of the application by ICE US Trust LLC, New York, to become a member of the Federal Reserve System <http://www.federalreserve.gov/newsevents/press/orders/20090304a.htm> accessed 26 May 2009; Chicago SEC Order granting temporary exemptions under the Securities Exchange Act of 1934 in connection with request of Chicago Mercantile Exchange Inc. and Citadel investment Group, LLC. related to central clearing of credit default swaps, and request for comments (13 March 2009) <http://www.sec.gov/rules/exorders/2009/34-59578.pdf> accessed 26 May 2009.

20 See, CCMR's Plan for Regulatory Reform:

> We also believe that the establishment of one or two international clearing facilities subject to vigorous oversight would be the most effective means of reducing systemic risk on a global basis. We thus encourage US, EU, and other national policymakers to work toward this common goal. Policymakers should consider whether there could be beneficial interactions between these global clearinghouses that would allow for even further netting.

21 See, Executive (EX) Committee, National Association of Insurance Commissioners, Final Recommendations (2 December 2008) <http://www.naic.org/documents/committees_ex_credit_default_swap_wg_final_recommendations.pdf> accessed 26 May 2009 (considering whether 'covered' CDS should be regulated as insurance but recommending no further action in this respect based on the SEC's announcement of planned regulations). See also Superintendent Eric Dinallo, New York State Insurance Department, Testimony to the US House of Representatives Committee on Oversight and Government Reform: Hearing on 'The Causes and Effects of the AIG Bailout' (7 October 2009) <http://oversight.house.gov/documents/20081007100906.pdf> accessed 26 May 2009.

22 Pub. L. No. 106-554 114 Stat. 2763 (2000) (codified as amended in scattered sections of 7 U.S.C.). As Secretary Geithner stated in Congressional testimony,

> In our proposed regulatory system, the government will regulate the markets for credit default swaps and over-the-counter derivatives for the first time. We will subject all dealers in OTC derivative markets and any other firms whose activities in those markets pose a systemic threat to a strong regulatory and supervisory regime as systemically important firms. We will force all standardized OTC derivative contracts to be cleared through appropriately designed central counterparties (CCPs). We will also encourage greater use of exchange-traded instruments.

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whether newly developed derivatives were subject to the oversight of the Commodity Futures Trading Commission (CFTC) or other regulators. The CFMA resolved the question, exempting from significant regulation a broad range of over-the-counter derivatives entered into by sophisticated parties.[23] The challenge in revisiting the CFMA reforms will be determining who the regulator should be for derivatives, the SEC, the CFTC or both. If both, determining how to draw distinctions among various derivatives will be crucially important, as will the apportionment of regulatory oversight.

Finally, many, including the author, believe that there should be greater transparency in the derivatives market. In this vein, some advocate requiring a holder of a derivative position to report the position to the same extent they would be required to report holding the underlying instruments to which the derivative relates.[24] For example, if an equity total return swap references an amount of securities in excess of the amount that would have to be reported if the reference securities were physically owned, the positions should be reported to the company and the market, even if cash settled.

Securitization and asset-backed securities

There is a continuing debate around ways to revise and improve the regulation of the origination and sale of asset-backed securities, in particular mortgage-backed securities, to better align the interests of originators and investors.[25] The concern is that origination standards declined dramatically because the originate-to-distribute model resulted in intermediaries not overseeing effectively the standards applied to creating products that they purchased solely for resale. While originators of the products sold for securitization may have made representations to distributors, intermediaries had no incentive to assure that origination standards did not deteriorate since they did not intend to hold the mortgages in their own portfolio. Consequently, intermediaries did not conduct sufficient due diligence to assess the accuracy of originator representations or the quality of the product resold, lulled, perhaps, into complacency by the rising real estate market. Thus, some have proposed that originators retain an interest in tranches sold to investors, between 5 and 10 per cent, to provide incentives for them

See, US Treasury Secretary Geithner, Written Testimony Submitted to the House of Representatives Financial Services Committee, 26 March 2009 (hereinafter 'Geithner's March 2009 Testimony'). See, also, the Levin–Collins Bill, introduced on 4 May 2009 (repealing statutory prohibitions that currently bar government regulation of swap markets) <http://levin.senate.gov/newsroom/supporting/2009/Levin-Collins.swaps.050409.pdf> accessed 26 May 2009; Press Release, 'Levin–Collins Bill Would Allow Immediate Regulation of Swap Agreements, including Credit Default Swaps' (4 May 2009) <http://levin.senate.gov/newsroom/release.cfm?id=312437> accessed 26 May 2009.

23 Edward F Greene *et al.*, *US Regulation of the International Securities and Derivatives Markets* (9th ed., New York, 2008) Section 1.08.

24 This was also an issue in the CSX Corporation (CSX) litigation, where the court found that the 'long' party in a total return swap referencing a publicly traded security was a beneficial owner of the reference shares for purposes of Section 13(d) of the Securities Exchange Act of 1934, implying that such parties may have to disclose such positions. See, eg, Edward G Eisert, Lorraine Massaro and Anthony RG Nolan, 'CSX Ruling Creates Reporting Uncertainty for Equity Derivatives Market' (20 June 2008) <http://www.klgates.com/newsstand/Detail.aspx?publication=4642> accessed 26 May 2009.

25 See, de Larosière (n 3) 18; G30 (n 1) 48; Turner (n 4) 36–7.

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to reduce risk.[26] These proposals typically also include rigorous licensing requirements for originators of mortgages (in the USA, at either the state or federal level) as well as the development of stronger originator representations and warranties, and enhanced disclosure of an originator's interest in securitized offerings.[27]

Notwithstanding the concerns about securitization and shadow banking, global capital-raising markets, both public and private, functioned well in general. There has been convergence on disclosure and accounting standards generally, including with respect to distributions and ongoing reporting requirements, and there has been no call for substantial modification. There has been some concern about complex products, especially asset-backed securities and collateralized debt obligations. The debate will be whether enhanced disclosure is the remedy or whether there should be limitations on the types of products that can be sold or the investors to whom they can be sold. Some accounting standards have been criticized, such as the 'fair value' and 'mark to market' standards, as procyclical.[28] However, disclosure and accounting standards for publicly held companies generally appear to be adequate and need not be the subject of increased or different regulation at this time.

3. Regulation of financial companies

With regard to financial company regulation, reformers have had to address two major issues. First, which of the financial companies not subject to regulation should be regulated going forward? Second, how do we improve the regulatory structure, both nationally and globally, for financial institutions already subject to regulation?

Bringing more financial companies under the regulatory umbrella

With respect to the first question, there seems to be a growing consensus that hedge funds be regulated in some capacity, though there has not been much specificity to date as to the parameters of such regulation.[29] There is less consensus as to whether private equity funds should also be regulated and, if so, how the regulatory approach should be similar to or different from that for hedge funds.[30]

An approach put forward by the G30 for hedge funds (which would likely be effective for private equity funds, too) is to have the advisers registered and licensed in the jurisdiction in which they, as opposed to their funds, reside (since many of the funds are incorporated in tax havens such as the Cayman Islands).[31] Information about funds and advisers would be available not only to the regulator of the adviser but also to a systemic

26 Securities Industry and Financial Markets Association, Regulatory Reform Agenda (January 2009) 6. On 29 April 2009 EU states approved rules that will force banks to retain 5 per cent of securitized products they originate and sell <http://uk.news.yahoo.com/22/20090429/tbs-uk-eu-banks-capital-sb-03c9bed.html> accessed 26 May 2009.

27 While the CCMR supports the strengthening of the licensing, disclosure and general obligations for originators of these mortgage products, they are wary of mandating risk retention for all securitizations. See CCMR's Plan for Regulatory Reform (n 5) ES-21.

28 See generally Section 2.2 of the Turner Review (n 4).

29 G30 (n 1) 30; de Larosière (n 3) 23–5; Turner (n 4) 72–3.

30 G30 (n 1) 30, 59; de Larosière (n 3) 24; CCMR's Plan for Regulatory Reform (n 5) ES-12.

31 See also G30 (n 1) 30 (endorsing such an approach).

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regulator (if there is one) overseeing macro-economic developments in the market. Such information would be confidential and would pertain to the fund's liquidity needs, leverage, risk concentrations and possibly counterparties, among other matters. There have been suggestions that, if any particular hedge fund were deemed to be systemically significant because of the size of its positions or leverage, or reliance on short-term funding, a systemic regulator should be able to set limits on its portfolio, leverage or market exposure. Secretary Geithner has proposed that hedge funds disclose their investors and counterparties on a confidential basis to enable regulators to better determine risks.[32] Such information would be shared with a systemic regulator, if one exists. The European Commission has proposed a Directive on Alternative Investment Fund Managers (AIFM) that would create a comprehensive supervisory framework for the registration, regulation and organization of both hedge funds and private equity funds throughout the EU that would not only monitor and mitigate risk but also protect investors and address the cross-border issues that these funds create.[33]

Hedge funds will not want to disclose to the market the identity of their investors nor their trading positions, leverage or strategy in connection with any regulatory regime to which they are subject. In addition, hedge funds would be concerned if there were any attempt to limit the types of investors to whom they could sell interests or the types of investments they could make. However, most hedge fund investors have been sophisticated and there have been few complaints directed at the nature of the investors. Rather, most concern has been addressed to the opaqueness of both their positions and activity, a sense that their short selling activity (in both the cash and derivatives markets) has contributed to the volatility in the prices of stocks of financial institutions, and that their size and interconnectivity to other market participants could raise systemic risk issues.

There has been agreement that the shadow banking systems that emerged in key markets, such as the USA and the EU, must come under the umbrella of regulation. However, there has not been specificity as to which activities are thought to be part of the shadow banking system and how regulation should apply.

One area of concern has been pools of capital that are considered by investors to be equivalent in terms of return and safety to insured deposits, such as money market funds in the USA.[34] Indeed, money market mutual funds could be seen as part of the shadow banking system that emerged in the USA, because depositors treated

32 See Geithner's March 2009 Testimony (n 22).

33 Commission of the European Committees, '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' (4 April 2009) <http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf> accessed 26 May 2009. Although the AIFM does offer extensive regulatory and disclosure requirements, the directive contains duplicative regulations which conflict with legislation currently in place. A lack of specificity in transitional provisions and definitions, as well as a lack of differentiation between requirements tailored to hedge funds and those applicable to private equity funds, create significant challenges in implementing this reform. See, Cleary Gottlieb Steen & Hamilton LLP, 'Alert Memo: European Commission Proposes New Regulatory System for Hedge Funds and Private Equity Funds' (12 May 2009) <http://www.cgsh.com/european_commission_proposes_new_regulatory_system_for_hedge_funds_and_private_equity_funds> accessed 26 May 2009.

34 See Geithner's March 2009 Testimony (n 22).

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the funds as equivalent to insured certificates of deposits; when the funds eventually 'broke the buck',[35] the Federal Deposit Insurance Corporation (FDIC) was forced to ensure investors' contributions and the FRB pumped billions into the funds to keep them afloat.[36] Citing the failures in the seemingly stable money market fund sector after the Lehman Brothers bankruptcy as an example, Secretary Geithner called upon the SEC to implement regulatory reforms reducing the credit and liquidity risk of money market mutual funds, though he did not specify the nature of such reforms.[37] Similarly, the Group of 30 Report views money market mutual funds as particularly volatile entities, due to the absence of capital reserves, supervision and a safety net as well as their bank-like maturity transformation function (ie incurring short-term, deposit-like liabilities and purchasing longer-term assets).[38] They recommend that these funds reorganize as special-purpose banks, entitling them to borrow from the lender of last resort while subjecting them to comprehensive regulatory oversight. Focusing on the regulation of money market funds may lead to an overall review of the mutual fund industry in the USA and perhaps collective investment trusts in Europe.[39]

Another area of the shadow banking system, special investment vehicles (SIVs), also raises concerns.[40] These vehicles funded the purchase of long-term assets, such as collateralized debt obligations or asset-backed securities, through short-term funding in the wholesale market, primarily through the issuance of commercial paper. They were often sponsored by banks looking for off-balance entities that could purchase long-term assets from them. Like money market mutual funds, SIVs, too, were bank-like in their maturity transformation, incurring short-term liabilities and purchasing longer-term assets. However, their counterpart to short-term deposits, commercial paper, was not insured and often the back up liquidity lines furnished by the sponsors either were inadequate to finance their long-term assets if the commercial paper could not be rolled over or, when activated, required the sponsoring bank to bring the assets and accompanying liabilities onto their balance sheets, creating pressure on capital adequacy requirements.

Another form of maturity transformation in the USA, considered to be part of the shadow banking system, is the auction rate securities (ARS) market. Here, issuers of long-term obligations relied on periodic monthly (or more frequent) auctions to reset interest rates in order to provide borrowers with lower financing costs. Intermediaries distributing ARSs committed to conduct the auctions and often stepped in to prevent

35 Typically money market mutual funds were marketed to investors as always being redeemable at par. The term 'broke the buck' means that the value of a redemption would be for less than par.

36 US Department of the 'Treasury, Treasury Announces Guaranty Program for Money Market Funds' (Washington, 19 September 2009) <http://www.treas.gov/press/releases/hp1147.htm> accessed 26 May 2009. See also, Federal Reserve Bank of New York, 'Money Market Investment Funding Facility at the Federal Reserve Bank of New York' <http://www.newyorkfed.org/markets/mmiff.html> accessed 26 May 2009.

37 See Geithner's March 2009 Testimony (n 22).

38 See G30 (n 1) 29.

39 See CCMR's Plan for Regulatory Reform (n 5) ES-15, 105.

40 The SIV market has changed dramatically as a result of the credit crisis; many SIVs have defaulted and either been liquidated or taken on-balance sheet by their sponsor banks.

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them from failing. Investors tended to treat the purchase of an ARS as comparable to short-term or money market obligations because they were assured that they could always liquidate their positions in an auction and that auctions had never failed in the past. However, as was disclosed, if the auction did fail, investors would be compelled to hold the security until maturity at a failed rate, which was often lower than market. There was no commitment built into the ARS structure to provide an exit for investors if auctions failed. As market conditions worsened and the demand in ARS auctions weakened, certain intermediaries bought ARS in the auctions to prevent them from failing. However, purchasing ARS meant taking the securities onto their balance sheets, putting pressure on capital adequacy. Eventually, the intermediaries stopped buying in the auctions and let them fail, forcing investors to hold the failed ARS to maturity, with, in many cases, interest rates at below market.

It is not clear how the activities of the shadow banking system should be regulated. Regulators need to consider the role and adequacy of disclosure, recognizing that enhanced disclosure may not be sufficient. Additional safeguards, such as liquidity backups provided by shadow bank sponsors, may be necessary because the market cannot tolerate the risks that disclosure warns about and that some investors are willing to take. Most of SIV and ARS prospectuses warned about the consequences of failed funding, but investors treated those risks as remote because of the buoyancy of the market. And while investors in SIVs were predominantly institutional, there were a significant number of retail investors who purchased ARSs. The SEC required key sponsors to purchase at par ARSs held by individual investors in recognition either that the disclosure was insufficiently robust with respect to investments sold on a retail basis or that the ARSs were unsuitable for many retail investors, especially when marketed as alternatives to more regulated investments such as certificates of deposit.[41]

Another aspect of the shadow banking system is the practice of booking derivatives in unregulated entities, relying on the fact that often derivatives are not considered securities. In a functional regulatory system, where function rather than activity is regulated, the exposure and leverage of such non-regulated positions can create significant market risk, as the experience of AIG demonstrates. Here, the question is whether the combination of greater transparency with respect to derivative positions plus a prudential regulator's ability to intervene with respect to systemically significant financial institutions will be sufficient or whether all derivative positions should be on the balance sheets of regulated entities.

There is also a broad consensus that rating agencies must be regulated. Indeed, regulation is under active consideration in the EU, the USA, Australia and Japan among other markets.[42] The focus of such reforms, as currently contemplated, is on conflicts of

41 See, Securities and Exchange Commission, Press Release, 'Citigroup Agrees in Principle to Auction Rate Securities Settlement' (7 August 2008) <http://www.sec.gov/news/press/2008/2008-168.htm> 26 May 2009.

42 See, eg, Commission of the European Communities, Brussels, 12 November 2008, Com (2008) 704 final, 'Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies' <http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf> accessed 26 May 2009; Turner (n 4) 78; Minister for Superannuation & Corporate Law,

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interest, disclosure of rating models and the rating history of the instruments rated, and agency governance. However, several other questions must also be addressed. First, if there is separate regulation in key markets, will it be coordinated, and if not, what will be the guidelines for cross border sales of rated instruments? It is clearly preferable that uniform standards and regulations be applied globally by separate national regulators. Second, should the regulators oversee the modelling used by the rating agencies or depend on disclosure to market participants? Third, what due diligence, if any, should rating agencies conduct with respect to information about issuers or instruments they consider when determining the rating? Fourth, what is the best way for rating agencies to communicate to the market how the ratings of complex products differ from those of simpler products, such as corporate debt? Fifth, should rating agencies be permitted to conduct an advisory business in addition to their rating agency business or is that an unmanageable conflict? Sixth, can one create a business model such that the investor rather than the issuer pays for the ratings? And finally, how much reliance should regulators place on ratings and the methodologies employed to determine either compliance with capital adequacy standards or granting more rapid access to the capital markets (which is the case in the USA for investment grade issuers). There is currently no consensus with respect to these issues.

Improving the regulation of financial institutions

The regulation of traditional financial institutions themselves is the most difficult challenge facing regulators. Again, there are common themes throughout all the reports and the statements by the G20.[43] First, regulation must be by national regulators, implementing agreed global standards in the context of enhanced cooperation. Second, regulation must be of activity, not of function, and should be seamless. That is to say, activities by broker dealers, commercial banks, investment banks, insurance companies and hedge and private equity funds overlap; to regulate by entity rather than activity precludes assessment of the potential impact of that combined activity on the overall market. Third, gaps in the regulatory structure should be eliminated, particularly those that allow excessive risks to build up in unregulated entities. Fourth, excess leverage should be prevented from accumulating on financial institution balance sheets by, for example, imposing gross leverage limits.[44] Fifth, there must be a regulator in place in each market responsible for overseeing macro-economic developments and systemic risk with a mandate to communicate early warning signals to the appropriate regulators. Finally, there must be cooperation among regulators globally with respect to regulatory

Media Release No. 077, 'Improved Australian Controls for Credit Rating Agencies and Research Houses' (13 November 2008) <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/077.htm&pageID=003&min=njs&Year=&DocType=> accessed 26 May 2009; Securities and Exchange Commission, Press Release, 'SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies' <http://www.sec.gov/news/press/2008/2008-284.htm> accessed 3 December 2008; Financial Services Agency, 'Report by the First Subcommittee of the Sectional Committee on Financial System of the Financial System Council: Toward Building Reliable and Vibrant Markets' (17 December 2008) <http://www.fsa.go.jp/en/news/2008/200811217-1.html> accessed 26 May 2009; de Larosière (n 3) 19; G20 Declaration (n 15) 6; GAO (n 2) 32.

43 Turner (n 4) 51; de Larosière (n 3) 15; G20 Declaration (n 15).

44 Turner Review (n 4) Section 2.2(vi).

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approaches, enforcement and winding up of failing institutions. It is easy to agree to principles such as these on a broad basis. However, the devil will be in the details and some significant issues must be addressed.

Secretary Geithner, the de Larosière Group and the CCMR, among other commentators, have called for a systemic risk regulator.[45] Secretary Geithner, in his Congressional testimony, called for a single regulator with the authority to supervise all systemically important financial firms (including hedge funds, private equity and other pools of capital if they are big or interconnected enough) and critical payment and settlement systems. The Committee on Capital Markets also endorsed a single regulator in the form of a newly created US Financial Services Authority, which would be granted full resolution powers pursuant to a Financial Company Resolution Act applicable to all financial companies. The CCMR advocates subjecting all financial company resolutions to a 'least cost' test except when a company's insolvency would pose a systemic risk, as identified by the relevant regulators. In these cases, regulators would be granted enhanced powers to resolve the troubled company.[46] The de Larosière Report proposed the creation of a new body called the European Systemic Risk Council (ESRC), which would replace the current Banking Supervision Committee of the European Central Bank (ECB), to oversee systemic risk in the EU market.[47] National regulators would maintain their current responsibilities, but the ESRC would be privy to extensive information from these entities necessary to predict risk and issue opinions and policy recommendations from a macro-prudential vantage point. The European Commission adopted a Communication on Financial Supervision in Europe endorsing the Larosière proposal and outlining a set of reforms, including the creation of the ESRC to be up and running during 2010.[48]

The first issue in implementing either such an approach is definitional: how do we define systemic risk and identify those institutions that pose it? Secretary Geithner acknowledged the issue in his Congressional testimony. While he did not provide any such definition, he did say that one would have to take into account a financial institution's interdependence with other firms; its size, leverage and reliance on short-term funding and its importance as a source of credit to, for example, consumers.[49]

45 See Eric S Rosengren, President & Chief Executive Officer, Federal Reserve Bank of Boston, 'Could a Systemic Regulator Have Seen the Current Crisis?', Speech at the 10th Seoul International Financial Forum, Seoul, Korea (15 April 2009) <http://www.bos.frb.org/news/speeches/rosengren/2009/041509.pdf> accessed 26 May 2009 (proposing a framework for how monitoring systemic risk).

46 See, CCMR's Plan for Regulatory Reform (n 5) ES-18.

47 de Larosière (n 3) 44.

48 See Europa, Press Release, 'Financial services: Commission proposes stronger financial supervision in Europe' (Brussels, 27 May 2009) <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/836&format=HTML&aged=0&language=EN&guiLanguage=en> accessed 26 May 2009.

49 CCMR defines systemic risk as follows:

> Systemic risk is the risk of collapse of an entire system or entire market, exacerbated by links and interdependencies, where the failure of a single entity or cluster of entities can cause a cascading failure. We recognize that there are at least five key externalities particular to financial markets that contribute to systemic risk. First, the spread of speculative information through the market can create the perception that economic difficulties impacting one financial institution will affect similarly situated firms. Second, customers of failed institutions may subsequently find themselves in a less friendly market when looking to re-direct their business. Third, there is considerable inter-connectedness between the financial institutions participating in modern financial markets, so that the failure of one firm can affect many others. Fourth, a negative spiral may

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However, consideration must be given to whether identifying institutions as potentially posing systemic risk raises issues of moral hazard. That is, would such an identification be a signal to the institutions, the markets and counterparties that they will be considered too big to be allowed to fail and thus must be rescued if they teeter on insolvency? Geithner acknowledged this issue but suggested that any negative effects could be neutralized by more rigorous capital requirements and leverage restrictions.[50] Furthermore, in the Treasury's proposed resolution authority for systemically significant financial companies, the determination of whether a particular financial company is systemically significant would be made *ad hoc*, in consideration of the particular circumstances and company involved.[51]

The second key issue is who the systemic risk regulator should be—an already existing regulator or a newly created one. Furthermore, should the systemic risk regulator be independent or report to the executive branch in the national market? In the EU, the call has been for the creation of the ESRC, a newly created regulator reporting to the ECB who would 'form judgements and make recommendations on macro-prudential policy, issue risk warnings, compare observations on macro-economic and prudential developments and give direction' on such issues.[52] In the USA, the debate will be whether the systemic risk regulator should be the FRB or a newly created entity, perhaps one reporting to or coordinated by an enhanced President's Working Group.[53]

The third key issue is the scope of a systemic risk regulator's powers and its relationship to other regulators. Should its role be more of a coordinating function, overseeing existing regulators, with the power to resolve conflicts or to override with respect to requirements and restrictions for systemically significant financial institutions? Should it be responsible for creating reporting and information gathering systems that will ensure that it and other authorities are able to identify and take account of macro-prudential risks across the financial system? Should it have direct supervisory power over all financial institutions, but rely on existing regulators to carry out day-to-day supervision? Should it have supervisory power only over systemically significant financial institutions however identified or defined? Answers to these questions are

be created by falling asset prices and resulting liquidity constrictions. Fifth, falling asset prices and liquidity crises could cause institutions to become reluctant to extend credit.

See, CCMR's Plan for Regulatory Reform (n 5) ES-3.

50 See Geithner's March 2009 Testimony (n 22).

51 See, *Draft of 'Resolution Authority for Systemically Significant Financial Companies Act of 2009'*, Section 2(b)(1) <http://www.ustreas.gov/press/releases/reports/032509%20legislation.pdf> accessed 26 May 2009.

52 de Larosière (n 3) 44.

53 On 6 May 2009, FDIC Chairman Sheila Bair submitted testimony to the Senate Banking Committee calling for a systemic risk council comprised of the Federal Reserve, US Treasury, FDIC and the SEC, which is essentially a modified version of the President's Working Group. See, John Porier 'FDIC's Bair says U.S. needs systemic risk council' (6 May 2009) <http://www.reuters.com/article/politicsNews/idUSTRE5450UG20090506> accessed 26 May 2009. In the USA, regulators have consistently proposed supervisory groups such as this, but continue to evade a move towards consolidation. The CCMR, however, opposes a council of regulators and calls for the Federal Reserve to increase its current role and be the sole regulator for systemic risk, responsible not only for monitoring risk, but also for implementing and enforcing regulation and capital requirements for all financial institutions. See, CCMR's Plan for Regulatory Reform (n 5) ES-33.

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critical and will in turn clearly define how the existing regulatory structure should be reformed.

The USA is perhaps the most fragmented regulatory market; a number of reform proposals have been put forward. Secretary Geithner called for a single regulator, unidentified as existing or new, which would supervise systemically important financial firms.[54] It would have the power to set capital and risk management standards for covered institutions, likely to be higher than those standards set by other regulators for institutions not under its supervisory power. It would have consolidated supervisory authority over all activities of covered institutions, including the power to implement registration requirements for hedge funds, for example, and have expanded insolvency resolution powers, as reflected in the Treasury's legislative proposal submitted to the Congress.[55]

The Treasury's proposal is a good start, but I suggest the following as possible improvements. First, I would give the systemic regulator authority over all financial institutions and markets in the USA, not just systemically important ones. It would coordinate with relevant functional regulators as well as the President's Working Group. It would have the authority to gather information from, make uniform regulations binding on and act as the lender of last resort to all US financial institutions and markets. It would have greater powers over systemically important financial institutions, including the power to conduct examinations, the power to take prompt corrective action and the power to appoint or act as the receiver or conservator of such institutions. Its powers and duties would also include adopting uniform systemic risk rules with respect to capital, liquidity, collateral and margin requirements, risk management and transparency. It would gather and share information from all financial institutions and share that information, including with international institutions with which it would coordinate.

A US systemic regulator should be the exclusive umbrella supervisor of systemically important financial groups with oversight of all activities conducted by those groups.[56] It would rely on other regulators and coordinate supervision with respect to non-systemically important families of financial companies. It would have the power to promulgate prompt corrective action regulations with respect to any systemically important financial institution or group that becomes undercapitalized or is engaging in an unsafe or unsound practice. It would be the lender of last resort, have the power to provide emergency financial assistance, and to appoint itself or another agency as conservator or receiver of any member of a systemically important financial group.

54 US Dep't of the Treasury, Press Release, 'Treasury Outlines Framework For Regulatory Reform: Provides new Rules of the Road, focuses first on containing systemic risk' (26 March 2009) <https://treas.gov/press/releases/tg72.htm> accessed 26 May 2009. See also, Treasury's proposed legislation, 'Resolution Authority for Systemically Significant Financial Companies Act of 2009' <http://www.ustreas.gov/press/releases/reports/032509%20legislation.pdf> accessed 26 May 2009 (hereinafter 'Treasury's Proposed Resolution Authority for Systematically Significant Financial Companies Act of 2009').

55 See Treasury's Proposed Resolution Authority for Systematically Significant Financial Companies Act of 2009 (n 54).

56 A systemically significant financial group is corporate family that either includes a systemically significant financial company or, on aggregate, is itself systemically significant.

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With respect to enforcement, it could either rely on existing agencies or act itself with respect to these institutions if it were not satisfied as to the action taken or proposed to be taken.

With respect to systemically important financial groups, a key question will be whether to restrict certain activities of those members that operate as universal banks. The Group of 30, for instance, in an effort to reduce conflicts of interest within a financial institution, recommends prohibiting bank sponsorship of hedge funds in which they have an equity interest.[57] Furthermore, the Group of 30 recommends limiting a bank's proprietary trading positions through strict capital and liquidity restrictions.[58] The Turner Review considers separating 'utility' banking from 'investment' banking but it ultimately rejects the idea because of the difficulty of drawing such a distinct line.[59] Rather, Turner notes the inherent risks associated with 'classic' bank loans (as exemplified by the failure of Washington Mutual) and the potential for more complex securitized credit transactions to flourish under more vigorous regulation. Accordingly, Turner advocates improving the regulatory structures governing banks' existing activities.

In the USA, there is a call by some to revisit the restrictions on bank holding company activities removed by the Gramm–Leach–Bliley Act and to reinstate the Glass–Steagall Act.[60] Glass–Steagall was enacted to separate commercial banking from investment banking and the underwriting of securities. The Bank Holding Company Act expanded on the Glass–Steagall regime, requiring that the securities activities of any non-bank subsidiary of a bank holding company (ie any affiliate of a bank that is not itself a bank) be 'closely related' to banking and in the public interest.[61] If limitations are imposed on systemically important financial groups, that activity can be expected to migrate to smaller competing entities, which may be beneficial in creating more competition and alternatives. I think it is impractical to turn back the clock; it is better to be sure the risks of whatever activities financial institutions engage in are adequately capitalized and supervised for risk.[62]

There are alternatives to the Treasury proposal for a systemic regulator, though they are consistent in approach. The Committee on Capital Markets Regulation (CCMR) believes that the USA should have two or, at most, three independent regulatory bodies: the FRB and a newly created US Financial Services Authority (USFSA), with an independent investor/consumer protection agency existing either independently or as part of the USFSA.[63] The single agency approach would allow significant expertise to develop and be applied to new products as they are introduced. Under the CCMR's

57 G30 (n 1) at 28.
58 G30 (n 1) at 28.
59 Turner Review (n 4) at 94–5.
60 Gramm–Leach–Bliley Act, Pub.L. 106-102, 113 Stat. 1338 (codified in Title 15 of the US Code); Glass–Steagall, 73 Pub. L. 66, 48 Stat. 162.
61 12 U.S.C. §1841.
62 The CCMR also recommends refraining from reimposing Glass-Steagall and leaving the Gramm-Leach-Bliley Act as is. See, CCMR's Plan for Regulatory Reform (n 5) ES-31.
63 CCMR's Plan for Regulatory Reform (n 5) ES-32.

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proposal, the FRB would be the lender of last resort and set capital requirements for all financial institutions. The USFSA would consolidate all existing functional regulatory agencies and regulate all aspects of the financial system, including market structure and activities, safety and soundness, and, unless lodged in a third agency, consumer and investor protection. Professor Warren and the Congressional Oversight Panel endorse locating the investor/consumer protection function in a third independent agency to avoid it being overshadowed by other regulatory priorities.[64] Such an agency would focus exclusively on protecting customers from unfair business practices and ensuring that financial product information is comprehensible to the public. There is concern that separating investor/consumer protection regulatory oversight from safety and soundness oversight may result in enforcement insensitive to the costs and consequences to the institutions involved.

With respect to the allocation of supervisory duties, CCMR identifies three options: (i) the FRB supervises 'systemically important' financial institutions and the USFSA all others; (ii) the FRB supervises all institutions or (iii) the USFSA supervises all institutions. While CCMR acknowledges the benefits of consolidated supervision, it does not endorse any option. Unfortunately, while there is agreement that the US regulatory system is fragmented, there is no consensus about how to combine the regulators; while everyone accepts the system is fragmented, no fragment wants to go out of business.

In the EU, the de Larosière Report calls for empowered European-wide Level 3 Committees, such as the Committee of European Securities Regulators (CESR), but the three resulting entities would still be function oriented—banking, securities and insurance—and not activity oriented. Another common proposal is a 'twin peaks' proposal reflecting the regulatory structure in the Netherlands and Australia—that is to have one regulator oversee institutions for safety and soundness and another to oversee markets to protect consumers and investors, both perhaps under the umbrella of the systemic regulator, or with the safety and soundness regulator also the systemic regulator.

In addition to the multitude of other regulatory reforms discussed, there is outrage throughout the world at the compensation paid to key employees of financial institutions and calls for reform of compensation structure and enhanced oversight by the boards of directors. And that outrage has led to proposed legislation, especially in the USA, aimed at clawing back amounts that are thought to be excessive. The Financial Stability Forum (FSF) has articulated principles with respect to compensation, which the G20 has adopted. Specifically, the FSF called on boards of directors to alter compensation policies to reflect both relevant and potential risk and to create more transparency with respect to compensation to enable better supervision of compensation-related risk.[65] In addition, in particular in the USA, there likely will be increased pressure on the SEC and on boards

64 Congressional Oversight Panel, 'Special Report on Regulatory Reform' (January 2009) <http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf> 35, accessed 26 May 2009; Securities Industry and Financial Markets Association (SIFMA), 'Regulatory Reform Agenda', 5 January 2009.

65 See, Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) <http://www.fsforum.org/publications/r_0904b.pdf> accessed 26 May 2009; see also, G20 Declaration (n 15).

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of directors to permit advisory ‘say on pay’ shareholder resolutions to be included in a company’s proxy statement. ‘Say on pay’ advisory votes are not uncommon in other jurisdictions, such as the UK. Although national supervisory groups have issued guidance on compensation plan reform, enforcing the implementation by financial institutions of such guidelines presents a challenge. One innovative and promising solution recently proposed by the EU calls for increased capital requirements for institutions that do not comply with EU compensation guidelines.[66]

4. Coordinating international regulatory efforts

A key aspect of the new regulatory regime will be coordination of regulation of the cross-border activities of systemically important financial groups, especially since regulatory oversight will remain the principal responsibility of the home regulator, and not an international organization such as the Financial Stability Board (FSB) or the International Monetary Fund (IMF). One promising approach is to appoint colleges of supervisors to oversee the activities of national regulators.[67] The FSB has been tasked by the G20 to set guidelines for and support the establishment, functioning of and participation in supervisory colleges, including through ongoing identification of the most systemically important cross-border firms that should be subject to a college of regulators. A particular thorny issue, as demonstrated by the collapse of the Icelandic banking system, is the relationship between home regulator and the regulator in jurisdictions in which branches are established. The risk, of course, is that national regulators, in an effort to protect local markets, will ring-fence the assets of a branch or require foreign banks to operate subsidiaries rather than branches as a way of doing cross-border business. Although 25 colleges of supervisors are currently in place, the challenge will be whether these colleges can adequately address this and other issues and effectively coordinate with each other and newly formed colleges.[68] As FSA Chairman Turner observed, in the absence of a global financial regulatory regime (an unlikely occurrence), national regulators will inevitably lean towards separate, ring-fenced capitalization of local branches.[69] Beyond that, the G20 also want the IMF, The World Bank, the FSB and The Basel Committee on Banking Supervision (BCBS) to develop an international framework for cross-border bank resolution arrangements, which is critical and which will supplement new arrangements to be put in place on the national level (eg, in the USA

66 See, Draft of Legislative Proposal by the European Commission (29 April 2009) <http://ec.europa.eu/internal_market/bank/docs/regcapital/consultation-renumeration_en.pdf> accessed 26 May 2009.

67 A college of supervisors is comprised of national supervisory authorities of major cross-border financial institutions to address risk and regulatory issues on a global level. See, Parliament resolution of 9 October 2008 with recommendations to the Commission on Lamfalussy follow-up: future structure of supervision <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0476+0+DOC+XML+V0//EN#BKMD-15> accessed 26 May 2009.

68 G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets, ‘Final Report’ (March 2009) <http://www.g20.org/Documents/g20_wg2_010409.pdf> 19, accessed 26 May 2009 (hereinafter ‘G20 Working Group 2’); de Larosière, (n 3) 51; Turner (n 4) 97.

69 Adair Turner, Speech, ‘Building a more stable global banking system’, Global Financial Forum (27 April 2009) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0427_at.shtml> accessed 26 May 2009.

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by the legislation proposed by the Treasury).[70] An effective international framework would reduce the pressure on national host regulators to ring fence assets of the branch or subsidiary of a foreign financial institution regulated by its home country with respect to, among other things, capital adequacy.

A subset of regulatory reform will be improving the quality, quantity and international consistency of capital in the banking system, to prevent excessive leverage and to create capital buffers. However, the G20 was clear that reform to capital requirements should only be implemented once global economic recovery is assured, since it is difficult in today's markets for financial institutions to raise additional capital from sources other than governments. The assumption is that Basel II will be revised and then, hopefully, implemented in a more coordinated and timely fashion than the initial version. The de Larosière report noted that a key goal is to have within the EU a consistent approach as to what constitutes Tier 1 capital.[71]

The G20 and the Turner Review have called for improved accounting standards to the extent that they might be pro-cyclical, especially when used to determine capital adequacy.[72] In particular, the G20 called on accounting standard setters to improve standards on valuation and provisioning and to 'achieve a single set of high-quality global accounting standards'.[73] There is some concern that a focus on accounting standards rather than the regulators runs the risk of politicizing the standards' setting process. Indeed, in response to Congressional pressure, the Financial Accounting Standards Board (FASB) issued guidance on mark-to-market accounting, particularly in the areas of impairment of debt securities and estimating values in illiquid markets. The American Bankers Association, however, has criticized the FASB for not going far enough towards the use of economic value, as opposed to market value, for banks' balance sheet accounting.[74] The International Accounting Standards Board (IASB) has announced that it is reviewing the standard.[75] An aspect of this issue is the appropriate structure, independence and oversight of the IASB, the standard setter for what will clearly be the single set of high-quality standards called for by the G20.

The issue with respect to accounting standards raises the broader issue of whether regulators have relied too extensively on rating agencies and accounting standards to determine capital adequacy without doing an independent review of how capital

70 G20 (Working Group 2) (n 59) 19.

71 de Larosière (n 3) 19.

72 G20 Declaration (n 15) 5; G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency (Working Group 1), 'Final Report' (25 March 2009) <http://www.g20.org/Documents/g20_wg1_010409.pdf> p. x., accessed 26 May 2009; Turner Review (n 4) Section 2.2.

73 G20 Global Plan (n 6) 4.

74 See, American Bankers Association (ABA) News Release, *ABA Welcomes FASB Guidance on Mark-To-Market Accounting and Impairment Rules* (2 April 2009) <http://www.aba.com/Press+Room/040209FASBGuidanceMarktoMarket.htm> accessed 26 May 2009; see also, ABA New Release, *ABA Notes FASB Staff Positions (FSPs) on Mark-To-Market Accounting and Impairment Rules*, by Edward L Wingling, ABA President and CEO (10 April 2009) <http://www.aba.com/Press+Room/041009FASBStaffPositions.htm> accessed 26 May 2009.

75 See, International Accounting Standards Board (IASB), *IASB Responds to G20 Recommendations and US GAAP Guidance* (7 April 2009) <http://www.iasb.org/News/Press+Releases/IASB+Responds+to+G20+Recommendations+and+US+GAAP+Guidance.htm> accessed 26 May 2009.

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should be calculated. While there may be regulatory concern about the pro-cyclicality of certain accounting standards, there are other ways of addressing capital adequacy than changing the standards, with respect to which there has not been significant investor concern expressed. One innovative approach, proposed by Professor Flannery is the use of contingent capital certificates, debt securities that convert to equity securities, either on the determination of a regulator or according to specified capital adequacy or leverage formulae.[76]

A final subset of regulatory reform will be to address the existence of tax havens and financial institutions doing business in jurisdictions that do not implement best regulatory practices. In their London statement, the G20 agreed 'to take action against non-cooperative jurisdictions, including tax havens . . . [and] to deploy sanctions to protect our public finances and financial system'.[77] With respect to best practices, markets will be expected to conduct a Financial Sector Assessment Program (FSAP) and if there are significant deficiencies, regulators will be expected to impose stricter conditions on either capital or activities with respect to financial institutions doing business in those countries.[78]

Finally, a key component is the role of international organizations such as the FSB, the IMF and BCBS, among others. Because national regulators will retain sovereignty over financial institutions as to which they are the home regulator, these international bodies will be limited to developing best practices with respect to regulation and supervision and recommending that they be implemented in each relevant market. There have been examples where this has happened—capital adequacy as determined in accordance with Basel II, and disclosure standards for debt and equity offerings as adopted by IOSCO and subsequently implemented in most key markets. At its London summit, the G20 members committed significant financial support to the IMF in order to ease the significant effects of the crisis and facilitate growth in poor and developing countries and agreed to make any necessary regulatory reforms to support the IMF's efforts. Furthermore, they agreed to support a doubling of the IMF's lending capacity and its sales of IMF gold reserves and endorsed the IMF's Flexible Credit Line. The G20 also announced that the Financial Stability Forum, which recently expanded their membership to include all G20 countries as well as Spain and a representative from the European Commission, would be re-established as the Financial Stability Board. The G20 welcomed their extended role, influence and collaboration with the IMF and IOSCO among other institutions. The FSB will work to ensure cross-border financial stability by establishing guidelines and policies on regulation and monitoring their

76 Mark J Flannery, 'No Pain, No Gain? Effecting Market Discipline via "Reverse Convertible Debentures" ' in Hal S Scott (ed.), *Capital Adequacy beyond Basel: Banking, Securities, and Insurance* (Oxford University Press, Oxford 2005); Mark J Flannery, 'Market Discipline in Bank Supervision', Chapter 15, in A Berger, P Molyneux and J Wilson (eds), *Oxford Handbook of Banking*, forthcoming.

77 G20 Global Plan (n 6) 4.

78 G20 Declaration (n 15).

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implementation in various markets. Although national regulation will prevail, the FSB will work to develop cross-border cooperation and management.

Much of the focus has been on the flaws of the regulatory system. There has been little discussion about possible failures of the regulators, except with respect to the SEC and Bernie Madoff. But a key question is do regulators have both adequate resources and personnel to oversee complex financial institutions, especially if the regulatory net is to be cast wider. Indeed, there are some who would argue that a commitment to attracting and retaining high-quality staff, through pay and benefit packages competitive with the private sector, would go a long way to addressing some of the concerns about lack of adequate oversight. Markets and products are becoming more and more sophisticated, as is the risk modelling used to assess the health of a financial institution. We must make sure that we attract regulators who are up to the task of regulating large and highly complex institutions.

5. Conclusion

In implementing the reforms necessary to properly regulate markets and institutions, two approaches are necessary. The first is the complex 'top down' regulatory approach discussed above and throughout this special issue. The second is a 'bottom up' approach—making sure that the right people are in place, both in financial companies and in financial regulators, with the right motivation and incentives. Neither approach alone is sufficient. The 'top down' regulatory approach has some potentially profound flaws, the chief among which is its extraordinary complexity. There are legitimate concerns over whether the institutional, national and international regulatory infrastructure, once erected, will be able to work efficiently, given the number and nature of the entities involved and the variety of political and economic policies driving them. Supervision of international politics has not worked perfectly (see, eg the League of Nations or the United Nations) and neither will worldwide supervision of financial markets. Furthermore, additional regulation typically increases costs for market participants. Equally, the second, 'bottom up' personnel approach will always be threatened by self-interest, herd instinct and shareholder pressure to maximize returns.

To succeed, both approaches are necessary, with the one reinforcing the other. Accordingly, in implementing regulatory reforms, care should be taken to ensure that the right cultural and behavioural attitudes exist within each financial institution—on the trading floor, among the risk controllers, and at board level. Similarly, the bottom-up approach should be focused on internal controls and feeding relevant information to supervisors. With the creation of new systemic risk regulators, taking an aggregate market view, a virtuous cycle can be created promoting market efficiency and stability (compared with the vicious cycle that has just culminated of poorer regulation and less stability). Our special issue, focusing primarily on the 'top down' regulatory approach, cannot provide complete solutions to the problems discussed in this article or by other commentators. But our hope is that we can identify some of the key issues and provide

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alternatives to be considered and debated. It is clear that we need thoughtful analysis and close cooperation as we evolve the existing systems. If we do not have convergence and cooperation (both among nations and between the regulated and the regulators), we will reduce the efficiency of cross-border flows of capital, which will be to the detriment of the global economy and investors.

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