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FINANCIAL PRIVATE REGULATION AND ENFORCEMENT

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EUROPEAN UNIVERSITY INSTITUTE, FLORENCE
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Financial Private Regulation and Enforcement

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This series of working papers aims at disseminating the work of scholars and practitioners on regulatory issues.

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Abstract

This paper considers the topic of private regulation and enforcement for internationally active financial services firms. The paper documents the following types of regulation and enforcement that involve significant private input: house rules, contracts, internal compliance, management-based regulation, private standard-setting bodies, cartels, and private litigation. The paper assesses these systems or modalities along the dimensions of effectiveness, legitimacy, quality, and enforcement. The paper suggests that the following factors (among others) will contribute to determining the pattern of private/public interaction in a given regulatory context: (1) minimization of transactions costs; (2) access to information; (3) expertise; (4) political power of the regulated industry; (5) contests over regulatory turf; (6) regulatory budget constraints, and (7) history or path-dependence.

The topic of financial private regulation and enforcement concerns the activities of private firms in the financial sector which are involved in cross-border activities – Citigroup, Bank of America, HSBC, UBS, JPMorgan Chase, RBS, BNP Paribas, Barclays, Morgan Stanley, Goldman Sachs, Deutsche Bank, HBOS, Société Générale, Banco Santander, American Express, Nomura, and so on. For convenience of reference, I will refer to this type of organization as an “internationally active financial services firm” (IAFSF). This paper will categorize different types of private regulation and enforcement applicable to IAFSFs and then will offer some tentative thoughts about the underlying forces that may determine the phenomena under observation, with special reference to the HiiL Concept Paper, “The Added Value of Private Regulation in an Internationalised World? Towards a Model of the Legitimacy, Effectiveness, Enforcement and Quality of Private Regulation.” The principal subject of investigation will be the activities of IAFSFs under U.S. law, but attention will be given to international standards and regulations as well.

Keywords

Transnational private regulation; financial service firms; public/private distinction

I. Types of Private Regulation and Enforcement

House Rules

All IAFSFs operate according to internal rules governing the day-to-day administration of the company.

Rules of organization define the roles of offices and allocate responsibility for operations. All large IAFSFs, like almost all large firms in any industry, take the form of complex corporate groups involving holding companies, subsidiaries, and subsidiaries of subsidiaries. These networks are partially the result of government regulation. The US Gramm-Leach-Bliley Act, for example, permits commercial banks to affiliate with securities firms and insurance companies, but only through the framework of a financial holding company. Similarly, commercial banks doing business abroad may be encouraged or compelled by host countries to operate their banking operations through separately-chartered subsidiary banks rather than through branches. Often, however, the decision to structure an operation in an affiliate rather than a division is a matter of convenience or history rather than government mandate. In either case, the division of a firm into separate divisions or affiliates has important consequences for how the firm is managed: the organizational structure allocates and distributes power and authority in fundamental ways.

Companies or divisions within a corporate family also administer detailed standards and procedures for allocating power and responsibility. A securities firm may maintain separate trading divisions for fixed-income and equity securities; and within these categories, separate units specializing in different types of securities (bankers acceptances, certificates of deposit, asset-backed securities, and so on). These internal structures also distribute, limit, and check the exercise of power and authority.

Rules of compensation and conditions of employment define stakeholder entitlements to share in the firm's fortunes. For IAFSFs, as for many service industry companies, the most important such rules are those pertaining to senior managers. These rules may be established by a human resources department or, for the most senior managers, by a compensation committee of the board of directors. Workplace rules also govern the compensation and working conditions of lower level workers such as clerical staff; these may also be set in part through a process of collective bargaining. Some employment rules are mandated by the government; workplace safety standards or pension policies are examples. Others are formulated within the sole discretion of the firm and its employees. In many of the latter cases the formal terms of the employment agreement capture only part of the relationship between the parties; the employment relationship is characterized by significant extra-contractual elements that bear more resemblance to gift exchange than to formal contractual conditions.¹

House rules can sometimes be enforced by the government, either because they are mandated by law or because they take the form of legally binding contracts (as in the case of employment agreements). Much more often, however, house rules are principally enforced within the firm without government involvement. Enforcement can take the form of rewards or punishments on the job: a person may be sanctioned for not complying with the rules by being denied a promotion, not receiving an expected bonus, having his or her trading discretion restricted, or a myriad of other devices. Senior managers at IAFSFs usually serve under at-will employment contracts which entitle their supervisors to dismiss them with or without cause. Enforcement also occurs through informal mechanisms. Because reputation is an important asset in the financial services world, a person who is a conspicuous rule-breaker can suffer collateral career consequences even if they are not subjected to formal disciplinary action.

¹ See George A. Akerlof, Labor Contracts as Partial Gift Exchange, 97 Quarterly Journal of Economics 543-69 (1982).

The category of house rules is the most “private” of the strategies for regulation and enforcement discussed in this paper. Both the formulation of rules and the enforcement of violations occur principally within the four walls of the firm.

Contracts

IAFSFs enter into many contracts with other firms. These contracts set norms and standards for behavior. Often they have a transnational dimension, either because the contract is with a foreign counterparty or because the subject matter of the contract is inherently international in dimension. Contracts for simple purchase or sale do not have a significant regulatory impact beyond the time of the closing. Other contracts, however, are more “relational” in function.² They do carry long-term implications and accordingly can be seen as regulatory in scope.

Consider a line of credit issued by a bank in one country for the benefit of a foreign borrower. The credit agreement will usually specify the purposes for which the line is granted (which can be quite specific, or can be as general as “to repay existing indebtedness”). They may require the borrower to submit regular financial statements; remain in compliance with legal rules; maintain minimum liquidity and operating income; satisfy specified financial ratios; not incur additional indebtedness; or not undergo a change in control. Credit agreements, in short, can operate as reasonably comprehensive regulatory systems, entered into by private contract and not compelled by any government action. All IAFSFs are party to many credit agreements, either as borrowers or as lenders.

Private contracts are largely enforced by private action.³ On the borrower side, enforcement takes the form of compliance with the terms of the lending agreement. Responsibility for performance is delegated bureaucratically to a defined individual or office. On the lender side, enforcement principally takes the form of monitoring.⁴ Lenders designate personnel to review and track the performance of the borrower and to verify that the borrower remains in compliance with the terms of the loan agreement. Reputation is also important: a borrower who earns a bad name among lenders is likely to find it harder to obtain credit at a competitive price in the future.⁵ The contracts themselves contain specific enforcement rules defining counterparty remedies in the event of specified future events. For suppliers of credit, these remedies may include the right to terminate further credit advances, to demand that the borrower post or increase collateral, or to declare an event of default and demand immediate repayment of the full loan amount. Some lending agreements give lenders specific management rights over the operations of distressed borrowers, including the right to veto large transactions, to prohibit the payment of dividends during the period of distress, or even to influence the selection or retention of senior management personnel. Because these remedies are explicitly spelled out in the loan agreements, there is usually no need for recourse to the courts for enforcement.

If these private mechanisms fail, the parties to the contract have other available means for enforcement short of relying on state action. Some contracts among sophisticated entities contain procedures for mediation of disputes that discourage recourse to legal processes. They may provide, for example, that in the event of disagreement over the terms of the contract, specified senior managers from both parties will meet to attempt a resolution. Recourse to legal remedies may also be discouraged by terms imposing a penalty on the first mover, such as venue rules that specify that the

² See G. Baker, R. Gibbons, and K.J. Murphy, Relational Contracts and the Theory of the Firm, 117 *Quarterly Journal of Economics* 39-84 (2002).

³ See generally B. Klein and K.B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 *Journal of Political Economy* 615-641 (1981).

⁴ See Douglas Diamond, Financial Intermediation and Delegated Monitoring, 51 *Review of Economic Studies* 393-414 (1984).

⁵ See Douglas Diamond, Reputation Acquisition in Debt Markets, 97 *Journal of Political Economy* 828-862 (1989).

site for dispute resolution will be in the home city of the party who has not triggered the process. Contracts may also specify that disputes will be resolved by binding arbitration rather than litigation.⁶

Ultimately, however, the courts provide a backstop: if the parties are unable to work out a disagreement or renegotiate terms after default, if the borrower enters formal bankruptcy proceedings, or if either party is unwilling to accept the terms of an arbitral award, the courts will step in and adjudicate rights and duties. Even then, however, the courts will often seek to maintain the fundamental terms of the relationship among the parties, so long as the arrangement has not broken down altogether.⁷ Private parties, moreover, routinely include choice-of-law clauses and (less frequently) forum-selection clauses in their contracts, thus retaining a degree of control over the nature of the legal process by which contractual rights are tested and enforced.⁸

Internal Compliance

Now consider the setting where public authorities set the norms for behavior. Even here, private enforcement is the principal means by which public norms are enforced for IAFSFs.

The internal audit function, employed by IAFSFs as well as most other large companies, is a means by which the firm can monitor its own performance across a variety of dimensions, including ensuring that the firm is complying with applicable laws and regulations, probing to detect the presence of financial or other fraud, assessing the reliability of the firm's financial reporting systems, and generally checking on the overall efficiency of the firm's operations. Many firms maintain an internal auditing department headed by an official with a title such as "chief of internal audit" or "chief audit executive." The head of the internal audit department typically reports directly to the chief executive officer and also to the audit committee of the board of directors. Audit committees and internal auditors are required for listing on the New York Stock Exchange.⁹

Complementing the role of the internal audit is the function of compliance management. Every major IAFSF maintains one or more compliance offices headed by an official with a name such as "chief compliance officer," often reporting to a special compliance committee of the board of directors. These individuals and offices have become powerful over the past decade due to a combination of public and private factors. Within firms, managers realized that compliance costs and exposure could be reduced, and a favorable public appearance achieved, if responsibility for legal compliance, which had formerly been distributed across the firm along functional lines, were centralized in a single office. Accordingly, even without legal compulsion, many firms would have centralized their compliance function in a single unit. At the same time, public authorities increasingly mandated that IAFSFs maintain procedures and policies to manage the task of legal oversight and risk control.

Delaware Chancellor Allen's decision in the 1996 *Caremark* case provided much of the spur for this movement.¹⁰ That opinion announced that a board of directors' duty of care involves, at a

⁶ Surprisingly, however, sophisticated commercial parties apparently agree to binding arbitration less frequently than might be supposed based on the supposed advantages of arbitration over litigation. See Theodore Eisenberg & Geoffrey Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in Publicly-Held Companies' Contracts*, 56 *De Paul Law Review* 335 (2007).

⁷ See S. Johnson, J. McMillan and C. Woodruff, *Courts and Relational Contracts*, 18 *Journal of Law, Economics and Organization* 221-77 (2002).

⁸ See Theodore Eisenberg and Geoffrey Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts*, 30 *Cardozo Law Review* 1475 (2009); Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 *Vanderbilt Law Review* 1975 (2006).

⁹ New York Stock Exchange Listed Company Manual § 303A.

¹⁰ *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

minimum, the duty to undertake minimal steps to ensure that a corporation has adequate reporting and information systems in place. The American Law Institute, an influential private organization devoted to promulgating best practices in various legal fields, added to the pressure with its Principles of Corporate Governance, which encouraged the establishment of a chief compliance and ethics officer with a “major policymaking” function within the corporation.¹¹ In the same general vein, the Model Penal Code, another initiative of the American Law Institute, provides that a corporation may assert a defense against criminal liability if it can prove that the “high managerial agent having supervisory responsibility over the subject matter of the offense employed due diligence to prevent its commission.”¹²

The Federal Sentencing Guidelines provide another important impetus to the development of formal compliance procedures by encouraging leniency in sentencing for corporations that maintain an “effective compliance and ethics program.”¹³ To qualify, such a program should “exercise due diligence to prevent and detect criminal conduct” and “promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”¹⁴ To ensure that the initiative is effective, the guidelines require that “high-level” people in the organization should exercise overall responsibility for the program. The guidelines further require qualifying firms to maintain and publicize effective whistle-blower programs under which employees may report or seek guidance about actual or potential criminal conduct.¹⁵

Section 404 of the Sarbanes-Oxley Act of 2002 added to the mix by requiring that management of listed firms annually produce an “internal control report” which must “state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting” and “contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.”¹⁶ The management report must be evaluated and attested to by the external auditor.¹⁷

Many other rules and regulations encourage or require the creation of specialized compliance offices or functions.¹⁸ Among the most pertinent to IAFSFs, the USA PATRIOT Act, the anti-terror law enacted in 2001, requires financial institutions to establish anti-money laundering programs that have, as essential elements, the development of internal policies, procedures, and controls, designation of a compliance officer, an ongoing employee training program, and an independent audit function.¹⁹

Management-Based Regulation

Much of the regulation confronting IAFSFs does not take the traditional form of general pronouncements of an administrative agency applicable to all firms in the industry. Management-

¹¹ American Law Institute, Principles of Corporate Governance *Id.* § 1.27 cmt. c. (1994).

¹² Model Penal Code § 2.07(5) (1985).

¹³ Federal Sentencing Guideline §8B2.1(a).

¹⁴ *Id.*

¹⁵ *Id.* §8B2.1(b)(5)(c).

¹⁶ 15 U.S.C. § 7262(a).

¹⁷ 15 U.S.C. § 7262(b).

¹⁸ See, e.g., Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7262 (2006) (mandating internal controls to ensure the accuracy of financial reports and disclosures); 17 C.F.R. § 240.15c3-4(a) (2009) (requiring over-the-counter derivatives dealers to establish and maintain a “system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.”); § 31(b)(3) of the Investment Company Act (requiring the SEC to exercise its inspection authority with due regard for the benefits of internal compliance policies and procedures and the effective implementation and operation thereof).

¹⁹ 31 U.S.C. § 5318(h)(1).

based regulation, which is individually tailored to particular firm operations, has assumed increasing importance in recent years.²⁰ The basic assumption of management-based regulation is that regulated firms have better information about their industry and their individual situations than do the regulators. Management-based regulation seeks to free-ride on these advantages by enlisting the regulated firm itself to participate in the formulation or application of rules pertinent to its operations. Firms are required to develop their internal processes and procedures and to share these with the regulators, whose review then focuses on whether the internal standards are rational, justifiable, and consonant with the regulatory purposes.

The Basel II Guidelines take the principle of management-based regulation to a new level. The Basel Committee on Banking Supervision was explicit on this point, recognizing that a “significant innovation” of the revised framework is the “greater use of assessments of risk provided by banks’ internal systems as inputs to capital calculations.” Consistent with this philosophy, Basel II’s IRB (internal ratings-based) approaches to credit risk rely explicitly on a bank’s internal risk-management models to evaluate the credit risk for particular assets. The Foundation IRB approach allows banks to supply their own estimates of the probability of default for a client or group of clients. The Advanced IRB approach allows banks, in addition, to use their internal quantitative models to estimate exposure at default and loss given default.

Even more generous attitudes towards internal modeling is found in Basel II’s approach to operational risk – the risk of the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The standardized approach to operational risk, which offers banks some potential to reducing capital charges if they qualify, is available if the institution’s board of directors and senior management are involved in the oversight of the operational risk management framework and the firm has a sound and reliable operational risk management system. This approach calculates capital charges for operational risk by dividing the bank’s activities along functional lines. The advanced management approach to operational risk is even more deferential. It permits banks to develop their own empirical models of operational risk, and provides “significant flexibility” to such banks in the development of operational risk measurement and management systems.

These forms of management regulation go to the formulation of standards rather than to enforcement per se. Yet, because the standards to be formulated are specifically tailored to the facts and circumstances of each IAFSF, and because these firms are often allowed to use their own internal models in the development of rules pertaining to them, the functions of regulation and enforcement become blurred. In a real sense, the formulation of the rules pertinent to an institution is part of the enforcement process. Once the rules are in place, however, the enforcement function becomes similar to that utilized for any publicly formulated standards: internal compliance coupled with a backdrop of public enforcement processes.

Private Standard-Setting Bodies

The activities of IAFSFs are importantly impacted by private standard-setting bodies. Among the most important of these in the United States is the Financial Accounting Standards Board (FASB). The FASB is an independent, private body consisting of five independent individuals who serve for five year terms (renewable once). The FASB follows procedures for public comment and rulemaking similar to those applicable to federal government agencies under the Administrative Procedure Act. Its Emerging Issues Task Force (EITF) tracks developing issues in the financial accounting world and promulgates consensus guidance which is usually accepted as authoritative by the FASB. The SEC has statutory authority to promulgate accounting standards for publicly traded firms, but it has consistently

²⁰ See generally Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 *Law & Society Review* 691 (2003).

elected to defer to the FASB for the adoption of authoritative standards. While FASB has very broad authority to set standards for financial accounting, it has essentially no enforcement authority. Violations of FASB auditing standards are enforced through the internal and external audit process and by means of public enforcement by the SEC and private litigation.

The Public Company Accounting Oversight Board (PCAOB), created by the Sarbanes-Oxley Act, has the powers to set auditing, independence, and quality control standards for the preparation of audit reports and to register public accounting firms performing an external audit function. Although legally and formally a private sector body, the PCAOB is closer to a government agency than is the FASB. Its powers are conferred by legislation. The SEC appoints PCAOB's members, approves its budget, oversees its operations, and has the power to censure or remove its members. Decisions by the PCAOB can be appealed to the SEC, which has the power to overturn its rules. (The public nature of PCAOB's activities has sparked an important constitutional challenge, *Free Enterprise Fund v. Public Company Accounting Oversight Board*,²¹ in which objectors to the board's activities claim that the authorizing statute unconstitutionally denies the President of the United States the constitutional authority to appoint federal officers.) The PCAOB exercises important regulatory functions: it can conduct investigations, require submission of documents and information, and administer sanctions against auditing firms subject to its jurisdiction.

The International Swaps and Derivatives Association (ISDA), a trade association of firms in the derivatives industry, is another important standard-setting body whose work impacts IAFSFs in important ways. Established in 1985, ISDA is principally known for developing the ISDA Master Agreement, the authoritative contract used by industry participants. But ISDA also engages in other activities that could be considered regulatory in nature. It claims as part of its mission statement the tasks of "promoting practices conducive to the efficient conduct of the business," "promoting the development of sound risk management practices," and "fostering high standards of commercial conduct." Because all IAFSFs participate in the derivatives market, some to a substantial extent, the ISDA is an important standard-setting body for their industry. However, ISDA is not an enforcement agency; enforcement of contractual terms under the master agreement must take the form of the usual mechanisms of private pressure, arbitration or litigation.

Completing the quartet of important standard-setting bodies is the Financial Industry Regulatory Authority (FINRA). Like the other three just discussed, FINRA is officially a private organization, created in 2007 through the consolidation of NASD and the regulatory and enforcement functions of the New York Stock Exchange. FINRA's principal responsibility is to oversee the broker-dealer industry in the United States. In that capacity it has an important, although limited, regulatory authority over IAFSFs, most of which maintain a broker-dealer as part of their corporate structure. FINRA promulgates rules for the broker-dealer industry through a process resembling federal notice-and-comment rulemaking. It also offers informal standard-setting by means such as interpretative letters, examination letters, and interpretations of financial and operational rules.

In addition to setting standards, FINRA exercises an enforcement function. It monitors markets to detect evidence of fraud, manipulation or insider trading, and conducts compliance examinations for firms subject to its jurisdiction. It is authorized by federal law to take disciplinary actions against its members, which can include fines, orders of restitution, censures, suspensions, or expulsion of firms or individuals from the industry. It also provides arbitration services to help resolve disputes between and among investors, securities firms and individual brokers. FINRA is substantially a private self-regulatory organization. Its board of governors is elected by the membership at an annual meeting, not appointed by the SEC or any other governmental agency. It ostensibly sets standards and conducts enforcement activities free of SEC oversight and supervision. Nevertheless, it is clear that the SEC

²¹ No. 08-861, Supreme Court of the United States.

exercises substantial influence over the FINRA extending even beyond its power to reject proposed rules for incompatibility with federal law.

Cartels

The past decades have witnessed the exposure and prosecution of numerous international cartels, ranging from the world-wide vitamins conspiracy to agreements to fix the prices of international air travel and air freight, aluminium, batteries, beta carotene, carbon electrical products, automotive glass, fine art auction services, DVD players, shipping – even the Three Tenors CD. Somewhat surprisingly, no major cartels have been discovered involving international financial services. Perhaps some of the reasons for this welcome absence are the ease of entry into the market, the lack of concentration even with very large institutions playing pivotal roles, the relative transparency of pricing and other terms, and the heavily regulated nature of most segments of the industry. However, the fact that cartels have not been in evidence in intentional services does not mean that they do not or could not exist.

A cartel fits our definition of private regulation and enforcement. Even though the purposes of the cartel are contrary to the public interest, that fact – a public purpose – is not essential to the definition. Often, indeed, it is difficult to ascertain what the public interest requires in a given case: the difference between a cartel to fix prices in financial services and the requirement long in effect in the United States that banks could not pay interest on checking accounts is somewhat difficult to ascertain, aside from the fact that one is illegal and the other was legally required.

To be effective, cartels require coordination and agreement among industry participations to restrict production and to avoid undercutting of the agreed-on prices. These are, in effect, forms of regulation – no less so because they are typically formulated in secret and distributed in carefully disguised code. Cartels, moreover, require extensive policing if they are to be stable. Members must abide by the agreement despite ever-present temptations to enhance their profits by undercutting the cartel price; and must do what they can to discourage entry by persons not members of the club. Accordingly, we classify cartels as a form of private regulation and enforcement – albeit not one shown to have played a major role in the operation of IAFSFs.

Private Litigation

Private litigation is also a form of private enforcement. Private parties seek to obtain relief for themselves, but do so by establishing that the defendant has violated some applicable principle of law. When many plaintiffs are involved, as in the American-style class action, the relationship between private litigation and public enforcement is even clearer – so clear that one of the traditional justifications for class action litigation is that the representative plaintiff acts as a “private attorney general” on behalf of a large group of similarly situated persons. We therefore should include private litigation in the general category of private mechanisms for regulating and enforcing rules pertaining to IAFSFs.

IAFSFs are subject to litigation in any country where they do business. As a practical matter, however, the risk they face from private lawsuits is relatively minor except in the case of jurisdictions that recognize class actions or similar procedures. The principal such jurisdiction, of course, is the United States. Class actions are often brought against these companies for alleged false or misleading statements in financial disclosures. Claims are also framed as shareholders derivative litigation, alleging that the senior managers of an IAFSF violated a duty of care or loyalty to the company. IAFSFs can also be caught up in securities litigation brought against other companies with which the IAFSF has dealt. For example, a lawsuit for fraud arising out of a securities underwriting will nearly always join the underwriter on the ground that the underwriter signed the registration statement with knowledge of false or misleading statements of material fact. For a time it appeared that IAFSFs would face another, potentially unbounded liability as “aiders” or “abettors” of their customers’

frauds. The Supreme Court has twice ruled that aider-and-abettor liability is unavailable under the federal securities laws.²² But the liability cloud has not entirely cleared, since resourceful plaintiffs' attorneys are able to claim (sometimes with plausibility) that an IAFSF was an active participant in the alleged fraud, not just an aider and abettor.

II. Assessment

The discussion so far has identified a variety of different mechanisms for the private regulation and enforcement of norms pertinent to IAFSFs. What can we make of the information so compiled?

One point should be obvious, but bears emphasis because it is so commonly ignored. Scholars of regulation and enforcement have tended to focus, for understandable reasons, on public institutions and processes. They examine the activities of legislatures and administrative agencies, of investigators and police, of courts and hearing examiners. These, after all, are the sorts of regulation and enforcement that are most apparent, and also the ones that are most easily identified as part of a process for enforcing public norms. Yet a realistic examination of the behavior of IAFSFs – of or any major industry group – reveals that government regulation and enforcement is a small part of the overall processes by which rules of conduct are created, promulgated, and enforced. By far the greatest share of standard-setting and enforcement is conducted by private actors in one or more of the modalities described above. For this reason, among others, the study of private regulation and enforcement in the global economy is an eminently desirable avenue of research.

The foregoing discussion identified the following types of private regulation and/or enforcement for IAFSFs: (1) house rules, (2) contracts, (3) internal compliance and audit, (4) management-based regulation, (5) private standard-setting bodies, (6) cartels, and (7) private litigation. More modalities could be added to the list – for example, codes of corporate governance or codes of corporate ethics could be included. Even the items that have been discussed reveal a wide range of public involvement in the process of standard setting and enforcement, ranging from minimal (in the cases of house rules, cartels and contracts), to moderate (internal compliance and audit, private standard-setting bodies, litigation), to substantial (management-based regulation). The government involvement, moreover, does not assume the same form for all of these modalities: sometimes the government plays a major role in the formulation of norms but not in their enforcement (e.g., litigation), other times the government stays out of norm-formation but plays a bigger role in enforcement (e.g., the FASB), and sometimes the government plays a role in both functions (management-based regulation). The pattern is complex, shaped in part by history, and not necessarily consistent from country to country. Nevertheless, some tentative judgments may be offered based on the evidence presented so far, with due caution for the fact that most although not all the data are from the United States.

The verdict on effectiveness is mixed. Certainly the system of overlapping public and private standard setting for IAFSFs did nothing to prevent to financial meltdown of 2008. What is less clear is whether any other approach would have done better. Governments were no better than the private sector at foreseeing the grave risk to the world financial system posed by the enormous flood of cheap credit coursing through financial markets during the 2000s. Quite the opposite: governments, in the form of central banks operating monetary policy, were the chief culprits in setting loose the forces of disaster. The ebullient spirit that infuses a nation in the midst of an asset bubble affected government actors as well as private ones. On the other hand it appears clear that the system of overlapping regulation and fail-safe monitoring that appeared to be so carefully embedded in the mix of public and private regulation and enforcement also failed its mission. Risk management committees did not pick up on or adequately control the fat-tail potential inherent in financial markets. Corporate governance standards promulgated in the wake of the corporate scandals of the 1990s appear to have accomplished

²² *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. and Motorola, Inc.*, 552 U.S. 148 (2008).

little. Very few people, and no one in a position of real authority, properly appreciated the fact that the financial world was teetering on the precipice of disaster during the credit boom of the 1990s.

The system of public-private regulation appears relatively successful at conferring legitimacy on the actions taken in the case of IAFSFs. There is an obvious value in vesting the rule-setting and enforcement powers in the group being regulated, in that the presence of self-regulation appears calculated to induce greater compliance and acceptance of the validity and reasonableness of the regulations being enforced. On the other hand, the enhanced legitimacy among regulated parties is offset, to an extent, by the reduced credibility they have as impartial champions of the public interest. The example of cartels proves all too clearly that the private sector cannot be relied on to regulate itself when the interests of private actors conflict substantially with the public interest. To deal with the suspicions of industry favoritism, self-regulatory organizations and private standard-setting bodies, such as FINRA or ISDA, make concerted and well-publicized efforts to conduct open rulemaking procedures involving extensive input from all interested parties. The same dialectic occurs in the case of management-based regulation: the enlistment of company management into the regulatory and enforcement process both creates better-informed standards and induces potentially greater compliance by the regulated party; but allowing IAFSFs to supply their own models and assumptions could also be seen, by a critic, as an example of allowing the fox to guard the henhouse.

Difficult as it is to judge quality of regulation, it appears that the private involvement in regulation and enforcement may offer certain advantages as compared with “top-down” government rules. Private regulation and enforcement may bring the expertise and substantial knowledge base of the private sector into the regulatory mix, with good effect. On the other hand, what the private sector provides in expertise and knowledge, it may lack in overall perspective. The financial services industry cares about itself but not so much about the public interest; government regulators may score better on this score.

The presence of private sector actors in the process of enforcement also yields potential benefits and costs as regards IAFSFs. On the plus side, the private sector often is privy to valuable information pertinent to enforcement, including soft information such as gossip and rumor. No one knows more about what goes on at an IAFSF than people in other similar organizations. Private sector enforcement can take advantage of these and other bases of knowledge which are less accessible to the government. On the negative side, private sector enforcement may be hamstrung by the special interests of the industry being regulated or by the lack of strong sanctions for violations. Further research, ideally involving empirical tests and analyses, would be needed to assess the degree to which private sector involvement enhances or hinders effective enforcement of public norms.

The choice between the various regulatory options does not boil down to a single variable or criterion. Instead, multiple considerations appear to be determinative of the observed pattern, interacting in a complex and interrelated fashion. The major factors appear to include the following considerations, each of which apply on an “other things equal” or *ceteris paribus* basis:

1. Minimization of transactions costs. The mix of private and public regulation seeks to minimize the transactions costs associated with the regulatory process.
2. Access to information. The regulatory and enforcement functions are vested in persons who can obtain relevant information rapidly and at reasonable cost.
3. Expertise. The mix of private and public regulation and enforcement takes advantage of specialized expertise in technical or rapidly evolving fields.
4. Political power of the regulated industry. The regulatory and enforcement functions reflect the political power and economic strength of the industry being regulated, as well as the power of potentially competing industries.

5. Turf. The mix of private and public regulation and enforcement reflects competition of regulators for “turf” – the power to set rules or conduct enforcement proceedings in a particular industry.
6. Budget. The mix of private and public regulation reflects the costs of the regulation and the financial constraints facing public regulatory bodies.
7. History. The structure of the regulatory and enforcement functions of private and public bodies is a function of history and path dependency. For this reason, we expect to see substantial differences in the pattern across national boundaries.

The study of private involvement in transnational regulation in a globalised world is still in its infancy. The foregoing discussion is intended as a preliminary effort towards developing a typology of private regulatory and enforcement activity pertinent to the business of internationally active financial services firms, identifying some of the determinants of the observed regulatory structure, and evaluating how the public-private mix of regulation and enforcement for IAFSFs measures up along the dimensions of effectiveness, quality, legitimacy and enforcement.

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