WHO GOVERNS FINANCE?

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

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 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 tendency to rely on self-regulatory mechanisms and market discipline that had characterized the approach of regulators prior to the crisis. However, while public regulatory agencies have consolidated in the hands the authority to regulate and oversee markets previously left outside their regulatory oversight, the content and the purpose of their regulatory intervention have not radically changed.

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I. Introduction

Who governs finance? Most debates on the regulation of financial markets are informed by the implicit assumption that a clear division of roles exists between the “regulators” and the “regulated” entities. The responsibility to regulate and oversee financial markets is seen as naturally falling in the hands of the state, which delegates this function to regulatory agencies both at the domestic and 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 is not fixed, but it has radically changed across historical periods, countries, and financial sectors.

This paper argues that the latest significant turn in the “public-private” divide in regulation of finance has been triggered by the global financial crisis erupted in the summer of 2007 from the US housing market. This crisis has spurred heated debates among national and international regulatory bodies on what gaps had been revealed in the international financial regulatory architecture, but also on 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.

This paper explores 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. Focusing in particular on the extensive reforms that have been introduced in the regulation of OTC derivatives, credit rating agencies, and hedge funds, this paper argues that the crisis has halted the shift in the public-private divide that took place in the fifteen years or so prior to the crisis. During this period, regulators had frequently opposed measures to bring these three markets within the perimeter of their regulatory oversight. Instead, they had delegated important regulatory functions to private market actors, granting a public policy role to industry-driven self-regulatory measures, and elevating market discipline as the primary mechanism to monitor and enforce compliance with international standards.

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The financial crisis of 2007-2009 has reversed this trend in three ways. First, regulators have placed in their hands the regulation of markets that had prior been left to the crisis outside their regulatory umbrella, as illustrated by the case of OTC derivatives markets (section III). Second, regulators have questioned the efficacy of market pressures in disciplining private market actors, and they have taken upon themselves the task of monitoring and sanctioning the implementation of financial standards, as the case of credit rating agencies shows (section IV). Third, regulators have expressed their skepticism about the capacity of voluntary self-regulatory measures to address the regulatory gaps revealed by the crisis and often replaced them with their regulatory intervention, as the case of hedge funds illustrates (section V).

The conclusion to this paper will discuss how significant is this shift in the public-private divide triggered by the crisis. The argument presented in this paper is that while the crisis has consolidated in the hands of public regulatory agencies the authority to regulate and oversee markets previously left outside their regulatory oversight, the purpose of their regulatory intervention have not been radically altered.

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

As several authors have documented, the fifteen years or so preceding the financial crisis of 2007-09 have witnessed the emergence of a new paradigm in the regulation of financial markets, which has tilted the public-private divide in favour of private market actors.2 Andrew Crockett, former General Manager of the Bank for International Settlements, has argued that a ‘paradigm shift’ has occurred in the approach taken by

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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.\(^3\) Tommaso Padoa-Schioppa, former Chairman of the Basel Committee, has talked instead of “market-friendly regulation”.\(^4\) These labels well summarize the attempt of public regulatory authorities during this period to actively leverage market forces in support of their goals by shifting part of the responsibility to regulate and supervise market in the hands of private market actors.

It is possible to identify three pillars that characterize this regulatory approach and that differentiate it from prior regulatory initiatives: 1) a “hands-off” approach, leaving innovative markets outside the regulatory oversight of public regulatory agencies; 2) the elevation of “market discipline” vis-à-vis “regulatory discipline” as a central mechanism to monitor and enforcing compliance with regulatory standards; 3) an official public-policy role granted to self-regulatory initiatives.

First, regulators have refrained from extending the perimeter of their regulatory oversight to cover innovative institutions and markets, leaving them only lightly regulated or unregulated. At the same time, also the content of the regulatory intervention has changed, leaning towards a “soft touch” approach. Traditional command and control approaches where the regulatory intervention defines what market participants can and cannot do through orders and prohibitions have become less prominent. The intervention of public regulators has instead focused on establishing minimum requirements and adding on top provisions to align financial actors’ incentives with the goals of the regulation (what Alexander, Dhumale, and Eatwell call ‘incentive-based regulation’ in contrast with traditional “rule-based regulation”).\(^5\) The intervention of regulators has thus frequently focused on setting disclosure requirements to enhance the transparency of certain markets, or on drafting (or encouraging financial industry actors to draft) non-binding best practice standards for market players to uphold.

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Second, since the 1990s financial regulators have actively focused on how the discipline enforced by public authorities over financial firms could be strengthened by the discipline imposed by market actors (so called “market discipline”). While regulators have placed disclosure requirements at the centre of their intervention, these have often not taken the form of “private” reporting to the same regulators, but rather of “public” disclosure to the markets. These disclosure requirements were meant to allow other market actors to distinguish the worse managed institutions from the most virtuous ones, punishing the former while rewarding the latter. Also the enforcement of codes of best practices was often left to market pressures rather than to the coercive powers of public regulatory agencies. These measures suggest how public regulatory agencies have sought to harness the self-interest of the myriad of anonymous market participants in the monitoring and enforcing compliance with financial rules. The advantages of market discipline were described by Richard Herring as that of being “forward-looking and inherently flexible and adaptive … continuous, impersonal and non-bureaucratic”, in contrast with the discipline imposed by regulators which he describes as “rule-based, episodic, bureaucratic and slow to change”.

Third, regulators have also intervened to grant a public policy role to industry-driven codes of best practices or other self-regulatory mechanisms. National and international financial regulatory bodies have endorsed existing best practice standards formulated by financial industry associations. In those cases where industry-driven initiatives were inadequate or non-existing, public regulatory agencies 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. Regulatory initiatives have also made one of their

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7 HERRING, 'How Can the Invisible Hand Strengthen Prudential Supervision? and how can prudential supervision strengthen the invisible hand?', in.
goals that of promoting enhancements in the self-regulating skills of financial institutions.\(^8\)

While these three pillars well exemplify the approach of regulators towards innovative markets and instruments, especially those who did not seem to present immediate investors protection concerns, the tendency to “work with the market” can be found also in the other areas, such as the evolution of the capital regime set by the Basel Committee.

The first Basel accord, concluded in 1988 defined the amount of reserve capital that banks were required to put aside by establishing an exogenous relationship between exposure and capital requirements. Instead, the Basel II agreement published in 2004 allowed market participants to use their own data and risk-management schemes to self-determine the amount of reserve capital. Moreover, for those financial institutions not sufficiently sophisticated to self-regulate their capital requirements, the agreements delegate this regulatory function to another private actor: commercial credit rating agencies. Moreover, the Basel II agreement elevated “market discipline” to one of its three pillars, besides capital requirements and supervision, introducing several disclosure requirements. Duncan Wood argues: ‘Basel II has thus not only been an effort to modernise the original Accord and render it more efficient; a central goal has been to shift a large part of the responsibility of regulation to the market itself’.\(^9\)

From an historical perspective, the shift in the public-private divide in the period preceding the crisis could be described as a “return to the past”. 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, enforced through the threat of ostracism from the merchant community and of boycotting of all future trade.\(^10\)

The influence of private financial actors over the regulation of international financial markets 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, like the London Stock Exchange, the Corporation of Lloyds, and the New York Stock Exchange. But self-regulatory arrangements also governed other corners of the financial system, like commercial bank clearinghouses, payments and securities settlement systems, and interbank deposit markets.¹¹

From an historical perspective, the assumption of responsibility by sovereign states over the regulation of financial markets is a more recent development. This coincides mainly with the Great Depression, when the governments of most industrialized countries widened their intervention in the regulation of finance, placing restrictions on financial market participants (e.g., the Glass-Steagall Act of 1933 restricting the freedom of US banks to operate in the securities markets) and creating new domestic regulatory institutions (e.g., the creation of the Securities and Exchange Commission to oversee self-regulatory organizations, like the existing stock exchanges).¹² Nonetheless, also after the 1930s 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 “meso-corporatist” arrangements. Under this model, the state granted to an extensive network of stock exchanges and other self-regulatory organisations the license to govern themselves, through a “charter” defining their duties and rights.¹³

However, two elements differentiate the new paradigm that emerged since the 1990s from past examples of private market actors rule-making in finance. First, while the meso-corporatists arrangements that followed the Great Depression were national in scope, the new regulatory paradigm has institutionalized the public policy role of private market actors in the regulation of finance also at the international level, as witnessed by

¹² Moran, The Politics of the Financial Revolution: the USA, UK, and Japan. 28
the endorsement given to self-regulatory initiatives of transnational business groups by international regulatory bodies.\textsuperscript{14}

Second, what differentiates the growth in the regulatory responsibilities of private market actors in the recent decade from its height in the period that preceded the First World War and the Great Depression is the fact that this “first wave of globalization” preceded the complete assumption of responsibility over the regulation of financial markets from the state during the 1930s. The increase in the regulatory authority conferred to private market actors during the “second wave of globalization” has instead occurred against a background of national regulatory agencies and international bodies created since the 1970s to coordinate their efforts at the international level. In other words, the shift in the public-private divide in the regulation of finance prior to the crisis has been favoured by these same public actors who have reordered their role in the attempt to “work with the market” in designing and enforcing of financial regulation.

This point is particularly important to appreciate how the shift in the public-private divide remained a contingent development rather than a structural one, and therefore subject to be reverted in the case the political conditions underpinning this delegation of regulatory responsibilities had weakened.\textsuperscript{15} As the three cases analyzed in the rest of the paper will illustrate, this has been the impact of the impact of the global financial crisis of 2007-2009. The argument presented in this paper holds that the crisis has halted the shift in the public-private divide that took place since the 1990s. The changes brought by the crisis in the regulation of OTC derivatives, credit rating agencies, and hedge funds presents a significant departure from three pillars of the regulatory paradigm that characterized their regulation prior to the crisis.

\textbf{III. OTC Derivatives}

\textsuperscript{14} Tsingou, ‘Policy preferences in financial governance: public-private dynamics and the prevalence of market-based arrangements in the banking industry’.

\textsuperscript{15} Louis W. Pauly, ‘Global finance, political authority, and the problem of legitimation’, in Rodney Bruce Hall & Thomas J. Biersteker (eds), The Emergence of Private Authority in Global Governance (Cambridge University Press, 2003).
Before the crisis

The first pillar in the regulatory paradigm emerged before the crisis is the tendency of regulatory authorities to oppose measures seeking to bring innovative financial markets under the perimeter of their regulatory oversight, and to leave these markets only lightly regulated or self-regulated. The regulatory framework for OTC derivatives markets in place until prior to the financial crisis well fits this description.

While the part of derivatives markets that is traded on exchanges remained under the regulatory oversight of financial regulators, public authorities decided not to extend the perimeter of public regulation to incorporate the growing portion of derivatives traded bilaterally, or over-the-counter (OTC).

When a few corporate scandals in the US originated in the OTC derivatives markets pushed different Congressmen to introduce in 1994 three distinct bills seeking to bring OTC derivatives under the regulatory umbrella, federal regulators created a unified front in arguing in front of Congress that legislation to regulate OTC derivatives was not necessary. They defended this position arguing that the firms operating in these markets were sophisticated and the markets themselves would discipline their activities.\textsuperscript{16}

US regulators went even further, recommending Congress to legislate in order to exempt many kinds of derivatives from federal oversight.\textsuperscript{17} Only one year later, Congress specifically exempted swaps from oversight by federal regulators through the “Commodity Futures Modernization Act”, thus allowing the OTC derivatives market to develop unfettered outside of the public regulatory umbrella.\textsuperscript{18} The same hands-off approach dominated also the approach of international regulatory bodies such as the Basel Committee and the International Organisation of Securities Commissions, whose recommendations throughout the 1990s have accepted a limited involvement of


regulators and focused on promoting better self-regulation and strengthening market discipline through enhanced disclosure.19

Besides opposing measures to bring derivatives under their regulatory umbrella, public authorities also expressed support for self-regulatory measures, the third pillar of the pre-crisis regulatory paradigm. Since the inception of OTC derivatives markets, different industry groups such as the Futures Industry Association, the Emerging Markets Traders Association, the Derivatives Policy Group, and, most importantly, the International Swaps and Derivatives Association (ISDA), and a private organization/think tank such as the G30, have developed a series of self-regulatory measures to bring order to the growing volumes of OTC derivatives and create a certain legal background against which derivatives markets could flourish. Moreover, industry-driven initiatives were instrumental in pre-empting the imposition of formal regulation, presenting OTC derivatives as safe risk-management instruments whose risks were sufficiently taken care by the same industry-participants and in making self-regulation the focal point of every regulatory debate.20

After the crisis

This approach has persisted also during the initial phase of the financial crisis.21 At the beginning of the crisis and before, US federal regulators have denounced how the infrastructure designed by the industry before the crisis had not kept pace with the explosion in these instruments complexity and the surging trading volumes.22 However, instead of requesting Congress the authority to address these gaps, US federal regulators under the leadership of Federal Reserve Bank of New York have convened the main derivatives market participants in a series of closed-door meetings, urging them to

address these regulatory gaps in the infrastructure of derivative markets through self-regulatory initiatives.  

Derivatives markets participants have been rapid in responding to the detailed set of requests advanced from federal regulators. Starting from March 2008, they have committed to take several steps 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, the Federal Reserve Bank of New York 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 major derivative dealers committed to clear derivatives through a central counterparty located in Europe only after that the European Commission threatened to impose higher capital requirements on credit default swaps not processed through a European clearing house.  

The reforms implemented in the first two years since the beginning of the crisis represent a landslide change in the regulation of OTC derivatives markets and their effectiveness in mitigating the risks of derivatives markets during the crisis has been praised by international regulatory authorities. However, these reforms did not depart from the
boundaries of the pre-crisis paradigm, since they remained voluntary and self-regulatory in nature. This does not mean that public authorities had no role in addressing the deficiencies in the operational infrastructures of OTC derivatives markets. On the contrary, the Federal Reserve Bank of New York and other financial regulators have been the main architects of this reform process, but their intervention focused on steering the self-regulatory steps taken by the industry in the direction of their public policy priorities, in some cases through the threat of more formal legislation.

It is only after the bankruptcy of Lehman Brothers and the bailout of the insurance giant AIG that both the Securities and Exchange Commission and the Commodity Futures Trading Commission reversed their position and urged Congress to provide them with the authority to regulate OTC derivatives markets.26 Their request was satisfied by the US Treasury, which in the summer of 2009 presented a comprehensive regulatory plan for OTC derivatives dividing the authority to regulate OTC derivatives between the CFTC and the SEC. The US Treasury plan was followed by a communication from the European Commission in July 2009, setting the stage for an equally comprehensive regulation of OTC markets in Europe.27

Both the US Treasury and the European Commission granted public regulatory agencies the authority to regulate and oversee three components of OTC derivatives markets: 1) the same derivatives contracts, 2) central counterparties and trading platforms, and 3) the counterparties in derivatives transactions that remain over the counter.28

**What kind of regulation?**

These three sets of measures have brought derivatives markets firmly under the public regulatory umbrella. While this represent a departure from the first pillar of the pre-crisis regulatory paradigm in the regulation of derivatives, in order to fully appreciate the

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28 Both the US Treasury Plan and the European plan have later introduced significant exemptions for those corporate end-users that are counterparties in OTC derivatives transactions.
impact of these reforms on the public-private divide we need to analyze the content of these reforms.

At the core of public authorities’ approach there is the attempt to shift derivative markets from predominantly OTC bilateral transactions, where regulators have little to no oversight, to more centralised clearing within central counterparties or trading platforms under the oversight of financial regulators and subject to binding regulatory requirements. The question is: how have regulators used their newly acquired regulatory authority to achieve this goal?

Public authorities have significantly expanded the reach of their regulatory intervention in this area. In the first stage of the crisis, regulators have maintained that central clearing or the trading on exchanges or electronic platforms of standardized OTC derivative contracts should only be “encouraged”, and have relied in some cases to the threat of formal legislation to obtain the commitment of dealers. After the collapse of Lehman Brothers, regulators toughened their intervention. Both the US Treasury and the European Commission plan made central clearing and exchange trading of standardized OTC derivatives mandatory. This principle was also affirmed at the international level by the G20 leaders at the Pittsburgh Summit in November 2009.

At the same time, the regulators’ involvement in this area does not go as far as suggested by some US lawmakers, who have introduced within Congress legislative proposals to mandate the trading onto exchanges of all derivatives contracts, thus de facto outlawing OTC markets. Other legislative proposals would pose limits to the kind of derivatives could be traded, banning the trading of credit default swaps unless investors owned the underlying asset on which the credit insurance was bought (so-called “naked derivatives”).

31 See The “Derivatives Trading Integrity Act of 2009”, introduced in January 2009 by Senator Tom Harkin, and the “Credit Default Swap Prohibition Act of 2009”, presented by Congresswoman Maxine Waters on July 2009. While the former bill would force all derivatives onto exchanges, the latter would introduce a total ban on customized credit default swaps.
Instead of banning OTC derivatives markets or “naked” contracts, the US and Europe plans allow “non-standardized” derivatives to continue to be traded over-the-counter. At the same time, regulators have enhanced the incentives of market actors to migrate of OTC derivatives onto central clearinghouses and exchanges by imposing higher prudential requirements for counterparties in non-centrally cleared derivatives transactions (eg capital requirements, reporting requirements, business conduct standards, and initial margin requirements).

Moreover, regulators have not taken upon themselves the task of defining when a derivative is sufficiently “standardized” to be cleared safely, leaving instead this judgment to the discretion of the same central counterparties. This delegation of regulatory responsibilities occurred despite the conflict of interest created by the significant stake that the major derivatives dealers have in the largest clearinghouse for credit default swaps. According to some commentators, this would give clearinghouses an incentive to declare that those derivatives that are the most profitable when traded OTC are not clearable.33

In sum, while the crisis has brought in the hands of public regulatory agencies the authority to regulate OTC derivatives markets, public authority have been cautious not to expand their regulatory intervention to the extent that it could hamper, prohibit, or make more costly the access of market actors to OTC derivatives markets.

IV. Credit Rating Agencies

Before the crisis

The second pillar in the regulatory paradigm emerged before the crisis saw regulators frequently seeking to strengthen the “invisible hand” of markets and enhance market

pressures in order to monitor and enforce compliance with international standards. The reliance on market discipline as a central compliance mechanism characterised the approach taken by international regulatory bodies to regulate credit rating agencies before the crisis.

Since Enron had remained highly rated until the wake of its collapse in 2001, its bankruptcy focused the attention of regulators on rating agencies and led to the publication by IOSCO of a “Code of Conduct Fundamentals for Credit Rating Agencies”. 34 This was a set of non-binding best practices for credit rating agencies, intended to be included on a voluntary basis by the same agencies in their individual codes of conduct. In order to promote compliance with its Code of Conduct, IOSCO asked rating agencies to disclose publicly how they had incorporated these measures in their internal guidelines and explain any deviation from it. This disclosure was meant to permit market participants to assess to what extent rating agencies adhered to international best practices and react accordingly, lending less weight to the ratings offered by agencies deviating from the IOSCO Code.

Also the regulation of rating agencies that emerged in Europe prior to the crisis placed in the invisible hand of the market pressures rather than in the visible hands of supervisors the task of monitoring and enforcing the implementation its Code of Conduct. Consulted by the European Commission on the appropriateness of subjecting rating agencies to proper regulatory requirements through a “European Registration Scheme”, the Committee of European Securities Regulators dismissed this option. According to European securities regulators, solutions placing regulators in charge of certifying or enforcing compliance could give investors the impression of an absolute guarantee of quality of ratings and threaten the independence and quality of ratings. Moreover, they expressed the belief that rating agencies already faced incentives to maintain the highest possible standards and that the market would sanction those agencies that are not fully compliant with best practices such as the IOSCO Code. In addition to these market-based

incentives, CESR noticed that “the current threat of regulatory action should the rating industry not be seen to be fully compliant significantly enhances these incentives”.  

The same focus on disclosure as compliance mechanism characterized the approach to managing conflicts of interests and regulating methodologies. CESR suggested that rating agencies should disclose more information about potential conflicts of interests and what mechanisms were in place to manage them, and a “minimum level of disclosure” on methodologies, in order to allow investors and issuers to understand the criteria used to determine a rating and to assess themselves the independence of these ratings.

In January 2006 the Commission followed the advice received from the Committee of European Securities Regulators (CESR) and announced that it would not have presented new legislative proposals to regulate credit rating agencies in Europe, letting rating agencies an opportunity to implement the voluntary standards set out in the IOSCO Code of Conduct.  

Both the IOSCO and the CESR have subsequently reviewed how rating agencies had implemented the IOSCO Code in the internal codes of conduct, finding out that the three largest rating agencies (Standard & Poor’s, Moody’s, and Fitch) had largely implemented these standards.

While the regulation of rating agencies in Europe and at the international level was based on a voluntary code of best practices whose enforcement was left to market pressures, a different model was adopted in the US, where Congress reacted to the Enron scandal by passing the Credit Rating Agency Reform Act of 2006. This piece of legislation ended the self-regulatory status in the industry that had lasted for one century and provided the SEC with the authority to regulate these agencies and to examine their records in order to assess the compliance with its rulebook.

35 CESR, ‘CESR’s technical advice to the European Commission on possible measures concerning credit rating agencies’ (Paris, Committee of European Securities Regulators, 30 March 2005).
36 EUROPEAN COMMISSION, ‘Communication from the Commission on Credit Rating Agencies, 2006/C 59/02’ (Brussels, 11 March 2006).
After the crisis

The financial crisis of 2007-09 has highlighted how credit rating agencies had severely underestimated the risk attached to mortgage back securities and other structured finance products, pushing IOSCO to amend in 2008 its Code of Conduct.\textsuperscript{38} Similarly to the past, these amendments remained non-binding and IOSCO called on the ratings agencies to incorporate them into their individual codes of conduct and to publicly disclose their level of compliance.

However, the reliance on market discipline as the main enforcement mechanism has progressively come under severe criticisms throughout 2008, in particular from the European Commission and the Commissioner Charlie McCreevy. In 2008 the European Commission launched a public consultation on the regulation of rating agencies in which it criticized the past reliance on self-regulation based on the IOSCO Code of Conduct and on the discipline imposed by markets as the only compliance mechanism. According to the Commission, 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.’\textsuperscript{39}

In the words of McCreevy, the reliance on market discipline made the IOSCO Code of Conduct a ‘toothless wonder’.\textsuperscript{40}

The Commission also dismissed the CESR proposal to reinforce the enforcement of this set of best practices through the creation of an industry-driven international standard setting and monitoring body, with the authority to “name and shame” agencies not complying with international standards. According to the European Commission this solution was inadequate: ‘the recent events have unveiled that the reputational risk is not sufficient for CRAs to abandon harmful practices. A model of supervision where CRAs decide what should be the information that the oversight body will receive and where naming and shaming is the most severe penalty for their lack of compliance is not


\textsuperscript{40} CHARLIE MCCREEVY, ‘Regulating in a Global Market’ (Dublin, Inaugural Global Financial Services Centre Conference, 16 June 2008).
efficient.'\textsuperscript{41} Finally, 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.\textsuperscript{42}

Throughout the crisis, regulators have gradually shifted the responsibility to monitor and enforce compliance with the IOSCO code of conduct away from market pressures and placed it in their own hands. The Washington Summit on November 2008 G20 leaders asked regulators to “review credit rating agencies’ adoption of the standards and mechanisms for monitoring compliance”.\textsuperscript{43} IOSCO had then developed a “common monitoring module” to assist supervisors in monitoring compliance with its Code of Conduct,\textsuperscript{44} and worked to facilitate 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.\textsuperscript{45}

G20 leaders took another step in increasing the involvement of financial regulators in the regulation of rating agencies when at the Washington Summit requested credit rating agencies that provide public ratings to be registered.\textsuperscript{46} 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 filled the gap 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.\textsuperscript{47} Similar regulatory frameworks are being implemented in countries such as Japan, South Korea, and Australia.\textsuperscript{48}

\textsuperscript{43} G20, ‘Declaration of the summit on Financial Markets and the World Economy’ (Washington, 15 November 2008).
\textsuperscript{44} IOSCO, IOSCO urges greater international coordination in the oversight of credit rating agencies ’ (Madrid, International Organization of Securities Commissions, 17 September 2008). See also IOSCO, IOSCO announces next steps on Credit Rating Agencies’ (Madrid, International Organization of Securities Commissions, 28 July 2008).
\textsuperscript{46} G20, ‘Declaration of the summit on Financial Markets and the World Economy’.
What kind of regulation?

These regulatory initiatives represent a radical departure from the pre-crisis regulatory paradigm as they place in the hands of public regulators the authority to impose regulatory requirements upon rating agencies regulatory and to monitor and sanction their compliance. Similarly to the discussion of OTC derivatives above, it is important to analyze the content of these reforms to appreciate to what extent they have shifted the public-private divide. The crisis has highlighted the failure of rating agencies to correctly appreciate the risk in structured finance products, and the conflicts of interests generated by the fact that the main rating agencies are paid by the same issuers of the products they rate. How have financial regulators used their regulatory to address these issues?

First, both the SEC and the proposal presented by the European Commission have not sought to directly influence the methodologies used by the rating agencies, but rather they have 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 participants in monitoring and compare how rating agencies originally rated an entity or a security, to understand the limitations and implication of ratings and conduct “what if” analyses.

An additional a set of disclosure requirements has been introduced to assist investors in identifying conflict of interests potentially threatening the rating agency’s independence, as well the polices implemented by the same rating agency to mitigate those threats. US securities regulators have also required issuers to disclose all the preliminary ratings obtained from a credit rating agency prior to selecting a firm to conduct a rating. This
disclosure was introduced to prevent issuers from “shopping” among multiple agencies and hiring the one giving the highest preliminary rating.\textsuperscript{49}

The attempt to mitigate conflicts of interests in the rating business has led regulators to go beyond the simple introduction of disclosure requirements and to mandate changes in the internal governance of rating agencies. For instance, regulators have barred 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. The European regulation interferes even more profoundly in the internal governance of rating agencies by requiring rating agencies to introduce rotation arrangements for analysts, by regulating the compensation of employees involved in the rating process, and by setting requirements rating agencies to have at least three independent directors on their boards.

In sum, while the crisis has led regulators to become more deeply involved in the regulation of rating agencies, their regulatory intervention has focused largely on the introduction of disclosure requirements. Regulators have been wary of measures that could force them to interfere with the ratings business and methodologies as these measures would put them in the position to validate the operation of rating agencies and exacerbating over-reliance on ratings. In the same way, in the regulation of the conflicts of interests, the US Treasury stated that the primary role of public authorities should be ‘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’ rather than ‘to prescribe allowable business models in the free market’.\textsuperscript{50} Regulators in Europe and in the US have thus refrained from supporting the emergence of investor-funded rating agencies where ratings are paid by the investors nor required issuers to finance a “common pool” from which rating agencies would be selected in order to sever the link between issuers and raters.

Finally, regulators have also used their authority to reduce the excessive reliance on


\textsuperscript{50} US TREAURY, 'Assistant Secretary for Financial Institutions Michael S. Barr. Written Testimony. Senate Committee on Banking, Housing, and Urban Affairs ’ (Washington, DC, Senate Committee on Banking, Housing, and Urban Affairs, 5 August 2009).
ratings by market actors as a replacement for adequate risk analysis and risk-management. Authorities have acknowledged that this issue could not be addressed uniquely by market actors, since the reliance on ratings is partially hard-wired in the existing regulatory framework through the increasing number of references to credit ratings in regulatory requirements.\(^{51}\) In order to lessen undue reliance on ratings, the SEC has removed references to credit ratings in different parts of securities laws. Moreover, 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,\(^ {52}\) thus reversing the reliance on market-based measures of price and risk that had characterized the regulatory paradigm prior to the crisis.\(^ {53}\)

V. Hedge funds

Before the crisis

The third pillar in the regulatory paradigm emerged before the crisis is the public policy role assigned by public regulators to industry-driven codes of best practices or other self-regulatory mechanisms. This trend has already been described in the endorsement given by US and international regulatory agencies to the self-regulatory steps taken by derivatives dealers, and in the reliance on credit rating agencies’ own codes of conduct.

The preference for self-regulation by market participants over direct regulation has also characterized the regulation of hedge funds since they reached the table of major national and international regulatory agencies after the collapse of the US fund Long-Term Capital Management in 1998. Similarly to the case of OTC derivatives markets and credit rating agencies, the report by the President’s Working Group on Financial Markets in the

\(^{51}\) BASEL COMMITTEE ON BANKING SUPERVISION & JOINT FORUM, ‘Stocktaking on the use of credit ratings’ (Basel, Bank for International Settlements, June 2009).

\(^{52}\) G20, ‘Declaration on Strengthening the Financial System’ (London, G20, 2 April 2009).

US\textsuperscript{54} and by the Financial Stability Forum report at the international level\textsuperscript{55} opposed proposals to directly regulate hedge funds.\textsuperscript{56} Regulators justified the decision to exempt hedge funds from their regulatory oversight on the ground that hedge funds’ investors were sufficiently wealthy and sophisticated to conduct their own due diligence, while direct regulation would have generated moral hazard and induced investors to reduce their due diligence. The FSF and US regulators recommended instead that excessive leverage and risk-taking could be constrained through a regime of “indirect regulation”, that is, focusing the regulatory intervention on the already regulated financial institutions which act as counterparties and provide credits to hedge funds. These reports also opposed proposals that would have placed regulators in charge of overseeing the activities of hedge funds, such as the proposal from the German delegate to introduce an international credit register on exposures to hedge funds.\textsuperscript{57} Regulators questioned the feasibility of collecting and processing the data and the moral hazard this regulatory oversight could generate. Instead of “private” reporting to regulators, the FSF and US regulators favoured enhanced “public” disclosure by hedge funds to their counterparties and the markets, arguing that financial market participants had stronger incentives to monitor hedge funds’ position and greater resources than those available to regulators. The role that regulators assigned themselves was not that of directly monitoring hedge funds, but rather of creating an environment in which investors and counterparties could obtain sufficient information through effective disclosure requirements.

Moreover, both report urged hedge funds to draft a set of sound practices to improve their risk management, internal controls, and disclosure of relevant information to their counterparties. The same focus of reliance on self-regulatory codes of best practices informed the approach of regulators a decade later, when the German government brought the regulation of hedge funds back in the international agenda during its


\textsuperscript{56} For an analysis of these reports see BARRY EICHENGREEN, Governing Global Financial Markets: International Responses to the Hedge Funds Problem’, in Miles Kahler & David Lake (eds),Governance in a Global Economy (Princeton University Press, 2003); PAOLA ROBOTTI, ‘Mapping the regulatory debate on hedge funds: a political analysis’ (London, Financial Markets Group at the London School of Economics); PAOLA ROBOTTI, ‘Capture or self-capture? US Domestic Actions to Reach out the World of Hedge Funds: implications for international negotiations’, in, (presented at the International Studies Association Annual Convention 2007).

\textsuperscript{57} ROBOTTI, ‘Mapping the regulatory debate on hedge funds: a political analysis’. More recently, the European Central Bank has supported the creation of an “international highly leveraged institutions credit register” to help regulators identify concentrations,
presidency of the G7. Also this time, the FSF renewed its calls on the hedge fund industry to review the existing sound practice benchmarks for hedge fund managers in the light of expectations set out by regulators and market participants, while G7 officials facilitated the emergence of these self-regulatory initiatives by meeting directly with representatives of the main hedge funds associations and by threatening legislative intervention. At the outset of the crisis, US federal regulatory agencies also took upon themselves the task of 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 for HFs and their investors. This combination of ‘carrots and sticks’ from public authorities was successful in fostering in a short period the emergence of a plethora of different voluntary codes of best practices drafted by hedge funds groups, such as the Hedge Fund Working Group, the Managed Funds Association, and the Alternative Investment Management Association.

After the crisis

The support for industry-driven codes of best practices was not undermined by the outbreak of the financial crisis in 2007. On the contrary, during this phase the Financial Stability Forum, the G7, and the major European leaders all gave their seal of approval to self-regulatory initiatives drafted under the aegis of the US President’s Working Group on Financial Markets, and those published by the London-based Hedge Fund Working Group. Moreover, the FSF asked the HFWG to release regular reports on the adoption of these standards by the hedge funds.

When hedge funds reached the international agenda for the first time in the middle of the crisis, the G20 leaders at the Washington Summit reached out to the same hedge fund

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59 G7 official met with hedge fund managers at the margin of the G8 summit in Heiligendamm and of the IMF/WB meeting in Washington. See G7, ‘G7 Deputies Exchanged Views with the Private Sector on Hedge Funds’ (Washington, April 16), Financial Times, “Hedge Funds to meet G7 on greater openness” (11 April 2007).
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 the adequacy of these proposals”. 65

Similarly to past episodes of financial instability, these calls from regulators have triggered the reaction from major hedge funds groups, which have committed to foster convergence between different industry best practices 66 and delivered to the FSB a set of harmonised Principles of Best Practices for Hedge Fund Managers on 24 June 2009. 67

However, unlike past episodes of instability, these measures generated only lukewarm reaction from public authorities. Securities regulators gathered within IOSCO have raised doubts about the effectiveness of industry codes of best practices as a substitute of direct regulation and highlighted three weaknesses. First, IOSCO argued that the adoption the different standards by hedge fund managers 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, 68 and there had 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”. 69

Therefore, while in the past industry-driven initiatives were successful in deflecting the threat of more stringent regulation, this time the outcome was different. 70

Following the election of President Barack Obama, the new Treasury Secretary Timothy Geithner, and the new Chairwoman of the SEC Mary Schapiro pledged to remove those exemptions from the Investment Advisers Act that allowed advisers to hedge funds to avoid the registration with the Securities and Exchange Commission. This

68 Kinetic Partners, Press release: UK Hedge Funds Uncommitted to Adopting Best Practice Standards, 17 November 2008
measure would provide the SEC with the authority to conduct on-site examinations, and oversee the managers and the funds they manage. In Europe, the European Commission abandoned its long-standing support for self-regulation in the hedge fund industry and presented a regulatory plan (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 requirement in order to operate in Europe.71

Not only these measures left little official role for industry-driven regulatory initiatives, but they also departed from the other two pillars of the pre-crisis regulatory paradigm. Regulators have mandated the registration of hedge funds managers, as well as they have taken upon themselves the primary responsibilities to supervise their activities by requiring hedge fund managers to disclose appropriate information on an ongoing basis to supervisors or regulators.72

What kind of regulation?

While the crisis has brought a radical change by placing the regulation of hedge funds firmly directly in the hands of public authorities, how have regulators used this newly acquired regulatory power?

First, similarly to the case of derivative and credit rating agencies, regulators have imposed several disclosure requirements. Hedge fund managers are required to provide information regarding the identity of their funds (e.g., personnel, assets under management, investment strategies), their internal governance arrangements, the key service providers (e.g., their custodians, and prime brokers). Fund managers are also requested to report on their trading activities, including on the principal markets and instruments in which they trade, their principal exposures and concentrations, the use of short-selling, the overall level of leverage. This information would allow regulators to police hedge funds and identify market abuses (e.g., insider trading and market manipulation), as well as to assess


72 G20, ‘Declaration on Strengthening the Financial System’ (London, 2 April 2009).
the systemic risk they pose to the financial system.\textsuperscript{73}

Second, regulators have used their authority to influence the internal organization and operational conduct of the funds. In the US, hedge funds manager that register with the SEC are required to develop internal compliance programs administered by a chief compliance officer, as well as to have adequate policies to manage conflicts of interest and appropriate asset safekeeping arrangements. The European directive interfere more deeply with hedge funds internal arrangements, requiring hedge fund managers to appoint an independent valuator and an independent depository to safekeep their assets, mandating the separation of the risk management and portfolio management functions and, regulating the remuneration of hedge fund managers.\textsuperscript{74}

However, disagreements have emerged among national regulators on whether the regulation of hedge funds should go beyond these measures and include prudential requirements similar to those imposed on banks.

Some national regulators called for the imposition of capital requirements similar to those of banks to ensure that hedge fund managers are in a stronger position to face the risks incurred, and to restrict their ability to use leverage. The directive drafted by the European Commission requires hedge fund managers to hold level of capital equal to 0.2 per cent of their assets under management. Moreover, the same directive initially empowered the Commission to set limits to the level of leverage managers could employ, although this provision was lately scaled back, giving regulators the authority to impose limits to the level of leverage only when the stability of the financial system is threatened.

The IOSCO Report and the US Treasury plan recommended neither the introduction of capital requirements nor of a cap on leverage for non-systemically relevant hedge funds, continuing to regard the discipline imposed by the banks that provide hedge funds with credit as the primary mechanism to constrain leverage and excessive risk-taking. Moreover, none of the regulatory initiatives described above pose restrictions to the

\textsuperscript{73} According the US Treasury Plan, the SEC would then share this information with a systemic-risk regulator, in particular the Federal Reserve and the newly created Financial Services Oversight Council. US TREASURY, ‘Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation’ Department of the Treasury, 17 June 2009).

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, the crisis has brought hedge funds under the perimeter of public regulation through the mandatory registration of hedge fund managers and placed national supervisors in charge of monitoring the risk they pose. However, public regulators have used their regulatory power mainly to impose disclosure requirements and mandate changes in the internal governance of hedge funds, without seeking to impose limitations on the investment strategies of hedge funds or introduce bank-like prudential regulatory requirements. The regulation that has emerged could be better described as “enhanced oversight” of hedge funds managers than a “granular approach” to closely regulating their activities.75

VI. Conclusion

Commentators have frequently drawn up parallels between the global financial crisis of 2007-2010 and the Wall Street crash of 192976. Besides their severity and their global scope, both shocks came after a decade of unleashed financial innovation and enthusiasm in the financial markets. This paper has illustrated how another parallel between the two crises could be found in the regulatory response they have triggered, which have led public authorities in both cases to increase their involvement in the regulation of financial markets. However, the analysis of the content of the regulatory reforms in this paper suggests that the two shocks had a very different impact on the public-private divide.

In response to the Wall Street crash of 1929, public authorities in the major industrialized countries intervened to prohibit some of the financial instruments created before the crisis, restricted the freedom of banks to operate in the securities industry, reduced the competition in the industry, and discouraged financial innovation. Moran argues: “from the outbreak of the First World War, until the 1950s, the characteristic features of

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75 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)
76 HAROLD JAMES
financial markets were restrictions on competition and hostility to product innovation. The financial services were a backwater of capitalism”.77

The content and the purpose of regulators’ intervention in response to the global financial crisis of 2007-09 have been different. Regulators have been cautious not to expand their regulatory intervention on OTC derivatives markets to the extent that it could hamper, or prohibit the access of corporate end-users to OTC derivatives markets. They have rejected measures that could interfere significantly with the methodologies and business models of credit rating agencies, wary of the risk that this could put them in the position to validate the operation of rating agencies. They have imposed disclosure and organizational requirements upon hedge funds managers, but they have refrained from imposing prudential requirement interfering with their trading activities such as capital requirements, caps on leverage, short-selling restrictions, or position limits.

In other words, the main shift brought by the crisis to the public-private in the regulation and supervision of finance has been the consolidation in the hands of public regulatory agencies of the authority to regulate and oversee markets previously left outside their regulatory oversight, but the content and the purpose of their regulatory intervention maintain significant similarities with the dominant regulatory paradigm before the crisis.