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## Deregulation and the power of private surveillance in markets

**Abstract:** This paper serves as a brief discussion on the current international financial architecture, and the power afforded to private actors in capital markets. When the term 'private surveillance' is used, it denotes the activities of supervisory bodies which are privately owned, unelected and largely unaccountable to state, national or international authorities. This also encompasses the supervision of market participants which use products that are extraneous to current direct international regulatory structures. This paper is grounded in observational research; it uses observations of capitalist market ideology and its relationship with modern finance, together with brief discussions of market actors, to form a critique of the arrangements that have come to dominate regulation of the free market system. It also reflects the author's position as a lawyer, rather than an economist, and focuses on the regulatory challenges that face Western economies.

Liberalized financial markets and the attendant increased capital flows between territories have required a deregulatory drive since the collapse of Bretton Woods. This deregulation is an aspect of the political philosophy referred to as neoliberalism, an ideology founded on the principles of minimum state intervention and highly decentralized and liberalized capital markets. This, in turn, has placed great power in the hands of non-state bodies and the market itself in the overarching framework of financial regulation, in preference to the ethos of state surveillance of financial services, products and capital flows which dominated during the post-war era.

With this power comes responsibility for the integrity of the financial system, but this paper will highlight the ambiguous role that orthodox liberal philosophy has demanded of these private bodies, and discuss the implications this has for future regulatory structures. It will also critically analyse the danger that placing such power in the hands of private bodies may generate in terms of potential systemic risk. It will briefly address the experience of less financialized economies and their greater resilience to economic contraction. It will conclude by examining ways in which future regulation of capital markets may be served by moving away from the highly deregulated neoliberal paradigm and moving towards the creation of a more interventionist legal axiom.

**Keywords:** Regulation, law, governance, credit crisis, neoliberalism, privatization, financialization, liberalization.

**JEL classifications:** B50, G01, K20.

## 1. Introduction

It is clear from the financial wreckage wrought in the wake of the credit crisis of 2007–2009, that a fundamental change in the ethos of how to regulate financial markets is required. The system of laissez-faire capitalism, which necessitates the advent of highly unregulated markets and the destruction of barriers to the circulation of capital, has been relied upon in Anglo-American governance systems to deliver growth, prosperity and development to countries and region which subscribe to this economic ideology. The process of liberalization was underpinned by a concerted programme of retreat by Western governments from spheres of economic and industrial activity, most evident in the privatization drive experienced in both West and East Europe during the latter twentieth century. However, the last few months have witnessed the near-collapse of the financial system, and in its fragility, revealed the crisis management arrangements in global finance to be ad hoc. Many of the world's financial institutions owe a large debt of gratitude to state authorities that have recapitalised the banks and prevented economic catastrophe. That it was the liberal reforms to the financial system that those same state authorities made which facilitated these collapses, many have noted with irony. The present system of regulation, therefore, has been revealed to be deeply flawed, and in need of reform. The next section of the paper will analyze the basis for Western regulatory structures, which are themselves reflective of prevailing political and economic ideologies.

## 2. The current regulatory philosophy

The neoliberal reforms made since the 1970s following the collapse of Bretton Woods, which instigated the highly liberalized market philosophy that dominates Anglo-American governance of financial capitalism have been characterized by a retreat from reliance on centralized authority. The removal of much of the state's role in regulating finance is regarded as a necessary pre-condition for the enhanced flow of capital and trade necessary for the realization of greater capital accumulation. Further, the breakdown of barriers to the movement of capital allows it to be recycled more quickly, allowing the use of increasingly sophisticated financial instruments to exploit new areas of finance, and to achieve greater allocative efficiency in economies.

Regulatory structures have evolved in tandem with the burgeoning role played by the financial sector in Western economies<sup>1</sup>. 'Exotic' markets have become a par-

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<sup>1</sup> For example, financial and business services constituted about one-third of UK GDP in 2006. Source: <http://news.bbc.co.uk/1/hi/business/7789844.stm>, last visited 30th March 2009.

ticularly significant avenue for investors, as traditional streams of investment such as government and corporate bonds have failed to yield the rates of return required for the sustainable growth of funds. Long-term low rates of interest in these investment sources have driven investors towards less conventional instruments, leading to a pronounced expansion in financial innovation and securitisation. The search for yield in financial markets has been compounded by structural modifications in the banking sector, which have led to major retail banks splitting their activities between traditional 'high-street' banking, and investment banking operations. The effects of this process have been exacerbated as the process of disintermediation has developed, leading to banks being displaced by the capital market as the main source of borrowing for investors.

State interference in these areas has long been regarded as a hindrance to the development of capital markets, and the realization of greater market value. The role of the state in neoliberal theory is as guardian of the fundamental freedoms that allow economic development to take root, such as strong individual and corporate property and contractual rights (Friedman 1962). Private enterprise and entrepreneurial initiative – the fundamentals of the so-called 'entrepreneurial society' – are regarded as the fulcrum of innovation and wealth creation. Compliance costs associated with tough state regulation are not conducive to creating a favourable business environment for financial institutions to operate in, and the close ties between 'big business', banks and successive Anglo-American governments have led to less onerous standards of surveillance being employed. Indeed, in his final speech to City financiers as UK Chancellor of the Exchequer, Gordon Brown congratulated himself on 'resisting pressure' to toughen up regulation of banking activities. This rationale mirrored the approach taken in the United States when, in the late twentieth century, the Glass-Steagall Act was repealed<sup>2</sup>, thus removing the prohibition on banks from pursuing both commercial and investment banking operations from a unitary corporate body. The process of disintermediation was supported by the presumption that the risk of contagion in the financial system could be more adequately marginalised if borrowers utilized capital markets instead of banks, displacing the latter as the prime source of capital lending.

The banking system in particular therefore was targeted with 'light-touch' regulation. The growth of investment banking and the attendant securitisation of credit, was lauded by many market participants as an effective tool with which to manage risk. Diversified holdings of credit, increased liquidity in the financial system and the lessening of the potential for contagion by greater disintermediation resulted in a perceived reduction in the need for expensive bank capital. Credit losses would be less likely to produce systemic failure. (FSA 2009, 15). The explosion in the so-

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<sup>2</sup> The Act was repealed by the Financial Services Modernisation Act 1999.

phistication of credit products was welcomed as a further tool with which to effectively counter risk.

This attitude to risk influenced the attitude to regulation. One of the cornerstones of ‘market fundamentalism’<sup>3</sup> is that because the market is in possession of information on prices and values that a central authority cannot possibly know, self-regulation is more efficient and more effective than the imposition of rules by external or public bodies suffering from information asymmetries, acting in the name of a higher state authority (Stiglitz 2003). The implicit philosophy of global financial regulators was, until recently, therefore based upon several overt tenets: that markets are self-correcting; that management should bear responsibility for managing risk (rather than regulators who do not fully appreciate the business models that banks use); and that risk is effectively contained not through regulation of products but through ensuring that wholesale markets are transparent and firm conduct is appropriate (FSA 2009, 87). Thus, the evolving character of international finance has resulted in a shift away from normative regulation towards a decentralized plexus of codes, ‘soft law’, and non-binding supra-national agreements. The globalization of finance, moreover, has led to a blurring of the roles of domestic regulatory bodies and international financial supervisors.

This globalization of finance further dictates that only concerted action by national and supra-national regulators could have any discernible effect in guarding against financial and systemic risk. Until the credit crisis of 2007–09, there was little appetite for such intervention, and the formation of a general consensus on the issue was difficult<sup>4</sup>. Liberalization and its attendant consequences endure great tension with the international regulation of markets. As Picciotto argues:

“The dominance of pressures for liberalization has created a strong ideological presumption... that regulation is an unnecessary burden, and generally results from protectionist motives. From this perspective, international integration means the creation of open markets, which requires only strong provisions for the protection of property rights, the maintenance of public order, and not much else. Certainly, at the international level regulatory standards have proved hard to agree, which accounts for the trend towards functional fragmentation, the preference for soft law, and in particular the problem of inadequate coverage of, and consequent loopholes in, the global regulatory networks.” (Picciotto 1998, 8)

Regulation has not been dispensed with. Indeed, there is now such a myriad of associations charged with ‘oversight’ of the financial system that the present market

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<sup>3</sup> A term reputedly coined by George Soros.

<sup>4</sup> Even now, forming a concerted response to the crisis has proved extremely difficult, with France threatening to leave the April G20 summit in London unless strict rules for financial regulation are guaranteed. Source: The Daily Telegraph, ‘Sarkozy threatens to walk out of G20’, 31st March 2009, available at <http://www.telegraph.co.uk/finance/financetopics/g20-summit/5079690/Sarkozy-threatens-to-walk-out-of-G20.html> last visited 31st March 2009.

system of supervision has been said to be encapsulated by the phrase ‘freer markets, more rules’ (Vogel 1996). Escalating global financial flows demand regulatory supervision, resulting in a labyrinth of networks consisting of clearing houses, exchanges, law firms, private regulatory bodies and state authorities acting with little direct co-ordination or concerted supervision. A hierarchy or order in the modern regulatory paradigm is absent. Although financial markets and transactions are regulated, they are policed through soft law and market-participant generated norms and procedures, characterised by public intervention following the failure of private governance (Porter 1993). Regulatory systems have suffered fragmentation, with the delineation between public and private oversight blurred by the complexity of modern international financial markets. This phenomenon is a side-effect of the economic liberalization experienced in capital markets since the 1970s, creating: “an exponential growth of networks of regulatory co-operation, coordination and harmonization...reflect[ing]...changing public-private forms, since these regulatory networks are very often neither clearly state nor private but of a hybrid nature.” (Picciotto 2006, 2)

It is, therefore, the tenor of modern regulation that causes concern. It is driven largely by liberal economic principles, with the aims of reducing transaction costs and has encouraged financial innovation on a vast scale, both to avoid regulation altogether, or to engage in regulatory arbitrage (Picciotto 2008). Global regulatory structures are permeable, and contain legal disparities which can be exploited by private market actors to avoid national supervisory frameworks. The inherent instability of capitalist systems is amplified by the fragmentation of international financial regulation and the endemic crises of capitalism are intensified by the lack of coherence in substantive rules, and the lack of formal, binding standards on market participants. In the next section, the paper will examine specific areas of international financial regulation which evidence the paradox generated by reliance on neoliberal philosophy, and how fractures in the regulatory lattice have been exposed by the events of the great credit crash of 2007–09.

### **3. Private surveillance in market regulation**

#### **3.1. General**

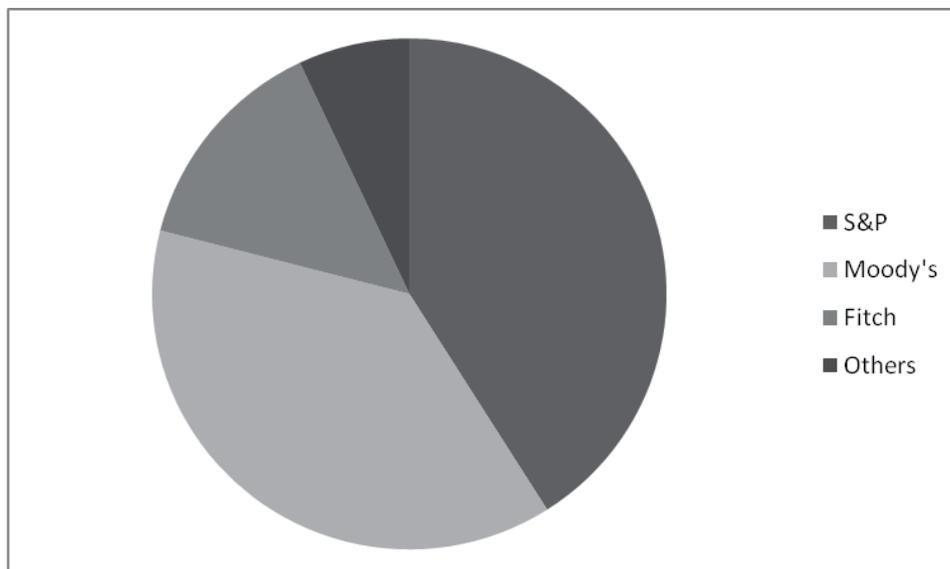
One of the phenomena associated with the deregulation of the market that has occurred over the last thirty years or so, is that many of the supervisory duties in the financial system have been ceded to non-state, private actors: areas of finance have developed which have received little centralized regulatory attention. This ‘privatisation of surveillance’ has important consequences for the integrity of the financial sys-

tem yet, despite this, until recently the process of incorporating regulation enforced by private bodies had aroused a surprising lack of scrutiny or, more significantly, had not attracted the political will required to ensure necessitous reform was made.

There are several high-profile and exceedingly significant private bodies which have been granted special status in financial markets to combat the build-up of excess risk in the system, and this paper will examine briefly three areas of finance in which market discipline has been preferred to direct regulation: credit ratings agencies; derivatives monitoring; and offshore investment funds. These sectors pose dilemmas to observers, both in terms of accountability and, more importantly, suitability to the roles afforded to them. In analyzing these sectors, and their roles in recurrent crises, these themes will become apparent, and demonstrate that modern capitalist theory is dominated by how to respond to crises, rather than how to avert them.

### 3.2. Credit rating agencies

Credit ratings are 'opinions of the future ability, legal obligation, and willingness of a bond issuer or other obligor to make full and timely payments on principal and interest due to investors' (Moody's 2003). The market for ratings is highly concentrated: there are just 3 global credit ratings agencies – Moody's, Standard & Poors and Fitch. Between them they control about 93% of the global ratings market. By



**Figure 1. Relative concentration of ratings industry by firm**

Source: J.C. Coffee (2006), *Gatekeepers: The Professions and Corporate Governance*, OUP, Oxford, p. 284

way of example, in 2007, there were about 2.6 million ratings issued in the US ratings universe, covering the five classes of ratings identified in the Securities and Exchange Act 1934. Across the five sectors, all but about 43,000 ratings were issued by the three largest agencies, a proportion of over 99 percent (SEC 2008). Using the Herfindahl-Hirschmann Index (HHI), the SEC calculated the concentration of the ratings industry at 3778, which is the equivalent of 2.65 equally weighted firms (see figure 1)<sup>5</sup>.

The rating agencies have come under increasing attack from all sides following the latest financial crisis. Their role as arbiters of credit-worthiness has been cemented in the global financial architecture by the reliance on their risk profiles by agencies charged with the task of guarding against systemic risk, particularly since the direct integration of their data into banking supervision under the Revised Capital Accord (usually referred to as Basel II) issued by the Basel Committee on Banking Supervision (BCBS).

Basel II is designed partly to mitigate against the risks inherent in banking through the adoption of core principles in relation to banking activities and capital reserves. This system is underpinned by three pillars; the first pillar, which is designed to preserve capital adequacy, uses credit ratings to determine banks' risk profile and, by proxy, how much capital each bank must hold in relation to the liabilities and leverage it maintains. The previous Basel Accord relied upon public regulatory agencies to determine risk weighting, but Basel II replaces this system with a system of external credit assessments, largely conducted by private bodies or firms which are to provide credit-risk assessments of all borrowers. This entrenches the role of private credit ratings agencies in the regulatory system of bank surveillance. Further, the Securities and Exchange Commission in the US, the largest financial market, employs ratings to determine capital reserve requirements for broker-dealers, under SEC Rule 15C3-1, which was implemented in 1973. The rule sets out certain requirements on net capital for broker dealers, and it explicitly incorporates credit ratings as a benchmark against which to measure risk and determine minimum capital levels (SEC 2003, SEC 1975). Due, in part, to this incorporation of private evaluation of debtor creditworthiness, the role of credit rating agencies has become an issue of great contention in discussions concerning global financial regulation. Moreover, these are apposite examples of the way in which private actors have become legitimized as regulatory agents in modern neoliberal markets.

There is a strong basis for objection to the use of private ratings in regulatory structures: the performance of ratings analysts has proved questionable and, allied to this, the agencies pose serious accountability issues to the notion of a truly representative global economic organization. When one considers the issue in

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<sup>5</sup> The HHI scale runs from zero to 10,000, with zero indicating a market experiencing 'perfect' competition. According to the US Department of Justice, a score on the HHI scale over 1800 points indicates a concentrated market.

the context of the recent credit crisis, it becomes clear that the institutionalization of ratings in financial system regulation carries dangers which could exacerbate systemic risk. For example, a root cause of the crash has been identified as the underpricing of risk in various mortgage-backed securities (Collateralised Debt Obligations - CDOs). Credit rating agencies awarded the highest ratings available (generally, AAA) to many of these structured products, yet recent research has revealed that almost half of the complex credit products linked to mortgage securities ever devised have now defaulted (Davies 2009). The defaults related to these products resulted in huge losses at banks such as Lehman Brothers, Citigroup, UBS and Merrill Lynch, and were damned by the Bank for International Settlements (BIS) as too complex to be effectively risk managed (BIS 2008). These CDOs would have been recorded as assets in any assessment of bank capital adequacy under Basel II; yet, as the veracity of the value of these assets was questionable, banks' risk profiles were prejudiced by the inaccuracy in the ratings and exposed these institutions to larger losses (Wighton 2008).<sup>6</sup> This is but the most disturbing example of faulty ratings being ascribed to financial products, which were undermined by later, more thorough, analysis.

Regulation of credit-worthiness has therefore been outsourced to private authorities, with drastic consequences. The lack of accountability of ratings agencies to national and global regulators amplifies the conundrum that these private actors pose to the integrity of the financial system. It is contended by most observers of the credit ratings industry that the potential for a conflict of interest exists in relation to the fee structure that the major rating agencies employ (Schwarcz 2002, 15–16; Partnoy 2006, 71–73; Coffee 2006, 286); specifically, because rating agencies fund their operations through charges to the issuer of the financial product being rated, rather than subscriptions from investors. As the SEC comment:

“Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information. This potential conflict could be exacerbated by the rating agencies' practice of charging fees based on the size of the issuance, as large issuers could be given inordinate influence with the ratings agencies.” (SEC 2003, 41).

In neoliberal markets, this accountability deficit which exists may be tolerable when agencies fulfil their role as adequate financial gatekeepers. When they fail, wounded market participants demand that they are held accountable, but their entrenched status in modern finance allied with the fact that they are private bodies determines that there is an attendant accountability deficit.

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<sup>6</sup> Two of the 'big five' Wall Street US investment banks collapsed in 2008 (Lehman Brothers and Bear Sterns), whilst a third (Merrill Lynch) was swallowed up by Bank of America. These financial disasters were, in part, caused by the inadequate pricing of securitised products.

### 3.3. Derivatives monitoring

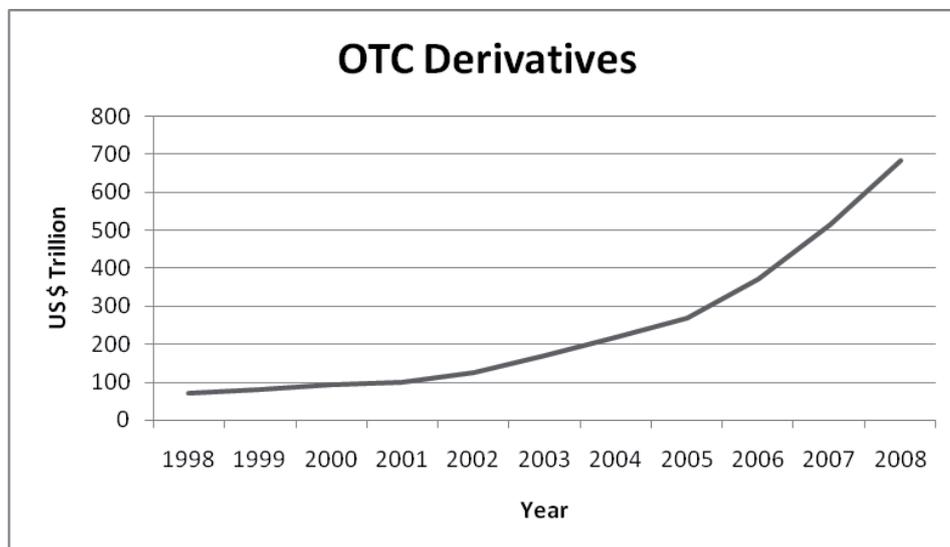
The use of derivatives is justified by participants in financial markets as a method of hedging investments through diversification, thereby reducing risk. Yet, many of the techniques used by financial actors over the past 20 years, especially derivatives, have contributed to financial instability by allowing huge losses to incur. The collapse of Barings Bank in 1995 was, perhaps, the first time that financial 'sophistication' in the form of financial derivative contracts led to the destruction of a financial institution which was directly attributable to exchange-traded derivatives. Certain derivatives are undoubtedly useful; derivative contracts in physical goods such as crops, for example, can guard against the risks associated with harvest failures or disease. Furthermore, some derivative contracts are regulated: the International Swaps and Derivatives Association (ISDA) monitor derivatives contracts through Master Agreements drawn up in 2002, following the 1998 East Asian financial crisis. The International Securities Market Association (ISMA), based in Zurich, also plays a role in operational monitoring of derivatives markets but, like the ISDA, it is a self-regulatory, privately-run trade association, with no direct accountability to investors or to national regulators.

An example of the limits of private regulation of derivatives is that derivative Master Agreements generally cover only exchange traded derivatives; so-called 'Over-The-Counter' (OTC) derivative contracts are traded in opaque markets, and bear full counterparty risks. Put simply, when a derivative is traded on an exchange, the seller is protected against default through a premium levied by the clearing house, thus reducing counterparty liability. This acts as insurance against the losses that the instrument could expose a derivative trader to, and ensures that trading liquidity is sufficient (as there will be many traders on the exchange competing for products). In contrast, OTC derivative trades are not traded on an exchange and therefore, the counterparties are exposed to unlimited losses: there is no protection on default. Added to this, the OTC market is generally more illiquid than the exchange derivative market; limits on liquidity lead to increased volatility and knock-on effects impacting the wider financial system (Cookson, Chung & Mackenzie 2009).

The size of the OTC derivatives market is staggering: the BIS estimated in June 2008, based upon 6-monthly surveys of market participants, that outstanding OTC derivatives contracts totalled \$683.7 trillion (BIS 2008). The OTC market is therefore approximately 48 times the size of US annual GDP.<sup>7</sup> The value of 'at-risk' derivative transactions is difficult to estimate, but the net aggregate exposure of the credit derivatives market was calculated at \$20.4 trillion in June 2008 (BIS 2008).

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<sup>7</sup> US GDP is approximately \$14.2 trillion. Source: National Economics Accounts, Bureau of Economic Analysis, available at <http://www.bea.gov/national/index.htm> last visited 16th March 2009.



**Figure 2. Growth of OTC derivatives market**  
 Source: Bank of International Settlements Derivatives Updates (1998–2009)

The underpricing of risk in CDS contracts has cost one insurance company alone, AIG, more than \$60 billion and the corporation’s criticality to the global financial system determined that the US government was forced to bail the company out with \$150 billion (Haldane 2009, 14). These figures suggest that a systemic collapse due to a widespread crisis in the derivative markets would be difficult to avoid, even with the assistance of the governments of leading economies.

The market has, thus far, been reluctant to regulate these transactions, following the neoliberal paradigm of self-regulating and corrective markets. Instead, regulation has focused on the potential consequences of default (such as the Barings collapse, the Enron bankruptcy, the bail-out of Long Term Capital Management, and the more recent examples during the credit crisis of 2007–09). The lack of a central clearing counterparty (CCP) has been identified as one of the key weaknesses in the financial system (Grant, Tett, & Van Duyn 2009); not – as is often erroneously claimed – because OTC derivative products were a driver of the credit crisis, but because the opacity of the market became extremely debilitating once liquidity contracted and banks became unwilling to lend to one another. The lack of a CCP and the inability of banks to assess counterparty liabilities (because they lay in OTC transactions) led to the protracted credit drought which has exacerbated the crisis.

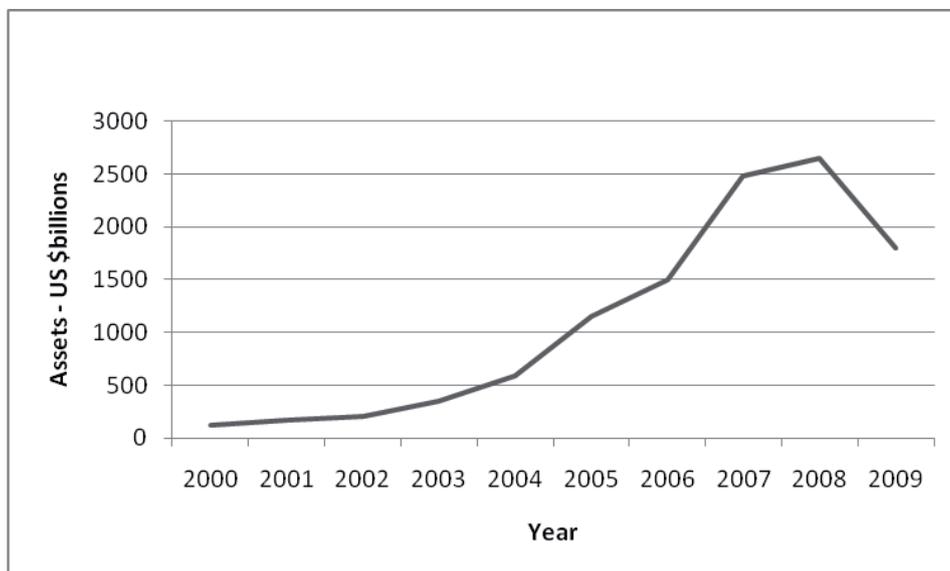
However, in the absence of a clear philosophical shift, establishing a clearing-house for a market of this size will be a formidable, if not impossible, task. Susan Milligan, senior vice-president of government relations at the Options Clearing Corporation claims that the fact that OTC contracts are not standardised (they are

tailored to individual users) dictates that direct regulation of OTC products is impossible as “some things are just too customised to clear” (Grant, Tett, & Van Duyn 2009). The role of the state in current regulatory philosophy is defined in terms of facilitating the installation and maintenance of markets, and intervention is justified only where remedial action is required to fix market failures (Picciotto 1999). In the absence of a derivatives disaster, it is difficult to see from where the political pressure for reform to guard against systemic risk from OTC contracts will emanate. There have been proposals put forward by investment banks to instigate mandatory central clearing of contracts in the CDS market (Weitzman 2008) and Intercontinental Exchange, a global CCP, began clearing CDS contracts on March 9<sup>th</sup> 2009. However, there is uncertainty whether all CDS contracts will be centrally cleared, with few, if any, individually tailored contracts insured, and very few legacy contracts dealt with by a CCP (Sri Pathma 2009). Exchanges have warned against attempts to regulate complex and illiquid derivatives products (Grant, 2009). This will continue to ensure that trades are not fully collateralised, with gaps remaining in the capitalisation of residual positions. The loopholes characteristic of the current global regulatory network will remain, and OTC trades will continue. This is tolerated despite the realization that the default of a major derivatives counterparty such as Lehman Brothers or AIG is not inconceivable, and funds for recapitalising financial institutions are constrained by the economic downturn.

### ***3.4. Hedge fund & investment fund surveillance***

Hedge funds are, perhaps, the most infamous creatures of modern high finance. As ‘anything goes’ investment funds, they employ a vast array of financial engineering techniques, predicated upon a range of investment strategies. Further, their use of derivatives and leverage have the potential to pose serious risks to the stability of the financial system. The liquidation of Long-Term Capital Management, a fund with capital of \$4.8bn, balance sheet positions of \$120bn (leverage factor of 25), with total gross notional off-balance sheet derivatives positions of about \$1.3 trillion, is the most grotesque example of failed surveillance in this area. The best estimate is that LTCM invested well over \$35 for every \$1 it actually owned (Greenspan 2007, 194).

Regulation of the hedge fund industry is viewed as largely unwarranted, because of the expertise of the practitioners involved. In LTCM’s case, two of its principals were Nobel prize-winning economists, and the fund received generous lending terms from its counterparties – the same counterparties that were forced to bail the fund out to avoid the domino-effect that the collapse of the fund would have produced. Consumer protection arguments are also obsolete; hedge fund investment is limited to individuals with a ‘high net worth’, and institutional investors and other investment funds. The process of arresting developments from hedge fund operations which could pose potential systemic risk is not assisted by the fact that



**Figure 3. Growth of global hedge fund industry**

Source: Hedge Fund Intelligence

most are located offshore and are not subject to the same international regulation as other investment vehicles.

Contrary to popular legend, hedge fund operations do not universally employ significant leverage; in fact, most hedge funds are significantly less geared than investments banks. Nevertheless, the case of LTCM is not an anomaly; several macro funds employ borrowing levels of significant multiples of their capital base. At the time of the LTCM collapse, eight macro funds had leveraged their portfolios by 700–800 percent and twenty-five funds had borrowed over five times their capital base. (Eichengreen 2003, 174). As they are structured offshore, national-based regulators can find it difficult to control or supervise hedge funds, a factor which can become a significant obstacle to guaranteeing systemic integrity during financial crises. The practices of margin requirements and collateralisation help to limit the risks that hedge funds can pose through shorting and derivative positions. Further, national authorities can exercise some control over the activities of hedge funds; regulators can mitigate the risks posed by leveraged hedge funds by exerting control over the lending practices of regulated banks to off-shore hedge funds. As noted above, however, less direct state regulation of banks has characterised some of the recent neoliberal reforms made to financial markets. Paradoxically, it is the desire of certain market actors such as hedge funds and investment funds to escape any form of regulation – even that of private authorities – that drives them to offshore financial centres where regulation is either lax or non-existent, and ensures that the risk they pose to the financial system is amplified. Therefore any reform to the risk

management regulation pertinent to banks should make explicit provisions for adequate monitoring of lending to highly leveraged institutions operating in opaque markets. There have been no successful attempts to impose comprehensive regulation on the hedge fund world; the only noteworthy development in monitoring terms was the creation of the Financial Stability Board (previously known as the Financial Stability Forum) following the 1998 LTCM bail-out and, as a private actor in a public market, the FSB has no direct authority to impose regulation on market participants. A recently drafted EU directive will require the compulsory registration of alternative investment fund managers, yet intense lobbying from the industry could conceivably derail these attempts to force further compliance with standards (Armitstead 2009). Hedge fund participants rightly question the merit in requiring the direct regulation of fund managers, arguing that this practice will drive business away from Europe (Armitstead 2009). However, the systemically-significant position that hedge funds occupy demand that their activities are monitored in some way and, in the face of recent failures, it is not guaranteed that the market itself could be trusted to prevent contagion. The former EU Commissioner for Internal Markets and Services, Charlie McCreevy, argues that it is clear that “[hedge funds] can affect the wider financial system through the direct effects of their trading in the markets where they have become important – and sometimes dominant – traders.” (McCreevy 2009). As Professor Robert Bliss of Wake Forest University notes, doubts persist about the hedge fund universe and its: “limited regulation... [lack of] financial reporting, concerns about capital adequacy...[and]...internal risk management” (Bliss 2006).

Research suggests (King, Maier 2009) that regulation of prime brokers in the hedge fund industry (namely banks) rather than direct regulation of hedge funds would mitigate against the threat posed to the system. This increased counterparty risk management is preferable to direct regulation because there are only a handful of global prime brokers which deal with hedge funds. As noted: “This approach has the advantage of being focused on the core institutions and channels through which systemic risk would be likely to propagate” (King, Maier 2009)

Further failures of private investment funds are more likely in these difficult times. Hedge fund redemptions reached an apogee in late 2008 during the credit crisis. (Walsh 2008; Costello 2009). The offshore investment fund operated by Allen Stanford appears to have cost investors approximately \$8 billion (Ishmael & Chung 2009) thanks, in part, to the liberal mechanisms available to allow the fund to be structured in a lax regulatory environment<sup>8</sup>. Further, the Bernard Madoff scandal has again highlighted the flaws in market-based regulation. (Chung, Rappeport & Masters 2009). The \$60bn loss to investors from this Ponzi scheme is made harder to bear by the fact that regulators on Wall Street were warned many years ago that the

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<sup>8</sup> The fund was incorporated in Antigua for regulatory purposes.

fund was, in all probability, a fraud (Markopoulos 2005). The SEC stated that they were “gravely concerned by the apparent multiple failures over at least a decade to thoroughly investigate these allegations or at any point to seek formal authority to pursue them” (SEC 2008). This is further evidence that current market regulation is inadequate to guard against systemic risks associated with the hedge fund industry, and that formal, public regulation of investment vehicles such as hedge funds must be made a high priority.

#### **4. Economic orthodoxy & future crises of capitalism**

These brief examples of regulatory deficiencies demonstrate that financial regulation, particularly at a global level, is liberalized, fragmented, and based upon notions which favour decentralized governance. Formalised rules and codes are common; however they are driven and promulgated by private market actors, and compliance is generally non-mandatory. Furthermore, even where regulation does exist, it has been shown to be deeply flawed; yet the regulators themselves are immune from censure or sanction. As has been noted with supreme irony, the UK bank Northern Rock had received approval for a waiver by the Financial Services Authority (FSA) on the capital requirements under Basel II thanks to results of stress-testing on its operating model (Mizen 2008).

The desire of emerging markets to attract increased capital flows has aggravated the potential for instability in financial markets. Neoliberal ideology has permeated the economic climate in emerging nations and shaped regulatory structures based upon the central tenets of neoliberalism: small government, market-driven governance, and reliance upon private enterprise to fulfil surveillance and monitoring functions. IMF loans are granted to emerging economies to encourage investment and development, but these loans are conditional upon the relevant country promoting neoliberal reforms and dismantling state apparatus of control. These reforms were necessary to allow the free movement of capital and investment into new jurisdictions and the development of modern infrastructure to support the technical and industrial revolutions occurring in an increasingly globalized community. This also entailed delegation of certain surveillance and monitoring functions to external bodies such as the BCBS, the IMF and the WTO. However, the influx of large amounts of foreign capital has led, in a number of cases, to economic crashes in emerging markets. For example, in the late 1990s, as ‘hot’ capital flowed into emerging nations in Latin American and South-East Asia speculative bubbles developed, allowing currency traders and hedge funds to put pressure on developing economies which lacked the capital resources and, in some cases, the expertise to defend their economies successfully. Systematic collapse was narrowly avoided

in Mexico, Brazil, Argentina, Chile, Poland and Thailand in the mid-90s, whilst the East Asian 'tiger' economies were virtually ruined a couple of years later. Anti-neoliberalists were quick to point to financial deregulation and the increased power afforded to private authorities as major causes of these crises, and with good reason (Harvey 2005, 87–119). Although the credit crisis of 2007–09 has been distinctly 'Western' in origin, its effects have been global. Emerging economies which have pursued liberal reforms to open up their markets to banking and financial operations have had difficulty in withstanding the shocks generated by the bursting of asset bubbles in the West<sup>9</sup> (McLaughlin 2009). A corollary to this consequence is that distressed financial institutions have been further damaged by the neoliberal environment promoted in developing economies; as these countries default on loans made to them by banks and other large financial institutions, and their currencies are decimated, global liquidity and funding crises are exacerbated, thus contributing to bank losses. These banks must therefore raise fresh capital from state or non-state sources to plug the funding gaps left by defaults on sovereign loans. The vicious cycle continues as emerging nations are forced to go 'cap in hand' to the IMF and request loans with which to rescue their economies, and the process of 'loans for liberalization' begins anew.

The engagement by financial participants in regulatory arbitrage is further testament to the failure of global regulation. The privatisation of regulation, based upon competing international centres, has led to a vast regulatory web, lacking in any central authority. The history of the BCBS, for example, has been characterised by reactive development to crises, rather than proactive attempts to reinforce global standards. The migration of regulatory control norms to a less state-centric model of supervision has led to the erosion of formal 'hard-law' to a regime of 'soft-law'; regulation which is promulgated through such bodies as international trade associations, standards-setting councils, and selected industry participants. In periods of crisis, it can be difficult to ascertain which regulatory agency or code has competency or jurisdiction. The retreat to a decentralized model of regulation, operated by epistemic communities, technocrats and market specialists, is a consequence of the fragmentation of global governance, and can intensify crises through the lack of potential for a co-ordinated and systematic regulatory response. If one is to regulate global markets effectively, even through private market actors, then a proactive global regulator, with entrenched status and formalized powers, is required.

Yet, there are signs that developing economies have not been bludgeoned by recent credit shortages to quite the same degree as more 'Westernized' economic de-

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<sup>9</sup> The time of writing, in Europe alone, several countries have approached the EU and/or IMF for emergency loans. As reported in the Independent Newspaper, "Hungary and Latvia have already sought billions of euros from the International Monetary Fund (IMF) to help them survive the crisis, and Romania is expected to follow suit; non-EU members Ukraine, Serbia, Belarus and Iceland have also received rescue packages from the IMF".

mocracies. Countries which have eschewed the wholesale 'financialization' of their economies have not experienced the economic contraction which has attended the credit crash in states which have relied heavily on financial services (Levitt, 2009).

Further, the erosion of the manufacturing and construction industries in Anglo-Saxon economies resulted in the United States and Britain, for example, outsourcing general labour and manufacturing to less-developed nations, leading to the financial sectors in these countries contributing disproportionately to GDP, while the 'real economy' has been denuded and marginalized. As evidence of this, financial sector debt reached 31.5% of total US debt in 2005, as compared with 9.7% in 1973. (Palley, 2007). As the financial sector has crumbled in the wake of the banking collapse, the erosion of industry in these countries has meant that an ability to rely on industry for economic output has failed to prevent widespread recession.

Added to this, the rampant decapitalization of Western companies, through debt financing and sustained leverage, has meant that even non-financial corporations have become financialized through their reliance on access to liquid capital markets for borrowing. The effects of increased financialization therefore become magnified; not only did the financial sector itself expand, but non-financial firms became reliant on finance capital to support their operations (Kaufman, 2009). Thus, a substantial segment of the non-financial sectors of 'Anglo-Saxon' economies was exposed to the privatisation of market surveillance, as the remit of regulatory agencies encroached upon the real economy. As firms became increasingly financialized, supervision of their activities was ceded to non-state actors. The failure of these private bodies to predict collapse meant that the effects of the crisis in the US and the UK, in particular, were thereby exacerbated.

Some less financialized economies, including Eastern European economies such as Poland, have avoided the full impact of financial contagion through the adoption of a process of steady and measured reform in their economic development. Although programmes of capital market liberalization have been undertaken, comprehensive integration of corporate and financial services has not materialised to the same extent as experienced in classic 'Anglo-Saxon' capitalism. Structural deregulation was not pursued with the same vigour in Eastern Europe as in the West, and many of the riskier aspects of capital market reform which characterized Western liberalization were not mimicked in the East (Matyjazsek, 2008). Further, the protection and promotion of industry in preference to greater reliance on financial services, has meant that economic contraction has been largely avoided. In fact, Polish GDP increased by over one percent in the second quarter of 2009 and the Polish economy was the only one in Europe to experience positive growth year-on-year (Bolkowska, Masiak 2009).

Nations which failed to take adequate precautions against the financialization of capital and relied upon the private regulation of markets have suffered intense liquidity shortages and severe recession. In contrast, countries which have placed less

reliance on the financial sector for economic expansion have insulated themselves from the shock fostered by the global banking crisis. Thus, the aggregation of risk that destabilised Western economies was not experienced to the same extent in less financialized economies, although due to the globalised nature of cross-border finance, some of the West's problems have leeches into emerging nations. In general, however, refusal to adhere to a comprehensive deregulatory drive characteristic of 'Anglo-Saxon' capitalism, has served some developing economies well.

The private regulation of risk in Western financial markets has been an abject failure. The question is: how can we better ensure the future stability of the financial system?

## 5. A regulatory response

The increased sophistication of financial markets is irreversible. The galaxy of financial products available to market participants is immense, and there is little to be gained from attempting to simplify high finance. However, more direct and state-sponsored regulation is warranted, and in searching for a new regulatory axiom, the relevant authorities may wish to follow the example of less financialized economies which have withstood contagion from the fall-out of the banking collapse.

The credit crisis of the preceding twenty-or-so months is due, in large part, to the failure of the gatekeepers of financial markets – the private agencies charged with guaranteeing the integrity of the system; these agencies have become fundamental to the functioning of liberalized Western markets.

Therefore, some reform is required<sup>10</sup>, and it could take the following forms:

1. The reliance on credit ratings derived from private agencies should be abolished in all forms of regulation. If, as rating agencies claims, their ratings are merely 'opinions', then they have no place in any regulatory system, and the failure of the supposed credit-worthy mortgage-backed securities market which precipitated the recent credit crisis is testament to the fallacy that private interpretation of complex credit products can possibly substitute for direct surveillance. Furthermore, as has been suggested in global fora, reforms are required to Basel II Capital Accord in respect to the internal credit risk management models used by banks. Other discussions regarding the introduction of a 'Glass-Steagall II' are also meritorious of consideration.
2. The introduction of a global monitor of derivatives trading should be welcomed, and OTC derivative trades should be continued to be monitored closely. Any

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<sup>10</sup> It must be noted that the reforms proposed here simply relate to the issues discussed in this paper; wholesale reform to the financial system, especially the banking sector is required.

arguments regarding the cost of implementing such a programme are countered by the dangers posed to financial stability when one considers the outstanding value of at-risk derivatives contracts held by counterparties today. Derivatives are necessary for the functioning of modern financial markets; however, their use must be controlled. Any attempts by financial industry participants to engage in regulatory arbitrage, or the introduction of contracts exempt from CCP control should be scrutinised by global regulators.

3. Further to this, the operations of private offshore investment funds must be more closely monitored by prime brokers incorporated in jurisdictions with the requisite level of financial regulation for adequate monitoring of systemic risk and malfeasance. The regulation of these prime brokers should be made a high priority in the reshaping of a global financial architecture. The opacity of funds and the opportunity to pursue risk-laden strategies pose serious issues for global systemic stability. The financial association and inter-dependence of such leveraged institutions with the derivatives sector intensifies the need for greater transparency. The proposals discussed earlier regarding mandatory regulation of prime brokers, should be considered and implemented where appropriate.

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