REGULATORS' RESPONSE TO THE CURRENT CRISIS AND THE UPCOMING REREGULATION OF FINANCIAL MARKETS: ONE RELUCTANT REGULATOR'S VIEW

LUCA ENRIQUES*

1. INTRODUCTION

In this short Article, I sketch out a few thoughts on securities regulators' response to the financial crisis of 2007–09 and on the upcoming process of financial markets reregulation, from the uncommon perspective of a moderately free market-leaning legal scholar who was appointed as commissioner of the Italian securities regulator just before the crisis erupted.

First, I show how a financial crisis like the one we have recently experienced requires regulators to become active and appear to be "doing something," no matter whether "something" will even help markets, given the extreme nature of the circumstances. Second, I ask whether such a knee-jerk, public relations-minded kind of response is inevitable or whether better corporate governance and accountability arrangements could improve the way regulators work and react to crises. Finally, I reflect upon the upcoming wave of reregulation, highlighting its perils and the most likely mistakes to come, concluding that, leaving aside the necessary overhaul of banking regulation, maintaining a pretence of doing something while actually innovating very little may in fact be the best course of action for policymakers who care about the effectiveness of financial market regulation in the long run.

2. WHEN THE GOING GETS TOUGH, . . . EVERYONE GETS GOING

Crises are a test for all. A systemic crisis like the one of 2008 has been a test for all institutions, both private and public. Among public institutions, the gravity of the situation put those with the

* University of Bologna, European Corporate Governance Institute and Commissione Nazionale per le Società e la Borsa ("Consob"). Opinions are exclusively the author's and of course do not necessarily reflect those of Consob. I am grateful to Marcello Bianchi for helpful comments on an earlier draft and to Matteo Gargantini for his excellent research assistance.

adequate ammunitions—i.e., central banks and governments—at the forefront.

In a severe financial crisis such as the current one, while (securities) regulators can do little to change the course of events, they still cannot simply stay idle: they have to do something, for at least two reasons. First, as conventional wisdom has it, if there is a crisis, then regulators must have previously failed to do their job by omitting to take action, whether regulatory or supervisory, that could have prevented it. Thus, further inaction, however justified in theory, is intolerable in the middle of a crisis. Second, in such a grave situation, a diffused sense of urgency implies that everyone is expected to do his or her part to avert the meltdown, and it would be embarrassing for any institution to confess that there is nothing it can do to help: doubts about whether such an institution is even necessary in normal times would spread, and a negative political spiral for that institution, similar to the negative market spirals we have observed for investment and commercial banks from Bear Stearns on, would ensue.

Thus, in response to the 2007–08 crash, regulators had to act, regardless of how little control they had over the situation. Their reaction, in the form of broad, temporary bans on short sales under the leadership of the British Financial Services Authority ("FSA") and the U.S. Securities and Exchange Commission ("SEC"), was the most important contribution to crisis management that any securities regulators gave.

Economists have plenty of data to analyze in order to evaluate the bans' impact on the markets. Even if the empirical evidence tells us that the bans had no positive impact, and that in fact they had a negative one, reducing liquidity and increasing volatility as economic intuition would suggest,[1] there still would be a *political*

[1] Some early studies are already showing this. *See* MATTHEW CLIFTON & MARK SNAPE, THE EFFECT OF SHORT-SELLING RESTRICTIONS ON LIQUIDITY: EVIDENCE FROM THE LONDON STOCK EXCHANGE 3 (London Stock Exchange 2008), http://www.londonstockexchange.com/NR/rdonlyres/5EDD66EF-B589-4974-95B1-73C51F1C9DFC/0/ShortsellingRestrictionsandMarketQualityDecember2008.pdf (showing that after the FSA's decision to ban short-selling the bid-ask spread for banned stocks increased significantly, while a decline was observed in depth, trades, volume and turnover); IAN W. MARSH & NORMAN NIEMER, THE IMPACT OF SHORT SALES RESTRICTIONS, 11 (2008) (independent study commissioned by the International Securities Lending Association, the Alternative Investment Management Association, and the London Investment Banking Association), http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales

justification for the ban. Given that doing nothing in the face of the crisis was not an option for political reasons, the decision to ban short sales, however disputable from a technical viewpoint, might well have been the best course of action for securities regulators to take: a ban on short sales like those devised by securities regulators around the globe is not only *very easy to sell* to public opinion as something both intuitively right and sufficiently bold, but also *hard to enforce* in an interconnected world in which trade orders can come from any jurisdiction via chains of intermediaries.[2] And last but not least, the ban was *temporary*. By enacting it, regulators effectively solved the trade-off between political expediency and the need to preserve well-functioning markets. Other alternatives would have been either ineffective (in terms of public opinion's perception, think, for instance, about the idea of reviving the "uptick rule," which sounds like a technicality) or even more disruptive (think about a resolution shutting down markets altogether, as the Russian federal agency for securities markets did twice in October 2008).[3]

The crisis has brought to the surface something that is inevitably true of (securities) regulators in normal times as well: political expediency is always of great concern regarding their actions (and inactions), no matter how formally independent and well-reputed regulators are. Rather than a concern for political expediency, we can more neutrally call it a concern for their image

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-restrictions.pdf (showing that there is no strong evidence that short-selling restrictions changed stock behaviour either in the U.K. or in other countries).

2 In theory, one could counter that this justification only holds if we take the presence of a separate securities regulator as a given. With a single financial regulator in charge, there would be other measures it could take to "do something," making a ban on short sales unnecessary. It is a fact, however, that the first regulator to ban short sales on financial stocks, a few hours before the U.S. SEC on the same day, was a single regulator: the U.K. FSA.

3 The uptick rule provided that, with limited exceptions, a listed security might be sold short either at a price above the price at which the immediately preceding sale was effected (plus tick), or at the last sale price if it is higher than the last different price (zero-plus tick). The rule was repealed by the SEC on July 6, 2007. *See* Securities and Exchange Commission, Regulation SHO and Rule 10a-1, Release No. 34-55970, 17 C.F.R. pts. 240, 242 (Jul. 3, 2007), *available at* http://www.sec.gov/rules/final/2007/34-55970.pdf (defining the uptick and zero-plus tick rules). Since then, several voices have called for the rule to be restored: *see, e.g.*, Charles R. Schwab, *Restore the Uptick Rule, Restore Confidence*, WALL ST. J., Dec. 9, 2008, at 17. On Russian regulators' decisions to shut down markets in October 2008, see, e.g., Charles Clover, et al., *Russian Trading Halted after Plunge*, FIN. TIMES (London), Nov. 13, 2008, at 33.

in a world dominated by mass media. In fact, good financial regulators are those who are able to put substance over form. But good financial regulators also tend to be smart enough to understand that they should put image over substance, if they want to thrive. And that, in general, can cause problems.

Concern about public opinion easily distorts the way regulators perform their functions; similarly, according to some, short-termism (an excessive concern for financial analysts' quarterly evaluations of a company's prospects) can distort managerial choices. In the private sector, corporate governance mechanisms—whether the result of private ordering or of lawmakers' efforts—curb the effects of such distortions and of agency problems more generally. Much less explored than with regard to corporations is the question of what governance mechanisms can similarly ensure that governmental organizations' agents pursue their institutions' objectives or, in other words, cater to the interests of their principals (the general public). Similarly, there is less debate on whether all steps have been taken by individual jurisdictions to have the best possible regulators' governance mechanisms in place.

From this perspective, it is interesting to note that the two jurisdictions currently hosting the largest financial markets have solved financial (securities) regulators' governance problems very differently.

On one hand, the U.S. SEC is a paradigmatic example of a supervisory agency relying almost exclusively on political control mechanisms. The four main *formal* governance mechanisms are: (1) appointment rights (in the hands of the President and the Senate); (2) what is known in the venture capital literature as staged financing (the annual approval of the SEC's budget by the U.S. Congress); (3) a public sector gate keeping function in the form of an audit by the Government Accountability Office ("GAO"); and (4) transparency, in the form for instance of the general rules of the Sunshine Act under which the Commission's meetings are open to the public unless secrecy is necessary to protect a general interest.[4]

On the other hand, the U.K. FSA relies on political control mechanisms no more (and on paper less) than on internal governance mechanisms, mimicking those commonly adopted by

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[4] An important *informal* feature of the SEC governance is the revolving door system: many SEC employees have previously and subsequently served in law firms or financial institutions, usually working at the SEC for just a few years.

publicly traded corporations.[5] Not only is the FSA formally incorporated as a private company limited by guarantee but, according to law, it also has to comply with the generally accepted best governance practices (to the extent that these are consistent with the FSA's tasks). A number of principles of the U.K. Combined Code of Corporate Governance are thus embodied in the law governing the FSA: for example, the majority of the FSA board members are non-executive directors (often maintaining their previous employment) and the board has to set up internal committees corresponding to audit and remuneration committees of listed corporations. Moreover, the roles of Chairman and CEO have to be split, and a lead non-executive director has to be appointed, while top management compensation is performance-related.

Whether political accountability is a sufficient governance mechanism to ensure that supervisory agencies' agents perform their task well or whether governance mechanisms typical of publicly traded corporations are useful complements for the same purpose are questions that it is impossible to answer on a general basis. A well-functioning political arena can make the marginal contribution of corporate governance mechanisms in the absence of market constraints absolutely trivial.

On the other hand, in countries where politicians have a strong clout on formally independent regulators, governance mechanisms granting voice to constituencies such as industry, practitioners and consumer representatives can help avoid excessive regulation and hyper-sensitivity to public image concerns, at least in circumstances not as extreme as the ones we have experienced in the early Fall of 2008.

3. REREGULATION: IS THERE A CHANCE TO AVOID THE USUAL MISTAKES?

While taking measures to avoid the financial meltdown and to smooth the effects of the crisis, policymakers around the globe are already busy fixing what the crisis purportedly has shown to be

[5] In the following no specific attention will be paid on political control mechanisms. Suffice it to say here that the FSA is much more independent from political bodies in making its budget decisions and in levying fees from market participants than the U.S. SEC. A form of accountability towards the market exists, in the form of a prior consultation on the entity and distribution of fees among the various market participants.

broken in (or shamefully absent from) financial markets laws. If (among others) Enron and WorldCom in the United States and Ahold and Parmalat in the EU prompted a season of "do something" reforms, as Roberta Romano has argued,[6] a crisis of such proportions will inevitably lead (and in fact is already leading) to the same kind of regulatory activism.

It is easy to predict that reregulation will take (at least) four forms. First, financial institutions that are currently unregulated or very lightly regulated (like hedge funds or rating agencies) will become more heavily regulated. Interestingly, just like measures in the Sarbanes-Oxley Act, proposals for tighter regulation of little regulated or unregulated players had already been in place for a while before the crisis erupted, showing once again that crises are the most effective catalyst for increased regulation.[7] Second, the most obvious loopholes in financial regulation will be eliminated (like the use of SIVs to lower capital adequacy requirements). Third, an overall review of the existing rules will take place, as it is already apparent with regard to the architecture of financial supervision in the United States and of the Basel II framework at the international level. Fourth, international coordination will intensify much more than in the 2000s round of post-scandal reforms, due to the apparent global interconnection of the market players at the center of the crisis, which will possibly lead to a reduction in the scope of regulatory arbitrage and therefore in regulatory competition.

There are a number of problems with reregulating (financial) markets during, or in the aftermath of, a severe financial (and economic) crisis. While such problems are well-known, it is perhaps not totally pointless to list some of them here.

First of all, during or after a crisis, the costs stemming from the new regulatory framework are overlooked, while the benefits are overestimated. Moreover, how can one overestimate the benefit of any given rule if its proponents can argue that it has the potential to reduce, however little, the risk of another such crisis? Take systemic risk: how could one possibly oppose something as

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[6] *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1525-26 (2005) (describing the "peculiar disjuncture between the substantive corporate governance provisions of SOX and the source of Enron's failure").

[7] *Id.* at 1526 ("The failure of Enron, then, provided the occasion for implementation of corporate governance initiatives that were already in the policy soup.").

intuitively good as a measure reducing systemic risk? Second, as many have noticed, after a crisis regulators act like generals of an army after losing a war: they reorganize to win that past war, which is a good recipe to be unprepared for the next one.[8] Finally, one problem with reregulation is that it is politically insensible for policymakers to scrap previous rules that have proven to be ineffective, inefficient, or obsolete, even while they introduce new rules that possibly tackle the same problems as the old ones. Unless the new rules are just formal substitutes of the previous rules, the latter will often stay despite their being (or having become) pointless. In fact, in deciding whether to repeal rules, a policymaker will anticipate the possibility that, in case of repeal, after the next scandal or crisis someone might ex post argue that those rules would have helped detect the scandal or prevent the crisis, casting a highly negative light on that policymaker's decision. Hence, there will be a strong bias in favor of preserving all rules in place.

4. "FACITE AMMUINA" AS A POSSIBLE SOLUTION?

Borrowing Gérard Hertig's words, the conclusion to one of my works published in this *Journal* was that, post-Enron, in the area of corporate law, the European Community should have had the courage to do almost nothing.[9] At the cost of sounding repetitive (and even more provocative), I argue here that this recommendation is more generally valid in today's post-crisis world. Of course, regulations like the capital adequacy framework for banks—that have proved easily avoidable and/or ineffective and/or to have unintended consequences—will have to be reshaped. But in many areas, the best course of action will be to stay idle, not least for the very simple reason that markets themselves are already self-correcting, and regulators are intensifying their action. Cultural change is already in place, as press reports on banks' attitudes show a trend towards tougher risk management and better policies on top executive

[8] *See, e.g.*, JOHN G. FRANCIS, THE POLITICS OF REGULATION 182 (1993) (comparing financial regulatory regimes to armies reorganizing to fight war they have just lost and predicting "a loss of confidence in the regulatory structure" as the likely result).

[9] *See* Luca Enriques & Matteo Gatti, *The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union*, 27 U. PA. J. INT'L ECON. L. 939, 998 (2006) (describing the context of Hertig's comment, and how it is very unrealistic to expect nothing to be done).

compensation.[10] Regulators' tendency to be tougher, abandoning previous light-touch approaches, is also evident.[11]

While theoretically defensible, the idea of doing almost nothing is, of course, a political non-starter. Something will have to be done—or at least will have to *appear* to be done. Then, a viable, second-best strategy (and possibly one governments are adopting already to some degree, especially so long as they keep acting primarily at the international level) could be what in Neapolitan dialect is known as "fare ammuina:" much like sailors of the Kingdom of the Two Sicilies' Navy back in the Nineteenth century did when the Highest Authorities of the Kingdom visited their ships,[12] regulators should make a lot of noise and show a lot of activism, all the while producing very little change. Of course, it would be hard to fool cognoscenti of financial markets regulation and practitioners, but the latter would not protest and the former would have too little an audience once the financial crisis is over.

A possible counterargument may be that if nothing "real" is accomplished and instead regulation is conducted in what is known in Italian as the "gattopardesco" way,[13] then a time will come when market players (and once again captive regulators) will have forgotten previous excesses and will again start taking excessive risk and inflating bubbles. Because those will be prosperous times, policymakers will have absolutely no clout to curb those excesses and to deflate those bubbles, much like they

[10] *See, e.g.*, Louise Story, *On Wall Street, a Bonus Season of Uncertainty*, INT'L HERALD TRIB., Dec. 10, 2008, at 11 (describing how Wall Street banks were to cut annual bonuses); Katrin Bennhold, *Report Pinpoints Faults at Société Générale*, INT'L HERALD TRIB., May 24, 2008 (reporting that Société Générale was planning to correct its risk control system after huge unexpected losses emerged as a consequence of a trader's fraud); KPMG, Lack of Stature and Resources for Risk Management Cited as Leading Contributors to Credit Crisis, KPMG Study Finds, Jan. 6, 2009, *available at* http://www.us.kpmg.com/RutUS_prod/Documents/12/Lack_of_Stature.pdf (reporting results of a survey among banks' risk managers according to which 78 percent of the respondents declare their intention to improve methodologies to measure and report risks).

[11] *See, e.g.*, Alistair MacDonald, *Britain's FSA Begins to Drop Its Light Touch*, WALL STREET J. (European Edition), Jan. 5, 2009, at 1, 28; Lina Salgol & Brooke Masters, *FSA Code Will Aim to Tackle Incentives for Risk-taking*, FIN. TIMES (London), Oct. 9, 2008, at 4 (FSA has recently started requiring that bonus plans be linked to long-term results).

[12] *See* Appendix.

[13] *Gattopardesco* is defined as a policy relative to a conservative policy based on the belief that the status quo can best be defended through reforms that merely change the surface of things. *See generally* GUISEPPE DI LAMPEDUSA, THE LEOPARD (Archibald Colquhoun trans., Pantheon Books 2007) (1958).

did prior to the present crisis. Therefore, as the argument would go, we should heavily reregulate now so as to have in place the curbs that will be needed when the current cultural change's effects are over. In other words, a culture of frugality and risk control can be a fad, while rules are here to stay.

The problem with this reasoning is, first, that, as hinted before, rules we devise now may not be the ones we will need to curb the excesses preceding and causing the next crisis. Further, rules are not that sticky (they are definitely less sticky than human greed). Indeed, excessive reregulation today is the best guarantee of effective pressure towards deregulation tomorrow.

APPENDIX

Regolamento della Real Marina del Regno delle due Sicilie del 1841

Art.27. "Facite Ammuina."

> All'ordine Facite Ammuina: tutti chilli che stanno a prora vann' a' poppa e chilli che stann' a poppa vann' a prora: chilli che stann' a dritta vann' a sinistra e chilli che stanno a sinistra vann' a dritta: tutti chilli che stanno abbascio vann' ncoppa e chilli che stanno ncoppa vann' bascio passann' tutti p'o stesso pertuso: chi nun tiene nient' a ffà, s'aremeni a 'cca e a 'llà."

Author's translation:

Regulation of the Royal Navy of the Kingdom of the Two Sicilies (1841)

Art. 27 "Move noisily around"

> When ordered, move noisily around: all those standing in prow shall move to the stern and all those standing astern shall move to the prow; all those standing near the starboard shall move to the port and all those standing near the port shall move to the starboard; all those standing at the tree-top shall go down to the hold and all those standing in the hold shall climb to the tree-top; everyone shall pass through the same hatch.
>
> Those who have nothing to do: do all you can hither and thither!