BALANCING THE GOVERNANCE OF THE MODERN FINANCIAL ECOSYSTEM: A NEW GOVERNANCE PERSPECTIVE AND IMPLICATIONS FOR MARKET DISCIPLINE

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ABSTRACT

Governance in the contemporary financial ecosystem is very unbalanced. It is neither sincere about nor effective at seeking the collaboration of regulators and all market participants in the exertion of regulatory power, or in the channeling of market force. Nor does it aim to manage the system-wide complexity by balancing its less flexible, prescriptive regulations and the more adaptive, experimental measures. This article maintains that a more balanced governance regime is urgently needed for the modern financial system. It offers a brief but comprehensive review of post-Crisis financial regulations, then identifies the major insufficiencies or limitations of these reform efforts. It proceeds to explore the prospect of using New Governance scholarship to rethink the current regulatory regime, and analyzes how such exploration yields implications for the use of market discipline. It concludes that a well-crafted collaborative standards-setting process that effectively incorporates the New Governance elements of collaboration and experimentation will

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bring a much-needed difference to the restoration of market discipline.

I. INTRODUCTION

Despite the several years that have passed since the onset of the Global Financial Crisis of 2008 ("the Crisis" or "the 2008 Crisis"), many of us have not really recovered from the traumatized economy. Every single agent in today's complex financial ecosystem, be it a retail consumer, banker, financial institution or even regulator, is in some way suffering from economic post-traumatic stress disorder. The ecosystem is itself weakened by this experience and has not yet developed sufficient resilience to sustain future unwelcome distress. The prevailing symptoms include a pervasive distrust of, and disgust with, "ruthless" bankers and "captured" regulators, hyper-arousal upon any potentially harmful financial activity or product, and collective emotional numbness towards, and detachment from, efforts and reforms to make the system healthier. Just like a suddenly-stretched-out slinky, the system responds by locking itself down to prevent any uncontrollable discharge of energy that may lead to another stretch-out.[1] The same situation pertains in today's post-traumatic financial market, where policymakers and reformers choose to respond to the crisis with complex and heightened regulations. We are somehow over-anxious about the occurrence of another catastrophic event, to the point that we would be willing even to overprotect market stability at the expense of market energy and vitality. This level of anxiety is reflected in the post-Crisis financial reforms to the point that the current governance of the global financial system remains

1. The analogy was inspired by Peter A. Levine, *A Summary of Trauma and Somatic Experiencing*, YOUTUBE (Aug. 17, 2009), https://www.youtube.com/watch?v=ByalBx85iC8.

unbalanced in its engagement of regulatory power and the market force. The focus of financial regulation is somehow either too hostile to industry practices, or too excessive in its use of regulatory powers.

This imbalance was created essentially by the confrontation of two fundamental forces: (1) the growing public distrust of banks, on the one hand, that all but destroys the possibility of regulators harnessing the "good power" in the industry to serve the common good;[2] and (2) the growing complexity in banking and finance, on the other hand, that renders the intention of safeguarding financial stability with "pure" regulation an essentially impossible mission.[3] To make things worse, public distrust is deepened by the escalation of complexity, and complexity is never reduced in the absence of trust. We cannot help but wonder if this is really how finance and banking have to be governed.

Heightened regulation may have the potential to maintain financial stability but will not necessarily do anything to restore the trustworthiness of the industry. After all, regulation in itself is suggestive of the very fact that industry members cannot be trusted completely, and it implies that the financial market cannot function without encountering failures. Can governance of the financial ecosystem be redirected to a path where the resilience of the system is enhanced, and not too much complex regulation and social distrust intrudes? This author is of the view that there is an affirmative answer, and it probably lies in better market discipline managed by the novel governance regime in which regulators collaborate extensively with the regulated.

Specifically, the post-Crisis system of governance has failed to balance at least the following of its aspects: (1) the use of regulatory weapons and market power;[4] (2) the use of prescriptive

2. Lawrence G. Baxter, *Fundamental Forces Driving United States and International Financial Regulations Reform*, 6 SUNGKYUNKWAN J. SCI. & TECH. L. 105, 107–08 (2012), https://www.cato.org/survey-reports/wall-street-vs-regulators-public-attitudes-banks-financial-regulation-consumer; Emily Ekins, *Wall Street vs. The Regulators: Attitudes on Banks, Financial Regulation, Consumer Finance, and the Federal Reserve*, CATO INST. SURV. REP. 1, 12 (Sept. 19, 2017), https://www.cato.org/survey-reports/wall-street-vs-regulators-public-attitudes-banks-financial-regulation-consumer.

3. Baxter, *Fundamental Forces*, *supra* note 2, at 112–14.

4. *See id.* at 113–14 (explaining regulator's reaction to large scale and complex

regulations and experimental measures;[5] (3) the one-size-fits-all and individually tailored approaches;[6] (4) the choice of a strictly observed schedule or an adaptive, flexible process for implementation;[7] and (5) the use of complex preventive rules and simple forward-looking principles.[8] These issues compound to formulate fundamental inquiries: How should financial markets be governed? Specifically: how should we regulate financial markets and craft regulatory regimes? Should we stay with the traditional command-and-control approach, or adopt a shared governance regime in which regulators and the regulated collaborate and learn together? Is there an optimal, or better, governance regime for the contemporary financial ecosystem? Is the post-Crisis financial regulation heading in the right direction? This article aims to explore these questions and provide tentative answers to them.

Part II conducts a brief but comprehensive review of post-Crisis financial regulations, then identifies the major insufficiencies or limitations of these regulations. That analysis will further support this author's conviction that a more balanced regime of financial governance is urgently needed. Part III explores further the possibility of using New Governance (NG) theory to reconstruct the current regulatory regime. This exploration will pave the way for the discussion of market discipline, a key building block of the more balanced governance regime this author envisages. The final section of Part III will analyze the implications of New Governance methodology for the practicing of market discipline. Part IV concludes.

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financial institutions in the market).

5. James D. Cox et al., *A Better Path Forward on the Volcker Rule and the Lincoln Amendment*, BIPARTISAN POL'Y CTR. 24–26 (Oct. 2013), http://bipartisanpolicy.org/sites/default/files/files/A%20Better%20Path%20Forward%20on%20the%20Volcker%20Rule%20and%20the%20Lincoln%20Amendment_Final.pdf (explaining how the use of data and metrics could aid financial market regulators).

6. *Id.* at 30–32.

7. *Id.* at 12–13.

8. *Id.* at 6–7, 36.

II. BRIEF INTRODUCTION TO POST-CRISIS FINANCIAL REGULATION

It is fairly important to understand the current development and direction of the post-Crisis financial regulations.[9] Such an understanding will shed light on the ongoing financial reforms, and most importantly, it will demonstrate why this author believes that restoring and enhancing the self-disciplinary power of the market is what the world of finance needs urgently. To briefly introduce the post-Crisis regulations, this author finds it helpful to categorize them into four groups, according to their different regulatory objectives: (1) Efforts to Enhance Resilience and Rein in Excessive Risk-Taking;[10] (2) Efforts to Eliminate the "Too Big to Fail" Perception, and Improve the Resolvability of Financial Conglomerates;[11] (3) Efforts to Regulate the Shadow Banking Systems;[12] and (4) Efforts to Revive Prudence and Transform Cultures.[13]

Discussion in this Part will be limited to the official regulations and regulatory proposals made by the authorities and will not engage with scholars or other commentators. Also, this discussion will be concentrated on the regulatory efforts of international agenda and standards setting bodies such as the Financial Stability Board ("FSB") and the Basel Committee on Banking Supervision ("BCBS"). A few local regulations, mostly those of the U.S., and only those of other sovereigns (the U.K. and the EU) that this author deems significant *per se* or more sensible than a comparable U.S. regulation will be covered.

A. *Efforts to Enhance Resilience and Rein in Excessive Risk-Taking*

The idea of enhancing resilience in the financial system has gained popularity in the aftermath of the Crisis. "Resilience" in

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9. *See* Baxter, *Fundamental Forces*, *supra* note 2, at 114–15. The author analyzes fundamental forces that drive international financial reform in the post-crisis era. *Id.* at 105.

10. *See infra* pp. 6–18.

11. *See infra* pp. 18–28.

12. *See infra* pp. 28–36.

13. *See infra* pp. 36–41.

the context of financial regulation can be said to carry a two-dimensional meaning. It refers to the broad system's capability to regain its original shape after a systemic shock, and to the individual firm's capability to regain its original shape after an idiosyncratic failure or system-wide meltdown.[14] These two dimensions suggest that policymakers have to take into account both the micro- and the macro-level regulation and supervision. Ordinary capital requirements, leverage ratio limits, liquidity regulations, and systemic surcharges are all the kinds of regulatory measures that serve this end.[15] Theoretically, the more common equity and liquid assets a financial institution has, the more resilient it will be when experiencing an external shock.[16] Generally speaking, effort aimed at enhancing resilience is a form of *ex-ante* regulation. It anticipates the possible consequence or economic loss consequent upon a systemic shock and requires banks to prepare accordingly.[17] Yet this kind of regulation will inevitably manifest as a game of "raising bars," as the potential negative consequence is so uncertain, and the only way to ensure a soft landing is to keep raising capital or liquid-assets requirements as much as one can. It is not hard to foresee that one can always argue how much is enough, or is justifiable, and will not jeopardize the market-wide liquidity.

Promoting resilience in the financial system by imposing capital, leverage and liquidity requirements is, of course, a sensible approach, as it functions like "speed limits" for banks, therefore damages can be reduced, should banks run into trouble.[18] The idea is that once banks' loss-absorbency capacity is

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14. BANK OF ENG., 25 FIN. STABILITY REP. 36 (June 2009), http://www.bankofengland.co.uk/publications/Documents/fsr/2009/fsrfull0906.pdf [hereinafter FIN. STABILITY REP.] (arguing that the financial system should be able to absorb system shock); Mary Dowell-Jones & Ross Buckley, *Reconceiving Resilience: A New Guiding Principle for Financial Regulation?,* 37 NW. J. INT'L L. & BUS. 1, 3–4 (2017), http://www.bankofengland.co.uk/publications/Documents/fsr/2009/fsrfull0906.pdf (explaining how the concept of resilience applies to the financial system).

15. *See* FIN. STABILITY REP., *supra* note 14, at 36–37 (explaining changes required in the financial sector's regulations).

16. *Id.* at 36.

17. *Id.*

18. Lawrence G. Baxter, *Götterdämmerung*, 18 N.C. BANK. INST. 91, 97 (2014) [hereinafter Baxter, *Götterdämmerung*].

enhanced, the entire system will be much more stable and resilient has been popular in reform debates.[19] Yet this proposition can be entirely sound only if we can uncover the magical number that indeed makes it sufficient for all banks to absorb losses, should a crisis hit. And importantly, that number must be one that will not eradicate investors' interest in putting equity into banks. The question of how much capital is enough is greatly complicated by this far more difficult question: Under what denominator are we to determine the required amount of capital? The concept of Risk-Weighted Asset is certainly a "risk-sensitive" one, but it is a contingency of the weighting approach that is used to calculate it, and that is subject to manipulation and arbitrage, and therefore an inherent deficiency.

Even though leverage ratio seems a fairer and manipulation-free one to consider, whether its denominator should include off-balance sheet assets or derivatives exposures is still a debatable question. Some commentators believe (on the assumption that the cost of funding for banks is irrelevant to whether banks are funded by capital or debt)[20] that this problem can be made insignificant if a higher numerator (capital) is required.[21] Leaving aside the question of whether "capital is indeed not more expensive than debt,"[22] banks are able to issue more equity if the

19. *Id.* at 97–98.

20. These commentators hold by far the most powerful and widely circulated arguments. *See Anat R. Admati et al., Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 86, 2011), https://www.gsb.stanford.edu/faculty-research/working-papers/fallacies-irrelevant-facts-myths-discussion-capital-regulation-whyhttp://papers.ssrn.com/abstract=1669704 (arguing that the net effect does not affect the cost of bank funding).

21. *Id.* at 6.

22. Powerful counterarguments have been made that capital is indeed more expensive in the real world of finance for a variety of reasons. *See* Paul Tucker, Deputy Governor, Fin. Stability, BANK OF ENG., Banking Reform and Macroprudential Regulation: Implications for Banks' Capital Structure and Credit Conditions, Address at the SUERF/Bank of Finland Conference on "'Banking After Regulatory Reform–Business as

Usual'" 9 (Jun. 13, 2013), https://www.bankofengland.co.uk/-/media/boe/files/speech/2013/banking-reform-and-macroprudential-regulation.pdf (arguing that "[s]uppose the market spotted first that the system was dangerously undercapitalized. Banks' debt funding costs would rise sharply and would remain elevated until the market saw evidence that either the banks or the authorities were grasping the nettle. A belated but decisive expected return on equity is high enough to attract investors. Many investors believe that well-performed banks should generate a ROE of anywhere between 15% and 20%.[23] Given the fact that banks' average ROE generally falls below that desired level,[24] raising capital to an unreasonably high level could make a bank's shares less attractive and make it far more difficult for banks to raise additional equity. The complexity and difficulty of determining a reasonable capital and leverage requirement is not the only problem this approach faces.

Another fundamental drawback of this "target-based" approach is in its efficacy. Any target-based monetary policy or financial regulation may violate the so-called "Goodhart's Law,"[25] the theory that once an economic regulation sets a specific target, the target will be self-defeating, and no longer serves as a good measure for the purpose of policymaking.[26] The underlying rationale of Goodhart's Law is at least twofold. First, policy rules or regulations do affect the expectations of market participants.[27] Therefore, policymaking should be aware that the expectations of economic agents will be changed, and further adjust the proposed policies accordingly. This is the exact focus of the "Lucas Critique."[28] The Lucas Critique basically claims that large-scale

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action to raise capital levels would then come as welcome news.").

23. J.B. Maverick, *What Level of Return on Equity is Common for Bank?,* INVESTOPEDIA (Sept. 15, 2017, 11:27 AM), http://www.investopedia.com/ask/answers /040815/what-level-return-equity-common-company-banking-sector.asp. For a discussion of how ROE is used to measure a financial institution's efficiency, see Lawrence G. Baxter, *Betting Big: Value, Cautions and Accountability in An Era of Larger Banks and Complex Finance*, 31 REV. BANKING & FIN. L. 765, 803–05 (2012) [hereinafter Baxter, *Betting Big*].

24. Baxter, *Betting Big*, *supra* note 23, at 876.

25. For the origin of Goodhart's Law, see Charles Goodhart, *Problems of Monetary Management: The U.K. Experience* (1970–84), *in* MONETARY THEORY AND PRACTICE: THE U.K. EXPERIENCE 91, 96 (1983). Goodhart's Law can also be understood in the context of complexity science. *See* Dirk Helbing, *Systemic Risks in Society and Economics*, *in* INT'L RISK GOVERNANCE COUNCIL, REPORT ON EMERGING RISKS—PROJECT PHASE 1: CASE STUDIES AND ILLUSTRATIONS 8 (2010), http://irgc.org/IMG/pdf/Systemic_Risks_Helbing 2.pdf (observing Goodhart's law as a generalization of self-fulfilling and self-destroying prophecy effects).

26. *Baxter Discusses Financial Regulation in Europe, Asia*, DUKE L. NEWS (Oct. 3, 2012), https://law.duke.edu/news/baxter-discusses-financial-regulation-europe-asia/ [https://perma.cc/M2WV-RXWC].

27. Goodhart, *supra* note 25, at 116.

28. For the origin of the "Lucas Critique," see generally Robert E. Lucas, Jr.,

macro-econometric models fail to take into account individual agents' expectations, and falsely assumes that the entire macroeconomic system functions in a "mechanical" way, such that the efficacy of a policy can be predicted on historical data.[29] The Lucas Critique informs us, for example, that a leverage ratio requirement may eventually encourage banks to increase their risk per unit of asset, because such a requirement gives banks the impression that policymakers care only about a bank's capital amount in absolute terms, and disregard the risk sensitivity of each asset type.[30] In short, the usefulness of leverage ratio as an indicator of bank safety will be reduced considerably, due to the play of Goodhart's Law.[31] The second rationale basically echoes the first one. Financial institutions will always act strategically to "game" their regulators on any set target.[32] A target that intended to enhance a bank's loss-absorbance capacity may end up being the bank holding more risky assets.

The above discussion suggests that target-based regulation, like capital regulations imposed by Basel III, may not be the most suitable approach in today's complex financial ecosystem. Goodhart's Law will manifest more frequently in a gigantic ecosystem, and the scenario will be made far more intricate when other factors of complexity-science are also at play.[33] Target-based rules, therefore, might not be the most effective ones for enhancing resilience in the financial system.

Econometric Policy Evaluation: A Critique, 1 CARNEGIE-ROCHESTER CONFERENCE SERIES ON PUBLIC POLICY 19–46 (1976).

29. *See id.* at 24 (arguing that long-term economic models based on the past are meaningless because they do not take into account the long-term, infinite variances of the system).

30. *See id.* at 39–41 (laying out his critique of economic forecasts and their effect on policymaking); Thomas Hartmann-Wendels, *The Leverage Ratio: Design, Supervisory Objectives, Impact on Banks' Business Policy*, INST. FOR BANKING MGMT. AND BANKING LAW AT THE UNIV. OF COLOGNE IV–V (Jan. 31, 2016), https://die-dk.de/media/files/Jan_2016_en_komplett_final_korr_002.pdf.

31. Hartman-Wendels, *supra* note 30, at IV.

32. *Id.* at 105.

33. Goodhart, *supra* note 25, at 103–04, 106 (explaining how regulations in the U.K. failed to predict the behavior of market players because they were not created for a large unconstrained ecosystem where individual banks could compete aggressively for money expansion).

1. "Ring-Fencing" Type Reforms

In addition to target-based regulations, there is another reform idea that aims to achieve the same goal of enhancing resilience. Safeguarding depositor funds from external shocks has always been on top of every reform agenda. The rationale is simple. If we cannot assure the safety and soundness of *all* financial institutions when a crisis hits, at least we can protect the depositors' money first. Among the most clear and ambitious of strategies for protecting deposit funds has been the "ring-fencing" proposed by the U.K. Vickers Report,[34] and the implementing of the HM Treasury White Paper.[35] Ring-fencing deposit-taking institutions from other activities is just one form of "legally deconstructing a firm in order to more optimally reallocate and reduce risk."[36] Other ways include the legal separation of risky financial activities from deposit-taking institutions, as proposed by the EU Liikanen Report,[37] and prohibiting the deposit-taking institutions' engagement in risky activities, as proposed by the U.S. Volcker Rule.[38]

Generally speaking, these "ring-fencing" proposals are similar in many respects.[39] The idea is basically to prohibit banks that accept retail deposits from engaging in activities that are not

34. Timothy Edmonds, *The Independent Commission on Banking: The Vickers Report*, HOUSE OF COMMONS LIBRARY 4–5 (2013) [hereinafter *The Vickers Report*], http://www.parliament.uk/briefing-papers/SN06171.pdf.

35. HM TREASURY, BANKING REFORM: DELIVERING STABILITY AND SUPPORTING A SUSTAINABLE ECONOMY 7–8 (White Paper, Cm 8356, June 2012) [hereinafter U.K. White Paper], https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32556/whitepaper_banking_reform_140512.pdf. (This article broadly implements the recommendations of the Independent Commission on Banking (ICB), chaired by Sir John Vickers).

36. Steven L. Schwarcz, *Ring-Fencing*, 87 S. CALIF. L. REV. 69, 108 (2013).

37. Erkki Liikanen et al., *High-level Expert Group on Reforming the Structure of the EU Banking Sector Final Report* 100 (Oct. 2, 2012) [hereinafter The Liikanen Report], http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

38. *See* Paul Volcker, *Commentary on the Restrictions on Proprietary Trading by Insured Depositary Institutions* 1 (Feb. 13, 2012) [hereinafter Volcker, *Commentary*] http://www.sec.gov/comments/s7-41-11/s74111-182.pdf (explaining how commercial bank trading is contrary to financial reform because it poses financial risk).

39. *See* James Benedict et al., *Comparison of Proposed Structural Reforms to the Banking Sector in the EU, U.K. and U.S.*, LINKLATERS (Oct. 2012), (noting a comprehensive comparison of the Vickers Report, Liikanen Report, and Volcker Rule).

directly connected to ordinary retail banking business such as providing payment services and granting loans and from engaging in securities dealing activities.[40]

Another noteworthy distinction between the Vickers and Liikanen Reports is the Intra-group Relationships, i.e. the relationship between the depository institution and the trading entity. In general, both proposals require that both the deposit bank and trading entity should be individually subject to all the regulatory requirements, such as liquidity and capital requirements, as well as to supervisory regimes and that no more than one-third of the members of the ring-fenced bank's board may be representatives of the rest of the group (either as board members of the wider group or as executives)."[41]

The Volcker Rule is also similar to the U.K. and EU proposals but differs in a few respects. The basic rationale of the Volcker Rule, as outlined by Paul Volcker, after whom the Rule is named, is to ensure that explicit and implicit support by the Federal Government extends only to those institutions that provide essential financial services.[42] Since certain activities undertaken by banks (such as trading securities, derivatives or other financial instruments with their own money) are essentially speculative in nature, taxpayer subsidy in any form should not extend to cover the outcomes of those activities.[43]

In short, the U.K. and EU ring-fencing prohibits banks that accept retail deposits from undertaking activities not directly connected to providing payment services and issuing loans.[44] The Volcker Rule focuses on constraining the ability of banks to undertake "proprietary trading," and to affiliate with hedge funds and private equity funds.[45] The concept of "proprietary trading"

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40. U.K. White Paper, *supra* note 35, at 4, 10, 18, 21.

41. *Id.* at 25–26.

42. *See generally* Volcker, *Commentary*, *supra* note 38.

43. *See generally* U.K. White Paper, *supra* note 35, at 3–5, 7; The Liikanen Report, *supra* note 37, at i, iv.

44. U.K. White Paper, *supra* note 35, at 10; *see also* Benedict et al., *supra* note 39, at 3.

45. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5535, 5536 (Jan. 31, 2014) [hereinafter The Final Volcker Rule]; *see also* Vinita Tandon, *The Volcker Rule: Clarifying the Anti-Evasion Provision to Facilitate Compliance*, 20 N.C.

has been attracting heavy criticisms.[46]

Despite the fact that Paul Volcker refutes almost all the criticisms raised, he seems to have agreed, during a talk, that the proposed rule is too complicated: "It's much more complicated than I would like to see."[47] The former FDIC Chairwoman, Sheila Bair also noted in a testimony delivered before the Senate Banking Committee: "I fear that the recently proposed regulation to implement the Volcker Rule is extraordinarily complex and tries too hard to slice and dice these exceptions in a way that could arguably permit high risk proprietary trading in an insured bank while restricting legitimate market making activities in securities affiliates."[48] The concerns raised by former regulators are only one example of the discomfort with the regulatory complexity introduced by the Volcker Rule.[49] The profound effect of this kind of complexity is reflected also by the fact that it took several years for the Rule to be implemented fully.[50]

Albeit true that complex problems have emerged as a result of the Volcker Rule, it is also true that complexity, lack of clarity, and difficulty in implementation are the common problems of the "ring-fencing" types reform. As Professor Lawrence Baxter observes:

> [N]ot only are the separations extremely difficult to

BANK. INST. 385, 385–86 (2016) (noting that the Volcker Rule was implemented in the Dodd Frank Act as section 13 in the Banking Holding Act).

46. The Final Volcker Rule, *supra* note 45, at 5545; Tom Braithwaite & Gina Chon, *Prospect of A Deal on Volcker Rule Worries Banks*, FIN. TIMES (Nov. 11, 2013), https://www.ft.com/content/4b5ef106-4a1b-11e3-9a21-00144feabdc0; Volcker, *Commentary*, *supra* note 38, at 1.

47. Rachel Armstrong, *Paul Volcker Says Volcker Rule Too Complicated*, REUTERS (Nov. 9, 2011), http://www.reuters.com/article/2011/11/09/us-regulation-volcker-idUSTRE7A83KN20111109.

48. *Enhanced Supervision: A New Regime for Regulating Large, Complex Financial Institutions: Hearing Before Senate Committee on Banking, Housing and Urban Affairs Financial Institutions and Consumer Protection Subcommittee*, 112th Cong. 13 (2011) (statement of Sheila C. Bair, Chairman, FDIC).

49. *See* Baxter, *Götterdämmerung*, *supra* note 18, at 98 (noting that commentators have concerns with the Volcker Rule's "complexity risks").

50. Braithwaite & Chon, *supra* note 46. Conformance period of certain provisions of the Rule had been extended to July, 2017 by the Federal Reserve Board. *See, e.g.*, Federal Reserve Board, Federal *Reserve Board formalizes previously announced one-year conformance period extension for certain Volcker rule legacy fund investments* (July 7, 2016), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160707a.htm.

> implement in practice, but efforts to do so are becoming labyrinthine in themselves, not least because the industry's own fierce resistance to any kind of meaningful reform has forced regulators into ever-more complicated rulemaking exceptions. The convoluted results are themselves generating what one commentator has aptly named "complexity risk."[51]

Despite the potential value of these "ring-fencing" reforms, proposals of this kind may nonetheless be inherently problematic, not only because they add extra layers of regulatory complexity into the already extremely complex financial system, but also because of the almost impossibility to implement a clear-cut separation in the era of complex finance. The business model "universal bank" has been the dominant form of the biggest financial institutions across the globe.[52] If ring-fencing regulation is to mean anything in post-Crisis financial reform, it must be implemented firmly and unambiguously by those financial behemoths, the universal banks. After all, the original intent of ring-fencing was to isolate depositors' money from the risk generated by other functions within a financial group.[53] And financial behemoths are among those that generate and spread the greatest risk to system-wide stability.[54] Yet, financial behemoths are called "behemoths" for a reason: the convoluted intra-group relationships, and the gigantic sizes, make it difficult for outsiders to identify the species of the financial group before their eyes.[55] The distinctions that demarcate their different business lines and activities are very opaque, and even the senior managements of these financial institutions have trouble with drawing the fine lines that would compartmentalize their institutions' activities such that the proposed legal separation can

51. Baxter, *Götterdämmerung*, *supra* note 18, at 98.

52. *See generally* Baxter, *Betting Big*, *supra* note 23, at 774, 782.

53. *The Vickers Report*, *supra* note 34, at 3.

54. Baxter, *Betting Big*, *supra* note 23, at 768 (stating that "financial behemoths have grown too large, too powerful, too complicated to regulate and too dangerous for global and domestic financial stability").

55. *Id.* at 780–81 (noting that banks group themselves into four closely related categories of retail banking, commercial banking, capital markets, and payments and clearing services and with the exception of retail banking, the groups are less visible to ordinary members of the public).

be practiced.[56] JP Morgan's "London Whale" debacle is certainly the most salient example to show how difficult it is even for senior management to distinguish hedging from speculative trading.[57] The only possible way to avoid the poor implementation of these ring-fencing regulations, therefore, is to "give agencies the option to implement the rule on a phased-in basis rather than universally at one time,"[58] and to allow regulators to "continually analyze the real world impacts" of these regulations after they are implemented.[59]

A phased-in and adaptive approach not only improves the implementation of these rather complex structural reform measures but also informs regulators in that continuous learning process of potential unintended consequences. The lesson, therefore, is that the most efficient and effective means of implementation and supervision may be a process of experimentation— i.e., a pilot program in which certain parts of the banking sector come into compliance on a more accelerated schedule than others—as suggested by the Bipartisan Policy Center Report ("BPC Report") regarding the Volcker Rule:

> This process would still require banking entities to begin developing the necessary infrastructure and to work steadily toward full compliance during the relevant conformance period. It would also allow banking entities and their regulators to obtain valuable experience with the practical workings of the Volcker Rule and to address technological, logistical, interpretive, and other issues that may arise on a smaller and more controlled scale. And, this would afford time for compliance and government-monitoring programs to be introduced in an informed and orderly basis.[60]

56. *See generally* Braithwaite & Chon, *supra* note 46 (noting that banks disbanded their trading desks where they took their own positions on stocks, bonds, or derivatives and redeployed them in-house or hired by hedge funds where the activity is still permitted, and that the executives thought this activity was legal hedging, not an illegal proprietary bet).

57. *See id.* (noting that London Whale executives claimed that using the banks money to invest in credit derivatives was a "hedge" and not a proprietary bet).

58. Cox et al., *supra* note 5, at 13.

59. *Id.*

60. *Id.* at 34.

The Final Volcker Rules have appeared, as stated by the Director of the BPC's Financial Regulatory Reform Initiative, to follow some of the BPC Report's recommendations for "a phased-in conformance and the use of an iterative, metric-based approach that will adjust according to incoming data."[61] Although the efficacy of such an adaptive approach remains to been seen, it is nonetheless a good start.

2. Short-term Wholesale Funding Reducing Efforts

Another focus being considered indispensable in the maintaining of system-wide resilience is the reduction of the industry's reliance on short-term wholesale funding.[62] The Crisis has demonstrated that a wholesale bank-run in 2008 could have been as destructive as the deposit-run in 1930.[63] And the case is made the worse because a deposit-insurance-like protection is absent for broker-dealers who engage in short-term "securities financing transactions" (SFTs), a term that "generally refers to repo and reverse repo, securities lending and borrowing, and securities margin lending."[64] Post-Crisis regulatory reform has taken some steps to address the risks associated with a dealer's use of short-term SFT funding to finance operations.

A number of measures have been adopted locally or internationally to serve this end. First, the Liquidity Coverage Ratio (LCR) under Basel III requires banks to hold a buffer of high-quality liquid assets, "to cover the net cash outflows the bank would expect to occur over a 30-day stress scenario."[65]

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61. *Bipartisan Policy Center's Aaron Klein Reacts to Volcker Rule*, BIPARTISAN POL'Y CTR. (Dec. 10, 2013), http://bipartisanpolicy.org/press-release/bipartisan-policy-centers-aaron-klein-reacts-volcker-rule/.

62. *See* Daniel K. Tarullo, Member, Bd. of Governors of the Fed Reserve Sys., Shadow Banking and Systemic Risk Regulation: Remarks at the Americans for Financial Reform and Economic Policy Institute Conference 1–2 (Nov. 22, 2013) [hereinafter Tarullo, Shadow Banking and Systemic Risk Regulation], http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.pdf (noting the necessity to create an environment that can lead to short-term wholesale funding runs in order to create a stable financial system for the early twenty-first century).

63. *Id.*

64. *Id.* at 9.

65. Governor Daniel K. Tarullo, Address at the Federal Reserve Bank of Cleveland and Office of Financial Research 2016 Financial Stability Conference: Financial Regulation Since the Crisis (Dec. 2, 2016) (transcript available at

Second, the FSB has been proposing policy recommendations for enhancing oversight of the shadow banking system. Among its efforts is a set of recommendations aimed at imposing haircuts and margin requirements on SFTs.[66] At last, though this sounds like an indirect effort to tackle short-termism, advocates of the Financial Transactions Tax argue that financial institutions will be redirected from the pervasive short-term-trading culture toward a long-term investing mindset by the imposition of a small amount of imposts on their financial transactions.

All the reform measures are workable in some sense, but none of them seems to have become the fundamental solution that will transform the industry's overreliance on short-term wholesale funding. For example, the LCR does not take into account SFT liabilities that mature in more than 30 days, and therefore the danger still exists if firms engage extensively in SFT liabilities that mature in a longer term.[67] In addition, although a capital surcharge based on the short-term wholesale funding position would provide an incentive for firms to rely more on stable funding, it nonetheless faces the same problem that every kind of capital regulation will face: how much is enough and the almost inevitable manifestation of Goodhart's Law.[68] The FSB's market-wide application of margin and haircut requirements, though promising, is nevertheless set at a relatively low level and is largely unsettled.[69] Finally, the idea of a financial transaction tax does not seem to have offered, in the empirical sense, the value that its proponents had claimed it would.[70] A study of New York State's securities transaction tax from 1932 to 1981 by Anna

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https://www.federalreserve.gov/newsevents/speech/tarullo20161202a.htm).

66. *Id.* at 14–15. For the FSB's recent effort in this regard, see FIN. STABILITY BD., TRANSFORMING SHADOW BANKING INTO RESILIENT MARKET-BASED FINANCE - REGULATORY FRAMEWORK FOR HAIRCUTS ON NON-CENTRALLY CLEARED SECURITIES FINANCING TRANSACTIONS (2015), http://www.fsb.org/wp-content/uploads/SFT_haircuts_framework.pdf.

67. Tarullo, Shadow Banking and Systemic Risk Regulation, *supra* note 62, at 11.

68. *Id.* at 13.

69. *Id.* at 15.

70. Steven Davidoff Solomon, *In Wall St. Tax, A Simple Idea but Unintended Consequences*, N.Y. TIMES: DEALBOOK (Feb. 26, 2013, 5:20 PM), https://dealbook.nytimes.com/2013/02/26/in-wall-street-tax-a-simple-idea-with-unintended-consequences/.

Pomeranets and Daniel G. Weaver found that the tax actually increased trading volatility by as much as 10 percent, rather than reduced trading volatility as its supporters had anticipated.[71]

Despite the fact that each of the proposed solutions has its own limitation, they are all headed in the right direction, as these are all efforts to internalize the social costs of such funding, that is, they are efforts to align the incentives of these firms and of the public. Again, it seems that it is the issue of implementation that dampens the potential usefulness of these reforms.

B. Efforts to Eliminate the "Too Big to Fail" Perception, and Improve the Resolvability of Financial Conglomerates

Eliminating the Too-Big-to-Fail perception is undoubtedly the central piece of the post-Crisis financial reforms. After all, a substantial proportion of the new reform measures is designed to end the practice of bailing out large financial institutions with taxpayer money, a practice that had antagonized the Main Street, given the sheer amount of subsidies big banks had enjoyed in the run-up to the Crisis.[72] Although the literal meaning suggests that Too-Big-To-Fail has everything to do with the size of a financial institution, this is simply not the case. A financial institution is "too big" only when there is a widely subscribed expectation that governments will do whatever it takes to rescue that institution from failure.[73] Therefore, this is the kind of expectation policymakers undertake to address, rather than the "bigness" *per*

71. *Id.*

72. For counterarguments, see BIPARTISAN POL'Y CTR., TOO BIG TO FAIL: THE PATH TO A SOLUTION 18–19 (2013) [hereinafter BIPARTISAN POL'Y CTR., TOO BIG TO FAIL], http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/TooBigToFail.pdf; Press Release, Fin. Servs. Forum, et al., Financial Industry Addresses Alleged Large Bank Subsidy 2 (Mar. 11, 2013), http://images.politico.com/global/2013/03/10/financial_industry_addresses_alleged_large_bank_subsidy_11_march_13.html; PAUL SALTZMAN, THE CLEARING HOUSE, VANQUISHING TBTF: RHETORIC VERSUS REALITY AND THE VALUE OF SYSTEMICALLY IMPORTANT BANKS IN THE GLOBAL FINANCIAL SYSTEM 31 (2013), https://www.theclearinghouse.org/-/media/files/association%20documents/20130326%20tch%20vanquishing%20tbtf%20sifi%20value.pdf.

73. Jerome H. Powell, Member, Board of Governors of the Federal Reserve System, Ending "Too Big to Fail": Remarks at the Institute of International Bankers 2013 Washington Conference 1 (Mar. 4, 2013).

se of financial institutions. How such an expectation arose has much to do with the *interconnectedness* of a bank, as only *interconnectedness* has the great potential to transform a seemingly idiosyncratic risk into a systemic one.[74] As observed by Governor Powell, the TBTF reforms seek to eliminate the expectation of bailouts in generally two ways: by reducing the probability of systemic firm failures, and by limiting the costs to the wider economy of such failures.[75] Only if systemic failures are unusual, and the costs of such failures are modest, will the TBTF expectation be substantially contained.[76] Many reforms concerning the structural and "speed limit" regulations of financial institutions (as noted in the previous section of this Part) are aimed at reducing the likelihood of systemic failures.[77] In this section, the author will briefly address both.

1. Regulatory Framework of SIFIs

Resolvability consists of two major elements: an *ex-ante* enhanced regulatory regime that makes less likely the disorderly failure of large financial institutions, and an *ex post* credible mechanism to manage the failure of these firms without causing or amplifying a systemic crisis.[78] Among the *ex-ante* regimes, the FSB's SIFI Framework, and the Title I of Dodd-Frank in the U.S., are probably the most active responses to the TBTF problem.[79] The FSB SIFI framework, initiated by the G20 at the Seoul Summit in 2010, addresses the "too-big-to-fail" issue by reducing the probability and impact of SIFIs failing.[80] It does so by "reducing the probability of SIFIs failing through requirements for additional loss absorbency and increased supervisory intensity, and by reducing the impact of failure through effective resolution regimes and strengthened core financial market infrastructures, which reduce the potential for contagion arising

74. Baxter, *Betting Big*, *supra* note 23, at 859.

75. Powell, *supra* note 73, at 1.

76. *Id.*

77. *Id.*

78. BIPARTISAN POL'Y CTR., TOO BIG TO FAIL, *supra* note 72, at 46.

79. *Id.*

80. FIN. STABILITY BD., PROGRESS AND NEXT STEPS TOWARDS ENDING "TOO-BIG-TO-FAIL" (TBTF): REPORT OF THE FINANCIAL STABILITY BOARD TO THE G-20 2 (2013), http://www.fsb.org/wp-content/uploads/r_130902.pdf?page_moved=1.

from interconnectedness."[81] To implement the SIFI Framework, the FSB and the various international standard-setting bodies have developed policy measures to address systemically important banks (G-SIBs) and global systemically important insurers (G-SIIs), including the designation of 30 G-SIBs[82] and 9 G-SIIs in 2016.[83]

2. Title I of Dodd-Frank: Living Wills and Others

Similar *ex-ante* efforts have been made in the U.S. under Title I of the *Dodd-Frank Act*, nonbank financial companies (designated by the Financial Stability Oversight Council) are made subject to supervision by the Federal Reserve, and bank holding companies with $50 billion or more in assets (together as "Title I Institutions") are made to face a set of heightened prudential standards for risk-based capital requirements, leverage limits, liquidity requirements, overall risk management requirements, credit exposure reporting, and concentration/credit exposure limits.[84] Also, *Dodd-Frank* requires the Federal Reserve Board of Governors ("FRB") to establish provisions for the early remediation of the financial distress of a large financial group, in order to minimize the possibility that such a group will become insolvent, and potentially harm the financial stability of the U.S.[85]

In the Title I regime, the most noteworthy measure, with regard to improving the resolvability of financial conglomerates, is the "Living Wills" provision.[86] Section 165 (d) of *Dodd-Frank*

81. *Id.* at 7.

82. FIN. STABILITY BD., 2017 LIST OF GLOBAL SYSTEMICALLY IMPORTANT BANKS (G-SIBS) 1 (2017), http://www.fsb.org/wp-content/uploads/P211117-1.pdf.

83. FIN. STABILITY BD., 2016 LIST OF GLOBAL SYSTEMICALLY IMPORTANT INSURERS (G-SIIS) 1 (2016), http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-insurers-G-SIIs.pdf.

84. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 165(a)(1), 165(b)(1)(A)(i)–(v), 124 Stat. 1376 (2010) (codified in scattered sections of 5 U.S.C., 12 U.S.C., 15 U.S.C., & 42 U.S.C.); 12 U.S.C. § 5365 (establishing standards for bank holding companies with $50 billion or more in assets).

85. *See* Dodd-Frank Act §§ 166(a)–(b) (requiring the FRB to establish provisions "or the early remediation of financial distress of a nonbank financial company").

86. *Living Wills (or Resolution Plans)*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/bankinforeg/resolution-plans.htm (last updated Dec. 19, 2017).

requires Title I Institutions to submit rapid resolution and recovery plans to the FRB and FDIC every year.[87] These Living Wills[88] are expected to provide a very clear picture of each institution's operational models and business entities, to give regulators a more comprehensive understanding of those institutions.[89] Having big banks write their own Living Wills is considered by many proponents of dismantling big banks to be impractical, if not illusionary.[90] A credible and workable resolution-plan requires that the management has a supremely clear overview of its own banks.[91] But such clarity is often lacking, as these financial behemoths are so big that they defy full understanding. Financial behemoths are not just, as classical corporate theory suggests, a complex web of contracts. Rather, they are more like systems of countless complex webs of contracts. The level of complexity and interconnectivity in these systems is sometimes simply beyond the power of the human brain to grasp. Yet the "practical resolution plan" requires a farsighted estimate of which part of a bank's operation is most likely go wrong, and

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87. *See* Dodd–Frank Act § 165(d) (providing that systemically important nonbank financial companies be required to report periodically to the Board of Governors, Financial Stability Oversight Council, and the FDIC company plans for "rapid and orderly resolution in the event of material financial distress or failure").

88. For the public portion of these plans, see *Living Wills (or Resolution Plans)*, *supra* note 86.

89. SALTZMAN, *supra* note 72, at 37.

90. Shah Gilani, *"Living Wills" For Banks Won't Kill Systemic Risk or Greed,* FORBES (June 27, 2011), https://www.forbes.com/sites/shahgilani/2011/06/27/living-wills-for-banks-wont-kill-systemic-risk-or-greed/#10b9af873537; The FRB and the FDIC's joint review of the eleven big banks' 2015 resolution plans seems to have vindicated this point. The agencies concluded that the proposed resolution plans of Bank of America, Bank of New York Mellon, JP Morgan Chase, State Street, and Wells Fargo "was not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code, the statutory standard established in the Dodd-Frank Wall Street Reform and Consumer Protection Act." And "identified weaknesses in the 2015 resolution plans of Goldman Sachs and Morgan Stanley that the firms must address." Press Release, BD. OF GOVERNORS OF THE FED. RESERVE SYS. & FED. DEPOSIT INS. Corp., Agencies announce determinations and provide feedback on resolution plans of eight systemically important, domestic banking institutions (Apr. 13, 2016), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160413a.htm.

91. Mayra Rodríguez Valladares, *Regulators' Rebuke of 'Living Wills' Proves Dodd-Frank Is Working*, AM. BANKER (Aug. 9, 2014, 10:00 AM), https://www.americanbanker.com/opinion/regulators-rebuke-of-living-wills-proves-dodd-frank-is-working.

the consequent setting forth of strategies to repair that which has "gone wrong" only hypothetically, that is, not in fact. This exercise is at best logically obtuse, because if management *knows of* the existence of a weak spot where something might go wrong, it would take the measures necessary to correct it, rather than keep it weak for the purpose of showcasing a "practical resolution plan."

Another *ex-ante* effort that aims to eliminate the bailout expectation is to explicitly prohibit, by statute, regulators' rescuing of individual institutions. During the Crisis, regulators relied heavily on Section 13(3) of the *Federal Reserve Act* to provide assistance to distressed institutions.[92] In order to limit the authorities' capability to do this in the future, Title XI of *Dodd-Frank* requires that all assistance under Section 13(3) may provide only "broad-based" programs or facilities, and only to solvent institutions.[93] Furthermore, Title XI has eliminated the FDIC's authority to provide assistance to banks outside of receivership, pursuant to Section 13(c)(4)(G) of the *Federal Deposit Insurance Act*.[94] As a result, the FDIC must now first place a bank into receivership, or seek Treasury Department and Congressional approval prior to providing any assistance.[95]

An *ex-ante* promise not to provide any governmental bailout sounds sensible. It nevertheless has the potential to be seriously compromised by the "time-inconsistency" problem observed by economists.[96] Policymakers often find themselves unable to keep the promise that no benefits (or bailout) from the safety net will be provided when it is socially or politically desirable in the short term, especially when they realize that the *ex-post* cost of not intervening with a bailout may be far greater than the cost of

92. SALTZMAN, *supra* note 72, at 38.

93. *Id.*

94. This is often referred to as "open bank assistance." *Id.*

95. *Id.*

96. For a comprehensive discussion of the relationship between time-inconsistency problems and bank regulation, see, e.g., Andrew G. Haldane, Exec. Dir., Bank of Eng., Speech at the Wincott Annual Memorial Lecture: Control Rights (and Wrongs) 6–9 (Oct. 24, 2011) (transcript available at http://www.bis.org/review/r111026a.pdf) (explaining the time-inconsistency problems in banking); Marc J.K. De Ceuster & Nancy Masschelein, *Regulating Banks through Market Discipline: A Survey of the Issues*, 17 J. ECON. SURV. 749, 759–60 (2003).

breaking the *ex-ante* promise. In addition, one has to keep in mind that a government-support regime still seems to be permissible under *Dodd-Frank*, if the entire industry is facing a liquidity event. A fair guess is that, had the *Dodd-Frank Act* been in place before the Crisis, most regulators would probably have considered the failure of Lehman as the sort of "liquidity event" that constitutes as the onset of a series of seriously adverse effects on financial stability.

3. Title II of Dodd-Frank: The Orderly Liquidation Authority, Single Point of Entry, and Bail-in Regime

None of the abovementioned *ex-ante* measures can guarantee that there will be no failure of SIFIs. But certain *ex-post* regulations are expected to limit the system-wide impact of their potential failures. Title II of Dodd-Frank, for example, provides the FDIC with new powers to resolve SIFIs by establishing the orderly liquidation authority (OLA).[97] Under the OLA,[98] at the Secretary of the Treasury's request, or of their own initiative, the FRB and the FDIC are to make a written recommendation[99] requesting that the Secretary appoint the FDIC as receiver for a systemically important financial institution that is in default, or in danger of default, and whose resolution under the U.S. Bankruptcy Code (or other relevant insolvency process) is likely to maintain the systemic instability.[100]

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97. FED. DEPOSIT INS. CORP. & BANK OF ENG. *Resolving Globally Active, Systemically Important, Financial Institutions* 4 (2012), [hereinafter FDIC White Paper] http://www.fdic.gov/about/srac/2012/gsifi.pdf.

98. For how the OLA will be operated in practical, see *The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, 5 FDIC Q., no. 2, 2011, at 1, https://www.fdic.gov/bank/analytical/quarterly/2011-vol5-2/article2.pdf.

99. *See* 12 U.S.C. § 5383(a)(2) (summarizing the recommendation's main requirements as: an evaluation of whether the financial company is in default or is in danger of default; a description of the effect the failure of the financial company would have on U.S. financial stability; an evaluation of why a case under the Bankruptcy Code is not appropriate; an evaluation of the effect on creditors, counterparties, and shareholders of the financial company and other market participants; and certain other evaluations required by statute).

100. FDIC White Paper, *supra* note 97, at 4. Please note that the recommendation to place a broker or dealer, or a financial company in which the largest domestic subsidiary is a broker or dealer, into receivership is made by the Federal Reserve and the Securities and Exchange Commission (SEC) in consultation with the FDIC. Similarly, the recommendation to place an insurance company or a financial company in which the

Among the Title II OLA, one FDIC-proposed approach, "Single Point of Entry," seems to be by far the most sensible strategy for implementing an orderly liquidation.[101] As Jerome Powell, the Governor of the FRB, explains:

> Under single point of entry, the FDIC will be appointed receiver of only the top-tier parent holding company of the failed financial group. Promptly after the parent holding company is placed into receivership, the FDIC will transfer the assets of the parent company (primarily its investments in subsidiaries) to a bridge holding company. Equity claims of the failed parent company's shareholders will be wiped out, and claims of its unsecured debt holders will be written down as necessary to reflect any losses in the receivership that the shareholders cannot cover. To capitalize the bridge holding company and the operating subsidiaries, and to permit transfer of ownership and control of the bridge company back to private hands, the FDIC will exchange the remaining claims of unsecured creditors of the parent for equity and/or debt claims of the bridge company. If necessary, the FDIC would provide temporary liquidity to the bridge company until the "bail-in" of the failed parent company's creditors can be accomplished.[102]

The Single Point of Entry approach is of great use to address the problem of runs. By taking control of the SIFI at the top of the group, subsidiaries that carry out critical services can remain open for business, and thus limit the possibility of destabilizing insolvency-proceedings at the subsidiary level.[103] Yet this strategy is not without potential deficiencies. Its efficacy relies on market participants' (especially that of creditors, counterparties, and customers of SIFIs) reasonable level of understanding of the treatment in the recapitalization process, so that they do not pull away from the process and not thereby destroy the potential for a

largest domestic subsidiary is an insurance company, is made by the Federal Reserve and Director of the newly established Federal Insurance Office in consultation with the FDIC.

101. Powell, *supra* note 73, at 6.

102. *Id.* at 7.

103. FDIC White Paper, *supra* note 97, at 6.

distressed firm to recover.[104] Nonetheless, as Governor Powell himself points out, certain "questions remain about how the FDIC will apply its broad statutory discretion . . . . How will the FDIC exercise its discretion to treat dissimilarly creditors of the same class? How will a creditor's "minimum right of recovery" be determined? And how will the FDIC value the failed firm?"[105] It takes time for regulators to establish and acquire the necessary certainty and clarity.

In addition to the above, two challenges remain to the improving of the resolvability of SIFIs. One is to ensure that all SIFIs have sufficient "bail-inable" long-term debts at the parent level to recapitalize a bridge holding-company in the process of OLA;[106] the other is to mitigate impediments to the resolution of cross-border SIFIs.[107] Despite the fact that under the new loss-absorbency requirement of Basel III,[108] "all non-common Tier 1 and Tier 2 instruments issued by an internationally active bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event,"[109] unless certain conditions are met.[110] Most subordinated debts or Contingent Convertible bonds issued under this new requirement are basically "written-off" debts, rather than "equity conversion" debts.[111] Only when the use of the "equity conversion" instrument is widely promoted and accepted by banks and regulators across the globe will the bail-inable debts be sufficient to make the recapitalization of a cross-border financial behemoth

104. *Id.*

105. Powell, *supra* note 73, at 8.

106. *Id.*

107. *Id.* at 9.

108. *See* BASEL COMM. ON BANKING SUPERVISION, MINIMUM REQUIREMENTS TO ENSURE LOSS ABSORBENCY AT THE POINT OF NON-VIABILITY 3 (2011), https://www.bis.org/press/p110113.pdf (establishing "minimum requirements to ensure that all classes of capital instruments fully absorb losses").

109. *Id.*

110. *See* BASEL COMM. ON BANKING SUPERVISION, PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REGULATORY CAPITAL AT THE POINT OF NON-VIABILITY 5 (2010), https://www.bis.org/publ/bcbs174.pdf (explaining the terms and conditions that require non-common Tier 1 instruments and Tier 2 instruments to be written-off).

111. *Id.*

successful.[112] The FSB's recently finalized Minimum TLAC requirements may have the potential to cure such a problem, but its efficacy remains to be seen.[113] Lastly, the mitigation of impediments to the cross-border resolution of SIFIs will require significant coordination among the main central banks and supervisors around the world.[114] The prospect of cross-border regulatory coordination seems promising, as some jurisdictions of the major developed economies have been working together extensively to this end. For example, the FDIC and the Bank of England have been vigorously engaged in this direction, as they have proposed in their joint paper the applying of the single-point-of-entry approach to the resolution of a globally active, U.S. or U.K.-headquartered SIFI.[115] But, again, a credible, workable and effective resolution of G-SIFIs may still take years to come into reality.

By putting extreme confidence in the efficacy of the OLA, the financial industry in the U.S. seems to have subscribed to the theory that the TBTF perception has been, and can be, eliminated, and taxpayer money will no longer be jeopardized when the next systemic event hits.[116] Some regulators share this industry sentiment. For instance, the then Bank of England Deputy Governor Paul Tucker, and FDIC Chairman Martin Gruenberg, say in their joint editorial: "The 'too big to fail' problem must be cured. We believe it can be and that serious progress is being made. Evidence can be seen in the joint paper released by [the FDIC and Bank of England] . . . which outlines a resolution strategy for large and complex financial companies."[117]

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112. Ze'-ev D. Eiger, Partner, & Jeremy C. Jennings-Mares, Partner, Morrison & Foerster LLP, *Frequently Asked Questions about Contingent Capital and Related* Developments 16 (2017), https://media2.mofo.com/documents/faqs-contingent-capital.pdf.

113. *See* FIN. STABILITY BD., PRINCIPLES ON LOSS-ABSORBING AND RECAPITALISATION CAPACITY OF G-SIBS IN RESOLUTION 5–8 (2015), http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

114. Powell, *supra* note 73, at 9.

115. *Id.* at 9–10; FDIC White Paper, *supra* note 97, at 1.

116. SALTZMAN, *supra* note 72, at 3.

117. Martin Gruenberg & Paul Tucker, *When Global Banks Fail, Resolve Them Globally*, FIN. TIMES (Dec. 10, 2012), http://www.ft.com/intl/cms/s/0/fd66d172-3fd4-11e2-b0ce-00144feabdc0.html#axzz2n0rj13ET.

Mark Carney, the Chairman of the FSB, expresses an even more optimistic view by announcing that "we reached a watershed in ending too big to fail, with agreements to take forward proposals on total loss absorbing capacity for globally systemic banks"[118] in a speech given in Singapore.

In the opinion of this author, it is hard to tell how much of the confidence and certainty revealed in these comments is groundless optimism. But, it certainly takes time and uncompromised political determination to see to the elimination of the too-big-to-fail phenomena.

C. Efforts to Regulate the Shadow Banking Systems

Despite a concrete and internationally accepted definition of shadow banking does not seem to have existed, it is appropriate to include in the scope of shadow banking those entities and activities that engage in maturity, credit, and liquidity transformation, intermediate the demands of the providers of funds and the end consumers of funds, and have the potential to pose financial-stability risk in the form of "bank runs."[119] Accordingly, "shadow banking" should be understood to subsume at least: all activities, conduits and entities involving securitization, securities financing transactions (SFTs), funds that have the "withdraw-on-demand" feature, such like MMFs, and off-balance sheet activities banks conduct that make themselves potentially liable for their consequences.[120] The FSB

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118. Mark Carney, Governor, Bank of Eng. and Chair of the Fin. Stability Bd., The Future of Financial Reform, Speech at 2014 Monetary Authority of Singapore Lecture 2 (Nov. 17, 2014), http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf.

119. For a variety of definitions of shadow banking, see FIN. STABILITY BD., STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING: AN INTEGRATED OVERVIEW OF POLICY RECOMMENDATIONS 1 (2012) [hereinafter FSB, INTEGRATED OVERVIEW OF POLICY RECOMMENDATIONS], http://www.financialstabilityboard.org/publications/r_121118.pdf; Paul McCulley, *Teton Reflection*, PIMCO GLOBAL CENTRAL BANK FOCUS (2007), https://www.pimco.com/en-us/insights/economic-and-market-commentary/global-central-bank-focus/teton-reflections; Steven L. Schwarcz, *Regulating Shadow Banking*, 31 REV. BANK & FIN. L. 619, 622 (2012) ("I therefore define 'shadow banking' to mean not only the provision of financial products and services by shadow banks, but also the financial markets used to provide those products and services.").

120. *See* FSB, INTEGRATED OVERVIEW OF POLICY RECOMMENDATIONS, *supra* note

policy framework for shadow banking is largely in line with the scope this author envisages. It basically classifies the scope of shadow banking into two primary categories, and sets forth different policy recommendations for each: shadow banking *activities* include all SFTs and securitization activities; and shadow banking *entities* including MMFs and "shadow banks."[121] The FSB further defines "shadow banks" as credit investment funds, exchange-traded funds (ETFs), credit hedge funds, private equity funds, securities broker-dealers, securitization entities, credit insurance providers/financial guarantors, finance companies, and trust companies.[122]

It is not hard to imagine how much regulatory effort and resources will have to be put into understanding, monitoring, and governing such a system. It is also fairly foreseeable that all reform efforts in this regard will inevitably look fragmented, lacking a central focus, and theoretically and logically inconsistent.[123] In general, there are three levels of reform efforts

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119, at 1; McCulley, *supra* note 119; Schwarcz, *supra* note 119, at 622.

121. Indeed, the FSB in its 2011 Report identified five specific areas in which it believed policies were needed to address the potential systemic risks associated with shadow banking (the regulation of banks' interactions with shadow banking entities, regulation of MMFs, regulation of other shadow banking entities, regulation of securitization, and the regulation of securities lending and Repos), it nonetheless broadly classified these five areas into two major groups through proposing two types of policy frameworks in 2012 that respectively targets SFT and Shadow Banking Entities. *See* FIN. STABILITY. BD., SHADOW BANKING: STRENGTHENING OVERSIGHT AND REGULATION 4–5 (2011), http://www.financialstabilityboard.org/wp-content/uploads/r_111027a.pdf [hereinafter FSB, SHADOW BANKING]; *see, e.g.,* FIN. STABILITY BD., STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING: POLICY FRAMEWORK FOR ADDRESSING SHADOW BANKING RISKS IN SECURITIES LENDING AND REPOS ii, 6 [hereinafter FSB, POLICY FRAMEWORK FOR SECURITIES LENDING AND REPOS] (2013), http://www.financialstabilityboard.org/wp-content/uploads/r_130829b.pdf?page_moved; FIN. STABILITY BD., STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING: POLICY FRAMEWORK FOR STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING ENTITIES 1, 3, 10–11 [hereinafter FSB, POLICY FRAMEWORK FOR SHADOW BANKING ENTITIES] (2013), http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf.

122. FSB, POLICY FRAMEWORK FOR SHADOW BANKING ENTITIES, *supra* note 121, at 1.

123. Carney, *supra* note 118, at 2, 3. For a conceptually consistent framework to regulate shadow banking, see Schwarcz, *supra* note 119, at 631–33, 635, 638, 640 (arguing that regulation of shadow banking should be focused on maximizing economic efficiency and minimizing systemic risk).

that have been directed toward the oversight and regulation of shadow banking: (1) policy initiatives led by the FSB that aim to establish a system-wide monitoring framework that tracks the financial-sector development outside the shadow banking system,[124] and to coordinate the development of policies in five different areas that address where oversight has to be strengthened, mostly to reduce systemic risks;[125] (2) debate among central bankers worldwide, and in academia, about whether the financial safety net should be broadened to cover the shadow banking sector;[126] and (3) local regulations aimed at effectively reducing risks posed by the various shadow-banking entities or activities.[127]

The first-level reform was premised on the idea that we actually know too little about systemic risk of which the sources are other than financial institutions traditionally subject to prudential regulation.[128] Therefore, it is of paramount importance to enhance national authorities' ability to track and assess developments and innovations in the shadow-banking system, in order for identifying the build-up of systemic risk.[129] The further premise was that the national high-level policy framework should include corrective measures for remediating those areas in which policymakers are aware of potential risk.[130] Specifically, the five areas in which the FSB believes[131] policies are needed to mitigate the potential for systemic risk are: (1) the spill-over of risks from the shadow banking sector to the regular banking system; (2) the vulnerability of Money Market Funds to runs; (3) the inadequate transparency and misaligned incentives in securitization; (4) the

124. FSB, POLICY FRAMEWORK FOR SHADOW BANKING ENTITIES, *supra* note 121, at 1, 2.

125. *Id.* at 3–4.

126. Klara Bakk-Simon et al., *Shadow Banking in the Euro Area: An Overview* 4 (European Cent. Bank, Occasional Paper Ser. No. 133, 2012), http://ssrn.com/abstract_id=1932063; Schwarcz, *supra* note 119, at 619.

127. *See, e.g.,* FIN. STABILITY REP., *supra* note 14, at 10, 18, 38 (Bank of England's comments regarding the U.K.'s report of liquidity regulation).

128. FSB, POLICY FRAMEWORK FOR SHADOW BANKING ENTITIES, *supra* note 121, at 1.

129. *Id.* at 13.

130. *Id.* at 12.

131. *Id.* at i.

pro-cyclicality and other financial stability risks in securities financing transactions; and (5) the financial stability risk posed by shadow-banking entities and activities.[132]

To mitigate the spill-over effect in the regular and shadow banking sector, the FSB proposes that a bank's large exposure to a single counterparty should be carefully controlled and limited.[133] The FSB suggests also that a bank's capital treatment for its investment of funds should be sensitive enough to reflect both the risk of the fund's underlying investments and its leverage.[134] As for the prevention of runs on MMFs, the FSB, in line with the IOSCO, proposes that MMFs that offer stable or constant net-asset value (NAV) to their investors should be converted into floating NAVs, where that is workable.[135] Where such conversion is not feasible, safeguards equivalent to the capital, liquidity, and other prudential requirements on banks should be applied to MMFs.[136] To better align the incentives in securitization, the FSB welcomes the idea of imposing credit-risk retention requirements on securitizers.[137] Finally, the most contentious part is probably the FSB's proposal to regulate SFTs and repos.[138] It introduces a framework of numerical haircut floors intended to prevent the erosion of margins below minimum levels when non-banks obtain leverage through the use of SFTs backed by non-government securities.[139] Minimum standards will be applied also to the methodologies market participants use to calculate the haircuts that limit the amount of financing that can

132. *Id.*

133. FIN. STABILITY BD., SUPERVISORY FRAMEWORK FOR MEASURING AND CONTROLLING LARGE EXPOSURES 1 (2014), http://www.bis.org/publ/bcbs283.pdf.

134. FIN. STABILITY BD., CAPITAL REQUIREMENTS FOR BANKS' EQUITY INVESTMENTS IN FUNDS 1 (2013), http://www.bis.org/publ/bcbs266.pdf.

135. FIN. STABILITY BD. , STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING: AN OVERVIEW OF POLICY RECOMMENDATIONS 3 (2013), http://www.fsb.org/wp-content/uploads/r_130829a.pdf.

136. *Id.*

137. FSB, POLICY FRAMEWORK FOR SHADOW BANKING ENTITIES, *supra* note 121, at 21–22 (FSB "strongly endorsed" the guidance and proposals for reform of the liquidity regulation.).

138. For specific proposals made by the FSB in regulating securities lending and repos, see FSB, POLICY FRAMEWORK FOR SECURITIES LENDING AND REPOS, *supra* note 121, at i.

139. Tarullo, Shadow Banking and Systemic Risk Regulation, *supra* note 62, at 14.

be provided against a given security.[140]

The second-level reform, as already noted, is in the debate about the extension of the financial safety net, such as a discount window to the shadow-banking system. Some suggest that the similarities between deposit runs and short-term wholesale funding runs justify similar policy responses.[141] Therefore discount-window access, as well as other government liquidity assistance, should be provided to wholesale funding activities, and even to the entire shadow-banking sector.[142] In response, some commentators including Governor Tarullo[143] express the concern that any such extension of the government safety net would invite greater moral hazard, while the opponents of such an extension argue that the savings of most U.S. households are generally not directly at risk in wholesale funding arrangements, and therefore do not deserve a deposit-insurance-like regime.[144] An insurance-like protection would eliminate also the potential market-discipline that the counterparties of wholesale funding can provide.[145]

The third-level reform occurs in the discrete jurisdictions. For instance, among the most widely referred example is arguably the U.S. Reform on Money Market Funds. This reform was mainly focused on mitigating MMFs' susceptibility to heavy redemptions during periods of stress and improving these funds' ability to mitigate potential contagion from high levels of redemptions.[146]

As portrayed by possibly the most-cited official report on shadow banking, shadow banking is a very complex interconnected system.[147] It is a complex system of which we hardly know the causes, scope of potential risks, and feedback

140. FSB, POLICY FRAMEWORK FOR SECURITIES LENDING AND REPOS, *supra* note 121, at i.

141. As pointed out by Tarullo, *supra* note 62, at 4.

142. *Id.*

143. *Id.*

144. *Id.*

145. SEC Open Meeting, *Fact Sheet of Reforming Money Market Funds*, http://www.sec.gov/News/Article/Detail/Article/1365171576956#.UquO6eJoeHg.

146. *Id.*

147. Zoltan Pozsar et al, *Shadow Banking*, 458 FED. RES. BD. N.Y STAFF REP. 23 (2010), http://ssrn.com/abstract=1645337. The Map of the Shadow Banking System was conceptualized, designed, and created by Zoltan Pozsar.

loop. Adair Turner, then the Chairman of the UK's Financial Service Authority, acknowledges:

> Any system this complex will defy complete understanding and any belief that we can precisely calibrate our response to it will therefore be a delusion. Given the enormous cost which instability can produce, and given the uncertain benefits which this complexity has delivered, our regulatory response should therefore entail a bias to prudence – a bias against complex interconnectivity, against procyclical market contracts, and against allowing maturity transformation or high leverage to develop in unregulated institutions or markets.[148]

Perhaps his acknowledgement reflects the post-Crisis reform developments in this regard: The efforts led by the FSB to emphasize the importance of data collection and the continuous assessments of such an opaque system, though moving in the right direction, are nonetheless a bit misplaced, as the FSB seems to try to impose a "one size fits all" approach and overemphasizes the use of prudential regulation.

Notwithstanding the passing of many years since the Crisis, commentators still hold very different views on the terminology, definition and scope of the shadow-banking system.[149] Therefore, the FSB's one-catches-all definition is often criticized for being too broad, and as having the potential to economically and financially penalize the beneficial parts of the system by subjecting those parts to unnecessarily heightened regulation.[150] In addition, the FSB focuses on certain *ex-ante* prudential regulatory measures in order to safeguard the regular banking system from shocks originating in the shadow-banking system.[151] Many

148. Adair Turner, Shadow Banking and Financial Instability, lectured at Cass Business School 36 (Mar. 14, 2012) (transcript available at http://www.fsa.gov.uk/static/pubs/speeches/0314-at.pdf).

149. *Id.* at 3–4.

150. *See, e.g.*, Clifford Chance, FSB Consultative Documents on Strengthening Oversight and Regulation of Shadow Banking, Comment Letter 5 (Jan. 14, 2013), http://www.fsb.org/wp-content/uploads/c_130129x.pdf (explaining that the FSB's definition of shadow banking lacks clarity in that it encompasses a broad range of activities resulting in regulations being inappropriately imposed).

151. *Id.* at 6.

commentators, especially those in the industry, argue that a set of *ex post* risk mitigation tools is preferable.[152] Furthermore, the industry argues that an approach that vigorously engages market participants should be harnessed and applied before prudential regulation is imposed.[153] The rationale of the industry's proposals is not difficult to understand. Burdening banks' interactions with non-banks with additional capital charges (or other measures) would create extra costs, and in many cases, perverse incentives. Imposing bank-like regulations equally and indiscriminately on all kinds of non-bank activities and entities may dampen market-wide liquidity and erode the benefits some non-bank activities may offer. Therefore, it is more sensible to have certain risk-mitigation tools on hand but use them only when situations require.[154]

Non-bank financial intermediation, or shadow banking, flourishes exactly when the regular banking system fails to meet the wider financing and investing needs.[155] Such "needs gaps" introduce shadow-banking activities, and those activities in turn fill gaps until a greater economic efficiency is reached.[156] Credit-needs gaps are generally created by inefficient markets, and are sometimes dampened by macro-economic or prudential policies.[157] For instance, trust companies, or Bank-Trust Cooperation, became so popular in China because financing costs for Small and Medium Enterprises had escalated drastically when the government implicitly encouraged banks to extend credit only to state-owned or operated enterprises.[158] The irony is that this prudential policy was in fact originally designed to reduce the potential severity of credit-risk to banks, but it inadvertently gave a huge momentum to the growth of the now-towering shadow-banking system, and introduced even more

152. For the most representative stance of the industry, see generally INST. OF INT'L FIN., "SHADOW BANKING": A FORWARD-LOOKING FRAMEWORK FOR EFFECTIVE POLICY (2012), [hereinafter IIF, SHADOW BANKING, FORWARD-LOOKING FRAMEWORK], https://www.iif.com/system/files/IIF_ShadowBankingPaper_06012012.pdf.

153. *Id.* at 18–22.

154. *Id.* at 31–32.

155. *Id.* at 4–5.

156. *Id.*

157. *Id.* at 28.

158. *Id.*

severe financial stability risks.[159]

This lesson informs us that shadow banking can only be contained when the unintended consequence of a prudential policy is fully understood and addressed. Attempts to rein in shadow banking without taking into account the implications of the incumbent monetary and prudential policy could end up being a case of fighting fire by adding firewood–the resultant conflagration, meant to purge the regular banking area of shadow-banking, jumps the water barrier of the regular banking area and ignites it.

Greater transparency of financial institutions' maturity transformations, and a clear understanding of the unintended consequence of a prudential regulation are needed to address such concern. On the one hand, full transparency of maturity transformations will allow regulators to anticipate potential areas of retail or wholesale runs, and to adopt precautionary measures.[160] On the other hand, an educated guess about the unintended consequences of regulatory changes will prevent regulators from imposing regulations that will in fact see shadow banking flourish, or dampen the pro-cyclicality of the financial system.[161] Both objectives can be achieved effectively only in a shared governance regime in which market participants' (the creators and users of shadow banking) voices are given much more attention, and regulatory actions are subject to an adaptive and flexible process that is more open to market experiments.[162]

D. Efforts to Revive Prudence and Transform Cultures

Reviving prudence and transforming banker culture always have something to do with the issues of corporate governance,

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159. *Id.* at 4–5.

160. *Id.* at 27–28.

161. *Id.*

162. Another sensible approach would be to rethink the corporate governance assumptions about limited liability and redesign it into mechanisms that can align social interests and incentives of the investor-managers of shadow banking entities. *See generally* Steven L. Schwarcz, *The Governance Structure of Shadow Banking: Rethinking Assumptions about Limited Liability*, 90 NOTRE DAME L. REV. 1 (2014) (deriving a normative framework for rethinking the corporate governance assumptions about limited liability in the context of shadow banking).

executive compensation, and professional standards for bankers.[163] With the transformation of business models in banking, the culture of traders has been mixed into, or grafted onto, the culture of the custodians that traditional retail banking had once enjoyed for decades.[164] Thanks to the cultural shift, bankers now focus more on how to generate spectacular short-term, personalized profits at the expenses of the long-term prosperity of institutions.[165] Speculative trading and excessive risk-taking have become the main themes of banking business, and the pursuit of prudence is the story of the past.[166] Among the most-cited criticisms of the industry-wide lack of prudence is that the decision-making of banks' managements is no longer aligned with long-term performance and that the senior executives whose behaviors put the sustainability of their own banks in jeopardy are not effectively held accountable.[167] The main direction of post-Crisis financial reform with regard to reviving prudence and transforming cultures is, as a result, to counterbalance the misaligned incentives and to reinforce individual responsibility.[168]

There are several reform proposals that have been gaining popularity among policymakers, such as the corporate governance reform provisions under the *Dodd-Frank* Act, the say-on-pay policy proposals in certain jurisdictions, and bankers' bonus cap under the EU Capital Requirement Directive (CRD) IV.[169] Among the global regulatory initiatives that directly address these ends is the proposal made by the U.K.

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163. *See, e.g.,* Steven L. Schwarcz, *Regulating Shadow Banking*, 31 REV. BANK & FIN. L. 619, 635–36 (2012).

164. *Id.*

165. *Id.*

166. *Id.*

167. *See* Grant Kirkpatrick, THE CORPORATE GOVERNANCE LESSONS FROM THE FINANCIAL CRISIS, Financial Market Trends, OECD Report, 2, 15 (2009), http://www.oecd.org/finance/financial-markets/42229620.pdf.

168. *Id.* at 2.

169. *See* James Benedict et al., *Comparison of Proposed Structural Reforms to the Banking Sector in the EU, U.K. and U.S.* 5–6, LINKLATERS (2012), http://www.linklaters.com/Publications/Comparison-Proposed-Structural-Reforms-Banking-Sector-EU-UK-US/Pages/Index.aspx.

Parliamentary Commission on Banking Standards.[170]

The three local reforms all have some merit, but also evitable deficiencies. The U.S. *Dodd-Frank* reform focuses basically on all listed companies but fails to consider the unique dynamics between shareholders and bank management.[171] Allowing shareholders, especially small retail ones, to have the final say on senior managers' salary is, of course, a legitimate action and is compliant with the principle of shareholder democracy.[172] But it apparently ignores two unwelcome facts that render the "say-on-pay" mechanism ineffective in terms of shaping the culture and behaviors of banks and their senior managements. One fact is that shareholders generally have a legitimate incentive to encourage the senior managements of banks to take extra risks to maximize returns on investments.[173] Their performance-based compensation regimes (in particular those equity-based ones) effect the legitimization of that incentive.[174] Shareholders, unlike debt holders, pursue the maximization of profits. And higher profits are made possible by heightened risk-taking activity.[175] When the speculative investments made by traders or senior managers are capable of generating handsome profits, one can hardly image that shareholders will have any problem with

170. *See* U.K. PARLIAMENTARY COMM. ON BANKING STANDARDS, CHANGING BANKING FOR GOOD, 49–52 (2013) [hereinafter PARLIAMENTARY COMMISSION ON BANKING STANDARDS], http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf (addressing reforming variable remuneration).

171. Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J. L. REFORM 55, 93 (2011).

172. *Id.* at 97–98.

173. *Id.*

174. David Larcker, Gaizka Ormazabal, Brian Tayan & Daniel Taylor, *Follow the Money: Compensation, Risk,*
and the Financial Crisis, STANFORD CLOSER LOOK SERIES, 2 (Sept. 2014), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-43-risk-compensation-financial-crisis.pdf (noting that "[r]esearch shows that executives understand that the expected value of a stock option increases with the volatility of the stock price and that executives tend to respond to stock option awards by investing in riskier projects," and finding that equity-based incentives are generally positively correlated with corporate risk.)

175. *Id.* at 98 (observing that despite some evidence suggests that "say-on-pay votes encourage modest reforms, shareholders almost always approve proposed executive compensation packages" and concluding that it is unclear "that say-on-pay votes have any effect on or enhance risk management oversight.")

consenting to pay their money-making machines handsome compensations.[176] In addition, shareholders in the financial industry are always eager to hire super-brains to work for them, and when everybody else does the same, it really makes experienced senior managers with excellent track records a scarce asset in the hiring market. One can hardly deny that the quality of its human resources is the most important determining factor of a financial institution's success. You always want to have the smartest in the room working for you instead of for another, and therefore you are willing to offer competitive salaries to maintain the competitiveness of your own houses. The say-on-pay vote and its relevant requirements, will undoubtedly push shareholders to pay more attention to monitoring their bankers, and to downsizing their compensations if necessary.[177] But these mechanisms cannot change the bald fact that the hiring market for skillful bankers is in fact a seller's market, and this often leaves shareholders with no choice but to offer their senior managements handsome, attractive compensation packages.[178]

The EU's bonus cap proposal is even more controversial and has been widely predicted to become another banking-reform failure. One of the most concerning unintended consequences is that a bonus cap will inevitably introduce dramatic increases in base salary. As one commentator has observed, the EU bonus cap rules are not very different from the limits on bank pay that were imposed by TARP and U.S. Pay Czar Kenneth Feinberg when banks were being bailed out.[179] Under these previous U.S.

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176. Martin J. Conyon, *Shareholder Say-on-Pay Voting and CEO Compensation*, (July 2015) 3, https://www.cbs.dk/files/cbs.dk/call_to_action/shareholder_say-on-pay_voting_and_ceo_compensation.pdf (finding that "firms with superior market performance (shareholder returns) or accounting performance
(return on assets) receive less shareholder opposition to executive pay arrangements).

177. *Id.* at 1 (finding that "shareholder dissent on CEO pay is higher in firms with poor performance, measured by stock-market or accounting returns.")

178. This point may well have been vindicated by the evidence that even though the Say-on-Pay requirement has curbed executive cash compensation (salaries and bonuses), it has led to alternative and less transparent forms of increased compensation, such as stock awards and deferred compensation. Furthermore, the requirement may have in fact resulted in higher, instead of lower, total compensation payout by companies. *See* Mathias Kronlund & Shastri Sandy, *Does Shareholder Scrutiny Affect Executive Compensation? Evidence from Say-on-Pay Voting* (Nov. 2016), http://ssrn.com/abstract=2358696.

179. *See* Paul Hodgson, *Bankers' Pay Caps Didn't Work Here, They Won't Work in*

schemes, limits were set on bonuses of one-third of total compensation, to be paid entirely in stock.[180] These resulted in huge increases in base salaries—up to 600 percent for all senior managers in most banks.[181] One of the key drawbacks of base-salary increase is that it will make clawing back bankers' bonuses more difficult when things go wrong.[182] Similar concern was also raised by U.K. Chancellor George Osborne in a more "radical" way by the filing of a lawsuit at the European Court of Justice.[183] Chancellor Osborne argued that an increase in fixed pay would be harder to cut in times of stress, or to claw back if a bank suffers financial problems.[184] He noted also that "these latest EU rules on bonuses, rushed through without any assessment of their impact, will undermine all of this by pushing bankers' fixed pay up rather than down, which will make banks themselves riskier rather than safer . . . they may undermine responsibility in the banking system rather than promote it."[185]

Despite all the criticisms, the bonus-cap rule was at least an effort that policymakers undertook to realign the incentives of bankers and the social optimum. The need to focus on mechanisms that are capable of reshaping individual and collective incentives, if there is to be any effective and meaningful reform, is certainly one of the most important lessons we have learned from the Crisis. The bonus-caps rule may still have the potential to discourage banks' senior managers' engagement in excessive risk-taking, so long as certain disincentives are imposed on banks paying high fixed salaries. Perhaps different tax treatments can balance banks' reliance on either fixed or variable pay, and thus really bring in line senior managers' compensation

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Europe, FORBES (Apr. 11, 2013), http://www.forbes.com/sites/paulhodgson/2013/04/11/bankers-pay-caps-didnt-work-here-they-wont-work-in-europe/ (concurring that the regulatory pay cap may actually push salaries up, as it did in the U.S.).

180. *Id.*

181. *Id.*

182. Alex Barker et al., *George Osborne Takes EU to Court over Bank Bonus Cap*, FIN. TIMES (Sept. 25, 2013), https://www.ft.com/content/0f54735a-25f6-11e3-8ef6-00144feab7de?mhq5j=e5.

183. *Id.*

184. *Id.*

185. *Id.* (quoting Chancellor Osborne's words).

with firms' long-term prosperity and stability.

The U.K. proposal on "Changing Banking for Good" is probably by far the most sensible one for shaping the culture of, and restoring prudence to, the banking system.[186] It rightly focuses on incentive formation, and on the reinforcement of individual responsibility.[187] It seeks to reshape behaviors at individual level, and correctly captures the importance of professional standards for bankers. A banking industry with the culture of prudence and adherence to professional responsibility will probably only exist when professional banking standards and a body that ensures compliance and continuous supply of these standards are established.[188] That culture can in turn be naturalized, as suggested by the U.K. proposal, through the introduction of non-financial incentives, such as peer pressure, and the power to shame and other disciplinary actions. Inability to promote such a culture may render all efforts aimed at correcting distorted incentives ineffective, because there are always "golden opportunities"[189] for an individual or a firm to act

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186. *Compare* PARLIAMENTARY COMM'N ON BANKING STANDARDS, *with* Thomas J. Curry, Comptroller of the Currency, Remarks at the Annual Conference of the Clearing House, New York, Nov. 21, 2014 (transcript available at http://www.occ.gov/news-issuances/speeches/2014/pub-speech-2014-160.pdf, *and* Daniel K. Tarullo, Governor of the Federal Reserve Board, Good Compliance, Not Mere Compliance, Speech at the Federal Reserve Bank of New York Conference: "Reforming Culture and Behavior in the Financial Services Industry," New York, Oct. 20, 2014 (It is worth noting, though, that both the FRB and OCC in the U.S. have indicated in late-2014 that they would be revisiting the compensation issue (incentive compensation arrangements in particular) as part of their attempts to ensure cultural change at big banks, transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20141020a.pdf).

187. *See generally* PARLIAMENTARY COMM'N ON BANKING STANDARDS, *supra* note 186.

188. *See* Emily Glazer & Christina Rexrode, *As Regulators Focus on Culture, Wall Street Struggles to Define It*, WALL ST. J. (Feb. 1, 2015), http://www.wsj.com/articles/as-regulators-focus-on-culture-wall-street-struggles-to-define-it-1422838659 (noting that regulators would consider breaking apart the banks if they did not do enough to avoid cultural breakdowns and giving examples of what big banks are doing to increase strong ethical behavior to establish better behavior overall); Emily Glazer & Christina Rexrode, *What Banks Are Doing to Improve Their Culture*, WALL ST. J. MONEYBEAT (Feb. 2, 2015, 8:05 AM), http://blogs.wsj.com/moneybeat/2015/02/02/what-banks-are-doing-to-improve-their-culture/ (noting that banks are doubling down on culture to ensure companies comply with the letter and spirit of the law and giving examples of how banks are pushing culture to make sure employees know how to behave).

189. For the definition of "golden opportunities," see DAVID C. ROSE, THE MORAL

to the detriment of others.

III. How Should the Financial Ecosystem be Governed?

Summarizing the observations in the analysis of the post-Crisis financial reform, this Part advocates that a more balanced governance approach is urgently needed in the financial ecosystem. Financial reforms can never be made perfect, due to the extremely complex nature of the rapidly changing financial ecosystem. But this does not necessarily mean that a more sensible and effective governance regime will always be absent. On the contrary, it suggests that an adaptive, public-private collaborative, and constantly-learning approach is required, if the top regulatory priority is to maintain long-term financial stability. This Part will first describe why a more balanced governance approach is needed, and the author will explain what exactly "more balanced approach" means. Then the scholarship of New Governance will be examined, and further applied to constructing the theoretical ground for the development of such an approach. Lastly, this Part will analyze how the use of market discipline should be reconsidered in the context of this governance approach.

IV. A More Balanced Approach Is Needed

If we view all the post-Crisis financial reform measures as a system, then it is not difficult to understand that this is basically a system in which the target-based approach (e.g. capital requirement and liquidity requirements), government-centered decision-making, top-down policy-making process, and complex rules of huge technicality generally dominate the formulation and implementation of regulatory regimes.[190] It is a system somehow very much unbalanced in that it does not seek to sincerely involve

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FOUNDATION OF ECONOMIC BEHAVIOR 53–55 (2011) (stating that "if a decision maker is convinced that he will not be detected if he chooses an action like *c* rather than an action like *d*, then institutional approaches will be rendered moot if the only reason why he is reluctant to behave opportunistically is that it is imprudent to do so. Such a decision maker will always act on any golden opportunity.").

190. Lawrence G. Baxter, *Adaptive Regulation in the Amoral Bazaar*, 128 S. AFR. L.J. 253, 255–57 (2011).

market participants, nor to adopt more adaptive regulations.[191] It is also a system in which firm political determination is often absent, and the objectives of intended regulations are frequently miscarried by poor implementation and regulatory arbitrage. In addition, it is a system in which policymakers and regulators act impatiently and hastily to put in place complex and overwhelming regulations, in quick response to the uncontainable rage and impatience of the Main Street.

The post-Crisis governance system has failed to reach balance at least on the following aspects: (1) the use of regulatory weapons and market power;[192] (2) the use of prescriptive regulations and experimental measures;[193] (3) the adoption of one-size-fits-all and individually tailored approach; (4) the choice of a strictly observed schedule or an adaptive, flexible process for implementation;[194] and (5) the use of complex preventive rules and simple forward-looking principles.[195] Why a more balanced approach for financial regulation is preferable is fairly self-evident, in two ways: the nature of the financial ecosystem requires it, and certain deficiencies in the post-Crisis financial reform are amply revealed.[196]

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191. It is noted that there is a growing literature on ideas about the development of adaptive regulation for the better addressing of complex adaptive systems. On how new concepts of adaptive regulation might help address regulatory challenges in today's complex financial systems, *see id.* at 264–68.

192. Baxter, *Fundamental Forces*, *supra* note 2, at 113–14 (explaining regulators' reaction to large scale and complex financial institutions in the market).

193. Cox et al., *supra* note 5, at 27–28, 30.

194. For example, some scholars advocate the view that the Volcker Rule should be implemented on a phase-in basis. *See id.* at 12–13 (proposing that "[f]inancial regulators should sequence compliance with the final regulations to allow agencies time to monitor for unanticipated effects and to make any appropriate modifications based on the metrics and unique characteristics of each individual market and product . . . . Therefore, this new approach would give agencies the option to implement the rule on a phased- in basis rather than universally at one time.").

195. *Id.* at 6–7, 36.

196. Another promising alternative to regulating the dynamically changing financial system is to adopt a functional approach, as advocated by Steven Schwarcz. He argues that financial regulation is generally tethered to the financial architecture at the time the regulation is promulgated, including the distinctive design and structure of financial firms and markets. This type of regulation, therefore, should be monitored and updated continually. As a result, "it may be more effective—or at least instructive—to focus on the system's underlying, and thus less time-dependent, economic functions than

From the standpoint of complexity theory, today's financial system is managed as a highly complex, dynamic game.[197] The way the system responds to the failure of financial institutions, or to new regulations, is largely unpredictable.[198] Newly imposed regulations often turn out to be merely adding another layer of complexity to the system, subjecting the entire system to ever greater uncertainty and instability. In addition, the system is defined and shaped mainly by ultra-large financial institutions, as well as by some seemingly unlikely extreme events.[199] Despite the fact that regulatory responses are correctly focused on dealing with systemic risks potentially introduced by big banks, regulators often find themselves hard pressed to keep track of change and the arbitrage antics of powerful industrial players. Moreover, policymakers at every level are often path-dependent (historically, culturally, or politically) and are able to put in place reform measures only within the parameters determined by that dependency.[200] In general, the overall financial ecosystem is not

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to tie regulation to any specific financial architecture." Steven L. Schwarcz, *Regulating Financial Change: A Functional Approach*, 100 MINN. L. REV. 1441, 1444 (2016), http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5995&context=faculty_scholarship.

197. Viewing the financial markets as a complex system is an analogy that begins to gain popularity in the aftermath of the 2008 Crisis. For instance, in 2010, the British Government Office for Science published a review that observes that "the global financial markets have become a complex adaptive ultra-large-scale socio-technical system-of-systems." DAVE CLIFF & LINDA NORTHROP, U.K. DEP'T OF BUS., INNOVATION AND SKILLS, THE GLOBAL FINANCIAL MARKETS: AN ULTRA-LARGE SCALE SYSTEMS PERSPECTIVE 4 (2010), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/289012/11-1223-dr4-global-financial-markets-systems-perspective.pdf; Lawrence G. Baxter, *Internationalisation of Law—The 'Complex' Case of Bank Regulation*, *in* THE INTERNATIONALISATION OF LAW: LEGISLATING, DECISION-MAKING, PRACTICE AND EDUCATION 3 (Mary Hiscock & William van Caenegem eds., 2010) [hereinafter Baxter, *Internationalisation of Law*] (noting how financial complexity gives regulators and public policy experts a field day and that complexity delights the most scholastic medieval mind); Andrew G. Haldane & Robert M. May, *Systemic Risk in Banking Ecosystems*, 469 NATURE 351, 351–55 (2011).

198. Baxter, *Internationalisation of Law*, *supra* note 197, at 14.

199. This feature can be understood as "Power Laws." For how power laws manifest themselves in financial markets, see, e.g., Xavier Gabaix et al., *A Theory of Power-Law Distributions in Financial Market Fluctuations*, 423 NATURE 262, 267–70 (2003).

200. This feature is referred to as "Path Dependency." *See, e.g.,* Donald T. Hornstein, *Complexity Theory, Adaptation, and Administrative Law*, 54 DUKE L.J. 913, 924–27

only extremely complex, but also a rapidly adaptive one that requires certain new governance approaches to redirect the spontaneous order of the system to serving the common good.[201]

The above-mentioned points all suggest that policymakers should: acquire and build up candid partnership with all market participants; be adaptive to systemic and ecological changes; be responsive and forward-looking; [202] be honest about their own limitations; and concentrate on harnessing the market power to serve the common good. Although many efforts are seemingly moving in the right direction, the post-Crisis regime has somehow ignored the contributions that the market itself can make to the perfecting of financial governance. A top-down, centralized policymaking process, the misplaced ambition to foresee all potential instability risks, and the imposing of *ex-ante* regulations accordingly are in fact weakening the market's power to regain its best shape, and creating an illusion of a safer, more stable financial ecosystem.[203] Unfortunately, this seems to be a reflection of the reality of the post-Crisis financial reform.

As previously noted in this article, post-Crisis efforts aiming to achieve different objectives all seem to have limitations that can be remedied by introducing a more balanced governance regime.[204] Target-based regulations, such as capital, leverage and

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(2005); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 646–53 (1996). For an overview of path dependency theory and its application in the common law system, see generally Oona A. Hathaway, *Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System*, 86 IOWA L. REV. 601 (2001).

201. *See* Cheng-Yun Tsang, *Rethinking Modern Financial Ecology and Its Regulatory Implication*, 32 BANKING & FIN. L. REV. 461, 491–94 (2017).

202. *See* Lawrence G. Baxter, *Did We Tame the Beast: Views on the US Financial Reform Bill*, 2 J. REG. & RISK N. ASIA 209, 217 (2010) (observing that "[i]f the global financial system is really more accurately understood as a truly complex environment in the scientific sense, then trying to regulate modern global finance will require more nuanced, skilled and rapidly reactive regulation than commands, prohibitions or greater enforcement powers. New techniques of adaptive regulation must be developed to meet the fast-paced world of payments, financial dealing and innovation.").

203. *Id.* at 216–17 (stating that the over-centralization risks exists and that while the Dodd-Frank Act is in theory helping reduce systemic danger, it is actually a vehicle for promoting systemic financial safety).

204. *See id.* at 214, 216–17 (noting that the global finance system possesses characteristics of complexity and interconnectedness which causes the system to resemble an unintelligent central design).

liquidity requirements, are perfect examples of top-down policymaking and examples of the endless pursuit of globally and industrially uniform standards.[205] Despite the risk-sensitivity and individuality of these reforms, these properties have unexpectedly been translated into more granular, complex rules and mutually-conflicting schedules for implementations. Structural reforms, such as ring-fencing and the Volcker Rule, though conceptually workable, are fiercely resisted by the industry for their extreme complexity, and for the difficulties of implementation and compliance that they bring.[206]

The Regulation and Resolution Regimes of SIFIs, though they seem promising for eliminating the TBTF phenomenon, still depend greatly on the successful and effective cooperation and coordination of worldwide regulators.[207] Innovative ideas, including Living Wills, though they try to harness industrial insights to perfect the current resolution regime, have ignored the very fact that even the senior managements of SIFIs are unable to portray the organizations they oversee, let alone take into account their interconnectivities when drafting the Wills. Furthermore, a successful regulatory and resolution regime for SIFIs requires an understanding of the supporting role of market discipline in macro-prudential policy. A sophisticated and precise interpretation of shock correlations and interconnectedness among banks is needed, and would require at least extensive disclosures on banks' liquidity reserves, the maturity distributions of their on-and-off balance sheet assets and liabilities, the qualitative and quantitative breakdown of their trading and non-trading market risks, and a culture-sensitive disclosure on risk governance.[208] In addition, the proposed

205. Baxter, *Götterdämmerung*, *supra* note 18, at 97, 98–99 (discussing how regulators demand greater capital and stricter liquidity requirements, and the industry relies on orderly liquidation authority that ensure consequences are felt internationally).

206. *Id.* at 98.

207. *See generally* Martin Gruenberg & Paul Tucker, *When Global Banks Fail, Resolve Them Globally*, FIN. TIMES (Dec. 10, 2012), http://www.ft.com/intl/cms/s/0/fd66d172-3fd4-11e2-b0ce-00144feabdc0.html#axzz2n0rj13ET (noting then the 28 SIFI's in countries around the world and during the financial crisis, the U.S. and U.K. lacked power and since then their regulators now work together).

208. Maria J. Nieto, *What Role, If Any, Can Market Discipline Play in Supporting*

regulatory regime for SIFIs is not very focused on the communication of information between market participants and regulators.[209] A macro-prudential regulator must be transparent and willing to communicate with market participants in order to build a market-wide understating of its actions.[210] Also, supervisors have to issue timely communications to market participants, and disclose the relevant proprietary information they obtain from both onsite and offsite examinations, so that the mechanism that market participants rely on when they factor counterparties' risk levels into their own assessments and pricing will be greatly improved.[211] This would guarantee an orderly liquidation when a firm is on the brink of failure, because the failing firm's counterparties will already have prepared for its failure.[212]

In areas where the next system-wide crisis is most likely to hit, such as in the shadow-banking system, an adaptive, *ex post*, decentralized regulatory and supervisory approach is much more preferable.[213] Policymakers and regulators still know too little about the causes and feedback loop of the shadow system, and therefore any *ex-ante* preventive measure has the potential to introduce unintended consequences that may further dampen the procyclicality and instability of financial systems. Regulating shadow-banking so that the occurrence of *unknown unknowns* will not cause too much surprise, and the provision of credit will not be inadequately restrained, is always a delicate task. Finding

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Macroprudential Policy?, BANCO DE ESPANA OCCASIONAL PAPER NO. 1202 (2012). These recommendations for disclosure are summarized from FIN. STABILITY BD., ENHANCING THE RISK DISCLOSURE OF BANKS: REPORT OF ENHANCED DISCLOSURE TASK FORCE (2012), https://www.financialstabilityboard.org/publications/r_121029.pdf.

209. *See* Nieto, *supra* note 208, at 19 (noting that financial institutions are reluctant to communicate information to the market that policymakers and regulators could use to supplement the signaling content of market prices).

210. *Id.* at 20.

211. *Id.* at 11, 20.

212. *See id.* at 20 (noting that this corrective action by supervisors allows market participants to fully anticipate policymakers' reactions and allow priority of claims to be protected in liquidation).

213. Karen Gilchrist, *Next Crisis Could Come from the Shadow Banking Industry, Says Ex-Fed Member Lockhart*, CNBC (Apr. 5, 2017, 4:50 AM), https://www.cnbc.com/2017/04/05/next-crisis-could-come-from-the-shadow-banking-system-says-ex-fed-member-lockhart.html.

the necessary balance requires extensive collaboration among regulators and the regulated market actors, and it takes time for both parties to learn and adapt.

Lastly, better prudence and culture can only be successfully cultivated upon the voluntary and spontaneous transformation of financial institutions themselves. Exogenous forces, like regulatory powers, may help incentivize internal transformation, but will sometimes curtail the growth of the self-awareness that bankers need to change their behaviors voluntarily. Punitive actions and enforcements at the institutional level may bring forced compliance with laws and rules, but only losses of individual reputations will bring real moral restraint and voluntary obedience to professional standards. Reputational capital can be accumulated and taken away only by the market itself, in repeated business dealings, and by an industry-wide recognition and examination of professional standards.[214] Regulators should serve more like coaches than judges by assisting the promotion of prudence and cultural transformation, but the appropriate coaching takes extensive public-private collaboration to achieve mutually beneficial partnerships.

On the other hand, one of the most salient lessons one can learn from the 2008 Crisis, in terms of regulating the market in a more balanced way, is that regulators may have "abdicat[ed] their responsibility where they implement flexible, iterative, collaborative systems without simultaneously developing mechanisms to 'kick the tires' on industry-generated solutions."[215] In other words, in the pre-Crisis era, regulators may actually have been too deferential, and too reliant on the industry's self-correcting and innovating powers. As Professor Ford's powerful criticism puts it:

> Regulators developed a chastened understanding of their own capacity and a heightened sense of the virtue and brilliance of industry. Regulatory capacity and status diminished, and regulators reacted predictably to their circumscribed mandate . . . . Consequently, in the face of

214. *See generally* REPUTATION CAPITAL: BUILDING AND MAINTAINING TRUST IN THE 21ST CENTURY (Joachim Klewes & Robert Wreschniok eds., 2009).

215. Cristie Ford, *Macro- and Micro-Level Effects on Responsive Financial Regulation*, 44 UBC L. REV. 589, 625 (2011).

> gaps in their own knowledge, regulators ceded too much of the power to ascribe content to regulatory principles to industry alone. They did not engage in insistent, probing conversations with industry around their precise understandings of what constituted "compliance", meaning that there really was no meeting of the minds around what "compliance" entailed . . . . Because regulators failed to manage change in conscious ways—by failing to record their own learning or to track movement over time in the meaning of terms, such as "adequate disclosure" or "material risk"—they failed to intervene in a downward behavioral cascade.[216]

Professor Ford's critique emphasizes the importance of the regulator's ability to discern the genuineness of the "industry's wisdom" and interrogate industry-wide best practices.[217] This is essentially saying that it is one thing for regulators to recognize the complex nature of today's financial ecosystem, but it is quite another to defer to the regulatory discretion of the industry (given its nature) without taking into serious account the regulatory capacity necessary to make flexible regulation work right.[218]

As required by the nature of the contemporary financial ecosystem, and by the limitations presented by the post-Crisis reforms, this author believes that a more balanced governance approach is critically needed. By "more balanced" approach, this article envisages the governance model for financial systems to be a new path introduced into the current context of the centralized, command-and-control regulatory regime, and the undue reliance on industry-based norms and standards.[219] It aspires to go beyond the separation of regulators-dictated supervision, and industry-initiated patrolling and safeguarding self-regulation.[220] Specifically, it is a governance regime in which participation, collaboration, and power-sharing with non-state market actors is increased, legislative and regulatory experimentation is

216. *Id.* at 621.

217. *Id.* at 616.

218. *See generally id.* (noting that industry delegation should be partial because state or public oversight is needed to put a brake on industry self-interest).

219. Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 443 (2004).

220. *Id.*

encouraged, competition and diversity of regulatory and industrial practices is promoted, an adaptive and responsive policy-and-regulation-making process is adopted, and the use of simple, flexible standards and stringent peer review is embraced. It would be an approach directly aimed at harnessing the self-disciplining power of the market, aligning the incentives of the industry and the public, and enhancing the accountability and trustworthiness of the regulators and the regulated. Nonetheless, on the other hand, this approach should not over-embrace the virtue and brilliance of the financial industry. Regulatory scrutiny and weapons should always be made ready to redirect, in a collaborative manner, the misplaced market innovations, or the market-savviness that miscarries.

This article finds the scholarship of New Governance ("NG") particularly informative and intelligently compatible with the author's envisaged balanced governance regime, and will therefore use it as the theoretical foundation upon which its analysis rests. Yet the NG approach is itself not without limitation. The following discussion will address a number of weaknesses in the NG approach, especially when the approach is applied to financial regulations. Lastly, harmonizing NG scholarship and the current financial governance regime should not be attempted as an entire overhaul of the regulatory structure, nor as the recreation of the current system. Rather, NG scholarship and wisdom should be carefully and sensibly naturalized into the existing regulatory landscape, such that reform will not be overdone, and unnecessary social costs will not be incurred.

V. THROUGH THE LENS OF NEW GOVERNANCE SCHOLARSHIP

In this section, this author will systemically examine the scholarship of NG: its definition, intended objectives, features and principles, and its scholarly application in the context of financial regulation.

NG scholarship basically claims that in a multifaceted and complex globalized world, sound regulation is not solely the product of state action; rather, it should be the co-product of governmental and nongovernmental actors, through a process of collective negotiation and collaboration.[221] The key regulatory objective, according to this paradigm, is not to control the regulated by subjecting them to government-enforced rules, but to arouse and utilize private capacity to achieve public goals.[222] Still, the NG paradigm is not essentially an advocacy of deregulation. Deregulation in the traditional sense is defined as those initiatives that seek a near-complete withdrawal of government from the regulatory universe,[223] whereas NG theory advocates a certain form of public-private partnership in the regulatory process.[224]

A. *What is New Governance and Why We Need It*

The origination and build-up of NG scholarship was in scholarly revisits of the concept "governance," and of the very role of "government." The primary proponent of NG, Professor R. A. W. Rhodes, uncovered the importance and potential usefulness of "networks," and their significant degree of autonomy from the state, during his reflections on the changes in the British governments of the 1990s.[225] After analyzing six different uses of the term "governance," Rhodes stipulates that "governance" refers to *self-organizing, interorganizational networks*, and argues that these networks complement markets and hierarchies "as governing structures for authoritatively allocating resources and exercising control and co-ordination."[226] He sees "governance as a broader term than government with services provided by any permutation of government and the private and voluntary

221. *See* Saule Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation,* 159 U. PA. L. REV. 411, 438 (2011).

222. *Id.* at 427–28.

223. *Id.* at 416. The term "deregulation" is itself multifaceted and may need to be understood through a broader appreciation of the role of law and the variety of governance mechanisms in the context of the market. For an analysis of the dynamics of deregulation, see Marc Allen Eisner, *Markets in the Shadow of the State: An Appraisal of Deregulation and Implications for Future Research*, *in* GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION (Edward J. Balleisen & David A. Moss eds., 2010).

224. Omarova, *supra* note 221, at 421, 427.

225. R. A. W. Rhodes, *The New Governance: Governing without Government*, 44 POL. STU. 652, 659 (1996) (highlighting the larger degree of freedom in autonomy versus self-governance).

226. *Id.* at 652.

sectors."[227] He uses the term "networks" to refer to those inter-organizational linkages and independent actors through which governing services are rendered.[228] In his view, networks are not accountable to the state, and are self-organizing.[229] On the other hand, even though the state does not occupy a privileged position, it can "indirectly and imperfectly steer networks."[230] In the network-driven regime, there has been a shift from government to governance, and it is the mix of bureaucracy, markets, and networks that really matters.[231] A key challenge for government, therefore, is to "enable these networks and to seek out new forms of co-operation."[232] Rhodes's theory reminds us that equal attention should be directed to the role of government, and to the connecting market and networks. Probably the most valuable contribution of his scholarly work is that it sheds light on how best-policy solutions could be reached, and how modern society should be governed.[233] And these very questions are exactly the underlying purposes setting and directing the research focus of NG scholarship.

On the traditional governance model, government and regulators, empowered by the citizens to make modern society and economy more fair and efficient, undertake most primary missions. Information-gathering and decision-making is generally a centralized, top-down, and unilateral process; and policy objectives are often achieved through commands and orders. This mechanism may function fairly well when the activities of civil society are still not very complex and diversified, but it may have trouble managing and governing society effectively and fairly when that society itself is in fact a complex system of systems.[234] NG scholarship, recognizing the

227. *Id.* at 658.

228. *Id.*

229. *Id.* at 660.

230. *Id.*

231. *Id.* at 665.

232. *Id.* at 666.

233. *Id.* at 667 (identifying governance as self-organizing networks as a prime example of governing without government).

234. Lobel, *supra* note 219, at 357 (observing that "life has reached a new degree of complexity which renders a central control-and-command structure impossible."); *see also* Michael C. Dorf & Charles F. Sabel, *Drug Treatment Courts and Experimentalist*

insufficiency of the command-and-control approach, is a product developed jointly by scholars[235] from the disciplines of law, political science, and public administration, and it aims to reform the traditional approach.

Defining the concept and scope of NG scholarship, given its rich interdisciplinary interpretations, is probably unnecessary. Scholarly theories that can be deemed as branches of the NG scholarship at least include[236] "soft law,"[237] "self-regulation,"[238] "embedded self-regulation,"[239] "collaborative governance,"[240]

Government, 53 VAND. L. REV. 831, 837 (2000) (claiming that "in a complex and rapidly changing world it is manifestly impossible to write rules that cover the particulars of current circumstances in any sphere of activity.").

235. S*ee* Scott Burris, Michael Kempa & Clifford Shearing, *Changes in Governance: A Cross-Disciplinary Review of Current Scholarship*, 41 AKRON L. REV. 1, 3, 5 (2008) (describing a more recent review of the multidisciplinary scholarship on New Governance); Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 345–56 (1998) (discussing a new form of government, democratic experimentalism); Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 27 n. 105 (2008) (providing a very limited list of key New Governance scholarship in footnote 105); James S. Liebman & Charles F. Sabel, *A Public Laboratory Dewey Barely Imagined: the Emerging Model of School Governance and Legal Reform*, 28 N.Y.U. REV. L. & SOC. Change 183, 191, 193 (2003) (proposing new legal strategies in public and reformed school systems); Lobel, *supra* note 219, at 357–58 (providing a thoughtful exposition of the emerging New Governance paradigm); Charles F. Sabel & William H. Simon, *Destabilization Rights: How Public Law Litigation Succeeds*, 117 HARV. L. REV. 1015, 1016 (2004) (explaining the experimentalist approach in public law litigation); Susan P. Sturm, *A Normative Theory of Public Law Remedies*, 79 GEO. L.J. 1355, 1365–76 (1991) (identifying developing forms of public remedial practice); Susan P. Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 555 (2001) (proposing a new structural regulatory solution to address second generation employment discrimination); *see also* Bradley C. Karkkainen, *'New Governance' in Legal Thought and In the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471, 472, 474, 476 (2004) (discussing the similarities and differences between various New Governance perspectives).

236. Lobel, *supra* note 219, at 345–47.

237. *Id.*; *see generally* Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, 54 INT'L ORG. 421 (2000) (discussing the advantages and disadvantages of soft and hard law).

238. *See generally* Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 L. & POL'Y 363 (1997) (discussing self-regulation policy instruments).

239. *See generally* John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 MICH. L. REV. 1466 (1982) (discussing the NG Scholarship of enforced/embedded self-regulation).

240. *Id.*; *see generally* Jody Freeman, *Collaborative Governance in the*

"meta-regulation,"[241] "iterative regulation,"[242] "negotiated governance,"[243] and "negotiated rulemaking."[244] The similarities and nuances of these theories aside, these subsets of ideas could be "understood together as generating a powerful vision within legal thought about the need for renewal through a shift to the governance paradigm."[245] Among the numerous efforts pushing for such a paradigm shift, the central focus of NG scholarship is nonetheless relatively clear and unambiguous: *to acknowledge the growing importance of non-governmental actors in today's complex modern society, and to harness these actors' power and wisdom to build up a more balanced, effective governance regime*.[246] NG scholarship, instead of being treated as a set of elements on which a single clear-cut theory was based, should be viewed as "a distinctive new brand of legal and policy scholarship," and a "family of governance innovations."[247] Fluid and diversified though the concepts of this scholarship might be, its objectives are nevertheless surprisingly focused.

In broad terms, all theories proposed under the NG flag have two common dimensions or objectives. On the one hand, NG scholarship aims to build up the most effective and legitimate decision-making mechanism in complex organizational

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Administrative State, 45 UCLA L. REV. 1 (1997) (discussing the theory of collaborative governance).

241. *Id.*; s*ee generally* Cary Coglianese & Evan Mendelson, *Meta-Regulation and Self-Regulation*, THE OXFORD HANDBOOK ON REGULATION (Robert Baldwin, Martin Cave, and Martin Lodge, eds., 2010) (discussing the theory of meta-regulation).

242. *See* James D. Cox, *Iterative Regulation of Securities Markets after Business Roundtable: A Principles-Based Approach* (July 24, 2014), http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6032&context=faculty_scholarship (observing that "[b]y far the approach most within reach and worthy of consideration is that whenever regulation is considered it is advisable to do so incrementally with the level being dictated by the breadth and complexity of the area to be regulated").

243. *Id.*; *see generally* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003) (analyzing the theory of negotiated governance and its form in the United States legal regime).

244. *Id.*; *see generally* Lawrence Susskind & Gerard McMahon, *The Theory and Practice of Negotiated Rulemaking*, 3 YALE J. ON REG. 133 (1985) (discussing refinements to improve the process of negotiated rulemaking).

245. Lobel, *supra* note 219, at 347.

246. *Id.* at 438.

247. Karkkainen, *supra* note 235, at 473.

structures[248] through a collaborative deliberation supported by decentralized groups of stakeholders "that can access local knowledge and context-specific understandings of a situation."[249] On the other hand, NG distinguishes itself from government regulation and market non-regulation through the adoption of a *softer* governance model[250] while preserving an active role for the government and regulators. This softer model envisages a system in which regulators use more guidance than regulations to govern,[251] and flexible processes that "allow open communication, fluid participation, and consensus-based deliberation."[252] In addition, a softer model is to be distinguished from the traditional concept of "soft law," as it relies heavily on a "meaningful and effective enforcement capacity."[253]

Professor Orly Lobel further identifies a number of reasons for why soft mechanisms may be preferable to hard regulation: (1) the complex nature of modern issues renders obvious solutions and clear-cut regulations impossible;[254] (2) Softer mechanisms allow the formation of minimum levels of adherence and then further enable the building up of higher, self-improving standards;[255] (3) Softer mechanisms could help facilitate implementation even when there is too much political or ideological resistance for reaching hard legislators;[256] (4) Flexible approaches generally advance the overall legitimacy of the system and semi-voluntary compliance regimes usually encourage the industry's collaboration and collective learning with the regulators.[257]

With the abovementioned objectives of NG in mind, the author will further analyze the defining features and elements of

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248. Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235, at 27–28.

249. *Id.* at 28.

250. Lobel, *supra* note 219, at 394.

251. *Id.* at 390.

252. *Id.*

253. Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235, at 32.

254. Lobel, *supra* note 219, at 357–58, 393.

255. *Id.* at 393.

256. *Id.* at 394.

257. *Id.* at 395.

NG in the following section.

B. Features and Principles of New Governance

1. Common Features of New Governance

To sum up, there are basically four major features of NG scholarship:[258] (1) the preservation of the active role of lawmaking and enforcement[259] (a "regulatory weapon" in the background); (2) active pursuit of non-government actors' knowledge to supplement policymakers' wisdom[260] (increased private participation and power-sharing); (3) flexible and communicative rulemaking processes[261] (dynamic decision-making process); and (4) collective and extensive use of flexible standards, benchmarks, and peer review to achieve policy objectives and ensure accountability (softer regulatory tools).[262]

The "Regulatory Weapon" concept symbolizes the distinctness of the NG approach from the other guises of self-regulation and deregulation. It is of paramount importance, if an NG regime is to succeed, to have a strong regulatory enforcement capacity. Complete reliance on the power of the market or networks, and the absence of supervisory powers, would subject the entire governance structure to a variety of market and human failures. Only when the regulatory gun's trigger is ready to be pulled can the accountability and legitimacy of a power-sharing regime of governance be assured.

Increased participation and power-sharing, on the other hand, make the structuring of collaborative solutions possible.[263] Negotiated regulatory deals have the potential to bridge the

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258. Robert Weber, *New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation*, 62 ADMIN. L. REV. 783, 838–39 (2010) (observing that there are three characteristics of New Governance measures: "(1) retention of the active role of lawmaking and enforcement; (2) active pursuit of non-state actors' knowledge to supplement, and sometimes replace, policymakers' expertise; and (3) a dynamic, flexible, and dialogic legislative and rulemaking process.").

259. *Id.* at 839.

260. *Id.* at 839, 842.

261. *Id.* at 839.

262. *Id.*

263. *Id.* at 842.

knowledge gaps between regulators and the regulated, and would increase sincere cooperation on both sides.[264] This approach can also strengthen legitimacy, as the likelihood that the regulated will retreat from a mutually agreed-upon regulatory solution is reduced.[265]

A dynamic decision-making process can complement the insufficiencies introduced by *ex-ante* laws and regulations, as it allows the flexibility of revising and adjusting flawed regulatory initiatives promptly. As observed by Professor Robert Weber:

> When regulating dynamic and complex market behaviors, such *ex-ante* laws will be either over- or under-inclusive and will often fail to achieve their objectives. Worse still, they might unnecessarily exacerbate market complexity by motivating a regulatory arbitrage game in which regulatees develop technologies to avoid the effects of the *ex-ante* law. Unless enforced simplicity is the favored solution, the challenge for lawmakers is to construct a regulatory system that is flexible enough to keep up with the dynamism of these regulated activities.[266]

Finally, the perfection of a flexible decision-making process can be realized only through the extensive use of softer regulatory tools, as these mechanisms are more "open to diverse forms of articulation,"[267] and can help both regulators and the regulated engage collectively and diligently in continuous learning, error detection, and peer reviewing.[268]

2. Key Elements of New Governance

According to Professor Lobel, there are essentially four principles of NG: *Participation*, *Collaboration*, *Experimentation*, and *Competition*.[269] Participation emphasizes the importance of

264. *Id.* at 843.
265. *Id.*
266. *Id.* at 845.
267. *Id.* at 847.
268. *Id.*
269. Lobel, *supra* note 219, at 371–404. Lobel originally listed participation, diversity, decentralization, competition, collaboration, and experimentation as the governing principles of New Governance, but the present author finds these can be summarized into four major principles as listed in the text, because diversity and

engaging multiple actors in the various stages of the decision-making process, and shifting non-government actors from passive to more active roles.[270] By setting more private actors on the decision-making arena, their diversified expertise and experience is expected to help facilitate and reach more informed and sensible policy decisions. Traditional theory of administrative law suggests that the policymaking powers of executive agencies are based on their superior knowledge and expertise.[271] The creation and development of legal doctrines are therefore generally expected to be delegated to agency expertise.[272] External participation was sometimes considered a threat to the legitimacy of the administrative state, since its allowance may subject agencies to the inappropriate influence of vested interests, and to regulatory capture due to industry pressure.[273]

Although such worries are not unrealistic, they nevertheless overestimate the expertise agencies enjoy in matters concerning real, complex dynamics. Also, they underestimate the potential value private participation can bring to society. Local knowledge, context-specific understanding of a given situation, and first-hand information about industrial development are all benefits that simply cannot be offered by executive agencies. Acknowledging the limitations of the closed-end and government-dominated decision-making process, the proponents of NG argue that participation is the first important principle to be observed.[274]

It is natural to develop a commitment to Collaboration, as it generally follows from the commitment to Participation.[275] The traditional regulatory model deems the industry and private actors to be the *objects* of regulation, while NG suggests that private actors should be treated as "norm-generating *subjects*."[276] NG identifies as the drawback of the traditional model the fact

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decentralization are theoretically compatible with the principle of participation.

270. *Id.* at 373.

271. *Id.*

272. *Id.*

273. *Id.* at 373.

274. *Id.* at 371–75.

275. *Id.* at 377.

276. *Id.*

that decision-making is left to "a small, detached group of number-crunching experts,"[277] and therefore the traditional regulatory model only gives rise to adversarial relations and sometimes, mutual distrust.[278] Proponents of NG further argue that commitment to collaboration would involve all actors, whether public or private, in the process of developing norms and behavioral standards.[279] Such a collaborative approach would help all parties realize their interests and goals in a mutually beneficial way, and it would entail a move from a win-lose game to a win-win environment, as all actors will come to realize that their interests are in fact intricately interlocked.[280] Eventually, a collaborative approach will enable a transition to a partnership-based and two-way communication model in which policy can be made by the sincere and diligent efforts from the two sides of the aisles.[281]

Despite the potential advantages that NG scholars claim for Collaboration, the term "collaboration" can very easily become a shallow one if it is not implemented by a well-crafted collaborative regime. Professor Lobel offers a general picture of how a collaborative regime should look:

> In a cooperative regime, the role of government changes from regulator and controller to facilitator, and law becomes a shared problem-solving process rather than an ordering activity. Government, industry, and civil society groups all share responsibility for achieving policy goals. Industry is expected to participate as part of a search for common goals, not just rigidly asserting its narrow economic or political interests.[282]

But she nonetheless recognizes the importance of a clear and specific procedure for all collaborative regimes. A collaborative environment, she argues, "heightens the need to include procedures that ensure that parties' interests and externalities are taken into account, negotiation processes are adequately

277. *Id.*
278. *Id.*
279. *Id.* at 377.
280. *Id.* at 379.
281. *Id.* at 377.
282. *Id.*

structured, and the bargaining power of stakeholders is addressed."[283] A detailed set of procedures by which the spirit of collaboration is translated into reality can be found in the U.S. *Negotiated Rulemaking Act* of 1996.[284] It aims to set up an administrative law process through which stakeholders "come together to negotiate and reach consensus as to the substance of regulation."[285] Similar kinds of procedures will be needed should genuine collaboration be achieved.

In addition to a clear set of procedures, it is of paramount importance that the outcomes of the collaboration approach should be subject to continuous review. In the complex contemporary ecosystem, both the *capacities* and the *identities* of all participants evolve substantially over time.[286] Collaboration thus has the potential to promote mutual accountability, which is accountability that enables to foster mutual trust and enhances the overall system's capacity to respond to changes and uncertainty.[287] Similarly, environmental-law scholars also recognize "the need for continuous experimentation and dynamic adjustment in response to new learning"[288] especially when an integrated, holistic management of ecosystems is to be achieved. The awareness of the importance of continuous learning and adaption signifies another integral component of NG–*Experimentation*.[289]

The practice of experimentation in the governance regime is in fact an explicit acknowledgment that the action undertaken now is necessarily temporary, and is subject to adjustment and adaption as future situations require. As Professor Bradley Karkkainen accurately observes: "This approach emphasizes

283. *Id.* at 379.

284. Negotiated Rulemaking Act of 1990, Pub L. No. 101-648, 104 Stat. 4969, *codified at* 5 U.S.C. §§ 561–570 (2012); Administrative Dispute Resolution Act of 1996, Pub. L. No. 104-320, § 11(a), 110 Stat. 3870, 3873.

285. Lobel, *supra* note 219, at 377.

286. L. David Brown, *Multiparty Social Action and Mutual Accountability, in* GLOBAL ACCOUNTABILITIES: PARTICIPATION, PLURALISM, AND PUBLIC ETHICS 94 (Alnoor Ebrahim & Edward Weisband eds., 2007).

287. *Id.* at 96.

288. Bradley C. Karkkainen, *Collaborative Ecosystem Governance: Scale, Complexity, and Dynamism*, 21 VA. ENVTL. L.J. 189, 193–94 (2002).

289. *Id.* at 193.

dynamic and flexible decision-making, adjusting and correcting decisions over time in light of subsequent scientific advances, new information, and the observed effects of past management efforts."[290] In this approach, the main focus lies in the creation of mechanisms that helps ensure that future decision-making remains well-informed.[291]

A governance regime that commits to experimentation usually requires that rules or regulations be self-consciously provisional and adaptive.[292] The existence of an experimental regulatory environment and adaptive rules is necessary if policymakers fully appreciate that ecological developments and changing conditions, as revealed in existing monitoring information, may prove our prior assumptions about the likely consequences of a given market action or policy decision wrong.[293] Another reason for our need of an experimental regime is that the behaviors of human beings are basically imperfect and difficult to control.[294] The feature would render policy measures remote deviations from what policymakers perceived at the beginning.[295]

Alongside provisional and adaptive regulatory arrangements, another key defining element of an experimental regime is the emphasis on continuous learning by all actors in the ecosystem. Scholars have identified three layers of continuous learning: technical, conceptual, and social learning: "[T]echnical learning involves the application of a limited number of policy instruments, conceptual learning includes the redefinition of policy goals and problems, and social learning has to do with the interactions and communication among actors."[296] The three types of learning can be understood also as three levels of policy adaption: (i) the fine-tuning of existing policy instruments and measures when applying them to different circumstances; (ii) the

290. *Id.* at 201.

291. *Id.*

292. *Id.* at 203.

293. *Id.*

294. *Id.*

295. *Id.*

296. Lobel*, supra* note 219, at 397 (citing Pieter Glasbergen, *Learning to Manage the Environment, in* DEMOCRACY AND THE ENVIRONMENT: PROBLEMS AND PROSPECTS 175, 176 (William M. Lafferty & James Meadowcroft eds., 1996).

overall modification of these instruments, as actors' responses, and games played out between regulators and the regulated, may contribute unintended consequences; and (iii) the making of fundamental changes to policy objectives (as the ecology of the governed system may have transformed dramatically) either by the application of modified instruments, or by the self-evolving power of the ecosystem.[297]

An experimental regime in which continuous learning is naturalized is of particular importance to regulators, as market actors generally enjoy greater knowledge of the market and are well motivated to pursue self-interests by engaging in regulatory arbitrage.[298]

The ability of private actors to learn how to avoid regulatory arrangements clearly outpaces the ability of regulators to realize that their dictates might have been circumvented.[299] Continuous learning has the potential to change the dynamic of repeated games between regulators and the regulated, and finally make the game a mutually beneficial one.

The last key element of NG is *Competition*. Responding to the rapidly increased complexity and diversity of the ecosystem,[300] NG scholars argue that "diversification, pluralization of solutions, and increased competition"[301] should be promoted vigorously. The preferred governance model, therefore, must take into account the diversity and changing interests of all stakeholders.[302] Another integral dimension of competition emphasizes the significance of regulatory competition. It requires not only diversity in the choice of regulatory models, but also pluralized powers distributed and shared among different executive agencies.[303] The perfection of policy instruments or regulatory

297. *Id.* at 397 (citing David M. Trubek & James S. Mosher, *New Governance, Employment Policy, and the European Social Model, in* GOVERNING WORK AND WELFARE IN A NEW ECONOMY: EUROPEAN AND AMERICAN EXPERIMENTS 33, 46 (Jonathan Zeitlin & David M. Trubek eds., 2003).

298. *Id.* at 398 (citing MAX WEBER, LAW IN ECONOMY AND SOCIETY 38 (Max Rheinstein ed.& Edward Shils trans., 1954).

299. *Id.*

300. *Id.* at 379.

301. *Id.*

302. *Id.* at 379–80.

303. *Id.* at 373.

measures can sometimes be achieved through stimulating competitions among regulators, as winning measures always bring more budgetary bargaining power and greater empowerments.

As one may realize very easily, these four principles or elements are in fact mutually reinforcing, and sometimes their theoretical lines of distinction are rather blurred. Nevertheless, they all direct to a very central focus–the pursuit of a more decentralized, a flexible and adaptive governance regime that acknowledges the rapidly changing, complex modern economy we live in.

C. New Governance in the Context of Financial Regulation

1. New Governance and Financial Regulation

It is only very recently that NG is being applied substantively to financial regulations.[304] The application of NG in the context of financial regulation is still in its infancy,[305] despite the several references to certain regulatory architectures or measures as born of NG methodologies.[306] Commonly referenced in this vein are: the IRB model adopted by the Basel II accord; the Consolidated Supervised Entity regime adopted by the SEC that allows certain broker-dealers to use internal models to compute net capital;[307] and the FSB's approach to regulating G-SIFIs. Professor Cristie Ford,[308] Robert Weber,[309] Annelise Riles,[310] and

304. Perhaps the foremost relevant literature can be traced back to Professor Ayres and Braithwaite's proposal to adopt "responsive regulation" approach in regulating economic behaviors. *See* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (Donald R. Harris et al. eds., 1992).

305. *See* Weber, *supra* note 258, at 837 ("Despite the ambition of new governance, comparatively little has been written to situate financial regulation reforms in the new governance context.").

306. Paul C. Kingsbery, *Stakeholder Inclusion and Shareholder Protection: New Governance and the Changing Landscape of American Securities Regulation*, 36 FORDHAM URB. L.J. 913, 915–16 (2008).

307. *See* Weber, *supra* note 258, at 830–35.

308. *See* Cristie Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, 2010 WIS. L. REV. 441 (2010).

309. *See* Weber, *supra* note 258.

310. *See* Annelise Riles, *Is New Governance the Ideal Architecture for Global Financial Regulation?* 31 MONETARY & ECON. STUD. 65 (2013).

Saule Omarova[311] are among the few academics whose scholarly works in this field have taken into account the radical industrial and regulatory changes in light of the 2008 Crisis.

Generally speaking, the presence of NG in financial regulation is often seen in efforts to promote (i) a principles-based regulatory regime, (ii) industrial participation, and (iii) heightened reliance on the industry to establish best practices.[312] NG tools or methodologies are detected mainly in markets or areas where information enjoyed by regulators and the regulated is greatly asymmetric, such as in securities markets, capital regulation, and risk governance.[313] As Weber observes, "the complexity paradigm of contemporary finance is characterized by widening information asymmetries between regulators and regulatees generally. In the face of dizzying complexity, the tools and methodologies of traditional regulation begin to appear arbitrary."[314] It is the urge to close this information gap, and to respond to dizzying complexity, that motivates regulators to adopt NG techniques.[315] NG theory articulately acknowledges that "the alternative is never between arbitrary regulation on the one hand and deregulation, 'voluntary self-regulation,' or flawed new governance on the other"[316] in the regulation of complex financial markets. It requires that regulators and policymakers use "command-and-control techniques (e.g., maximum LTV ratios, bans on trading activities, central clearing and collateral posting for derivatives) to shape the regulated market dynamics"[317] so that regulation can remain responsive to rapid and unpredictable market changes.

NG in financial regulation often suggests the adoption of a principles-based regulatory approach. A principles-based

311. *See* Omarova, *supra* note 221, at 430–31.

312. AYRES & BRAITHWAITE, *supra* note 304, at 838–39.

313. *See* Tamara C. Belinfanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789 (2014) (discussing the framework for implementing shareholder cultivation and new governance theory into the global financial market); *see also* Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235, at 28.

314. Weber, *supra* note 258, at 868.

315. *See* Belinfanti, *supra* note 313, at 801–02.

316. Weber, *supra* note 258, at 868.

317. *Id.*

regulatory regime, as perceived by NG theorists, has the following features: (1) it extends participation to as wide a field as industry associations, advocacy groups, and other stakeholders who might have a role in "facilitating regulation and contributing provisional content to principles,"[318] while at the same time, the regulator still enjoys the "[u]ltimate enforcement and coercive power;"[319] (2) rather than functioning as a complete self-regulation regime or a regime that subjects to the full-discretion of the regulators, it "provides a rational, systematic alternative to an unscripted layering-on of rules on rules to deal with each new situation and their corresponding adverse system effects;"[320] and (3) it places a substantial emphasis on the "regulatory oversight of compliance process and procedures."[321] Despite the foregoing features, one has to keep in mind that the picture of how NG might be applied in financial regulation can actually be very different and more colorful than what has been laid out.

A salient example of NG being used in financial regulation is the internal model under Basel II.[322] Just like the abovementioned features of the principles-based approach and the other components of NG, the BCBS first developed a set of criteria or standards, based on discussions among worldwide policymakers and practitioners (extension of participation at the standards-setting level), for banks to comply with capital requirements.[323] It then allows banks to adopt their own estimated risk parameters for the purpose of calculating risk-weighting assets, as long as the prescribed standards or criteria are met (acceptance of industrial wisdom).[324] The entire process

318. *See* Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235, at 38–39, n.137 (summarizing the current school of thought for new governance theorists).

319. *Id.* at 38.

320. *Id.* at 60.

321. *Id.* at 17, 28.

322. *See* Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, *supra* note 308, at 455–56, 461. *See also* Weber, *supra* note 258.

323. Margaret Rouse, *Basel Committee on Banking Supervision (BCBS)*, SEARCH COMPLIANCE (Jun. 21, 2013), http://searchcompliance.techtarget.com/definition/Basel-Committee-on-Banking-Supervision-BCBS?vgnextfmt=print.

324. *History of the Basel Committee*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/history.htm#foundation (last updated Dec. 30, 2016).

focuses more on how banks will comply with this approach from the viewpoint of *process and format*, as opposed to how they will comply with it in *substantial* terms.[325] The IRB approach deployed by Basel II might have demonstrated perfectly an NG-style financial regulation, but it nonetheless "falls into traps familiar to new governance reforms that render it susceptible to literal and softer forms of agency capture, thereby compromising its democratic legitimacy and effectiveness."[326]

By arguing that the failure of internal models is due to the malfunctioning of Pillar 3 of Basel II, and advocating a Tri-Party Collaboration, Professor Weber essentially views the failure of Basel's IRB model as a salient example of *insufficient collaboration* among all affected parties, or an imperfect manifestation of NG benefits. He argues that:

> . . . mandatory disclosure concerning the assumptions, mechanics, and back testing results of internal models would subject the models themselves to outside scrutiny. Provided the disclosure is meaningful, third-party organizations representing stakeholder constituencies affected by allocations of risk capital (e.g., depositors, capital markets investors, consumer credit customers, mortgage loan recipients) could subject the internal models to their own scenarios and tests, altering assumptions where necessary, in order to gauge institution-level risks. Moreover, because these interest groups represent wide arrays of actors, they are well positioned to examine the aggregate assumptions of bank industry capital modeling practices to test for correlations that could pose systemic risks.[327]

In other words, the internal model failed not because of its overreliance on industrial virtues and savviness, but because it did not extend participation wide enough to take in all affected parties, and therefore did not enable a collaborative regime where

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325. *See, e.g.*, *About the Basel Committee*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/about.htm (last updated Aug. 10, 2017) (explaining how the Basel Committee works to regulate international banking practices); *see also* Weber, *supra* note 258, at 827, 856 (explaining how under the Basel Accord banks used a standardized approach using qualitative and quantitative criteria to assess credit risk).

326. Weber, *supra* note 258, at 786, 856.

327. *Id.* at 836, 855, 863–64.

meaningful oversight of industry autonomy is made possible.[328] Professor Weber's observation is largely in line with Professor Annelise Riles' reflections on the shortcomings in the application of NG by the Financial Stability Board.[329] And this should now direct our attention to the weaknesses or limitations of NG when applied in financial regulation.

2. Limitations of New Governance in Financial Regulation

Recognizing that "some of the more innovative or hopeful dimensions of NG actually have been lost in the translation to international governance,"[330] Professor Riles argues that the emerging NG approach, which the FSB adopts to enhance international coordination for the purpose of regulating G-SIFIs, has a number of shortcomings.[331] For example, the FSB remains a closed-membership organization, and that precludes full participation.[332] Furthermore, although decision-making is on a consensus basis, in reality some members with more representatives in the FSB have significantly more bargaining power than others.[333] Secondly, the public-private collaborative approach has not been implemented in the FSB process. As Professor Riles observes, "[t]his process has mainly engaged representatives of governments and international bureaucracies, and private parties participate only through more attenuated opportunities for public comment."[334] Thirdly, although many FSB requirements use the "standards" language, the FSB regime nonetheless is essentially "rule-oriented rather than standards-oriented."[335] Finally, perhaps the most serious waste of NG

328. *See id.* (summarizing Weber's theory on why the internal model failed).

329. *See* Riles, *supra* note 310, at 68–69; *see also* Weber, *supra* note 258, at 836, 855, 863–64.

330. Riles, *supra* note 310, at 91.

331. *See id.* at 91–97 (arguing that the current shortcomings of the NG approach as its being applied by the FSB include: limited participation, limited public-private coordination, rules, harmonization, sociological approach, surveillance, and audit culture).

332. *See id.* at 91, 98–100 (pointing out that market participants and domestic legislators are unable to fully participate in negotiations at FBS and that broader inclusion of interested parties would create more diversity and plurality in the process).

333. *Id.* at 92.

334. *Id.*

335. *Id.*

techniques is the misuse of the "peer review" mechanism by the FSB. NG theorists originally promoted the peer review mechanism as a "tool for reflexive learning,"[336] but its real-world application often turns it into a "tool of surveillance" that focuses on "how closely statements conform to the given standard," rather than on the standard's appropriateness.[337]

Professor Riles' observation basically reckons Professor Ford's reflections on lessons learned from the 2008 Crisis for the application of NG in financial regulation.[338] Examining three recent examples of underperforming NG-style financial regulations prior to the financial crisis, Professor Ford (as summarized by Riles)[339] identifies a number of potential major drawbacks or limitations of NG when applied in financial regulation.

First, NG theory sometimes takes for granted that industry members will act in the public interest.[340] In the absence of a well-crafted oversight mechanism that assesses industry members' initiatives, those members may in fact tend to develop suboptimal solutions instead of optimal ones.[341] For example, "a local level comprised of self-interested bankers cannot be counted on to self-regulate effectively where no one is acting as an active, public-regarding counterweight in their interpretive community."[342] What this means is that we should not cast blind trust to industry's efforts toward pre-emptive self-regulation, and we should not be overoptimistic about regulators' ability to adapt measures to respond effectively to the industry's self-regulation.[343]

Second, NG relies heavily on the self-interest-seeking imputes of the regulated parties to direct themselves to the pursuit of the common good and therefore puts much emphasis

336. *Id.* at 95.

337. *Id.*

338. *Id.* at 100.

339. *Id.* at 90–91.

340. *Id.* at 90.

341. *Id.* at 89.

342. Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, *supra* note 308, at 471.

343. *Id.*

on the role played by information disclosure. Such information-based methodology may overlook the potential that a seemingly rational self-interest-seeking, if manifested collectively by the regulated actors, may in fact lead the entire industry to irrational behaviors and self-catastrophe.[344]

Third, unlike traditional regulatory areas such as environmental and labor law, NG scholarship tends to overlook the disproportionate power some market actors in the financial market can enjoy.[345] The financial industry can be extraordinarily powerful, especially in terms of its influence on the agenda-setting level, and its ability to shape the interpretation of regulatory terms at the implementation level.[346] As Professor Ford observes: "[F]or example, the industry's ability to hire lobbyists and fund political campaigns. Economic power can also be used more directly to force legislators' hands by changing facts on the ground, as occurred with the de facto repeal of the *Glass Steagall Act* (GSA) in the 1990s."[347]

3. Make New Governance More Workable in Financial Regulation

In light of the abovementioned limitations, Professor Ford concludes that there are three lessons one can draw from the application of NG in the context of financial regulation. First, NG methodology does not apply or work universally, especially where the authoritative power that ensures accountability and capacity is absent.[348] Regulators should not rely entirely on the regulated parties' self-interest-seeking ability to govern themselves.[349] Instead, regulatory oversight and powers will have to be used to counterbalance the disincentives of the industry. Sometimes the regulatory energy required to direct market actors away from their short-term incentives is simply more than the resources

344. *Id.* at 473.

345. Riles, *supra* note 310, at 68, 91.

346. *Id.* at 90–91.

347. Ford, *Macro- and Micro-Level Effects on Responsive Financial Regulation*, *supra* note 215, at 607–08.

348. Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, *supra* note 308, at 484.

349. Riles, *supra* note 310, at 90.

available to regulators.[350] This suggests that regulators should carefully allocate their resources, and adopt NG methodology only in relatively narrow areas.

Second, a governance structure that fosters active and diligent deliberation among all stakeholders is needed, and is not something that can be assumed.[351] As we are informed by the second limitation (mentioned above), overreliance on regulated parties for information without careful examination and appreciation of that "fed information" would subject the regulated market to catastrophic collective irrational thinking.[352] One response to this, as Professor Ford proposes, "is to build in real diversity and internal contestation, and to take silence not as consent but as an alarm bell. It may require much more serious attention to ensuring that a full range of perspectives, including perspectives unpopular with traditional insiders, are at the table."[353]

Third, uncertainty about norms, as certain NG theorists suggest, may sometimes not be desirable.[354] The disproportionate influence enjoyed by industry members may cause too much need for regulatory scrutiny, as uncertain, flexible rules usually leave more room for arbitrage. In response to this issue, Professor Ford advocates the need for "clear, prophylactic rules around areas where fundamental systemic requirements are involved."[355] This is because the rules-based approach might still be needed for reducing uncertainty and allowing regulators to be more precise about when and where the new governance methods should be implemented.[356]

The work of Professors Ford and Riles has at least the following three ramifications for the application of NG methodology to regulate financial markets. First, NG methods

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350. Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, *supra* note 308, at 472–73, 484.

351. *Id.* at 484.

352. *Id.* at 473. Riles, *supra* note 310, at 90.

353. Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, *supra* note 308, at 485.

354. *Id.* at 486 (noting how "clear, prophylactic rules" are preferable).

355. *Id.*

356. *Id.*

generally work well and effectively when the issue area they intended to address is very narrowly and adequately tailored.[357] A narrowly tailored area makes it more likely to extend participation to be as inclusive as possible of all market actors, regardless of directly or indirectly affected interests. Also, a narrowly tailored area enables regulators to focus their resources and energies on engaging all affected interests in deep, substantive deliberation and discourse. It helps to concentrate regulatory power on aligning, in a specific tailored area, the incentives of the industry and of the public. Second, better procedural safeguards are necessary if NG methods are to be effective.[358] An enhanced procedural safeguard–one that ensures expended participation, more focused and sophisticated collaboration, and prompt public oversight–is better guarantee of the quality of the collaborative output of regulators and the regulated.

Putting in place more detailed and granular procedure rules for public-private interaction would bolster NG methods against the likelihood of their waste on *superficial* or *illusionary* shared-governance regimes.[359] Finally, regulatory weapons should always be ready to eliminate short-termism and disincentives among market participants. The success of NG methods depends greatly on honest and *bona fide* inputs from industry members, and this certainly cannot be achieved if industrial members are still motivated to pursue self-interests to the detriment of the public interest. Regulators should always be alert and prepared to intervene if misaligned incentives become pervasive. The financial market, in short, cannot be regulated or governed purely by the use of NG methods; it will always require a big regulatory gun in the background to correct the insufficiencies that become apparent in NG-style financial regulations.

VI. IMPLICATIONS FOR THE USE OF MARKET DISCIPLINE

Largely considered a complement[360] to the traditional

357. Riles, *supra* note 310, at 101.

358. *Id.* at 100.

359. *Id.* at 92, 100.

360. *See, e.g.*, Laurence H. Meyer, Market Discipline as a Complement to Bank

prudential regulation, the use of market discipline[361] codified it as Pillar 3 of its Basel Accord in 1999.[362] (This was so despite the fact that the root of the idea can probably be traced back to an IMF Working Paper[363] authored in 1992). Although it is incorporated into Basel II and III as the Third Pillar,[364] market discipline has been mistakenly treated as primarily a disclosure regime[365] rather than as an institutional framework through which "*information, incentives, and control*"[366] can be utilized to

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Supervision and Regulation, Remarks before the Conference on Reforming Bank Capital Standards, Ernst & Young and AEI-Brookings Joint Ctr. on Regulatory Studies, Council on Foreign Relations, New York (June 14, 1999) (transcript available at http://www.federalreserve.gov/boarddocs/speeches/1999/19990614.htm); Steven L. Schwarcz, *Systemic Risk*, 97 DUKE L.J. 193, 233–34 (2008) (concluding that "although market discipline is attractive as a supplement to other regulatory approaches, there is some doubt whether it should serve as the exclusive, or even primary, regulatory mechanism").

361. For a compiled commentary of the theories and evidences with regard to market discipline in banking, see GEORGE G. KAUFMAN, MARKET DISCIPLINE IN BANKING: THEORY AND EVIDENCE (George G. Kaufman ed., 1st ed. 2003).

362. The first consultative document was proposed in 1999, whereas an updated version on Pillar 3 was published in 2000 and 2001, respectively. *See, e.g.*, BASEL COMM. ON BANKING SUPERVISION, A NEW CAPITAL ADEQUACY FRAMEWORK (Basel Committee on Banking Supervision ed., 1999) [hereinafter "A New Capital Adequacy Framework"], http://www.bis.org/publ/bcbs50.pdf; BASEL COMM.ON BANKING SUPERVISION, A NEW CAPITAL ADEQUACY FRAMEWORK: PILLAR 3 MARKET DISCIPLINE (Basel Committee on Banking Supervision ed., 2000), [hereinafter "A New Capital Adequacy Framework: Pillar 3 Market Discipline"], http://www.bis.org/publ/bcbs65.pdf; BASEL COMM. ON BANKING SUPERVISION, PILLAR 3 (MARKET DISCIPLINE) (Basel Committee on Banking Supervision ed., 2001), http://www.bis.org/publ/bcbsca10.pdf.

363. *See generally* Timothy Lane, *Market Discipline,* INT'L MONETARY FUND, *Staff Papers* (1993).

364. For the intended role of market discipline in the context of Basel Accord, see A New Capital Adequacy Framework: Pillar 3 (Market Discipline), *supra* note 362, at 3 (emphasizing that "[m]arket discipline performs an essential role in ensuring that the capital of banking institutions is maintained at adequate levels. Effective public disclosure enhances market discipline and allows market participants to assess a bank's capital adequacy").

365. One of the primary reasons that market discipline is often treated as merely a set of disclosure requirements is probably because the term "Pillar 3 Market Discipline" is often used interchangeably with the term "Pillar 3 Disclosure Requirements" by the Basel Committee of Banking Supervision itself. *See, e.g.,* BASEL COMM. ON BANKING SUPERVISION, PILLAR 3 DISCLOSURE REQUIREMENTS FOR REMUNERATION (Basel Committee on Banking Supervision ed., 2011), http://www.bis.org/publ/bcbs197.pdf.

366. The idea was proposed by Constantinos Stephanou, *Rethinking Market Discipline in Banking,* 4 (World Bank, Policy Research Working Paper No. 5227, 2010),

enhance prudence, resilience, and stability in financial ecology. Scholarly discourses on the sources of market discipline have largely focused on depositors,[367] subordinated debt holders,[368] and shareholders.[369] Although some researchers are now working on the identification of the potential sources[370] of market discipline, a systematic analysis is largely absent.[371] The role that regulators should play in reviving market discipline must not be limited to passively complementing or punishing the insufficiencies or deficiencies of market solutions; rather, regulators should actively engage in a collaborative and deliberative process in

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https://openknowledge.worldbank.org/bitstream/handle/10986/3717/WPS5227.pdf?sequence=1.

367. For the discussion on how depositors serve as a source of disciplining power and the relationship between deposit insurance and market discipline, see generally Maria Soledad Martinez Peria & Sergio L. Schmukler, *Do Depositors Punish Banks for Bad Behavior? Market Discipline, Deposit Insurance, and Banking Crises*, 56 J. FIN. 1029 (2001); Krishna G. Mantripragada, *Depositors as a Source of Market Discipline*, 9 YALE J. ON REG. 543 (1992).

368. Robert R. Bliss, *Market Discipline and Subordinated Debt: A Review of Some Salient Issues*, FED. RES. BANK OF CHI. ECON. PERS. 24, 37 (2001); *see generally* Gary Gorton & Anthony M. Santomero, *Market Discipline and Bank Subordinated Debt Note*, 22 J. MONEY, CREDIT & BANKING 119 (1990).

369. *See* Marc J.K. De Ceuster & Nancy Masschelein, *Regulating Banks Through Market Discipline: A Survey of the Issues*, 17 J. ECON. SURV. 749, 759–60 (2003), http://ssrn.com/abstract=467744; Robert Bliss & Mark Flannery, *Market Discipline in the Governance of U.S. Bank Holding Companies: Monitoring vs. Influencing* 12–16 (FED. RES. BANK OF CHI., Working Paper No. 2000-03, 2000), http://ideas.repec.org/p/fip/fedhwp/wp-00-3.html; R. Alton Gilbert, *Market Discipline of Bank Risk: Theory and Evidence*, 72 FED. RES. BANK ST. LOUIS REV. 3, 12–16, (1990), http://research.stlouisfed.org/publications/review/90/01/Discipline_Jan_Feb1990.pdf.

370. For the identification of potential sources of market discipline, see Robert Bartlett, *Making Banks Transparent*, 66 VAND. L. REV. 293, 311 (2012); John C. Coffee, *Bail-ins versus Bail-outs: Using Contingent Capital to Mitigate Systemic Risk* 9–11 (Colum. L. & Econ., Working Paper No. 380, 2010), http://ssrn.com/abstract=1675015; Kathryn Judge, *Interbank Discipline*, 60 UCLA L. REV. 1262, 1278–82 (2013), http://ssrn.com/abstract=2147899; Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011).

371. *See* Stephanou, *supra* note 366, at 5–6, 8–9 (asserting that "the mechanisms by which Market Discipline can function under different financial system structures and institutional contexts remain unclear", and "there is relatively little guidance on how much to rely on and on how to operationalize the concept under different financial system structures and institutional environments"); for a post-Crisis review of market discipline, see David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421, 1492–1500 (2015).

which distorted incentives can be corrected, and the competency of disciplinarians can be enhanced.

It is not difficult to see that NG scholarship is particularly compatible with the pursuit of that very goal of market discipline, as it emphasizes also the harnessing of the power of the market to serve the common good.[372] A comprehensive understanding of NG theory helps policymakers eliminate the dichotomy in which market discipline has to be held up as the promotion of deregulation or self-regulation, and the emphasis of regulatory oversight must be on heightened regulation or re-regulation.[373] The disciplinary and self-correcting power of the market can actually be enhanced by the sensible use of regulatory influence[374] *and* reliant on market discipline.[375]

A perfect manifestation of market discipline depends greatly on market actors' *willingness* and *capability* to monitor one another.[376] Specifically, an effectively functioning disciplinary process initiated by market actors themselves generally involves three distinct preconditions: the ability of lenders or investors to evaluate the counterparty's true financial condition; the responsiveness of borrowers to the signals that lenders convey to the market; and the willingness and capability of lenders to rely

372. John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention – A Model for the Future of U.S. Regulation*, 55 BUFF. L. REV. 1371, 1440–41 (2008).

373. *Id.*

374. Masaaki Shirakawa, Governor, Bank of Japan, Keynote Address at Seminar Co-Hosted by the Bank of Japan and the International Monetary Fund in Tokyo: International Financial Stability as a Public Good 1–2 (Oct. 14, 2012), https://www.boj.or.jp/en/announcements/press/koen_2012/data/ko121014a.pdf.

375. *See, e.g.*, Bill Witherell, Director for Financial, Fiscal and Enterprise Affairs, OECD, Banque de France International Monetary Seminar: The Roles of Market Discipline and Transparency in Corporate Governance Policy 4–5 (May 16, 2003), http://www.oecd.org/corporate/ca/corporategovernanceprinciples/2717763.pdf (stressing the need for regulatory improvement, including standards, procedures, and audits with broad oversight and improved enforcement).

376. Judge, *supra* note 370, at 1281 (observing that there are "three components which collectively suggest that banks play a meaningful role disciplining other banks: (a) an economic incentive to do so, (b) risk management systems that enable banks to monitor their exposure to other banks and to meaningfully assess the creditworthiness of those banks, and (c) mechanisms through which banks can alter their behavior in ways that affect the disciplined bank when its risk profile changes.").

upon the disciplining of disobedient borrowers.[377] So the disciplinary power of the financial market can be adequately exercised only when market actors have (1) sufficient *information* to evaluate their counterparties' financial situations, (2) strong *incentive* to act on information obtained, and (3) substantial *control* over the mechanisms with which counterparties' behaviors can be changed.[378] NG methodology can shed light on these three dimensions in the following ways:

First, with regard to facilitating the disclosure and understanding of information, the NG methodology's emphasis on expanded participation has the potential to encourage the three-way flow of information: from regulators to the industry, from the industry to regulators, and in the exchanges among industry members themselves.[379] Wider participation can engage all market actors, as well as regulators, in diligent and sincere deliberation and conversation, and therefore improve the way information is communicated, and the truthfulness of that information.[380] In addition, a broader participation process that includes less powerful market actors, such as financial consumers, could enhance these actors' ability to comprehend and analyze complicated disclosed information, and further engage them in the monitoring of the activities of the bigger, overwhelming market actors.[381] Finally, the commitment to participation suggests that the net should be cast wide enough to encompass all potential sources of market discipline, rather than merely focus on traditional sources such as shareholders,

377. For a number of classical literatures that explain how market discipline works, see Lane, *supra* note 363; Meyer, *supra* note 360; Bliss & Flannery, *supra* note 369; Mark J. Flannery, *The Faces of "Market Discipline",* 20 J. FIN. SER. RES. 107 (2001); Simon Kwan, *The Promise and Limits of Market Discipline in Banking* (FED. RES. BANK OF S.F., Economic Letter No. 2002-36, 2002), http://www.frbsf.org/economic-research/publications/economic-letter/2002/december/the-promise-and-limits-of-market-discipline-in-banking/; Andrew Crockett, *Market Discipline and Financial Stability*, 26 J. BANKING & FIN. 977 (2002); David T. Llewellyn, *Inside the "Black Box" of Market Discipline*, 25 ECON. AFFAIRS 41 (2005).

378. *See* David T. Llewellyn*, Inside the "Black Box" of Market Discipline,* 25 ECON. AFFAIRS 41, 42 (2005); *see also* Stephanou, *supra* note 366, at 4, 6–7.

379. Stephanou, *supra* note 366, at 6–7.

380. *The Knowledge-Based Economy,* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT 3, 11, 14 (1996), https://www.oecd.org/sti/sci-tech/1913021.pdf.

381. Weber, *supra* note 258, at 786, 789, 794.

depositors, and subordinate debt holders.[382]

Second, incentive to monitor one another can be enhanced through extensive collaboration among all market participants. A collaborative model under NG would help all parties realize their interests and goals in a mutually respectful way, and would entail a move from a win-lose game to a win-win environment, as all actors will eventually come to realize that their interests are in fact intricately interlocked.[383] In addition, NG theory emphasizes the importance of the existence of a benign regulatory gun.[384] The importance of having in place a credible enforcement regime is often overlooked by proponents of market discipline. In their imaginary universe, a regulatory approach that heavily relies on market discipline should have nothing to do with the regulators. Some of them live in an illusionary bubble where market actors will never fail to discipline one another, so long as necessary information is disclosed fully and promptly. To make the situation worse, industry members sometimes express no interests in "collaborating" with regulators, as collaboration under the NG model presumes transparent and sincere exchanges of thoughts.[385] They prefer either to enjoy complete autonomy, or to secretly impose their weighty influence on agenda-setting or rules-implementation.[386] Nevertheless, proponents of a "pure form" of market discipline overlook the very fact that a truly

382. Potential sources of market discipline include holders of contingent convertible instruments, derivatives and repo counterparties, banks, central counterparties, consumer groups, trade associations, and even insiders of financial institutions. For some relevant literature, see Judge, *supra* note 370.

383. Omarova, *supra* note 221, at 428.

384. Weber, *supra* note 258, at 839–41. *See generally* AYRES & BRAITHWAITE, *supra* note 304, at 35–41.

385. Riles, *supra* note 310, at 92. (stating that private parties primarily participate via public comment); *but see OECD Principles of Corporate Governance,* Organization for Economic Co-operation and Development 49 (2004), https://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf (noting how the failure to collaborate "can contribute to unethical behavior and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole").

386. Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235, at 600–01 (discussing the importance of autonomy of public companies); Riles, *supra* note 310, at 92 (stating that private parties primarily participate via public comment).

collaborative model will not only let misaligned incentive manifest itself, but also lead regulators to adopt less forceful and punitive measures to counterbalance such incentives. A collaborative engagement makes it possible for regulators to detect misaligned incentive when it is still in its infancy, and therefore there is no need to impose overwhelming regulatory power to get the incentive right.

Third, NG theorists advocate the use of experimental rules or processes.[387] The commitment to experimentalism protects the financial ecosystem from market failures caused by complexity. As complexity science has informed us, policymakers should always be prepared to change an existing policy or rule in response to the evolution of the complex financial ecology.[388] Complexity, be it of financial products, market structures, or regulations, often renders well-crafted rules or best market practice useless, or at various stages of losing applicability.[389] The rule-making and implementing process has to be flexible and adaptive enough to respond adequately to an unforeseeable complexity or market evolution. In addition, experimentalism, as perceived by NG scholars, also emphasizes the importance of continuous learning.[390] Continuous learning, especially in the dynamic games played by regulators and the regulated, enhances both regulators' and other market actors' capability to anticipate and influence the behaviors of their counterparties. All market participants can learn from trial and error in certain experimental regimes, then apply their experience to making sense of other actors' behaviors in the future. This sense-making

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387. Erika Szyszczak, *Experimental Governance: The Open Method of Coordination*, 12 EUROPEAN L.J. 486, 486–87 (2006).

388. *See* Stefano Battiston et al., *Complexity Theory and Financial Regulation*, 351 SCIENCE 818–19 (Feb. 19, 2016), http://science.sciencemag.org/content/sci/351/6275/818.full.pdf.

389. *See* Dorf & Sabel, *A Constitution of Democratic Experimentalism*, *supra* note 234, at 278 (attributing the loss of capacity of agencies and bureaucracies to increasing complexity).

390. WORLD BANK, LIFELONG LEARNING IN THE GLOBAL KNOWLEDGE ECONOMY: CHALLENGES FOR DEVELOPING COUNTRIES 57 (2003), http://siteresources.worldbank.org/INTLL/Resources/Lifelong-Learning-in-the-Global-Knowledge-Economy/lifelonglearning_GKE.pdf (highlighting the importance of continuous learning).

ability is of great help to market disciplinarians in predicting the consequences and market reactions of imposing a particular disciplinary action. Such clarity and foresight will make the exercise of disciplinary power more effective, and the effects of discipline more salient.

Finally, a detailed set of rules on the process in which the exercising of market discipline can be enhanced collaboratively by regulators and other market actors is urgently needed. The responsibility of maximizing market discipline should not impose on the market alone. Regulators should put in place a set of procedural safeguards to promote the flourishing of the market's disciplinary power.

Naturalizing the elements of *collaboration* and *experimentation* into the existing financial regulatory regime is essential, as the foregoing analysis suggests.[391] Take the U.S. regulatory regime as the work sample: NG methodologies have actually been adopted by this regime, to some extent, for decades. Of the four core elements of NG, *participation* and *competition* are the most commonly used, and are deeply embedded in the U.S. financial regulatory mindset. The spirit of participation was given flesh with the Notice and Comment rulemaking process, under which thousands of the rules regulating the financial system were produced.[392] The regulatory rivalry among different executive agencies can be viewed as an embodiment of competition, a reality that renders diversified and pluralized solutions possible in response to the growing complexity and volatility of the financial ecosystem. Yet it is nevertheless somehow rare to see *collaboration* and *experimentation* in use as an element of the governance of the financial system.

Some may argue that the advanced-approaches capital-adequacy framework in the U.S. meets that description.[393] Basel

391. *Id.* at 36 (explaining the importance of fostering collaboration in leadership); Houlin Zhao*, Collaborative Regulation: Why Collaborative Regulation is Critical*, 3 ITU NEWS 1 (2016) (identifying key conditions for a new economy).

392. U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: BANKS AND CREDIT UNIONS 67 (June 2017) (explaining the burden placed on participating institutions without public notice and comment).

393. U.S. DEP'T OF THE TREASURY, RISK-BASED CAPITAL STANDARDS: ADVANCED CAPITAL ADEQUACY FRAMEWORK 1 (Sept. 25, 2006), https://www.federalreserve.gov/generalinfo/basel2/NPR_20060905/NPR/Basel_II_NPR.p

III might also be one example of collaboration, but the level of collaboration there is still very confined in terms of standards setting. Real collaboration would require sincere and extensive teamwork among *all market actors*, in both the *setting* and *implementing* stage of the bringing-into-being of norms or standards.[394] Experimentation generally requires that rules or regulations are self-consciously temporary and adaptive, and it emphasizes the importance of continuous learning for all market actors.[395] Although the high frequency of the revising of rules may suggest the presence of experimentation in the U.S. regulatory regime, whether such a process is experimental enough to enable repetitive trial-and-error is not beyond question. The lack of collaboration and experimentation is detrimental to the flourishing of market discipline, as these two elements assist the market to use its own capacity to fix excessive regulatory arbitrage, distorted incentives, and ineffective supervisory controls.[396] The present author believes that incorporating these two elements into a well-crafted collaborative standards-setting process will bring a much-needed difference to the market-discipline environment.

Although designing and proposing such a collaborative standards-setting process goes beyond the scope of this article, its design should be indicated sufficiently to enable the addressing of

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df (proposing an inter-agency capital adequacy framework).

394. According to an empirical study that reviews 137 cases of collaborative governance across a range of policy sectors, the authors identified six important criteria for collaborative governance: "(1) the forum is initiated by public agencies or institutions, (2) participants in the forum include non-state actors, (3) participants engage directly in decision making and are not merely 'consulted' by public agencies, (4) the forum is formally organized and meets collectively, (5) the forum aims to make decisions by consensus (even if consensus is not achieved in practice), and (6) the focus of collaboration is on public policy or public management." This author believes that real collaboration should also have similar criteria or characteristics. Chris Ansell & Alison Gash, *Collaborative Governance in Theory and Practice*, 18 J. PUB. ADMIN. RES. & THEORY 543, 544–45 (2008).

395. *G20/OECD Principles of Corporate Governance: OECD Report to G20 Finance Ministers and Central Bank Governors*, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT 11, 37 (Sept. 2015), https://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf.

396. *See* Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235, at 486; Dan Awrey et al., *Between Law and Markets: Is there a Role for Culture and Ethics in Financial Regulation?*, 38 DEL. J. CORP. L. 191, 199–200 (2013); Weber, *supra* note 258, at 863.

the key ramifications of the application of NG methodology in the regulating of financial markets. As already noted, the more narrowly tailored the issue area an NG method aims to address, the more effective this method is. The optimal extension of participation to all market actors (regardless of whether those actors' interests are affected directly or indirectly) is more likely to happen in a narrowly tailored area.[397] Also, a closely tailored area enables regulators to focus their resources and energies on engaging all affected interests in deeper and substantial deliberation and discourse.[398] The effort to concentrate regulatory power on aligning the incentives of the industry and of the public is more easily exerted in an area that is designed to be a narrow one.[399]

A possible approach would be to restrict the use of the collaborative process to "perfecting an identified discipline mechanism," such as the design and improvement of the structure of contingent convertible instruments. The reason is quite obvious. It takes time and repetitive trial-and-error to determine whether and how a given market disciplinary-mechanism promotes or abases market discipline. It also takes a fine knowledge of the industry, and first-hand information from it, to work out efficient resolutions to the loose ends that emerge during the use of any given mechanism. Therefore, to achieve the optimal use of the existing discipline mechanisms, the governance regime has to make room for extensive engagement with the industry's wisdom and exploring the potential disincentives and unintended consequences of these mechanisms.

Furthermore, if NG methods are to be effective, better procedural safeguards must be in place. A sound set of procedural safeguards ensures expended participation, more focused and sophisticated collaboration and prompt public oversight, and is therefore better guarantee of the quality of the collaborative output of regulators and the regulated. Putting in place more granular rules concerning the process of implementing regulators-industry collaboration, and in the process of carrying

397. Riles, *supra* note 310, at 98–99, 101.

398. *Id.* at 80, 101.

399. *See* Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235, at 484–85.

out peer review, would ensure that NG methods are not wasted on a superficial or illusionary shared-governance regime.[400] An ideal collaborative standards-setting process, therefore, should set forth a detailed set of procedures that ensure expanded representation and more focused collaboration.

VII. CONCLUSION

In the aftermath of the Crisis of 2008, the objectives of mitigating systemic risk and promoting financial stability have opened dialogues about the need for extensive reforms within the banking industry. Despite the fact that some commentators and seasoned regulators do not see complex capital rules and endless rule-making processes as effective ways of achieving the desired regulatory outcomes,[401] many policymakers seem to believe that the adoption of regulations that are heightened and rules-based is the best way to persuade furious taxpayers that their pockets will not be raided again, and to proactively ensure the safety and soundness of financial institutions.[402] Such a belief is, among other things, reflected in the rulemaking of Dodd-Frank and in the standards-setting of Basel III, both of which drive their final products into extremely lengthy, complex, and inoperable users' guides.[403]

On the other hand, reform efforts that resort to pure reliance on the market's self-correcting power seem to be equally impracticable.[404] Market solutions, once trusted as the most effective mechanisms for channeling banks' behaviors, have proven ineffective when pre-crisis banks are incentivized to take excessive risks by relying on the prospect of massive public subsidies and implicit government guarantees being made

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400. Riles, *supra* note 310, at 100–01.

401. *Dodd-Frank: Too Big Not to Fail*, ECONOMIST (Feb. 18, 2012), http://www.economist.com/node/21547784.

402. Jack Ewing, *Global Regulators Agree on Rules to Prevent Future Financial Crises*, N.Y. TIMES (Dec. 7, 2017), https://www.nytimes.com/2017/12/07/business/global-regulators-agree-on-rules-to-prevent-financial-crises.html.

403. *Id.*; ECONOMIST, *supra* note 401.

404. Joseph Stiglitz, *The Lessons of the North Atlantic Crisis for Economic Theory and Policy*, IMF BLOG (May 3, 2013), https://blogs.imf.org/2013/05/03/the-lessons-of-the-north-atlantic-crisis-for-economic-theory-and-policy/.

available to bail them out should a crisis be imminent.

This scenario inevitably prompts an inquiry into the fundamental imbalance in the governance regime of our modern financial markets. The post-Crisis governance system, as this author believes, has failed in many ways to find balance. A balanced regulatory and market power has long been on policymakers' agendas.[405] Nonetheless, its realization is yet to be seen. The complex nature of today's financial markets has suggested a need for more experimental, flexible, and forward-looking measures for the making and implementing of regulations. Yet we continue to see prescriptive, disinclined-to-be-adaptive, and complex preventive rules dominating the regulatory space and giving momentum to system-wide complexity.[406]

Taking into account these imbalances, the limitations of the post-Crisis reforms, and the lessons learnt from NG scholarship, this article argues that a more balanced governance approach is needed. "More balanced" in the context of this argument envisages a governance model for financial systems as a whole new approach introduced into the current command-and-control regulatory regime, by means of which undue reliance on industry-based norms and standards is to be rolled back. This proposed new approach goes beyond the separation of regulator-dictated supervision, industry-initiated patrolling and safeguarding self-regulation. Specifically, it is a governance regime in which participation, competition, collaboration, and experimentation should be on an equal footing. It seeks to be an approach that harnesses the self-disciplining power of the market directly, aligning the incentives of the industry and the public, and thereby enhancing the accountability and trustworthiness of the regulators and the regulated. Regulatory scrutiny and weapons, on the other hand, should also be in place and ready to redirect,

405. Sabine Lautenschläger, Member, Executive Board of the European Central Bank and Vice-Chair, Supervisory Board of the European Central Bank, Statement at the Financial Stability Conference: Regulation, supervision and market discipline – striking a balance (Sept. 18, 2017), https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/ssm.sp170918.en.html.

406. ECONOMIST, *supra* note 401; Ford, *New Governance Compliance, and Principles-Based Securities Regulation*, *supra* note 235.

in a collaborative manner, misplaced market innovations, or miscarried market savviness.

Naturalizing NG methodology into the rethinking of market discipline informs policymakers at least of the following avenues for reform. First, the commitment to participation suggests that our net should be cast wide enough to encompass all potential sources of market discipline, rather than merely focus on traditional sources. A broader participation process should also include less powerful market actors, such as financial consumers, so as to enhance these actors' ability to comprehend and analyze complicated disclosed information and further engage them in the monitoring of the activities of the bigger market actors.

Second, "collaboration" means transparent and sincere exchanges of thought by regulators and the regulated. A truly collaborative model is beneficial to both parties, as it will not only let misaligned incentives manifest but also lead regulators to impose less forceful punitive measures to counterbalance such incentives.

Third, regulators should develop a detailed set of rules that regulate the process in which the exercising of market discipline can be enhanced by their collaboration with other market actors. They should note that research suggests that a well-crafted procedure can forge sincere and effective collaboration.

Fourth, the rule-making and implementing process has to be flexible and adaptive enough to respond adequately to any unforeseeable complexity or market evolution. Continuous learning should also be encouraged, as it enhances both regulators' and other market actors' capability to anticipate and influence the behaviors of their counterparties. Market actors can learn from trial and error in such an experimental regime, then apply their experience to making sense of other actors' behaviors in the future. This sense-making ability helps disciplinarians predict the consequences of, and market reactions to, imposing a particular disciplinary action. The ability to anticipate market reactions to the imposing of a particular disciplinary action is very important, as it makes the exercising of disciplinary power more effective, and the effects of discipline more salient.

Of the four reform directions, integrating the elements of *collaboration* and *experimentation* into the current governance regime is probably the most urgent mission. These two elements assist the market's use of its own capacity to fix excessive regulatory arbitrage, distorted incentives, and ineffective supervisory controls.[407] They are nonetheless significantly lacking in the current system.[408] A well-crafted collaborative standards-setting process that effectively incorporates these two elements will give a much-needed fillip to the restoration of market discipline.

407. Awrey et al., *supra* note 396, at 199–200; Weber, *supra* note 258, at 863.

408. Riles, *supra* note 310, at 83–84; Weber, *supra* note 258, at 863.