ARTICLE

WALL STREET AS COMMUNITY OF FATE: TOWARD FINANCIAL INDUSTRY SELF-REGULATION

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> Americans are angry at Wall Street, and rightly so. First the financial industry plunged us into economic crisis, then it was bailed out at taxpayer expense. And now, with the economy still deeply depressed, the industry is paying itself gigantic bonuses. If you aren't outraged, you haven't been paying attention.[1]

Paul Krugman

> Probably the circumstances most conducive to successful self-regulation are those where an industry, or at least industry leaders, perceive the future prosperity and perhaps even the very survival of the industry as dependent upon some form of self-control. The best examples are those of the nuclear power and chemical industries . . . .[2]

Neil Gunningham & Joseph Rees

INTRODUCTION

In the wake of the worst financial crisis since the Great Depression, policymakers around the world are searching for ways to manage sys-

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[1] Paul Krugman, Op-Ed., *Rewarding Bad Actors*, N.Y. TIMES, Aug. 3, 2009, at A21.

[2] Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 LAW & POL'Y 363, 391 (1997).

temic risk in the global financial market.[3] This Article argues that one key and currently overlooked potential mechanism for controlling and minimizing systemic financial risk is industry-wide self-regulation. This Article advocates a fundamentally new self-regulatory regime in the financial sector, which would focus explicitly on the issue of systemic risk prevention and impose the responsibility of protecting the public from financial crises directly on the financial services industry.[4]

Further, this Article argues that the financial services industry currently lacks meaningful incentives to develop this new type of more publicly minded and socially responsible self-regulation. It examines the experience with self-regulation in other sectors—in particular, the nuclear power and chemical manufacturing industries—and analyzes how the key factors that allowed such self-regulatory regimes to emerge in those industries might play out in the financial sector.

Finally, this Article argues that it is possible to alter the existing incentive structure through thoughtful regulatory design, and it proposes some steps that may be taken in that direction.

A. *The Paradox*

The past two years have seen a huge upsurge in proposals to reform the existing system of financial services regulation, both in the United States[5] and abroad.[6] Much of this debate, spurred by the

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[3] Systemic risk may be defined generally as a "risk that a disturbance will impair the efficient functioning of the financial system and, at the extreme, cause its complete breakdown." Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 47 (1997). For an in-depth treatment of the nature of systemic risk in the financial sector, see, for example, Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008).

[4] In my prior work, I have developed this argument in greater depth. *See* Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665 (2010) (arguing that a normative approach of "embedded self-regulation" can "redefine the broader social role of the private financial sector").

[5] *See, e.g.*, MARKUS BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION (2009) (arguing that current financial regulation should be replaced by coordinated bank-level and systemwide regulation); CONG. OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM (2009), *available at* http://cop.senate.gov/documentscop-012909-report-regulatoryreform.pdf (suggesting reforms to improve oversight, transparency, and fairness); U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf (presenting short-term and intermediate recommendations to improve the United States' regulatory structure); U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (2009) [hereinafter U.S. DEP'T OF THE TREASURY, A NEW FOUNDATION], *available at* http://

recent turmoil in global financial markets, has centered around issues of agency structure and the redrawing of regulatory and supervisory responsibilities.[7] With respect to more substantive changes to the existing regulation, the tendency has been to focus on specific "fixes" to individual problems widely viewed as key contributors to the recent crisis, including regulation of mortgage brokers, credit rating agencies, and over-the-counter derivatives.[8] The Dodd-Frank Act, which is widely viewed as the most comprehensive and far-reaching financial reform legislation in the United States since the New Deal, reflects these concerns and incorporates many of the ideas these proposals advance.[9] However, what is conspicuously absent from the new legisla-

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www.financialstability.gov/docs/regs/FinalReport_web.pdf (proposing increased supervision of financial firms and markets, increased consumer protections, and improved international cooperation). On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which incorporated many of the ideas advanced in various reform proposals. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[6] *See, e.g.*, FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf (detailing, from the perspective of the United Kingdom, localized and global recommendations for creating a stable and effective banking system); HER MAJESTY'S TREASURY, REFORMING FINANCIAL MARKETS (2009), *available at* http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf (discussing necessary regulatory reforms for the United Kingdom).

[7] *See* sources cited *supra* note 5. For critical analyses of the key trends in the debate, see, for example, Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009), and Saule Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009).

[8] *See, e.g.*, CONG. OVERSIGHT PANEL, *supra* note 5, at 30-37, 40-44 (recommending reforms in credit ratings and mortgage regulation); U.S. DEP'T OF THE TREASURY, A NEW FOUNDATION, *supra* note 5, at 46-49 (proposing comprehensive regulation of all over-the-counter derivatives); *see also* FRANK PARTNOY, RETHINKING REGULATION OF CREDIT RATING AGENCIES: AN INSTITUTIONAL INVESTOR PERSPECTIVE (2009), *available at* http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf (discussing the pros and cons of several proposals for redesigning regulation of credit rating agencies); Cassandra Jones Havard, *"Goin' Round in Circles" . . . and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 NEB. L. REV. 737 (2008) (describing the structural framework of the mortgage-broker industry and proposing a uniform federal regime of mortgage-broker regulation).

[9] *See* sources cited *supra* note 5. Despite its undeniable significance, the Dodd-Frank Act is unlikely to provide perfect solutions to the fundamental problems in this area and end the search for a more effective system of financial sector regulation and supervision. In fact, one of the main criticisms of the Dodd-Frank Act is its apparent failure to resolve many important issues because it left many key policy choices to the discretion of regulatory agencies. *See, e.g.*, Stacy Kaper, *Now for the Hard Part: Writing All the Rules*, AM. BANKER, July 22, 2010, at 1 ("[R]egulators must flesh out the details of a host of highly complex requirements . . . with little or no guidance from Congress."). According to some estimates, the statute requires regulators to adopt 243 new rules, conduct 67 one-time studies, and submit 22 periodic reports. *Id.*

tion, as well as the broader debate among academics and policymakers, is a meaningful discussion of the role and shape of industry self-regulation in the emerging postcrisis regulatory order, either on a national or transnational level.

Perhaps, to some, this absence is decidedly obvious and defensible: after all, it was the financial industry's unbridled pursuit of economic profit and the government's inability, or unwillingness, to keep it in check that led to the crisis in the first place. In today's postcrisis environment, the idea of financial industry self-regulation is not politically popular.[10] Wall Street's conduct in bringing about the near collapse of the world's credit and capital markets,[11] in arguably taking unfair advantage of governments' bailout programs,[12] and, finally, in paying exorbitantly high bonuses in the midst of a major recession triggered by the financial crisis[13] certainly did little to enhance the public image of

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[10] As the Financial Crisis Inquiry Commission (FCIC), a bipartisan body established to investigate the causes of the recent crisis, conducts its hearings and publishes reports and testimony, the political salience of this issue is likely to increase. It is telling that a group of Wall Street CEOs were the first called to testify in front of the FCIC on January 13, 2010. FIN. CRISIS INQUIRY COMM'N, THE OFFICIAL TRANSCRIPT: FIRST PUBLIC HEARING OF THE FINANCIAL CRISIS INQUIRY COMMISSION (2010), *available at* http://www.fcic.gov/hearings/pdfs/2010-0113-Transcript.pdf. For further information on the FCIC, see *About the Commission*, FIN. CRISIS INQUIRY COMM'N, http://www.fcic.gov/about/ (last visited Oct. 15, 2010).

[11] One of the recent revelations about large financial institutions' role in creating the "perfect storm" in the global financial market is that a number of them, including Goldman Sachs, Morgan Stanley, and Bank of America, may have sold certain complex financial instruments while knowing that the mortgages and other assets backing them were likely to default. *See* Joanna Chung & Francesco Guerrera, *US Regulators Subpoena Big Banks over CDOs*, FIN. TIMES (London), Jan. 16, 2010, at 6 (discussing the SEC investigation). In April 2010, the SEC brought a lawsuit against Goldman Sachs, accusing the firm of intentionally misleading investors about the true risk profile of a synthetic collateralized debt obligation (CDO) tied to the performance of a portfolio of subprime residential mortgage-backed securities. Press Release, U.S. Sec. & Exch. Comm'n, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-123.htm. In July 2010, Goldman Sachs settled the SEC's charges and agreed to pay $550 million and reform its business practices. *See id.* (noting that the figure is "the largest penalty ever assessed against a financial services firm in the history of the SEC").

[12] *See, e.g.*, John Gapper, Editorial, *A Credibility Problem for Goldman*, FIN. TIMES (London), Oct. 15, 2009, at 15 (describing public outrage at the news of the high profits Goldman Sachs made soon after taking advantage of a massive government bailout).

[13] *See, e.g.*, Justin Baer & Francesco Guerrera, *Banks Braced for Bonus Backlash*, FIN. TIMES (London), Jan. 11, 2010, at 1 (predicting public anger at bonuses paid by banks); Stephen Grocer, *Banks Set for Record Pay*, WALL ST. J., Jan. 15, 2010, at A1 (stating that major U.S. financial firms were "on pace" to pay their employees "a record sum" of about $145 billion in total compensation during 2009).

the financial services industry.[14] Amid widespread, and largely justified, skepticism toward banks' and other financial institutions' ability to act in a socially responsible or publicly minded manner, a call for allowing them to run their own affairs is counterintuitive, to say the least.

This anti-industry sentiment, however, obscures an important paradox. Although too much freedom for the financial industry to "innovate" in pursuit of ever-increasing profits may have been a major cause of the current problems in the financial sector, denying industry self-regulation its proper place in the future regulatory architecture will almost certainly foreclose a workable long-term solution to those problems. Given the complexity and global nature of the modern financial market, any government's attempt to regulate it in a purely unilateral command-and-control manner will inevitably encounter the fundamental problem of regulatory arbitrage, whereby financial institutions find new ways to get around government rules, thus creating a never-ending spiral of rulemaking and rule evading.[15] Only by enlisting the industry's active participation in the regulatory process can this vicious circle be broken. Thus, the lack of attention to self-regulation is an important omission in the debate on regulatory reform in the financial services sector. This Article fills that significant gap.[16]

It is crucial to state from the outset that this Article does not equate "self-regulation" with "deregulation." Nor does it advocate complete withdrawal of the government from the regulatory space in the financial sector. To the contrary, what drives this project is a

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[14] By the end of 2009, in response to public outrage over the industry's role in bringing about the financial crisis and resulting global recession, governments began searching for ways to "punish" big banks by imposing special taxes or assessments on them. *See* Patrick Jenkins, *US Levy and UK Supertax Level the Playing Field*, FIN. TIMES (London), Jan. 16, 2010, at 16 (describing the impact of the taxes on banks).

[15] For a recent scholarly treatment of the phenomenon of regulatory arbitrage, see Victor Fleischer, *Regulatory Arbitrage* (U. of Colo. Law Sch. Studies Research Paper Series, Paper No. 10-11, 2010), *available at* http://papers.ssrn.com/abstract_id=1567212.

[16] Recently, a few legal scholars began incorporating the notion of self-regulation in their reform proposals. *See, e.g.*, Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L.J. 777, 836-43 (2010) (proposing an industry organization comprised of systemically important financial institutions and designed to provide a cost-sharing mechanism in the event of a financial crisis); Kristin N. Johnson, *Things Fall Apart: Regulating Credit Default Swaps in the Battle of Man vs. the Gods of Risk* (Seton Hall Law Sch. Pub. Law & Legal Research Series, Working Paper, 2010), *available at* http://papers.ssrn.com/abstract_id=1572467 (proposing the establishment of a self-regulatory organization focusing on the regulation of credit default swaps). However, these recent proposals tend to focus on the potential application of a traditional concept of a self-regulatory organization in certain limited areas. They do not address directly the need for a fundamental shift in the paradigm of financial sector self-regulation.

search for new, creative ways to reinvigorate and strengthen the foundation of government regulation in the financial services sector, to make it more targeted and effective, and to broaden the regulatory perspective by taking a more comprehensive view of the reform process. Accordingly, this Article builds upon the vast and multidisciplinary body of academic literature known as New Governance.[17] The New Governance scholarship posits, generally, that the traditional top-down model of regulation, in which the power to create rules belongs exclusively to the state, is being replaced by a more flexible "governance" model, in which power to set and enforce the rules is increasingly diffused among a variety of societal actors working alongside the governments.[18] Using the insights that literature has developed, this Article seeks to redefine the meaning and goals of self-regulation and, more generally, the mode of interaction between public and private actors in the financial services sector. In that sense, it is a part of the larger process of rethinking the fundamental tenets of regulatory philosophy underlying the existing system of financial sector regulation and supervision.[19]

B. *Summary of the Argument*

Financial industry self-regulation has a long history in the United States and elsewhere. However, this Article argues that an understanding of financial sector "self-regulation" based primarily on the existing self-regulatory practices in the U.S. securities and commodity futures industries is fundamentally limited in scope. In the U.S. securities industry, a number of self-regulatory organizations (SROs), including registered stock exchanges and the Financial Industry Regulatory Association (FINRA), operate under strict oversight by the Securities Exchange Commission (SEC) and direct their activities primarily at managing, often in excruciating detail, the everyday business of securities broker-dealers and other market intermediaries.[20] Under this concept of industry self-regulation, rooted deeply in the regulatory paradigm of the post–Great Depression era, securities SROs func-

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[17] *See infra* note 56 and accompanying text.

[18] *See infra* notes 57-65 and accompanying text.

[19] For an argument emphasizing the importance of rethinking our broader regulatory philosophy as an essential step in the process of a comprehensive regulatory reform, see Omarova & Feibelman, *supra* note 7.

[20] *See infra* notes 203-10 and accompanying text. A similar scheme of self-regulation exists in the U.S. commodity futures industry. *See infra* note 206.

tion effectively as quasi-governmental entities performing resource-intensive tasks "outsourced" to them by the SEC.[21]

By contrast, the dynamics of the twenty-first-century global financial market demand a new approach to industry self-regulation, which has the potential to be much more comprehensive and systemic in its scope and operation. The most recent financial crisis clearly demonstrated that the most fundamental challenges facing financial regulators and policymakers stem from the increasing complexity of financial products and activities and the globalization of financial markets and institutions. Industry self-regulation could serve as the key link allowing us to tackle two issues central to regulatory reform in the aftermath of the crisis: the critical role of timely access to market information, on the one hand, and the need to monitor and manage risk across jurisdictional borders, on the other.[22] Private industry actors 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.[23] Unconstrained by matters of formal jurisdiction, private firms are also better equipped to monitor and manage their activities and risks on a global basis as an integrated economic enterprise.[24] Leveraging this unique position of private firms to control and regu-

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[21] For a detailed discussion of the hybrid public-private status of securities SROs, see Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151 (2008).

[22] *See infra* notes 78-81 and accompanying text.

[23] *See, e.g.*, John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 MICH. L. REV. 1466, 1468 (1982) (arguing that self-regulation can lead to greater coverage and depth in the inspection of corporations and that private industry inspectors make "more effective probers" than do government inspectors); Douglas C. Michael, *Federal Agency Use of Audited Self-Regulation as a Regulatory Technique*, 47 ADMIN. L. REV. 171, 181-88 (1995) (discussing five distinct advantages of self-regulation, the first of which is "the self-regulator's superior knowledge of the subject compared to the government agency"); *see also* Christodoulos Stefanadis, *Self-Regulation, Innovation, and the Financial Industry*, 23 J. REG. ECON. 5, 5-6 (2003) (stating that self-regulation enables faster access to information about new, efficiency-making technologies and facilitates their adoption in the financial sector).

[24] *See, e.g.*, Edward J. Balleisen, *The Prospects for Effective "Coregulation" in the United States: A Historian's View from the Early Twenty-First Century* ("Whatever the limitations associated with private regulation, it sometimes offers the only practical means of constraining the behavior of multinational corporations whose production facilities and distribution networks span the globe."), *in* GOVERNMENTS AND MARKETS: TOWARD A NEW THEORY OF REGULATION 443, 464 (Edward J. Balleisen & David A. Moss eds., 2010); *see also* Braithwaite, *supra* note 23, at 1468-69 (arguing that corporations are better at regulating their business activities than the government, based on examples from the international pharmaceutical industry).

late systemic risk in global financial markets can add to ongoing efforts to strengthen the government's regulatory framework and create market-based incentives for more prudent financial conduct.

This new, more comprehensive model of industry self-regulation will have to redefine the delicate balance between financial institutions' freedom to engage in increasingly complex activities in the most economically efficient way and their duty to conduct their profit- and risk-generating business activities in accordance with the overarching public interest in preserving financial stability. The new model should both enhance market participants' ability to adopt and enforce rules governing their business activities and make them more explicitly responsible for the economic and societal effects of such activities. In that sense, this new model will seek to "embed" financial practices in broader social values and regulatory principles, instead of "disembedding" them from the public interest.[25] Thus, this Article advocates a new concept of financial industry self-regulation: "embedded self-regulation."[26]

It bears emphasis that the search for a new model of financial sector self-regulation, one focused explicitly on preventing systemic failure and thus embedded in broader public interests and policy goals, should supplement the ongoing search for an optimal design of government regulation and supervision of financial institutions and activities. A new, publicly minded system of self-regulation by the financial services industry requires the existence of a strong and effective regulatory framework that defines the key objectives and monitors the functioning of self-regulatory institutions.[27] Successful and socially useful industry self-regulation is not entirely free from government intervention but is firmly "embedded" within the system of government regulation and oversight.

What drives private market participants to adopt a self-regulatory system that explicitly seeks to limit their previously unrestrained individual profit-seeking to avoid, or minimize, potentially disastrous consequences of their business activities to the broader public? To identi-

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[25] *See* Rawi Abdelal & John G. Ruggie, *The Principles of Embedded Liberalism: Social Legitimacy and Global Capitalism* (arguing for the relevance of "embedded liberalism" in the modern global economy), *in* NEW PERSPECTIVES ON REGULATION 153, 153-64 (David Moss & John Cisternino eds., 2009).

[26] *See* Omarova, *supra* note 4, at 701-06 (introducing the concept of "embedded self-regulation").

[27] The existence of a strong and effective system of government regulation and supervision is particularly important in the financial services sector because of the nature of financial risk and the general dynamics of financial markets. *See infra* notes 265-66 and accompanying text.

fy some of the factors that appear to facilitate this process, this Article examines the successful emergence of self-regulatory systems in two different industries—nuclear power and chemical manufacturing—and argues that, in each case, the key to the rise of self-regulation was the industry's collective perception of itself as a "community of fate."[28] Each industry's future prosperity was seen as depending upon its ability to impose collective self-restraint on its members' profit-seeking activities in the name of public safety. Using these cases as the comparative basis for evaluating self-regulatory potential in the financial services sector, this Article argues that modern financial institutions do not have meaningful incentives to create a system of embedded self-regulation. This absence of incentives to self-regulate is due to a variety of factors, including regulatory fragmentation and heterogeneity of interests throughout the industry, little direct public involvement in monitoring the industry's performance, and insufficient political pressure on the industry to self-monitor for systemic risk. Perhaps the most important obstacle to self-regulation is the lack of a "community of fate" mentality within the financial industry, which currently enjoys extraordinary security through its access to an extensive public safety net and the near certainty of government bailouts in the event of a crisis.

Turning to issues of regulatory design, this Article discusses several structural reforms that could alter the existing incentive structure in the financial sector to make publicly minded self-regulation a more viable path to supplement both direct state regulation and pure market-based regulatory mechanisms.[29] Thus, some of the elements of regulatory reform likely to "nudge"[30] the industry toward more socially responsible self-regulation include establishing a separate regulatory regime for financial institutions that deal and trade in complex instruments of risk transfer (as opposed to traditional forms of financial intermediation, such as deposit-taking or securities brokerage), eliminating those institutions' access to federal deposit insurance and other forms of public subsidy, and mandating mutual self-insurance against the systemic risk these institutions' activities create. A credible threat

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[28] *See generally* JOSEPH V. REES, HOSTAGES OF EACH OTHER: THE TRANSFORMATION OF NUCLEAR SAFETY SINCE THREE MILE ISLAND 173-79 (1994) (summarizing the emergence of the new self-regulatory culture within the U.S. nuclear power industry).

[29] In that sense, industry self-regulation may be viewed as a "third way," occupying the middle space between top-down government regulation and free market ordering. For a general discussion of the concept of a "third way," see ANTHONY GIDDENS, THE THIRD WAY 64-68 (1998).

[30] For a general exposition of the concept of "nudging," see RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE 1-14 (2009).

of government interference with the industry's ability to conduct its high-risk financial services business if the industry fails to self-regulate in accordance with the public policy goals, as well as functional substitutes for public interest groups' involvement in monitoring the industry's performance, might be important external constraints that prevent the industry from abusing the self-regulatory process.

This Article proceeds as follows: Part I provides an overview of the theoretical debate on industry self-regulation and the New Governance paradigm. Part II lays out the normative case for a system of embedded self-regulation as a form of the New Governance approach to the regulatory challenges posed by the increasing complexity and globalization of financial markets in the aftermath of the recent crisis. Part III examines self-regulatory initiatives in other sectors—primarily the nuclear power and chemical manufacturing industries—and identifies key factors and structural incentives that make industry self-regulation more or less likely to emerge and operate successfully. Part IV analyzes the characteristics of the modern financial services industry and argues that, despite the historical existence of self-regulation in certain segments of the financial market, the industry as a whole currently lacks an incentive structure conducive to a viable and effective self-regulatory regime aimed at reducing and preventing potential systemic risks. Part V uses this framework to propose a new perspective on regulatory design and discusses how certain regulatory reform measures might help to create or enhance the incentive structure for a new system of embedded self-regulation.

I. SELF-REGULATION AND NEW GOVERNANCE: THEORETICAL BACKGROUND

This Part provides an intellectual and theoretical context for the discussion of self-regulatory potential in the financial sector. It examines definitional and conceptual complexities in the ongoing academic debate on self-regulation and clarifies this Article's use of the term "self-regulation" to refer to a regime of collective rulemaking, whereby an industry-level entity develops and enforces rules and standards governing behavior of all industry members. This Part further outlines this Article's approach to financial industry self-regulation as a form of New Governance, a more flexible and cooperative mode of public-private interaction in today's increasingly complex financial marketplace.

A. *Self-Regulation in Academic Debate: Some Definitional Issues*

The concept of self-regulation as a form of social organization has a long history, going back to religious fraternities and medieval merchant and trade guilds.[31] In the modern world, various forms of self-regulation exist in a variety of settings, including professional self-regulatory arrangements in law and medicine, private accreditation and product-certification schemes, and formal self-regulatory organizations. It is hardly surprising that, given the wide variety of self-regulatory institutions, the meaning of the term "self-regulation" defies simple definition.

Despite its deceptive simplicity, self-regulation is a loaded concept. In academic and policy discourse, the notion of industry self-regulation is frequently used as a proxy for complete freedom of market actors from any government regulation.[32] In that sense, self-regulation is often viewed as the opposite of, and an alternative to, government regulation. The ideologically grounded rhetoric of the proponents of industry self-regulation, as well as its opponents, tends to influence policy choices and attitudes and can shape the form in which self-regulation exists in any particular setting.[33]

According to its supporters, self-regulation by market actors offers significant advantages over direct government regulation. Specifically, self-regulation is often said to be considerably more flexible and context-driven, as private entities participating in regulated market activities can respond better and more quickly to changes in market conditions.[34] A key advantage of such a flexible and localized approach to

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[31] *See, e.g.*, CTR. FOR FIN. MKT. INTEGRITY, CFA INST., SELF-REGULATION IN TODAY'S SECURITIES MARKETS 1 (2007), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n7.4819 ("In a broad sense, the concept of self-regulation dates back to the medieval guilds, which had their origins in religious fraternities.").

[32] *See* Darren Sinclair, *Self-Regulation Versus Command and Control? Beyond False Dichotomies*, 19 LAW & POL'Y 529, 531 (1997) (stating that academic literature often presents a "black and white picture" of command-and-control regulation and self-regulation, rather than a spectrum of coexisting policy choices).

[33] *See, e.g.*, JULIA BLACK, RULES AND REGULATORS 61-66 (1997) (discussing the role of political rhetoric in the design of the self-regulatory system set up in the United Kingdom under the Financial Services Act 1986).

[34] *See, e.g.*, WOLFGANG SCHULZ & THORSTEN HELD, HANS BREDOW INST. FOR MEDIA RESEARCH AT THE UNIV. OF HAMBURG, REGULATED SELF-REGULATION AS A FORM OF MODERN GOVERNMENT B-12-B-13 (2001) (arguing that self-regulation "can obviously be much faster than traditional regulation").

regulation is its diminished cost and increased efficiency.[35] In the eyes of its proponents, self-regulation exemplifies a regulatory system that is "responsive, flexible, informed, targeted, which prompts greater compliance, and which at once stimulates and draws on the internal morality of the sector or organization being regulated."[36] Advocates of self-regulation emphasize its potential to foster shared values among industry actors, a stronger sense of participation in the process of rulemaking reflecting such common values, and voluntary compliance with the resulting rules.[37]

Critics of self-regulation, on the other hand, point to the deep-seated conflicts of interest present in any self-regulatory arrangement and its inherent inefficiency.[38] From this perspective, self-regulation is "self-serving, self-interested, lacking in sanctions, beset with free rider problems, and simply a sham."[39] Driven by a powerful distrust of profit-seeking private enterprises regulating their own business activities, the opponents of industry self-regulation view it, in effect, as a form of de-regulation and the government's complete withdrawal from the field. In their view, self-regulation is highly problematic because of insurmountable collective action problems, weak or ineffective enforcement capabilities, the inability to gain or maintain legitimacy, and, ultimately, the failure of accountability.[40]

In addition to the deeply divisive ideological rhetoric surrounding the idea of self-regulation, another factor that makes an objective analysis of its regulatory potential extremely difficult is the lack of de-

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[35] *See* Michael, *supra* note 23, at 181 ("[S]elf-regulation can result in cost savings to the government, and these savings may be greater than the costs imposed on private groups, thus resulting in less costly regulation overall.").

[36] Julia Black, *Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World* (footnote omitted), *in* 54 CURRENT LEGAL PROBLEMS 103, 115 (M. D. A. Freeman ed., 2002).

[37] *See* Michael, *supra* note 23, at 183-84 (discussing how self-regulation "can provide greater incentives for compliance"); *see also* Jean J. Boddewyn, *Advertising Self-Regulation: True Purpose and Limits*, 18 J. ADVERTISING 19, 20 (1989) ("Industry self-regulation constitutes a form of *private government* to the extent that peers, rather than outsiders, formally control, or at least dominate, the establishment and enforcement of self-imposed and voluntarily-accepted rules of behavior.").

[38] *See* Black, *supra* note 36, at 115 (noting the negative opinion of certain critics of self-regulation).

[39] *Id.*

[40] According to one phrasing, "[s]elf-regulation is frequently an attempt to deceive the public into believing in the responsibility of a [sic] irresponsible industry. Sometimes it is a strategy to give the government an excuse for not doing its job." John Braithwaite, *Responsive Regulation for Australia*, *in* BUSINESS REGULATION AND AUSTRALIA'S FUTURE 81, 93 (Peter Grabosky & John Braithwaite eds., 1993).

finitional clarity. There are many forms of self-regulation in practice, as well as many definitions of what it is—or should be—in the academic and policy debate. "Self-regulation" is often used interchangeably with other, similar terms, such as "self-governance," "co-regulation," "voluntarism," "private regulation," "soft law," "quasi-regulation," "communitarian regulation," and so on. Each of these terms tends to emphasize a particular characteristic that arguably distinguishes "self-regulation" from regulation—the purely voluntary nature of regulation, the nongovernmental actors as the sole rulemaking authority, or the nonbinding or nonlegal nature of the rules.[41]

There are also multiple typologies of self-regulation in the academic literature, which reflects the wide variety of existing self-regulatory arrangements and their highly context-sensitive nature. Generally, distinctions are made between "voluntary" self-regulation without direct government intervention; "sanctioned" self-regulation, in which private actors formulate rules that the government approves; and "mandated" self-regulation, in which the government requires private actors to establish a self-regulatory framework.[42] In addition, some authors offer even more granular typologies referring to "accredited" self-regulation, in which privately established rules are accredited by another private body (such as a technical committee); "verified" self-regulation, in which third parties (auditors, NGOs, labor unions, etc.) monitor compliance with the rules; "partial" self-regulation, in which the private sector engages only in rulemaking; or "full" self-regulation, in which both rulemaking and enforcement are privatized.[43] Finally, self-regulation may be analyzed at the level of an individual firm, as well as at a broader level of collectivity—an industry, a region, or an administrative unit.[44]

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[41] See Black, *supra* note 36, at 116-17 (explaining, for example, that "soft law" and "self-regulation" are sometimes used interchangeably in the context of European Union regulation because of the nature of the rules).

[42] *See, e.g.*, *id.* at 118 (discussing these and identifying a fourth category, "coerced" self-regulation, in which the industry only formulates rules because of "the threat of statutory regulation"); Gunningham & Rees, *supra* note 2, at 364-66 (concluding that there is a continuum of self-regulation and distinguishing between voluntary self-regulation, mandated full self-regulation, and mandated partial self-regulation).

[43] Black, *supra* note 36, at 118-19; *see also* Gunningham & Rees, *supra* note 2, at 366 (noting that different forms of self-regulation lie on a continuum).

[44] *See* Black, *supra* note 36, at 119-20 (observing that "intrafirm" controls act as a form of self-regulation, whether or not they are required by industry regulators); Gunningham & Rees, *supra* note 2, at 364-65 (distinguishing between rulemaking within an individual firm and across an industry).

For the purposes of our discussion, it is important to keep in mind three key distinctions. First, the notion of self-regulation used in this Article does not denote a system of pure private ordering of economic activity and the complete absence of any government regulatory intervention. Contrary to a common misperception, self-regulation is not identical to "deregulation." The concept of self-regulation advocated here is significantly more complex and flexible, combining private rulemaking by industry actors with direct government regulation.[45]

The second distinction relevant to our discussion is between self-regulation and various forms of "negotiated rulemaking," or other similar public-private partnership arrangements in which private actors participate in government rulemaking.[46] In this way, this Article reinforces the importance of keeping "self" in "self-regulation."

Finally, the concept of self-regulation, as this Article uses it, does not refer to intrafirm governance[47] or "management-based regulation."[48] It is explicitly concerned with industry-wide self-regulatory institutions, rather than individual, entity-level systems of compliance or

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[45] *See* Omarova, *supra* note 4, at 693-706.

[46] For a discussion of "negotiated rulemaking," see, for example, Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 548-58 (2000).

[47] This is a very important qualification. There is a rich body of scholarly analysis of individual firms' incentives and disincentives to self-regulate, both in the financial sector and in other settings. *See generally* Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009) (concluding that corporate governance programs are not examples of a "New Governance" collaborative regulatory regime); Braithwaite, *supra* note 23, at 1469 (noting that corporations often lack incentives to invest in a robust compliance program to regulate corporate crime); Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127 (2009) (highlighting ways in which operational risk management programs are not suitable for enforced self-regulation); Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563 (2005) (suggesting that the incentives for securities markets to self-regulate are often at odds with their profit-maximizing mandates). However, the insights gained from these studies, while extremely valuable and informative, may not always be directly or fully applicable to analysis of industry-wide self-regulatory arrangements. Incentives and disincentives facing the managers and stakeholders in the context of an individual enterprise—such as a corporation's compliance with corporate governance rules, a financial institution's implementation of regulators' capital adequacy requirements, or a stock exchange's juggling of its regulatory responsibilities with its business interests as a profit-generating entity—may differ in significant respects from the incentives and disincentives that shape decisionmaking at the level of the industry as a collective actor.

[48] *See* Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 LAW & SOC'Y REV. 691, 692 (2003) (explaining that management-based regulation "requires firms to engage in their own planning and internal rule-making efforts . . . to aim toward the achievement of specific public goals").

risk management.[49] In this respect, self-regulation must also be kept conceptually separate from so-called "private regulation," where a single member of a group of private entities makes or enforces rules that apply to the rest of that collective group.[50]

In sum, this Article focuses on self-regulation as a regime of collective rulemaking, a "regulatory process whereby an industry-level (as opposed to a governmental or firm-level) organization sets rules and standards"[51] governing the behavior of the members of that industry and monitors and enforces compliance with the rules.[52] As a matter of principle, this concept of industry self-regulation is not inherently incompatible with some form of direct government regulation.

Of course, this attempt to delineate the universe of self-regulatory institutions relevant for the purposes of this Article still allows such institutions to take a wide variety of specific forms. For example, numerous voluntary product-certification programs also set standards for individual enterprises seeking to receive certifications for their products or processes.[53] Also, self-regulatory organizations may differ in their use of coercion or sanctions for noncompliance.[54] In that sense, emphasizing collective rulemaking and enforcement as the key elements of self-regulation may merely help to define the continuum along which numerous self-regulatory institutions coexist.[55]

Important factors explaining considerable variation in the substantive elements that define individual self-regulatory models are the

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[49] As argued below, this Article focuses on industry-wide self-regulation as a potentially effective mechanism to control systemic risk in the global financial market. *See infra* Section III.B.

[50] Examples of such "private regulation" may include regulatory functions performed by independent auditors, credit rating agencies, or various product-certification bodies.

[51] Gunningham & Rees, *supra* note 2, at 364.

[52] In that sense, the concept of industry self-regulation, as used in this Article, does not encompass activities of trade associations whose primary purpose and function is to lobby on behalf of the industry or to represent the industry's interests in the political process.

[53] *See, e.g.*, Tim Bartley, *Certifying Forests and Factories: States, Social Movements, and the Rise of Private Regulation in the Apparel and Forest Products Fields*, 31 POL. & SOC'Y 433, 434-37 (2003) (reviewing the certification structures for environmental and labor standards in the apparel and forest products industries).

[54] *See, e.g.*, Andrew A. King & Michael J. Lenox, *Industry Self-Regulation Without Sanctions: The Chemical Industry's Responsible Care Program*, 43 ACAD. MGMT. J. 698, 713 (2000) (concluding that explicit sanctions applied by outsiders may be needed to avoid opportunism in an industry self-regulatory scheme).

[55] This idea of a "continuum" follows from Gunningham & Rees, *supra* note 2, at 364-66.

nature and scope of the principal objectives of and reasons for self-regulation in a particular industry. Thus, to fill the initial definition with concrete meaning, one should start by discussing the theoretical and practical rationale for self-regulation in the financial sector in the wake of the recent global financial crisis.

B. *Self-Regulation as a Form of New Governance: A Brief Overview*

From a theoretical standpoint, this Article views self-regulation as a particular form, or an element, of the New Governance approach to structuring public-private relationships in the financial industry.

Despite its diversity and broad reach across different subject areas, the rapidly growing body of legal and social science scholarship on New Governance challenges the old dogma that the administrative state is, and should be, the sole locus of power to regulate and that the private sector is a passive recipient of the government's directives.[56] This literature generally maintains that the complexity, diversity, and fluidity of social processes in today's technology-driven and globalized world both explain and necessitate the greater decentralization of power to shape these processes.[57] In this sense, the old notion of "regulation" as a top-down exercise of power through a rigidly hierarchical structure is replaced, both as a descriptive and as a normative matter, by the New Governance paradigm. This paradigm views regulation as a reflexive, iterative, and dialogical process and "identifies ongoing deliberation as the most legitimate and most effective mechanism for making decisions in complex organizational structures."[58] The concept of governance in our polycentric world embodies a collaborative, cooperative enterprise of shaping social outcomes through negotiation among numerous public and private actors with stakes in those outcomes: nongovernmental organizations, business and trade associations, labor unions, technical standard-setting bodies, profes-

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[56] For a thoughtful exposition of the emerging New Governance paradigm, see Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004). For a more recent review of the multidisciplinary scholarship on New Governance, see Scott Burris, Michael Kempa & Clifford Shearing, *Changes in Governance: A Cross-Disciplinary Review of Current Scholarship*, 41 AKRON L. REV. 1 (2008).

[57] *See, e.g.*, Michael Moran, *Review Article: Understanding the Regulatory State*, 32 BRIT. J. POL. SCI. 391, 411-13 (2002) (summarizing a review of scholarly literature that advocates a push toward global regulation, rather than national hierarchical structures).

[58] Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 27-28 (2008).

sional groups, and so on.[59] The New Governance scholars believe that regulation "occurs in many locations, in many fora: 'regulation in many rooms.'"[60] In this paradigm, regulation is not solely a product of state action; it is "coproduced" by interdependent and interacting governmental and nongovernmental social actors.[61] The key process of deliberation is "accomplished by decentralized, broadly participatory stakeholder groups that can access local knowledge and context-specific understandings of a situation."[62]

Importantly, proponents of the New Governance approach do not simply advocate dismantling the regulatory state in favor of purely market-based forms of social ordering.[63] The world as seen through the theoretical lens of New Governance is a complex, dynamic, and intricately interconnected universe in which various governmental and nongovernmental forces constantly negotiate the boundaries between public and private spheres of economic and social life.[64] In this world, the key objective of the regulatory state is not to control the regulated by forcibly subjecting them to externally generated rules but to "harness[] private capacity to serve public goals."[65]

In recent years, there has been an explosion in academic studies examining the emerging governance regimes—local, national, and international—in such diverse areas as internet regulation,[66] nanotech-

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[59] *See, e.g.*, Joshua Cohen & Charles Sabel, *Directly-Deliberative Polyarchy*, 3 EUR. L.J. 313, 314 (1997) (envisioning a system in which regulated actors have a larger, more democratic role in collective decisions); Freeman, *supra* note 46, at 548 (conceiving of a system in which "[t]here is nothing to govern," but rather, "only problems to confront and decisions to make"); Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1 (1997) (comparing the EPA's negotiated rulemaking with a normative model of collaboration).

[60] Black, *supra* note 36, at 108 (citing Laura Nader & Claire Nader, *A Wide Angle on Regulation: An Anthropological Perspective*, *in* REGULATORY POLICY AND THE SOCIAL SCIENCES 141 (Roger G. Noll ed., 1985)).

[61] *Id.* at 109 (citing CLAUS OFFE, CONTRADICTIONS OF THE WELFARE STATE 310 (1984)).

[62] Ford, *supra* note 58, at 28.

[63] *See, e.g.*, Lobel, *supra* note 56, at 468 ("There is a tendency to equate shifts from top-down regulation with deregulation, privatization, and devolution. The new governance paradigm resists this dichotomized world and requires ongoing roles for government and law.").

[64] *See, e.g.*, Freeman, *supra* note 46, at 548 (proposing an "alternative conception of administration as a set of negotiated relationships" whereby "public and private actors negotiate over policy making, implementation, and enforcement").

[65] *Id.* at 549.

[66] *See, e.g.*, David R. Johnson & David Post, *Law and Borders—The Rise of Law in Cyberspace*, 48 STAN. L. REV. 1367, 1402 (1996) (concluding that cyberspace law must be different from a state's administrative regime because of the lack of geographically de-

nology,[67] health law,[68] environmental law,[69] transnational corporate law,[70] and international relations.[71] While a detailed review of the New

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fined territories); Lawrence Lessig, Commentary, *The Law of the Horse: What Cyberlaw Might Teach*, 113 HARV. L. REV. 501, 502-03 (1999) (proposing that discussions about cyberspace law can demonstrate "the limits on law as a regulator" and raise questions about our value systems); Neil Weinstock Netanel, *Cyberspace Self-Governance: A Skeptical View from Liberal Democratic Theory*, 88 CALIF. L. REV. 395 (2000) (contending that cyberspace self-governance must include some state regulation); Jonathan Weinberg, *ICANN and the Problem of Legitimacy*, 50 DUKE L.J. 187 (2000) (analyzing the challenges ICANN faces as a private entity in the role of a public policymaker).

[67] *See, e.g.*, J. CLARENCE DAVIES, WOODROW WILSON INT'L CTR. FOR SCHOLARS, EPA AND NANOTECHNOLOGY: OVERSIGHT FOR THE 21ST CENTURY 59-64 (2007), *available at* http://www.nanotechproject.org/projects/assets/files/2698/197_nanoepa_pen9.pdf (detailing a plan for twenty-first-century nanotechnology governance); Jennifer Kuzma et al., *Evaluating Oversight Systems for Emerging Technologies: A Case Study of Genetically Engineered Organisms*, 37 J.L. MED. & ETHICS 546 (2009) (explaining the parallels between genetic engineering and nanotechnology and advocating an oversight system for both of them); Jennifer Kuzma et al., *Upstream Oversight Assessment for Agrifood Nanotechnology: A Case Studies Approach*, 28 RISK ANALYSIS 1081 (2008) (promoting anticipatory governance for technology through the use of upstream oversight).

[68] *See, e.g.*, John Abraham, *Partial Progress: Governing the Pharmaceutical Industry and the NHS, 1948–2008*, 34 J. HEALTH POL. POL'Y & L. 931 (2009) (explaining the organic growth of the U.K. National Health Service and offering a critique of the regulator's performance); Eleanor D. Kinney, *Private Accreditation as a Substitute for Direct Government Regulation in Public Health Insurance Programs: When is it Appropriate?*, LAW & CONTEMP. PROBS., Autumn 1994, at 47, 72 (noting that private accreditation can foster innovation, promote competition, and possibly develop better quality standards in the health industry); Louise G. Trubek, *New Governance and Soft Law in Health Care Reform*, 3 IND. HEALTH L. REV. 139 (2006) (analyzing ways in which traditional legal values can coexist with New Governance reforms in health care).

[69] *See, e.g.*, Richard N. L. Andrews, *Environmental Regulation and Business "Self-Regulation,"* 31 POL'Y SCI. 177 (1998) (detailing the benefits and limitations of "environmental self-regulation"); Marc Allen Eisner, *Corporate Environmentalism, Regulatory Reform, and Industry Self-Regulation: Toward Genuine Regulatory Reinvention in the United States*, 17 GOVERNANCE 145 (2004) (advocating a hybrid system of environmental regulation composed of public oversight, government watchdogs, and corporate self-regulation).

[70] *See generally* Steven Bernstein, *Introduction: Power, Social Purposes, and Legitimacy in Global Governance* ("New public, private, hybrid, and networked forms of governance may come to replace earlier multilateral forms."), *in* GLOBAL LIBERALISM AND POLITICAL ORDER 3, 7-8 (Steven Bernstein & Louis W. Pauly eds., 2007); PHILLIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW (1993) (analyzing how corporate jurisprudence must be updated to meet the challenges presented by sprawling, multinational corporations and arguing that enterprise law is best suited to serve the needs of a complex market economy); Larry Catá Backer, *Multinational Corporations, Transnational Law: The United Nations' Norms on the Responsibilities of Transnational Corporations as a Harbinger of Corporate Social Responsibility in International Law*, 37 COLUM. HUM. RTS. L. REV. 287 (2006) (examining the influence of the U.N.'s Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights on the global regulatory framework); Stephen Bottomley, *From Contractualism to Constitutionalism: A Framework for Corporate Governance*, 19

Governance theories is beyond the scope of this Article, the key insight they offer is fully applicable to the analysis of financial regulation and its reform. An increasingly complex marketplace, dependence on fast-changing technology, and the rapid pace of product innovation render obsolete the unquestioning reliance on the state as the monopolistic source of regulatory and supervisory power in the financial sector. The flow of information is key to effective and efficient regulation of financial processes in today's economy, and the traditional state-centric paradigm of financial regulation is not likely to be able to manage this flow successfully, especially on a global basis. These factors suggest that private market actors, especially financial institutions, must play a different, and much greater, role in promulgating, monitoring, and enforcing the substantive and procedural rules under which financial markets operate. This "decentering" analytical perspective provides a theoretical basis for reconceiving the familiar concept of financial industry self-regulation as a new form of private governance focused explicitly on preventing public risks.

II. FINANCIAL INDUSTRY SELF-REGULATION IN THE POSTCRISIS WORLD: RETHINKING THE PARADIGM

This Part examines in further detail the extent to which the general theoretical perspective described above applies to the modern financial services industry. It argues that there are important practical and policy reasons for rethinking the role of industry self-regulation as a mechanism for preventing or minimizing systemic risk in the financial sector, particularly in the aftermath of the recent global financial crisis.[72] The most prominent among them is the need, forcefully underscored by the crisis, to leverage private actors' relative advantages

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SYDNEY L. REV. 277 (1997) (suggesting changes to the legal model of corporate governance in Australia to improve corporate decisionmaking).

[71] *See, e.g.*, Kenneth W. Abbott & Duncan Snidal, *Strengthening International Regulation Through Transnational New Governance: Overcoming the Orchestration Deficit*, 42 VAND. J. TRANSNAT'L L. 501 (2009) (arguing that a transnational New Governance system will strengthen cross-border regulation); Yishai Blank, *The City and the World*, 44 COLUM. J. TRANSNAT'L L. 875 (2006) (analyzing the globalization of cities and its effect on international regulations); Ileana M. Porras, *The City and International Law: In Pursuit of Sustainable Development*, 36 FORDHAM URB. L.J. 537 (2009) (identifying the problems inherent in leaving the formulation of transnational regulation regarding sustainable development to cities); Richard Price, Review Article, *Transnational Civil Society and Advocacy in World Politics*, 55 WORLD POL. 579 (2003) (surveying recent research on transnational activism).

[72] For an analysis of the key benefits and policy rationale of an enhanced and systemic risk–oriented regime of self-regulation in the financial services sector, see Omarova, *supra* note 4, at 683-85. Part II summarizes the argument originally presented there.

in timely access to, and potential ability to process efficiently, key financial information necessary to assess the systemic implications of market trends, as well as their capacity to regulate and monitor their own activities and risks on a seamlessly global, cross-border basis.

While industry self-regulation cannot and should not replace direct government regulation and supervision of the financial sector, only a system that successfully uses these potential benefits of self-regulation can provide a long-term solution to the fundamental challenges regulatory arbitrage poses. Without enlisting the industry's meaningful and active participation in the regulatory process, the government may be forever doomed to stay a step behind financial institutions that invent new, and more complex, ways to thwart the government's regulatory goals in pursuit of short-term private profits.

A. *Systemic Risk: A New Rationale for Industry Self-Regulation*

The global financial crisis of 2008–2009 profoundly changed the financial services industry and forcefully demonstrated the need to revisit the very foundations of the existing system of financial sector regulation. While fully understanding its causes and implications will take years of intense study and debate,[73] it is already clear that the two problems at the heart of the latest crisis were the unprecedented and poorly understood complexity of financial products and the increa-

[73] There is a vast and growing body of academic literature detailing the causes, timeline, and consequences of the recent financial crisis in the context of specific countries or regions and the international economy as a whole. *See, e.g.*, Gary Gorton, *The Subprime Panic*, 15 EUR. FIN. MGMT. 10, 30-42 (2009) (describing how interlinked securities, special-purpose vehicles, and derivatives all contributed to the subprime mortgage crisis); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1369-73 (2009) (explaining how the lack of opportunity for short-selling mortgage-backed securities prevented the market from being corrected); Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Legal and Economic Issues in Litigation Arising from the 2007–2008 Credit Crisis* (Harvard John M. Olin Discussion Paper Series, Paper No. 612, 2008), *available at* http://papers.ssrn.com/abstract_id=1096582 (analyzing the economic and legal consequences of the subprime credit crisis and the main legal issues that will arise in the subsequent subprime litigation); Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* 2-5 (Dec. 5, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/abstract=1020396 (arguing that the quality of subprime loans deteriorated years before the crisis but the problems were masked by high housing prices). A bipartisan Financial Crisis Inquiry Commission (FCIC) was officially established in May 2009 and charged with the task of examining the causes of the financial crisis and reporting its findings to Congress. The FCIC started holding its public hearings in January 2010. *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 10.

singly globalized character of financial markets and institutions.[74] The speed with which the troubles in the U.S. subprime mortgage market spread worldwide exposed the deep-seated vulnerabilities of the world's financial system, in which an intricate web of derivatives,[75] other complex financial transactions, and risk exposure closely interconnects innumerable players.[76] The widespread use of complex financial instruments also greatly contributed to the dangerously high levels of leverage accumulated throughout the system,[77] while cross-border arbitrage enabled financial institutions and market players to avoid national regulatory and supervisory oversight.

Therefore, any reform aimed at detecting and preventing, or at least minimizing, the risk of future systemic financial crises has to respond directly and effectively to the challenges that the complex and global nature of financial products, institutions, and activities pose.[78] As a corollary, such reform must address two critical issues: "(1) assur-

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[74] *See* Saule T. Omarova, *The New Crisis for the New Century: Some Observations on the "Big-Picture" Lessons of the Global Financial Crisis of 2008*, 13 N.C. BANKING INST. 157, 157 (2009) (explaining that the complexity of financial products and the global nature of financial markets were two key contributors to the crisis).

[75] Derivatives are financial instruments whose value is "derived" from the value of another asset, referred to as the underlying or reference asset. R. STAFFORD JOHNSON, INTRODUCTION TO DERIVATIVES: OPTIONS, FUTURES, AND SWAPS 1-10 (2009).

[76] It is worth noting that the role of derivatives and other complex financial instruments in creating or exacerbating the recent financial crisis is a difficult and hotly debated issue. *See, e.g.*, Thomas Lee Hazen, *Filling a Regulatory Gap: It Is Time to Regulate Over-the-Counter Derivatives*, 13 N.C. BANKING INST. 123, 124-29 (2009) (examining the regulation of derivative instruments similar to credit default swaps and arguing that credit default swaps should also be regulated); Lynn A. Stout, *How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another*, LOMBARD STREET, July 6, 2009, at 4, 4 (arguing that "Congress's decision to deregulate financial derivatives" in 2000 led to the collapse of AIG and the 2008 credit crisis); René M. Stulz, *Credit Default Swaps and the Credit Crisis* 21-28 (Eur. Corp. Governance Inst., Finance Working Paper No. 264, 2009), *available at* http://papers.ssrn.com/abstract_id=1475323 (arguing that credit default swaps did not cause the credit crisis of 2007–2008).

[77] A key example of this contribution to leverage is the central role that trading in credit derivatives played in the near failure and resulting bailout of the U.S insurance giant, American International Group. *See, e.g.*, Hugh Son & Zachary R. Mider, *AIG Rescue May Include Credit-Default Swap Backstop*, BLOOMBERG, Feb. 26, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=as_tDgcGmTdE (reporting that the U.S. government might provide AIG a backstop to protect against losses on credit default swaps). For a scholarly analysis of the AIG saga, see William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009).

[78] Regulating complex systems is a fascinating and growing academic field. For an example of these scholarly analyses, see Donald T. Hornstein, *Complexity Theory, Adaptation, and Administrative Law*, 54 DUKE L.J. 913, 940-49 (2005). For further discussion on this topic, see Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211 (2009).

ing timely access to, and analysis of, key market information; and (2) regulating and monitoring financial activities and risks on a truly global, cross-border basis."[79] "[I]ndustry self-regulation, as a form of regulatory intervention . . . distinct from both direct government regulation" and free market ordering,[80] "holds . . . significant promise in terms of addressing these challenges."[81]

With respect to informational access, private industry actors have an important potential advantage over government regulators. They may have a better ability to identify, analyze, and assess systemic implications of underlying trends in the financial markets, particularly regarding complex financial products and transactions.[82] Their "insider" position enables financial institutions and other market participants to access key market data in real time and, perhaps more importantly, make better-informed judgments as to what information is relevant to issues of systemic risk prevention and how it relates to the broader picture.

Of course, this informational advantage is a relative factor, meant to emphasize only that private actors, by virtue of their position as key participants in financial markets and creators and users of complex financial instruments, are in a better position to understand and analyze the bottom-up patterns of systemwide financial risk than govern-

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[79] Omarova, *supra* note 4, at 685; *see also* Omarova, *supra* note 74, at 160-65.

[80] It is worth reemphasizing that drawing a conceptual distinction between industry self-regulation and direct government regulation does not imply that these are mutually exclusive alternatives. This Article views industry self-regulation as a necessary supplement to government regulation and supervision in the financial sector.

[81] Omarova, *supra* note 4, at 685.

[82] Under the existing regulatory framework, U.S. financial regulators, as a general matter, do not require reporting of all trading data and other market information by financial institutions. *See, e.g.*, CONG. OVERSIGHT PANEL, *supra* note 5, at 13-15 (arguing that regulators have "permitted [financial institutions] to provide too little information," resulting in opacity in financial markets). Most highly complex financial transactions take place in the over-the-counter (OTC) markets, where individual counterparties enter bilateral contracts that they do not have to publicly disclose or report to regulators. *Id.* For decades, U.S. regulatory and supervisory authorities typically accessed this type of market information only after the fact, at times significantly so, and on an aggregated basis, with respect to a specific firm or an entire market segment. The Dodd-Frank Act seeks to remedy this problem by mandating more extensive disclosure of market data to regulators and, in certain cases, the investing public. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 727, 124 Stat. 1376, 1696 (2010) (to be codified at 7 U.S.C. § 2(a)) (authorizing public reporting of certain swap transaction data); *id.* § 729 (to be codified at 7 U.S.C. § 6o-1) (establishing reporting and recordkeeping requirements for swaps not accepted for central clearing); *id.* § 730 (to be codified at 7 U.S.C. § 1 et seq.) (prescribing large-swap trader reporting requirements that the CFTC will implement). However, this system's effectiveness depends greatly on its implementation. *See infra* notes 85-89 and accompanying text.

ment agencies.[83] Acknowledging private industry's potential informational advantage is not the same as claiming that financial institutions possess perfect knowledge and understanding of systemic risks and vulnerabilities and, therefore, should replace government as the sole source of regulatory decisionmaking.[84]

Nevertheless, leveraging the industry actors' relatively greater abilities to understand and analyze increasingly complex and overwhelmingly voluminous financial information offers a major potential benefit from the perspective of regulatory efficiency and efficacy.[85] In a system relying exclusively on direct government oversight of systemic risk, the government will always risk staying at least a step behind the industry, not only in a temporal sense but also in understanding the substantive implications of market practices and trends for systemic risk prevention.[86] Current efforts to boost the government agencies' ability to collect previously unreported market data[87] are unlikely to

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[83] *See, e.g.*, Henry T.C. Hu, Review Essay, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1463 (1993) (arguing that government regulators cannot keep up with development of complex financial derivatives).

[84] As the recent crisis so aptly demonstrated, even the highest-level executives at the most successful and sophisticated financial firms have not always been able to detect and measure the true amount of risk their firms carried on and off their balance sheets. For instance, the former CEO of Lehman Brothers testified that he had "absolutely no recollection whatsoever of hearing anything about" the so-called "Repo 105" transactions that were used to hide the true extent of Lehman's debt. *Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Comm. On Fin. Servs.*, 111th Cong. 3 (2010) (statement of Richard S. Fuld, Jr., Former Chairman and Chief Executive Officer, Lehman Brothers), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/fuld_4.20.10.pdf. The question is, however, to what extent this lack of knowledge resulted from willful blindness, driven by the managers' desire to maximize their individual enterprises' short-term profits.

[85] An important nuance should be added here. Scholars generally recognize the relative and fluid nature of informational power, which Julia Black describes as "fragmentation, and construction, of knowledge" in today's complex society, in which "no single actor has all the knowledge required to solve complex, diverse, and dynamic problems, and no single actor has the overview necessary to employ all the instruments needed to make regulation effective." Black, *supra* note 36, at 107. However, in the current debate on financial regulation reform, scholars and participants have not paid sufficient attention to the regulatory potential of using the industry's relative informational advantage.

[86] *See* Hu, *supra* note 83, at 1463 (noting that regulators are unable to understand the risks of complex financial transactions with certainty); Schwarcz, *supra* note 78, at 215 (arguing that regulators cannot "address all potential failures" because "financial markets evolve so rapidly").

[87] In the wake of the recent global financial crisis, various legislative proposals called for mandatory reporting of all OTC derivatives trades to regulatory agencies. The Dodd-Frank Act, among other things, requires the SEC and CFTC to promulgate rules for public reporting of certain swap-transaction and pricing data. *See, e.g.*, Dodd-

resolve two perennial problems—insufficient expertise and limited resources—that constrain the agencies' capacity to analyze and prevent systemic risk effectively and efficiently.[88] At the same time, private firms, free of regulatory responsibility and armed with superior market knowledge and financial and technological resources, will keep finding new ways to get around government-imposed rules.[89] The regulators' attempts to gather more detailed information and impose more rules are likely to create further incentives for the industry to evade regulatory limits.[90] This self-perpetuating dynamic, putting the state and the industry on opposite sides of a regulatory arbitrage

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Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 727, 124 Stat. 1376, 1696 (2010) (to be codified at 7 U.S.C. § 2(a)) (authorizing public reporting of certain swap transaction data); *id.* § 729 (to be codified at 7 U.S.C. § 6o-1) (establishing reporting and recordkeeping requirements for swaps not accepted for central clearing); *id.* § 730 (to be codified at 7 U.S.C. § 1 et seq.) (prescribing large-swap trader reporting requirements that the CFTC will implement).

[88] Commentators on financial regulation reform routinely lament this informational lag and expertise deficit and call for strengthening the cadre of regulatory agencies by attracting the best and the brightest economists, lawyers, and other trained specialists to serve at government agencies. *See, e.g.*, Henry T.C. Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 412 (1989) (suggesting that regulators must have direct transactional experience in order to be able to foresee the specific risks of certain products); Tom Wilson, Op-Ed., *Regulate Me, Please*, N.Y. TIMES, Apr. 16, 2009, at A29 (arguing that states "lack the expertise to properly oversee" insurance companies). An obvious practical difficulty is that, to do so, government agencies would have to offer these experts compensation high enough to lure them away from lucrative employment at investment banks and hedge funds. However, an even more fundamental issue with this approach to resolving the problem of informational asymmetry relates to the dynamic nature of the required expertise. In reality, one's education or natural brilliance does not necessarily translate into actual knowledge of the industry and market trends. In the fast-moving world of complex finance, the best, if not the only, way to develop and maintain such knowledge is to stay in the trenches, structuring and executing actual business transactions. Government employees, no matter how well trained or highly credentialed, cannot be expected to possess such intimate and highly dynamic transactional knowledge.

[89] *See, e.g.*, SCHULZ & HELD, *supra* note 34, at C-1 (listing informational obstacles to effective command-and-control regulation); Edward J. Balleisen & Marc Eisner, *The Promise and Pitfalls of Co-Regulation: How Governments Can Draw on Private Governance for Public Purpose* (describing firms' tendencies to present data regarding their compliance with environmental laws "with a bewildering array of metrics and baselines that make meaningful comparisons difficult"), *in* NEW PERSPECTIVES ON REGULATION 129, 143-45 (David Moss & John Cisternino eds., 2009); Sinclair, *supra* note 32, at 537-38 (arguing that flexible government regulation will lessen resistance and therefore increase the likelihood that private firms will comply with it).

[90] *See* SCHULZ & HELD, *supra* note 34, at A-6 (noting that traditional regulation may result in resistance if it "ignores the interests of its objects"); Sinclair, *supra* note 32, at 534-39 (explaining the shortcomings of traditional command-and-control regulation, as well as those of self-regulation, and discussing how industry actors exploit these flaws to avoid regulation).

game, is likely to increase complexity in the financial markets and exacerbate potential systemic risk.[91]

Industry self-regulation also has significant potential advantages over direct government regulation with respect to globalization and the cross-border flow of financial activities.[92] In today's globalized world, financial institutions' ability to move their activities among jurisdictions, or cross-border arbitrage, undermines governments' ability to implement and enforce laws and regulations they consider vital to maintaining their domestic economic stability or achieving other socioeconomic or political goals.[93] In addition, strict application and enforcement of domestic laws and regulations to internationally active firms tend to raise thorny issues of extraterritoriality and jurisdictional overreach.[94] Despite the ongoing efforts to ensure international regulatory cooperation, both in the formulation of rules and in their implementation and enforcement,[95] significant problems and gaps con-

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[91] Regulatory arbitrage can take a variety of forms. For example, it also occurs when private firms have a choice among alternative regulatory regimes to govern their activities, as is often the case in the highly fragmented U.S. system of financial regulation. As a result, "[f]inancial institutions position themselves to fall within the jurisdiction of the most accommodating regulator, and investment banks design new financial products so as to encounter the least regulatory oversight." John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 726 (2009).

[92] For an insightful analysis of the history and current architecture of international financial regulation, see Rolf H. Weber & Douglas W. Arner, *Toward a New Design for International Financial Regulation*, 29 U. PA. J. INT'L L. 391 (2007).

[93] *See, e.g.*, Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31, 49-51 (2007) (outlining the challenges that the SEC faces in an increasingly globalized marketplace). One recent example of the financial institutions' ability to escape domestic regulation was Goldman Sachs seriously considering moving its London operations to another jurisdiction after the United Kingdom imposed a fifty-percent tax on bonuses to bank employees. *See* Patrick Jenkins & Kate Burgess, *Whinge Factor Hides an Alarming Reality*, FIN. TIMES (London), Jan. 9, 2010, at 13 (citing polling data that indicated financial institutions' willingness to leave London because of the "supertax"); Megan Murphy, *City Limits*, FIN. TIMES (London), Dec. 14, 2009, at 6 (noting that the new "supertax" had already caused some super-rich individuals to leave London).

[94] National regulators are becoming increasingly dependent on the assistance of their foreign counterparts and are searching for creative ways of ensuring such cooperation. For an insightful analysis of the challenges national regulators face in their search for a greater and more effective international harmonization, see, for example, Chris Brummer, *Post-American Securities Regulation*, 98 CALIF. L. REV. 327 (2010).

[95] In response to the global financial crisis, the governments of the Group of Twenty (G-20) began focusing on greater coordination of their regulatory and supervisory activities, and they called for a number of measures aimed at creating an institutional structure for overseeing financial markets across borders. One such proposal envisions the establishment of so-called cross-border supervisory colleges in charge of supervising individual financial conglomerates with operations in multiple countries.

tinue to exist.[96] By contrast, private economic actors—financial institutions and investors—are not constrained by jurisdictional considerations and can oversee and manage their business affairs across national borders much more seamlessly than any government agency.[97] In fact, U.S. laws and regulations essentially require global financial firms to manage their own business risk on a consolidated basis.[98] As a result, industry participants are potentially in a better position to monitor and manage risk to the financial system on a global basis.[99]

It is important to emphasize that this Article does not argue that the financial services industry can, or will, actually perform regulatory func-

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Group of Twenty [G-20], *Action Plan to Implement Principles for Reform*, at 4 (Nov. 15, 2008), *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf. The G-20 leaders also proposed to redefine the role of the International Monetary Fund (IMF) as a de facto global lender of last resort, monitoring financial stability on an international level. G-20, *Declaration: Summit on Financial Markets and the World Economy*, at ¶ 7 (Nov. 15, 2008), *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf. The G-20 has also reinvented the existing Financial Stability Forum as the Financial Stability Board (FSB), a newly bolstered international regulatory body in charge of monitoring global systemic risk. *See generally* FINANCIAL STABILITY BOARD, http://www.financialstabilityboard.org (last visited Oct. 15, 2010) (providing an overview of the Financial Stability Board's principles and institutional goals). However, as the FSB's institutional structure and mode of operation are still largely in flux, it remains to be seen how well the FSB will be able to implement this mandate. Similarly, at this stage in the process, it is difficult to predict whether and to what extent the IMF will be successful in its newly envisioned role as the global liquidity provider.

[96] *See, e.g.*, Financial Stability Board [FSB] & Int'l Monetary Fund [IMF], *The Financial Crisis and Information Gaps* 4-8 (Oct. 29, 2009), *available at* http://www.financialstabilityboard.org/publications/r_091107e.pdf (identifying information gaps in the financial markets and summarizing recommended changes to address them).

[97] The European Union has attempted to supersede national jurisdictional boundaries by restructuring its system of financial sector oversight and setting up a new European System of Financial Supervisors (ESFS) with enhanced institutional capabilities and powers. *See, e.g.*, *Communication from the Commission: European Financial Supervision*, COM (2009) 252 final (May 27, 2009), *available at* http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C2009_715_en.pdf (formulating a new financial supervisory framework for European Union members). However, this process is still in its early stages, and the details of exactly how the EU-level agencies will interact with national financial supervisors have not been fully fleshed out. *See* Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243, 277-81 (2010) (noting that the ESFS was established by legislation in September 2009 and that the precise scope of its authority as an intergovernmental regulator is still being determined).

[98] *See* 12 C.F.R. § 225.200(b)(1)(i) (2009) (requiring bank holding companies to "maintain adequate capital on a fully consolidated basis").

[99] *See, e.g.*, Balleisen, *supra* note 24, at 464 ("Whatever the limitations associated with private regulation, it sometimes offers the only practical means of constraining the behavior of multinational corporations whose production facilities and distribution networks span the globe.").

tions better than the government. The argument here is merely that the industry has significant built-in advantages in its ability to address the fundamental regulatory challenges that the increasing complexity and globalization of financial markets and activities pose. Leveraging this uniquely advantageous position may offer an effective method of controlling systemic risks in global financial markets. Imposing responsibility for regulating and minimizing systemic risk directly on the financial services industry might serve as an important supplement to the ongoing efforts to reform the existing system of government regulation and create market-based incentives for more prudent financial conduct.

However, envisioning such a new regime requires a fundamental normative shift in our concept of self-regulation, especially in comparison to the existing SRO model in the U.S. securities industry. The existing model is much narrower in scope and focuses primarily on everyday conduct of business by securities professionals and issues of investor protection, rather than prevention of systemic risk.[100]

B. *"Embedded" Self-Regulation*

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. The challenge of detecting and managing systemic risk in today's financial markets requires a new approach to financial sector self-regulation, one that is not only more comprehensive and systemic in its scope and operation, but also consciously publicly minded.

To be effective, a self-regulatory regime aimed at preventing systemic financial crises must be firmly "embedded" within a broader system of government regulation and supervision, which would define the key policy objectives and ensure that industry self-regulation does not fall prey to the inherent conflict of interest. This new model—"embedded self-regulation"[101]—seeks to redraw the principal line be-

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[100] *See infra* notes 200-13 and accompanying text; *see also* Omarova, *supra* note 4, at 693-94 (arguing that SROs heavily focus on "investigating suspicious activities in securities trading" and "preventing securities fraud" and other forms of investor abuse, rather than controlling systemic risk).

[101] To social scientists, the term "embedded self-regulation" may be reminiscent of Peter Evans's classic concept of "embedded autonomy." Examining the strategies of economic development pursued by the East Asian "tigers," Evans argued that the key to the success of those states was their ability to be at once autonomous from business interest groups and firmly "embedded" within domestic business elites. According to Evans, this "embeddedness" is vital to the developmental state's capacity to tailor its economic policies to local business realities and to implement its policies more effec-

tween private institutions' freedom to regulate their own activities in the most economically efficient way, on the one hand, and their duty to conduct their profit- and risk-generating business activities in accordance with the overarching public interest in preserving financial stability, on the other. Its goal is to enhance private market participants' ability to adopt and enforce rules governing their business activities while increasing private actors' responsibility for the broader economic and societal effects of such activities.[102] From this perspective, the principal purpose of self-regulation is to "institutionaliz[e] responsibility" of private industry actors.[103] In effect, this new model of self-regulation seeks to "embed" financial practices in broader social values and regulatory principles, instead of "disembedding" them from the public interest.[104]

This model of embedded self-regulation has an explicitly macroprudential[105] focus, which sets it apart from various microprudential approaches, including the recently revised international capital adequacy framework, the Basel II Accord, promulgated by the Basel Committee on Bank Supervision (BCBS).[106] In contrast to the original

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tively and efficiently. *See* PETER EVANS, EMBEDDED AUTONOMY 227-50 (1995). One may argue that, parallel to Evans's approach, this Article should use the term "embedded regulation," instead of "embedded *self*-regulation," to describe its normative goal. While there is a strong basis for conceptualizing the envisioned self-regulatory regime as a system for "embedding" government regulation in the industry's institutional structure and culture, doing so would shift focus to direct government regulation. The term "embedded regulation" is inherently government-centered, while "embedded *self*-regulation" keeps the emphasis on the industry's regulatory process and culture. In this context, the "embeddedness" is inverted: the industry's governance of its own affairs must be organically connected to, and more deeply reflective of, the broader social and regulatory environment in which the industry operates.

[102] As Gunningham and Rees emphasize, "Industry self-regulation is a special kind of normative institution from this vantage point, and the crucial thing to understand is its variable capacity (or incapacity) to bring the behavior of industry members within a normative ordering responsive to broader social values." Gunningham & Rees, *supra* note 2, at 364.

[103] *Id.* at 406.

[104] *See generally* Abdelal & Ruggie, *supra* note 25.

[105] The term "macroprudential" generally refers to regulation and supervision that focus on the financial system as a whole and its relation to the macroeconomic context in which it operates. *See* Piet Clement, *The Term "Macroprudential": Origins and Evolution*, BIS Q. REV., Mar. 2010, at 59, 62-63, *available at* http://www.bis.org/publ/qtrpdf/r_qt1003h.pdf (tracing the origins and elucidating the meaning of the term "macroprudential").

[106] The Basel Committee on Banking Supervision (BCBS) is a committee of the Bank for International Settlements (BIS), which provides an international forum for financial regulators from different countries to cooperate on a variety of regulatory and supervisory matters. For more information on BCBS, see *About the Basel Committee*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/index.htm (last visited Oct. 15, 2010).

Basel Capital Accord adopted in 1988,[107] the Basel II framework seeks to encourage financial institutions to develop more effective internal risk management practices by allowing them to rely on their internal models for measuring the riskiness of their assets in calculating their individual capital requirements.[108] In that sense, Basel II provides an example, albeit not a fully successful one, of the New Governance approach to regulating bank capital adequacy,[109] which directly relies on financial institutions to generate the key inputs used to set capital charges for the risks they incur.[110] Basel II is also often viewed as an attempt at, or a form of, "enforced self-regulation,"[111] under which private businesses are required to assess, monitor, and regulate the risks they create, while the government determines and enforces the rules and standards with which private businesses must comply.[112]

However, it is important to avoid potential confusion between Basel II, which aims primarily to preserve the solvency of individual financial institutions, and an industry-wide self-regulatory regime concerned explicitly with systemic risk. The former focuses on how

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[107] *See* Basel Comm. on Banking Supervision [BCBS], *International Convergence of Capital Measurement and Capital Standards* (Jul. 1988, updated to Apr. 1998), *available at* http://www.bis.org/publ/bcbsc111.htm (providing the Committee's conclusions on adequate capital reserves for financial institutions).

[108] *See* BCBS, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2006), *available at* http://www.bis.org/publ/bcbs128.pdf (advising financial institutions about capital standards the Group of Ten countries agreed to under Basel II). The original Basel Capital Accord was adopted in 1988, and the revised Basel II Framework was adopted in 2004. For more on the BIS and Basel Capital Accord, see DANIEL K. TARULLO, BANKING ON BASEL (2008).

[109] *See generally* Cristie Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, 2010 WIS. L. REV. 441 (describing a New Governance regulatory framework reflecting the increasing sophistication and breadth of the global financial markets); Robert F. Weber, *New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation*, 62 ADMIN. L. REV. 783 (2010) (emphasizing that the New Governance approach to regulation is critical to fashioning a robust regulatory environment in the aftermath of the recent financial crisis).

[110] In the wake of the global financial crisis, Basel II came under intense criticism for allowing private actors too much leeway in effectively setting their own regulatory requirements and for failing to ensure that banks maintained capital levels sufficient to protect them from insolvency. *See, e.g.*, Krawiec, *supra* note 47, at 144-49 (criticizing the BCBS's "enforced self-regulation" approach to operational risk under Basel II).

[111] John Braithwaite coined the term "enforced self-regulation." *See* Braithwaite, *supra* note 23, at 1470 (summarizing the key characteristics of "enforced self-regulation").

[112] *Id.*; *see also* Robyn Fairman & Charlotte Yapp, *Enforced Self-Regulation, Prescription, and Conceptions of Compliance Within Small Businesses: The Impact of Enforcement*, 27 LAW & POL'Y 491, 493-94 (2005) (clarifying how self-enforced regulation differs from traditional "command and control" regulatory schemes).

individual entities manage their own risks and how they comply with the rules adopted by national regulators, while the latter is a true self-regulatory regime under which an industry-wide organization actually makes rules governing the conduct of all of its members and monitors compliance with such rules.

As the financial crisis demonstrated, placing the main regulatory focus solely on individual financial institutions' internal risk management is not an effective method of detecting and preventing systemic risk in the financial sphere.[113] An individual firm managing its own risk and calculating its own capital requirements may very well engage in a form of "self-regulation," but its regulatory decisions are based on potential costs and benefits of each action to that particular firm as an individual profit-seeking entity. In the world of complex global financial transactions, potential sources of systemic disturbance are numerous and often rooted in market patterns that are outside any single entity's internal governance or business activities. Thus, entity-level risk management is inherently limited as a means of identifying and addressing these threats to the financial system. By shifting the focus away from individual enterprises and adopting a macroprudential regulatory perspective, the concept of embedded self-regulation advocated in this Article targets systemic risk in a more comprehensive manner than Basel II. It identifies the financial services industry as a collective actor centrally responsible for preventing systemic disturbances.

This concept is consistent with the general tenor of the New Governance scholarship discussed above. The New Governance paradigm contains a strong, albeit often implicit, normative element. As many New Governance theorists recognize, devolution of regulatory power to private market participants also means that private actors assume significantly greater, and more direct, responsibility for achieving broader policy goals:

> In a cooperative regime, the role of government changes from regulator and controller to facilitator, and law becomes a shared problem-solving process rather than an ordering activity. Government, industry, and civil society groups all share responsibility for achieving policy goals.

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[113] For a discussion of the shortcomings of individual financial firms' risk management systems, see James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731 (2009), and Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127 (2009).

> Industry is expected to participate as part of a search for common goals, not just rigidly asserting its narrow economic or political interests.[114]

Balancing private governance and public regulation is a complicated and delicate matter of institutional design. One of the key policy challenges in this area is creating effective incentives for private industry members to limit their own otherwise permissible and economically profitable business activities, all in the name of avoiding the systemic shocks and public harm that may result from such activities. To put it simply, that financial sector self-regulation is a desirable normative goal does not necessarily mean that the financial services industry is ready or willing to regulate its own activities in an explicitly publicly minded way.[115] Therefore, a normative claim about the desirability of a more socially responsible model of self-regulation by private market participants must be combined with an analysis seeking to identify factors that might enhance (or hinder) the chances of a successful system of embedded self-regulation emerging in the global financial sector. As Gunningham and Rees posit, one question is at the heart of an institutional approach to understanding self-regulation: "When does self-regulation through industry association tend to result in self-serving standards, for example, and under what conditions might it become a real force for moral constraint and aspiration in industrial and commercial life?"[116]

The next Part will take a closer look at the experience of other industries with establishing self-regulatory regimes that are similar in certain fundamental respects to the concept of financial sector self-regulation this Article advocates.

III. THE ROAD TO SELF-REGULATION: LESSONS FROM OTHER INDUSTRIES

This Part examines two relatively recent examples of private industry actors developing a form of self-regulation explicitly aimed at

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[114] Lobel, *supra* note 56, at 377 (footnote omitted).

[115] As the CEO of Morgan Stanley, John Mack, famously remarked, "Regulators have to be much more involved . . . . We cannot control ourselves." *Morgan Stanley's Mack: 'We Cannot Control Ourselves'*, N.Y. TIMES DEALBOOK (Nov. 19, 2009, 8:47 AM), http://dealbook.blogs.nytimes.com/2009/11/19/morgan-stanleys-mack-we-cannot-control-ourselves. Mack's statement illustrates the deep problem with the existing system: the industry feels no responsibility for controlling its own conduct. Ultimately, this industry mentality, which puts responsibility for "controlling" the risks of Wall Street's greed squarely on the government, is at the core of today's problems in the financial markets.

[116] Gunningham & Rees, *supra* note 2, at 373.

preventing or minimizing negative externalities associated with their business: the creation of the Institute of Nuclear Power Operations (INPO) in the nuclear power industry and the formation of the Responsible Care program in the chemical manufacturing sector. In both of these cases, the key to the successful emergence of a self-regulatory regime was the industry's perception of itself as a "community of fate" whose future prosperity depended upon its ability to impose collective self-restraint on its members' profit-seeking activities in the name of public safety.[117] This Part analyzes key factors, both external and internal, that appear to drive the process whereby private firms in these industries reconceived themselves as a true collectivity bound by common fate. These factors include heightened external pressure on the industry to curb its potentially harmful activities, typically as a result of a major failure and a crisis of public confidence in the industry; the nature of the threat the industry's self-serving conduct poses to the public; the presence of active public interest groups capable of monitoring the industry's performance and mobilizing public opinion around relevant policy issues; the broader regulatory context in which the industry operates; its organizational structure and degree of internal interconnectedness; the existence of a strong industry leadership committed to uniting it around the new "industry morality"; and, finally, the realization among private industry actors of the potentially devastating consequences of continuing "business as usual" for the industry's long-term economic survival.

A. *"Community of Fate" as the Basis for Industry Self-Regulation*

Private market actors engage in collective self-regulation for a variety of reasons.[118] In some contexts, firms engage in self-regulatory efforts to enhance their economic returns by reducing uncertainty and the costs of transacting business. The adoption of voluntary industry-wide commercial standards and the formalization of market

[117] This Article does not focus on whether the self-regulatory regimes in the nuclear energy and chemical manufacturing industries are, in fact, fully successful in achieving their proclaimed goals. Instead, these two cases are examined primarily as examples of private industry actors realizing and internalizing the need for self-regulation to control significant negative externalities inherent in their business.

[118] Some commentators distinguish between forms of "economic" self-regulation aimed directly at securing economic benefits for industry members and a broader, more normative "social" self-regulation "whereby firms or their associations, in their undertaking of business activities, ensure that unacceptable consequences to the environment, the workforce, or consumers and clients, are avoided." Gunningham & Rees, *supra* note 2, at 365.

practices fall within that category. A leading example of this type of efficiency-enhancing private industry self-regulation in today's financial markets is the development of standardized contracts for over-the-counter (OTC) transactions in derivatives instruments by the derivatives industry's trade association, the International Swaps and Derivatives Association (ISDA).[119] A powerful industry player, ISDA created an entire architecture of standard contract forms, definitions, and supplemental documentation, which have been translated into many languages and are used nearly universally to document derivatives trades in the global financial markets.[120] Another powerful economic reason for private actors to submit to collective self-regulation is to increase market share and contribute to market growth of their products. The growing popularity and success of the standards for quality management promulgated by the International Organization for Standardization (ISO) is probably the best known instance of this type of self-regulation.[121] Firms also often seek to cooperate and establish binding industry-wide standards of conduct to protect the industry's turf against outside competition or other threats to its economic livelihood. The system of regulation by stock exchanges of their members emerged out of this type of self-regulatory impulse.[122]

However, in some situations, industry actors seem to come together in search of a common self-regulatory framework primarily, and explicitly, to minimize or eliminate potentially negative effects of their business activities on society.[123] Although private market actors pursue this collective goal not out of purely altruistic motives but rather out

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[119] For more information on ISDA's mission and activities, see *About ISDA*, INT'L SWAPS & DERIVATIVES ASS'N, INC., http://www.isda.org (last visited Oct. 15, 2010). ISDA describes itself as the world's largest global financial trade association and cites its mission as identifying and reducing the sources of risk in the derivatives field. *Id.*

[120] *See* Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211, 240-49 (2001) (giving a detailed description of ISDA's development and market activities).

[121] *See About ISO*, INT'L ORG. FOR STANDARDIZATION, http://www.iso.org/iso/about.htm (last visited Oct. 15, 2010) (indicating that the ISO is a nongovernmental organization that enables various countries to agree on international standards that meet "both the requirements of business and the broader needs of society").

[122] *See* Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. CORP. L. 865, 874-77 (2008) (recounting the history of self-regulation at the New York Stock Exchange prior to the establishment of a federal system of securities regulation).

[123] *See, e.g.*, Hugh S. Gorman, *Efficiency, Environmental Quality, and Oil Field Brines: The Success and Failure of Pollution Control by Self-Regulation*, 73 BUS. HIST. REV. 601, 637-40 (1999) (describing industry acceptance of federal environmental regulation as a "logical way" to comply with the environmental-quality requirements of the broader public).

of their desire to ensure the continuing operation of their businesses, an emphasis on the goal of minimizing negative externalities makes this type of self-regulation particularly relevant to the ongoing search for systemic risk containment in the global financial sector. It is this type of industry self-regulation, deliberately aligned with broader public and societal interests, that is the focus of this Article.

In the 1980s and, particularly, the 1990s, social scientists and students of regulation and governance around the world began developing a more nuanced and empirically grounded understanding of the inner dynamics of industry self-regulation. Scholars exploring self-regulatory practices in different sectoral and geographical contexts made a particularly valuable contribution to this process. Recognizing the complexity and heterogeneity of the phenomenon of self-regulation, this scholarship starts with the premise that "the effectiveness (or ineffectiveness) of self-regulation varies enormously among industries, due partly to its social and economic context, which varies widely, and partly to the self-regulation program's institutional design."[124] Despite the difficulty of generalizing across industry boundaries, this empirical and theoretical research provides a helpful starting point for further examination of some of the factors that might affect the viability and institutional design of a self-regulatory system in a particular industry.

There is a broad consensus among scholars and policymakers that a key condition necessary for a self-regulatory regime to succeed is the existence of a formal framework of government regulation and enforcement within which such self-regulation exists.[125] A "pure" form of self-regulation without any government presence or intervention is not realistic and is not commonly encountered in practice.[126] Government regulation, or "hard" law, does not have to occupy exactly the same space as self-regulation. However, the government's ability to enforce privately made rules and, if necessary, to step in and im-

[124] Gunningham & Rees, *supra* note 2, at 370.

[125] *See, e.g.*, Balleisen, *supra* note 24, at 452-54 (discussing how the U.S. Sentencing Commission's harsh regulatory program for white-collar crime led to a proliferation of self-imposed corporate compliance schemes).

[126] On the most fundamental level, some degree of government regulation is necessary to counter the strong pull of private industry actors' ever-present self-interest.

pose rules directly is critical.[127] To be successful, most self-regulatory systems have to operate "in the shadow of the law."[128]

Another important element that improves the chances of successful industry self-regulation is the perception that a "community of fate" exists among industry participants. Individual firms within the industry must realize the importance of assuring collective survival through voluntary limitation of their otherwise unconstrained profit-seeking activities.[129] The members of an effective community of fate internalize the notion that the failure of any one of them to comply with collectively established rules will have severe consequences for the rest of the industry. It is this realization of shared fate—a "we either stand together or we fall together" mentality—that drives private profit-seeking entities competing with one another and pursuing their own individual business interests to agree to cede a degree of their decisionmaking autonomy to a collective rulemaking body. Such a self-regulatory body 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.[130]

Industry morality can be defined as "a set of [commonly accepted, industry-wide] industrial principles and practices that defines right conduct as it spells out the industry's public commitment to moral restraint and aspiration."[131] As a mechanism for reorienting private actors' business conduct toward goals other than narrow economic self-interest, and for rethinking outdated perceptions of the industry's internal dynamics and external constraints, the development of such industry morality is central to the institution of industry self-regulation.[132] The process of formulating and negotiating industry-

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[127] *See* Gunningham & Rees, *supra* note 2, at 391 (arguing that the effectiveness of self-regulation is often increased with "the threat . . . of direct government intervention").

[128] *See, e.g.*, King & Lenox, *supra* note 54, at 713 (concluding that self-regulation is most effective when there is a threat of explicit sanctions from outsiders).

[129] *See* Gunningham & Rees, *supra* note 2, at 376-80 (insisting that the establishment of industry-wide norms that indicate the commitments, values, and competence of a particular industry, "industrial morality," is vital to avoiding opportunistic behavior in a self-regulatory regime); King & Lenox, *supra* note 54, at 702-03 (concluding that collective action with regard to self-regulation may occur because the overall benefits of improving a particular industry performance outweigh private costs incurred).

[130] *See generally* Gunningham & Rees, *supra* note 2, at 376-80 (defining the term "industrial morality" and emphasizing the need to unite an industry around a common normative framework for self-regulation to be effective).

[131] *Id.* at 376.

[132] *See id.* (arguing that developing an industrial morality—a common understanding among all in the industry—is vital to the success of self-regulation).

wide normative standards and principles, in and of itself, is an important step toward creating a sense of common fate among previously disparate members.[133]

So, how is such a community of fate created? What forces make a private industry in a free market economy realize the value of a collective system of effective self-restraint and self-discipline, ostensibly in the interest of upholding public policy goals? Under what conditions does a new, more socially responsible industry morality evolve? Two examples of this phenomenon, which received detailed academic treatment in recent years, are the nuclear power and chemical manufacturing industries, both of which instituted self-regulatory programs.

It is important to note that the purpose of this Part is not to present a detailed analysis of how these particular self-regulatory regimes operate and to what extent they have been successful in achieving their stated goals of increasing public safety. Rather, the focus of the following discussion is on the genesis of self-regulation in these cases, on the factors that made private enterprises in these two industries take the fateful first step toward that goal of recognizing the need to overcome their individual short-term orientation and develop a new normative framework to guide their business activities. While neither of these industry programs provides us with a perfect solution to the daunting challenges of making self-regulation work for the public benefit, there are valuable lessons to be learned from each of these examples.

B. *The Rise of Self-Regulation in the Nuclear Power and Chemical Manufacturing Industries: A Brief Overview*

The nuclear power industry instituted a brand-new regime of self-regulation after the Three Mile Island nuclear plant incident in March 1979, which became a public symbol of potential nuclear disaster.[134] The central element of this system was the creation, in Decem-

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[133] *See id.* (arguing that creating a discourse that challenges accepted norms in an industry helps to develop a new industry-wide consensus and reorients the focus of the group to what is best for society and the industry at large). Importantly, such a shared normative framework, being a product of collective reflection and deliberation, is more likely to be implemented voluntarily and internalized by individual firms in practice.

[134] The incident at the Three Mile Island nuclear power plant was the most serious nuclear accident ever to occur in the United States. Eric R. Pogue, *The Catastrophe Model of Risk Regulation and the Regulatory Legacy of Three Mile Island and Love Canal*, 15 PENN ST. ENVTL. L. REV. 463, 469-70 (2007). Through a combination of mechanical failure and human error, there was a partial reactor meltdown, which resulted in the release of radioactive gas into a Pennsylvania community, followed by mass hysteria and confusion. *Id.* Though no one was injured by the accident, it cost over $1 billion

ber 1979, of the Institute of Nuclear Power Operations (INPO), a private, industry-wide regulatory body whose official mission is "to promote the highest levels of safety and reliability—to promote excellence—in the operation of commercial nuclear power plants."[135] To this end, the INPO promulgates mandatory industry-wide safety and risk management standards and performance objectives; monitors compliance with the standards; conducts regular examinations and evaluations of individual nuclear power plants; investigates accidents; and provides technical assistance, training, and information-dissemination services throughout the industry.[136] The INPO has hundreds of permanent employees and a multimillion-dollar annual budget funded by the companies owning and operating nuclear plants in the United States, and it functions effectively as a "private regulatory bureaucracy."[137] It appears that the INPO was generally successful in creating "a distinctive kind of community in the nuclear power industry" and fostering "a new responsibility-centered industrial culture, a distinctive set of unifying principles and practices which spells out what conduct is virtuous and what goals are legitimate and desirable."[138]

According to Joseph Rees's classic study, the creation of the INPO signified a fundamental shift in the operation, institutional organization, and self-perception of the U.S. nuclear power industry.[139] The development of the INPO's program of plant inspections, peer reviews of plant safety programs, and industry-wide information sharing and communication channels, along with other methods of disseminating and encouraging best practices, gradually led to the emergence of a new industry morality focused on preventing nuclear plant acci-

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to clean up the mess. *Id.* As a result, a public call for increased regulation, and even complete abolition, of nuclear energy emerged. *See, e.g.*, *id.* at 490-92 (arguing that the government must establish independent bodies to deal with the consequences of catastrophes, such as those at Three Mile Island and Love Canal, rather than placing this burden on affected agencies).

[135] *About Us*, INST. OF NUCLEAR POWER OPERATIONS, http://www.inpo.info/AboutUs.htm (last visited Oct. 15, 2010).

[136] For a thorough examination of the nuclear power industry's self-regulatory response to the Three Mile Island accident, see REES, *supra* note 28, at 42-45.

[137] *See* Gunningham & Rees, *supra* note 2, at 369 (explaining that the creation of the INPO was a direct response to the accident at Three Mile Island and indicating that the organization has greatly increased nuclear safety).

[138] Joseph Rees, *Development of Communitarian Regulation in the Chemical Industry*, 19 LAW & POL'Y 477, 478 (1997).

[139] *See generally* REES, *supra* note 28, at 41-46 (explaining the effect of the formation of the INPO on the operation of the nuclear power industry and the emergence of an industry-wide commitment to safety and management integrity).

dents.[140] The industry's outdated conception of nuclear plant risk management as a purely technical matter of engineering safety was gradually replaced with a more sophisticated notion of comprehensive internal risk management processes.[141]

The chemical manufacturing industry faced its own crisis of public confidence in the aftermath of the deadly Bhopal accident in India in December 1984, involving a spillover of methyl isocyanate gas from Union Carbide's local plant.[142] As a result of the leak, "as many as four thousand people" died, and "tens of thousands" were injured.[143] Within ten years of the Bhopal disaster, the chemical manufacturing industry instituted a new global regime of self-regulation called "Responsible Care."[144] The Responsible Care program "commits companies, through their national chemical associations, to work together to continuously improve the health, safety and environmental performance of their products and processes."[145] The International Council of Chemical Associations (ICCA) oversees Responsible Care, monitors its implementation, and provides technical and informational assistance to participating national associations, each of which runs its own program.[146] Chemical industry associations in fifty-three countries, which collectively account for ninety percent of global chemical production, voluntarily adopted the program.[147] Every national Responsible Care

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[140] *See* INST. OF NUCLEAR POWER OPERATIONS, *supra* note 135 (providing general information about the INPO and stating its overall mission to promote safe and reliable operation of commercial nuclear power plants); *see also Institute of Nuclear Power Operations (INPO) Liaison*, OFF. OF HEALTH, SAFETY & SECURITY, http://www.hss.energy.gov/csa/csp/inpo/ (last visited Oct. 15, 2010) (describing the contractual relationship between the INPO and the U.S. Department of Energy and reiterating the INPO's mission to "promote excellence" in the nuclear power industry).

[141] *See* REES, *supra* note 28, at 68-73 (illustrating some of the ideals adopted by the INPO, including the belief that "industrial morality cannot be fully accounted for by merely technical criteria").

[142] *See* Sukanya Pillay, *Absence of Justice: Lessons from the Bhopal Union Carbide Disaster for Latin America*, 14 MICH. ST. J. INT'L L. 479, 483-84 (2006) (describing the accident and its impact in India).

[143] Rees, *supra* note 138, at 479.

[144] *Who We Are*, RESPONSIBLE CARE, http://www.responsiblecare.org/ (follow "Who We Are" hyperlink) (last visited Oct. 15, 2010). The Responsible Care initiative was conceived and launched in Canada in 1985, *id.*, and it was adopted in the United States in 1988. *World Map*, RESPONSIBLE CARE, *supra* (follow "World Map" hyperlink, then "United States" hyperlink) (last visited Oct. 15, 2010).

[145] *Member Support*, RESPONSIBLE CARE, *supra* note 144 (follow "Member Support" hyperlink) (last visited Oct. 15, 2010).

[146] *Who We Are*, RESPONSIBLE CARE, *supra* note 144 (last visited Oct. 15, 2010).

[147] *What We Do*, RESPONSIBLE CARE, *supra* note 144 (follow "What We Do" hyperlink) (last visited Oct. 15, 2010).

program requires a formal commitment by each company to follow a set of mandatory "guiding principles," codes of management practices, and various guidelines aimed at reducing the environmental and safety risks chemical production poses.[148] National industry associations running the programs develop indicators for measuring companies' performance and evaluate their implementation of Responsible Care.[149] They also communicate on various issues of health, safety, and environmental risks, both within the industry and with nonindustry interested parties.[150]

Although the issue is not free from debate, both the INPO and Responsible Care are generally recognized for their contribution to increased safety and a reduction in the number and severity of accidents in the nuclear power and chemical manufacturing industries.[151] In a number of other industries, voluntary self-regulatory organizations have also achieved success, albeit in different ways and to varying degrees.[152] These examples of voluntary industry self-regulation allow us to discern factors that make private profit-seeking firms more likely to perceive themselves as a community bound by a common fate and, thus, in need of a common "industrial morality."[153] Some of these factors are internal and some are external to the relevant industry.

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[148] *See* King & Lenox, *supra* note 54, at 699 (describing Responsible Care and explaining that the scope of the codes includes a company's interaction with suppliers, customers, and the community).

[149] *See* Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 377-78 (1998) (explaining that some national industry associations mandate compliance with Responsible Care guidelines).

[150] *Responsible Care Fundamental Features*, RESPONSIBLE CARE, *supra* note 144 (follow "What We Do" hyperlink, then "Fundamental Features" hyperlink) (last visited Oct. 15, 2010).

[151] For instance, in 2002, the United Nations Environmental Programme (UNEP) commended Responsible Care as "a significant contribution to sustainable development." *See Who We Are*, RESPONSIBLE CARE, *supra* note 144.

[152] *See, e.g.*, Marian Garcia Martinez et al., *Co-Regulation as a Possible Model for Food Safety Governance: Opportunities for Public-Private Partnerships*, 32 FOOD POL'Y 299, 308-10 (2007) (detailing voluntary regulation in the food industry); Herbert J. Rotfeld et al., *Self-Regulation and Television Advertising*, 19 J. ADVERTISING, 18, 19-20 (1990) (detailing attempts at self-regulation in the media industry); Richard J. Tobin, *Safety-Related Defects in Motor Vehicles and the Evaluation of Self-Regulation*, 1 POL'Y STUD. REV. 532, 535-38 (1982) (detailing defect reporting and notification by auto manufacturers).

[153] For an insightful and detailed discussion of the concept of "industrial morality," see Gunningham & Rees, *supra* note 2, at 376-80.

C. *Building a Community of Fate: Key Factors Behind the Transformation*

An important external factor that brings private companies together in search of a common organizing principle is a crisis of public confidence in the industry. The private sector is more likely to self-regulate if there is strong political and societal pressure for it to reform its practices, typically as a result of a major disaster caused by industrial actors' failure to manage the risks of their business activities. The Three Mile Island and Bhopal accidents were the triggers that made the nuclear power and chemical manufacturing industries, respectively, targets of intense public criticism and attacks by environmentalists and other social groups. It is under conditions of extreme uncertainty and mounting pressure from the outside that private industry actors perceive the greatest need to relate their industry's norms to its broader, and changing, context.[154]

The intensity of the external political and social pressure is greatly affected by how much the industry's self-serving conduct threatens human life, health, safety, or the environment. The nuclear energy and chemical manufacturing industries conduct activities that have the potential to cause great harm to humans and the environment—a fact of which industry insiders and outsiders are acutely aware.[155] The nature of the public interest involved and, importantly, the degree of actual and potential public involvement in debating the need for regulating the industry's activities play a significant role in shaping the incentives for industry-wide self-regulation. The heightened social and political visibility of the issue and the presence of active public interest groups capable of pressuring the industry and government to address regulatory and market failures and to limit self-interested in-

[154] As Gunningham & Rees put it, "[w]hen an industry's very existence is in question (like nuclear power), or it is going through a legitimacy crisis (like chemical manufacturing), there is a need for industry to make sense of its relationship to the norms and expectations that exist within its social environment." Gunningham & Rees, *supra* note 2, at 379.

[155] "[T]he most serious accident ever to occur in the nuclear power industry," the explosion at the Chernobyl reactor on April 26, 1986, came to symbolize the potentially devastating consequences of a major nuclear disaster for human health and the environment. *UNSCEAR Assessments of the Chernobyl Accident*, UNITED NATIONS SCI. COMM. ON THE EFFECTS OF ATOMIC RADIATION, http://www.unscear.org/unscear/en/chernobyl.html#Health (last visited Oct. 15, 2010). The accident released "considerable amounts of radioactive material," causing at least thirty deaths and over a hundred injuries within weeks. *Id.* Residents of large areas in Russia, Ukraine, and Belarus continue to experience the long-term effects of radioactive contamination. *Id.* By 2002, for example, four thousand children and adolescents in these countries who were exposed to the radiation were reported to have thyroid cancer. *Id.*

dustrial conduct seem to enhance the prospects for industry self-regulation.[156] Thus, the presence of a strong and active environmental movement, as well as the general salience of public safety issues in the nuclear energy and chemical manufacturing sectors, played a significant role in prompting private companies to institute self-regulatory systems aimed at reducing risks posed by nuclear energy and chemical production.[157] Similarly, in the context of labor and occupational safety regulation, the active involvement of labor unions, nongovernmental organizations, and individual employees, all keenly interested in improving workplace safety, encourages the industry to establish a system of self-regulation.[158]

The broader regulatory context within which an industry is situated—the presence or absence of a regulatory scheme, the nature of the government's regulatory interests in the field, and particularly whether there is a threat of imminent direct government regulation—is another external factor that shapes the incentives for industry self-regulation. For example, in the nuclear power sector, strong federal regulation by the Nuclear Regulatory Commission (NRC) and an immediate threat of legislation imposing strict government oversight of nuclear plants, or possibly even closing them down, served as a powerful catalyst for the creation of the INPO.[159] Similarly, chemical manufacturers developed Responsible Care in response to potential government regulation.[160]

Several factors internal to the relevant industry also shape incentives for the emergence and survival of industry self-regulation. The organizational structure, degree of integration, and homogeneity of

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[156] *See* Gunningham & Rees, *supra* note 2, at 391-92 (noting that public pressure may incentivize self-regulation, particularly in industries that are of great public concern, such as the nuclear and chemical industries).

[157] For an insightful discussion on how strong campaigns by various social movements forced the development of private certification programs to set standards for fair labor and sustainable forestry practices in the apparel and forest products industries, respectively, see Bartley, *supra* note 53.

[158] *See generally* Marius Aalders & Ton Wilthagen, *Moving Beyond Command-and-Control: Reflexivity in the Regulation of Occupational Safety and Health and the Environment*, 19 LAW & POL'Y 415 (1997) (promoting self-regulation in the areas of occupational safety and health and the environment through the use of "reflexive" tools that address an industry's relationship with itself).

[159] *See* REES, *supra* note 28, at 43-45 (describing how the formation of the INPO was seen as an effort by industry leaders to prevent NRC regulation).

[160] *See* Rees, *supra* note 138, at 484-85 (describing the government's steps towards regulating the chemical manufacturing industry before Responsible Care was developed).

interests within the industry play an important role in this process. For instance, the chemical manufacturing industry features an unusually high degree of mutual dependence among individual companies that frequently act as consumers of each other's products and form strategic alliances.[161] That the chemical industry was "its own best customer" tempered natural competition and created a base for intrasectoral cooperation.[162] Conversely, one may hypothesize that a highly fragmented, heterogeneous, and internally competitive industry structure may present a serious built-in obstacle to the emergence of, and industry-wide compliance with, a set of norms and standards of behavior indicative of a successful self-regulatory system.

The existence of strong industry leadership, genuinely committed to the idea of self-regulation and the creation of an industry-wide normative framework for more socially responsible business conduct, is another internal factor that makes effective self-regulation more likely. These "regulatory entrepreneurs" within the industry's senior ranks marshal industry support for, and genuine acceptance of, a self-regulatory system. A self-regulatory program that enjoys such support and is generally viewed by private market actors as legitimate and organic to the industry is more likely to succeed in altering such actors' behavior. For example, in the early stages of the chemical industry's Responsible Care program, the involvement of the chief executive officers of the largest chemical companies as chairs of the trade association in charge of the program significantly bolstered its legitimacy.[163]

Finally, the emergence of a community of fate often depends on a growing realization within the industry that continuing unregulated business activities is bound to have a negative long-term effect on the entire industry's economic viability. This internalization of the "we are all in this together" mentality often requires a clear threat to the economic foundation of the industry. One example of self-regulation under such circumstances is found among a community of fishermen in Alanya, Turkey.[164] "[U]nrestrained use of the inshore fishery" in that region led to violent conflict among the fishermen, created signif-

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[161] *Id.* at 489-90. Such strategic alliances among chemical manufacturing firms may include "technology transfers, cross-licensing agreements, manufacturing of marketing partnerships," and so forth. *Id.* at 490.

[162] *Id.* at 489.

[163] *See id.* at 500-03 (detailing the strong effort that was made to recruit top executives in the industry to legitimize the initiative).

[164] *See* Gunningham & Rees, *supra* note 2, at 367 (describing how fishermen developed a self-regulatory solution to a dispute within their industry).

icant uncertainty, and increased production costs.[165] To end this highly volatile situation, the fishermen devised a self-regulatory regime whereby they prepared lists of eligible fishermen, identified usable fishing areas, and created a system to assign and rotate fishing locations.[166] Similarly, after the Three Mile Island disaster, the nuclear power industry developed a strong sense that its very existence would be seriously threatened if another accident occurred and public pressure for "safer alternatives" forced the government to shut down nuclear plants.[167] It is reasonable to assume that the prohibitively high cost of relocating their operations to a different jurisdiction in an attempt to escape regulatory intrusion or public demands made this perception of vulnerability particularly acute for the nuclear power and chemical manufacturing industries. Limited regulatory arbitrage opportunities made these firms take the threat of government intervention and the demands and expectations of the community very seriously.

Thus, the perceived threat to an industry's existence as an economic enterprise can come from internal conflicts and collective action problems, environmental fragility, potential depletion of resources vital to the economic enterprise, or a governmental action disbanding the industry or effectively prohibiting it from conducting its business. What is important for our purposes is industry actors' realization that such a threat is imminent and that they must address it through self-regulation.

The presence of these external and internal factors does not guarantee that an effective system of self-regulation will arise in a given sector. Moreover, the list presented above is not exhaustive and is drawn on a relatively limited set of examples.[168] Nevertheless, identifying

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[165] *Id.*

[166] *Id.*; *see also* ELINOR OSTROM, GOVERNING THE COMMONS 19-20 (1990) (summarizing the rules the Alanya fishermen created).

[167] *See* REES, *supra* note 28, at 43-45 (noting that the INPO was formed largely because of industry officials' collective fear of the catastrophic impact another Three Mile Island Disaster would have on the nuclear power industry).

[168] In reality, the process through which self-regulatory regimes evolve (or fail to evolve) in individual industries or industry segments is highly complex. A wide variety of factors—structural, historical, political, ideological—interact to shape the outcome in each particular case. For instance, in some industries, private actors' political and economic clout and lobbying power may be strong enough to counteract otherwise potentially significant effects of public interest groups' involvement or to diffuse the threat of government regulatory intervention. The balance of power shaping an industry's response to internal and external crises may also shift over time, depending on a variety of factors. Thus, although the recent oil spill in the Gulf of Mexico may be a far more serious environmental disaster than the near-meltdown at Three Mile Island, it may not lead to the emergence of a new industry morality in the oil sector in the immediate fu-

these factors serves as a useful map for evaluating the existing incentives for a new type of self-regulation in the global financial industry.

IV. ASSESSING INCENTIVES FOR THE EMERGENCE OF A SYSTEM OF EMBEDDED SELF-REGULATION IN THE FINANCIAL SERVICES SECTOR

By the end of 2009, the global financial industry had begun its slow recovery from severe market turmoil that changed the face of that industry and possibly set in motion forces that will continue changing its operation in the years and decades to come. In this volatile environment, the key challenge for policymakers and academics is to develop a better, more up-to-date understanding of the structure, functioning, and complex dynamics of the global financial industry in the wake of a major financial crisis.[169] Although a detailed empirical examination of the emergent financial sector's business and risk profile is far beyond the limits of this Article, several characteristics of the financial services industry are particularly relevant to evaluating existing incentives for the emergence of an industry-wide self-regulatory framework aimed explicitly at reducing and managing systemic risk in the financial services sector.

This Part analyzes whether the same phenomena that helped to spur the self-regulatory initiatives in the nuclear power and chemical manufacturing industries operate in today's financial sector. It argues that the financial services industry does not have meaningful incentives to create a comprehensive system of self-regulation aimed at preventing systemic risk. Some of the key factors explaining such an unfavorable set of incentives to self-regulate include the heterogeneity of interests throughout the industry; the low degree of direct public involvement and political pressure on the industry to self-monitor for systemic risk; and the absence of a "community of fate" mentality within the financial industry, which enjoys extraordinary security through its access to an extensive public safety net.

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ture. However, if a similar accident occurs in the next decade or so, when alternative sources of energy are more easily available and economically viable, it may force the oil industry to react very differently. Drawing comparisons and generalizations based on specific industries' historical experiences necessarily leaves out many of these subtleties.

[169] *See, e.g.*, Omarova & Feibelman, *supra* note 7, at 911-14 (arguing that comprehensive knowledge of the domestic financial sector's postcrisis composition and operation is required before developing effective regulatory reform policies).

A. *Intrasector Homogeneity and Commonality of Interests*

In assessing the external and internal conditions for the emergence of a new model of self-regulation in the financial sector, the key inquiry is to what extent the industry is likely to perceive itself as a true community of fate.

As noted above, one factor that makes such a communitarian approach[170] more likely to take shape is relative homogeneity and significant mutual dependence and cooperation within the relevant industries.[171] By contrast, today's financial industry is expansive, highly diverse, and heterogeneous. Moreover, it is increasingly bifurcated in terms of the size of financial institutions, as well as the complexity, scale, and scope of their operations.[172] The world's biggest financial institutions are truly global enterprises that provide a wide variety of financial services to sophisticated clients around the globe and use the latest technology to boost their ability to derive profit from increasingly complex trading and investment strategies.[173] As a result of rapid consolidation and conglomeration, a handful of giant, multifunctional financial firms now control the majority of assets in the global financial services industry and generate the greatest amount of systemic risk.[174] A far greater number of medium-sized and small financial institutions continue to operate mostly at a local or national level and primarily offer more traditional services and products to their clients, which include small and medium-sized businesses and retail customers.[175] This category includes, for example, community banks and sav-

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[170] *See* Rees, *supra* note 138, at 478 (describing the "communitarian" approach to self-regulation in the nuclear power industry as having "industrial morality . . . backed by enough communal pressure to institutionalize responsibility among its members").

[171] *See supra* notes 161-62 and accompanying text (describing mutual dependence in the chemical manufacturing industry in terms of "strategic alliances").

[172] For a thorough account of the transformation in the financial industry in recent decades, see Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 476.

[173] *See id.* at 312-17.

[174] Industry consolidation has been particularly rapid during the recent financial crisis, which caused a wave of failures and mergers and resulted in the survival of even fewer, even larger financial conglomerates dominating the wholesale financial services market.

[175] *See, e.g.*, Tim Critchfield et al., *The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects*, 16 FDIC BANKING REV., no. 3, 2004 at 1, 4-5, *available at* http://www.fdic.gov/bank/analytical/banking/2005jan/article1.pdf (emphasizing the continued function of community banks as creditors for small-business, agriculture, and first-time borrowers); Heather Gratton, *Regional and Other Midsize Banks: Recent Trends and Short-Term Prospects* 2, 18

ings associations, retail securities brokerage firms, small investment advisors, and consumer finance companies.[176] Although large global financial conglomerates also have vast retail deposit bases and offer other financial services to broadly based customers, there is a great disparity between that group and the smaller financial services providers in terms of their economic and political power and interests.

The modern financial industry is also divided functionally, along key product lines, such as commercial banking, investment banking, securities brokerage, investment advice, and insurance. In the United States, these divisions are built firmly into the existing legislative and regulatory scheme, which subjects these different types of financial institutions to different regulatory regimes.[177] Commercial banks and other deposit-taking institutions perform important public functions—providing transaction services and liquidity and serving as channels for the transmission of monetary policy by the central banks—and are vulnerable to "runs."[178] As a result, national governments typically impose strict regulation on, and provide significant public subsidies to, commercial banks. Other financial institutions, as a rule, have no access to government liquidity facilities and do not en-

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(FDIC Future of Banking Study, Draft FOB-2004-06.1, 2004), *available at* http://www.fdic.gov/bank/analytical/future/fob_06.pdf (describing some midsize banks as "covering a region of the country" and some as being "more geographically concentrated," and showing the asset composition of community and midsize banks over the past two decades).

[176] To be sure, some of the institutions providing traditional (mainly retail) financial services are owned by large financial conglomerates. This discussion, however, focuses on the majority of firms in this category, which are not subsidiaries of global financial conglomerates.

[177] *See, e.g.*, Michael Taylor, *The Search for a New Regulatory Paradigm*, 49 MERCER L. REV. 793, 795-96 (1998) (describing the highly fragmented system of financial regulation in the United States, with multiple agencies overseeing different sectors under separate statutory schemes). For an insightful and comprehensive analysis of the policy justifications for regulating different types of financial transactions and institutions differently, see Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 332-39 (1999).

[178] *See, e.g.*, E. Gerald Corrigan, *Are Banks Special?* (arguing that banks are special by virtue of their unique functions, including providing transaction accounts and serving as the "backup source of liquidity for all other institutions" and the "transmission belt for monetary policy"), *in* FED. RESERVE BANK OF MINNEAPOLIS, 1982 ANNUAL REPORT (1982), *available at* http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm; E. Gerald Corrigan, *Are Banks Special? A Revisitation*, THE REGION, March 2000, at 15, 15-16, *available at* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id_3527 (reflecting that the "core traits" making banks uniquely important to the operation of the financial system remain relevant).

joy a public guarantee of their liabilities.[179] Moreover, significant pockets of the financial services sector, such as hedge funds and other private pools of capital, remain either unregulated or only lightly regulated by national governments.

On the other hand, complex financial products (such as derivatives) increasingly blur the traditional lines between market segments and create unprecedented interconnectedness among financial institutions.[180] In the multitrillion dollar markets in derivatives,[181] which permit parties to turn anything that can be measured into a financial asset and then tie together any such assets in a seemingly endless variety of ways, financial institutions acting as buyers and sellers of financial risk are intricately connected through a web of mutual risk exposure.[182] The failure of major U.S. investment bank Lehman Brothers and the near failure of insurance giant AIG, both in the fall of 2008, forcefully underscored this unprecedented degree of interconnectedness and shared risk among large financial institutions.[183]

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[179] Of course, this "normal" state of affairs radically changed during the recent financial crisis, when national governments significantly expanded public subsidies to nondepository institutions. *See* Meena Thiruvengadam, *US Fed Discount Window Borrowing Continues to Hit New Highs*, DOW JONES NEWSWIRES, Oct. 2, 2008, *available at* http://www.fxstreet.com/news/forex-news/article.aspx?storyid=541fa3e0-7f7f-45e8-b4ba-7429828732e0 (noting that for "the first time since the Great Depression," the Federal Reserve allowed entities other than commercial banks to borrow from its discount window).

[180] For a definition of derivatives, see *supra* note 75. For a discussion of the uneasy regulatory status of OTC derivatives, see Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 388-95 (2005).

[181] According to Bank for International Settlements (BIS) statistics, the total notional amount of OTC derivatives outstanding at the end of June 2009 was nearly $605 trillion. BANK FOR INT'L SETTLEMENTS, BIS Q. REV., June 2010, at A121 tbl.19. Even the gross market value of these contracts (a much more conservative measure) exceeded $25 trillion. *Id.*

[182] *See, e.g.*, Krawiec, *supra* note 3, at 6 (emphasizing the relational nature of derivatives by defining them as "complex and highly leveraged" bilateral contracts); Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 2-3 (1996) (cataloguing entities, large and small, that posted significant losses due to derivative investments); Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?*, 43 AM. U. L. REV. 1023, 1026 (1994) ("[T]he panoply of risks presented by the derivatives markets could lead to systemic breakdown in the global capital markets.").

[183] *See* Justin Fox, *Why the Government Wouldn't Let AIG Fail*, TIME, Sept. 16, 2008, http://www.time.com/time/business/article/0,8599,1841699,00.html (explaining that the government decided to bail out AIG because the financial market's interconnectedness rendered the consequences of its collapse uncertain and potentially chaotic); Neha Singh, *AIG May Take Huge Markdowns on Lehman Impact*, REUTERS, Sept. 15, 2008,

Thus, in terms of industry structure, homogeneity of interests, and mutual cooperation, the financial services industry seems to present at least an ambiguous situation. On the one hand, its sheer size, great heterogeneity, and internal divisions seem to work against the emergence of a "community of fate" mentality conducive to self-regulatory solutions. On the other hand, at least in wholesale financial services markets, the growing complexity and interdependence of financial institutions could be said to create a de facto community of fate, as the failure of one major player could lead to the failure of the entire market.[184] How does today's financial services sector fare with respect to other factors that shape the incentives to create an effective self-regulatory system?

B. *Relationship Between the Industry and the Public*

In the wake of major global financial turmoil, public confidence in the financial services industry's ability to behave in a socially responsible manner has eroded, if not disappeared.[185] Given the severity of the crisis, it is hardly an exaggeration to say that the industry is facing its most serious public relations disaster in recent decades, a truly pervasive crisis of public confidence.[186] On a more fundamental level,

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http://www.reuters.com/article/idUSBNG12175020080915 (chronicling AIG's potential $30 billion loss after the sale of Lehman Brothers' assets).

[184] It may be argued that this interconnectedness among financial institutions differs from chemical manufacturing companies' interconnectedness in that financial firms enter complex transactions binding them to one another purely voluntarily and, at least in theory, can break these contractual bonds at will. In practice, however, financial institutions seeking leveraged returns or pursuing other economic goals through the use of derivatives and other complex financial instruments may not really be free to walk away from their trading counterparties without losing profitable opportunities.

[185] Perhaps the most vivid, albeit extreme, example of the strong anti-industry public opinion is Matt Taibbi's famous description of Goldman Sachs: "The world's most powerful investment bank is a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money." Matt Taibbi, *The Great American Bubble Machine*, ROLLING STONE, July 9–23, 2009, at 52, 52. In November 2009, Goldman Sachs CEO Lloyd Blankfein's comment that he was "doing God's work" spurred a wave of small but vocal protests around the country. *See* Kevin Sieff, *Protesters Lash out at Goldman*, FT.COM (Nov. 16, 2009), http://www.ft.com/cms/s/0/05985428-d2ec-11de-af63-00144-feabdc0.html.

[186] The extent of public outrage at the financial industry's behavior during the crisis became especially clear amid revelations that the firms that received taxpayer money to help them stay afloat had granted their executives and traders lavish bonuses. For example, at the end of 2009, it became public knowledge that Goldman Sachs "set aside $16.7 [billion] for compensation in the first nine months" of 2009 after earning record profits in a sharp rebound from financial turmoil. *See* Francesco Guerrera & Justin Baer, *Goldman Apologises for Role in Crisis*, FT.COM, Nov. 17, 2009, http://www.ft.com/cms/s/

the prevailing theoretical and ideological paradigm under which deregulation and unfettered financial innovation were viewed as unconditionally beneficial[187] has been publicly discredited and has lost its precrisis intellectual dominance.[188]

However, in certain fundamental respects, this situation is very different from the one in which the nuclear power industry found itself after the Three Mile Island accident. Although the crisis caused severe economic dislocation around the world, including massive home foreclosures and bankruptcies, rising unemployment, large stock market losses, and general economic contraction and recession, public perceptions of these phenomena tend to be less acutely personalized and emotionally loaded than those of a nuclear or chemical accident. The consequences of a financial and economic crisis are generally diffused; they tend to operate on an abstract level and, importantly, lack the powerful symbolism of an innocent human life lost as a result of an industrial accident.

Moreover, unlike the Three Mile Island and Bhopal accidents, the recent financial meltdown is not easily traced to a wrongful act by a particular industry actor, or even to the misconduct of the financial industry as a whole. There are numerous competing explanations and analyses of the causes of the financial crisis, which originated in the United States subprime mortgage market and quickly spread to

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0/782afd66-d3bd-11de-8caf-00144feabdc0.html (contrasting Goldman's planned $100-million annual investment to help small businesses with $21.8 billion in estimated total compensation expenses in 2009). *See also* sources cited *supra* note 13 (discussing record compensation at banks and the resulting negative public reaction).

[187] *See, e.g.*, Anthony Faiola et al., *What Went Wrong*, WASH. POST, Oct. 15, 2008, at A1 (arguing that financial regulators' refusal to heed the call for more oversight and the resulting deregulation of financial markets contributed to the financial collapse); Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1 (discussing Greenspan's policy of discouraging regulation of derivatives and the possibility that the financial crisis could have been avoided if the Federal Reserve followed a different strategy).

[188] Even Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve System and perhaps the most famous proponent of this philosophy, admitted its fundamental error in essentially assuming risks away. *See* Alan Greenspan, *We Will Never Have a Perfect Model of Risk*, FIN. TIMES (London), Mar. 17, 2008, at 13 (opining that risk models "are still too simple to capture the full array of governing variables that drive global economic reality"). World-famous financier George Soros recently announced his decision to fund a new think tank tasked with reconceiving the field of economics, which he believes is too deeply entrenched in free-market ideology. *See* Alan Rappeport, *Soros to Invest $50m in Economic Think-Tank*, FT.COM, Oct. 27, 2009, http://www.ft.com/cms/e45b353a-c2f3-11de-8eca-00144feab49a.html (describing Soros's hope that the organization will shift the focus of economic scholarship from rigid modeling to ideas that are "more reality based").

other segments of the financial universe.[189] While it is widely accepted that Wall Street's greed and financial institutions' excessive risk-taking were the key ingredients of the fallout,[190] many competing explanations are being offered and debated in the media, as well as in academic and policymaking circles. Some of these explanations fault central banks for pursuing allegedly crisis-inducing monetary policies,[191] while others focus on the negative effects of deregulatory legislation in the United States and abroad.[192] Finally, a popular narrative blames the consumers of financial services, such as imprudent homeowners who borrowed beyond their ability to repay and then de-

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[189] *See generally* Adam J. Levitin, Foreword, *The Crisis Without a Face: Emerging Narratives of the Financial Crisis*, 63 U. MIAMI L. REV. 999 (2009) (describing competing narratives of the crisis).

[190] *See, e.g.*, Alan S. Blinder, Op-Ed., *Crazy Compensation and the Crisis*, WALL ST. J., May 28, 2009, at A15 (arguing that compensation systems in place before the crisis led to excessive risk-taking and that, once fear from the crisis expires, greed will take back over); Clive Crook, Op-Ed., *Smarter Ways to Punish a Banker*, FIN. TIMES (London), Jan. 18, 2010, at 13 (pointing out that greed drove banks to take advantage of a system that allowed for excessive risks); Stewart Hamilton, Op-Ed., *Boards Must Stand Up to Bullying CEOs*, FIN. TIMES (London), Apr. 19, 2010, at 6 (blaming the crisis on excessive risk-taking by bankers seeking large bonuses).

[191] *See, e.g.*, Edmund L. Andrews, *Bernanke Defends Steps Taken to Contain Crisis*, N.Y. TIMES, Feb. 19, 2009, at B3 (chronicling Federal Reserve Chairman Ben Bernanke's defense of the central bank's policies in a public forum); Michael Barone, *Ad Hoc Fed, Treasury Acts Caused the Financial Crisis, Not Deregulation, Tax Cuts*, U.S.NEWS.COM (Mar. 10, 2009), http://www.usnews.com/blogs/barone/2009/03/10/ad-hoc-fed-treasury-acts-caused-the-financial-crisis-not-deregulation-tax-cuts.html (summarizing the argument by John B. Taylor that low interest rates set by the Federal Reserve, in conjunction with government programs that were intended to promote home ownership, caused the economic crisis). For a full debate regarding the role of the Federal Reserve in causing the housing bubble and subsequent financial crisis, see the following opinion pieces published in the Wall Street Journal: David Henderson, Op-Ed., *Don't Blame Greenspan*, WALL ST. J., Mar. 27, 2009, at A13, David Malpass, Op-Ed., *The Fed Provided the Fuel*, WALL ST. J., Mar. 27, 2009, at A13, Gerald P. O'Driscoll Jr., Op-Ed., *What Savings Glut?*, WALL ST. J., Mar. 27, 2009, at A13, Vincent Reinhart, Op-Ed., *To Change Policy, Change the Law*, WALL ST. J., Mar. 27, 2009, at A13, Judy Shelton, Op-Ed., *Loose Money and the Derivative Bubble*, WALL ST. J., Mar. 27, 2009, at A13, and Todd J. Zywicki, Op-Ed., *Low Rates Led to ARMs*, WALL ST. J., Mar. 27, 2009, at A13.

[192] *See, e.g.*, McCoy, Pavlov & Wachter, *supra* note 73, at 1329-32 (concluding that deregulation and private-label securitization encouraged risky mortgages and created an unsustainable situation in which lenders and securitizers were able to pass off financial risk that was improperly priced by the market); *see also* Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1 (reporting that Christopher Cox, then-Chairman of the SEC, had found that "failures in a voluntary supervision program for Wall Street's largest investment banks had contributed to the global financial crisis" and called for greater market supervision by the government); Catherine Rampell, *Lax Oversight Caused Crisis, Bernanke Says*, N.Y. TIMES, Jan. 4, 2010, at A1 (citing Federal Reserve Chairman Ben Bernanke in a January 3, 2010, speech as stating that the financial crisis was caused by "[r]egulatory failure, not low interest rates").

faulted on their loans.[193] By effectively blaming the victims of the crisis for its occurrence and by isolating them as an identifiable group directly affected by it, this narrative tends to reinforce the public perception of the financial crisis as a highly generalized systemic event. It is not seen as a true human tragedy, in which innocent lives are ruined by the greedy industry. Instead, the victims' demise becomes, to a great extent, a product of their own misguided behavior. Consequently, the intensity of public outrage at the financial industry's self-interested behavior and the accompanying political pressure to address its internal gaps in risk management are generally lower in the case of a major financial crisis than in the case of a major nuclear-safety or environmental disaster.

This phenomenon is closely related to additional factors that are relevant to our inquiry: the nature of the public interest involved and the degree of actual and potential public involvement in debating the need to regulate the industry's activities. In 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.[194] Truly informed interest and direct involvement in financial regulation on the part of the general public is even less likely. In the United States, with the exception of certain consumer advocacy organizations that generally limit their focus to issues directly relating to retail consumers' rights vis-à-vis financial institutions, there are virtually no organized public interest groups capable of participating effectively and consistently in regulating the global financial sector. The

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[193] *See, e.g.*, Maureen Dowd, Op-Ed., *Dark Dark Dark*, N.Y. TIMES, Feb. 22, 2009, at WK11 (describing the position of CNBC reporter Rick Santelli, who argued that responsible homeowners had borne the financial burden of irresponsible homeowners, as "str[iking] a populist nerve"); Declan McCullagh, *Homeowner Bailout Rewards Irresponsibility*, CBS NEWS (Jan. 14, 2009), http://www.cbsnews.com/stories/2009/01/14/politics/otherpeoplesmoney/main4720465.shtml (arguing that a bailout of homeowners by taxpayers would aid some undeserving homeowners, like speculators, who purchased houses that they could not afford).

[194] *See, e.g.*, ERIC HELLEINER, STATES AND THE REEMERGENCE OF GLOBAL FINANCE 19 (1994) (noting the "low domestic political visibility of . . . financial liberalization among . . . the general public" in the 1970s and 1980s).

regulatory process in the financial industry tends to unfold behind closed doors—in conference rooms filled with industry insiders and government agency staff—far removed from the public eye.[195]

C. *Regulatory Context and the Tradition of Self-Regulation*

Regulatory context, more generally, is another important factor shaping the incentives for self-regulation of the industry. The financial services industry has long been subject to government regulation. As discussed above, certain segments of that industry, such as commercial banking and securities trading, are regulated and supervised particularly heavily. Regulated financial institutions, especially large conglomerates whose business activities span a variety of regulatory landscapes, are used to dealing with regulators and engage in sophisticated and effective regulatory arbitrage and lobbying.[196] Over the decades since New Deal legislation in the United States established the basis for the existing system of financial services oversight, the relationship between the industry and regulatory agencies has evolved into a complex web of interdependencies. Regulatory agencies in charge of the financial services sector often display strong signs of industry "capture" and increasingly engage in nontransparent and highly informal rulemaking that falls outside public scrutiny and tends to favor the industry.[197] The incestuous relationship between the industry

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[195] There are many examples of this pattern of nonpublic interaction between financial regulators and industry actors, particularly in the notoriously secretive and opaque area of banking regulation. One recent example of regulatory agencies and financial firms failing to inform the public of important policy choices occurred when the Federal Reserve Bank of New York asked AIG not to disclose the terms of its payments under derivatives contracts to specific counterparties, including Goldman Sachs and other large financial institutions. *N.Y. Fed Told AIG Not to Disclose Swap Details*, N.Y. TIMES DEALBOOK (Jan. 7, 2010, 6:11 AM), http://dealbook.blogs.nytimes.com/2010/01/07/the-federal-reserve-bank-of-ne.

[196] *See, e.g.*, Binyamin Appelbaum, *On Finance Bill, Lobbying Shifts to Regulations*, N.Y. TIMES, June 27, 2010, at A1 (detailing the financial industry's lobbying efforts intended to shape the new rules implementing the Dodd-Frank Act); John Plender, *How to Tame the Animal Spirits*, FIN. TIMES (London), Sept. 30, 2009, at 11 (pointing out that, in 2007, there were five financial industry lobbyists per member of Congress); Fredreka Schouten, *Financial Industry Taps D.C. Insiders*, USA TODAY, Apr. 23, 2010, at 9A, *available at* 2010 WLNR 8419348 (indicating that in the first quarter of 2010, financial firms significantly increased their spending on lobbying Congress and hired "well-connected lobbyists" to influence implementation of regulatory reform).

[197] *See, e.g.*, Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking,"* 63 U. MIAMI L. REV. 1041, 1077 (2009) (examining the process by which the Office of the Comptroller of the Currency, the primary federal regulator of national banks, granted and expanded commercial banks' legal authority to engage in a variety of derivatives transactions).

and its government watchdogs is further exemplified by the existence of a "revolving door" policy, where agency officials move to lucrative private sector positions and prominent industry executives are appointed to top regulatory posts.[198] Given these factors, it seems unlikely that the threat of a new and unfamiliar regulatory regime would serve as a powerful external source of industry-wide mobilization around a new "industry morality," or as a strong internal push to create a genuinely publicly minded private alternative regulatory framework to contain systemic risk. A far more likely response would be the familiar pattern of intense industry lobbying to stall the reforms or to secure sufficient loopholes in the proposed rules to enable regulatory arbitrage.[199]

Importantly, the global financial industry has a significant history of self-regulation. However, the scope of this self-regulation has traditionally been quite limited, in terms of both the activities covered and the goals it seeks to achieve.[200] Nonetheless, industry self-regulation has long been an important element of the U.S. regulatory approach to securities markets.[201] U.S. securities laws assign significant oversight responsibilities to securities exchanges, clearing agencies, and other SROs, which are required to register with the SEC and

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[198] Perhaps two of the most famous examples of such appointments are Robert Rubin and Henry Paulson, two former Chairmen of Goldman Sachs who were appointed Secretary of the Treasury by Presidents Bill Clinton and George W. Bush, respectively. *See* Howard Gleckman, *Paulson to the Rescue?*, BUSINESSWEEK, May 30, 2006, http://www.businessweek.com/bwdaily/dnflash/may2006/nf20060530_1022.htm (analyzing the similarities and differences between Rubin and Paulson in their public-servant capacity).

[199] In fact, former regulatory-agency officials and employees often lobby on private firms' behalf. *See, e.g.*, Eric Lichtblau, *Ex-Regulators Lobby to Shape Overhaul*, N.Y. TIMES, July 28, 2010, at B1 (noting that almost 150 people who registered as lobbyists from 2009 to 2010 were previously employed with financial regulatory agencies).

[200] *See, e.g.*, Ross P. Buckley, *The Role and Potential of Self-Regulatory Organizations: The Emerging Markets Traders Association from 1990 to 2000*, 6 STAN. J.L. BUS. & FIN. 135, 135-37 (2000) (describing the formation and functioning of the Emerging Markets Traders Association, an industry association engaged primarily in the standardization and dissemination of best practices in the trading of emerging markets debt instruments); Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735, 769-79 (2009) (describing the U.K. insurance industry's private ombudsman service to resolve consumer disputes with their financial service providers).

[201] For a useful description of the history of self-regulation in the U.S. securities industry, see Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475, 480-87 (1984).

are subject to its comprehensive oversight.[202] Securities SROs, such as the Financial Industry Regulatory Agency (FINRA)[203] and the New York Stock Exchange,[204] act as "frontline regulators" tasked with ensuring the integrity of the process of distribution and trading of securities and policing the conduct of securities broker-dealers and other market participants.[205] A similar scheme exists under the commodity futures laws.[206] By contrast, in the U.S. banking sector, no SROs exist and regulation and supervision are concentrated within state and federal bank-regulatory agencies.[207]

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[202] *See generally* 23 JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES, CREDIT REGULATION, AND CUSTOMER PROTECTION (9th release 2001).

[203] FINRA, formed in 2007 as a self-regulatory entity, combined the National Association of Securities Dealers, Inc. (NASD) and the regulatory arm of the NYSE. *About the Financial Industry Regulatory Authority*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/AboutFINRA/index.htm (last visited Oct. 15, 2010).

[204] For general information on the NYSE, see *About Us*, NYSE EURONEXT, http://www.nyse.com/about/1088808971270.html (last visited Oct. 15, 2010).

[205] Under the statutory scheme, all U.S. securities broker-dealers are required to register with FINRA and are subject to its regulation and supervision. According to FINRA's official website, as of 2010, it "oversees nearly 4,700 brokerage firms, about 167,000 branch offices and approximately 635,000 registered securities representatives." *About the Financial Industry Regulatory Authority*, *supra* note 203.

[206] Commodity Exchange Act, 7 U.S.C. §§ 1–27 (2006); *see also* Markham & Harty, *supra* note 122, at 882-87 (describing the regulatory role that commodity futures exchanges play). In the U.S. futures sector, the Commodity Futures Trading Commission (CFTC), a federal agency established in 1974, oversees registered commodity exchanges. *See Mission & Responsibilities*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Oct. 15, 2010). The CFTC also oversees the National Futures Association (NFA), an industry SRO with which all futures-market professionals must register. *See Who We Are*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/NFA-about-nfa/index.html (last visited Oct. 15, 2010).

[207] To a great extent, these differences in the regulatory roles of private market participants in the securities and commodity futures industries, on the one hand, and the banking industry, on the other, are rooted in fundamentally different assumptions about these industries' core business models. The U.S. system of financial sector regulation, established mostly in the post–Great Depression era, was built on an assumption that securities firms were essentially fee-earning agents for issuers, investors, and other market participants, so that one of the key purposes of securities regulation was preventing fraud and overreaching by market professionals. *See, e.g.*, 5 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 55-59 (6th ed. 2009) (describing the historical roots and current focus of the U.S regulation of securities professionals, which places major emphasis on prohibiting fraudulent and manipulative conduct by securities broker-dealers). This substantive policy objective dictated the focus on decentralizing day-to-day oversight of market professionals' conduct and operation of markets in general. By contrast, the key assumption in the banking area was that banks engaged primarily in the purely spread-based business of taking deposits and extending loans, with an inherent mismatch between banks' short-term liabili-

The U.S. model of securities SROs, presenting "a peculiar mix of private sector self-regulation and delegated governmental regulation,"[208] is largely a product of political compromise[209] and economic expediency.[210] This concept of industry self-regulation, deeply rooted in the regulatory paradigm of the post–Great Depression era, is fundamentally limited in its scope. In effect, securities SROs function as quasi-governmental entities performing resource-intensive tasks "outsourced" to them by the SEC. Although the SEC has independent statutory authority to regulate the activities of securities broker-dealers and other market intermediaries, in practice, the agency has fully delegated these functions to SROs, all of which are privately funded. The SEC has instead chosen to function as the watchful guard and supervisor, ensuring that the SROs perform their statutory duties faithfully and effectively.[211] SROs maintain extensive rulebooks governing in excruciating detail the everyday conduct of business by their members. For example, FINRA Rules contain detailed standards dictating how broker-dealers communicate with their customers, segregate and safeguard customers' funds, collateralize extensions of credit to customers, make recommendations to their clients with respect to securities transactions, supervise the actions of their employees, and maintain books and records, as well as what types of information they provide to their customers.[212] Virtually every aspect of securities firms' daily business activities, including the most detailed and mundane tasks, is subject to various, frequently overlapping SRO rules.[213]

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ties and long-term assets dictating the regulatory focus on stability and solvency, or safety and soundness, of banking institutions, *see, e.g.*, Corrigan, *supra* note 178 (citing this "term structure risk" as a "realit[y] that gives rise to concerns" about bank stability), which may be a task more "naturally" suited for government agencies.

[208] Karmel, *supra* note 21, at 151.

[209] *See, e.g.*, Smythe, *supra* note 201, at 481 ("The regulatory structure crafted for the securities industry in 1934 was more a function of political compromise than of logic.").

[210] As one commentator put it, "[a]lthough the premises of self-regulation have regularly been called into question, the concept has endured because lawmakers have generally regarded self-regulation to be a practical and efficient way to outsource the burdens of regulation to the private sector." Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317, 323 (2007).

[211] The SEC's Office of Compliance Inspections and Examinations (OCIE) conducts routine and special inspections of SRO regulatory and enforcement programs. *Office of Compliance Inspections and Examinations*, SEC, http://www.sec.gov/about/offices/ocie.shtml (last visited Oct. 15, 2010).

[212] *FINRA Rules*, FIN. INDUSTRY REG. AUTHORITY, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=607 (last visited Oct. 15, 2010).

[213] As part of the establishment of FINRA, the old NASD Rules and the NYSE Rules are being consolidated into a single rulebook, which is meant to streamline compliance

In recent years, the rapid increase in computerized trading across platforms and geographic borders, as well as a string of scandals uncovering governance failures at the world's leading stock exchanges, led to what some observers describe as an "identity crisis" of the SROs in the securities industry.[214] A particularly intensely debated issue is the future of securities exchanges. Stock exchanges, the first self-regulatory membership associations in the industry, have recently gone through a wave of demutualization, cross-border mergers, and attempts to resolve the conflict of interest inherent in their dual function as regulators and profit-seeking economic enterprises.[215] Commentators have also raised serious questions about how effective and efficient existing securities industry SROs really are, in light of their increasing bureaucratization and close integration into the federal government regulatory scheme.[216]

This strongly entrenched tradition of industry self-regulation, concerned primarily with the conduct of business by, and solvency of, securities-market intermediaries, may act as a double-edged sword in its effect on incentives for self-regulation in the global financial sector. On the one hand, 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. On the other

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and eliminate the unnecessary duplication of standards. *See FINRA Rules*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/Industry/Regulation/FINRARules (last visited Oct. 15, 2010).

[214] *See* Dombalagian, *supra* note 210, at 317 (using the term "identity crisis" to describe the effect recent developments have had on SROs).

[215] *See, e.g.*, Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435, 1450-63 (2008) (observing that international linkages between exchanges have contributed to the rise of a "private market" for securities regulation); Roberta S. Karmel, *The Future of Self-Regulatory Organizations*, N.Y. L.J., June 18, 2009, at 3 (describing the history of SROs and discussing their potential future); Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355, 356 (2007) (presenting demutualization of exchanges and cross-border exchange consolidations as factors promoting globalization of exchanges); Macey & O'Hara, *supra* note 47, at 583 (proposing that due to conflicts of interest facing self-regulating exchanges, "private firms' ability to regulate should be confined to issues related to the private ordering of the firm"); Eric J. Pan, *A European Solution to the Regulation of Cross-Border Markets*, 2 BROOK. J. CORP. FIN. & COM. L. 133, 138-39 (2007) (introducing potential regimes for regulation of a transatlantic exchange).

[216] *See, e.g.*, Dombalagian, *supra* note 210, at 324 (suggesting that "federalization of securities law" has contributed to the decline of SROs); Karmel, *supra* note 21, at 151 (discussing how integration of SROs into the federal regulatory scheme has made them "a peculiar mix of private sector self-regulation and delegated governmental regulation").

hand, that 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.[217] In addition, the internal conflicts and problems plaguing existing securities industry SROs may divert attention from the necessary debate on the contours of global financial industry self-regulation. The failure of securities SROs to detect and prevent blatantly wrongful conduct by industry professionals may seriously dilute any potential support for allowing the financial industry to assume responsibility for managing the systemic risk it generates.[218] In other words, the old culture and the ambiguous legacy of securities industry self-regulation may complicate the birth of a new culture of comprehensive financial sector self-regulation.

D. *Effects of the Public Safety Net*

A very important factor creating incentives for such a new culture is an increasingly widespread understanding among the firms within the relevant industry that continuing their purely profit-driven business practices will jeopardize the entire industry's long-term survival. This is perhaps the most important factor that explains the absence of any real incentive for the global financial services industry to formulate a new normative framework to guide its activities. While 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. In contrast to the nuclear power industry, which faced a very realistic possibility of being shut down as a result of the Three Mile Island accident, abolishing the entire financial services industry in favor of a "safer alternative" is not a viable policy option.[219] Moreover, in modern times, national governments typically provide a

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[217] *See supra* Part II.

[218] Some of the best-known recent examples of such self-regulatory failure include the Wall Street research analyst scandal, *see* Andrew Ross Sorkin, *Analyzing Wall Street's Research*, N.Y. TIMES, Aug. 12, 2008, at C1, the uncovered practices of unfair distribution by underwriters of shares in initial public offerings, *see* Randall Smith & Chad Bray, *IPO-Abuses Lawsuit Is Settled*, WALL ST. J., Oct. 7, 2009, at C3, and, finally, the long undeterred run of Bernie Madoff's Ponzi scheme, *see* Alex Berenson & Diana B. Henriques, *S.E.C. Issues Mea Culpa on Madoff*, N.Y. TIMES, Dec. 17, 2008, at B1.

[219] This practical impossibility does not mean that lawmakers have no power to restrict the growth of, or even legally abolish, certain segments of the financial industry. Similarly, it is possible to argue that comprehensive legal reform aims, in essence, to develop a "safer alternative" to the existing financial system by diminishing its riskiness.

significant public safety net for financial institutions viewed as crucial to the functioning of their economies.[220] For example, in the United States, the Federal Deposit Insurance Corporation (FDIC) guarantees retail deposits at commercial banks and other deposit-taking institutions, minimizing the threat of depositor "runs."[221] Another important mechanism for preventing bank failures is the system of credit extensions by Federal Reserve Banks to depository institutions with temporary liquidity problems.[222] These protective mechanisms effectively amount to significant federal subsidies to the banking sector and create a serious "moral hazard" problem.[223]

The recent global financial crisis has forcefully underscored the true extent of this problem. In response to the quickly spreading market turmoil and investor panic in late 2008, the world's leading governments put in place massive bailout programs designed to infuse capital into technically insolvent, or nearly insolvent, financial institutions, to enhance their creditworthiness by guaranteeing their obligations to third parties, and to subsidize open market purchases of their quickly depreciating and illiquid assets.[224] While the short-term bene-

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[220] For an insightful discussion of the elements and operation of the public safety net in the global financial sector, see HEIDI MANDANIS SCHOONER & MICHAEL W. TAYLOR, GLOBAL BANK REGULATION 51-71 (2010).

[221] For a general discussion of the basic principles and operation of the U.S. system of bank regulation and supervision, see KENNETH SPONG, BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION, AND EFFECTS (1983). *See also* LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES (2d ed. 2004); RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS (4th ed. 2009); HOWELL E. JACKSON & EDWARD L. SYMONS, JR., REGULATION OF FINANCIAL INSTITUTIONS (1999).

[222] *See* CARNELL, MACEY & MILLER, *supra* note 221, at 45. Federal Reserve Banks extend short-term credit either through advances secured by qualifying collateral (such as U.S. government securities and other high-quality debt) or through the discount of eligible paper, at rates established with the approval of the Federal Reserve Board. *See* FED. RESERVE SYS. STUDY GRP. ON ALT. INSTRUMENTS FOR SYS. OPERATIONS, FED. RESERVE SYSTEM, ALTERNATIVE INSTRUMENTS FOR OPEN MARKET AND DISCOUNT WINDOW OPERATIONS app.3.A at 29-33 (2002), *available at* http://www.federalreserve.gov/boarddocs/surveys/soma/alt_instrmnts.pdf.

[223] Moral hazard exists because the federal deposit guarantee creates incentives for bank shareholders, shielded by their limited liability, to take on greater risks with depositors' funds in search of higher returns for the bank. Bank shareholders receive the entire payoff from the riskier investments, but the federal deposit insurance fund or depositors themselves bear any additional loss. *See, e.g.*, SCHOONER & TAYLOR, *supra* note 220, at 60-66 ("The moral hazard is that the insured will allow him or herself to incur greater losses knowing that a third party is footing the bill.").

[224] *See generally* Ana Petrovic & Ralf Tutsch, *National Rescue Measures in Response to the Current Financial Crisis* (Eur. Cent. Bank, Legal Working Paper Series No. 8, 2009),

fits and long-term effects of these responses to the global credit and capital market crisis will be hotly debated for years to come, one critically important lesson of this cumulative experience is clear: by using public funds to prevent the failure of the biggest financial institutions, whose excessive risk-taking caused the crisis in the first place, the world's governments sent a clear signal that they would never allow the global financial services industry to fall under the weight of its own mistakes or greed.[225] As a result, in the post-2008 universe, the global financial industry is effectively liberated from the operation of fundamental free-market forces.

Another feature of the emerging postcrisis landscape is the higher degree of concentration in the financial services sector. As a result of the failure or forced sale of some of the world's most established firms, a smaller number of significantly larger financial conglomerates now control the bulk of total assets in the financial system and dominate global financial markets.[226] These financial institutions wield a disproportionate amount of economic and political power, and they are even more entrenched as "too big to fail" behemoths, effectively holding the governments and the public, whose tax payments finance those governments, hostage.[227] These "too big to fail" institutions, in particular, have no real reason to feel any threat to the economic or political viability of the financial industry. In fact, they appear to be perfectly justified to think that even if the majority of smaller firms failed, they would always be rescued by taxpayers.

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available at http://papers.ssrn.com/abstract_id=1430489 (discussing the responses of various governments to the financial crisis).

[225] In late 2008, for the first time since its establishment in 1913, the Federal Reserve used its statutory power under section 13(3) of the Federal Reserve Act, 12 U.S.C. § 343 (2006), to grant nondepository financial institutions access to its liquidity-support facilities, thus significantly expanding the federal safety net. *See* Meena Thiruvengadam, *Investment Bank Borrowing at Discount Window Hits Record*, WALL ST. J. (Sept. 26, 2008), http://online.wsj.com/article/SB122237806611776365.html.

[226] The most salient examples of this consolidation trend are the failure of venerable U.S. securities firm Lehman Brothers, the government-brokered acquisition of Bear Stearns and Washington Mutual by JPMorgan Chase, and the acquisition of Merrill Lynch and Wachovia by Bank of America and Wells Fargo, respectively.

[227] The term "too big to fail" (TBTF) was introduced into the regulatory vocabulary by the former Comptroller of the Currency, C. Todd Conover, who used it to describe the eleven largest banks in the wake of the failure of the Continental Illinois National Bank in 1984. *See Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearing Before the Subcomm. on Fin. Insts. Supervision, Regulation & Ins. of the H. Comm. on Banking, Fin., & Urban Affairs,* 98th Cong. 300 (1984) (statement of Rep. Stewart McKinney).

Thus, several important factors—the heterogeneity of interests throughout the financial industry, the low degree of direct public involvement and political pressure on the industry to self-monitor for systemic risk, and the absence of a "community of fate" mentality within the industry, which enjoys extraordinary security through its access to an extensive public safety net—help to explain why the financial services industry does not currently appear to have any meaningful incentive to create a robust and comprehensive system of self-regulation aimed at preventing systemic risk.

E. *Potential for Industry Initiative*

It should be acknowledged that some trends within the global financial industry can be conducive to the emergence of a new self-regulatory culture. For instance, individual financial institutions may see important benefits to self-regulation, particularly in terms of cutting costs of regulatory compliance, which can become quite burdensome for firms operating on a global basis. An enhanced ability to streamline their operations and use their technology and other resources more efficiently—by eliminating existing bureaucratic inefficiencies and duplicative regulatory requirements—can potentially incentivize financial institutions to support the idea of greater self-regulation. Of course, the strength of that incentive ultimately depends on the outcome of institutions' intricate cost-benefit analyses, which are difficult to assess in the abstract.

There is also some basis for optimism with respect to the emergence of internal support for reviving the industry's morale and morality and making it a more publicly responsible economic actor. The tradition of senior industry figures forming informal policy groups focused on a variety of industry-wide regulatory and risk management issues may facilitate the appearance of an internal circle of powerful proponents of new self-regulation in the global financial sector. Two of the best-known examples of such informal industry leadership in recent years are the Group of Thirty (G-30) and the Counterparty Risk Management Policy Group (CRMPG).

The G-30 is a private sector organization that brings together senior officials from the world's largest financial institutions, central banks, and international organizations to act as a "transnational policy community of experts . . . actively promoting neoliberal economic

principles."[228] The G-30, which has traditionally favored private sector self-regulation, published a series of influential studies on regulatory issues, including a 1993 study on over-the-counter derivatives regulation[229] and a recent proposal for financial-regulation reform.[230] The CRMPG is another influential group of senior officials from major financial institutions and was originally formed in the wake of the near-collapse of the hedge fund Long-Term Capital Management in 1998.[231] CRMPG's proclaimed goal is to identify the key weaknesses in financial institutions' counterparty credit and market risk management practices.[232] The group also develops practical recommendations to enhance industry-wide risk management standards to minimize the possibility of future systemic meltdowns and to strengthen the ability of individual institutions, and markets in general, to deal with distressed or failing counterparties.[233] CRMPG has published three reports—in 1999, 2005, and 2008—addressing various aspects of systemic risk prevention in the financial sector and advancing a range of risk management recommendations for individual financial institutions.[234] Among other things, CRMPG has been widely credited for bringing attention to the backlog of documentation in the credit de-

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[228] Eleni Tsingou, *Transnational Policy Communities and Financial Governance: The Role of Private Actors in Derivatives Regulation* 3 (Ctr. for the Study of Globalisation & Regionalisation, Working Paper No. 111/03, 2003).

[229] *See* GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 9-21 (1993) (making twenty recommendations for the management of derivatives).

[230] GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 21 (2009), *available at* http://www.group30.org/pubs/pub_1460.htm (recommending that the gaps in prudential regulation and supervision be eliminated, the quality and effectiveness of such regulation be improved, institutional policies and standards be strengthened, and financial markets and products be made more transparent).

[231] Long-Term Capital Management (LTCM), a large hedge fund that was managed by Nobel Prize–winning economists and Wall Street stars, experienced a severe liquidity crunch as a result of the financial crises in East Asia and Russia and was rescued by a consortium of its largest investor institutions. Federal Reserve officials fearing systemic fallout from the fund's failure orchestrated the LTCM rescue. *See generally* THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT viii-ix (1999) (summarizing the near failure of LTCM and examining mechanisms of systemic risk transmission).

[232] *Cf.* CRMPG III, CONTAINING SYSTEMIC RISK: THE ROAD TO REFORM 1 (2008) ("The scope of the CRMPG III initiative was designed to focus its primary attention on the steps that must be taken by the private sector to reduce the frequency and/or severity of future financial shocks . . . .").

[233] *See id.* at 7-15 (discussing methods by which private actors can help prevent financial turmoil).

[234] *See generally id.*; CRMPG II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (2005); CRMPG, IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICES (1999).

rivative markets and for cooperating closely with federal regulators in the industry-wide effort to clean up that backlog.[235]

There is hardly any doubt that the G-30 and the CRMPG are essentially industry interest groups with a clear policy agenda aimed, first and foremost, at protecting the financial industry's economic freedom and avoiding increases in government regulation. However, what is important for the purposes of our discussion is that these groups also work toward developing industry-wide standards for risk management and situating private actors' interests within a broader policy framework. Regardless of the content or effectiveness of those standards, the very existence of these high-level industry groups is relevant. These types of informal organizations may provide an important forum for the industry-wide discussion and negotiation necessary to reach a consensus on issues of self-regulation, as well as serve as a potential source of future industry leaders who are capable of taking initiative in forging a new industry morality.

Notwithstanding these rather modest signs that the financial industry may be open to new self-regulation, it is clear that the overall incentive structure for such development in the global financial sector is very weak. Does this rather pessimistic conclusion mean there is no way to alter the existing incentives to make the framework for financial industry self-regulation more tenable? Or, should we at least consider the possibility, remote as it may be, of institutional reforms that could reshape the current unfavorable incentive structure and clear the way for a new system of embedded self-regulation in the financial services sector?

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[235] *See* CRMPG II, *supra* note 234, at 113-14 (highlighting a serious problem with back-office operations at the major bank-dealers in OTC credit derivatives, which failed to document trades in a timely and accurate manner). In a series of informal meetings that followed CRMPG's report, federal regulators urged the dealer-banks to resolve this potentially risky situation without the need for a formal regulatory intervention and set specific milestones for their performance. *See* Chris Kentouris, *The Partial (80 Percent) CDS Solution*, SEC. INDUS. NEWS, Oct. 16, 2006, at 4 (explaining that "[t]he Federal Reserve Bank of New York" led "a global effort by regulators" to convince the dealer-banks to fix the problem); Henry Sender, *Credit Derivatives and Their Risks Are on the Table*, WALL ST. J., Sept. 15, 2005, at C1 (describing the "implicit threat of regulation" in regulators' communications with the dealer-banks). By the end of 2006, the backlog of unprocessed credit derivative trades was largely eliminated. *See* Kentouris, *supra* (commenting on the significant progress made in clearing the backlog, as well as the remaining uncertainties in dealing with large numbers of unconfirmed transactions).

V. TOWARD EMBEDDED SELF-REGULATION IN THE FINANCIAL SECTOR: SHAPING COMMUNITY OF FATE THROUGH REGULATORY DESIGN?

Examining some of the factors that facilitated the introduction of self-regulation in other industries and evaluating whether similar forces are at work in the financial industry set the stage for thinking creatively about the issues of regulatory design. As envisioned in this Article, embedded self-regulation is an organic supplement to government regulation, rather than an alternative to it. Creating the basis for a comprehensive industry self-regulatory regime aimed explicitly at containing systemic risk cannot, and should not, be separated from the broader process of reforming the regulatory system. However, different regulatory reform measures may have different effects on the incentives for, and the scope and shape of, financial industry self-regulation. If we are to take the role of self-regulation in the financial sector seriously, we ought to weigh those effects alongside other factors in evaluating competing regulatory reform proposals.

Applying this new perspective on regulatory reform, this Part examines potential changes to the existing regulatory structure that are likely to create effective incentives for the global financial industry to reconceive itself as a true community of fate. An approach to reform that envisions a regulatory separation between financial firms trading and dealing in OTC derivatives and complex financial instruments, on the one hand, and those providing purely traditional financial intermediation services aimed at facilitating capital formation, on the other, would have the greatest potential to reshape the incentives for industry self-regulation. This redrawing of regulatory boundaries is likely to have two important effects: (1) to create a more homogeneous and unified set of smaller and more nimble players operating in the complex financial markets, where an embedded self-regulatory regime would be the most effective and desirable, and (2) to eliminate key policy reasons for the continuation of a public safety net for high-risk institutions. Loss of access to federal deposit insurance and liquidity-backup facilities, among many other effects, would incentivize these firms considerably to view themselves as a "community of fate" whose collective long-term survival depends on their ability to manage the risks posed by their activities. Another regulatory measure likely to enhance the "community of fate" mentality among financial institutions dealing and trading in complex financial instruments would be the introduction of a mandatory system of mutual self-insurance.

Turning to issues of "embedding" industry self-regulation in a broader regulatory context, this Part argues that a credible threat of targeted government intervention, such as a direct ban on complex financial products, and the creation of functional substitutes for public-interest-group monitoring of the industry's performance may serve as important external checks on the industry. By doing so, they may enhance the prospects for a socially responsive regime of financial sector self-regulation.

Unavoidably, the ideas advanced here are largely an intellectual experiment, rather than a comprehensive legislative proposal ready for adoption. Altering the existing incentive structure to encourage the financial industry to develop a self-regulatory regime aimed at preventing systemic risk is an enormously complex and multidimensional task. While it is clearly possible to mandate self-regulation by law,[236] it is hardly practical to impose a new industry morality on private institutions through coercive government measures. There is no guarantee that any particular regulatory scheme or device, however elaborate and well conceived, will achieve the goal of making the financial industry genuinely embrace its new freedom to self-regulate and its new responsibility to guard systemic financial stability in the interest of a greater good. Accordingly, the purpose of the following discussion is not to defend any particular regulatory proposal on its full merits, but rather to highlight some examples of high-level reforms that might have an added, and currently entirely overlooked, benefit of bringing us closer to achieving that goal.

A. *Regrouping the Industry*

Perhaps the single most important step toward creating a new incentive structure that is conducive to financial industry self-regulation would be to radically redraw regulatory boundaries in the financial sector so that they are based on the nature of key risks associated with different types of financial activities. Under the current U.S. regulatory framework, financial institutions (such as commercial banks, securities firms, and insurance underwriters) are regulated and supervised under separate regimes based purely on formalistic differences in their products or functions.[237] Despite substantial criticism, this prin-

[236] *See, e.g.*, Securities Exchange Act of 1934 § 19, 15 U.S.C. § 78s (2006) (mandating the existing system of securities SROs in the United States).

[237] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-32, FINANCIAL REGULATION: INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUC-

ciple of vertical (i.e., functional or license-based) regulatory separation nevertheless persists.[238]

By contrast, the proposal discussed here would involve the creation of separate regulatory and supervisory regimes for financial institutions acting as traders and dealers in complex financial instruments of risk transfer (such as derivatives and structured products) and those acting as providers of traditional financial services (such as lending to individuals and businesses, deposit-taking, and securities brokerage and underwriting). Precisely labeling these two new regulatory categories is somewhat of a challenge. As a crude approximation, one might refer to them as the "wholesale" and "retail" financial services providers or markets, respectively. However, that designation is not entirely accurate insofar as the financial institutions in the latter category provide services both to individuals and businesses, thus combining retail and certain traditional wholesale financing, brokerage, and advisory activities. Alternatively, these groups may be designated simply as "Tier I" and "Tier II" financial services providers, respectively.[239] Under this categorization, Tier I financial services providers would be licensed solely as dealers and traders in complex financial instruments of risk transfer. Tier II institutions would be licensed to engage in a wide variety of traditional financial intermediation activities and capital formation services for retail and business clients.[240]

This horizontal redrawing of the main regulatory division line might overlap with a popular proposal to regulate systemically important institutions under a separate organizational and substantive um-

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TURE 4-5 (2007) (explaining that the current approach to regulating financial institutions is based on an individual institution's charter, products, and activities, and concluding that trends toward consolidation and conglomeration in the financial sector present an increasing challenge to the regulatory system).

[238] The Dodd-Frank Act retains this approach and focuses on assigning powers and responsibilities to various existing and newly created agencies in a way intended to provide some integrated oversight at the level of a holding company or the industry as a whole. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 312, 124 Stat. 1376, 1521 (2010) (to be codified at 12 U.S.C. § 5412) (transferring functions of the Office of Thrift Supervision to other federal agencies).

[239] The Obama Administration's White Paper, published in June 2009, used the same terminology to differentiate so-called "Tier 1" Financial Holding Companies (FHCs). *See* U.S. DEP'T OF THE TREASURY, A NEW FOUNDATION, *supra* note 5, at 10-11. However, in contrast to the approach discussed here, the Administration's proposal defined Tier 1 FHCs as all financial firms "whose combination of size, leverage, and interconnectedness could pose a threat to financial stability" in the event of their failure. *Id.* at 10.

[240] Accordingly, these two categories of financial institutions could also be designated as providers of "risk transfer services" and "capital formation services," respectively.

brella.[241] Despite its appeal, the latter approach may not be as effective in practice, mainly due to the inherent difficulty of determining which institutions are "systemically important" in today's highly interconnected and technology-driven financial markets.[242] Ultimately, the main and most easily applicable criterion for including a financial institution in that class appears to be its size.[243] The approach discussed here, however, focuses directly on financial activities and risks, rather than the size or other superficial attributes of an institution, and thus may align government regulation and supervision more closely with the key risks in the financial markets.

Regardless of the labels, the thrust of this type of structural reform is clear. The "Tier I" (i.e., risk transfer) segment of the financial market, in which sophisticated counterparties trade highly risky and complex financial instruments, is the primary arena for cutting-edge financial strategies and innovation. It is also the predominant source of risk to the global financial system. Under this proposal, the largest and most influential financial institutions with active cross-border operations would be the key intermediaries in that market for financial risk management and transfer and would be regulated under a single scheme specifically tailored to address the risks their activities pose to global financial stability. Given its complexity and global scope, it is in

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[241] *See, e.g.*, STAFF OF S. COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, 111TH CONG., RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010 § 805 (Comm. Print 2010) (proposing special regulation by the Federal Reserve Board of systemic risk posed by large complex companies—so-called "systemically important" companies—because their failure would affect the whole financial system); U.S. DEP'T OF THE TREASURY, A NEW FOUNDATION, *supra* note 5, at 8 (proposing a new authority, "modeled on the existing authority of the FDIC," to "address the potential failure" of a large financial firm that would threaten the entire financial system). The Dodd-Frank Act creates a hybrid system under which the Federal Reserve and the newly created Financial Stability Oversight Council share responsibility for identifying and regulating certain systemically important "nonbank financial companies" alongside, and largely in the same manner as, bank holding companies with at least $50 billion in assets. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 113–115, 124 Stat. 1376, 1398 (2010) (to be codified at 12 U.S.C. § 5323–5325).

[242] As a recent FSB report prepared by the IMF and the BIS pointed out, "All types of financial intermediaries, markets and infrastructure can potentially be systemically important to some degree." FIN. STABILITY BD. ET AL., GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS 2 (2009), *available at* http://www.financialstabilityboard.org/publications/r_091107c.pdf.

[243] *See, e.g.*, CONG. OVERSIGHT PANEL, *supra* note 5, at 22-23 (identifying institutions deemed "too big to fail" as posing systemic risk and noting that "as financial institutions grow they become more 'systemically significant'"); BRUNNERMEIER ET AL., *supra* note 5, at 26 (characterizing large, interconnected, and iconic financial institutions as "individually systemic").

this segment of the financial industry that creating a new model of self-regulation focused on systemic risk management and prevention should become the key regulatory priority.[244]

Importantly, this type of regulatory restructuring is not the same as reviving the activity prohibitions that existed under the Glass-Steagall Act.[245] The Glass-Steagall Act, passed in 1933, created barriers between commercial banking and investment banking on the theory that securities underwriting and dealing presented the greatest risk to the safety and soundness of depository institutions.[246] In today's financial marketplace, the biggest and potentially least understood systemic risks come from large-scale trading in highly complex derivatives, structured products, and other instruments of risk transfer used for sophisticated speculation and arbitrage.[247] Thus, while the principle of protecting certain traditional financial markets and activities from the potentially destabilizing effects of much riskier and more novel activities remains as important today as it was in 1933,[248] the substantive determi-

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[244] Regulation and supervision of the "Tier II" (i.e., capital formation) markets and institutions may remain much closer to the existing system, with the key regulatory policy goals being more diverse. The focus of this Article is on the potential role of industry self-regulation in the Tier I market, where it would be likely to generate the greatest benefit in terms of addressing systemic risk.

[245] Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.) (repealed in part 1999). Congress partially repealed the Glass-Steagall Act in 1999, when the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 and 15 U.S.C.), allowed securities firms and commercial banks to affiliate under a common holding company umbrella. *See* 12 U.S.C. § 1843(k) (2006) (allowing bank holding companies that meet certain requirements to engage in activities "financial in nature," including securities dealing and underwriting).

[246] For critical analysis of this issue, see generally, for example, GEORGE J. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED (1990), and Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483 (1971).

[247] *See generally* Jean-Charles Rochet & Jean Tirole, *Interbank Lending and Systemic Risk* (discussing the risk inherent in complex financial transactions and suggesting peer monitoring as a solution), *in* JEAN-CHARLES ROCHET, WHY ARE THERE SO MANY BANKING CRISES? 126 (2008); GARRY J. SCHINASI ET AL., MODERN BANKING AND OTC DERIVATIVES MARKETS: THE TRANSFORMATION OF GLOBAL FINANCE AND ITS IMPLICATIONS FOR SYSTEMIC RISK (2000) (describing the OTC derivatives markets, explaining their potential to undermine systemic financial stability, and outlining the associated legal and regulatory challenges).

[248] In late 2009, the idea of reinstating the Glass-Steagall Act's strict separation seemed to gain popularity among lawmakers. For example, in December 2009, U.S. Senators John McCain and Maria Cantwell introduced a legislative proposal to reconstruct the prohibition on deposit-taking institutions engaging in securities underwriting and trading. *See* Alison Vekshin & James Sterngold, *War on Wall Street as Congress Sees Returning to Glass-Steagall*, BLOOMBERG (Dec. 27, 2009), http://www.bloomberg.com/apps/news?

nation of where and how to draw these lines is different under the proposed approach than it was under the Glass-Steagall Act.[249]

Restructuring the regulatory system in this way would have significant consequences for the prospects for financial industry self-regulation.[250] It would create a much more homogeneous "industry," or relevant segment thereof, with the interests of the newly delineated industry members much more clearly aligned than is the case in today's vastly diverse and fragmented environment. In the new system, firms dealing in complex financial derivatives would not be lumped together with small community banks offering traditional deposit-taking and lending services to individuals and local businesses.[251] Furthermore, without direct access to retail deposits and other cheap sources of funding to fuel the high-finance business, the Tier I segment of the financial services market would inevitably shrink.[252] Although the number of key players in this market might remain small, their balance sheets would likely be a mere fraction of those of today's financial conglomerates, such as JPMorgan Chase and Bank of America.[253] As a result, none of these firms would be likely to remain, or perceive themselves as, "too

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pid=21070001&sid=aeQNTmo2vHpo (reporting on McCain and Cantwell's proposal and the ensuing discord in Congress and on Wall Street).

[249] For a recent argument in support of reviving the spirit, if not necessarily the letter, of the Glass-Steagall Act, see Raj Date & Michael Konczal, *Out of the Shadows: Creating a 21st Century Glass-Steagall*, *in* ROOSEVELT INST., MAKE MARKETS BE MARKETS 61 (2010), *available at* http://www.rooseveltinstitute.org/sites/all/files/MMBM%20FINAL%20March%208.pdf.

[250] It must be noted that a reform that redrew regulatory boundaries in such a radical manner would have a wide range of critically important consequences for the operation of the financial services industry. However, a discussion of all such implications, with all of their complexities, is beyond the scope of this Article. Rather than advocating this particular measure as a necessary and comprehensive method of regulatory reform, the point of this Article is merely to discuss its potential impact on the incentives for financial institutions to create a regime of embedded self-regulation.

[251] Increasing the homogeneity of the Tier I, or risk transfer, segment of the financial market may also have negative consequences. For instance, there is a serious concern that in a smaller and more homogeneous industry, a handful of the largest players would be able to exert disproportionate influence over their peers, effectively dictating the substance of any industry-wide normative framework, and to "capture" more easily the regulatory agency overseeing them.

[252] For this decrease in size to occur, it may be necessary to disallow affiliation between Tier I and Tier II institutions.

[253] *See* Bank of Am. Corp., Annual Report (Form 10-K), at 20 (Feb. 27, 2009) (showing over $1.817 trillion in total assets at the end of the 2008 fiscal year); JPMorgan Chase & Co., Annual Report (Form 10-K), at 38 (Mar. 2, 2009) (showing over $2.175 trillion in total assets at the end of the 2008 fiscal year).

big to fail," at least in terms of their sheer size and hold on retail deposits, payment systems, and other systemically important segments.[254]

Even more importantly, separating complex financial transactions and instruments from retail deposit-taking and other "special" financial services considered vital to the national economy's functioning[255] would eliminate the fundamental reason for continuing extensive public subsidies to financial institutions actively dealing in financial risk in the Tier I markets for complex financial instruments.[256] There would be no need to provide these financial institutions with access to government-run deposit insurance and liquidity-backup programs. By eliminating this public safety net, the government would not only drastically reduce potentially unlimited taxpayer exposure to the failure of large risk-taking financial institutions, but it would also remove one of the strongest disincentives for the emergence of effective self-regulation in the financial sector. As argued above, the public safety net, effectively extended to highly risky activities not originally intended for such subsidization,[257] and the virtually assured prospect of a "bailout" in the event of a major crisis, is one of the key—and

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[254] To keep the size of this market and its players under control, 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. Increasing the cost to a financial institution of holding risky assets generally forces the institution to reduce the size of its balance sheet (as well as off-balance-sheet assets and liabilities) significantly. This type of measure is widely seen as a prudent approach to limiting risk-taking by large financial institutions. *See, e.g.*, N. Gregory Mankiw, *Trying to Tame the Unknowable*, N.Y. TIMES, Mar. 28, 2010, at BU6 ("Higher capital requirements would be a step in the right direction."); Squam Lake Working Grp. on Fin. Regulation, *Reforming Capital Requirements for Financial Institutions* 3-4 (Ctr. for Geoeconomic Studies, Council on Foreign Relations, Working Paper, 2009), *available at* http://www.cfr.org/content/publications/attachments/Squam_Lake_Working_Paper2.pdf (advocating that regulators take a bank's size and other systemic risk factors into account when setting its capital requirements).

[255] *See* Corrigan, *supra* note 178 (explaining that banks are "special" because they play an essential role in maintaining a stable and healthy economy).

[256] Deposit insurance and liquidity-backup provisions are provided to banks and other deposit-taking institutions to minimize the danger of "bank runs." *See* CARNELL, MACEY & MILLER, *supra* note 221, at 309-10 (explaining that "[i]n a world without credible deposit insurance," banks would be susceptible to runs). This danger arises from the inherent mismatch between banks' short-term liabilities (such as demand deposits that can be withdrawn at will) and long-term assets (such as loans, which typically have longer maturity and cannot be "called" for repayment at will). *See id.*

[257] *See* Arthur E. Wilmarth, Jr., *Subprime Crisis Confirms Wisdom of Separating Banking and Commerce*, BANKING & FIN. SERVICES POL'Y REP., May 2008, at 1, 5-8 (describing the extension of the "safety net" to nonbanks, including commercial firms that own industrial loan companies).

unique—factors undermining any impulse for collective self-restraint of risk-seeking behavior.[258]

By contrast, once the sophisticated financial intermediaries found themselves in a new regulatory universe, in which any single one of them faced a very real threat of failure in the event of a systemic crisis, they would be considerably more likely to begin viewing themselves as members of a community of fate whose long-term collective survival requires a far more stringent management of the risks their business activities pose. The high degree of concentration and the increasing interconnectedness among these players, linked to one another through an intricate network of contractual exposure and liabilities, would create this enhanced perception of mutual dependence and collective self-interest.

The introduction of a mandatory system of mutual self-insurance among these firms is another measure likely to incentivize private firms in the wholesale financial services industry to see themselves as a community of fate.[259] Under this system, similar in principle to the mutualization of risk by exchanges and clearing organizations, the licensed Tier I financial services providers would be required to establish a collective self-insurance fund, which would be used to provide emergency liquidity support to the system in the event of any firm's failure. The industry could work out the principles for determining the amount of regular contributions to this self-insurance fund, as well as any additional assessments in shortfall situations, in consultation with and under the oversight of the regulatory authorities. Under this arrangement, the failure of any individual firm would directly affect all other industry members, which would create a strong incentive for

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[258] *See supra* Section IV.D.

[259] The Dodd-Frank Act mandates the establishment of an Orderly Liquidation Fund within the Treasury Department that is not prefunded by the industry and from which the FDIC may borrow funds to carry out its new mandate to resolve systemically important financial companies. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(n), 124 Stat. 1376, 1506 (2010) (to be codified at 12 U.S.C. § 5390). To fund the resolution of any such company, the FDIC may borrow funds from the Treasury and then impose assessments on financial institutions with total consolidated assets of $50 billion or more. *See id.* § 210(o). The key difference between that provision and the approach suggested here is the scope of the envisioned mutual self-insurance scheme; under the proposal discussed in this Part, such a self-insurance requirement would target specifically the institutions dealing in complex financial instruments of risk transfer. *See also* Dombalagian, *supra* note 16, at 836 (discussing a proposal to require systemically important financial institutions to join a "self-regulatory organization," which would help internalize the costs of a market recovery after a crash, as well as make the members consider their risky financial partnerships more carefully).

them to monitor each other's risk-taking activities and general business conduct more closely.[260] A mutual self-insurance scheme would provide a degree of protection to sophisticated investors in complex financial products at the expense of the financial services providers who are in the best position to control and avoid conduct harmful to investors. More broadly, by tying the costs of failure directly to the riskiness of the financial institutions' activities, this approach would help to eliminate the pernicious combination of "privatized rewards" and "socialized risks" of complex financial transactions entrenched in the current regulatory regime.[261]

This analysis brings us to another critically important question: what needs to be done to ensure that industry self-regulation is truly embedded in broader public and regulatory interests, rather than serving as a mere smokescreen allowing private market actors to avoid regulatory constraints? The precise shape and role of government "regulation of self-regulation"[262]—or "meta-regulation"—is a complex issue at the heart of ongoing scholarly and policy debates.[263] While a full examination of this important issue is beyond the scope of this project, it is possible to outline some key points for future research and discussion.

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[260] On the other hand, one might argue that such mutual self-insurance could exacerbate the free-rider problem, already a significant concern in any self-regulatory arrangement.

[261] *See, e.g.*, Joseph E. Stiglitz, *Government Failure vs. Market Failure: Principles of Regulation* (advocating risk-adjusted capital adequacy standards, which "undo the distortions associated with government deposit insurance and provide incentives for banks to undertake less risk"), *in* GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION 13, 43-45 (Edward J. Balleisen & David A. Moss eds., 2010).

[262] *See* SCHULZ & HELD, *supra* note 34, at A-7 (describing the process as usually involving a two-level framework of government regulation—a legislative framework and "direct influence" from a regulatory body); *see also* Braithwaite, *supra* note 23, at 1470-73 (describing a radical approach to regulation in which the government would enforce self-regulation of corporate conduct deemed to be illegal); Coglianese & Lazer, *supra* note 48, at 693-96 (discussing "management-based regulation," an approach which allows for planning by regulated organizations to achieve public goals, with flexibility for the firms to choose the proper methods); Michael, *supra* note 23, at 176-77 (examining the role of the government in "audited self-regulation," where the government delegates regulatory power to a nongovernmental entity but retains overall review powers in a federal agency).

[263] *See, e.g.*, Black, *supra* note 36, at 138-40 (discussing the role of the government as "regulator" and the tools at its disposal to undertake that responsibility); Anil K. Gupta & Lawrence J. Lad, *Industry Self-Regulation: An Economic, Organizational, and Political Analysis*, 8 ACAD. MGMT. REV. 416, 417 (1983) (discussing a system in which industry self-regulation is either auxiliary or complementary to the regulation imposed by the government).

B. *"Regulating Self-Regulation": Reshaping the Broader Context*

As discussed above, there is a broad consensus among students of self-regulation that, for an effective self-regulatory system to emerge and thrive, there must be a strong regulatory and supervisory framework in whose shadow such self-regulation operates.[264] The government provides general boundaries and defines broad public policy goals that guide industries' self-regulatory efforts. In the financial services industry, it is particularly important that any self-regulatory scheme be firmly embedded within a sophisticated, comprehensive, and effective scheme of direct government regulation and supervision.

The nature of the risk in the financial sector necessitates vigilant government oversight of the industry's self-regulatory process. In contrast to the nuclear power or chemical manufacturing industries discussed above, there is a strong correlation between individual actors' risks and rewards in the financial sphere; engaging in riskier activities tends to increase a financial institution's potential short-term profits. Moreover, while the risk of a nuclear or chemical accident is primarily a matter of safety and risk management at an individual plant or company, the risk of a major financial meltdown is inherently systemic and may be triggered by events outside of any particular entity's control.[265] Furthermore, overall risk in the financial system tends to accumulate during good times, when asset prices and investor confidence soar, which may seriously constrain the industry's ability and resolve to detect and lower systemic risk.[266] In this context, direct government

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[264] *See* Gunningham & Rees, *supra* note 2, at 400 (acknowledging the critical importance of "general law" provided by a central regulatory body to ensure that those being regulated "comply with the self-regulatory program"); Sinclair, *supra* note 32, at 544-45 (mentioning a self-regulatory scheme in Australia in which the government had already established some parameters).

[265] *See, e.g.*, George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, 16 CATO J. 17, 17-18 (1996) (explaining that bank failures are perceived to be more deleterious than other firms' failure because of the potential for a "domino" effect "throughout the banking system").

[266] *See generally* Esteban Pérez Caldentey et al., *The Current Global Financial Crisis: What Was Really 'Purely Prime'?* 13 (United Nations Econ. Comm'n for Latin Am. & the Caribbean, Working Paper, 2009), *available at* http://www.iadb.org/intal/intalcdi/PE/2009/03611.pdf (illustrating how "off balance sheet funding practices," combined with "pro-cyclical leverage management," helped create the current economic crisis through the changing of assets from prime to subprime); Már Gudmundsson, Deputy Head, Monetary & Econ. Dep't, Bank for Int'l Settlements, How Might the Current Financial Crisis Shape Financial Sector Regulation and Structure?, Keynote Address at the Financial Technology Congress (Sept. 23, 2008), *available at* http://www.bis.org/speeches/sp081119.htm ("The crisis was preceded by a period of low real interest rates and easy access to credit, which fuelled risk-taking and debt accumulation.").

regulation and supervision are necessary as the principal external safeguard against these tendencies and a critical check on the industry's ability to self-regulate.

Redrawing the regulatory boundaries within the financial industry is likely to require corresponding restructuring in the system of government oversight agencies, perhaps necessitating the creation of a separate regulatory agency in charge of the more complex financial markets and institutions. This "Tier I" financial regulator would not necessarily act as a systemic risk regulator; another agency or a council comprising representatives of various financial regulators might perform that role better.[267] The role of this particular agency would be to oversee and manage the system of industry self-regulation actively, to ensure that it stays focused on preventing systemic risk, and to confirm that it is functioning effectively and in accordance with public policy objectives. Thus, government regulation of a self-regulating financial industry would have to be structured, in terms of both substantive rules and institutional setup, with the goal of providing the broader public interest context within which industry self-regulation is embedded.

The SEC and its jurisdiction over securities industry SROs, including FINRA and the stock exchanges, provides one obvious model for establishing a new government regulator and defining the parameters of its authority over an industry self-regulatory organization under the proposed system. Under the existing securities statutes, the SEC has a great deal of power over the SROs' activities, including explicit authority to inspect SROs, approve their rules, and directly channel regulatory mandates through the SRO mechanism.[268] Such extreme granularity of government intervention, however, may not be appropriate for the new, embedded self-regulation in the complicated and innova-

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[267] Both of these possibilities were widely discussed in the recent debate on regulatory reform. Proposed measures included putting the Federal Reserve in charge of systemic risk regulation, creating a separate federal agency specifically for that purpose, or establishing a council of regulators to coordinate systemic oversight. *See, e.g.*, Roberta S. Karmel, *The Controversy over Systemic Risk Regulation*, 35 BROOK. J. INT'L L. 823 (2010) (discussing in detail different proposals about how to regulate systemic risk). The Dodd-Frank Act settled the issue by splitting the responsibility for systemic risk oversight between a new interagency body, the Financial Stability Oversight Council, and the Federal Reserve. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-304, § 113, 124 Stat. 1376, 1398 (2010) (to be codified at 12 U.S.C. § 5323) (explaining that the Council will identify institutions whose distress could "pose a threat to the financial stability of the United States" for special supervision by the Board of Governors of the Federal Reserve).

[268] *See, e.g.*, 15 U.S.C. § 78s (2006) (establishing procedures for the SEC's registration and oversight of SROs).

tive markets for complex financial products. Establishing the right type of regulatory involvement, on the continuum between excessive micromanagement, on the one end, and no meaningful oversight, on the other, is necessarily a delicate and highly detail-oriented task. Thus, the exact structure of this pivotal relationship between the financial industry's new self-regulatory body (or bodies) and the federal agency (or agencies) regulating and supervising that industry will have to be carefully negotiated as part of a much broader process of regulatory reform in the financial sector.[269]

Nevertheless, certain broad-stroke suggestions may be made at this preliminary point in the discussion of the "meta-regulatory" design. There is broad scholarly consensus that one of the critically important issues in designing this type of governance framework is ensuring maximum accountability and transparency of the industry self-regulatory process without compromising its efficiency and its potential for a flexible and targeted approach to specific problems.[270] One of the key factors ensuring such transparency and accountability is the monitoring of the self-regulatory body's activities, as well as mandatory periodic reporting by that body to the relevant government regulator. Such a system would not only provide the government with vital information on trends and developments in the financial sector, but it would also discipline the industry self-regulator and guard against that body's potential failure to fulfill its responsibilities in conformity with the public interest and regulatory objectives. Armed with up-to-date information, the government would be able to intervene in a timely manner, if necessary, to correct socially undesirable industry action.[271] Another potential check on "backsliding" by the industry is a system of substantive performance assessments and periodic government inspections of individual financial institutions, as well as the industry's

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[269] This complex and important issue goes beyond the scope of this Article and requires further research and discussion. The key point here is that the new system of industry self-regulation this Article advocates should be viewed not as a replacement for government regulation and supervision, but rather as an integral part of the new governance scheme that brings together, and takes advantage of the relative strengths of, direct government oversight and private ordering.

[270] *See, e.g.*, Balleisen, *supra* note 24, at 465-68 (stressing the "pivotal importance of transparency and accountability" (emphases omitted)). For an insightful discussion of the concept of accountability, see Jerry L. Mashaw, *Accountability and Institutional Design: Some Thoughts on the Grammar of Governance*, *in* PUBLIC ACCOUNTABILITY: DESIGNS, DILEMMAS AND EXPERIENCES 115 (Michael W. Dowdle ed., 2006).

[271] Of course, the government must be careful to exercise its power of direct regulatory intervention only when it is truly necessary and potentially effective. Otherwise, the use of this particular lever would not only be ineffective, but also self-defeating.

self-regulatory organization.[272] A regulatory approach relying heavily on industry self-regulation requires that the government agency overseeing the self-regulatory process maintain the strong capacity for investigation of potential malfeasance by private actors and enforcement of legal and regulatory requirements.[273]

Most importantly for the purposes of this discussion, there must be a credible threat of direct government regulation to force private market participants to self-regulate and to keep them committed to such a self-regulatory system.[274] Because the financial services sector is already subject to extensive government regulation and supervision, a threat of additional government intervention has to be strong and very carefully targeted at an area of great importance to the financial industry.[275] William O. Douglas famously described the role of the SEC in managing the SROs in the securities industry as being akin to keeping a "well oiled" regulatory "shotgun" safely "behind the door."[276] According to one commentator,

> Business self-regulation works best when those responsible for it know not only that their actions will be visible to their peers and public officials, and not only that poor performance will trigger sanctions, but also that if business institutions systematically fail to achieve regulatory objectives, a more vigorous regulatory shotgun waits in the wings. That expectation in turn depends on the perception that governmental leaders, and public opinion, are willing to pursue regulatory techniques of command and control as part of the arsenal of governance.[277]

One potential "shotgun" in the hands of the government is the threat of prohibiting 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.[278] The

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[272] *See* Balleisen, *supra* note 24, at 465 (discussing the roles of individual firms and regulatory bodies in policing the activities of the corporations to ensure compliance).

[273] *Id.* For a classic exposition of a graduated approach to regulatory enforcement, see IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE REGULATION DEBATE (1992).

[274] *See, e.g.*, Gunningham & Rees, *supra* note 2, at 389-92 (discussing the importance of the threat of external regulation to keep an industry's actions in the best interests of the public).

[275] Ian Ayres and John Braithwaite discuss this background threat of potentially severe sanctions as a "benign big gun" in the hands of the regulators. AYRES & BRAITHWAITE, *supra* note 273, at 19-53.

[276] WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 64-65 (1940).

[277] Balleisen, *supra* note 24, at 473-74.

[278] The Dodd-Frank Act prohibits any banking entity from engaging in proprietary trading in a variety of financial instruments, as well as from sponsoring or investing in any hedge fund or private equity fund, subject to certain important exceptions. *See,*

policy rationales behind such product bans may include curbing excessive speculation in the financial markets and minimizing the potential systemic risk of such activities spilling over into the rest of the global financial markets and the broader economy. Alternatively, the threatened action could be to require regulatory preapproval of each complex financial product or transaction, which would limit the financial institutions' capacity to roll them out quickly and thus effectively foreclose certain market opportunities. In any event, it is crucial that the threatened default rule triggered by a failure of industry self-regulation be clearly defined and credible.

A number of potential concerns arise in this respect. To constitute an effective external incentive to engage in bona fide self-regulatory effort, the threat of regulatory intervention in the event of the industry's failure to guard against systemic risk must not be contestable. However, the perceived credibility of the measure depends, among other things, on the existence of strong political will to go through with it under the appropriate circumstances. Given the divisive legacy of the Glass-Steagall Act, whose pros and cons are debated to this day,[279] garnering the requisite political support for across-the-board product bans or a system of mandatory regulatory preapproval for all complex financial instruments may be difficult. In addition, in today's globalized world, implementing any such drastic command-and-control measure would require significant international coordination and consensus among national financial services regulators and supervisors. In the absence of significant harmonization of domestic rules in this area, the threat of reverting to harsh "default" regulatory rules in one country is likely to be considerably less effective, given the ease of moving financial services operations abroad and the high probability of cross-border regulatory arbitrage.[280] On the other hand, despite these potential challenges, the

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e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620 (2010) (to be codified at 12 U.S.C. § 1851). This provision grew out of a proposal initially advanced by Paul Volcker, a former Federal Reserve Chairman, and is known as the Volcker Rule. *See* David M. Herszenhorn, *Senate, 59-39, Approves Vast Financial Overhaul*, N.Y. TIMES, May 21, 2010, at A1. It is important to keep in mind, however, that the Volcker Rule specifically targets banks' proprietary trading and investment activities, while a product ban discussed here would effectively prohibit all trading in a particular financial instrument, whether it be proprietary or client-driven.

[279] *See supra* notes 245-49 and accompanying text.

[280] In fact, the relative ease of moving its business across geographic and jurisdictional borders is one of the key factors that set the financial services industry apart from the nuclear power and chemical manufacturing industries, whose experience with communitarian self-regulation was discussed in Part III. Manufacturing plants and nuclear power facilities create enormous sunk costs for the companies owning and op-

recent global financial crisis demonstrated the possibility of fostering greater cooperation among different actors, domestic or international, on issues involving global economic risk.[281]

To summarize, various channels of targeted government intervention, if properly structured and implemented, could assure that financial institutions do not use the self-regulatory system merely as a disguise to gain a formal seal of approval for their profit-seeking activities without improving their actual performance.[282] In addition to the government, the public interest community is an important potential source of external pressure on the financial services industry to keep its risk-taking and risk-generating activities under control. However, as discussed above, the nature of increasingly complex and professionalized modern financial markets and activities renders active and direct public participation in the regulatory process unlikely.[283] Financial regulation, especially outside traditional consumer protection in the retail sector, is handled primarily through interaction between the financial industry and the regulating agencies.

While it is impossible to mandate creation of a suitable nongovernmental organization or community watch group to act as an independent representative and effective defender of the public interest in the complex financial services sector, there may be functional substitutes for direct public involvement. For instance, one potential measure may be the creation of an independent council of experts including academics, industry observers, public figures, and representatives of consumer advocacy groups. Such a council would be a third-party stakeholder in the regulatory process, thereby ensuring greater transparency and accountability. Its primary role would be to put both the financial industry and the regulators under intense and informed scrutiny. To increase public awareness of key issues and to disseminate relevant information to the public, such a council could

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erating them, which explains the greater importance for these companies to comply with government and public demands.

[281] The Group of 20 (G-20), the primary international forum for policymakers from the world's most powerful countries to coordinate their responses to the global financial crisis, provides an example of such cooperation. *See supra* note 95.

[282] For example, some scholars have argued that the chemical industry's Responsible Care program is vulnerable to such opportunistic behavior, with certain highly polluting firms seeking membership in the program to free-ride on its established reputation. *See, e.g.*, King & Lenox, *supra* note 54, at 712-14 ("It may be that a program like Responsible Care will grow at first, only to experience free riding and opportunism, and will consequently fall apart and disappear over time.").

[283] *See supra* notes 194-95 and accompanying text.

be required to publish regular reports assessing the state of the financial services sector and the effectiveness of industry self-regulation, as well as government regulation and supervision, in managing systemic risks in the global financial markets. This would help raise the political visibility and social salience of issues currently considered too technical and obscure for public participation.

Creating an independent council of experts as a functional substitute for a third-party public interest watchdog, which is absent in the modern financial industry, raises a host of potential issues with respect to the council's role and potential effectiveness. Financial institutions trading and dealing in highly complex financial instruments tend to guard their trading information very closely. Any attempt to bring outsiders into the regulatory dialogue involving this information would have to be carefully structured to avoid imposing unreasonable disclosure requirements on financial institutions.[284] The potential effect of firms' intellectual property rights on the council's ability to access relevant data may pose additional problems. Thus, the type and amount of market information that may—and should—be disclosed to the public as part of the mandate of the independent council of experts is a complicated issue that would require careful consideration and balancing of various policy interests.

As stated in the beginning of this Part, the goal of the foregoing discussion was not to advocate a self-contained set of detailed regulatory reform proposals purely on the basis of their potential for encouraging the industry to self-regulate. Rather, its purpose was to offer a fresh

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[284] While it is difficult to overstate the importance of this issue, it may be helpful to bear in mind examples in which financial firms' managers and top executives have discussed sensitive market information within the confines of an industry-wide forum and in the presence of regulators. The New York Federal Reserve Bank's Foreign Exchange Committee (FXC), a self-regulatory body that develops best practices and monitors the foreign exchange markets in the United States, presents one such example. As the Chairman of the FXC and a Bank of New York Mellon executive, Richard Mahoney described the FXC's deliberations on liquidity trends in the foreign exchange markets:

> We do discuss our empirical observations. People comment on what their own client base is doing without ever being too specific or divulging competitive secrets to the other banks around the table. We discuss general issues about liquidity, and the depth and breadth of the market at different times during the global dealing day.

Julie Ross, *The FX Success Story: Self-Regulation 101*, PROFIT & LOSS, May 2009, at 10, 14. The FXC is an advisory group to the New York Federal Reserve Bank and its mandate and range of activities are limited. Nevertheless, its experience with bringing financial institutions' managers together and discussing broader market trends and potential threats to stability may provide valuable guidance in setting up a broader self-regulatory regime in the financial sector.

perspective on assessing specific regulatory-design choices, one that explicitly takes into consideration their effect on the viability of a new, more publicly minded model of financial industry self-regulation.[285]

CONCLUSION

This Article proposes an approach to regulatory design that aims to create structural incentives for the emergence of a new model of embedded self-regulation in the financial industry. As the first attempt to tackle this complex and understudied issue in a systematic way, it is necessarily lacking in important details and may be open to a variety of criticisms.

The most powerful potential objection to the proposed approach is that the very idea of reviving self-regulation in the financial industry is fundamentally flawed because it is based on an inherently unsound proposition that financial institutions can be trusted to regulate and limit their own risk-taking activities despite their high profit-generating potential. Greed is the driving force in the financial markets; it is at best naïve and at worst hypocritical to claim that financial firms and their managers will be willing or able to control their greed for the sake of the public good. Under this view, no amount of institutional reform will be able to "nudge" the financial services industry toward greater responsibility and effective self-regulation.[286] Another potential concern is 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

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[285] This Part focused primarily on how certain regulatory reform measures may help reshape the currently unfavorable incentives that stymie the emergence of a system of embedded self-regulation in the financial services sector. It deliberately omitted the important issue of the organizational structure of such a form of industry self-regulation. How should the new self-regulatory body be set up and managed? What should its internal governance structure look like? Should it have full-time professional staff or may it rely instead on employees temporarily seconded from firms? What types of rules and standards should it promulgate and, more broadly, what regulatory objectives should it pursue? How can it overcome the collective-action problems inherent within the self-regulatory framework? How would the self-regulatory body monitor and enforce compliance with its rules? What sanctions must it have at its disposal to be truly effective? How would it insulate itself from improper influence by individual firms within the industry? These are only some of the questions that need to be answered to develop a better understanding of how to make a new system of embedded self-regulation in the financial industry more likely to succeed in reducing systemic risk and enhancing global financial market stability. However, this extremely important and complex topic deserves careful examination of its own, which goes beyond the limits of this Article.

[286] *See* THALER & SUNSTEIN, *supra* note 30, at 6.

share proprietary market information even with their peers in the industry. This fact would make industry cooperation in a self-regulatory regime much harder to achieve in practice.

It is difficult to counter these criticisms, as they raise the most fundamental and real concerns about the future of financial sector self-regulation. It is entirely possible that none of the regulatory-design measures discussed in this Article would make a new model of self-regulation in the financial sector more feasible in practice. However, it is equally true that, without engaging private sector actors in the regulatory process in a new and meaningful way, any efforts to devise an effective system of regulation and supervision in today's increasingly global and complex financial services market will most likely fail, at least in the long run. Because of the critical importance of timely access to relevant market information and the ability to exercise regulatory authority across jurisdictional and geographic borders, private sector actors are currently in a better position to manage systemic risk in global financial markets than any government regulators are. Thus, designing a regulatory framework better suited to take full advantage of the industry's ability to regulate itself is important and necessary, albeit extremely difficult.

It is becoming increasingly clear that, to meet the growing regulatory challenges of the twenty-first century, we must learn to harness the power of the intangible: ideas, perceptions, beliefs, and moral and ethical standards.[287] An effective industry-wide self-regulatory organization has the strong potential to overcome the short-term orientation of individual free-market enterprises by creating a common normative framework—an industry morality—that introduces a crucial element of long-term thinking and institutionalizes responsibility for the broader social consequences of business conduct.[288] The approach proposed here combines this normative ideal with an explicitly pragmatic institutional perspective. By focusing on potential changes to the existing regulatory structure, which may alter the industry's incen-

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[287] *See, e.g.*, Robert B. Ahdieh, *The Visible Hand: Coordination Functions of the Regulatory State*, 95 MINN. L. REV. (forthcoming 2010) (manuscript at 48-49), *available at* http://papers.ssrn.com/abstract_id1522127 (discussing regulatory constraints as a means of changing industry norms and perceptions). These issues are also explored in great depth in the rich academic literature on the role of social norms in ordering behavior and the expressive function of law. *See, e.g.*, ERIC A. POSNER, LAW AND SOCIAL NORMS (2000); Lawrence Lessig, *Social Meaning and Social Norms*, 144 U. PA. L. REV. 2181 (1996); Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649 (2000).

[288] *See generally* Gunningham & Rees, *supra* note 2, at 376 (asserting that a critical step in industry self-regulation is to develop an "industry-wide normative framework").

tives and attitudes toward self-regulation, this Article seeks to ground the self-regulatory project in the realities of institutional politics, rather than in naïve faith in financial institutions' internal moral standards.[289]

It is important to emphasize that the structural measures discussed in this Article should be placed in the broader context of the comprehensive reform of financial sector regulation. Shaping institutional incentives for private market actors to start regulating their activities more in line with their collective interests, and the interests of the public at large, is not a substitute for creating effective and efficient institutions of government regulation and supervision of the industry. The search for the optimal structure of financial industry self-regulation must continue *alongside, and not in lieu of*, the search for the optimal structure of government regulation of financial markets and activities. Effective regulation of systemic risk is possible only through the thoughtful and carefully calibrated integration of these mutually reinforcing processes.

Without a doubt, the ideas laid out in this Article are more of a thought experiment than a polished set of fully developed regulatory proposals. These ideas and suggestions need a great deal of additional thought and a deeper, more granular and rigorous analysis of their potential consequences, benefits, and costs. Moreover, this Article explores only how to create conditions conducive to the emergence of comprehensive industry self-regulation that is embedded in the broader public interest and regulatory goals. It does not directly address what the ideal new model of financial industry self-regulation should look like or what mechanisms are needed to assure its effectiveness, legitimacy, and accountability. These critically important and highly complicated issues will require further research and analysis. The purpose of this Article is far more modest: to expand the boundaries of the debate on the future of global financial regulation and to start a serious discussion of all potential paths to reform, including the largely neglected and underexamined self-regulatory path.

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[289] However, while a healthy dose of skepticism in this respect is both justified and necessary, it may be overly pessimistic to dismiss entirely the potential role of moral suasion and public responsibility in shaping and modifying the behavior of private market participants, especially in the long run. As recent studies show, other-regarding behavior is a powerful source of human motivation. *See, e.g.*, Lynn A. Stout, *Social Norms and Other-Regarding Preferences* (arguing that the human tendency to act in an other-regarding fashion, or to sacrifice in order to help or harm others, is more pervasive and powerful than is generally recognized and that such other-regarding behavior is driven mostly not by personal payoffs but by social context), *in* NORMS AND THE LAW 13 (John N. Drobak ed., 2006). Nurturing and cultivating these deeply ingrained prosocial norms may ultimately hold the key to solving some of today's most intractable regulatory problems.