Brooklyn Journal of International Law

Volume 35
Issue 3
SYMPOSIUM: New Paradigms for Financial Regulation in the United States and the European Union

Article 2

2010

Rethinking the Future of Self-Regulation in the Financial Industry

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Recommended Citation

Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 Brook. J. Int'l L. (2010).
Available at: https://brooklynworks.brooklaw.edu/bjil/vol35/iss3/2

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RETHINKING THE FUTURE OF SELF-REGULATION IN THE FINANCIAL INDUSTRY

Saule T. Omarova[*]

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INTRODUCTION

In many respects, the global financial crisis of 2008–2009 marked the beginning of a new era. It forcefully demonstrated that today's financial markets pose extremely serious potential risks to every national economy as well as the entire global economic system. What started initially as tremors in the U.S. subprime mortgage market, in a matter of months, turned into a full-blown turmoil that nearly incapacitated the global financial system and resulted in massive economic and social dislocation in virtually every corner of the world.[1] It is hardly surprising, therefore, that the crisis brought to the forefront of the public policy debate the need for a fundamental reform of the existing system of regulation and supervision of the financial services sector. The objectives, scope, and elements of such wide-reaching financial regulatory reforms are at the heart of intense ongoing discussions among policy-makers, academics, and industry experts in the U.S.[2] and abroad.[3]

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1. 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, regions, or the international economy as a whole. *See*, *e.g.*, Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Legal and Economic Issues in Litigation Arising From 2007-2008 Credit Crisis* 1, 5 (Harv. L. Sch. John M. Olin Ctr. for Law, Economics and Business Discussion Paper, Paper No. 612, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1096582; Yuliya S. Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, (Dec. 5, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396&rec=1&srcabs=1096582; Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 493 (2009); Gary Gorton, *The Subprime Panic*, 15 EUR. FIN. MGMT. 10, 15 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1320704.

2. *See*, *e.g.*, U.S. DEP'T OF TREAS., BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), *available at* http://www.ustreas.gov/press/releases/report/blueprint.pdf; Markus Brunnermeier, et al., *Fundamental Principles of Financial Regulation* ix (Int'l Ctr. for Monetary and Banking Studies, Prelim. Conf. Draft, Jan. 24, 2009), *available at* http://www.voxeu.org/reports/Geneva11.pdf; CONGRESSIONAL OVERSIGHT PANEL, MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY (2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf; GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009), *available at* http://www.group30.org/pubs/pub_1460.htm; U.S. GOV. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM GAO-09-216 (Jan. 2009); U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. On July 21, 2010,

Numerous proposals, coming from the official sector and various non-governmental sources in response to the crisis, have advocated regulatory reforms of differing magnitude.[4] Such proposed reform measures generally range from a complete overhaul of the regulatory structure to more discrete steps aimed at regulating specific market products or segments.[5] The majority of these proposals focus primarily on designing the structure of the regulatory and supervisory apparatus in the financial sector and reallocating functions among various government agencies overseeing financial markets. To the extent these proposals deal with substantive revisions to the existing regulatory scheme, they tend to focus on regulation of specific products or market participants, such as over-the-counter ("OTC") derivatives or credit rating agencies, directly implicated in the crisis. Many substantive reform proposals seek to strengthen some of the existing regulatory tools, such as capital adequacy or liquidity requirements applicable to banks and other regulated financial institutions. Many proposals also call for closer and more effective coordination and cooperation among national financial regulatory and supervisory authorities and creation of transnational regulatory bodies whose primary task

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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. *See* The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

3. For key proposals debated in the United Kingdom, see, e.g., HER MAJESTY'S TREASURY, REFORMING FINANCIAL MARKETS (2009), *available at* http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf; FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL FINANCIAL CRISIS (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

4. In July 2010, U.S. Congress passed the Dodd-Frank Act introducing significant changes in the existing system of financial sector regulation and supervision. *See supra* note 2. Although frequently referred to as the most sweeping financial sector reform in the United States since the New Deal, the Dodd-Frank Act leaves many fundamental policy issues to be resolved through the regulatory agencies' action in implementing the statute's broadly phrased mandates. *See, e.g.*, Stacy Kaper, *Now for the Hard Part: The Top Five Challenges of Reg Reform*, AM. BANKER, July 22, 2010, *available at* http://www.americanbanker.com/issues/175_139/now-for-the-hard-part-1022715-1.html. This Article's primary focus is not on the details of the Dodd-Frank Act, or any other specific legislative or regulatory proposal, but rather on the key trends in the broader debate on financial regulation reform in the aftermath of the recent financial crisis.

5. *See supra* note 2. For critical analyses of the key trends in the debate, see, e.g., 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); Saule Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009).

would be detection and prevention of systemic risk in the financial sector.[6]

These reform proposals tackle extremely important issues and contain a wide range of highly valuable and insightful ideas, some of which are incorporated into the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law by President Obama on July 21, 2010.[7] However, despite the depth and diversity of current approaches to reform, neither the newly adopted U.S. reform legislation nor the broader theoretical discussions on the future of financial sector regulation address explicitly one vitally important issue: the role of industry self-regulation in the post-crisis world of finance.[8] This Article seeks to cure this omission by bringing the problem of self-regulation into the focus of the ongoing policy debate.

The recent crisis has profoundly changed the face of the global financial industry. Some of the biggest players in the financial markets ceased to exist as independent enterprises,[9] while others came perilously close to failure and had to be rescued by their governments.[10] The public opinion

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

7. *See supra* note 2.

8. 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 (2010) (proposing an industry organization comprising systemically important financial institutions and designed specifically 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* (March 16, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572467 (proposing an establishment of a self-regulatory organization focusing on the regulation of credit default swaps). However, these recent proposals tend to focus on specific areas of potential application of a more traditional concept of a self-regulatory organization rather than a broader shift in the paradigm of financial industry self-regulation.

9. The best-known examples in this respect are two venerable U.S. investment banks: Bear Stearns, which was acquired by J.P. Morgan, and Lehman Brothers, which was forced into bankruptcy in September 2008.

10. For instance, as a result of its bail-out efforts, the U.K. government currently owns more than 70% of shares in the Royal Bank of Scotland. *See* HM TREASURY, ROYAL BANK OF SCOTLAND: DETAILS OF ASSET PROTECTION SCHEME AND LAUNCH OF ASSET PROTECTION AGENCY (2009), *available at* http://www.hm-treasury.gov.uk/d/rbs_aps_apa.pdf. Similarly, as of April 2010, the U.S. government owned about 27% of Citigroup's stock. *See Treasury Plans First Citigroup Stock Sale*,

around the world turned decidedly anti-industry,[11] especially amid the revelations that the firms that received taxpayers' money to help them stay afloat granted their executives and traders lavish bonuses.[12] The prevailing theoretical and ideological paradigm, which viewed deregulation of financial activities and financial innovation as unconditionally beneficial,[13] has been publicly discredited and lost its pre-crisis intellectual dominance.[14] In light of these developments, it may seem counter-intuitive, if not outright misguided, to suggest that part of the solution is giving more regulatory power to the very industry that manufactured the crisis.

Nevertheless, this Article argues that any meaningful long-term regulatory reform in the financial services sector must seriously consider the potential role of industry self-regulation as a key mechanism of controlling and minimizing systemic risk. Industry self-regulation has two important potential advantages over both direct government regulation of the financial services sector and pure market-based regulatory mechan-

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WASH. POST, April 26, 2010, *available at* http://www.washingtontimes.com/news/2010/apr/26/treasury-plans-first-citigroup-stock-sale/.

11. Matt Taibbi's famous quote describing Goldman Sachs as "a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money" provides one of the most vivid, albeit extreme, examples of the strong anti-industry public opinion. Matt Taibbi, *The Great American Bubble Machine*, THE ROLLING STONE, July 13, 2009, *available at* http://www.rollingstone.com/politics/story/29127316/the_great_american_bubble_machine/print.

In November 2009, Goldman Sachs CEO Lloyd Blankfein's ill-timed statement that he was "doing God's work" spurred a wave of small but vocal public protests around the country. *See* Kevin Sieff, *Protesters Lash Out at Goldman*, FIN. TIMES, Nov. 16, 2009.

12. Thus, in late 2009, it was reported that Goldman Sachs was setting 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*, FIN. TIMES, Nov. 17, 2009.

13. *See*, *e.g.*, Peter Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008; Anthony Faiola, Ellen Nakashima & Jill Drew, *What Went Wrong*, WASH. POST, Oct. 15, 2008, at A1.

14. Thus, the former Chairman of the Board of Governors of the Federal Reserve System (the\ Federal Reserve), Alan Greenspan, perhaps the most famous proponent of this philosophy, publicly admitted its fundamental mistake in essentially assuming risks away. *See* Alan Greenspan, *We Will Never Have a Perfect Model of Risk*, FIN. TIMES, Mar. 16, 2008. Interestingly, a world-famous financier, George Soros, recently announced his decision to fund a new think tank whose mission would be to re-conceive the field of economics, which is too deeply entrenched in the free-market ideology. *See* Alan Rappeport, *Soros to Invest $50m in Economic Think-tank*, FIN. TIMES, Oct. 27, 2009, *available at* http://www.ft.com/cms/s/0/e45b353a-c2f3-11de-8eca-00144feab49a.html.

isms. One such potential advantage is the industry's superior ability to access and assess, in a timely and efficient manner, the relevant market information. This informational advantage is critical to effective regulation of the increasingly complex financial markets and activities. The other potential advantage of private industry actors over government regulators is their ability to monitor and regulate their own business operations on a truly global basis, without regard to national borders and jurisdictional limitations. Financial globalization, which poses serious challenges for government agencies constrained by their formal jurisdictional mandates, makes a seamlessly integrated approach to regulating financial activities across national borders an indispensable condition for effective reduction of systemic risk.

However, in order to realize these potential advantages, the very foundation of the concept of self-regulation in the financial services industry has to be revisited. As this Article argues, the currently existing system of self-regulation in the U.S. securities industry falls far short of a model that fully utilizes the potential benefits of private industry regulation. The statutorily authorized system of securities self-regulatory organizations, or SROs, serves mainly as the means of delegating certain narrowly drawn governmental functions to the industry and occupies an awkward position between the government and private sector.[15] The U.S. securities SROs were not designed to address effectively the issues of systemic risk control in today's financial markets.[16] Accomplishing this goal by leveraging financial sector's self-regulatory potential requires a fundamental shift in the very paradigm of financial industry self-regulation, its purpose, scope, and the broader institutional context within which it operates.

As the first step in this direction, this Article argues for a new model of financial sector self-regulation, one that focuses explicitly on prevention of systemic failure and is firmly embedded in the broader public interests and policy goals. This new normative approach to self-regulation in the financial services sector—what this Article refers to as "embedded self-regulation"—seeks to redefine the broader social role of the private financial sector and impose the primary responsibility for guarding financial stability against excessive risks directly on the financial services industry that created them. Importantly, this approach recognizes that a strong and effective system of government regulation, which defines key policy objectives and monitors performance of self-regulatory institu-

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15. *See, e.g.*, Roberta Karmel, *Should Securities Industry Self-Regulatory Organizations be Considered Government Agencies?,* 14 STAN. J.L. BUS. & FIN. 151 (2008).

16. *See infra* Part III.A.

tions, is critical to the proper functioning of financial sector self-regulation. This Article argues that an effective model of embedded self-regulation should serve as an important supplement to the ongoing quest for an optimal design of the government regulation and supervision of financial institutions and activities.

This Article proceeds as follows. Part I sets broader theoretical context for further discussion by highlighting some of the key insights that the growing body of academic literature on New Governance has to offer with respect to the general nature of regulatory challenges in the 21st century. It also addresses some of the principal definitional issues in the ongoing academic debate on self-regulation. Part II shifts focus directly to self-regulation in the financial sector. It examines the rationale for the renewed importance of industry self-regulation in the wake of the recent global financial crisis and argues that financial sector self-regulation has significant potential benefits from the perspective of managing global systemic risk. Part III analyzes the limitations of the currently existing system of the U.S. securities SROs and proposes a new concept of "embedded self-regulation," which represents a fundamental shift in the normative basis for self-regulation in the financial sector. Finally, the Article ends with brief concluding remarks.

I. NEW GOVERNANCE AND SELF-REGULATION

Self-regulation as a form of social organization has a long history, which can be traced back to religious fraternities and medieval merchant and trade guilds.[17] In today's world, self-regulatory regimes exist in a variety of different areas, including professional self-regulation in law and medicine, private accreditation and product certification schemes, and formal self-regulatory organizations in many industries. It is hardly surprising that, given the wide variety of self-regulatory institutions, the meaning of the term "self-regulation" defies simple definitions. This Part seeks to place the search for a new self-regulatory model in the financial sector in a broader intellectual and theoretical context by outlining the ongoing debate on New Governance approaches to regulatory issues. It also addresses some of the definitional and conceptual complexities in the academic debate on self-regulation.

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17. *See*, *e.g.*, SELF-REGULATION IN TODAY'S SECURITIES MARKETS: OUTDATED SYSTEM OR WORK IN PROGRESS? 1 (CFA Inst. Ctr. for Fin. Mkt. Integrity, 2007), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n7.4819.

A. New Governance Theories: A Brief Overview

Legal scholars and social scientists working within the so-called New Governance paradigm have long recognized the fundamental inadequacy of a purely top-down, centralized state regulation of complex systems.[18] Working across many academic disciplines and analyzing regulatory processes in various empirical settings,[19] these scholars generally argue that the complexity and fluidity of informational flows in today's society pose insurmountable challenges to so-called command and control regulation.[20] Thus, one of the central criticisms aimed at the top-down regulatory approaches, whereby the government exercises full monopoly on making and enforcing the rules, is that the government "has insufficient knowledge to be able to identify the causes of problems, to design solutions that are appropriate, and to identify non-compliance (information failure)."[21] In addition, the failings of the government regulation include the inability to design appropriately sophisticated and effective legal and policy instruments to address complex social problems (instrument failure), inadequate implementation of the rules (implementation failure), and failure to motivate the regulated entities and individuals to comply with the rules (motivational failure).[22]

While these criticisms are often directed at what may be viewed as a caricature of direct government regulation, rather than a far more complex reality of how state and non-state actors interact in making and implementing rules and regulations,[23] they bring home a fundamentally important point. Relying on the government as the sole source of regulation applicable to complex systems, including the global financial system,

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18. *See e.g.*, 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 cross-disciplinary review of New Governance scholarship, see Scott Burris, Michael Kempa & Clifford Shearing, *Changes in Governance: A Cross-Disciplinary Review of Current Scholarship*, 41 AKRON L. REV. 1 (2008).

19. For a recent overview of the governance scholarship across various academic disciplines, see VASUDHA CHHOTRAY & GERRY STOKER, GOVERNANCE THEORY AND PRACTICE: A CROSS-DISCIPLINARY APPROACH (2009).

20. The term "command and control regulation" generally denotes a strictly centralized system of government rule-making and enforcement. *See, e.g.*, Darren Sinclair, *Self-Regulation Versus Command and Control? Beyond False Dichotomies,* 19 LAW & POL'Y 529, 531–32 (1997).

21. Julia Black, *Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a "Post-Regulatory" World*, 54 CURRENT LEGAL PROBS. 103, 106 (2001).

22. *Id.*

23. The New Governance scholarship generally recognizes that a pure form of command and control regulation does not exist in practice, much like there is no pure form of complete private industry self-regulation. *See*, *e.g*., Sinclair, *supra* note 20, at 531–32.

suffers from the important built-in handicaps of informational asymmetry and expertise deficit. These handicaps are likely to render financial regulation inherently reactive, rather than proactive, and thus incapable of addressing financial systemic risk *ex ante*, as opposed to trying to remedy it *ex post*.

The New Governance scholars seek to understand how regulatory decisions are made in practice and how both power and responsibility are allocated among different public and private actors interacting in real life. One of the key insights of this school of thought is the realization that regulation is a multi-layered process that takes place on many different levels and in many different fora.[24] It recognizes that technological progress and advances in communication fundamentally change the very context in which regulation operates by creating a new demand for openness and encouraging self-regulation by private actors empowered to act collectively and to form norm-generating institutions.[25]

However, it is important to emphasize that the New Governance scholars do not simply advocate dismantling the regulatory state in favor of free market and purely private mechanisms of social ordering.[26] Proponents of the New Governance approach view the world as a complex, dynamic, and intricately interconnected system in which multiple governmental and non-governmental forces constantly negotiate, and renegotiate, the boundaries between public and private spheres of economic and social life.[27] In this world, the key objective of the regulatory state is not to control the regulated by imposing externally generated rules on them but to "harness[…] private capacity to serve public goals."[28]

This Article seeks to build upon this general approach as it examines the concept of self-regulation and its potential role in the post-crisis financial regulation reform.

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24. Black, *supra* note 21, at 108.

25. Lobel, *supra* note 18, at 359–60.

26. *See*, *e.g.*, Lobel, *supra* note 18, 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.").

27. *See, e.g.*, Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 548 (2000) (proposing an "alternative conception of administration as a set of negotiated relationships" whereby "public and private actors negotiate over policy making, implementation, and enforcement.").

28. *Id.* at 549.

B. Self-Regulation in Academic Debate: A Multi-Faceted Concept

To the extent self-regulation denotes devolution of regulatory authority to private industry actors, it can be viewed as a particular form, or an element, of a broader model of New Governance. However, because the concept of self-regulation is both deceptively simple and heavily normatively loaded, it is worth examining its meaning and boundaries in some detail.

Policy-makers and academics debating the pros and cons of self-regulation frequently equate that concept with "deregulation" and directly juxtapose it to the concept of government regulation of private economic activities. Both the staunchest proponents and the most adamant opponents of self-regulation often share this fundamental view of self-regulation and regulation as mutually exclusive alternatives.[29]

Supporters of the idea of self-regulation by market actors claim that it offers significant advantages over direct government regulation. They tend to stress that self-regulation is considerably more flexible and context-driven. Because private entities actively participating in the regulated market activities are able to respond faster and better to the changes in market conditions, self-regulation is said to be inherently more efficient, less costly, and less complicated than government regulation. From this perspective, self-regulation exemplifies a regulatory approach 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."[30] Importantly, the advocates of self-regulation emphasize its potential for fostering shared values among private actors, cultivating their sense of ownership and participation in the rule-making process reflecting those values, and facilitating voluntary compliance with the resulting rules.

The skeptics, on the other hand, view self-regulation as fundamentally "self-serving, self-interested, lacking in sanctions, beset with free rider problems, and simply a sham."[31] The critics argue that private profit-seeking enterprises cannot be trusted to regulate their own activities in a manner conducive to promotion of publicly desirable goals. From this perspective, private industry self-regulation is unlikely to amount to anything more than a mere smokescreen intended to create an illusion of

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29. The ideological content and rhetoric of self-regulation can also influence the practical policy decisions with respect to regulatory design. *See*, *e.g.*, JULIA BLACK, RULES AND REGULATORS 1, 46–80 (1997) (discussing the role of political rhetoric in the actual design of the self-regulatory system set up in the U.K. under the Financial Services Act 1986).

30. Black, *supra* note 21, at 115.

31. *Id.*

regulation. In addition to the deeply seated conflict of interest, the opponents of self-regulation point to its inherent inefficiencies, including widespread collective action problems, lack of effective enforcement capabilities, inability of self-regulatory organizations to gain or maintain legitimacy, and, ultimately, the failure of accountability.[32]

Despite the powerful rhetoric both for and against self-regulation, the concept itself lacks definitional clarity. In practice, there are many different forms of self-regulatory arrangements and institutions, depending on the specific context in which they evolve.[33] Partially as a reflection of this reality, participants in theoretical and policy debates often employ different definitions of self-regulation, both in a positive and a normative sense. Thus, self-regulation is often used interchangeably with terms, such as "self-governance," "collaborative governance," "negotiated governance," "co-regulation," "voluntarism," "private regulation," "soft law," "quasi-regulation," "enforced self-regulation," "communitarian regulation," and so on. Each of these terms places the emphasis on a particular characteristic that arguably distinguishes true "self-regulation" from direct government regulation: the purely voluntary nature of regulation, the concentration of rule-making authority solely in the hands of non-governmental actors, or the non-binding or non-legal nature of the rules themselves.[34]

Many of these concepts attempt to overcome the one-sidedness of the traditional dichotomy between regulation and self-regulation and introduce various hybrid solutions combining self-regulatory mechanisms with some degree of government involvement or oversight. These more sophisticated accounts view "command and control" and self-regulation as extreme points on a single regulatory continuum, with the majority of real-life regulatory regimes falling somewhere between them.[35] For example, an increasingly popular notion of "co-regulation" envisions a system in which the public agencies and private market actors cooperate in

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32. According to one such critic, "Self-regulation is frequently an attempt to deceive the public into believing in the responsibility of a[n] irresponsible industry. Sometimes it is a strategy to give the government an excuse for not doing its job." John Braithwaite, *Responsive Regulation in Australia*, *in* BUSINESS REGULATION AND AUSTRALIA'S FUTURE 91 (Peter Grabosky & John Braithwaite eds., 1993).

33. For example, various self-regulatory or public-private regulatory arrangements exist in such diverse fields and sectors of the economy as nuclear power industry, chemical manufacturing, healthcare, food safety, occupational safety, labor regulation, environmental compliance, and corporate governance.

34. Black, *supra* note 21, at 116–117.

35. *See* Robyn Fairman & Charlotte Yapp, *Enforced Self-Regulation, Prescription, and Conceptions of Compliance within Small Businesses: The Impact of Enforcement*, 27 LAW & POL'Y 491, 492 (2005).

the creation, implementation, and enforcement of rules.[36] According to the proponents of the co-regulation model, Co-regulation is an approach in which a mixture of instruments is brought to bear on a specific problem […] typically involving both primary legislation and self-regulation or, if not self-regulation, at least some form of direct participation of bodies representing stakeholders in the regulatory decision-making process. Co-regulation aims to combine the advantages of the predictability and binding nature of legislation with the flexibility of self-regulatory approaches.[37]

Another popular approach, "enforced self-regulation,"[38] advocates a system under which private businesses are required to assess, monitor, and regulate the risks they create, while the government enforces such privately made rules alongside with its enforcement of the direct administrative rules and regulations.[39] In this regime, the government places the key responsibility for risk management directly on individual private entities, which results in a fundamental shift in the focus of the government's enforcement activity from discovering instances of non-compliance with specific rules toward assessing the firms' internal compliance and risk management systems. Importantly, however, enforced self-regulation generally "differs from true self-regulation in that the standards to be achieved are determined by the regulator and not from within the industry."[40]

Even when scholars seem to agree on the definitional boundaries of self-regulation setting it apart from other forms of regulatory arrangements, such as co-regulation or enforced self-regulation, they often part company when it comes to drawing more subtle internal distinctions among different kinds of self-regulation. Once again, multiple typologies of self-regulation developed in the academic literature reflect the wide

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36. *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 (2007); Edward Balleisen, *The Prospects for Effective Coregulation in the United States: An Historian's View from the Early Twenty-First Century*, *in* GOVERNMENTS AND MARKETS: TOWARD A NEW THEORY OF REGULATION 443 (Edward Balleisen & David Moss eds., 2009).

37. Martinez et al., *supra* note 36, at 302.

38. The term "enforced self-regulation" was coined by John Braithwaite. *See* John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 U. MICH. L. REV. 1466 (1982). Braithwaite's concept of "enforced self-regulation" is an integral part of the famous pyramidal regime of so-called "responsive regulation." *See* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992).

39. *See* Fairman and Yapp, *supra* note 35, at 493.

40. *Id*.

variety of real-life self-regulatory arrangements and their highly context-sensitive nature. Generally, however, social scientists and legal academics tend to distinguish between systems of "voluntary" self-regulation, characterized by the absence of direct government intervention; "sanctioned" self-regulation, in which private actors formulate rules subject to government approval; and "mandated" self-regulation, in which private actors are required by the government to establish a self-regulatory framework.[41]

Another important nuance in the debate on self-regulation involves the choice of the main unit of analysis. Some authors examine self-regulatory arrangements and techniques on an individual entity level,[42] as is often the case in the field of corporate governance or compliance with environmental regulations, while others focus on self-regulation at a variety of broader levels of collectivity—an industry, a region, or an administrative unit.[43]

While resolving these definitional issues is beyond the scope of this Article, even the most cursory overview of the ongoing debate on the meaning and variety of self-regulation is helpful in framing the inquiry into the basic nature of a potentially desirable self-regulatory regime in the financial services sector. However, the threshold question in this respect is why, as a general matter, self-regulation may potentially be a valuable mechanism of financial sector regulation.

II. AFTER THE CRISIS: A NEW RATIONALE FOR SELF-REGULATION IN THE FINANCIAL SECTOR?

This Part focuses on the concept of self-regulation in the financial services sector and argues that redefining that concept should be a key element of our post-crisis quest for an optimal regulatory framework geared toward preventing future financial meltdowns.

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41. *See*, *e.g.*, Black, *supra* note 21, at 118–19; Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 LAW & POL'Y 363, 364–66 (1997). Some of the more granular typologies also refer to "accredited" self-regulation, in which privately established rules are accredited by another private body (such as, e.g., 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 private sector engages only in rule-making; or "full" self-regulation, in which both rule-making and enforcement are privatized. *Id.*

42. Some scholars refer to intra-firm self-regulatory activity as "management regulation." *See* Cory Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 LAW & SOC'Y REV. 691 (2003).

43. *See* Black, *supra* note 21, at 120–21; Gunningham & Rees, *supra* note 41, at 364.

A. Financial Crisis and Regulatory Reform: A Brief Outline of the Debate

The recent global financial crisis brought the issues of long-term regulatory reform into the center of public debate in the U.S., as well as in other countries. Not surprisingly, in the past two years, academics and policy-makers advanced numerous proposals for reforming financial sector regulation. These proposals, ranging from abstract ideas to drafts of actual laws and regulations, address in a variety of ways the fundamental issue of translating the lessons of that last crisis into regulatory mechanisms designed to minimize the chances of similar crises in the future.[44] Responding to the mounting political pressure, lawmakers and government agencies around the world are presently working on legislative and regulatory reform packages, which reflect many of the ideas advanced in these proposals.[45] One of the key milestones in this process was the recent passage of the Dodd-Frank Act introducing major changes to the U.S. financial sector regulation.[46]

However, even the successful adoption of wide-ranging financial reform legislation in the U.S., despite its undeniable importance, is unlikely to provide perfect solutions to main regulatory dilemmas and end the broader debate on the future of financial sector regulation and supervision.[47] Leaving aside the gaps and ambiguities in the new law, it is important to remember that financial regulation reform in the era of rapid technology-driven innovation is an inherently dynamic phenomenon. Conceptually, it should be viewed as an ongoing intellectual enterprise, a process of continuous collective deliberation and exchange of ideas, rather than a static set of rules enacted into law at any particular point. Effective prevention of financial crises and containment of systemic risk in the increasingly complex global financial markets will continue to be a

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44. *See supra* notes 2–3.

45. Thus, the European Union is currently in the process of restructuring its system of overseeing financial institutions and setting up new European regulators with enhanced institutional capabilities and powers. *See*, *e.g.*, COMMISSION OF EUROPEAN COMMUNITIES, COMMUNICATION FROM THE COMMISSION: EUROPEAN FINANCIAL SUPERVISION (2009), *available at* http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf.

46. *See supra* note 2.

47. One of the key criticisms of the Dodd-Frank Act is its deliberate vagueness and failure to resolve many fundamentally important policy issues, leaving them instead to the discretion of implementing agencies. Thus, according to some estimates, the statute mandates that regulators enact 243 new rules, conduct 67 one-time studies and submit 22 periodic reports. This approach creates a great deal of uncertainty as to the ultimate effect of the reform. *See* Kaper, *supra* note 4.

moving target for regulators and policy-makers. The insights and approaches developed in today's discussions will continue to shape the search for more effective long-term policy solutions that go beyond the current legal and regulatory changes. From this perspective, mapping out the principal trends in the current debate on the form and substance of the financial sector regulation and identifying some of the key themes running through most of the recent proposals is an important step toward understanding potential gaps in this ongoing process.[48]

The first unifying characteristic of the current debate on financial regulation reform is the strong focus on the structure, functions, and jurisdictional boundaries of regulatory agencies overseeing the financial services sector. Despite the vastly different substantive approaches to these issues, nearly all major proposals for redesigning financial regulation concentrate heavily on such issues as the role and organizational form of a regulatory agency directly charged with monitoring and prevention of systemic financial risk,[49] the proper role of central banks vis-à-vis prudential regulatory and supervisory bodies,[50] and creation of institutional mechanisms for stronger protection of retail investors and consumers of financial services.[51] An important part of the discussion concerns the

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48. For an analysis of some of the key trends in the reform debate, see also Cunningham & Zaring, *supra* note 5; Omarova & Feibelman, *supra* note 5.

49. While nearly all reform proposals seem to accept the need for a regulatory body charged with systemic risk oversight, there is some disagreement as to the form of such a regulator. In the U.S., the main debate centered around proposals to assign this function to the Federal Reserve, to a newly established separate federal agency, or a council comprising representatives of financial regulators. *See*, *e.g.*, Roberta S. Karmel, *The Controversy Over Systemic Risk Regulation*, 35 BROOK. J. INT'L L. 823 (2010) (discussing in detail different approaches to the issue of systemic risk regulation). The Dodd-Frank Act mandates the establishment of the interagency Financial Stability Oversight Council, which will work closely with the Federal Reserve to monitor and minimize systemic risk.

50. The debate about whether or not central banks should perform regulatory and supervisory functions, in addition to their traditional monetary policy duties, is hardly a new one. In the post-crisis era, this issue was replayed not only in the context of the debate over the Federal Reserve's role in overseeing financial institutions, but also with respect to potential reallocation of regulatory and supervisory powers between the United Kingdom's Financial Services Authority ("FSA") and the Bank of England. *See*, *e.g.*, Brooke Masters & George Parker, *Osborne Promises Caution Over FSA Reform*, FIN. TIMES, Sept. 9, 2009, *available at* www.ft.com/cms/s/ae5477a4-9d6d-11de-9f4a-00144feabdc02.html2.nclick_check=1. On June 16, 2010, Chancellor Osborne announced his decision to abolish the FSA and transfer its bank regulatory and supervisory powers to the Bank of England. *See*, *e.g.*, George Parker & Brooke Masters, *Osborne Abolishes FSA and Boosts Bank*, FIN. TIMES, June 16, 2010, *available at* http://www.ft.com/cms/s/0/0203b99e-797f-11df-b063-00144feabdc0.html.

51. Thus, creation of the new federal regulatory authority specifically dealing with consumer protection in the financial services sector has been at the center of an intense

formation of a new resolution authority that would be in charge of orderly unwinding of financial conglomerates falling outside the jurisdictional reach of any of the existing resolution authorities in the financial sector.[52] In the U.S., the debate on specific regulatory structure also involves issues of consolidating multiple regulators in banking, securities, and commodities futures sectors,[53] introducing federal regulation of insurance industry,[54] and redefining the general balance of state and federal regulatory powers with respect to the provision of financial services.[55]

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debate among policy-makers, academics, and industry lobbyists in the U.S. *See*, *e.g.*, CONGRESSIONAL OVERSIGHT PANEL, *supra* note 2, at 34–37 (discussing potential alternatives for creation of a new consumer financial protection regulator); U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION*, supra* note 2, at 55–70 (proposing the creation of the Consumer Financial Protection Agency). The Dodd-Frank Act mandates the creation of an independent Bureau of Consumer Financial Protection within the Federal Reserve, a result of political compromise reached in Congress after a prolonged battle over this issue.

52. The failure of Lehman Brothers, a major U.S. investment bank with worldwide assets and liabilities, has forcefully underscored the importance of regulatory coordination, and ideally preventive intervention, not only across geographic borders but also across sectoral and entity lines. In the wake of the crisis, many reform proposals focused on the need to allocate the authority to resolve large financial conglomerates to a single regulatory agency, such as the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), or a newly established separate resolution authority. The Dodd-Frank Act generally grants the FDIC new resolution authority over a broad range of financial institutions.

53. The U.S. federal system of regulation and supervision of the financial services sector is highly fragmented, with the regulatory authority split among five different agencies overseeing depository institutions (the Federal Reserve, the Office of the Comptroller of the Currency, the FDIC, the Office of Thrift Supervision, and the National Credit Union Administration), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC"). Over the years, numerous proposals called for reducing the number of financial regulators by merging some or all of them. *See*, *e.g.*, U.S. GOV. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE GAO-08-32 (Oct. 2007). In the current debate, various proposals approached this issue in differing ways. *See*, *e.g.*, U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION*, supra* note 2, at 32 (proposing the creation of a single National Bank Supervisor overseeing all federally-chartered banks). By contrast, the Dodd-Frank Act calls only for the elimination of the Office of Thrift Supervision ("OTS").

54. One of the peculiar features of the U.S. system of financial regulation is that insurance industry is regulated and supervised by individual states. Numerous reform proposals over the years advocated the creation of a federal insurance charter and establishing a federal insurance regulator. *See*, *e.g.*, U.S. DEP'T OF TREAS., BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE*, supra* note 2, at 128–29 (proposing an optional federal insurance charter and the creation of the Office of National Insur-

Another important general theme running through the current debate on regulatory reform is regulatory oversight of presently unregulated, or under-regulated, financial markets and institutions. It is now common wisdom that one of the main causes of the recent crisis was the uncontrolled accumulation of financial risk in the so-called "shadow banking system" that operated entirely outside any governmental supervision.[56] To remedy this situation, many proposals call for introduction of some form of direct government regulation and supervision of OTC derivatives markets, as well as hedge funds and other private investment vehicles.[57] Similarly, many proposals seek to subject mortgage brokers and credit ratings agencies to greater oversight.[58]

The third line of proposed reforms aims at strengthening certain existing rules and regulations and enhancing the quality of enforcement and compliance. One of the most prominent issues in this area involves revision of the current capital adequacy regime for banks and other financial

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ance). The Dodd-Frank Act leaves the existing structure of insurance regulation largely intact.

55. Thus, one of the critical issues in the ongoing debate on bank regulation is the extent of federal preemption, especially with respect to states' power to enforce their consumer protection laws in connection with national banks' operations. *See, e.g.*, Watters v. Wachovia Bank, 550 U.S. 1 (2007) (holding that state authorities are precluded from enforcing states' licensing, registration, and inspection laws against state-chartered subsidiaries of national banks); Cuomo v. Clearing House Ass'n, LLC, 129 S. Ct. 2710 (2009) (upholding states' authority to seek judicial enforcement of applicable state laws against national banks).

56. For one of the early attempts to argue that the unchecked growth of the "shadow banking system" was at the core of the growing problems in the financial services sector, see Timothy F. Geithner, Remarks at the Economic Club of New York, Reducing Systemic Risk in a Dynamic Financial System, (June 9, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html (referring to the expansion of a "parallel financial system" vulnerable to runs and other increased risks).

57. *See, e.g.*, U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 46–49. In the second half of 2009, proposals seeking to move the majority of OTC derivatives trading onto organized exchanges and to mandate centralized clearing for such instruments garnered a significant momentum and generated general support among policy-makers and financial institutions. The Dodd-Frank Act explicitly incorporated these proposals.

58. *See, e.g.*, U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 46; CONGRESSIONAL OVERSIGHT PANEL, *supra* note 2, at 7. *See also* Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* (Univ. of San Diego Sch. of Law, Legal Studies Research Paper Series, 2009), *available at* http://ssrn.com/abstract=1430608; 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).

institutions as a way to limit their leverage, enhance liquidity, and better align their capital with their actual risk profiles.[59] Another important topic that falls under the same broad rubric is the proposed creation of an enhanced regulatory and supervisory oversight of financial institutions deemed to be of systemic importance—so-called "systemically important financial institutions," or SIFIs.[60]

Finally, a significant recurring theme in the reform debate relates to the perceived need to strengthen global regulatory and supervisory cooperation and coordination of efforts to monitor cross-border markets and activities for potential accumulation of systemic risk and to adopt measures to deal with such risk effectively and on a timely basis.[61] Although the critical importance of international aspects of regulatory reform is widely acknowledged, there is little clarity or consensus on the specific measures that would be both effective and politically feasible in resolving the deep underlying problems of sovereignty and national differences in regulatory approaches.[62]

Many of the recently advanced regulatory reform proposals combine, in various ways, these key themes and offer highly valuable analytical insights and potential solutions to perceived problems. Nevertheless, the overall discussion of financial regulation reform seems excessively preoccupied with the issues of regulatory structure and architecture. With respect to substantive changes in legal and regulatory frameworks, the prevailing tendency is to focus debate on specific market products or actors directly implicated in the recent financial crisis. In pursuit of concrete, politically viable solutions to identifiable problems, the majority of approaches to regulatory reform tend to lose sight of the fundamental problems that such reforms ultimately seek to address. Characteristically,

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59. *See*, *e.g.*, U.S. GOV. ACCOUNTABILITY OFFICE, FINANCIAL MARKETS REGULATION: FINANCIAL CRISIS HIGHLIGHTS NEED TO IMPROVE OVERSIGHT OF LEVERAGE AT FINANCIAL INSTITUTIONS AND ACROSS SYSTEM, GAO-09-739 (July 2009).

60. *See, e.g.*, U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 51–54; CONGRESSIONAL OVERSIGHT PANEL, *supra* note 2, at 7; Brunnermeier, et al., *supra* note 2, at 24. The Dodd-Frank Act vests the power to identify systemically important financial institutions in the newly created Financial Stability Oversight Council but leaves it largely to the Federal Reserve to determine how such institutions are to be regulated and supervised.

61. *See*, *e.g.*, GROUP OF THIRTY, *supra* note 2; FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW, *supra* note 3.

62. For a general overview of some of the key issues in this area, see, e.g., Douglas W. Arner & Michael W. Taylor, *The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of the International Financial Regulation?*, 32 U.N.S.W.L.J. 488 (2009).

none of the mainstream reform proposals has addressed explicitly the future of industry self-regulation as part of the long-term regulatory transformation in the financial services sector.

B. Potential Benefits of (Reinventing) Financial Sector Self-Regulation

As the recent financial crisis demonstrated, the most fundamental problems that a truly effective regulatory reform must address are the increasing complexity of financial markets and activities and their global reach.[63] The unprecedented speed with which the tremors in the U.S. subprime mortgage market spread worldwide exposed the fundamental vulnerabilities of the global financial system, including the ways in which numerous institutions and investors are intimately interconnected through a web of complex financial transactions and risk exposure.[64] The widespread use of complex financial instruments also greatly contributed to the dangerously high levels of leverage accumulated throughout the system.[65] Thus, in the post-crisis world of finance, the ability of regulatory authorities to detect and prevent, or at least minimize, systemic risk depends ultimately on their ability to manage the complexity and global nature of financial products, institutions, and activities.[66]

This view of the financial crisis leads to two general conclusions. The first conclusion relates to the centrality of information flow to regulatory

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63. *See* Saule 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 (2009).

64. The general issue of regulating complex systems is a fascinating and growing academic field. For some examples of these scholarly analyses, *see*, *e.g.*, Donald T. Hornstein, *Complexity Theory, Adaptation, and Administrative Law,* 54 DUKE L.J. 913 (2005); Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211 (2010).

65. Thus, one of the key examples in this respect is the central role that trading in credit derivatives played in the near-failure and the resulting bailout of American International Group ("AIG"). *See*, *e.g.*, Hugh Son & Zachary R. Mider, *AIG Rescue May Include Credit-Default Swap Backstop*, BLOOMBERG.COM, FEB 26, 2009. For a scholarly analysis of the AIG saga, see William K. Sjostrom, Jr., *The AIG Bailo*ut, 66 WASH. & LEE L. REV. 943 (2009).

66. The role of derivatives in creating or exacerbating the recent financial crisis is a complicated and hotly debated issue. *See*, *e.g.*, Lynn Stout, *How De-Regulating Derivatives Led to Disaster, and Why Re-regulating Them Can Prevent Another*, LOMBARD STREET, Vol. 1, No. 7, at 4 (July 6, 2009), *available at* www.finreg21.com/system/files/Lombard+Street+-+Volume+1+Issue+7.pdf; Rene M. Stulz, *Credit Default Swaps and the Credit Crisis* (Eur. Corp. Governance Inst., Fin. Working Paper No. 264/2009, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1475323 (arguing that credit default swaps did not cause the credit crisis of 2007-2008).

success. It is clear that the key to managing an increasingly complex financial system is timely access to, and ability to process, relevant market information. In a world driven by the never-ending quest for faster and more sophisticated technology, it is critically important that financial regulators maintain their capacity to monitor, identify, evaluate, and promptly respond to the risks and challenges presented by the increasingly complex financial instruments and trading strategies.[67] The second observation concerns the effect of financial globalization on regulatory capacity. In today's increasingly interconnected and globalized financial markets, national governments face serious challenges in their efforts to regulate and supervise internationally active financial institutions. Monitoring cross-border financial activities and enforcing compliance with any single country's laws and regulations is a particularly delicate and complex political task because it raises numerous issues of state sovereignty and extraterritoriality. In the world of sovereign nation-states, national regulators' limited jurisdiction over financial matters is increasingly inconsistent with the seamlessly integrated cross-border operations of modern financial institutions. Despite the ongoing efforts to implement various forms of international coordination and market oversight,[68] this inherent limitation on regulatory capacity continues to com-

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67. *See, e.g.*, Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993); Schwarcz, *supra* note 64.

68. One of the best-known and studied examples of such efforts to institutionalize international regulatory coordination and harmonization is the international capital adequacy accord promulgated by the Basel Committee on Banking Supervision ("BCBS"), an organization comprising heads of central banks and bank supervisors from different countries. For more information on the BCBS and Basel capital adequacy regime, see About the Basel Committee, http://www.bis.org/bcbs (last visited Aug. 7, 2010). Another example of international cooperation in the area of monitoring and enforcing compliance by individual countries with various internationally adopted standards is the Financial Sector Assessment Program ("FSAP") established by the International Monetary Fund ("IMF") and the World Bank. For an analysis of the activities of, and challenges faced by, FSAP since its inception in the late 1990s, see THE FINANCIAL ASSESSMENT PROGRAM AFTER TEN YEARS: EXPERIENCE AND REFORM FOR THE NEXT DECADE (International Monetary Fund and The World Bank, 2009), *available at* http://www.imf.org/external/np/pp/eng/2009/082809B.pdf. However, despite their successes in addressing a variety of specific regulatory issues arising in the global financial marketplace, there remain important limitations on these institutions' ability to provide lasting and universal solutions to the underlying problems of effective regulation and supervision of global and increasingly complex financial markets and institutions. These institutions generally operate through non-mandatory, legally non-binding arrangements dubbed as "soft law." *See generally*, ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER (2004); David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. J. INT'L. L. 547 (2005). Developing these regulatory norms and monitoring

plicate the detection and prevention of risk to the entire global financial system and broader economy.[69]

These two general observations make it clear that, in order to be able to avoid systemic crises in the future, any reform of the financial sector regulation must address two fundamental issues: (1) assuring 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. This Article argues that industry self-regulation, as a form of regulatory intervention into the economy distinct from both direct government regulation and pure market discipline, holds significant promise in terms of addressing these challenges.

It is important to emphasize from the outset that industry self-regulation cannot, and should not fully replace government regulation and supervision of the financial services sector. Government oversight is crucial to ensuring that private financial activity promotes, or at least is consistent with, the broader public interest.[70] Learning the difficult les-

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their implementation is of necessity a heavily negotiated, highly politicized and complex process, and the reach of these institutions is limited. For a recent scholarly discussion of the dilemmas and limitations of international financial regulation, see Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L. L. (forthcoming 2010).

69. Thus, in response to the global financial crisis in 2008-2009, the governments of the Group of Twenty (G-20) began focusing on greater coordination of their regulatory and supervisory activities and called for a number of measures aimed at creating an institutional structure for overseeing financial markets across borders. GROUP OF TWENTY (G-20), DECLARATION SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY, Nov. 15, 2008, *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf. One related proposal envisions an establishment of so-called cross-border supervisory "colleges" in charge of supervising individual financial conglomerates with operations in multiple countries. The G-20 leaders called for redefining the role of the International Monetary Fund as a *de facto* global "lender of last resort" monitoring financial stability on international level. Larry Wall, et al., Creating an EU Level Supervisor for Cross-Border Banking Groups: Issues Raised by the U.S. Experience with Dual Banking (unpublished manuscript, presented at Federal Reserve Bank of Dallas Conference, EU Economic Integration: Lessons of the Past, and What Does the Future Hold?, Mar. 18, 2010), *available at* www.dallasfed.org/institute/events/2010/10eu_mayes.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 About the Financial Stability Board*, http://www.financialstabilityboard.org (last visited Aug. 6, 2010). 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 in practice. 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.

70. *See infra* notes 125–127 and accompanying text.

sons of the latest financial crisis, national governments and domestic and international regulatory bodies are actively working toward refining and improving financial regulators' and supervisors' capacity to access and manage market information, both domestically and across borders. Many of the currently contemplated regulatory reforms aim precisely at the principal weaknesses identified in these areas.

However, despite the fact that these reform efforts, without a doubt, are both important and necessary, government agencies may be ultimately facing an uphill battle in this respect. There are compelling reasons to believe that, in today's world, government regulators may be increasingly less effective in managing the complexity and internationalization of financial markets, particularly if they continue relying on the traditional regulatory methods and techniques. Involving private institutions in the process of actively regulating complex, information-intensive financial activities and markets may serve as an effective and efficient supplement to governments' efforts, thus offering an important potential solution to this fundamental regulatory problem.

With respect to access to market information, private actors have a significant potential advantage over government regulators in terms of their relative ability to identify, analyze, and evaluate potential systemic implications of the underlying trends in the global financial markets, particularly with respect to complex financial products and transactions. As a general matter, private investors and financial institutions are better equipped to access the key market data in real time and to process that information intelligently and efficiently. Their "insider" position enables private market participants to make potentially better-informed judgments as to what financial information is relevant to issues of systemic risk prevention, and how any particular piece of such information affects the broader picture. The industry actors' relatively greater potential ability to understand and analyze increasingly complex and overwhelmingly voluminous financial information represents a crucial advantage from the perspective of regulatory efficiency and efficacy.

It is important to keep in mind that this informational advantage is a relative phenomenon. It is meant to emphasize only that financial institutions, by virtue of their very position as key participants in financial markets and actual creators and users of complex financial instruments, are inherently in a better position to understand and analyze the bottom-up patterns of systemic financial risk than government regulators. Acknowledging the industry's relative informational advantage is not the same as claiming that financial institutions, in fact, always possess the perfect knowledge and understanding of system-wide trends and vulnerabilities and, therefore, should replace government as the sole source of

regulatory decision-making. As the recent crisis so aptly demonstrated, even the highest-level executives at the most sophisticated financial firms around the world have not always been able to detect and measure the true extent of risk their companies carried on, or off, their balance sheets.[71]

Nevertheless, even allowing for all these complexities in the modern-day fragmentation of knowledge,[72] it is fair to say that government agencies in charge of the financial services sector suffer from serious built-in informational disadvantages vis-à-vis financial institutions. Under the existing legal and regulatory framework, U.S. financial regulators, as a general matter, do not require reporting of all trading data or other market information by financial institutions. The bulk of the most complex financial transactions take place in the over-the-counter, or OTC, markets, where individual counterparties enter in bilateral contracts that do not have to be publicly disclosed or reported to the regulators. To the extent the regulatory and supervisory authorities get access to this type of market information, it usually happens after the fact, at times significantly so, and on an aggregated basis, either with respect to a specific firm or an entire market segment.[73] While this information is very important for

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71. *See*, *e.g.*, *Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. (2010) (testimony of Richard S. Fuld, Jr.), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/fuld_4.20.10.pdf [hereinafter, Fuld Testimony]. In this statement, the former CEO of Lehman Brothers claimed that he had absolutely no recollection of ever hearing anything about the so-called "Repo 105" transactions used to hide the true extent of Lehman's debt.

72. Thus, Julia Black describes this phenomenon as "fragmentation, and construction, of knowledge" in today's complex society:

> In the decentered understanding of regulation, however, the information problem is more complex. For unlike the traditional analysis, it does not assume that any one actor has all the information necessary to solve social problems: it is not a question of industry having, government needing. Rather, 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 21, at 107.

73. For example, Office of the Comptroller of the Currency ("OCC"), the primary regulator of the U.S. federally chartered banks, collects information on U.S. banks' OTC derivatives transactions mainly through the analysis of the mandatory quarterly financial reports and the process of on-site examination of individual banking institutions. The OCC then aggregates the information on an industry-wide basis and publishes, on a quarterly basis, a report on the total size and trends in the OTC derivatives activities of U.S. commercial banks. *See*, *e.g.*, OCC's Quarterly Report on Bank Trading & Derivatives

the purposes of gauging the overall size of, and trends in, the relevant markets, it is of a limited usefulness in terms of enabling the regulators to keep up with the developments in some of the most complex, and rapidly expanding, financial markets.

Of course, it is possible to change the law to mandate real-time reporting of all, or most, market information that currently goes unreported to financial regulators.[74] However, such a measure would hardly resolve the underlying issue of regulatory capacity to make efficient use of such information. For example, if all trade data in the OTC financial markets is collected and reported directly to the government agencies, the sheer amount of such data may prove to be overwhelming, especially given the perennial staffing and budgetary constraints at the agencies. Moreover, increasingly sophisticated trading strategies involving complex coordinated plays across many different asset classes may not be readily visible to the regulator's eye, even if the individual elements of a particular strategy are disclosed to such regulator as part of the mandatory reporting process. As a result, it may be extremely difficult, if not impossible in most cases, for the regulatory authorities to discern potentially troublesome signs of systemic vulnerabilities emerging in the markets for complex financial products in time to be able to respond to them.[75] Although U.S. financial regulators accumulated significant experience with monitoring securities and futures markets for potentially abusive or fraudulent activities, detecting potential systemic risk accumulation requires a much more nuanced and intimate understanding of how all pieces of this highly complicated puzzle fit together. Even the best and most efficient government agencies are unlikely to possess sufficient expertise—

Activities, Fourth Quarter 2009 1, 1 (Comptroller of the Currency Adm'r of Nat'l Banks, Mar. 19, 2010), *available at* http://www.occ.treas.gov/ftp/release/2010-33a.pdf.

74. In fact, several legislative proposals to require reporting of all OTC derivatives trades to regulatory agencies have been put forward in 2009. 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.

75. It is worth noting that the supervisory practice of placing resident examiners at the largest and most complex financial institutions, as it exists in the U.S. banking sector, is not necessarily effective in assessing systemic financial risks and vulnerabilities. Even if resident examiners may develop a thorough understanding of a particular firm's business operations and risk profile, they are hardly in a position to assess broader risks to the financial system because the focus of their examination remains on an individual enterprise. Thus, despite the fact that, beginning in March 2008, examiners from the SEC and the Federal Reserve were stationed at Lehman Brothers and monitored the firm's activities on a daily basis, they failed to foresee or avert the firm's ultimate failure. *See* Fuld Testimony, *supra* note 71, at 2.

as well as financial and organizational resources—to meet that challenge.[76]

An obvious practical difficulty in this respect is that, in order to enhance their professional expertise, government agencies have to hire the best available specialists in the relevant areas and offer these experts compensation high enough to lure them away from potentially lucrative employment at investment banks and hedge funds. Competing with the private sector on these terms is hardly a viable proposition for government agencies. 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, the level of one's education or natural brilliance does not necessarily translate into the 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.

This expertise deficit, coupled with the resource limitations, is a significant disadvantage of a system relying exclusively on direct government oversight of systemic risk in an increasingly complex financial universe. In such a system, the regulators will always run the risk of staying at least a step behind the industry, not only in a temporal sense but also in terms of understanding substantive implications of market practices and trends for systemic risk prevention. At the same time, private industry actors, free of regulatory responsibility and armed with superior market knowledge and financial and technological resources, will keep finding new methods of circumventing government-imposed rules and regulations. The government agencies' attempts to gather more information and impose more onerous rules are likely to create further incentives for the industry to evade regulatory limits.[77] This self-perpetuating dynamic,

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76. In fact, many commentators on financial regulation reform lament the fact of such 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); Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK J. CORP. FIN. & COM. L. 317, 331 (2007).

77. Regulatory arbitrage is the fundamental challenge facing regulators in an increasingly complex financial sector environment. *See*, *e.g.*, Edward J. Balleisen & Marc Eisner, *The Promise and Pitfalls of Co-Regulation: How Governments Can Draw on Private Governance for Public Purpose*, *in* NEW PERSPECTIVES ON REGULATION 127, 143 (David Moss & John Cisternino eds., 2009); WOLFGANG SCHULZ & THORSTEN HELD, REGULATED

putting the regulators and the private actors on opposite sides of a regulatory arbitrage game, is likely to elevate the level of complexity in the global financial markets and further exacerbate potential systemic risk.

In principle, the government can attempt to resolve this fundamental problem by pursuing a radical solution and imposing strict absolute limits on the level of risk in the financial system. One example of such regulatory strategy would be an outright prohibition on certain types of complex financial products, such as, credit default swaps.[78] Extending the application of state anti-gambling statutes and so-called "bucket shop" prohibitions to certain derivative instruments would also outlaw such products.[79] A less drastic alternative would be a requirement of prior regulatory approval for complex financial products. Although the mandatory approval system stops short of direct product prohibition, for many practical reasons, it is likely to have the same practical effect. While potential benefits and disadvantages of pursuing these options are the subject of ongoing academic debates, as a practical matter, they may not be feasible, at least in the foreseeable future. Part of the reason is the politi-

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SELF-REGULATION AS A FORM OF MODERN GOVERNMENT B11–B12 (Interim Report for Study commissioned by the German Federal Commissioner for Cultural and Media Affairs, Oct. 2001), *available at* http://www.humanrights.coe.int/media/documents/interim-report-self-regulation.pdf; Sinclair, *supra* note 20, at 542.

78. A credit default swap ("CDS") is a derivative instrument under which one party (seller) sells to another party (buyer) protection against default on a credit obligation of a third party (a reference entity). *See*, *e.g.*, PAUL C. HARDING., A PRACTICAL GUIDE TO THE 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 6 (2004). In 2009, various proposals to outlaw so-called "naked" CDS transactions, in which the buyer of protection does not have an actual credit exposure to the reference entity and essentially uses the CDS as a means of speculation, were under consideration. For instance, in November 2009, the National Conference of Insurance Legislators, an organization consisting of state legislators involved in oversight of their states' insurance regulatory matters, voted to approve so-called Credit Default Insurance Model Legislation that prohibited "naked" CDS contracts. *See* Press Release, Nat'l Conf. of Ins. Legislators (NCOIL), NCOIL Approves CDI Legislation, Eliminates "Naked" Swaps (Nov. 25, 2009), *available at* http://www.ncoil.org/HomePage/2009/11232009CDIPressRelease.pdf.

79. *See*, *e.g.*, Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions,* 26 J. CORP. L. 225, 256 (2001) (explaining the operation of state anti-gambling and anti-bucket shop statutes); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 729 (1999); Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance,* 24 ANN. REV. BANKING & FIN. L. 375, 395 (2005). For a more detailed discussion of the history of state anti-gambling statutes and "bucket shop" prohibitions, see Thomas Lee Hazen, *Rational Investment, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effects on the Underlying Capital Markets*, 86 NW. U. L. REV. 987 (1992).

cal difficulty of passing legislation that would essentially shut down a significant part of the U.S. financial markets. This type of legislation would likely draw fierce opposition and heavy lobbying by the financial industry. Even more importantly, even if lawmakers did adopt such drastic measures, it is unclear whether the regulators would be able to implement and enforce them effectively, especially given the financial institutions' cross-border mobility and arbitrage capacity.[80]

With respect to globalization and cross-border fluidity of financial activities, industry self-regulation also has significant potential advantages over direct government regulation. In today's globalized world, cross-border arbitrage significantly undermines national governments' ability to implement and enforce laws and regulations they consider vital for the purposes of maintaining their domestic economic stability or meeting other socio-economic or political goals.[81] Moreover, strict application and enforcement of domestic laws and regulations to internationally active financial institutions frequently raises thorny issues of extraterritoriality and jurisdictional overreach.[82] In order to be able to monitor and enforce compliance with domestic law, government regulatory agencies are becoming increasingly dependent on cooperation and assistance of their foreign counterparts, most notably with respect to information-sharing and coordination of enforcement activities, and are searching for creative ways to ensure such cooperation.[83] Despite the ongoing efforts to ensure international regulatory cooperation in the formulation of rules,

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80. In the aftermath of the recent financial crisis in Greece, which threatened stability of the entire Eurozone, the EU authorities began considering limiting the use of certain credit derivatives that were viewed as contributing factors in that crisis. *See* David Oakley, *Moves in Motion to Limit CDS Use*, FIN. TIMES, Feb. 24, 2010, *available at* http://www.ft.com/cms/s/0/608abed2-218b-11df-830e-00144feab49a.html.

81. *See*, *e.g.*, Ethipois Tafara & Robert Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L. L.J. 31, 32 (2007).

82. *See* Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327 (2010).

83. For instance, in addition to using traditional inter-agency Memoranda of Understanding establishing a framework for bilateral regulatory cooperation in specific areas, the U.S. financial regulators are increasingly relying on more subtle and indirect methods of actively encouraging foreign governments to adopt regulatory and supervisory approaches similar to those underlying the U.S. system. Among others, one such method involves lifting or easing barriers to entry into the U.S. financial markets for foreign market intermediaries. For an insightful analysis of the challenges national regulators face in their search for a greater and more effective international harmonization, see, for example, Brummer, *supra* note 82.

as well as their implementation and enforcement, significant problems continue to plague such efforts.[84]

By contrast, private economic actors—financial institutions and investors—are not constrained by jurisdictional considerations and are able to oversee and manage their business affairs across national borders much more seamlessly than any government agency. In fact, the U.S. laws and regulations essentially mandate that large, internationally active financial institutions manage their business risk on a consolidated basis.[85] As a result, industry actors are potentially better situated to monitor and manage risk to the financial system on a truly global basis.[86]

Importantly, this Article does not argue that the financial services industry can, or will, actually perform the regulatory functions better than the government. The argument here is merely that the financial industry has certain built-in potential advantages with respect to its ability to address the key regulatory challenges posed by the increasing complexity and globalization of financial markets and activities. Leveraging this uniquely advantageous position of private market participants for the purposes of addressing these challenges may offer an effective method of controlling systemic risks in global financial markets. Imposing responsibility for regulating and minimizing systemic risk directly on financial institutions can serve as a powerful addition to the ongoing efforts to strengthen the government regulatory framework and market-based incentives for more prudent financial conduct.

Whether or not, and to what extent, this regulatory potential is realized in practice depends ultimately on the institutional design and the broader incentive structure within which a self-regulatory regime exists. First and foremost, 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.

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84. *See*, *e.g.*, THE FINANCIAL CRISIS AND INFORMATION GAPS: REPORT TO THE G-20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS (prepared by the Int'l Monetary Fund Staff and the Fin. Stability Bd. Secretariat, Oct. 29, 2009), *available at* http://www.financialstabilityboard.org/publications/r_091107e.pdf.

85. *See*, *e.g.*, 12 C.F.R. § 225.200(b) (2009).

86. *See*, *e. g.*, Balleisen, *supra* note 36, at 443 ("Whatever the limitations associated with private regulation, it sometimes offers the only practical means of constraining the behavior of multi-national corporations whose production facilities and distribution networks span the globe.").

III. REINVENTING SELF-REGULATION IN THE FINANCIAL SECTOR: FROM SROS TO "EMBEDDED SELF-REGULATION"

Financial industry self-regulation is by no means a new concept. Various self-regulatory arrangements operate, with different degrees of success, in many countries and in multiple institutional settings. In the U.S., self-regulation is one of the defining characteristics of the existing regulatory scheme in the securities industry but is virtually absent in banking or insurance. This Part examines the existing self-regulatory regime in the U.S. securities industry and argues that a fundamental shift in the entire paradigm of financial sector self-regulation is necessary in order to overcome its current limitations from the perspective of monitoring and minimizing systemic risk.

A. The SRO System: Existing Self-Regulation in the U.S. Securities Industry

Self-regulation of market intermediaries through a system of statutorily established SROs is one of the core elements of the U.S. securities regulation framework. Under the Securities Exchange Act of 1934,[87] a variety of SROs, including national securities exchanges and the Financial Industry Regulatory Authority ("FINRA"), exercise extensive oversight over securities broker-dealers, stock exchange members and listed companies, and other market intermediaries.[88] Stock exchanges were the original self-regulatory organizations that governed the trading of securities and regulated their members well before the creation of the Securities Exchange Commission ("SEC") and the current statutory framework formalizing their SRO status.[89] The New York Stock Exchange ("NYSE") is the largest and most important SRO among the registered national securities exchanges.[90] However, it is FINRA, a national securities association formed in July 2007 by merging its predecessor, the National Association of Securities Dealers ("NASD"), with the NYSE's

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87. Securities Exchange Act of 1934, 48 Stat. 881(codified as amended at 15 U.S.C. § 78a–78mm (2000)).

88. *See* 15 U.S.C. § 78f; 15 U.S.C. § 78o-3.

89. *See*, *e.g.*, Roberta S. Karmel, *The Future of Self-Regulatory Organizations*, N.Y. LAW J., June 18, 2009, at 3; Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for Accommodation*, 62 N.C. L. REV. 475, 481 (1984).

90. For general information on NYSE, see New York Stock Exchange Euronext, About Us, http://www.nyse.com/about/1088808971270.html (last visited Aug. 7, 2010).

regulatory arm, that is the single largest SRO regulating securities broker-dealers.[91]

Under the statutory scheme, SROs are primarily responsible for establishing the standards under which their members conduct business and monitoring the way their members conduct their business in practice. Securities SROs enforce compliance by their members with the U.S. securities laws and regulations and discipline their members for violating such laws and regulations, as well as SROs' own rules.[92] The SRO regulatory oversight focuses heavily on monitoring and investigating suspicious activities in securities trading, detecting and preventing securities fraud and other forms of investor abuse, and generally acting as one of the key gatekeepers in the securities markets.[93] It is hardly an exaggeration to say that the fundamental objective of self-regulation in the U.S. securities industry is "investor protection and market integrity through effective and efficient regulation."[94]

To fulfill their regulatory responsibilities, securities SROs maintain extensive rulebooks governing in detail the day-to-day conduct of business by their members. For example, FINRA Rules contain detailed provisions mandating how broker-dealers communicate with customers and what types of information they provide to them. Numerous standards govern how securities professionals segregate and safeguard customers' funds, collateralize extensions of credit to customers, and make recommendations to their clients with respect to securities transactions. Furthermore, a long list of FINRA rules deal with the members' duty to supervise the actions of their employees, maintain books and records, and

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91. 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 the end of 2009, it oversaw "nearly 4,800 brokerage firms, about 171,400 branch offices and approximately 644,000 registered securities representatives." *See About the Financial Industry Regulatory Authority,* http://www.finra.org/AboutFINRA/index.htm (last visited Aug. 8, 2010).

92. *See generally,* JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER DEALER OPERATIONS AND REGULATION UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES, CREDIT REGULATION, AND CUSTOMER PROTECTION (2009).

93. For instance, FINRA administers the federal scheme of licensing and examinations for securities broker-dealers and their employees, while securities exchanges maintain listing requirements for companies issuing securities.

94. *See* 2008 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT: REFORMING REGULATION TO BETTER PROTECT INVESTORS 8 (Financial Industry Regulatory Authority, 2009), *available at* http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p119061.pdf.

so forth.[95] Virtually every aspect of securities firms' everyday activities, down to the most detailed and mundane tasks, is subject to various, frequently overlapping, SRO rules.[96]

The SEC exercises extensive oversight of SROs through a variety of mechanisms, including review and approval of SROs' rule proposals, as well as any changes or amendments to their policies and procedures, and periodic inspections of their operations.[97] The SEC has an independent statutory authority to regulate the activities of securities broker-dealers and other market intermediaries directly. However, in practice, the agency has fully delegated these regulatory functions to privately funded SROs, choosing instead to function as the watchful guard and supervisor ensuring that the SROs perform their statutory duties in an appropriate manner.[98]

To a great extent, the U.S. system of securities SROs is a historical product of political compromise[99] and economic expediency.[100] In many respects, it represents "a peculiar mix of private sector self-regulation and delegated governmental regulation."[101] This model of financial industry self-regulation, which constitutes an integral part of the post-Great Depression regulatory paradigm, is fundamentally limited in its scope. Effectively, securities SROs operate as quasi-governmental entities per-

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95. *See Financial Industry Regulatory Authority (FINRA) Rules*, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=607 (last visited Aug. 8, 2010).

96. As part of the establishment of FINRA, the old NASD Rules and the NYSE Rules are in the process of being consolidated in a single rulebook, which is meant to streamline compliance and eliminate the unnecessary duplication of standards. *See Financial Industry Regulatory Authority (FINRA) Regulation – FINRA Rules*, http://www.finra.org/Industry/Regulation/FINRARules/.

97. *See*, *e.g.*, 15 U.S.C. § 78s(b)-(c) (2000) (establishing procedures for filing with the SEC of any proposed rule or any proposed change to the existing rules of any SRO).

98. The SEC's Office of Compliance Inspections and Examinations ("OCIE") conducts routine and special inspections of SRO regulatory and enforcement programs. *See* U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examination, http://www.sec.gov/about/offices/ocie.shtml (last visited Aug. 8, 2010).

99. *See*, *e.g.*, Smythe, *supra* note 89.

100. As one commentator put it,

> Although 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.

Dombalagian, *supra* note 76, at 323.

101. Karmel, *supra* note 15, at 151.

forming the most resource-intensive tasks "outsourced" to them by the SEC.

In recent years, rapid increase in computerized trading across markets[102] and a string of governance failures at major stock exchanges[103] led to what some observers describe as an "identity crisis" of the SROs in the securities industry.[104] A particularly intensely debated issue is the future of securities exchanges, which were historically the first self-regulatory membership associations in the industry. In the past decade or so, securities exchanges around the world have been going through demutualizations, cross-border mergers, and attempts to resolve the conflict of interest inherent in their dual function as a regulator and a profit-seeking economic enterprise.[105] In addition, commentators continue to raise serious questions about how effective and efficient the existing securities industry SROs really are, particularly in light of their increasing bureaucratization and close integration into the federal government regulatory scheme.[106]

In late 2004, the SEC weighed in this debate by issuing a Concept Release discussing and soliciting public comments on the potential role, fairness, and efficiency of the existing SRO structure in the changing market context.[107] In its Concept Release, the SEC discussed several potential structural alternatives to the current SRO system. These alternatives included, among other things, the establishment of a single SRO or a non-industry self-regulatory body (similar to the Public Company Accounting Oversight Board formed pursuant to the Sarbanes-Oxley Act)

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102. As a result of recent technological advances, securities exchanges around the world are facing increasingly stiff competition from various electronic communication networks ("ECNs") that are attracting a growing share of trading in listed securities. *See*, *e.g.*, Jeremy Grant, *Sweeping Changes are On the Way*, FIN. TIMES, Oct. 20, 2009; Michael Mackenzie, *U.S.: High Frequency Trading Dominates the Debate*, FIN. TIMES, Oct. 20, 2009.

103. *See*, *e.g.*, Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW 1347 (2004).

104. *See* Dombalagian, *supra* note 76.

105. *See, e.g.*, Karmel, *supra* note 89; Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435 (2008); Eric J. Pan, *A European Solution to Regulation of Cross-Border Markets*, 2 BROOK. J. CORP. FIN. & COM. L. 133 (2007); Roberta Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355 (2007); Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563 (2005).

106. *See*, *e.g.*, Dombalagian, *supra* note 76; Karmel, *supra* note 15.

107. Concept Release Concerning Self-Regulation, 69 Fed. Reg. 235, 71256–71282 (issued Dec. 8, 2004), *available at* http://www.sec.gov/rules/concept/34-50700.pdf.

overseeing the entire securities industry and even the abolishment of self-regulation in favor of direct SEC regulation and supervision.[108] While causing quite a stir within the securities industry at the time of its publication, the SEC's Concept Release did not lead to any fundamental changes in the SRO system. Serious concerns about the overall efficiency and legitimacy of securities SROs continue to persist, especially in light of the SROs' failure to detect and prevent major market abuses that led to, or were uncovered in the course of, the recent financial crisis.[109] As global financial markets evolve, driven by technological innovation, and as the traditional lines between financial products and institutions dissipate, policy-makers and academics debate the future of securities SROs and the ways to adapt their structure and functions to new challenges. However, these discussions generally do not address the broader conceptual issue of whether or not the very foundational premises of the existing SRO model continue to make sense in light of the regulatory challenges posed by the 21st century's financial marketplace.

B. Toward a New Paradigm of Financial Industry Self-Regulation

This Article argues for the reinvention of the old concept of self-regulation to fit the realities of today's financial markets and to tackle the fundamental challenge posed by the increasing complexity and global scope of financial activities and products. The purpose of the following discussion is quite modest: to start a broader long-term conversation on this critically important topic by calling for a fundamental shift in our conception of the principal goals, scope, and function of self-regulation in the post-crisis financial services sector.

1. Drawing conceptual boundaries

As a preliminary matter, it is helpful to address some fundamental definitional issues and state explicitly the basic assumptions that inform the following discussion.

First, it is important to re-emphasize that the notion of self-regulation used in this Article does not denote a system of pure private ordering of economic activity and complete absence of any government regulatory

108. *Id*., at 71275–71282.

109. Perhaps the most infamous recent example of such failure on the part of SROs is the scandal involving Bernie Madoff's Ponzi scheme that was allowed to run for years despite the numerous warnings. *See* Diana B. Henriques, *Madoff Is Sentenced to 150 Years for Ponzi Scheme*, N.Y. TIMES, June 29, 2009, at B1, *available at* http://www.nytimes.com/2009/06/30/business/30madoff.html?pagewanted=1&_r=2&hp.

intervention. Contrary to a common misperception, self-regulation is not identical to "de-regulation." The concept of self-regulation advocated here is a significantly more complex and flexible regime combining private rule-making by industry actors with direct government regulation.

Secondly, this Article advocates a system of self-regulation that fundamentally differs from various forms of public-private partnership arrangements, in which private firms participate in the process of rule-making ultimately exercised by the government.[110] To utilize fully the potential benefits of financial sector self-regulation, it is essential to allow the financial services industry to engage in promulgating and enforcing the actual rules governing its members' conduct. Similarly, self-regulation, as that term is used in this Article, is conceptually separate from so-called "private regulation" where a single member of a group of private entities (such as credit rating agencies or outside auditors) makes or enforces rules applicable to the rest of that group.

Finally, the concept of self-regulation, as used in this Article, refers to an industry-wide self-regulatory regime, as opposed to any form of intra-firm governance or internal risk management. This is a critically important distinction, because the underlying dynamics and the key factors determining potential success or failure of self-regulation may operate differently on the level of an entire industry, as opposed to an individual enterprise.[111]

In this respect, the new model of industry self-regulation advocated here should not be confused with the arrangements envisioned under the recently revised international capital adequacy regime known as Basel

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110. For a discussion of "negotiated rulemaking," see, e.g., Freeman, *supra* note 27.

111. Of course, this is not to say that there are no significant parallels in this respect between these two forms of self-regulation. There is a rich body of scholarly analysis of some of the key incentives and disincentives to self-regulate on the part of individual firms, both in the financial sector and in other settings. *See, e.g.*, Braithwaite, *supra* note 38; Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127 (2009); Miriam H. Baer, *Governing Corporate Compliance,* 50 B.C. L. REV. 1 (2009); Macey & O'Hara, *supra* note 105. 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 an individual enterprise—such as a corporation complying with corporate governance rules, a financial institution implementing regulators' capital adequacy requirements, or a stock exchange juggling its regulatory responsibilities with its business interests as a profit-generating entity—may differ in certain significant respects from the incentives and disincentives that shape decision-making at the level of the industry as a collective actor.

II.[112] Adopted in 2004, the Basel II framework allows large, internationally active financial institutions to use so-called Internal Ratings-Based ("IRB") approaches to calculate the amount of regulatory capital they must hold against their risk-weighted assets. In contrast to the original Basel Capital Accord of 1988 ("Basel I"), under which regulators assigned risk weights to specified categories of assets,[113] the IRB methodology essentially enables financial institutions to exercise this previously governmental function on the basis of their internal modeling. This system is often viewed as an example of the New Governance approach to capital regulation enabling private market participants to manage their own risks,[114] endorsed by some as encouraging financial innovation and criticized by others as effectively removing regulatory constraints on financial firms' risk-taking.[115] However, it is worth emphasizing that this particular type of regulatory devolution, while it may be conceptualized as a form of enterprise-level self-regulation by financial firms, is fundamentally different from a self-regulatory model aimed explicitly at managing systemic risk, rather than enterprise risk, through an industry-wide self-regulatory mechanism.

There are important practical reasons for focusing on an industry-wide self-regulatory regime, the most important of which relate fundamentally to the nature of the risk such regime is supposed to address. As the recent financial crisis so aptly demonstrated, placing the main regulatory focus solely on individual financial institutions' internal risk management is not effective with respect to detection and prevention of systemic risk in the financial sphere.[116] An individual firm managing its own risk and calculating its own capital requirements may very well engage in a form of "self-regulation" but it makes its regulatory decisions on the basis of

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112. *See* BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK – COMPREHENSIVE VERSION (Basel Comm. on Banking Supervision, 2006), *available at* http://www.bis.org/publ/bcbs128.htm.

113. *See* INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (Basel Comm., 1998), *available at* http://www.bis.org/publ/bcbsc111.htm.

114. *See*, *e.g.*, 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. (forthcoming 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1552013##.

115. *See*, *e.g.*, Krawiec, *supra* note 111 (criticizing the Basel II approach to operational risk).

116. For a discussion of the shortcomings of individual financial firms' risk management systems, see, e.g., James A. Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV 731(2009); 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).

comparing potential costs and benefits of each action to the firm as an individual profit-seeking entity. However, in today's world of complex global financial transactions, potential sources of systemic crises are difficult to detect and often rooted in patterns of market interconnectedness that are outside any single firm's internal governance or business activities.[117] From this perspective, even the most successful regime of entity-level self-regulation is inherently limited as a means of identifying and addressing the threats to the financial system as a whole.

To summarize, the following discussion is based on the working definition of self-regulation as a regime of collective rule-making, a "regulatory process whereby an industry-level (as opposed to a governmental or firm-level) organization sets rules and standards"[118] governing the behavior of the members of that industry and exercises a degree of monitoring and enforcement of compliance with the rules.[119]

Of course, this attempt to delineate the universe of self-regulatory institutions relevant for the purposes of this Article allows for an extremely wide variety of specific forms such institutions may take.[120] Emphasizing collective rule-making and enforcement as the key elements of self-regulation may merely help to define the continuum along which numerous self-regulatory institutions co-exist. Nevertheless, at this initial stage of inquiry into the future of self-regulation in the financial services sector, attempts to develop a more specific (and therefore more rigid) definition of what constitutes self-regulation may be counterproductive and unnecessarily limiting. Ultimately, it is the specific design of the new system of financial self-regulation—its normative basis, core substantive principles, procedural mechanisms, and organizational structure—that would define its place along that continuum.

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117. *See*, *e.g.*, Schwarcz, *supra* note 64.

118. Gunningham & Rees, *supra* note 41, at 364–65.

119. The concept of industry self-regulation, as used in this Article, does not encompass activities of trade associations whose primary purpose and function is lobbying on behalf of the industry or representing the industry's interests in political process.

120. For example, numerous voluntary product certification programs also set standards for individual enterprises seeking to receive certifications for their products or processes. *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 (2003). Different self-regulatory organizations may also differ in their use of coercion, or sanctions for non-compliance methods. *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 (2000).

2. Making the normative shift: "embedded self-regulation"

From a normative perspective, the fundamental rationale for designing a new self-regulatory model in the financial services sector should be prevention of systemic risk on a global basis. As discussed above, the main flaw of the existing system of the U.S. securities SROs is its relatively narrow scope and its focus primarily on the mundane aspects of securities firms' conduct of business. By contrast, the challenge of detecting and managing systemic risk in today's complex global financial markets requires a qualitatively new model of financial sector self-regulation, one that is significantly more comprehensive and systemic in its scope and operation.

At the heart of the new model of financial sector self-regulation, advocated here, is a fundamentally new guiding principle of "embeddedness." This model of "embedded self-regulation" seeks to redefine the delicate balance between financial institutions' freedom to regulate their own increasingly complex activities in the most economically efficient way, on the one hand, and their duty to conduct their legitimate profit- and risk-generating business in accordance with the overarching public interest in preserving financial stability, on the other. The goal of this model is to enhance the ability of private market participants to adopt and enforce rules governing their business activities but combine it with a greater, and more explicit, responsibility for the broader economic and societal effects of such activities. In effect, this new approach to self-regulation seeks to "embed" financial practices in the broader social values and regulatory principles, instead of "disembedding" them from the public interest.[121]

The concept of embeddedness represents a qualitatively new approach to financial industry self-regulation.[122] Empirical experience shows that

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121. *See* Rawi Abdelal & John G. Ruggie, *The Principles of Embedded Liberalism: Social Legitimacy and Global Capitalism*, *in* NEW PERSPECTIVES ON REGULATION 151–62 (David Moss & John Cisternino eds., 2009).

122. To social scientists, the term "embedded self-regulation" may be reminiscent of Peter Evans' classic concept of "embedded autonomy." Examining the strategies of economic development pursued by the East Asian "tigers," Evans argued that the key to their developmental success was those states' ability to be at once autonomous from business interest groups and firmly "embedded" within domestic business elites. According to Evans, this "embeddedness" is the key to the developmental state's capacity to tailor its economic policies to local business realities and to implement its policies more effectively and efficiently. *See* PETER EVANS, EMBEDDED AUTONOMY: STATES AND INDUSTRIAL TRANSFORMATION (1995). One may argue that, in parallel to Evans' approach, this Article should use the term "embedded regulation," instead of "embedded *self*-regulation," to describe its normative goal. While there is a good basis for conceptualizing the envisioned self-regulatory regime as a system for "embedding" government regulation in the

private market participants may choose to regulate their activities, either on an individual entity-level or collectively, for a wide variety of reasons. In many contexts, private actors are motivated purely, or primarily, by their self-interest, such as where they introduce voluntary private regulatory mechanisms in order to increase their market share or minimize their transactions costs.[123] These underlying objectives shape the nature and functions of each particular self-regulatory regime. By injecting public policy interests directly and explicitly into the very center of the financial industry's self-regulatory arrangements, the model of embedded self-regulation seeks to redefine the broader social role of the private financial sector and impose the primary responsibility for guarding financial stability against excessive risks on the collective creator of such risks.

Of course, it may be argued that it is naïve to expect self-interested private parties to impose voluntary limitations on their own profit-seeking activities for the sake of the highly diffused and indeterminate public benefits. There must be strong incentives to induce financial institutions to accept collective responsibility for minimizing systemic risks and guarding financial stability, at the expense of their individual and immediate profit. Given what we know about the financial industry's compensation structure, governance, and overall culture, it is highly doubtful such incentives currently exist. In the absence of such incentives, allowing the greedy and unconscious Wall Street types to run their own affairs may lead to greater abuses and future calamities.[124]

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industry's institutional structure and culture, doing so would shift focus to direct government regulation as the primary object of the inquiry. In that sense, 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: it is the industry's governance of its own affairs that needs to be organically connected to, and more deeply reflective of, the broader social and regulatory environment in which the industry operates.

123. Thus, one of the best-known examples of such successful standard-setting is the derivatives documentation developed by the International Swaps and Derivatives Association ("ISDA"), a powerful trade association representing global derivatives industry. See *International Swaps and Derivatives Association, Inc. (ISDA)*, http://www.isda.org/ (last visited Aug. 8, 2010). For a detailed examination of ISDA's development and market activities, see generally Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211 (2001).

124. While a healthy dose of skepticism in this respect is both justified and helpful, it may be overly pessimistic to dismiss entirely the potential effects of other-regarding behavior, which presents a powerful source of human motivation. *See*, *e.g.*, Lynn A. Stout, *Social Norms and Other-Regarding Preferences*, *in* NORMS AND THE LAW 13 (John N. Drobak ed., 2006).

In order to guard against the many dangers associated with private regulation and to ensure proper functioning of this new public-minded model of financial sector self-regulation, it is critical to create and maintain a strong and effective system of government regulation, which defines key policy objectives and monitors performance of self-regulatory institutions. Successful and socially useful industry self-regulation cannot be entirely free from government intervention but must be firmly "embedded" within the system of government regulation and oversight.[125]

The nature of the risk in the financial sector makes vigilant government oversight of the industry's self-regulatory process particularly important. In the financial sphere, there is a strong correlation between individual actor's risks and rewards, where riskier activities tend to increase a financial institution's potential to reap higher short-term profits, creating powerful incentives for excessive risk-taking. Furthermore, the risk of a major financial meltdown is inherently systemic and may be triggered by events outside of any particular entity's control.[126] Finally, the overall risk in the financial system tends to accumulate during the good times of rising asset prices and soaring investor confidence, which may seriously constrain the industry's ability and resolve to detect and lower systemic risk.[127] Comprehensive government regulation and supervision are necessary as the principal external safeguard against these tendencies and a critical check on the financial industry's ability to regulate its affairs. Therefore, the search for a new model of financial sector self-regulation, one that focuses explicitly on prevention of systemic failure and is embedded in the broader public interests and policy goals, should serve as a supplement, and not as an alternative, to the ongoing search for an optimal design of the government regulation and supervision of financial institutions and activities. Bringing these two processes together will allow for a more comprehensive approach to regulatory reform in the financial sector, which will focus on designing more effective and

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125. It is often asserted that, to be successful, most systems of self-regulation have to operate "in the shadow of the law." *See*, *e.g.*, Michael Moran, *Understanding the Regulatory State*, 32 BRIT. J. POL. SCI. 391, 399 (2002) (describing John Braithwaite's popular concept of "responsive regulation").

126. *See*, *e.g.*, George G. Kaufman, *Bank Failures, Systemic Risk, & Bank Regulation*, 16 CATO J. 17, 17–18 (1996).

127. *See generally* Esteban Pérez Caldentey, Daniel Titelman & Ramon Pineda*, The Current Global Financial Crisis: What Was Really 'Purely Prime'?*, UNITED NATIONS, ECLAC (2009), *available at* http://www.iadb.org/intal/intalcdi/PE/2009/03611.pdf; Már Gudmundsson, Deputy Head of the Monetary and Econ. Dep't, Bank for Int'l Settlements, How Might the Current Financial Crisis Shape Financial Sector Regulation and Structure?, Address at the Financial Technology Congress (Sept. 23, 2008), *available at* http://www.bis.org/speeches/sp081119.htm.

adaptable institutional mechanisms, organically linking the industry's self-regulatory regime with the broader system of government regulation and oversight.[128]

Both the normative and the institutional aspects of "embeddedness" are equally important in defining the main features of the proposed new approach to financial sector self-regulation. However, these broad concepts cannot possibly capture the many nuances of, nor can they offer concrete solutions to, the many problems and questions that are bound to arise in the process of actually designing an embedded self-regulatory system.

In this regard, the normative ideal of embeddedness and the explicit focus on the prevention of systemic risk leave two fundamentally important sets of questions unanswered. The first such set of questions relates to the incentive structure and asks what would drive the financial services industry to establish or embrace a system of self-regulation envisioned in this Article. This line of inquiry comprises many questions. What are the general preconditions for the emergence of a self-regulatory regime seeking explicitly to minimize potentially harmful external effects of private economic actors' behavior? Do such preconditions exist in the context of today's financial services industry? Which specific factors may potentially facilitate or, conversely, impede the emergence of an industry-wide consensus on the necessity of self-regulation aimed at minimizing systemic risk? How can a broader regulatory reform create the missing incentives for the financial services industry to adopt, or accept, a shift toward embedded self-regulation?[129]

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128. Of course, this approach also introduces an element of complexity. Establishing a truly effective regime of embedded self-regulation in the financial sector may require a great deal of creativity and intricate regulatory "engineering" to overcome potential conflicts of interest inherent in a self-regulatory regime and to assure a sufficient degree of transparency and accountability. For instance, to make this self-regulatory model work, it may be necessary to reorder the existing division of regulatory and supervisory authority among government agencies overseeing financial sector and rewrite significantly numerous substantive rules and regulations governing delivery of financial services.

129. One example of potential structural reform aimed at creating incentives for self-regulation may be redrawing of regulatory boundaries within the financial services industry in such a way that would realign institutions based on the types of their business activities and the risks inherent in such activities. Such regulatory regrouping of financial institutions based on their risk profile, rather than the type of license or legal status (as, e.g., a commercial bank or a securities broker-dealer), could potentially help to ensure greater homogeneity of interests and create a stronger sense of common destiny among the relevant private industry actors. Another potential step in this direction may be elimination of, or imposition of strict limits on, explicit federal subsidies and implicit bailout guarantees to certain types of financial institutions whose activities generate the bulk of financial systemic risk. I explore these and related issues as part of a separate project that focuses more specifically on the issue of incentives for self-regulation in the financial

The second key inquiry aims at the efficacy of the proposed regime and asks how exactly that system should be structured and operated in order to achieve its proclaimed normative goals and not fall prey to conflicts of interest and abusive behavior on the part of the industry actors. This is perhaps the most challenging and complicated line of inquiry dealing with a wide variety of organizational as well as substantive regulatory issues. How should the new self-regulatory body be organized and governed? What is the optimal scope of its functions and powers, both with respect to rule-making and implementation and enforcement? What specific methods for monitoring and minimizing systemic risk will such a self-regulatory body employ and how will it ensure their efficacy? What institutional safeguards should be put in place to prevent "capture" of a self-regulatory authority by self-serving industry members threatening to subvert its normative goals? What is the optimal mechanism for linking the new self-regulatory regime with the broader government regulation? How much, and what type of, oversight should the government exercise over the industry self-regulatory body?

An important issue in this respect is to what extent the existing system of securities SROs can serve as the basis for the new, redesigned and refocused, self-regulatory regime. Is it possible, and indeed desirable, to retain the existing SRO system in some form alongside a new, more comprehensive self-regulatory scheme aimed explicitly at systemic risk concerns? If so, how would that affect the process of redrawing regulatory and supervisory boundaries in the post-crisis financial services sector?

Of course, these are only some of the fundamentally important and highly complex questions that must be addressed in the process of crafting a truly effective regime of embedded self-regulation in the financial services sector. Both of these broadly defined areas of inquiry defy easy answers and require a great deal of research and discussion, which is beyond the scope of this initial foray into the empirically rich and intellectually challenging topic of financial industry self-regulation.

This Article presents a case for radically broadening the scope of what we traditionally view, at least in this country, as financial industry self-regulation. Whatever its ultimate institutional shape, the basic concept of embedded self-regulation advanced here denotes a paradigmatic shift in that view. It calls for altering the primary focus of self-regulation from policing financial firms' conduct of business, or even individual enterprise-level safety and soundness, to a much more comprehensive notion

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industry. *See* Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PENN. L. REV. (forthcoming 2010).

of systemic risk prevention explicitly embedded in the broader public policy interests.

CONCLUSION

In today's post-crisis world, arguing in favor of self-regulation in the financial services industry is sure to raise many eyebrows and invite significant disagreement. Much of the skepticism in this respect may be fully justified: the lack of truly effective incentives or political obstacles may ultimately foreclose the possibility of creating a new regime of embedded self-regulation aimed at detection and prevention of systemic financial risks. Nevertheless, as this Article sought to demonstrate, the realities of today's financial marketplace make it critically important that we give the idea of industry self-regulation a full consideration.

The main goal of this Article was to start this deliberative process by making a general case for reinventing financial sector self-regulation. There are compelling reasons to believe that private financial market participants are potentially in a far better position to address the two principal regulatory challenges currently facing governments around the globe: the increasing complexity and global nature of financial transactions and instruments. Leveraging private industry's potential capacity to manage systemic risk would require giving financial institutions greater self-regulatory authority, while at the same time imposing direct, and very real, responsibility on the industry actors to curb their own profit-seeking activities to the extent they may endanger broader societal interest in preserving long-term financial stability. "Responsibilizing" the industry in this manner must be an inalienable element of any regulatory reform granting or expanding financial industry's freedom to regulate its own activities.

This Article does not offer a fully developed set of concrete reform proposals—a complicated and multi-faceted task that requires a great deal of further research and analysis. Instead, it represents a pure thought experiment seeking to broaden the scope of the ongoing debate on regulatory reform in the financial sector and to initiate a meaningful discussion of all potential solutions to the fundamental problem of containing systemic risk in global financial markets.