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## RESPONSE

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### FINANCIAL INDUSTRY SELF-REGULATION: ASPIRATION AND REALITY

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In response to Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411 (2011).

#### INTRODUCTION

This essay on financial industry self-regulation responds to Professor Saule Omarova's recent article on that topic.<sup>1</sup> Omarova believes that self-regulation could address two issues better than government regulation could: "the critical role of timely access to market information . . . and the need to monitor and manage risk across jurisdictional borders."<sup>2</sup> In each case, Omarova's goal for the self-regulation is to prevent systemic risk,<sup>3</sup> in contrast to the narrower issues that traditional self-regulatory organizations focus on—such as "investigating suspicious activities in securities trading" and "preventing securities fraud and other forms of investor abuse."<sup>4</sup>

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<sup>1</sup> Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411 (2011). Although her examples sometimes overlap, Professor Omarova's concept of self-regulation appears to be different from private ordering, whereby the government delegates powers to private bodies. See Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 319 (2002) (explaining that private ordering has expanded in scope in recent years, both in the United States and abroad).

<sup>2</sup> Omarova, *supra* note 1, at 418.

<sup>3</sup> *Id.* at 438.

<sup>4</sup> *Id.* at 438 n.100 (internal quotations marks omitted). Omarova indeed acknowledges,

The key to success for a self-regulatory regime aimed at preventing systemic risk, Omarova contends, is “to embed financial practices in broader social values and regulatory principles” by making market participants “more explicitly responsible for the economic and societal effects of [their business] activities.”<sup>5</sup> This can be achieved, she maintains, if the financial industry (by which she appears to mean, as I will in this Response, the financial services industry) collectively perceives itself as a “community of fate”<sup>6</sup>—such that each individual actor’s “future prosperity depend[s] upon its ability to impose collective self-restraint on its members’ profit-seeking activities in the name of public safety.”<sup>7</sup>

Unfortunately, Omarova observes, there currently is an “absence of a ‘community of fate’ mentality within the financial industry,”<sup>8</sup> due in part to “[the] extraordinary security [the industry enjoys] through its access to an extensive public safety net.”<sup>9</sup> Although “individual firms may not necessarily feel immune to enterprise failure and bankruptcy, the modern financial services industry as a whole enjoys a relatively secure existence”<sup>10</sup>—at least relative to the nuclear power industry, for example, which faced an uncertain future after the Three Mile Island reactor accident.<sup>11</sup> This is because “in modern times, national govern-

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[Although] the decades-long experience with self-regulation by stock exchanges and securities associations (like the old NASD and its successor, FINRA) has created a deep institutional familiarity with, and built-in acceptance of, the self-regulatory model. . . . [T]hat same familiarity may limit the industry’s ability to reconceptualize self-regulation as a broader and significantly more demanding system of industry governance aimed at minimizing and managing systemic risk, rather than micromanaging the members’ everyday conduct of business.

*Id.* at 467-68.

<sup>5</sup> *Id.* at 419 (internal quotations marks omitted).

<sup>6</sup> See *id.* at 420 (pointing to the nuclear power and chemical manufacturing industries as existing examples of such communities).

<sup>7</sup> *Id.* at 443; see also *id.* at 446 (noting that such a collective perception “has the potential to unify an industry around a common normative framework, an industry morality, which embodies a more socially responsible and publicly minded approach to conducting business”).

<sup>8</sup> *Id.* at 455.

<sup>9</sup> *Id.* at 471.

<sup>10</sup> *Id.* at 468.

<sup>11</sup> *Id.*

ments typically provide a significant public safety net for financial institutions viewed as crucial to the functioning of their economies.”<sup>12</sup>

Omarova considers the “crisis of public confidence” and corresponding “political and societal pressure”<sup>13</sup> for financial industry reform that the recent financial crisis triggered as an opportunity to take away the financial industry’s “extensive public safety net,”<sup>14</sup> thereby creating a “community of fate” mentality.<sup>15</sup> To this end, she argues for the creation of a regulatory separation based on the “nature of key risks associated with different types of financial activities.”<sup>16</sup> Her regulatory proposal would separate “financial firms trading and dealing in OTC [over-the-counter] derivatives and complex financial instruments” like structured products (“Tier I” firms) from financial firms providing “purely traditional financial intermediation services [like lending, deposit-taking, and securities brokerage and underwriting] aimed at facilitating capital formation.”<sup>17</sup>

This separation, she maintains, would (among other things) allow regulators to better focus on the risky Tier I firms.<sup>18</sup> Regulators could prohibit Tier I firms, for example, from taking deposits—a low-cost form of borrowing—and thus cause them, she argues, to shrink in

<sup>12</sup> *Id.* at 468-69. Omarova further observes that the recent move toward a higher degree of concentration in the post-collapse financial services industry exacerbates this problem. *Id.* at 470.

<sup>13</sup> *Id.* at 451.

<sup>14</sup> *Id.* at 455. Omarova admits, however, that the current crisis lacks a “powerful symbolism” for reform, such as “an innocent human life lost as a result of an industrial accident,” as occurred in the now self-regulating nuclear and chemical industries. *Id.* at 460. On this point, she argues that

[i]n contrast to the nuclear energy and chemical manufacturing industries, the key public policy interest that financial regulation seeks to protect does not directly implicate human life, health, or physical safety. The public policies in the financial services sector aim primarily at protecting the integrity, efficiency, and stability of capital markets—all fundamentally important but rather abstract, depersonalized, highly technical, and expertise-driven issues. Accordingly, in the absence of a major crisis or scandal, issues of financial regulation tend to attract limited public attention.

*Id.* at 462.

<sup>15</sup> *Id.* at 455.

<sup>16</sup> *Id.* at 475. Omarova is wary of the popular proposal to redraw lines by regulating “systemically important institutions under a separate organizational and substantive umbrella.” *Id.* at 476-77.

<sup>17</sup> *Id.* at 474; *see also id.* at 476 (introducing the distinction between “Tier I” and “Tier II” firms).

<sup>18</sup> *See id.* at 477-78 (“[Tier I firms] would be regulated under a single scheme specifically tailored to address the risks their activities pose to global financial stability.”).

size.<sup>19</sup> More relevant to her thesis, she contends that government safety nets should not support Tier I firms because these firms do not provide traditional financial intermediation services aimed at facilitating capital formation.<sup>20</sup> Lacking a safety net, Tier I firms would be more likely to cohere into a self-regulating community of fate.<sup>21</sup>

I agree in principle with many points of Professor Omarova's provocative article. For example, the ideal goal of financial industry self-regulation should indeed be to reduce systemic risk.<sup>22</sup> I also agree that any self-regulation that has this goal must operate in the shadow of government regulation in order to be effective.<sup>23</sup> Furthermore, I agree that the primary impediment to self-regulation is a lack of incentives for financial institutions.<sup>24</sup>

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<sup>19</sup> *Id.* at 479. Omarova's argument that cutting off access to low-cost deposit-based funding will automatically shrink the Tier I financial services market appears inconsistent with the existence of huge investment banks that did not take deposits before the financial crisis. She later seems to tacitly concede this point by admitting that additional measures may still be necessary to adequately reduce the size of Tier I firms. *See id.* at 480 n.254 (suggesting that to limit size, "it may also be desirable to subject these institutions to significantly higher capital adequacy requirements and impose other regulatory limits on their ability to use leverage").

<sup>20</sup> *Id.* at 480.

<sup>21</sup> *Id.* at 481.

<sup>22</sup> *See id.* at 438 ("From a normative perspective, the fundamental rationale for designing a new model of self-regulation in the financial services sector should be the monitoring and prevention of systemic risk on a global basis.").

<sup>23</sup> *Compare id.* at 416, 445-46 (arguing that a self-regulatory regime requires a government framework to be successful), and Jodi L. Short & Michael W. Toffel, *Making Self-Regulation More Than Merely Symbolic: The Critical Role of the Legal Environment*, 55 ADMIN. SCI. Q. 361, 368 (2010) (observing that "[r]esearch has shown that self-regulatory initiatives tend to fail in the absence of external deterrence pressures like the possibility of sanctions"), with Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 1019-23 (2000) (arguing that sovereign debt negotiations must take place "under the shadow" of United States law). The sanctions nonetheless should not be so punitive as to "compromise goodwill and actors' intrinsic and reputational motivations to comply with the law and cooperate with regulators." Short & Toffel, *supra*, at 368. The critical task, however, is forming a regulatory framework with a shadow that creates appropriate incentives and does not leave a regulatory lacuna. *Cf.* Omarova, *supra* note 1, at 445-46 (emphasizing the need for the government to be able to impose rules). The government clearly should not completely withdraw from regulating systemic risk. *See id.* at 416 (explicitly not advocating "complete withdrawal of the government from [this] regulatory space").

<sup>24</sup> *See id.* at 413, 442, 455 (arguing that the financial services industry lacks the incentive to develop socially responsible self-regulation).

## I. FRAMEWORK FOR ANALYSIS

In order to analyze Omarova's proposals more closely, however, it may be useful to introduce a conceptual framework (hereinafter, the "3Cs+TOC framework") that I have been using in other contexts to think about systemic risk and the recent financial crisis. That crisis, I have argued, can be attributed in large part to four types of market failures: conflicts of interest, complacency of market participants, complexity of financial markets and the securities traded therein, and a type of tragedy of the commons (hereinafter the "TOC failure") under which the benefits of exploiting finite capital resources accrue to individual market participants—each of whom is motivated to maximize use of the resource—whereas the costs of exploitation are distributed more widely.<sup>25</sup> Two of these market failures—complexity and the TOC failure—can help to inform Omarova's proposals.

## II. CREATION OF A SYSTEMIC RISK FUND

Omarova advocates the creation of "a mandatory system of mutual self-insurance"<sup>26</sup> among financial firms to encourage these firms to see themselves as a "community of fate."<sup>27</sup> This type of approach is, I agree, essential to fixing the TOC failure because any resolution of this failure requires financial industry participants to internalize their externalities. To this end, Professor Iman Anabtawi of the UCLA School of Law and I, as well as others, have been arguing for the creation of a systemic risk fund to motivate self-monitoring.<sup>28</sup> Omarova's mandatory mutual self-insurance and our systemic risk fund are conceptually identical because both would require systemically important

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<sup>25</sup> Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 376, 386 (2008). Running throughout these causes is another cause—cupidity. *Id.* at 376. But because greed is so ingrained in human nature and so intertwined with the other causes, cupidity adds little insight when viewed separately. One also might add complicity as a cause, though I have seen many allegations but little proof.

<sup>26</sup> Omarova, *supra* note 1, at 474, 481.

<sup>27</sup> *Id.*

<sup>28</sup> See Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. (forthcoming 2011) (manuscript at 46, 54), available at <http://ssrn.com/abstract=1735025> (describing the potential use of a loss-sharing pool funded by financial institutions). For a similar proposal, see Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 154 (2011), which argues for a prefunded insurance fund into which all large financial institutions would pay premiums.

financial market participants to contribute to a common fund which would then be used as needed to deter systemic meltdowns.<sup>29</sup>

I further argue elsewhere that

a systemic risk fund funded by market participants not only can mitigate externalities resulting from TOC failure but also can help minimize the potential that market participants who believe they are too big to fail will engage in risky behavior. The too-big-to-fail problem [would be minimized because the problem] is effectively an externality imposed on government (and ultimately taxpayers) by a market participant engaging in such risky behavior. A privately-funded systemic risk fund would help to internalize that externality. Furthermore, the ability of government to require additional contributions to this type of fund should motivate contributors to the fund not only to monitor themselves but also to monitor each other to reduce the potential for such risky behavior. Contributors could be further motivated to monitor by enabling at least a portion of the fund, if unused, to be returned over time and also by requiring the fund, if sufficient levels are maintained, to pay a periodic rate of return to the contributors.<sup>30</sup>

In order to make a systemic risk fund or Omarova's mandatory mutual self-insurance most viable, such a fund or insurance scheme should be internationally mandated.<sup>31</sup> An international system would help avoid anticompetitively "taxing" financial industry participants in any given jurisdiction.<sup>32</sup> Omarova's article does not appear to address that point, though I imagine she would readily agree.

I therefore agree in concept with Omarova's mandatory mutual self-insurance proposal, although it should not be used (as she sometimes

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<sup>29</sup> Compare Anabtawi & Schwarcz, *supra* note 28 (manuscript at 46, 54) (referring to these meltdowns as "risk-spillovers"), with Omarova, *supra* note 1, at 481 (describing the use of a self-insurance fund, "which would be used to provide emergency liquidity support to the system in the event of any firm's failure").

<sup>30</sup> Steven L. Schwarcz, *Marginalizing Risk*, 89 WASH. U. L. REV. (forthcoming 2012) (manuscript at 28-29), available at <http://ssrn.com/abstract=1721606>; see also Eric Dash, *F.D.I.C. Says Banks Lost \$3.7 Billion in 2nd Quarter*, N.Y. TIMES, Aug. 28, 2009, at B3 (explaining that the government's deposit-insurance fund rises and falls with the success of its contributors). On the issue of repayment, the fund that the IMF established to help bail out defaulting member-nations pays a periodic rate of return to the contributing nations. See Steven L. Schwarcz, *"Idiot's Guide" to Sovereign Debt Restructuring*, 53 EMORY L.J. 1189, 1195-96 (2004) (noting, however, that repayment is not guaranteed). Unfortunately, the IMF pays those nations less than a market rate of interest on their contributions. *Id.* at 1196.

<sup>31</sup> Schwarcz, *supra* note 30, at 27-28.

<sup>32</sup> *Id.*

appears to advocate) as a blanket substitute for the public safety net of “government-run deposit insurance and liquidity-backup programs.”<sup>33</sup>

### III. STANDARDIZATION AND RISK MANAGEMENT

Further applying the 3Cs+TOC framework outlined above to Omarova’s proposals, I take note of her argument that government could encourage good self-regulatory behavior by threatening to prohibit financial institutions “from selling or marketing certain types of complex financial instruments if the industry fails to monitor and manage the risks associated with such products.”<sup>34</sup> This argument, of course, ties into the problem of complexity.<sup>35</sup> One possible response to complexity, Professor Anabtawi and I have argued, is standardization of financial products.<sup>36</sup> Since this response would allow the use of complex products so long as they are standardized, it offers a more nuanced version of a direct ban on complex financial products. The goal of this response would be to make financial products more cognizable to prospective investors and to reduce the cost to investors of familiarizing themselves with the products.<sup>37</sup>

Anabtawi and I conclude, however, that the overall economic impact of standardization is unclear because it would interfere with the ability of parties to achieve efficiencies arising from financial products that are tailored to the particular needs of investors, such as products that “provid[e] a variety of options relating to risk, return, and timing of cash flows.”<sup>38</sup> We therefore argue that, to achieve those efficiencies, it is “preferable to address complexity through supplemental protections that do not interfere with the ability of market participants.”<sup>39</sup> To the extent that a threat of banning complex financial products, as Omarova advocates—or even worse, an actual ban of those products—

<sup>33</sup> Omarova, *supra* note 1, at 480.

<sup>34</sup> *Id.* at 486; *see also id.* at 475 (calling for the threat of a “direct ban on complex financial products”); *id.* at 431 (referring to “the unprecedented and poorly understood complexity of financial products” as a problem “at the heart of the latest crisis”).

<sup>35</sup> *See supra* text accompanying note 25 (identifying market failure caused by the complexity of financial markets and the securities traded therein, among other factors).

<sup>36</sup> *See Anabtawi & Schwarcz, supra* note 28 (manuscript at 41) (arguing that standardization of financial products would reduce “information uncertainty”).

<sup>37</sup> *See id.* (manuscript at 41-42) (explaining that standardization reduces costs of learning about new securities).

<sup>38</sup> *Id.* (manuscript at 42).

<sup>39</sup> *Id.* at 42; *see also* Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 241 (2009) (noting concern for unintended consequences caused by standardization—a process that is itself intended to limit uncertainty).

would interfere with the ability of market participants to achieve those efficiencies, the argument that complexity should be addressed through supplemental protections would be even more applicable. But Omarova's proposed threat could be beneficial insofar as it motivates industry participants to improve transparency of financial products, thereby reducing information asymmetry without interfering with the ability of market participants to achieve those efficiencies. The desirability of Omarova's proposed threat, though, is indeterminate absent details of its operation and empirical data on its impact.

Omarova's goal of facilitating "timely access to market information" also appears to tie into the problem of complexity.<sup>40</sup> She argues that market participants "may be in the best position to identify and understand underlying trends in the increasingly complex financial markets and to gather and analyze, in real time, information most relevant to systemic risk management."<sup>41</sup> Furthermore, market participants "may have a better ability [than government regulators] to identify, analyze, and assess systemic implications of underlying trends in the financial markets, particularly regarding complex financial products and transactions" and may also be in a position to "make better-informed judgments as to what information is relevant to issues of systemic risk prevention and how it relates to the broader picture."<sup>42</sup> Omarova is nonetheless realistic about the possibility that "financial institutions, whose profitability depends on their ability to acquire and use information not available to their competitors or other market participants, are highly unlikely to share proprietary market information even with their peers in the industry."<sup>43</sup> Therefore, "the type and amount of market information that may—and should—be disclosed . . . is a complicated issue that would require careful consideration and balancing of various policy interests."<sup>44</sup>

#### IV. REGULATORY SEPARATION AND ITS CONSEQUENCES

The central proposal of Omarova's article ties into the 3Cs+TOC framework in a more intricate way. She advocates a regulatory separa-

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<sup>40</sup> Omarova, *supra* note 1, at 418; *see also id.* at 431-34, 491.

<sup>41</sup> *Id.* at 418.

<sup>42</sup> *Id.* at 433-34.

<sup>43</sup> *Id.* at 490-91; *see also id.* at 489 (observing that "[f]inancial institutions trading and dealing in highly complex financial instruments tend to guard their trading information very closely").

<sup>44</sup> *Id.* at 489.



tion between Tier I firms on one hand and financial firms providing purely traditional financial intermediation services aimed at facilitating capital formation on the other.<sup>45</sup> She argues that such a separation can advance self-regulation by making it practical to deprive risky firms of government safety nets, thereby making those firms more likely to cohere into a self-regulating “community of fate.”<sup>46</sup> A deprivation of safety nets to risky financial firms ties into the 3Cs+TOC framework because such a deprivation helps to reduce TOC failure by internalizing those firms’ externalities.<sup>47</sup> Moreover, the advancement of self-regulation ties into the 3Cs+TOC framework because self-regulating financial firms are, as Omarova contends, able to reduce complexity.<sup>48</sup>

Omarova does not appear to fully explore, however, the extent to which the advancement of self-regulation might increase the potential for conflicts of interest—another factor in the 3Cs+TOC framework—between financial firms and government.<sup>49</sup> Nor does she fully explore the extent to which regulatory separation itself could cause negative consequences. She explains that those consequences are beyond her article’s scope, even though they can be significant.<sup>50</sup> For example, separation may create inefficiencies by reducing a financial firm’s economy of scope. Furthermore, because the financial industry is international, imposing regulatory separation on a national basis as opposed to international basis—as would likely occur from a pragmatic

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<sup>45</sup> See *supra* notes 16-17 and accompanying text (describing Omarova’s proposal for regulatory separation based on the nature of key risks); see also Omarova, *supra* note 1, at 477-78. Omarova emphasizes that her proposed separation would draw the line somewhat differently from the separation under the former Glass-Steagall Act, which “created barriers between commercial banking and investment banking.” *Id.* at 478 (citing the Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, 48 Stat. 12 (codified as amended in scattered sections of 12 U.S.C.) (repealed in part in 1999)).

<sup>46</sup> See *supra* text accompanying notes 15-21 (explaining Omarova’s idea of regulatory separation).

<sup>47</sup> See *supra* text accompanying notes 27-28 (noting how several proposals aimed at curbing systemic risk can help fix the TOC failure).

<sup>48</sup> See *supra* text accompanying notes 40-42 (summarizing Omarova’s views on complexity).

<sup>49</sup> See *supra* text accompanying note 25 (identifying conflicts of interest as the first “C” in the 3Cs+TOC framework). Omarova addresses the conflicts issue in only the most general sense. See Omarova, *supra* note 1, at 423 (briefly discussing potential criticism of self-regulation, including a concern for conflicts of interest); see also *id.* at 438-39 (arguing that the “inherent conflict of interest” would dissipate once the financial practices of self-regulation become “embedded” in “broader social values and regulatory principles”).

<sup>50</sup> See *id.* at 479 nn.250-51 (observing that “a reform that redrew regulatory boundaries in such a radical manner” may have some “negative consequences”).

standpoint—could foster cross-border regulatory-arbitrage incentives<sup>51</sup> and potentially reduce the international competitiveness of firms subject to the regulation. Moreover, Omarova does not explore the extent to which regulatory separation might actually undercut one of her two goals for self-regulation: the need to monitor and manage risk across jurisdictional borders.<sup>52</sup>

#### CONCLUSION

Omarova's article therefore may raise more questions than it answers—even questions about whether the consequences of her proposals outweigh her proposals' benefits. But perhaps raising questions is Omarova's intention. After all, she explicitly states that “[r]ather than advocating [her proposals] as a necessary and comprehensive method of regulatory reform, the point of [her] Article is merely to discuss its potential impact on the incentives for financial institutions to create a regime of embedded self-regulation.”<sup>53</sup>

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<sup>51</sup> Although Omarova identifies this problem and acknowledges “the high probability of cross-border regulatory arbitrage,” *see id.* at 487, she incongruously argues elsewhere that her proposals should have the goal of reducing regulatory arbitrage. *See id.* at 416 (“Only by enlisting the industry’s active participation in the regulatory process can this vicious circle [of arbitrage] be broken.”); *see also id.* at 436 (highlighting the potential for arbitrage in today’s market).

<sup>52</sup> *Cf. supra* text accompanying note 2 (explaining her argument that self-regulation could address these issues better than government regulation).

<sup>53</sup> Omarova, *supra* note 1, at 479 n.250.