Public Salience and International Financial Regulation.

Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds

by

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A thesis

presented to the University of Waterloo

in fulfilment of the

thesis requirement for the degree of

Doctor of Philosophy

in

Global Governance

Waterloo, Ontario, Canada, 2013

I hereby declare that I am the sole author of this thesis. This is a true copy of the thesis, including any required final revisions, as accepted by my examiners.

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Abstract

What explains the shift towards greater direct public oversight of financial markets in international financial regulation that has characterized the response to the global financial crisis of 2007-2010? Over this period, the main international financial regulatory bodies have abandoned the market-based mechanisms that had informed their approach towards the regulation of different financial domains in the years before the crisis and significantly expanded the perimeter of state-based regulation. However, the extent and the timing of this shift cannot be regarded only as the by-product of the crisis, nor they can be explained by the existing interpretations of the political determinants of international regulatory policies. This study builds upon existing state-centric explanations of international regulatory policies, but it goes beyond these works by exploring how the preferences of the most influential countries in response to the crisis have been influenced by variations in the degree of public salience of different financial domains. More specifically, this study argues that the lasting increase in the public salience of financial regulatory policies in the US and different European countries since the last quarter of 2008 has created strong incentives for elected officials in these countries to challenge the market-based approach that had emerged in the decade and half before the crisis and to directly interfere in the international regulatory agenda. In order to explain this shift, this study will analyse the evolution in the international governance of three sets of markets and institutions that have occupied an important position in the international regulatory agenda in recent years: 1) OTC derivatives; 2) rating agencies; 3) hedge funds. Besides making an empirical contribution to the literature on the politics of international financial regulation, this study also contributes theoretically to this literature by deepening our understanding of the nexus between international regulatory coordination and domestic public opinion.

Acknowledgments

This thesis is the end point of a five years long journey that brought me across many more places, cities, and countries than I could have ever imagined when I decided to do a Ph.D. This thesis would not have been possible without the support of a number of people that I was privileged enough to meet during this process.

First of all, I need to thank my Ph.D. Supervisor Eric Helleiner. The kind of support, dedication, and enthusiasm that Eric has given me and my doctoral work have certainly exceeded even the most optimistic expectations I had while typing his name on Google in search for potential PhD supervisors. Working under Eric's supervision during these years has been an invaluable experience, not only intellectually, but also from a personal standpoint. I am also grateful to the other members of my supervisory committee, Bessma Momani and Tony Porter, as well as the examiners Elliot Posner and Olaf Weber. They have provided me with many valuable suggestions and criticisms which will help me carry this project forward.

This research project was born in Waterloo. The Global Governance Programme at the University of Waterloo has been an ideal intellectual nest and Waterloo has become a place that I have learnt to call home. This is largely thanks to the support of many friends and fellow students. The list of people to thank would be too long, but I am particularly grateful to Troy Lundblad, Laura Reidel, Michael Stevenson, and Jason Thistlethwaite with whom I have spent many winter days discussing half-baked ideas and sharing coffee and laughs. The University of Waterloo and the Center for International Governance Innovation have also provided the financial support without which this research would not have been possible.

This research project has benefited enormously from the period spent as a Visiting Scholar at Columbia University. I am indebted to Initiative for Policy Dialogue and its staff for their support during this period. In particular, I need to thank Stephany Griffith Jones for making this experience possible and for many stimulating chats about financial regulation. I also thank Eva Kaplan and Sarah Green, whose help and friendship have contributed to making this a memorable period. Gaetano Gaballo and Maria Chiara Di Guardo have accompanied me during the long days at the Columbia Business School library when the core of this thesis has taken shape. Most of the writing has actually taken place in a number of bus terminals, train waiting stations, parks, and other unlikely places across Canada, from Vancouver to Halifax, and across the United States, from

New York City to San Francisco. My eternal gratitude goes to all those bartenders that have tolerated my presence as I camped in busy coffee shops, reaching for the closest power plug to recharge my laptop.

This thesis has also benefited enormously from the different academic conferences and workshops where I had the opportunity to present my research. The list of professors and Ph.d. students that I need to thank for their comments and words of encouragement here would be longer than this thesis.

The different pieces of this dissertation have come together in London, where I have returned three years after having moved to North America. Teaching at the London School of Economics has allowed me to enter in contact and to learn from a large number of colleagues, fellow Ph.D. candidates, and bright students. In particular, I need to acknowledge the help received during this period by Andrew Walter and Kevin Young. I also need to thank two LSE graduate students, Catherine Hart and Berry Kurland, who have patiently proofread the entire manuscript. Also, working with the International Center for Financial Regulation in London and with its research team has been a precious opportunity and source of ideas.

None of the names mentioned has been as affected by my decision to move across the Atlantic as my parents Luisa Ferrari and Antonio Pagliari. I need to thank them for their understanding and their support throughout these years when my desires brought me very far from them.

Finally, I should thank Natali, another Ph.D. student with whom my path crossed at the London School of Economics, and who two years later became my wife. Among the many things Natali has taught me, there is certainly one lesson I should never forget. That is what really matters in life are the things that happen when we step away from our research and shut down our computers. I am grateful for continuously reminding me this lesson and for never taking my “One more minute, please. I need to finish something important!” as an answer.

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Introduction

In Brief: Public Opinion and the International Regulatory Response to the Global Financial Crisis

This study will investigate the political sources of an historical shift in the governance of international financial markets that has been set in motion in response to the global financial crisis of 2007-2010. Over this period, the main international financial regulatory bodies have abandoned the reliance on market-based mechanisms that had informed their approach towards regulating different financial domains in the years before the crisis. These same international institutions have instead drafted international measures putting regulation of these markets and institutions firmly under the hand of public authorities. As a result, the international regulatory response to the crisis led to a significant expansion in the perimeter of state-based regulation. What explains this shift towards greater direct public oversight of financial markets in international financial regulation since the outbreak of the global financial crisis of 2007-2010?

In order to answer this question, this study will analyse the evolution in the international governance of three sets of markets and institutions that have occupied an important position in the international regulatory agenda in recent years: 1) OTC derivatives; 2) rating agencies; 3) hedge funds. This study will identify the primary determinant of the shift in the international approach towards the governance of these three sectors and institutions in a shift in the international preferences of the countries that dominate the international regulatory agenda, that is the US and Europe. However, it will complement existing pluralist, historical institutionalist, and constructivist explanations of state preferences in international financial regulation by exploring the impact that variations in the degree of public salience of different financial domains have in altering the domestic bases of international regulatory politics.

This analysis will make two main contributions to the existing academic literature. The first contribution is an empirical one. This study provides the first political analysis of the evolution of international regulatory cooperation vis-à-vis CRAs, hedge funds and derivatives in the period between the mid-1990s until the end of 2011. Different studies have explored the turn towards market-based regulation in the years before the crisis, including individual assessments of each of these three sectors. More recently, a growing body of work has started to explain the same changes in their regulation brought by the crisis. However, none of the existing IPE analyses matches this study in scope, which spans three sectors during both the pre- and post-crisis period.

Second, this study makes a theoretical contribution to broader literature that has, since the work of Kapstein on the Basel Agreement, investigated the political determinants of international financial regulatory policies.[1] More specifically, it will contribute to this literature by deepening our theoretical understanding of the nexus between international regulatory coordination and domestic public opinion. The impact that the general public's degree of attention towards the governance of different issues has over the policymaking process has been widely debated within the broader political science literature. However, to the best of my knowledge, this is the first study to place the level of public attention towards a determined financial domain at the centre of the analysis of international regulatory cooperation in finance.

This analysis will conclude that variations in the degree of salience of different financial domains in the most powerful countries played an important role in determining the patterns of international regulatory cooperation in the governance of OTC derivatives, rating agencies, and hedge funds before the crisis. More specifically, while the low salience of financial regulation represented a key enabling condition for the emergence of market-based governance arrangements before the crisis, the lasting increase in the salience of regulatory policies since the last quarter of 2008 had the effect of creating strong incentives for elected officials to reverse this approach.

The Research Question: Understanding the International Regulatory Response to the Global Financial Crisis of 2007-2010

The global financial crisis that originated in the summer of 2007 from the US subprime mortgage markets and escalated in 2008 to a full-fledged transatlantic banking crisis was an historic event whose consequences and ramifications span across a large number of areas of the global agenda. One of the most visible and debated consequences of the crisis can be found in the reforms this event has triggered in the governance of global financial markets. The crisis has set the stage for a period of unprecedented activity in the reform of international financial regulation. This period has been characterized by the introduction of numerous new international regulatory

[1] Kapstein 1989.

initiatives as well as by different institutional innovations, such as the creation of the Financial Stability Board.

One important post-crisis change in the governance of international financial markets is the way the policies adopted by the some of the main international regulatory institutions, such as the Financial Stability Forum (FSF), Basel Committee, and the International Organisation of Securities Commissions (IOSCO), have extended the reach of direct regulatory intervention in addressing the regulatory gaps revealed by the market turmoil.

This shift is clearly visible in the approach adopted by these international institutions towards the governance of three of the markets and institutions that have been debated since the outbreak of the crisis: 1) OTC derivatives, 2) rating agencies; and 3) hedge funds. The global financial crisis of 2007-2010 was not the first episode of market instability that has led the international regulatory community to discuss the regulatory status of these three financial sectors. However at different moments between 1994 and 2007, the FSF, Basel Committee, and IOSCO have opposed measures to bring OTC derivatives, hedge funds, and rating agencies within the perimeter of direct regulatory oversight. Instead, their approach to governing these three innovative market sectors relied extensively on the capacity of markets to self-regulate. This approach gave a public policy role to industry-driven self-regulatory measures and designated market discipline as the primary mechanism to constrain excessively risky behaviour and to monitor and enforce compliance with international standards.

The reliance on market-based measures that characterized the governance of these three markets and institutions is consistent with a broader shift in the approach of the international regulatory community since the late-1990s that has been widely documented by numerous authors within the IPE literature.[2] While most scholars have characterized this trend as a structural change in the international regulation of financial markets, Lou Pauly argued forcefully in 2003 that the delegation of regulatory authority to private market actors in the global economy remained a fleeting phenomenon. According to Pauly, public authority would likely reassert control over what they had delegated to private actors in the case of a financial crisis or a phenomenon seriously delegitimizing market mechanisms.[3]

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[2] Underhill & Zhang 2008; Rethel & Sinclair 2012; Foot & Walter 2010; Tsingou 2004.
[3] Pauly 2003.

The kind of reassertion of state-based regulation that Pauly envisioned has clearly taken place since the outbreak of to the 2007-2010 global financial crisis. The crisis has set the stage for one of the most significant turning points in public-private divide in the regulation of finance since the 1930s. International regulatory bodies have over this period come to endorse measures giving public regulatory officials the responsibility to set and enforce rules governing markets and institutions, including OTC derivatives, rating agencies, and hedge funds, that had deliberately left outside public regulatory oversight in the period preceding the crisis.

However, this shift cannot be regarded solely as the by-product of the global financial crisis of 2007-2010. Both the scope and the timing of this shift in the international approach towards the regulation of OTC derivatives, rating agencies, and hedge funds support this conclusion. First, the expansion in the perimeter of public regulation has involved both industries that were among the main culprits of the crisis, such as derivatives markets and rating agencies, but also ones that played a rather peripheral role, such as hedge funds. This aspect is even more puzzling when we consider how the market-based approach that dominated the international regulation of hedge funds before the crisis emerged in response to the collapse of LTCM, a crisis that exposed the systemic risks associated with their activities more directly than the 2007-2010 global financial crisis. Second, the initial international regulatory response in 2007 and 2008 reinforced rather than undermined the market-based approach that had emerged before the crisis. During this initial period international institutions such as the FSF repeatedly turned to the same derivative dealers, rating agencies, and hedge funds and demanded self-regulatory improvements to their regulatory status. Only since the last quarter of 2008, international regulatory bodies have committed to bring derivatives markets, hedge funds, and rating agencies under the direct purview of regulatory authorities. What then explains the shift in international financial regulation since the financial crisis towards greater direct public oversight of financial markets that has happened since the outbreak of the global financial crisis of 2007-2010?

The Literature

The previous section has suggested that the shift in the international approach towards the regulation of OTC derivatives, rating agencies, and hedge funds that followed the crisis cannot be regarded as uniquely the product of this historical event. This study will review the main theoretical explanations of international financial regulation presented in IPE literature and argue that these theories cannot adequately explain the reassertion of direct regulatory oversight over international financial markets that the crisis set in motion.

Many pre-crisis functionalist analyses (reviewed in Section 2.2) developed in the years before the crisis have described the international shift towards a greater reliance on market-based mechanisms in the governance of financial markets as driven by structural transformations such as the process of financial globalization and financial innovation. The international regulatory response to the crisis has challenged this view and expanded the regulatory oversight over a number of markets and institutions that before the crisis had been left outside of the perimeter of public regulation. Moreover, this expansion in the perimeter of public regulation has also involved sectors that had played a peripheral role in the context of the crisis. From this perspective, the scope of the international regulatory change since the crisis is difficult to reconcile with those functionalist explanations considering regulatory policies as driven by the attempt to respond to specific market failures.

Realist analyses of financial regulatory politics have identified the primary determinant of the international regulatory agenda in the relative market power of the different countries controlling the main international regulatory institutions. In particular, the greater reliance on market-based mechanisms before the crisis has been attributed to US authorities' predominant role in shaping the international agenda and their interest in letting their firms dominate world markets free from burdensome regulatory measures. State power has continued to be an important determinant of the international regulatory response to the global financial crisis. However, rather than a relative decline in the power of those countries that had in the past supported market-based based measures, the change in the international agenda has followed a shift in the preferences of these same countries. In particular, US policymakers have since the beginning of the crisis supported reasserting more direct regulation of the markets dominated by their own firms.

Third, explaining this shift in state preferences remains a challenge not only for those realist theories of international regulatory change that have focused on the distribution of market power, but also for those works that have derived state preferences from their respective domestic systems. In particular, historical institutionalist scholars have derived state preferences towards international financial regulatory policies in the years before the crisis from the different role and structure of the financial systems in different “varieties of capitalism”. These studies are important to highlight how the main divide over the regulation of these sectors has not been running along the Atlantic but rather cutting across Europe, between coordinated-market economies and liberal-market economies. However, it remains difficult to reconcile the sudden turn in the international regulatory approach since the end of 2008 with the focus on the incremental adjustments and path dependency that characterize historical institutionalist analyses.

Fourth, an alternative explanation of change in state preferences towards international issues is provided by pluralist analyses of international regulatory politics. These have traced the main determinant shaping international agreements to the competition among interest groups and other societal actors. Many works applying this insight to the financial regulatory domain have focused on the preferences of financial industry groups and their growing capacity to capture the regulatory process at the national level as well as the transnational level where transnational financial industry associations have become privileged interlocutors of international regulatory bodies. However, while much of this literature had described the influence of financial industry as akin to that of a power elite unlikely to lose important regulatory battles, much of the changes introduced during the global financial crisis have occurred despite, rather than because of, financial industry preferences.

Finally, constructivist scholars have provided another important explanation of preferences on international regulatory issues. From a constructivist perspective, the pre-crisis delegation of regulatory responsibilities to private market actors reflected the influence within the international regulatory community of an ideational consensus stressing the efficient and rational nature of financial markets. It also echoed the need to remove the impediments that might produce inefficient and illiquid markets, starting with intrusive regulatory interference in the markets. Different analyses of post-crisis regulatory policies have argued that the crisis has set in motion a rethinking about markets’ capacity to self-regulate and of the pre-crisis ideational consensus. However, the existing constructivist literature suggests that ideational shifts tend to be slow moving in its impact over international regulatory policies. This literature describes policymakers as reacting to crisis by re-adjusting their ideational toolkit in only relatively minor ways. The conceptualization of ideational change that informs constructivist scholars is therefore incompatible with the timing of the shift in the international regulatory agenda.

Given the limitations of these theoretical approaches in providing a satisfactory account of the timing and extent of the shift in international approach towards the regulation of financial markets, this analysis will present a theoretical framework whose analysis centers on an element that existing theories of financial regulatory change have largely neglected: the degree of attention that the general public pays towards different financial domains.

The Explanatory Variable: Public Salience

The implications of general public attention levels towards a particular issue – so-called 'issue salience' – have been at the center of an important scholarly debate within the political science literature. This literature initially focused on the impact that the salience of different issues has over the outcome of electoral competitions.[4] More recent studies have investigated its impact over the governance of a number of policy domains, both at the domestic and international levels, such as budgetary policy, corporate governance regulation, security issues, and regional integration.[5]

However, most analyses of financial regulation at the domestic and international level have regarded the policymaking process through which financial rules are designed and implemented as immune or only mildly constrained by public opinion. In particular, the complexity of financial regulatory policies and their frequently indirect impact over stakeholders outside of finance limits the general public's capacity and incentives to pay attention to financial regulatory developments and to invest time and resources to understand where their interests lie.

The impact of public opinion over financial regulatory policies is often described as even less significant in the case of policies negotiated at the international level. The discussions occurring within international regulatory bodies such as the Basel Committee or IOSCO are frequently described as being fleshed out in a non-transparent environment that hinder the capacity of the public to keep track of them.[6] Elected politicians seeking to maximize their probability of reelection by appeasing the public opinion do not negotiate these agreements. Instead, they are mostly drafted by independent regulatory agencies that are not embedded in the executive hierarchy and thus not subject to direct political pressures.[7] Unlike international trade agreements negotiated within the WTO, international financial standards are better conceived as

[4] Edwards III, Mitchell, & Welch 1995; Fournier, Blais, Nadeau, Gidengil, & Nevitte 2003; Krosnick 1990; Damore 2004; RePass 1971; Belanger & Meguid 2008; Mayer & Tiberj 2004.
[5] Culpepper 2011; Franklin & Wlezien 1997; Kai Oppermann & Viehrig 2011; Soroka & Wlezien 2005.
[6] Underhill 1995.
[7] Singer 2007.

"soft law", since they mostly do not require any formal ratification from domestic legislative assemblies. As a result, the international regulatory process has often been described as influenced by the symbiotic relationship between bureaucratic regulatory agencies and the financial industry under their purview, presented as part of the same "policy community".[8]

Other works have acknowledge that the low degree of public attention surrounding national and international financial regulatory policies can be altered by shocks such as financial crises, which may significantly increase the level of attention that the public pays towards financial regulatory policies. While during normal times the process of international regulatory cooperation occurs largely insulated from domestic pressures, financial crises or similar 'shocks' may increase the constraints that regulators participating to the work of international bodies face from their political masters and from their respective domestic political systems.[9] At the same time, these works disagree on the mechanisms through which public opinion comes to influence international financial regulatory policies. While for Singer crises may create bureaucratic incentives for regulators to take action in order to appease their political masters, Oatley and Nabors argue that elected politicians rather than regulators are likely to play a direct role in shaping the content of national and international regulatory policies after crises. In other words, the extent of the general public's influence over international regulatory policies and the mechanisms through which this influence is exercised remain either unclear or unresolved in the existing literature.

This study will build upon the existing analyses of the domestic bases of international financial regulatory cooperation and deepen the understanding of the determinants and dynamics through which public opinion comes to shape international financial regulatory policies. It will do so by incorporating the contribution of the literature on issue salience. This study will investigate how different degrees and lengths of general public attention towards the financial domain following a crisis will affect the design of international regulatory policies by altering the preferences of elected officials and the likelihood these will delegate defer to regulatory agencies or other experts.

In particular, this study will explore the following hypothesis. When a crisis does not lead to a long-lasting increase in the level of public attention, issue salience will create strong incentives for the financial industry groups directly affected by the crisis to design self-

[8] Lall 2011; Tsingou 2007; Underhill 1995; Underhill & Zhang 2008.
[9] Oatley & Nabors 1998; Kapstein 1994; Singer 2007.

regulatory measures in order to de-politicize the governance of that area, while elected politicians will not face strong incentives to challenge these arrangements. But a shock that triggers a significant and long-lasting increase in the level of public attention towards a financial domain is likely to create strong electoral incentives for elected politicians to pressure regulators or directly intervene by introducing formal regulatory frameworks, even when these run against the preferences of the domestic financial industry groups.

This kind of long-lasting increase in the salience of financial regulation is likely to occur only when the impact of the shock is not internalized by the same financial institutions affected by the shock, as is the case for bailouts or a crisis requiring the deployment of taxpayers' money in support of financial institutions. The degree of salience is not directly related to the severity of the crisis or role that the specific sector has in originating the crisis. From this perspective, the likelihood that a crisis will generate a market-based regulatory regime or a more direct regulatory framework is not dependent on the severity of the regulatory failures uncovered by the crisis. Rather, it depends on the extent to which the crisis raises the public salience of that financial domain in the countries that dominate the international regulatory policymaking, an argument first presented by Culpepper in his analysis of corporate governance regulation.[10]

Case Selection and Methodology

In order to empirically explore the capacity of this hypothesis to explain determinants of the shift in the international approach set in motion by the crisis, this study will engage in qualitative case-oriented research. Instead of analyzing a large population of cases as is typical of quantitative research, this study will seek to acquire in-depth knowledge of a limited number of relevant financial areas. The three cases analyzed in this study are 1) the international regulation of OTC derivatives, 2) the international regulation of credit rating agencies, and 3) the international regulation of hedge funds.

These three markets and institutions have been selected on the basis of a number of factors. First, the three sectors have been the focus of different analyses within the IPE of finance literature which provided the empirical backbone for different theories of financial regulatory change.[11] The presence of a literature that has already analyzed these cases facilitates the task of comparing and contrasting the interpretations provided

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[10] Culpepper 2011.
[11] For derivatives, see Helleiner 2010; Morgan 2010; Tsingou 2006; for rating agencies see Bruner & Abdelal 2005; Sinclair 2005. On hedge funds, see Fioretos 2010; Quaglia 2011; Woll 2011.

by alternative theoretical explanations with the one advanced in this study. Second, the three sectors represent some of the most dynamic and fast-growing segments in the financial markets over the last two decades. Third, and most importantly, the evolution of the international regimes governing these three markets and institutions and the ways in which they allocated regulatory functions between public and private actors before and after the crisis exemplify well the kind of shift in the international public-private triggered by the 2007-2010 global financial crisis that this study seeks to explain.

Different authors have criticized this ‘case selection on the dependent variable’; that is, selecting cases based on their outcomes and then analyzing the causes of these outcomes.[12] However, this approach is justified in this case given this study’s interest in shedding light on an historical shift in the governance of international financial markets triggered by the global financial crisis of 2007-2010.

This study will infer the level of public salience of OTC derivatives, rating agencies, and hedge funds from the amount of media reporting on these sectors.[13] The strengths and weaknesses of this approach will be discussed in Chapter 3. While other academic works have used the results of the analysis of media coverage as one of many variables included into regression analyses,[14] this study will not seek to explicitly derive any causal inference from the quantitative results of the media analysis. Instead, they will guide qualitative analyses of the three case studies. In particular, the media analysis of issue salience in this chapter will function to identify the “turning points” in the public salience of different financial domains, as well as to highlight noticeable differences in the level of public attention across the different cases and across national contexts.

The regulation of the three sectors and markets will be analyzed through what George and Bennett call the method of “structured focused comparison”, asking several cases the same set of questions that reflect the research objective.[15] In particular, this study will engage first and foremost in within-case analyses, comparing and contrasting the ‘causal recipes’[16] that have led international regulatory institutions to adopt different approaches before and after the global financial crisis. Cross-case analyses will also be

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[12] In particular, one of the risks of selecting on the dependent variable is to increase the number of positive cases where the outcome of interest occurs. See J. Mahoney & Goertz 2006, p. 239.

[13] Knecht & Weatherford 2006, p. 713; Baumgartner, Berry, Hojnacki, Kimball, & Lebon 2009; Culpepper 2011; B. D. Jones & Baumrgartner 2005; Epstein & Segal 2000; Miller & Krosnick 2000; Page, Shapiro, & Dempsey 1987.

[14] See for instance Baumgartner et al. 2009. For an exception, see Culpepper 2011.

[15] As these authors argued, “[t]he method is “structured” in that the researcher writes general questions that reflect the research objective and that these questions are asked for each case under study to guide and standardize data collection, thereby making systematic comparison and cumulation of the findings of the cases possible. The method is “focused” in that it deals only with certain aspects of the historical cases examined”. George & Bennett 2005, p. 67.

[16] Ragin 2008, p.23; J. Mahoney & Goertz 2006.

conducted in order to identify similarities and differences across the conditions that determine different regulatory approaches.

The analysis of the cases will rely on process tracing to empirically assess the conditions that have shaped the international regulation of these sectors. Goldstone defines process tracing as "analyzing a case into a sequence (or several concatenating sequences) of events and showing how those events are plausibly linked given the interests and situations faced by groups or individual actors". [17] Process tracing represents the most common approach for within-case analyses of regulation assessing the qualitative characteristics of different actors' activity, the strategy adopted to achieve their goals, and to evaluate their influence in shaping the content of policies.[18] In the context of this study, process tracing will be employed primarily to assess the evolution in the regulatory policies and in the preferences and mobilization of different actors across different levels of salience.

What are the sources used in this study to infer causal patterns and to test different theoretical explanations? The position of different regulatory agencies, elected politicians, and interest groups will be extracted from a variety of primary and secondary sources. The preferences of elected politicians will be extracted primarily from their voting behavior, as well as through public speeches, press releases, and statements to the press. The preferences of regulatory agencies will be extracted from their regulatory proposals submitted for public consultations, the position expressed in front of legislative assemblies (e.g. Congressional hearings where regulators are regularly required to report), as well as public speeches from senior regulators. Interest groups' positions will be extracted primarily from their submissions to public consultations, such as those from the European Commission and from the SEC and CFTC in the US, as well as from the public statements of interest groups representatives, such as in the case of their appearances before Congressional hearings. Press releases regularly released by these groups to express their positions on the most pressing regulatory issues will also be used to derive these groups' preferences. The financial press will represent an important source of secondary sources to assess the mobilization strategies and the expressed preferences of different actors. Indeed, it is possible that some of the preferences presented by regulators or interest groups through public speeches may reflect

[17] Goldstone 2008, p. 47.
[18] Mahoney 2010; Dur 2008; Klüver 2011; Woll 2008.

"'strategic' rather than 'true' policy positions".[19] However, as Klüwer argues, "this should not be problematic because it is plausible to assume that there is no systematic variation in strategically over- or understating preferences across all interest groups, so that the revealed policy position can be taken as a proxy for the true policy position."[20]

The Findings

The empirical investigation of these three cases will provide some important insights towards explaining the market-based approach that dominated the international regulatory agenda before the crisis. In particular, the evidence will contest the notion advanced before the crisis by a number of academics and regulators that the emergence of market-based governance mechanisms reflected a functionalist response to evolution in the structure of the financial markets. Instead, this study will discuss how the emergence of international market-based governance mechanisms during this period reflected the preferences of those countries that exercised the greatest influence over the international regulatory agenda.

From this perspective, the evidence presented in this study provides some empirical support to those IPE theories that have highlighted the dominance of US regulators in international regulatory bodies, their ideas regarding the limits of traditional regulatory approaches, and the close coordination with their domestic financial industry. These factors combined in creating a powerful configuration in support of market-based regulatory mechanisms in a number of areas.

However, this study will complement these existing theoretical analyses of the pre-crisis period by arguing that the environment of "quiet politics"[21] that characterized most financial regulatory debates in the US - the country dominating the international regulatory agenda - represented a key enabling condition. In particular, the lack of sustained public attention towards financial regulation in the US weakened the incentives for the US Congress to support more direct regulatory approaches opposed by their domestic financial industry, while increasing the incentives to defer to federal regulators and the financial industry agencies. These have over this period rather consistently formed a common front in support of market-based solutions.

[19] Klüver 2011, p. 490.
[20] Klüver 2011, p. 490.
[21] Culpepper 2011.

At the same time, the degree of salience does not seem to be sufficient to explain one important exception to the self-regulatory model that dominated over this period: the decision by Congress to directly regulate rating agencies in 2006. While the bankruptcy of Enron has increased the salience of the sector in the US more than previous episodes, other factors such as the failure of regulators and the industry to negotiate a viable market-based alternative and the lack of competitive concerns are important to explain this rare expansion in the perimeter of regulation during this period.

These domestic foundations of the international market-based regime have been undermined by the global crisis of 2007-2010. This crisis had the effect not only of revealing substantial market and regulatory failures in the eyes of the regulatory community and experts, but also of increasing in a sustained way the public salience of financial policies salience in the US and Europe. The high salience of financial regulation since the second half of 2008 has made financial regulation one of the key issues within the US Congressional agenda.

Different members of Congress have over this period taken advantage of the changed political climate to re-introduce legislative proposals first presented during earlier Congressional sessions. While these proposals had not received significant support before the crisis, the increased the level of public attention has reinforced the momentum in favor of extending the regulatory net over different markets and institutions. However, the impact of the crisis in turning financial regulation into a "high salience issue" area has not been limited to the US. In Europe, the heightened public salience of financial regulation had the impact of enhancing the activism of those Continental European governments that in the past had been more critical of market-based regulatory approaches. Moreover, the greater degree of public attention also had an impact within the main veto-player in Europe, that is the UK degree of salience have a significant impact over the influence and behavior of the financial industry. More specifically, the changed domestic environment made it more difficult for the British government to maintain its traditional support for light touch regulation of the City of London.

In a nutshell, the unprecedented level of public attention towards financial regulatory issues triggered by the crisis has created strong electoral incentives for the same domestic elected policymakers in the US and Europe who had in the past supported market-based regulatory mechanisms to reverse their conduct and support the introduction of visible measures to increase the regulatory oversight of financial markets.

This change has also directly affected the international level at which politicians dictate the agenda of transnational technocratic bodies, defining their agendas and assigning stringent deadlines. These discussions are increasingly happening within the context of the G20.

This focus on the level of issue salience for financial regulatory policies and the impact in shaping the incentives of elected politicians is important to explain the two patterns in the international regulatory response presented above. First, the fact that financial regulation remained a low salience area in the first stages of the crisis is important to explain the continuation of the same market-based regulatory approach emerged before the crisis that characterized the initial international regulatory response to the crisis. Second, the fact that the crisis has eventually raised the attention of the public towards finance in general is important to explain why the regulatory response in the US and elsewhere also reversed the market-based regulatory status of sectors that had not played a central role in causing the crisis.

This theoretical explanation of international regulatory politics must be regarded as complementary rather than as an alternative to the main interpretations presented in the IPE literature. Like other domestic analysis of international regulatory politics,[22] this framework primarily seeks to explore the origins of the preferences expressed by different national representatives on international regulatory issues. It does not explain whose preferences will dominate in the international regulatory agenda. It thus needs to be complemented by realist theories that have explored the relevance of relative market power in allowing that allow national preferences to be translated in the international agenda.[23] For example a shock that increases the level of salience in a peripheral country is by itself unlikely to move the international regulatory agenda towards greater public oversight of that sector. An example of this dynamic can be found in the regulatory response towards the East Asian financial crisis. While this crisis significantly politicized the debate over the regulation of hedge funds and other financial sectors in the countries most affected by the crisis, the low salience of financial regulation in the "core countries", in particular the US, was far more consequential in determining the international regulatory response to that crisis.

This study will not question the focus on market-power as the primary source of state influence over the international agenda that characterize most state-centric analyses of

[22] Fioretos 2010; Oatley & Nabors 1998; Singer 2007; Kapstein 1994.
[23] Drezner 2007; Fioretos 2010.

international financial regulatory policies. Instead, the major contribution of this theoretical explanation is to explain country preferences on international regulatory issues, levels of public salience remains only one of the factors explaining the national position on a given issue. During periods of low salience, public opinion is likely to be inconsequential in shaping the position of national representatives. Instead, the position of regulatory agencies remain far more likely to be driven by interest group preferences or by dominant ideas. However, during periods of sustained high salience, the need to appease the general public will be a far more significant factor shaping the behavior of officials responding to electoral incentives, trumping other elements identified by the literature.

The impact of different degrees of salience on the electoral incentives of politicians analyzed in this study is not the only mechanism through which the public opinion shapes regulatory policies. On the contrary, different degree of salience have a significant impact over the influence and behavior of the financial industry, other societal actors, as well as of bureaucracies such as regulatory agencies. Although these actors do not directly respond to electoral incentives, they will be forced to react to the changed environment that characterize the politics of financial regulation during periods of high or low salience. While these elements will be analyzed within the three cases presented in this study, the argument presented in this study focuses on the impact that salience has over the electoral incentives of officials as this represents the most direct way in which the public opinion comes to shape regulatory policies.

Structure of the Thesis

Chapter 1 will introduce the dependent variable in this study, that is, the way in which the international regulatory community has relied on market-based versus direct public regulatory approaches to govern these OTC derivatives, rating agencies, and hedge funds before and after the crisis. This chapter will detail the evolution in the approach adopted by the main international regulatory institutions (FSF/IOSCO/Basel Committee) towards the regulation of OTC derivatives markets, hedge funds, and rating agencies in the period between the mid-1990s and the end of 2011.

After having set the dependent variable of this study, Chapter 2 will review the main IPE theories of financial regulatory change in order to determine to what extent the empirical evidence introduced in the first chapter conforms with the expectations of these theoretical approaches. This chapter will conclude that while these theoretical contributions have come a long way in explaining the pre-crisis trend, they are unable to fully explain the scope and timing that characterize the reversal of this trend set in motion by the global financial crisis.

Chapter 3 will present a complementary theoretical framework to explain the evolution of the public-private divide in the international regulation of finance that focuses on the degree of attention paid by the public in the most powerful countries towards a certain financial regulatory domain. The analysis of the media coverage of OTC derivatives, rating agencies, and hedge funds in this chapter will provide early support for the working hypothesis. The analysis will demonstrate how the resilience of the industry-driven regime that informed the governance of these markets and institutions before the crisis coincided with a period of what Culpepper calls "quiet politics" in the major jurisdictions, interrupted by different shocks that failed to raise the salience of these domains in a long-lasting way. The departure of the market-based regime after late 2008 then coincided with a period of heightened and sustained public attention towards the markets and institutions, including even sectors such as hedge funds that had not been responsible for the 2007-2010 crisis.

The impact this heightened public salience had over the preferences and conduct of elected officials at the domestic level – the intervening variable analyzed in this study - will be analyzed in three in-depth case-study analyses of the regulation of OTC derivatives (Chapter 4), rating agencies (Chapter 5), and hedge funds (Chapter 6). The three chapters will follow a similar structure. First, each chapter will investigate the causal dynamics that have sustained an international market-based regime in the governance of these three markets and institutions before the crisis. Second, the determinants of the reversal of this international approach since the beginning of the crisis will be explained. These chapters will trace the evolution of the international regulatory regime in the political dynamics occurring within the US and Europe.

As discussed more extensively in Chapter 2, the focus on these two jurisdictions is justified by the size of their securities markets. As acknowledged by different authors, this market power has conferred on to US and European regulatory authorities a significant influence over the international regulatory negotiations in the policy domains analyzed in this study.[24] While relatively common in the IPE literature, the comparison of the regulatory process in the US with the one in the EU can raise some problems from an analytical standpoint given that the former is a state and the latter is not. However, as Bach and Newman argue, this problem can be avoided by "compar[ing] processes that—while distinct—can be treated as analytic equivalents, provided the comparison is appropriately contextualized".[25] In particular, this analysis will remain actor-centric, analyzing the conduct of stakeholders with functionally equivalent roles in the US and EU, while overlooking the different institutional context.

While these chapters will investigate the sources of the shift in the international public-private development in each of the three sectors, the Conclusion (Chapter 7) will look across these cases. This chapter will summarize the evidence presented in this study regarding the role of public salience in influencing the patterns of international financial regulatory cooperation before and after the global financial crisis. Moreover, this chapter will also discuss the implications of this study for the broader literature on the politics of international financial regulation. First, this chapter will discuss the implications of this study for the literature that has investigated on the domestic political foundations of international regulatory cooperation. While building upon this analytical tradition, the evidence presented in this study reveals how sustained increases in the level of public salience have the effect of altering the domestic bases of international financial regulatory cooperation in ways that differ from existing accounts of international regulatory politics, with elected politicians playing a prime role both at the national and international level.

Second, this chapter will discuss how the degree of public salience of regulatory policies also influences the conditional scope of some of the other factors identified by the literature reviewed in Chapter 2. In particular, the evidence presented in this study suggests that the autonomy of international regulatory institutions, as well as the influence of financial industry groups, are both in part dependent on the level of public salience.

Third, this chapter will argue that the analysis of the emergence and decline of the market-based approach towards the regulation of finance has some implications for the broader literature on global governance beyond finance. Different studies within this literature have in recent years investigated the emergence of "private authorities" in the

[24] Drezner 2007; Fioretos 2010; Posner 2009.
[25] Newman & Bach 2004.

global economy[26], or a "privatization of regulation in the world economy"[27], or the rise of "transnational private governance".[28]

While most of these analyses tend to describe this trend as a structural shift in the governance of the global economy, the analysis of the reassertion of a more state-based form of regulation in the governance of international financial markets challenges this view. Instead, this analysis provides empirical support to the argument made by Culpepper regarding the importance of a certain degree of inattentiveness from the public as a condition for the resilience of informal or industry-based governance arrangements.[29] Unlike Culpepper, this analysis will however demonstrate how the degree of salience in the key jurisdictions will affect the strength of industry-based governance arrangements not only at the national level, but also at the international level.

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[26] Cutler, Haufler, & Porter 1999c; R. B. Hall & Biersteker 2003.
[27] Buthe & Mattli 2011.
[28] Graz & Nolke 2008b.
[29] Culpepper 2011.

Chapter 1. The Evolution of the Public-Private Divide in the International Regulation of Finance

1.1 Plan of the Chapter

This chapter will explore how the responsibility to regulate and oversee international financial markets is divided between public regulatory agencies and private market actors, discussing in particular the impact of the global financial crisis that erupted in the summer of 2007. Focusing on the extensive reforms coordinated at the international level in the regulation of OTC derivatives, credit rating agencies, and hedge funds this chapter will argue that the crisis has halted the shift in the public-private divide that took place during fifteen years or so prior to the crisis. During this period, international regulatory bodies such as the FSF, IOSCO, the Basel Committee, and the political forum such as the G7 and G20 opposed measures to bring OTC derivatives markets, credit rating agencies, and hedge funds within the perimeter of public regulatory oversight. Instead, these institutions delegated important regulatory functions to private market actors, granting a public policy role to industry-driven, self-regulatory measures, and using regulatory policies to harness “market discipline”.

This shift did not occur as a functionalist reaction to the emergence of the market turmoil in 2007 and the discovery of regulatory failures. On the contrary, international regulatory bodies initially designed a regulatory response largely based on soliciting self-regulatory improvements for the three institutions and markets studied here. Only, since the last quarter of 2008 did the international regulatory community and the G20 begin to negotiate a series of international regulatory agreements to bring these markets and institutions under their regulatory oversight and have taken the task of monitoring and enforcing financial standards implementation, which had previously been left to the market discipline, upon themselves .

This chapter is primarily descriptive in nature. It describes the patterns of change in the international financial regulatory regime that represent the main dependent variable that will be explained from a theoretical standpoint in the next chapters.

This chapter will be structured as follows. In order to understand the significance of the post-2007 changes in the public-private divide in the governance of international financial markets, Section 1.2 will briefly analyze this issue from an historical perspective. Section 1.3 will focus on the regulatory paradigm that dominated the international regulatory agenda in the decade and half preceding the crisis. This chapter will later introduce the changes triggered by the crisis in the international regulation of OTC derivatives, rating agencies, and hedge funds. Section 1.4 will then discuss how the initial international regulatory response to the crisis relied on the same market-based approaches that had dominated the period before the crisis. Section 1.5 will discuss the reversal of this approach in the second stage of the regulatory response to the crisis.

1.2 The Public-Private Divide from an Historical Perspective

From an historical perspective, the emergence of the notion that sovereign states bear the primary responsibility to regulate and oversee financial markets is a relatively recent development. Historically, the first rules bringing order to international transactions originated in the so-called *lex mercatoria,* the customs of merchants who were the first to provide credit within and across the borders of the emerging nation-states. These were enforced through the threat of ostracism from the merchant community and of boycotting of all future trade.[1]

During its ascent towards becoming most important financial center in the world, the City of London was regulated through highly independent and self-governing corporatist institutions, such as the London Stock Exchange and the Corporation of Lloyds, which represented the interests of the markets at the same time as playing a regulatory function.[2] Traders' honor was the glue sustaining these self-regulatory institutions, "based on trust and shame among men who shared a code of honor they had learnt at the same schools."[3] But self-regulatory arrangements also governed other corners of the financial system such as commercial bank clearinghouses, payments and securities settlement systems, and interbank deposit markets.[4]

The influence of private financial actors over the regulation of international financial markets reached its height during with the "first wave of globalization" at end of the XIXth and early XXth century. As Braithwaite and Drahos argue, "in the nineteenth century the

[1] Braithwaite & Drahos 2000; Cutler 2003.
[2] Moran 1991.
[3] Braithwaite & Drahos 2000, p.150.
[4] Moran 1991; Braithwaite & Drahos 2000, p. 158.

house of Rothschild was more powerful than most states. By the end of the century JP Morgan had become more powerful, an influence it retained for the first decades of the 20th century." As these authors put it, "the height of merchant bank power preceded not only the globalization of regulation, but the rise of state regulation from 1934."[5]

It is only during the Great Depression that followed the Wall Street crash of 1929 that the governments of most industrialized countries widened their intervention in the regulation of finance. During this period, the US government and the governments of the other financial centers started to place restrictions on the freedom of financial market participants, as symbolized by the famous Glass-Steagall Act of 1933 which restricting the freedom of US banks to operate in the securities markets. Also during this period, governments started to strengthen their capacity to regulate financial markets by creating new domestic regulatory institutions. For instance, the Securities Exchange Act of 1934 created the US Securities and Exchange Commission in order to oversee self-regulatory organizations, like the existing stock exchanges.[6]

These reforms represented a watershed in the public-private divide, as different governments started to more directly attempt to prevent the disruptive effects witnessed during the Wall Street crash of 1929. Nonetheless, private financial actors were not completely stripped away of their regulatory functions. According to Moran, the reconstruction of the financial systems in the United States and the United Kingdom after the Wall Street Crash of 1929 relied on "meso-corporatist" arrangements. Under this model, financial regulators granted an extensive network of stock exchanges and other self-regulatory organizations the license to govern themselves through a "charter" defining their duties and rights, thus transforming private, voluntary associations into authoritative bodies.[7] For instance, in the US regulation of securities markets has continued to rely to a significant extent on self-regulatory organizations (SROs) such as FINRA and the Public Company Accounting Oversight Board, charged with broad regulatory authorities, including rulemaking, examination, and enforcement authority.[8] Also in England, the regulatory framework governing the City of London prior to the creation of the Financial Services Authority relied extensively on industry-self-regulation and informal "gentleman's agreements' between financial institutions and the Bank of England and on a series of Self-Regulatory Organizations under the oversight of the

5 Braithwaite & Drahos 2000 p.158.
6 Moran 1991, p.28.
7 Moran 1991, 15-23.
8 Moran 1991; GAO 2011.

Securities and Investments Board.[9]

However, the significant role played by self-regulatory organizations, especially in the Securities Markets, did not obfuscate the fact that, as Tsingou argues, after the 1929 Great Crash and for the rest of the twentieth century "there was some clarity with regards to public and private functions, with regulation and supervision firmly in the hands of public authorities."[10]

1.3 Before the Crisis: The New Paradigm in the Regulation of Finance

While the policies of the Great Depression era have triggered a shift of the public-private divide towards a great role for public actors, the opposite turn took place during the fifteen years or so preceding the financial crisis of 2007-10. This period represented a partial 'return to the past', as private rule-making by the financial market actors became considered as the privileged regulatory solution in the international regulation of several financial markets and institutions.[11]

While historically private rulemaking had been the norm in the regulation of sectors such as securities markets and stock exchanges, in the years preceding the crisis self-regulatory initiatives were institutionalized in a larger number of financial sectors. This trend was particularly evident in three of the most dynamic and fastest growing markets and institutions over this period: OTC derivatives, rating agencies, and hedge funds. Industry self-regulatory initiatives from the main derivatives dealers gathered within groups such as the International Swaps and Derivatives Association (ISDA), Futures Industry Association (FIA), the Emerging Markets Traders Association, the Derivatives Policy Group (DPG), and a private organization/think tanks such as the G30 have developed the legal base underpinning the growing volumes of transactions outside of regulated exchanges, also known as "over the counter" (OTC) markets.[12] After the collapse of the US hedge fund Long-Term Capital Management in 1998 (LTCM), self-regulatory measures adopted by hedge fund groups and by their bank counterparties parts have become the most important regulatory mechanism to reduce the leverage employed by hedge funds and the risk they posed to their counterparties. Groups such as the Managed Funds Association, Alternative Investment Funds Associations, and

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9 Robb 1997; Augar 2001; Moran 1991.
10 Tsingou 2004, p.8 .
11 Helleiner & Pagliari 2009a, 2009b; Mügge 2006a; Porter 2005b; Strulik 2006; Tsingou 2004; Underhill & Zhang 2008; Wood 2005.
12 Coleman 1996; Tsingou 2006.

Hedge Fund Working Group have over the years taken the lead in developing self-regulatory mechanisms for hedge fund managers, while their bank counterparties have coalesced into the Counterparty Risk Management Policy Group. In the case of rating agencies, while the Credit Rating Agency Reform Act of 2006 put an end to the self-regulatory status of the industry in the United States, the activities of credit rating agencies in Europe and elsewhere continued to remain self-regulated in the other countries, despite the global presence acquired by these actors.

These initiatives differed from previous episodes of private-rule making in two key ways. Unlike the self-regulatory initiatives in place since the 1930s in countries such as the UK and US, the industry-driven initiatives governing OTC derivatives, hedge funds, and rating agencies acquired a transnational dimension.[13] Underpinning this shift of self-regulation from a national to transnational dimension was the emergence at the global level of a restricted number of transnational financial industry associations composed of internationally oriented firms or high-profile individuals capable of drafting voluntary self-regulatory initiatives whose scope transcended national boundaries.[14] Second, unlike the examples of private rule-making in governing global financial markets that characterized both the "first wave of globalization" that preceded the First World War and the Great Depression that led to the rise of state regulation, the revived importance of self-regulation in the "second wave of globalization" has taken place in an environment governed by international regulatory institutions.[15]

Since the end of the Bretton Woods exchange rate system in the early 1970s, the greater internationalization of the activities of financial market actors has led regulatory authorities from the industrialized countries to coordinate their regulatory policies through trans-governmental regulatory networks. International regulatory cooperation first emerged in the banking sector. The international spillovers associated with the collapse in 1974 of Bankhaus Herstatt in Germany and of the Franklin National Bank in the US led the G10 central bank Governors to set up the Basel Committee on Banking Supervision (Basel Committee).[16] The establishment of the Basel Committee was followed by the creation in 1983 of the International Organization of Securities Commissions. This organization emerged from an inter-American association of securities regulators and quickly expanded its membership to include the most important

[13] Tsingou 2004.
[14] Porter 2006; Tsingou 2004.
[15] For a review see Porter 2005a.
[16] Kapstein 1994; Goodhart 2011.

securities regulatory authorities.[17] Over the years a plethora of trans-governmental networks of regulators organized along sectoral lines have emerged in response to different episodes of financial instability. In 1999, in an attempt to bring order to these institutions, the G7 created the Financial Stability Forum (FSF), an institution bringing together the main standard-setting bodies, international financial institutions, and national policymakers involved in financial regulatory policies.[18] While the FSF and international standard-setting bodies have remained primarily a transnational network of regulators from industrialized economies and their decisions have maintained the characteristics of soft laws, they have nonetheless played an important role in influencing regulatory policies implemented in a number of countries beyond their membership. It is therefore important to consider how the resurgence of private rulemaking since the mid-1990s has been influenced by a series of policies that these international institutions adopted during this period.

First, in the period preceding the crisis, international regulatory authorities had in some cases refrained from recommending direct regulation of some innovative markets and instruments, including hedge funds, rating agencies, and OTC derivatives. When different episodes of financial instability in the 1990s and early 2000s put OTC derivatives markets, hedge funds, and credit rating agencies on the international regulatory agenda, the recommendations released by international network of regulators did not seek to put the responsibility to regulate and supervise these markets and institutions in the hands of public regulatory authorities. Moreover, the role of international regulatory institutions in favoring the emergence of self-regulatory mechanisms was not limited to scaling back the public regulatory intervention and leaving a regulatory vacuum that could be filled by industry-driven initiatives. While the international initiatives described above have not pushed regulators to directly oversee and regulate these markets, their recommendations sought to leverage the self-regulatory skills by the same financial actors targeted by the regulation to achieve their public policy goals.

After several corporate scandals in 1994 involving the use of derivatives traded bilaterally (or over-the-counter), the recommendations released by the Basel Committee and IOSCO endorsed only very limited regulator involvement over the parts of the

[17] Underhill 1995.
[18] Porter 2005a.

market outside regulated exchanges.[19] The guidelines drafted by the Basel Committee and IOSCO sought to assist national authorities in promoting the development of sound risk management practices for market actors involved in OTC derivatives transactions, encouraging self-regulatory organizations to ensure their members met management control objectives, and influence the acceptance of best practices by non-regulated market participants.[20]

A similar outcome characterized the regulation of hedge funds and credit rating agencies. When hedge funds entered the regulatory agenda after the collapse of the US-based fund Long-Term Capital Management in 1998, the Financial Stability Forum discussed but ultimately rejected proposals to directly regulate and supervise these entities. The FSF instead endorsed an "indirect" approach to the regulation of hedge funds, based on the principle that the task of monitoring hedge funds' activities should not be performed by regulators, but rather by hedge funds' investors and prime-brokers, which were described as having stronger incentives to monitor hedge funds' positions and greater resources than those available to regulators. The recommendations released by the FSF thus focused on strengthening information disclosure of hedge funds' activities to their private counterparties, rather than privately reporting this information to the supervisory authorities.[21] In order to promote stronger risk management by hedge funds, the FSF has repeatedly called upon the hedge fund industry to draft a set of sound practices to improve risk management, internal controls, and disclose relevant information to their counterparties. The same approach has also informed the recommendations presented by the FSF on the regulation of hedge funds in 2007.[22]

Finally, a similar reliance on market-based regulatory solutions also informed the international approach towards the regulation of rating agencies, which entered the international regulatory agenda with the collapse of Enron in 2001. In response to this scandal, in 2004 IOSCO drafted a set of best practices to strengthen the capacity of rating agencies to manage the conflicts of interest involved in the rating business and improve the quality of their ratings. However, instead of openly recommending that national regulatory authorities take responsibility for enforcing compliance with these rules, these recommendations were addressed to the same rating agencies they sought

[19] Basel Committee on Banking Supervision 1994; IOSCO 1994. For an analysis see Tsingou 2006.
[20] IOSCO 1994; Tsingou 2006.
[21] FSF 2000. For an analysis see Eichengreen 2003; Robotti 2006.
[22] FSF 2007c.

to regulate. For instance, IOSCO relied on the voluntary incorporation of these principles by rating agencies into their own internal self-regulatory schemes. As enforcement, IOSCO demanded that rating agencies explain any deviations from the schemes to allow the ratings users to monitor the implementation of these international best practices and punish non-complying agencies.[23]

In sum, the contribution of international regulatory institutions to the resurgence of self-regulation during the pre-crisis period went beyond the decisions not to bring derivatives markets, hedge funds, and rating agencies under the direct public oversight. During this period, the international standards presented by the main international regulatory bodies sought to harness the “invisible hand” of markets in support of their public policy objectives. They leveraged the self-regulatory skills of the market actors targeted by the regulation, as well as the capacity of their private counterparties to monitor their conduct and penalize excessive risk-taking without the need for supervisor intervention, endorsing industry-driven codes of conduct and demanding financial firms to improve information disclosure to their counterparties in order to help market actors to distinguish the well-managed institutions from the more risky ones.[24]

This use of the visible hand of regulation to harness the “invisible hand” of markets in support of public policy objectives is consistent with a broader shift in the regulatory approach over this period. For instance, studies of the evolution of the international capital requirement regime for banking institutions have documented how traditional command and control policies seeking to ensure the behavior of banks conformed to standardized norms ceded ground to regulatory policies seeking to promote their self-regulatory capabilities and encourage financial innovation by the same institutions.[25] The first 1988 Basel Capital Agreement established a rigid relationship between banks’ exposures and the amount of reserve capital they were required to put aside. The Basel II Agreement, completed in 2004, allowed the most sophisticated banks to use their own data and risk-management schemes to self-determine their risk exposure and the amount of reserve capital they had to retain. Supervisors were instead given the task of approving the internal operations of these institutions contingent on meeting certain requirements regarding their internal procedures.[26] Strulik argued that a reorientation of regulatory strategies have been observable since the early 1990s, when “qualitative

[23] IOSCO 2004a.
[24] Flannery 2001Hamalainen, Hall, & Howcroft 2005; Herring 2004; Tsingou 2004.
[25] Strulik 2006; Power 2005; Greenspan 2001.
[26] Strulik 2006; Tarullo 2008.

regulatory practices [emerged], which additionally concentrate on the banks' internal requirements for risk measurement, assessment and control".[27]

The elevation of "market discipline" within the Basel II Agreement as a "third pillar" besides capital requirements and supervisory policies reflects the more prominent role granted over this period to market pressures as a monitoring and enforcement mechanism in international regulatory policies.[28] Disclosure requirements have been a central piece in financial regulatory policy tool kit in since the first half of the XXth century. However, in the fifteen years preceding the crisis, their role has gone beyond the prevention of frauds and abuses in securities markets towards prudential regulatory policies seeking to bolster financial stability.[29] In addition to the role of private counterparties in monitoring the implementation of regulatory standards, international regulatory initiatives came to rely on the capacity of markets to monitor changes in a financial firms' activities, not only by incorporating market-based measures of value and risk (e.g. security prices, private ratings, interest rate spreads, or secondary prices of debt, credit ratings) into regulatory policies to replace standardized regulatory requirements.[30]

Indeed, important policymakers, such as the former General Manager of the Bank for International Settlements Andrew Crockett, have argued that a 'paradigm shift' occurred over this period in the approach taken by financial regulators, who increasingly attempted 'to work with, rather than against, the grain of market forces' in their approach to the regulation of financial markets.[31] The former Chairman of the Basel Committee Tommaso Padoa-Schioppa talked instead of the emergence of "market-friendly regulation."[32] These labels summarize the shift in the content and purpose of regulatory intervention during this period well. Rather than ending the use of "visible hand" regulation to monitor international financial markets by directly dictating the proper conduct of financial firms, public regulatory authorities have granted a greater degree of flexibility to their operations and have actively leveraged the "invisible hand" of market

[27] Strulik 2006, 4.
[28] As the chairman of the Basel Committee Caruana has argued, the Basel II agreement sought "to draw on the power of markets to create strong incentives for banks, incentives to help ensure that banks manage their risks properly and do not hold unrealistically low amounts of capital for their risk". Caruana 2003.
[29] Avgouleas 2009.
[30] For a review, see Flannery 2001; Bond, Goldstein, & Simpson Prescott 2006; Basel Committee on Banking Supervision & Joint Forum 2009.
[31] Crockett 2002.
[32] Padoa-Schioppa 1997.

forces in support of their policy objectives.[33] The Chairman of the Federal Reserve Ben Bernanke described this approach a few months before the outbreak of the crisis as follows:

> "That market-based approach is regulation by the invisible hand, as opposed to the very visible hand of direct government regulation and enforcement. The invisible-hand approach to regulation aims to align the incentives of market participants with the objectives of the regulator, thereby harnessing the same powerful forces that allow markets to work so efficiently. In the financial arena, this approach often creates incentives for market participants to monitor and control financial firms' risk-taking behavior—that is, to exert market discipline—thereby reducing the need for direct oversight by the government."[34]

From this perspective, it would be misleading to regard this shift in the public-private divide in the period before the crisis as evidence of a shift in power away from states towards market actors or as an example of deregulation. Indeed, as the case studies in this study will discuss more in details (Chapter 4-6), the resurgence of market-based regulatory mechanisms was partially the by-product of the actions taken by international regulatory institutions which in the period preceding the crisis have come to repeatedly endorse instead industry-driven initiatives.

1.4 The Initial Regulatory Response to the Crisis: Continuity with Market-based Regulation

While the increased delegation of regulatory responsibilities to private market actors attracted increasing interest from policymakers and academics in the years preceding the crisis, few scholars and practitioners tended to describe this shift as a rising trend in international financial market regulation. The possibility that this trend could be reversed in the future was only rarely discussed. One exception was Lou Pauly who argued forcefully in 2003 that the delegation of regulatory authority to private market actors in the global economy remained a fleeting phenomenon. According to Pauly, public authority would likely reassert control over what they had delegated to private actors in

[33] This approach has been called by Alexander, Dhumale, and Eatwell 'incentive-based regulation', in contrast with traditional "rule-based regulation". Alexander, Dhumale, & Eatwell 2006, 181.
[34] Bernanke 2007.

the case of a financial crisis or a phenomenon seriously delegitimizing market mechanisms.[35]

This possibility has manifested itself during the global financial crisis that emerged in the summer of 2007 from the US subprime mortgage markets and escalated in 2008 to a full-fledged transatlantic banking crisis.[36] However, it is important to recognize that this shift along the public-private divide took place only gradually. The initial regulatory reaction from the main international regulatory bodies, in particular the FSF and IOSCO, did not challenge the pre-crisis regulatory approach towards the regulation of OTC derivatives, credit rating agencies, and hedge funds and its focus on self-regulation and market-discipline as primary regulatory mechanisms.

In the case of OTC derivatives markets, the initial international response coordinated by the FSF in April 2008 highlighted a set of deficiencies revealed by the crisis in the operational infrastructure for over-the counter derivatives markets. However, international regulators did not abandon the emphasis on industry-driven solutions that had emerged before the crisis and these recommendations were directed respectively to "market participants" and to the "financial industry", rather than to the same regulatory authorities.[37] During its initial crisis-related report in April 2008, the FSF limited the role of public authorities to "encourag[ing] market participants to act promptly to ensure that the settlement, legal and operational infrastructure for over-the-counter derivatives is sound."[38] Similarly, in a follow-up report published in October 2008, the FSF envisioned the role of authorities as "maintaining momentum in developing and implementing the recommended actions effectively and in full".[39] During the same period, some of the regulatory authorities in US and Europe also sought to solicit such self-regulatory response by meeting periodically with the main derivatives markets participants in a series of closed-door meetings to communicate their regulatory expectations. They also formalized this approach by creating the "OTC Derivatives Regulators' Forum" in September 2009, which had among its goals to "encourage strong and open communication within the regulatory community and with the industry".[40]

[35] Pauly 2003. This possibility is also mentioned by Mügge 2006a.
[36] This study will not discuss in depth the causes and dynamics of the crisis but it will cover uniquely the aspects associated to the three case studies. For a review, see FSA 2009b; FCIC 2011; Nesvetailova & Palan 2009; Rajan 2010; Schwartz 2009.
[37] FSF 2008b, p.12.
[38] FSF 2008b, p.6.
[39] FSF 2008c, p. 3.
[40] Federal Reserve Bank of New York 2009b.

Derivatives market actors acted quickly to take steps to deliver the improvements in the operational infrastructures of the markets demanded by the FSF. In 2008, they committed to implementing self-regulatory measures to enhance the processing of derivatives traded over-the-counter, to expand automation of credit derivatives trade processing, to reduce OTC trade confirmation backlogs, and to increase the use of central counterparties. The solidity of these self-regulatory improvements has been tested repeatedly since the second half of 2008 when numerous episodes triggered the settlement of credit derivatives contracts. A report published in March 2009 by the Senior Supervisors Group, a group comprising senior financial supervisors from US, Canada, France, Germany, Japan, Switzerland, and the UK, found that the management of credit default swaps during the financial crisis had been orderly and that it was not a major disruption. The report praised the success of industry-based mechanisms in allowing credit derivatives to be unraveled or “netted off” in the aftermath of these credit events.[41]

In the case of credit rating agencies, the initial international regulatory response continued the past practice of relying on self-regulatory steps taken by the same rating agencies. The immediate acknowledgment of how rating agencies had severely underestimated the risks attached to mortgage backed securities and other structured finance products led IOSCO to amend its “Code of Conduct Fundamentals for Credit Rating Agencies” in 2008.[42] However, like the first set of best practices drafted in 2004, the revised Code of Conduct remained non-binding, relying on ratings agencies to voluntarily incorporate its recommendations into their individual codes of conduct, Moreover, this initiative continued to promote compliance by having users of the ratings agencies impose proper discipline. Indeed a review published by IOSCO in March 2009 “found that a larger proportion of the CRAs reviewed were aware of the IOSCO CRA Code, and [had] taken steps to incorporate its provisions into their codes of conduct, than when they were previously surveyed for IOSCO’s first implementation review in 2007.”[43]

Despite the success of the IOSCO in convincing rating agencies to adopt its Code of Conduct on a self-regulatory basis, IOSCO has gradually sought to strengthen the capacity of its members to monitor the compliance of regulatory agencies this set of

[41] Senior Supervisors Group 2009.
[42] IOSCO 2008a.
[43] IOSCO 2009e, p. 15.

principles. The development of a “common monitoring module” to assist supervisors in monitoring compliance with its Code of Conduct[44] was followed by the establishment of a college of regulators to facilitate the monitoring and surveillance of rating agencies operating in multiple jurisdictions.[45] IOSCO also created a permanent “Standing Committee on Credit Rating Agencies” to “regularly discuss, evaluate and consider regulatory and policy initiatives vis-à-vis CRA activities and oversight” and to “facilitate regular dialogue between securities regulators and the CRA industry itself.”[46]

Finally, in the case of hedge funds, the outbreak of the crisis did not initially undermine the support for industry-driven codes of best practices and market-based regulatory solutions that had characterized the regulation of hedge funds since the collapse of Long-Term Capital Management in 1998. When the FSF met for the first time since the beginning of the crisis on 25-26 September 2007, it stated that “the hedge fund sector has not been the primary source of recent market turmoil” and welcomed the industry-driven self-regulatory initiatives developed by hedge fund groups at the eve of the crisis.[47] Concerns regarding the regulatory status of hedge funds reached the international agenda for the first time in the middle of the crisis at the G20 Washington Summit in November 2008. However, G20 leaders also reached out to the same hedge fund bodies that had already developed codes of best practices, asking them to “bring forward proposals for a set of unified best practices.” The role of public authorities as envisioned by the G20 was limited to “assess[ing] the adequacy of these proposals”.[48]

Similarly to the past, the call from the G20 at the Washington summit to the hedge fund associations to “bring forward proposals for a set of unified best practices” triggered a reaction from major hedge funds groups. They committed to fostering convergence between different industry best practices and delivering a set of harmonized Principles of Best Practices for Hedge Fund Managers to the FSB on 24 June 2009.[49]

In sum, despite acknowledging the significant regulatory shortcomings in the three areas analyzed, the initial international regulatory response continued to rely on the adjustments by the same private market actors.

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[44] IOSCO 2008d; IOSCO 2008c.
[45] IOSCO 2009c; IOSCO 2009d.
[46] IOSCO 2009c.
[47] FSF 2007a.
[48] G20 2008.
[49] AIMA 2009b.

1.5 The Second Stage of the International Regulatory Response to the Crisis

Starting in the last quarter of 2008, successive initiatives from the same international regulatory institutions have progressively given public regulatory authorities the responsibility to directly oversee OTC derivatives, rating agencies, and hedge funds and to set the rules governing these markets. This section will review the changes in the regulation of these three sectors in order.

1.5.1 OTC Derivatives

While the role of public authorities envisioned by the FSF throughout 2008 in the regulation of derivatives remained confined to steering the industry-driven initiatives using carrots and sticks, this has progressively shifted. A turning point in the international agenda regarding the private-public divide in the regulation of derivatives occurred only one month later with the greater G20 leader involvement. When the G20 met for the first time at the leaders' level in November 2008, they called for "a review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated".[50] Unlike the two FSF reports, the G20 addressed its recommendations primarily to "supervisors and regulators" who "should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes."[51]

Up until the G20 intervention, regulators had seen their role as simply that of "encouraging" the shift of derivative markets from predominantly OTC bilateral transactions to more centralized clearinghouses or trading platforms under the oversight of financial regulators and subject to binding regulatory requirements. The G20 Working Group in March 2009 called upon regulators to "enhance incentives as needed for the use of central counterparties to clear OTC credit derivatives." Some of its suggested measures included increasing the capital charges for transactions not cleared through

[50] G20 2008.
[51] G20 2008.

central counterparties.[52] The G20 Working Group 1 also expanded the role of public authorities to the oversight of same central counterparties, which "should be subject to transparent and effective oversight by prudential supervisors and other relevant authorities, including central banks, and meet high standards in terms of risk management, operational arrangements, default procedures, fair access and transparency."[53]

The following G20 summit in Pittsburgh in September 2009 was even more categorical. It demanded that all standardized OTC derivative contracts be centrally cleared and traded on exchanges "by end-2012 at the latest", that all OTC contracts report to trade repositories, and that non-centrally cleared contracts be subject to higher capital requirements. [54]

In response to this initiative, in October 2010 the FSB released a report detailing an extensive set of recommendations to meet the objectives set by the G20. Out of the 21 recommendations presented by the FSB to strengthen the regulation of the sector, only the four recommendations presented to increase the level of standardization in derivatives markets actively relied on markets. In line with the pre-crisis regulatory paradigm, the FSB has continued to work with the major OTC derivatives market participants by "demanding implementation milestones for achieving greater standardization" and for "increasing volumes of centrally cleared transactions".[55] The newly created FSB OTC Derivatives Supervisors Group has taken on this task.[56]

However, the vast majority of the regulatory initiatives coordinated by the FSB have been directed towards public regulatory authorities. The FSB also called for a more extensive role for regulators in moving derivatives towards central clearing (Recommendations 6-12). The FSB presented recommendation for regulators to "determine which products should be subject to a mandatory clearing obligation," to

[52] G20 Working Group 1 2009, p. xvi. In the same document, G20 sherpas also stated that tegulators "should also encourage the financial industry to standardize contracts and to use data repository for the remaining non-standardized contracts and promote fair and open access to central counterparty services".

[53] G20 Working Group 1 2009, p.32.

[54] G20 2009b.

[55] FSB 2010.

[56] Indeed, in October 2010 the FSB still demanded public authorities to "work with market participants" to increase standardisation of OTC derivatives products' contractual terms" (Recommendation 1) and operational processes (Recommendation 2), and invited the OTC Derivatives Supervisors Group to "continue to secure ambitious commitments from the major OTC derivatives market participants". These commitments included demanding "implementation milestones for achieving greater standardisation and, as an interim measure until mandatory clearing requirements are fully implemented, increasing volumes of centrally cleared transactions". See FSB 2010. One year later in October 2011, the FSB reported that the "coordinated industry action led by the OTC Derivatives Supervisors Group (ODSG) has been the main driver of increased standardisation through a series of quantitative and qualitative commitments" and that "authorities expect the industry to continue to increase standardisation of OTC derivatives products". See FSB 2011, p.3.

subject the same CCPs "to robust and consistently applied supervision and oversight on the basis of regulatory standards," and to also impose prudential requirements on non-banking institutions that engage in non-centrally cleared contracts. The FSB also called regulators for subjecting trade repositories "to robust and consistently applied supervision, oversight and regulatory standards" (Recommendation 15), and to require all "market participants to report all OTC derivatives transactions, both centrally-cleared and non-centrally cleared, accurately and in a timely manner to trade repositories" (Recommendation 18). The FSB envisioned a more limited role the for public authorities in promoting trading on exchanges (Recommendations 13-14), requesting that they explore the benefits and costs of such moves and of requiring public transparency of all trades.

The task of designing international standards to achieve these objectives has been taken on not only by the FSB but also by other international standard-setting institutions such as IOSCO, the Basel Committee, the Committee on Payment and Settlement Systems (CPSS), and the Committee on the Global Financial System (CGFS) (see Table 1 for a summary of these international initiatives).

Table 1 - International Standards in the regulation of derivatives markets since 2010 (adapted by the FSB Report on "OTC Derivatives Market Reforms")[57]

International Institution	Commitment	Action	Date
CGFS	Central Clearing	Report on the macro-financial implications of alternative configurations for access to CCP in OTC derivatives markets[58]	November 2011
BCBS and CPSS	Central Clearing	Revision of the BCBS Supervisory guidance for managing settlement risk in foreign exchange transactions	Expected by end of 2011
IOSCO	Central clearing	Report on international standards to address coordination of central clearing requirements with respect to products and participants[59]	January 2012
CPSS and IOSCO	Central clearing, Reporting to Trade Repositories	Principles for financial market infrastructures, including derivatives CCPs and trade repositories[60]	Consultative Report published in March 2011
BCBS, IOSCO, CPSS, CGFS Working Group	Central clearing	International standards on margining for non-centrally cleared	Consultative report by June 2012

57 FSB 2011.
58 CGFS 2011.
59 IOSCO 2012.
60 CPSS & IOSCO 2011.

		derivatives	
IOSCO	Exchange trading	Report on trading of OTC derivatives[61]	February 2011
IOSCO	Exchange and electronic platform trading	Stock-taking on the use of multi-dealer and single dealer trading platforms for OTC derivatives	December 2011
CPSS and IOSCO	Reporting to trade repositories	Report on OTC derivatives data reporting and aggregating requirements[62]	January 2012
ODRF (OTC Derivatives Regulators' Forum)	Reporting to trade repositories, Central clearing	Development and implementation of framework for effective cooperation and coordination on oversight arrangements and information sharing among the relevant authorities for individual trade repositories and systemically important OTC derivatives CCPs	On going
BCBS	Capital requirements	Regulatory capital adequacy rules for capitalization of both trade and default fund exposures to CCPs[63]	Second consultation – November 2011
ODSG	Roadmap of industry initiatives	Strategic Roadmap	March 2011
IOSCO	Commodity derivatives	Report on principles for the regulation and supervision of commodity derivatives markets[64]	September 2011

International regulatory institutions have also taken steps to monitor implementation at the domestic level of these international commitments. Two broadly equivalent regulatory frameworks have been introduced in the US and in Europe to directly regulate OTC derivatives markets: the Chapter VII of the Dodd-Frank Act and the European Market Infrastructure Regulation proposed by the European Commission (EMIR).[65]

Both these regulations have expanded the official regulatory clout over a broad range of derivatives beyond the credit derivatives at the core of the crisis, including interest rate, credit, equity, commodity, and FX swaps. Moreover, both regulatory frameworks have sought to regulate all the derivatives and other major market actors involved in the derivatives markets, including major non-financial end-users.[66] The direct regulatory

[61] IOSCO 2011c.
[62] CPSS & IOSCO 2012.
[63] BCBS 2011.
[64] IOSCO 2011a.
[65] For a detailed review of these and other national regulations of the derivatives sector CFTC & SEC 2012; FSB 2011.
[66] Title VII of Dodd-Frank provided regulators with rulemaking authorities over the banks that operate as dealers in the derivatives markets as well as over other market actors such as hedge funds maintaining a "substantial position" in major categories of swaps or whose position would have "serious adverse effects on the financial stability of the United States banking system or financial markets" (defined as "major swap participants"). Also EMIR is characterized by a similar scope of actors covered, which include all types of financial institutions (banks, insurance companies, asset management companies, pension funds, and hedge funds), some non-financial institutions in the case their non-hedging OTC derivatives positions exceed a certain threshold.

requirements imposed upon these market actors in the US and EU have been summarized in Table 2.[67]

Table 2 – Regulation of OTC Derivatives Markets in the US and in the EU (as of end of 2011)[68]

Issue	Self-regulation	Delegated Self-Regulation	Regulation by Information	Internal standards	Regulating market outcomes
Registration requirements				Registration requirement for dealers and major swap participants (**US & EU**) Registration of clearinghouses **(US & EU)** Mandatory registration of trade repository **(US & EU)**	
Prudential Regulation of dealers and major swap participants			Recordkeeping and reporting requirements (**US & EU**)	Capital requirements **(US & EU)** Initial and variation margin requirements **(US & EU)** Standards for the confirmation, processing, netting, documentation, and valuation of swaps **(US & EU)** Business conduct	Prohibition for banks receiving Federal assistance to directly engage in derivatives trading (**US**)

[67] Dodd-Frank required registered clearinghouses to register with a regulator, to designate a chief compliance officer, and to comply with different disclosure and data collection requirements to provide regulators with the information needed to monitor the markets, as well as rules to mitigate conflicts of interest in connection with swap dealers that may have a debt or equity investment in the clearinghouse. Also trade repositories were required to register with regulators, and to comply with standards set by regulators regarding antitrust considerations, governance arrangements, conflicts of interest, procedures concerning the collection and maintenance of data, the establishment of systems to analyze data, procedures to share data with regulators. Exchanges and swap execution facilities have been required to register and comply with recordkeeping and recording requirements, as well as to ensure the publication of trading information, antitrust requirements and rules to prevent the conflict of interests, financial resources system safeguards, and requirements regarding the designation of chief compliance officers.

[68] This table categorize the different measures according to the degree of public regulatory interference. On the left end of the table (self-regulation) are identified those regulatory tasks that continue to be performed by industry actors outside of a state-based regulatory frameworks. Moving towards the right, this table shows those areas where the legislation continues to rely on self-regulatory improvements ("delegated self-regulation") or it seeks to foster market discipline by introducing disclosure requirements ("regulation by information"). On the right end of the spectrum the table identifies those areas where the legislation has come to directly govern the internal organization of firms operating in the OTC derivatives markets ("internal standards"), or directly defined what market activities are admissible ("regulating market outcomes").

				standards **(US & EU)**	
Investor protection requirements				Segregation requirements **(US & EU)** Standards for conflicts of interests, fraud, and abusive behavior (**US & EU)**	
Clearing requirement	Industry-based initiatives to increase the range of contracts eligible for central clearing (**US & EU**)		Reporting of non-centrally cleared and centrally-cleared trades to a trade repository (**US & EU**) Holders of significant shareholding must be reported to the regulator. No numerical ownership limits **(EU)**	CCPs subject to rules on margin, financial resources, risk management, settlement, and conflict of interests **(US & EU)** Clearing organization ownership limits **(US)** Higher capital requirements for non-cleared swaps **(US & EU)**	Mandatory clearing of derivatives determined to be eligible by regulators **(US & EU)** Exemption for commercial end-users (**US & only to a threshold in the EU**)
Trading requirement				Registration of exchanges and swap execution facilities **(US & EU)** Recordkeeping and recording requirements **(US & EU)** Antitrust, conflict of interests, and internal governance requirements **(US & EU)**	Mandatory exchange trading of derivatives eligible for clearing (**US & proposed EU**)
Trade repository				Governance and conflict of interests requirements for trade repositories **(US & EU)** Internal standards for the collection and maintenance of data **(US & EU)**	
Market Integrity					Authority to establish limits on the aggregate number of positions held by any market actor **(US)** Considered within

					the review of MIFID and EU Market Abuse Directive **(EU)**

Other G20 members are following in the footsteps of the US and Europe in implementing the international commitments negotiated within the G20. At the Pittsburgh Summit, G20 leaders demanded that “the FSB and its relevant members […] assess regularly implementation” of the commitments regarding derivatives regulation.[69] A FSB OTC Derivatives Working Group was created by April 2010 with the task of monitoring the implementation of the international commitments and to develop reporting metrics to assess the level of implementation (Recommendation 20).[70] The first initial progress report was published by the FSB in March 2011, followed by a second report in October of the same year. In this report, the FSB announced that the OTC Derivatives Working Group would “continue to actively monitor developments across jurisdictions and flag where these may be leading to opportunities for regulatory arbitrage.”[71]

1.5.2 Rating Agencies

International initiatives have also gradually shifted the responsibility to regulate credit rating agencies to public regulatory authorities. While the initiatives taken by IOSCO during the first stage of the regulatory response to the crisis sought to strengthen the capacity of public authorities to monitor the self-regulatory action taken by rating agencies, IOSCO did not recommend placing public authorities in charge of directly regulating rating agencies and sanctioning non-compliance. This approach was openly criticized at the international level by the G20. The G20 Working Group on “Enhancing Sound Regulation and Strengthening Transparency” that was convened after the Washington Summit presented in March 2009 an explicit criticism of the self-regulatory status of credit rating agencies: “a self-regulatory framework does not appear sufficient to ensure compliance with the IOSCO Code … Effective supervision requires surveillance of CRAs' activities and, where necessary, enforcement of rules applying to CRAs”.[72]

[69] G20 2009b.
[70] FSB 2010.
[71] FSB 2011, p.4.
[72] G20 Working Group 1 2009. The G20 Working Group 1 recommended that that “Leaders complement their commitment on the registration of credit rating agencies with one to enhance enforcement, by empowering regulators with the ability to

G20 leaders took another step towards increasing the involvement of financial regulators in the regulation of rating agencies at the Washington Summit in November 2008. There, they requested credit rating agencies that provide public ratings to be registered.[73] The implications of this commitment were better specified at the London Summit on 2 April 2009. Here G20 leaders stated that "all rating agencies whose ratings are used for regulatory purposes to be subject to a regulatory oversight regime that includes registration" and that "national authorities will enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and assuring the transparency and quality of the rating process."[74] The significance of this shift in the public-private divide was acknowledged also by IOSCO, which stated in May 2010 that "a consensus emerged that the IOSCO CRA Code, as an industry code that promoted CRAs to implement internal controls and processes designed to give effect to the IOSCO CRA Principles, should be supplemented with regulation of CRAs by national competent authorities."[75]

The US Congress introduced a public regulatory framework for rating agencies in 2006 with its approval of the Credit Rating Agency Reform Act. This act required rating agencies to be registered with the SEC as "Nationally Recognized Statistical Rating Organizations" and be subject to its regulatory oversight if they wanted their ratings to be used for regulatory purposes in the US. The European Commission introduced equivalent regulation in 2008, which it revised in 2011. European regulation required rating agencies operating in Europe to register with the relevant European authority and by requiring that only rating agencies subject to this oversight could be used by firms based in the EU for regulatory purposes (see Table 3 for a comparison of the US and EU legislation).[76] Moreover, the G20 agreement triggered the introduction of similar regulatory frameworks in Europe, Japan, Australia, Mexico, Canada, and Hong Kong that placed the responsibility to regulate rating agencies in the hands of public regulators.[77]

require changes to a CRA's practices and procedures for managing conflicts of interest at credit rating agencies and assuring the transparency and quality of the rating process".

[73] G20 2008.

[74] G20 leaders' also addressed the issue of the use of ratings in regulation stating that "the Basel Committee should take forward its review on the role of external ratings in prudential regulation and determine whether there are any adverse incentives that need to be addressed". See G20 2009a.

[75] IOSCO 2010b, p.10.

[76] European Commission 2009h; European Commission 2011f.

[77] FSB 2009a; FSB 2009b.

Table 3 - Regulation of Rating Agencies in the US and Europe (as of end of 2011)

Issue	Self-regulation	Delegated Self-Regulation	Regulation by Information	Internal standards	Regulating market outcomes
Registration				Rating agencies required to register (**US & EU**)	
Methodologies, Models, Assumptions		Rating agencies required to have adequate financial and managerial resources to consistently produce ratings and comply with its procedures and methodologies (**US & EU**)	Disclose information regarding procedures and methodologies employed (**US & EU**)	Rating agencies required to implement an independent review function of their methodologies, and to review ratings and methodologies on at least annual basis (**EU**)	Require rating agencies to re-rate securities after significant methodology change (**EU**)
Performance of ratings			Disclose information on the historical performance of their credit ratings (**US & EU**)		Power to revoke the authorization of a rating agency if it fails to maintain an adequate performance (US)
Information underlying ratings			Disclose reliability of info on underlying assets (**US and EU**)		Prohibition to issue a rating when robust data is lacking of creditworthiness cannot be assessed (**EU**)
Qualification of rating analysts		Require rating agencies to allocate sufficient number of employees with appropriate knowledge and experience to its credit rating activities (**EU**)	Disclose information regarding credit analysts and their qualifications **(US)**		
Rating of structured finance products			Disclose information regarding limits of SF ratings (**US & EU**) Add symbols to the rating of SF ratings (**EU**) Disclose info used for issuing ratings of SF products to other agencies **(US)**		Ratings from 2 different agencies required for SF products (**EU 2011 proposed**)
Board of Directors				Requirements for CRA boards of directors' composition,	

				compensation and duties (**US and EU**)	
Conflict of interests emerging from issuer-pays model		Require rating agencies to establish policies to manage conflicts of interests (**US & EU**)	Disclose conflicts of interests emerging from issuer-pays model (**US & EU**) Disclose revenues from the largest clients (**US and EU**) Disclose Policies adopted to mitigate conflicts of interest (**US & EU**)	Credit analyst prohibited from having a financial stake in the rated entity (**US and EU**) Rating analyst prohibited from engaging in free negotiations and from receiving gifts (**US & EU**) Mandatory rotation of analysts (**EU**) Mandatory look-back review of ratings conducted by an analyst leaving for a client (**US**)	Study regarding the creation of a clearing rating house (**US**) Mandatory rotation of rating agencies (**EU 2011 proposed**)
Conflict of interest emerging from Consultancy and Ancillary Services			Disclose Revenues from ancillary services (**US, EU**)	Analysts prohibited from giving advice on the structure of the securities they rate (**US & EU**) Require separation of rating and other services into operationally distinct units (**US, EU**)	

Like in the case of derivatives, international regulatory institutions have also expanded their role into monitoring these domestic regulatory frameworks' consistency with the international commitments. Responding to a request from the G20,[78] the Technical Committee of IOSCO has included the task of evaluating the compatibility of the different regulatory initiatives introduced at the domestic level with its own international principles in the mandate for the Standing Committee on Rating Agencies.[79] In May 2010, the Standing Committee on Rating Agencies published a report (updated in February 2011) to review "how provisions in the various emerging CRA government regulations are designed to implement and promote the objectives in the four IOSCO CRA Principles" and to help regulators in "addressing potential conflicts that may arise from the differing

[78] G20 2009a. *The G20 Leaders at the London summit had stated that the regulatory oversight regimes designed by their members "should be consistent with the IOSCO Code of Conduct Fundamentals", and it demanded IOSCO to "coordinate full compliance".*
[79] IOSCO 2010b;

regulatory requirements imposed by different jurisdictions upon globally operating CRAs.[80]

1.5.3 Hedge Funds

The long-standing international support for self-regulation in hedge funds came to an end at the beginning of 2009. While in the past industry-driven initiatives were successful in deflecting the threat of more stringent regulation, this time the self-regulatory initiatives presented by the hedge fund industry in response to the call from the G20 generated only lukewarm reactions from the international regulatory community. Securities regulators gathered within IOSCO have raised doubts about the effectiveness of industry codes of best practices as a substitute for direct regulation. First, IOSCO argued that the adoption by hedge fund managers of these industry codes of best practices had remained low, as demonstrated by a survey showing that only less than 10% of British hedge fund managers were prepared to sign up to the standards drafted by the HFWG,[81] and there has been no demand by investors of these hedge funds to adopt the standards. Second, IOSCO denounced the variety of different industry standards covering different issues and the lack of a globally consistent solution. Third, IOSCO argued that there were “still open questions regarding the enforceability of such codes either by regulators or industry associations”.[82]

The consultation report presented by IOSCO in March 2009 on the regulation of hedge fund industry departed from the international approach that dominated before the crisis in recommending the registration/authorization of hedge fund managers, as well as requiring these actors to comply with different regulatory requirements.[83] The G20 leaders also endorsed this approach. Their communiqué at London Summit on April 2009 announced an agreement ‘to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds’.[84] Also the “Declaration on Strengthening the Financial System” better specified this commitment by stating that “hedge funds or their managers will be registered and will be required to disclose appropriate information on

[80] To further this goal, IOSCO has also established a dialogue with the same rating agencies to examine “emerging issues and any implementation problems from the industry’s perspective” and, in particular, “whether differences in the implementation of national and regional regulatory frameworks based on the IOSCO Principles and Code of Conduct Fundamentals for CRAs present compliance problems or arbitrage opportunities”. See IOSCO 2011b; FSB 2009b.
[81] Kinetic Partners 2008.
[82] IOSCO 2009b, p.7.
[83] IOSCO 2009a, p.33.
[84] G20 2009c.

an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively."[85]

Mandatory registration and enhanced disclosure of information to the authority to assess the risks posed by hedge funds also informed the final recommendations released shortly after by IOSCO in June 2009. Moreover, IOSCO went beyond the G20 declaration in specifying ongoing regulatory requirements to which the registered hedge fund managers should be required to obey. IOSCO recommended that its members introduce regulatory requirements related to the organizational and operational standards followed by hedge fund managers (e.g. independent risk management function, compliance function, use of independent custodians to protect client monies and assets), the conflicts of interest (e.g. remuneration for hedge fund managers), and disclosure to investors. IOSCO has also published an agreed template to assist public authorities in collecting and sharing hedge fund information useful in assessing possible systemic risks arising from the sector.[86]

The commitment by the G20 leaders at the London summit to extend regulation and oversight for the first time to hedge funds was followed by the introduction of different regulatory frameworks at the domestic level. In the US, this objective was pursued through the Private Fund Investment Advisers Registration Act of 2010, included in the Title VI of the Dodd-Frank Act signed into law in the summer of 2010. In Europe, the Alternative Investment Fund Managers Directive (AIFMD) was introduced to regulate the hedge funds manager.[87] Both pieces of regulation required hedge fund managers to register with regulatory authorities as well as to comply with a number of regulatory requirement, although their scope differed quite significantly in the two jurisdictions (for a summary, see Table 4).[88]

[85] G20 2009a.
[86] IOSCO 2010a.
[87] European Commission 2011a.
[88] The Private Fund Act removed the so-called "private adviser" exemption that had traditionally allowed hedge fund managers to register with the SEC and be subject to the regular scrutiny by this institution. The registration requirement was made mandatory for those fund advisers with assets under management above $100 million. Similarly, also the AIFM Directive required all the fund managers with a portfolio of assets under management higher than 100 million Euro (raised to 500 million in the case of unleveraged portfolio) to be subject to registration with the competent authorities.

Table 4 - Regulation of Hedge Funds in the US and Europe (as of end of 2011)

	Self-Regulation	Delegated self-regulation	Regulation-by-information	Internal Standards	Regulating Market Outcomes
Registration				Register HF managers (**US + EU**) Designate Chief Compliance officer (**US + EU**)	
Reporting and Recordkeeping			Report information about assets under management, counterparty credit risk exposures, trading and investment positions, the level of leverage, valuation policies and practices, types of assets held (**US & EU**)		
Investor protection, Custody and Valuation		Develop processes regarding the accuracy of disclosures to investors, investors assets safeguards, marketing practices, private protection of client records, recordkeeping, and to value client holdings (**US**)		US: surprise examination by an independent public accountant (**US**) Report from an independent public accountant with respect to the adviser's or related person's controls over the custody of client assets (**US**) Require independent valuator or functionally separated from portfolio management (national authorities would retain authority to retain an external valuer) (**EU**)	

				Asset segregation and liability requirements for depositories (**EU**)	
Systemic risk and Leverage		Develop procedures regarding portfolio management processes, employees' personal trading (**US**) Requirement to implement adequate risk management and liquidity management systems (**US**) HF managers to define leverage limits (**US**)	Report information about assets under management, counterparty credit risk exposures, trading and investment positions, leverage level, valuation policies and practices, types of assets held (**US & EU**)	Minimum initial Capital requirements (**EU**) Require at least 40% of variable remuneration to be deferred, claw back requirements, independent remuneration committee (**EU**)	Authority to impose limits to on the leverage levels for safeguard, the stability and integrity of the financial system (**EU**)
Stake in companies			Notification sent to authorities, investors, and employees of the company (**EU**)		

The design of these regulatory frameworks in the US, Europe, and other countries was followed by the FSB announcement in September 2009 that "To further facilitate global coordination on hedge fund regulation, IOSCO plans to monitor the progress in domestic regulation of the hedge fund sector and review how they align with the IOSCO principles"[89]. IOSCO has also taken steps to facilitate the work of regulatory authorities monitoring the activities of hedge funds and published a set of systemic risk data requirements[90]

1.6 Conclusion

This chapter has analyzed the way in which international regulatory guidelines have directed the allocation of the responsibilities to regulate OTC derivatives, rating

[89] FSB 2009a
[90] IOSCO 2010a.

agencies, and hedge funds between public regulatory agencies and private market actors. This analysis has highlighted how the global financial crisis that erupted in the summer of 2007 began a significant shift in the main international financial regulatory institutions' approach.

In the years before the crisis the FSF, IOSCO, and Basel Committee purposefully left OTC derivatives markets, hedge fund managers, and rating agencies outside of the direct oversight of public regulatory agencies. Beginning in late 2008, the commitments made at the international level within transgovernmental regulatory bodies such as the FSF/B and IOSCO, or at leaders forums such as the G20 have departed from the approach adopted by the same institutions before the crisis. New regulatory measures have promoted the direct regulation of derivatives, hedge funds, and rating agencies by recommending that the responsibility to regulate and oversee these three markets and institutions be placed firmly in the hands of public regulatory authorities. In addition to coordinating international measures to directly regulate OTC derivatives, hedge funds, and rating agencies, the same international regulatory bodies have also taken an active role in monitoring the consistency of domestic regulatory initiatives with these international commitments

The degree of change should not be overstated. A more in depth analysis of the regulatory policies introduced in the US and Europe to implement the international commitments reveals that the decisions to bring derivative dealers, rating agencies, and hedge fund managers under the direct oversight of public authorities coexists with a continuous reliance on different market-based mechanisms. Only in a few circumstances have the new regulatory frameworks have extended the reach of regulatory intervention as far as interfering in the structure of derivatives markets, hedge funds and rating agencies. In other words, while the crisis' severity has drawn comparisons with the Wall Street Crash of 1929, the impact of the regulatory response over the public-private divide is less extensive. Nonetheless, the expansion in the perimeter of financial market actors whose activities fall within the perimeter of public regulation is certainly a significant shift in the governance of international financial markets.

At the same time, this shift in the public-private divide cannot be regarded as simply a mechanical reaction to the global financial crisis of 2007-2010 and the regulatory failures the crisis revealed. Two patterns of the shift described in this chapter are inconsistent with this interpretation: its scope and its timing. First, when we analyze the scope of the regulatory response, it appears that the change in the approach of international regulatory institutions not only affected both market actors that were among the main culprits of the crisis, such as derivatives markets and rating agencies, but also actors that played a rather peripheral role such as hedge funds. This aspect is even more puzzling when we consider how the market-based approach that dominated the international regulation of hedge funds before the crisis emerged in response to a crisis that more directly exposed the systemic risks associated with their activities, that is, the collapse of LTCM.

Second, when we analyze the timing of this shift in the international public-private divide, we see that the outbreak of the crisis in the summer of 2007 initially reinforced rather than undermined the market-based approach that had emerged before the crisis. The initial response by international institutions such as the FSF repeatedly turned to the same market-actors and demanded self-regulatory improvements. It is only in a second moment, and primarily as a result of the demands coming from the G20, that the international regulatory response to the crisis acquired a commitment towards directly regulating derivatives markets, hedge funds, and rating agencies.

In order to set the stage for an explanation of these patterns in the international regulatory response to the crisis, the next chapter will review the contribution of main theories on the politics of international financial regulation in the IPE literature.

Chapter 2. Literature Review

2.1 Plan of the Chapter

How is it possible to explain the turn in the public-private divide that characterized the international regulatory agreements introduced since the beginning of the financial crisis to bring OTC derivatives, hedge funds, and rating agencies under direct regulatory oversight? In order to begin to answer this question, this chapter will turn first to the IPE literature on the politics of international financial regulation. The growth of international regulatory cooperation since the 1970s has led to the emergence of a significant body of academic work investigating the political drivers behind this process.[1]

The central question that has driven this literature seeks to determine the conditions under which national authorities succeed or fail in coordinating their financial regulatory policies at the international level. However, in the decade before the crisis, a number of authors also highlighted a qualitative change in the way in the way international regulatory agreements allocate the responsibility to regulate markets between public regulatory agencies and private market actors. They sought to explain from a theoretical standpoint the greater reliance on private-rulemaking and market-based mechanisms in the governance of international financial markets. These works have in particular focused on the two main "poster-children" of this turn: the Basel II agreement, which increased regulators' reliance on the self-regulatory capacity of individual financial institutions and the rising status of the International Accounting Standard Body, a private standard-setting body in the accounting realm.[2] However, a number of works have also explored the markets and institutions analyzed in this study.[3]

The significance of the global financial crisis of 2007 and its impact on the international regulatory architecture have provided new impetus to this academic literature. Since the beginning of the crisis, different works have started to investigate the politics of the international regulatory response to the global financial crisis. These include studies of derivatives regulation,[4] hedge funds,[5] and rating agencies[6] although these studies have

[1] For a review of this literature see Helleiner & Pagliari 2011.
[2] Buthe & Mattli 2011; Perry & Nolke 2006; Tsingou 2008.
[3] Eichengreen 2003; Sinclair 2005; Tsingou 2003.
[4] Helleiner and Pagliari 2009b; Helleiner 2010; Clapp & Helleiner 2012.
[5] Fioretos 2010; Quaglia 2011; Woll 2011.

focused primarily on the regulation of single sectors rather trying to draw lessons by looking across them.

This chapter will review the contribution of this range of IPE literature to explain from a theoretical standpoint what factors represent the primary determinant of the division of responsibilities between public regulators and private market actors in the regulation of financial markets. By analyzing both pre-crisis and post-crisis regulatory developments literature, it is possible to distill five competing theoretical explanations to explain how international regulatory institutions will allocate regulatory responsibilities between public and private actors:

- Functionalist explanations regard the structural characteristics of financial markets as the primary determinant of how international regulatory policies will divide regulatory functions between public and private actors. In particular, one strand of functionalist arguments reviewed in this section attributes the dominance of market-based regulatory mechanisms before the crisis to the constraints posed upon regulators' capacity to regulate finance by structural changes in the financial markets such as the processes of financial globalization and financial innovation. Other functionalist analyses in this section instead consider the technical nature of financial markets as constraining the kind of regulatory change. (*Section 2.2*).
- Realist explanations identify in the relative market power of different states as the primary determinant of how international regulatory policies will allocate regulatory functions between public and private actors. In particular, the works belonging to this tradition have attributed the dominance of market-based regulatory mechanisms before the crisis to US predominant influence in international financial negotiations (*Section 2.3*).
- Historical institutionalist explanations identify in the institutional characteristics associated with different 'varieties of capitalism' as the primary determinant of whether countries will support market-based or more direct types of regulation. In particular, the works belonging to this tradition will attribute the emergence of market-based international regulatory regimes before the crisis to the dominance of liberal market-economies over international regulatory debates (*Section 2.4*).
- Pluralist explanations identify the preferences and relative influence of different interest groups as the primary determinant of how international regulatory policies

[6] Quaglia 2009.

will divide regulatory functions between public and private actors. In particular, the works belonging to this tradition attribute the dominance of market-based regulatory mechanisms before the crisis to the dominance of financial industry groups mobilizing on a national and transnational basis vis-à-vis other societal actors and their capacity to systematically infuse the international regulatory process with their own preferences (*Section 2.5*).

- Constructivist explanations identify in the dominant ideas as the primary determinant of how international regulatory policies will divide regulatory functions between public and private actors. In particular, the works belonging to this tradition attribute the dominance of market-based regulatory mechanisms before the crisis to the emergence of an ideational consensus within the international regulatory community around the efficiency of markets (*Section 2.6*).

Table 5 summarizes the main theoretical expectations of each approach and their shortcomings in explaining the changes triggered by the crisis.

Besides reviewing the main claims of this literature, this chapter will discuss to what extent these theoretical perspectives are capable of explaining the shift in the public-private divide that has been set in motion by the financial crisis in the international regulation of derivatives, rating agencies, and hedge funds. In particular, this chapter will explore to what extent these theories can explain the empirical evidence presented in the previous chapter.

Table 5 - Theoretical Expectations of the Literature

Theoretical paradigm	Main determinant of the public-private divide	How would the theory predict reassertion of public oversight?	How has the crisis challenged this thesis?
Functionalism	Financial Globalization and innovation. Constraints these processes pose upon regulators' capacity to regulate specific issue areas.	Structural changes in financial markets, such as reversal of the process of financial globalization and innovation Crisis revealing significant shortcomings in market-based regulatory solutions	A reassertion of public regulatory oversight has occurred in those areas that before the crisis were described as most complex and dynamic, and in sectors that were not the culprit for the crisis.
Realism	Distribution of relative state power	Change in the inter-state balance of power away from those countries that maintain a vested interest in a market-based regulatory approach	Crisis did not change the balance of power between countries, but rather altered the preferences of the leading countries. Dominant powers pursuing regulation detrimental to the competitive position of their respective financial industries.
Historical Institutionalism	Varieties of capitalisms.	Evolution in the national models of capitalism	Timing of change in preferences of liberal market-economies that have abandoned support for market-based regulation. US promoting more intrusive regulation of derivatives than EU
Pluralism	Preferences of Financial industry group and competitive dynamics	Inter-industry competitive struggles prevent emergence of self-regulation. Greater influence of interest groups outside the financial industry	A reassertion of public regulatory oversight has gone against the preferences expressed by financial industry groups and by some non-financial groups.
Constructivism	Dominant ideas regarding the state-market relations	Widespread ideational shift within the international regulatory community	Timing of the change (ideational shifts occur over the medium-term)

The conclusion of this chapter (Section 2.7) will maintain that while these theoretical explanations have gone a long way in identifying the primary forces influencing the market-based regulatory regime governing these three markets and institutions prior to the crisis, they fail to adequately explain the shifting patterns in international regulation triggered by the financial crisis of 2007-10 analyzed in the previous chapter.

2.2 Functionalist Explanations

A rather variegated group of authors within the IPE literature has identified the primary determinant of changes in the patterns of international financial regulatory cooperation in the characteristics of financial markets and the way these have evolved over time. More specifically, different authors have argued that the expansion of "private authorities" can be regarded as a response to epochal changes in the global economy such as the twin processes of financial globalization and technological change.

One of the earliest formulations of this argument can be attributed to Susan Strange. In her influential book "The Retreat of the State", Strange acknowledges that in a wide range of segments of the world economy "what were once domains of authority exclusive to state authority are now being shared with other loci or sources of authority."[7] According to Strange, the origin of the shift in the location of the authority to regulate markets are to be found in a structural transformation that occurred with the increasing globalization of markets, which had previously constrained the capacity and/or willingness of states to regulate them.

Cutler, Haufler, and Porter in their collective study on the rise of 'private authority' in international affairs identify three overlapping trends as potential explanations of this phenomenon: the expansion of market forces, globalization in general, and the pace of technological change.[8] According to these authors these three overlapping trends have constrained the capacity of states to cope with the demands for governance solutions for emerging international issues. They argue that "as states voluntarily abandon some of the functions that we traditionally associate with public authorities due to the force of liberal ideology, globalization, or the lack of state capacity to manage current issues, those functions that are needed for smoothly operating markets may be given to or taken up by firms".[9]

Miles Khaler and David Lake argue in their analysis of global economic governance that "globalization constrains the array of policy instruments available to states. This consequence of globalization is particularly important in explaining shifts of governance across the public-private divide. Regulation or standards governance by national political authorities may become less effective in a global economy. Capital can too easily evade national regulations. Incompatible national standards become barriers to trade, raising consumer prices and engendering discord between firms and states."[10]

While the focus of these works is not confined to the realm of finance, other authors have drawn upon these insights to explain how the evolution of international financial regulation has been influenced by historical trends of financial globalization and financial innovation.

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[7] Strange 1996, p.82.
[8] Cutler, Haufler, & Porter 1999a.
[9] Cutler, Haufler, & Porter 1999b, p.4.
[10] Khaler and Lake 2003, p. 426.

First, several authors have highlighted how the globalization of financial markets that was set in motion by the breakdown of the Bretton Woods system has undermined the capacity of national regulators to individually control domestic banks whose activities extend across jurisdictions. Moreover, given that financial activity is more capable of escaping national regulation and moving across jurisdictions than other areas of the global economy, states are wary of introducing regulatory policies that may encourage regulatory arbitrage through the threat of capital outflows towards laxer jurisdictions or to harm their competitiveness in attracting investment.[11] Different authors have argued that the risks of regulatory arbitrage and of a race to the bottom can be mitigated through the international harmonization of regulatory policies.[12] However, this remains a difficult process. Tsingou has therefore argued that "a look at the way the financial system currently operates shows that the more transnational the activity, the less it is likely to rely on traditional forms of regulation (that is, nationally based and public), thus giving way to self-regulatory practices."[13]

Second, financial globalization and technological changes brought by the digital revolution since the 1970s have also created constraints to the operation of public regulators by increasing the volume and speed of transactions occurring daily in the financial markets. Their financial resources and the personnel employed in financial regulatory bodies have failed to keep pace with the increase in the size and scope of the financial markets they are supposed to supervise and regulate. Phil Cerny argued that the "dramatic innovations in communications and information technology have led to huge transnational capital flows and complex patterns of two-way cross-border price sensitivity which dwarf the monitoring and controlling capabilities as well as the public financial resources of states, thereby making pre-existing nation-state-based patterns and systems of regulation and intervention less effective."[14]

Third, several authors have highlighted how innovations in communication and information technologies have increased the level of complexity in the financial markets, transforming finance into a "knowledge intensive" sector.[15] This innovative capacity of markets has gained prominence in recent years with the explosion in the 'securitization' of traditional operations such as bank loans and mortgages into negotiable securities, the creation of 'off-balance sheet' instruments, and the design of complex and tailored

[11] Andrews 1994; Cerny 1996; Cerny 2002; Gill & Law 1989.
[12] Kapstein 1994.
[13] Tsingou 2003, p. 4.
[14] Cerny 2002, p. 210; Cerny 1994; Cerny 1996.
[15] Strulik 2007; Porter 2003.

instruments, especially in the derivatives markets. Studies of the evolution of the financial sector throughout the XXth century have documented how the increase in the complexity of finance since the 1980s has coincided with finance becoming a high-skill high-wage industry compared to other industries.[16] The greater asymmetry between salaries of regulators and those of the financial industry has constrained the capacity of regulators to attract and retain qualified personnel who can be lured into moving to the private sector.

Moreover, different authors have argued that the increasingly knowledge-intensive nature of financial regulatory policies have posed constraints upon the capacity of public regulatory agencies to govern markets that are not exclusively monetary but also "cognitive".[17] Cerny and others have argued that the pace of innovation and the increased knowledge-intensive nature in today's financial markets have increased the information asymmetry between public regulators and the financial industry, placing financial regulators are at a great cognitive disadvantage compared to the industry they are supposed to regulate.[18]

Beyond heightening information asymmetries, Strulik argues that these developments in financial markets have increasingly confronted regulators with situations of "ambiguous ignorance […] which cannot be quantified on the basis of experience and with the help of probability calculations."[19] As ambiguous ignorance becomes more relevant and it becomes more difficult to understand cause/effect relationships, imposing simple rules such as quantitative norms and controlling conformity for them is described as inadequate.[20]

Moreover, the same twin processes of financial globalization and technological developments which limit the capacity of financial regulators to govern financial markets have also been presented as creating incentives for these actors to seek out alternative, more flexible, and less resource-intensive forms of regulation. Several political scientists, economists, and theorists of regulation have theorized that under certain conditions granting regulatory authority to private market actors may be more "efficient" than solely relying on public authorities. According to Cutler, Haufler and Porter, endowing private actors with authority could mitigate the costs associated with information and

[16] Philippon & Reshe 2009.
[17] Strulik 2006; Porter 1999b.
[18] Cerny 1994; Hoenig 1996.
[19] Strulik 2006, p.4.
[20] Kette 2009; Strulik 2006.

uncertainty, costs directly associated with negotiation, and enforcement costs.[21] They argued that "the state is likely to continue to enjoy a decisive advantage in governance where transactions are characterized by large scale risks or where they involve multiple industries or issue areas." However, the advantages that states have relative to firms are substantially reduced when transactions are "restricted to private firms operating in single industries," in the case of policies designed "at the international level, where there is no centralized political authority and interstate cooperation remains difficult,"[22] as well as in "areas where technology is complex or information plays a significant role". [23] For instance, the rise of rating agencies as "private authorities" in the global economy has been explained as the product of their greater efficiency in monitoring and assessing borrowers.[24]

Different authors have therefore theorized how public authorities regulators have to stay abreast of market developments in an increasingly knowledge-intensive and dynamic industry is to leverage the expertise and resources of private market actors and to shift to them part of the task of regulating and supervising markets.

For instance, Walter Mattli has argued that "high economic costs attributable to a mismatch between limited public capabilities and expansive private sector needs have led to a much greater involvement of market actors in transnational standardization, in effect moving a key site of standards governance horizontally from the transnational public domain to the private sphere."[25] According to Mattli, this has taken the form of either market players bypassing intergovernmental standard-setting bodies or an act of delegation by governments of regulatory authority to private sector transnational standards organizations which "typically have greater resources and technical sophistication, as well as a better feel for market needs, than public official and thus may be in a better position to produce complex international standards in a timely and cost-effective way." [26] Several authors have argued that public authorities are more likely to delegate regulatory responsibilities to private market actors in those areas where the latter have greater "regulatory capacity" than traditional public regulatory bodies, such as

[21] Cutler et al. 1999a, p. 338.
[22] Cutler et al. 1999a, p. 341-2.
[23] Cutler et al. 1999b, p.4.
[24] Sinclair 1999.
[25] Mattli 2003, p. 211.
[26] Mattli 2003, p. 212. See also Mattli & Buthe 2003; Knill & Lehmkuhl 2002.

in areas characterized by increasing technological complexity, rapid change or in areas of novel economic activity.[27]

Finance certainly fits this description. Changes in the content of financial regulation and its greater reliance on market-based regulatory mechanisms have been described as the acknowledgment that traditional hierarchical forms of regulation that set strict and detailed quantitative requirements had become inadequate for the financial system's accelerated innovation dynamic that arose over the last few decades.[28] For instance, Kette argues: "As the private knowledge (e.g. of market participants) differs from the 'regulatory knowledge' the regulators are forced to incorporate private expertise in order to develop rules that can deal with the complexity of the financial system. Otherwise, the aim of a stable financial system would hardly be achievable."[29] Tsingou has argued that while public authorities lag behind in terms of technical capabilities and expertise and therefore cannot regulate nor oversee effectively complex financial activities, "the complexity and speed of financial innovation has put banks in a privileged position as knowledge holders." She concludes that as a result of this asymmetry of knowledge, public regulatory authorities have shifted the focus of their intervention from regulation to supervision: "this has left financial institutions in charge of making their own rules, or rather creating their own flexible standards, and public authorities in charge of market-based supervision, increasingly reliant on private sector know-how and transparent practices."[30]

In sum, according to these explanations, the delegation of regulatory and supervisory responsibilities to private market actors that gained traction in the regulation of OTC derivatives, hedge funds, and rating agencies before the crisis could be described as regulators' attempt to leverage private market actors' resources to supplement their capacity to effectively govern these markets and institutions. Indeed, OTC derivatives have been regarded as among the most complex and innovative financial products. The complexity and volume in the trading strategies of hedge funds dwarfs those of other investment vehicles such as pension funds. Finally, the task of assessing the default risk for corporate bonds and structured products is regarded as a particularly complex and knowledge-intensive business that over the years banks and other financial institutions have delegated to specialized rating agencies.

[27] Florini 2000; Mattli 2003; Boas, Bull, & McNeill 2004.
[28] Kette 2009; Strulik 2006.
[29] Kette 2009, p.5.
[30] Tsingou 2008, p. 58.

Moreover, the view that developments in financial markets had rendered traditional approaches to the regulation and supervision of financial markets unworkable has also been expressed by some of the most influential regulatory authorities in the decade preceding the crisis. In particular, since the mid-1990s, several members of the Federal Reserve have made this case. For instance, the President of the Federal Reserve Bank of Kansas City Thomas Hoenig argued in 1996 that "in light of the changes in financial markets … simply extending the traditional regulatory approach to achieve the goals of financial regulation may be too difficult and costly", while "private sectors maintained significantly more resources—both human and financial—than the regulators for keeping pace with the changes in financial."[31] The Governor of the Federal Reserve Laurence Meyer also argued in 1999 that the "renaissance in appreciation of the contribution of market discipline" in the regulation of the banking sector "undoubtedly reflects a growing awareness that recent developments in banking and financial markets have made regulatory standards less effective and supervision more challenging, that it may be simply impossible to adapt regulatory standards and supervisory practices fast enough to keep pace with market developments."[32] In another study published in 2000, the Federal Reserve also argued: "The accent on market discipline and transparency has been prompted in large part by changes reshaping banking. With consolidation, convergence, globalization, and the rapid pace of financial innovation, more-effective market discipline is a preferred alternative to large-scale expansion of supervision and regulation as a means of limiting risk-taking by large, complex financial institutions with substantial banking activities."[33] The head of the Federal Reserve during this period Alan Greenspan summarized this view well, stating that 'regulators can still pretend to provide oversight, but their capabilities are much diminished and declining'. He claims that at the Federal Reserve, he and his colleagues 'increasingly judged that we would have to rely on counterparty surveillance to do the heavy lifting'.[34]

However, the interpretation that regulatory agencies' weakened capacity and resources caused greater reliance on market-based mechanisms before the crisis faces significant challenges from the analysis of the international regulatory changes that have followed the crisis. The twin processes of financial globalization and innovation at the core of this thesis are usually regarded as structural features of contemporary financial markets that

[31] Hoenig 1996.
[32] Meyer 1999a, p. 346; Meyer 1999b.
[33] Board of Governors of the Federal Reserve System 2000, p.1.
[34] Quoted in Davies & Green 2008, p.20.

are unlikely to be reversed or weakened by episodes of financial instability. The financial crisis has neither “turned the clock back” on the structure of financial markets nor provoked a significant retreat of financial globalization. Therefore, arguments based on the structural transformations in the financial markets would expect financial regulatory authorities to continue to delegate significant responsibilities for addressing the gaps in the international financial regulation that the crisis highlighted to the same financial industry, especially in those areas that are regarded as more dynamic and knowledge intensive. This thesis cannot then easily explain the reassertion of regulatory responsibilities over market actors and activities regarded as among the most complex and dynamic such as in the case of hedge funds and derivatives.

An alternative functionalist explanation would present the departure from the market-based measures that had emerged before the crisis as driven by the acknowledgement of the inadequacies of these arrangements in solving specific regulatory changes. From this perspective, one of the impacts of the financial crisis should have been to provide new information regarding the effectiveness of the market-based measures that emerged before the crisis. However, this argument does not seem tenable in light of the evidence presented in the previous chapter.

The case of hedge funds provides evidence of the success of the self-regulatory measures introduced in the years before the crisis in reducing leverage in the hedge fund industry and mitigating the risks that hedge funds posed upon banking system. In fact, this time around, the collapse of an unprecedented number of hedge funds during the crisis had no significant impact on the stability of banks that provide them with leverage. This is even more puzzling when we consider that the market-based regime governing hedge funds had emerged in the aftermath of a more severe hedge fund crisis, that is, the collapse of LTCM.

Moreover, international regulatory institutions’ change in attitude cannot be regarded as a response to the failure of market-actors in meeting their requests for self-regulatory improvements. As argued in the previous chapter, international regulatory institutions praised the self-regulatory steps taken by the derivative dealers to improve the settlement of credit derivatives during the crisis,[35] as well as the self-regulatory

[35] Senior Supervisors Group 2009.

implementation by the main rating agencies of the recommendations presented by IOSCO.[36]

Porter has presented an alternative functionalist approach to explain the patterns of international financial regulation. Going beyond traditional functionalist approaches, Porter has highlighted the nature of finance as a "technical system" and the impact that the technical demands of the systems have had in shaping the conduct of the actors involved in the development of financial regulatory policies.[37] Porter particularly highlights how the nature of finance as a technical system restricts the portfolio of policy solutions policymakers considered feasible because it injects a significant degree of path dependency when developing international regulatory policies and it encourages the development of incremental adjustments.

According to Porter, the international regulatory response to the East Asian crisis clearly demonstrated the legacy of finance's technical nature. Rather than starting from scratch in considering how to respond to the regulatory failures highlighted by the crisis, the international response was shaped by a prior history of technical collaboration and it relied extensively on institutions and standards that had been developed in the past.[38]

Unlike the functionalist argument reviewed above, this argument does not imply that the knowledge-intensive nature of financial markets would preclude a reassertion of greater public regulation. However, according to Porter, the technical nature of financial markets would shape and limit the patterns of re-regulation. As Porter argues, "change in transnational regulatory arrangements is likely only to involve an incremental strengthening of the existing disaggregated arrangements, despite the massive failure of the financial system that the crisis revealed".[39]

Porter's argument on the legacy of technical cooperation is important for explaining the continuity in the approach adopted by international regulatory institutions in responding to the global financial crisis. IOSCO's initial response to rating agencies' failure to correctly assess the creditworthiness of structured finance product has been to amend its existing Code of Conduct while preserving its self-regulatory nature. The initial initiatives coordinated by the FSF to strengthen the operation infrastructures of derivatives markets have built upon cooperation patterns established by the Federal Reserve of New York with the main derivative dealers in 2005. Finally, the initial

[36] IOSCO 2009e.
[37] Porter 2003.
[38] Porter 2003, p. 547.
[39] Porter 2008.

response by the G20 to strengthen the regulation of hedge funds has also consisted of calling upon hedge fund associations to devise voluntary codes of best practices, similarly to the approach endorsed by the G7 and FSF in the wake of the crisis.

At the same time, Porter's functionalist view is less capable of explaining the direction change that has occurred in the international agenda since the last quarter of 2008 and the same institution's decision to endorse the need to bring these market and institutions under public authorities' direct regulatory oversight.

2.3 Realist explanations

Some of the functionalist arguments presented above maintains that that the globalization of economic activities has compromised state authorities' grip on financial market governance. An important school of thought has contested this view. Realist explanations have described the emergence of self-regulatory mechanisms in the governance of international finance and other areas of the global economy as the outcome of an explicit or implicit delegation of regulatory responsibilities from the leading states, which remain ready in a moment of crisis to seize back the authority they had ceded. [40] For instance, Louis Pauly argues that national authorities deliberately "obfuscate their final authority in financial markets" in order to render opaque their political responsibility."[41]

From the perspective of these works, a primary determinant of the division of regulatory responsibilities between private market actors and public regulatory agencies remain the different states' relative leverage and preferences for international financial regulatory policies.

Numerous works that have built upon the realist tradition of international political economy have explained the shape of international regulatory regimes in terms of the preferences of countries that dominate international regulatory negotiations.[42] According to this literature, the primary determinant of the leverage that states are able to exercise on the international agenda is the "market power" they derive from the size of their domestic markets. The literature has highlighted how countries with the largest domestic markets are able to secure compliance from other countries for their preferred regulatory

[40] Pauly 2003.
[41] Pauly 2003.
[42] Gruber 2000; Krasner 1991.

approaches by explicitly threatening to close their markets to foreign firms.[43] Larger states also threaten to forestall more ambitious international agreements by simply not participating to these international regulatory initiatives, what Wood calls "spoiling behaviour."[44] Moreover, unilateral regulatory initiatives in hegemonic countries have been described as having international implications because they strengthen other countries' incentives to match these regulatory policies through the unleashing of competitive pressures that change the balance of interests within other countries.[45]

Building on this notion of power as "market power", most analysis of the international financial arena have identified the US as the "hegemon" shaping the patterns of change in the financial regulatory regime. These studies have detailed their capacity to promote the strengthening of international financial regulation in those areas where it benefited most its interests, such as the Basel I negotiations, while hindering progress in areas posing fewer negative externalities, such as securities market regulation.[46]

This is also the true in the regulation of the three markets and institutions analysed in this work. The US is the home of a greater concentration of derivative dealers than in any other country,[47] of more than two thirds of the global hedge fund management industry,[48] and of the two rating agencies that dominate the international market for ratings.[49] The size of the American financial industry has granted US policymakers a unique influence over the evolution of the international regulatory regimes governing these markets. Indeed, the cases analysed in this study will reveal how the endorsement of market-based solutions from international regulatory bodies such as IOSCO (in the case of derivatives and rating agencies) and the FSF (in the case of hedge funds) frequently built directly upon the approach endorsed domestically by US regulatory authorities. Moreover, the lack of support by US authorities during this period for more heavy-handed forms of regulation coming in particular from Continental European and East Asian regulatory authorities, particularly in the case of hedge funds, has effectively allowed US authorities to forestall the emergence of stringent international agreements to regulate these markets and institutions by effectively acting as a veto player.

[43] Simmons 2001.
[44] Wood 2005, p.163.
[45] Helleiner 1994.
[46] Simmons 2001.
[47] Emm & Gay 2005. However Sally Davies argues that "over half (and as much as three-fourths) of U.S. dealers' exposure from derivatives is exposure to foreign residents". See Davies 2009.
[48] Woll 2011.
[49] While S&P and Moody's are headquartered in the US and controlled by US companies, Fitch is controlled by the company based in France FIMALAC and is dual-headquartered in New York and London.

The global financial crisis has been described as accelerating what many perceive to be a power shift in global finance away from the US. Not only has the crisis damaged American "market power" deriving from the predominance of US financial firms, but, more significantly, has damaged American "soft power" stemming from New York's reputation as a financial center and has undermined the credibility of several pillars of the Anglo-American financial regulatory model.[50] At the same time, the crisis has bolstered international activism from policymakers, such as those European countries that had in the past criticized market-based regulatory solutions.

In the years before the crisis, different authors have argued that the combined financial space of European countries and increased institutional capacity at the EU level would allow the EU to increasingly challenge US dominance in international regulatory politics. According to Posner, the US hegemony in international financial regulation had been replaced by a "Euro-American regulatory condominium" in financial politics.[51] Along the same lines, Drezner has argued that changes in the international regulatory agenda required the combined agreement of the US and the EU.[52] During the crisis, leaders of Continental European countries such as the French President Sarkozy and the German Chancellor Merkel have openly criticized the support for self-regulation that had emerged before the crisis and publicly stated that Europe would not hesitate to act unilaterally if the US and other countries did not commit to implementing stringent reforms.[53]

However, the empirical analysis of the regulation of OTC derivatives, hedge funds, and rating agencies does not provide support to the notion that the shift away from the market-based approach of these markets derives from a decline in the leverage of the countries that championed this approach before the crisis. As Helleiner argued, it was first and foremost US regulatory authorities that led the way in reasserting public control over the regulation of derivatives, while Europe clearly lagged behind.[54] In the case of rating agencies, Europe clearly promoted an international agreement over mandatory registration of rating agencies but did not meet any resistance from the US on this since rating agencies had been facing this kind of requirement in the US since 2006. In the case of hedge funds, Continental European countries effectively pushed the inclusion of the regulation of these institutions into the international agenda. However, the wording

[50] For a review of this argument, see Helleiner & Pagliari 2011.
[51] Posner 2009.
[52] Drezner 2007; Posner 2009.
[53] Willard & Murphy 2009.
[54] Helleiner 2010.

adopted by international institutions did not go beyond what already agreed domestically by US authorities who had independently come to endorse the extension of public regulatory oversight. As Fioretos argues, the acceptance of direct regulation of the hedge fund industry by the US authorities is particularly puzzling from the perspective of market-power theories given the US hedge fund industry's growth over the years.[55] According to Fioretos, "since the relative market power of the four countries most directly involved in international negotiations over hedge fund regulation – the United States, Britain, Germany and France – were more or less constant during the late 1990s and the 2000s, if not increasingly in favor of the former two that had long opposed regulation, market power is not a variable that can fully capture why the nature of international agreements evolved so significantly in the decade after the Asia financial crisis of 1997".[56]

This does not imply that the relative influence of different countries highlighted by realist scholars is not a crucial characteristic of international financial regulatory agreements. On the contrary, the evidence presented in this study provides strong empirical support to the notion that the most powerful state's preferences are the main driver of the shift in the international agenda. This conclusion is derived from the policies agreed upon within the G20 and other international bodies. Their position regarding how to allocate regulatory functions between public and private actors has consistently represented the least common denominator between the policy approach previously agreed on independently at the domestic level by US and EU authorities. For instance, the endorsement for the mandatory registration of rating agencies and hedge fund managers and for the mandatory central clearing of derivatives by the FSB and IOSCO followed, rather than preceded, the endorsement of these measures at the domestic level in Europe and in the US.

In other words, the public-private divide in the international regulation of derivatives, hedge funds, and rating agencies is still determined by what Posner calls the "Euro-American Regulatory Condominium."[57] The shift in the public-private divide triggered by the crisis is best described not of as change in the balance of influence among different countries, but rather as the product of a change in the preferences of those countries that continue to dominate the international policymaking process.

[55] Fioretos 2010.
[56] Fioretos 2010, p. 698.
[57] Posner 2009.

At the same time, this shift in the preferences cannot be easily by those realist analyses focusing uniquely on the relative distribution of market power among countries. The preferences brought to the international level from different countries during the crisis does not conform with what we could expect by deriving them from where different countries stand on the global hierarchy of financial powers. From this systemic perspective, we would expect those countries whose firms dominate the world markets to have an incentive to narrow down stringent international regulatory agreements that could pose a significant burden on their domestic firms and undermined their competitive advantage. However, as discussed above, the crisis has been followed by a shift in the position of the US which has come to champion an international agreement to directly regulate derivatives markets. This occurred despite the major costs of this solution would have been bore from US-based derivatives dealers. Similarly, by looking at relative market power, we would expect countries that are significantly exposed to foreign financial firms to support more stringent forms of regulation over self-regulatory solutions in order to avoid granting authority for regulating their markets to firms located in foreign country. However the analysis in this study reveals how in the years before the crisis Europe has decided not to follow the US in directly regulating rating agencies despite the dominance of US agencies within European securities markets. More generally, realist theories analyzing the relative distribution of market power cannot easily explain the reversal in the position of US and Europe during the crisis as this event has not triggered a radical shift in relative market power.

2.4 Varieties of Capitalism

When faced with the problem of explaining the origin and changes in state preferences, most state-centric analyses have complemented the realist focus on market power with the analysis of domestic politics. For instance, one of the most prominent authors in realist IPE literature, Robert Gilpin, has acknowledged that ‘it has become increasingly clear that the role of domestic economies and the differences among these economies has become a significant determinant of international economic affairs’.[58]

Furthermore, Drezner’s prominent realist interpretation of global governance has turned towards the domestic level in order to derive the origin of preferences. According to Drezner, states will pursue international arrangements that correspond as closely as

[58] Gilpin 2001, p. 148. Cited by Fioretos 2010.

possible to their preexisting national regulatory framework to limit adjustment costs.[59] When trying to explain variations in country preferences, Drezner argues that national institutional arrangements will vary significantly from country to country depending on their different levels of "national economic development."[60] For instance, Drezner illustrates how the main divide over the design of a "new international regulatory architecture" that followed the East Asian financial crisis of 1997-98 ran between industrialized economies and developing countries, with the developing countries calling for more stringent regulation of international capital flows.[61] However, Drezner notes how state preferences can also diverge across countries with similar levels of development due to differences in the "national economic histories and the embedded institutional structures that determine and are determined by these histories".[62]

In particular, Drezner builds upon the concept first introduced by Peter Hall and David Soskice of "varieties of capitalism."[63] These authors identified key differences in the interaction of firms and the way in which they resolved their coordination problems across two ideal types of national economic systems: liberal market economies and coordinated market economies. In the first group of countries, firms coordinated their activities primarily via "hierarchies and competitive market arrangements," while most market relationships remained at arm's-length. On the contrary, in coordinated market economies, "firms depend[ed] more heavily on non-market relationships to coordinate their endeavors with other actors."[64] These differences characterize a number of aspects of the national economy such as the market for corporate governance, the internal structure of firms, the system of industrial relations, the relationship between employers and trade unions, the system of setting wages, the education and training systems, as well as inter-company relations. For Hall and Soskice, the US and Germany represented the most typical instance of respectively liberal market economy and coordinated market economies. According to Drezner, these differences in the national economic models will also inform the preferences of different countries over international economic issues. For instance, Drezner argues that the European Union's position promoting environmental

[59] Drezner 2007.
[60] Drezner 2007, p.40
[61] Drezner 2007, p.40
[62] Drezner 2007, p.40.
[63] Hall & Soskice 2001
[64] Hall & Soskice 2001, p. 8.

and social regulation reflects the coordinated market institutions that characterize Continental European countries.[65]

While according to Drezner the respective varieties of capitalism can explain the broader attitude of governments towards global economic governance issues, a number of scholars have in recent years applied the built upon the insights of the “Varieties of Capitalism” literature to explain conflict in the development of international financial rules. As Hall and Soskice had acknowledged in their work, the role of the financial system and its impact on the market for corporate governance represents one of the key elements that differentiated liberal market economies and coordinated market economies. Since their pioneering work, other authors have highlighted the key differences in the structure, as well as the economic and social role of finance in different varieties of capitalism.[66] While capital markets play a key role in allocating resources in liberal market economies, they have remained a relatively small part of coordinated-market economies’ financial systems. In coordinated market-economies, bank funding has remained the primary source of capital and the centrality of banks in these markets is also heightened by the tight connections and shareholdings between banks and large manufacturing firms.

Different authors have argued that these characteristics also explain these countries’ preferences for how international regulatory policies should allocate regulatory responsibilities between governments and markets. More specifically, liberal market-economies are described as more likely to favor market-based regulatory mechanisms and the inclusion of market-based measures of value and risk in regulation.

Fioretos has presented a more refined version of this argument, exploring the impact that the institutional context had in shaping the patterns of interest group preferences and mobilization. According to Fioretos, the centrality of securities markets in the US and UK national financial systems has led to the emergence of broad coalitions within the financial sector supporting a deregulated financial system at home.[67] The same kind of coalition has not emerged in coordinated market economies like Germany’s. Instead, in these countries banks and manufacturing firms have often perceived the rise of capital

[65] Drezner 2007, p. 42.
[66] Allen & Gale 2001; Fioretos 2010.
[67] Fioretos 2010.

markets as a threat to the position and to the model designed to encourage long-term financing for the manufacturing sector.[68]

In line with this literature's insights, several studies have used the different role that the financial sector plays in their respective varieties of capitalism and the resulting patterns of interest groups mobilization to explain numerous disagreements that informed the pre-crisis international regulatory agenda. For instance, the US and Germany have over these years clashed on a number of issues such as the inclusion of credit rating agencies within the Basel II negotiations,[69] the regulation of hedge funds,[70] and the adoption of fair value accounting versus historical cost accounting.[71] From the perspective of these authors the primary source of the reliance on market-based measures in the years before the crisis can be found in the dominance of liberal market-economies such as the US and UK.

But how can these theoretical approaches explain the international evolution in the governance of OTC derivatives, rating agencies, and hedge funds analysed in this study? First of all, these studies are important to acknowledge how the main divide over the regulation of these sectors has not been running along the Atlantic but rather cutting across Europe. As Fioretos argues, "unlike Drezner's theory of international market regulation which predicts that the primary cleavage in global negotiations over hedge funds would be one between the US and the EU, a theory of state preferences anchored in historical institutionalism expects that there will be a cleavage between liberal and coordinated market economies within the EU and that such a cleavage will persist in global regulatory negotiations".[72]

The existing literature as well as the cases below reveal how this unity has often failed to emerge in the period before the crisis, when in different circumstances British authorities have opposed the calls for more stringent regulatory measures by Continental European countries. The informal practice within the European Council of deciding by consensus on international regulatory issues ensured that the British government had a veto also the regulation of OTC derivatives, hedge funds, and rating agencies also at the European level, thus preventing the European Union to act as a unitary actor and exercising its potential joint market power vis-à-vis the US.[73] Instead, British authorities

[68] Fioretos 2010.
[69] Baker 2006; Wood 2005.
[70] Baker 2006; Fioretos 2010; Robotti 2006; Zimmermann 2009.
[71] Perry & Nolke 2006.
[72] Fioretos 2010, p. 705.
[73] Fioretos 2010.

have in areas such as the regulation of hedge funds formed a common front with their US counterparts in international regulatory negotiations. Besides the deployment of market power, the greater familiarity and expertise with these markets has made it possible for British and American regulators to occupy central positions in the drafting of international regulatory initiatives over this period.[74]

However, this approach faces greater difficulties in shedding light over the shift in international approach away from market-based regulation and towards more direct regulation set in motion by the crisis. As argued in the previous section, this cannot be regarded as the product of a decrease in the relative influence of liberal-market economies in setting the international stage.

Unlike the realist approaches based on market-power, historical institutionalists theories are better equipped to explain the shift in the preferences of countries. As Fioretos argues in his study, country preferences regarding regulatory issues are not static. On the contrary, they evolve gradually overtime along the evolution in their respective models of capitalism and the constellation of interests that relies on the continuation of this specific set of institutions in order to sustain their competitive advantages.

However, historical institutionalist explanations present this change as occurring gradually and in an incremental fashion. The fact that the institutional context is regarded by historical institutionalists as "analytically prior to material interests"[75] of different economic groups, which as a result are descrived by historical institutionalists as consistent also after a major crisis.[76] This "thick" institutional context creates "positive feedback effects that push economic groups to actively support incremental processes of change over radical reforms and thus to contribute to significant continuity in diverse forms of governance".[77] From this perspective, the impact of crises such as the global financial crisis of 2007-2010 is not to transform the preferences of major economic groups but rather to "transform the ability of long-standing advocates of reform to have their agendas more broadly accepted".[78]

For instance, Fioretos explains the shift from market-based regulation to direct regulation of hedge funds as the product of a slow and incremental realignment in the US national

[74] Robotti 2006. For instance, Howard Davies, Chairman of the Financial Services Authority (FSA), was appointed as the chairman of the Working Group created by the FSF to present recommendations on the regulation of hedge funds. The IOSCO Task Force on Credit Rating Agencies that drafted the 2003 Principles was chaired by Roel Campos, Commissioner from the US Securities and Exchange Commission.
[75] Fioretos 2010, p. 699.
[76] Streeck & Thelen 2005
[77] Fioretos 2010 p. 699. See also Streeck & Thelen 2005.
[78] Fioretos 2010 p. 719.

model of capitalism over more than a decade. However, this interpretation faces two important limitations when it comes to explaining the shift in the international agenda triggered by the crisis.

The first is the timing and extent of this shift. As argued above, the initial international regulatory response to the crisis from the major international regulatory institutions has built upon the pre-existing market-based regulatory models and adjusted them in an incremental fashion as predicted by historical institutionalist scholars. However these works cannot easily explain the sudden turn towards the endorsement of direct direct regulation that occurred in a relative short time from the last quarter of 2008. The pace of this significant change is not well suited to the focus on incremental adjustments that characterized analysis of national models of capitalisms. Moreover, a similar shift in the US approach from market-based regulation to direct regulation has not been limited to the case of hedge funds as described by Fioretos. In reality, the fact that it has extended to other areas such as derivatives suggests a common cause. This insight is supported by the fact that during the same period an analogue shift involved the position of some European countries towards the regulation of these sectors, as well as the regulation of rating agencies.

Secondly, when we compare the expressed preferences of authorities from the US and European countries for regulating these three sectors, they do not fit well with the notion of liberal market-economies consistently promoting more market-based approaches. For instance, European policymakers supported a self-regulatory approach towards the regulation of rating agencies in the years before the crisis even after US authorities had adopted direct regulation of the sector. Similarly, US authorities have promoted a more stringent and extensive regulation of OTC derivatives during the crisis. In a nutshell, elements different from the respective models of capitalism seems to have informed the preferences of US and EU authorities towards the regulation of financial markets over the period analyzed in this study.

2.5 Pluralist Explanations

Another popular interpretation of the greater emphasis on market-based forms of regulation in the governance of international financial markets before the crisis is the preferences of financial industry groups and in their capacity to “capture” the transnational regulatory process. While the historical institutionalist analyses reviewed above regarded the institutional context as analytically prior to the preferences of interest groups, pluralist interpretations have used the preferences of the financial industry groups and other interest groups as seeking to maximize their economic utility and regarded domestic institutions as shaped by these groups.

In recent years, several studies have sought to explain evolutions in the global regulatory regime by analyzing the struggle among competing societal actors seeking to influence the content of global regulatory arrangements.[79] Other areas of financial policymaking such as exchange rate policy[80] or monetary integration[81] have focused on a variety of societal actors competing to shape international public policies. However, most analyses of the politics of international financial regulation have argued that the complexity of financial regulatory policies and their more indirect and less obvious costs and benefits significantly restrict the range of domestic societal actors engaged in policy debates about international financial regulation. The only societal actors that consistently take an active interest in international financial regulatory debates are financial market participants directly targeted by the regulation for whom the distributional consequences of international regulations are more immediate.

The predominance of financial industry groups is bolstered by the resources that these groups can deploy for lobbying or for financing electoral campaigns.[82] Other authors have highlighted how the influence of financial industry groups is further bolstered by the nature of the institutional context in which regulatory policies are developed – and in particular the so-called ‘revolving doors’ phenomenon,[83] as well as the same structure of contemporary capitalistic economies[84]. Different authors have borrowed the concept of “regulatory capture” from “public choice theory” to describe the privileged position that financial industry groups occupy in the development of financial regulation.[85]

Indeed, while most arguments regarding the capacity of the financial industry to capture regulation have been developed to explain the development of regulatory policies at the domestic level,[86] different IPE authors have extended this concept to the international arena, and have in some cases talked about “transnational regulatory capture.” For

[79] Milner 1997.
[80] Frieden 1991; Henning 1994.
[81] Frieden 2002.
[82] Braun & Raddatz 2009; Singer 2007; Johnson & Kwak 2010.
[83] Bhagwati 1998; Bhagwati 2008; Johnson 2009.
[84] Andrews 1994; Gill & Law 1989; Underhill & Zhang 2003; Underhill & Zhang 2008.
[85] See Stigler 1971; Laffont & Tirole 1991; Peltzman 1976; Dal Bó 2006.
[86] For applications of the theory of regulatory capture to financial regulatory policy see Hardy 2006; Heinemann & Schüler 2002; Kane 1981; Woodward 2001.

some authors, these sources of influence have traditionally been described as permitting the financial industry to shape the content of international regulatory initiatives only indirectly, that is, by shaping the position of national regulatory authorities on international issues, in a sort of two-level game (this view will be reviewed more extensively in the next chapter).[87] However, a number of IPE scholars have argued that the financial industry has increased its capacity to *directly* shape the international regulatory regime by directly interacting with transnational regulatory bodies.[88] In particular, different analyses of the making of the Basel II agreement have focused on the interaction between banking groups and members of the committee, and the capacity of the former to systematically shape the policies of the latter. In a recent incarnation of this argument, Lall argued that "large international banks, were able to systemically manipulate the provisions of Basel II and Basel III to their advantage, extracting rents and maximizing profits at the expense of other stakeholders."[89] Moreover, rather than promoting the interest of the banking industry from a specific country, Lall and others have argued that the Basel II agreement promoted "the interests not of particular countries on the Basel Committee, but of large international banks *regardless* of their national origin"[90]

Different factors allow the financial industry to shape the agenda and regulatory measures introduced by international regulatory institutions. Tony Porter analyzed a change in the organizational patterns of the financial industry. Besides the increased engagement of national financial industry associations with international regulatory issues, a few transnational private financial associations with a truly global membership have emerged.[91] This trend is particularly visible in the evolution of banking industry mobilization for shaping international rules. During the negotiations that led to the 1988 Basel Agreement banks exercised an "indirect" influence over the agreement by lobbying their domestic regulators. In the case of 2004 Basel II agreement, the largest internationally-oriented banks began to present their views collectively at the transnational level through the Institute of International Finance (IIF), an industry association representing the world's largest international financial institutions.[92] Mugge

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[87] Oatley & Nabors 1998; Singer 2004.
[88] Mattli & Woods 2009b; Underhill & Zhang 2008; Lall 2011. For a critical take, see Young 2012.
[89] Lall 2011.
[90] Lall 2011; Claessens, Underhill, & Zhang 2008.
[91] Graz & Nolke 2008a; Mügge 2006a; Porter 2005b.
[92] Tarullo 2008; Tsingou 2008; Claessens, Underhill and Zhang 2008.

argues that a similar transformation has also occurred at the European level, where the larger internationally oriented firms have created pan-EU trade associations.[93]

The emergence of industry associations with international reach has enhanced the influence of financial industry groups from different countries to tame international competitive struggles. These groups are also able to directly interact with international regulatory institutions and to take advantage of the consultation processes launched in recent years by international financial regulatory bodies in order to reach out to different to different stakeholders. Different works have argued that the same informal and opaque nature of the institutional context within which regulators and financial industry groups interacts at the at the international level enhances financial industry group's capacity to capture the policymaking process.[94]

Going beyond the formal institutional context, other authors have drawn from the literature on policy networks[95] to analyze the personal interactions and connections between members of international regulatory bodies and international financial groups. According to Lall, this web of personal relationships has granted the financial industry groups a crucial "first-mover advantage," allowing financial industry groups to influence the work of international regulatory institutions at the earliest stage of the regulatory process, before other groups are able to mobilize.[96] From a more sociological perspective, Tsingou notices that the government officials and financial industry that dominate the transnational governance of financial markets are mostly educated in an Anglo-American context, have experience in both the public and private sector, interact regularly both in formalized and informal settings, and share similar beliefs and common goals.[97] Authors coming from very different theoretical perspectives have therefore argued that the close relationship between regulators and financial industry participants in the making of international financial rules justified abandoning "sterile" distinctions between 'public' and 'private' actors and seeing these actors as part of the same "transnational policy community" as Tsingou put it. Others, like historical materialist

[93] Mügge 2006b.
[94] As Young summarizes this view, in "the contextual setting in which Basel II construction proceeded … not only did regulators and bankers both work within the same 'intellectual bubble', but the BCBS conducted closed meetings with transnationally organized private sector groups, away from the press or non-governmental organization (NGO) participants, in an exclusive and non-transparent setting". Young 2012. See also Mattli & Woods 2009b. Different accounts of Basel II have stressed how while banking industry groups were the most effective in communicating their views to the Basel Committee, while non-financial groups have been described as absent from the consultative process. See Tsingou 2008; Helleiner & Porter 2010.
[95] Thatcher 1998.
[96] Lall 2011.
[97] Tsingou 2004.

scholars, describe the relationships as expressions of the same transnational class that represents the political organization of transnational capitalism.[98]

Moreover, besides infusing international regulatory bodies' agendas with their preferences, other authors have highlighted a second mechanism through which financial industry groups are capable of directly influencing the public-private divide, that is, by acting as "rule-makers." The development of voluntary codes of "best practices," "industry guidelines," and other self-regulatory measures have enhanced financial industry groups' capacity to directly shift the public-private divide by altering the international regulatory status quo and demonstrating to regulators the industry's capacity to police itself.[99] For this reason, Fuchs describes the capacity to self-regulate as a form of "structural power" in the hands of business groups.[100]

In sum, from the perspective of the "regulatory capture" thesis, the capacity of financial groups to influence the agenda of international regulatory institutions by lobbying at the national and international level and to alter the status quo by means of implementing self-regulatory measures represent the central determinant of the public-private divide in the governance of international financial markets. Indeed, this perspective is particularly appealing to explain the turn towards greater reliance on market-based measures that characterized the period before the crisis. In fact, in principle financial firms want to minimize the interference of public regulatory authorities over their activities and are ready to lobby in favor of market-based forms of regulation that impose minor costs upon their activities and give them greater flexibility.

The case studies analyzed in this study provide strong empirical support for this view by revealing how derivative dealers from groups such as the International Swaps and Derivatives Associations (ISDA), hedge funds groups such as the Managed Funds Association (MFA) and Alternative Investment Management Associations (AIMA), and rating agencies lobbied extensively in the period preceding the crisis to keep the regulation of OTC derivatives, hedge funds, and rating agencies outside of the scrutiny of public authorities, and bolstered these demands by introducing different self-regulatory measures.[101]

While the lobbying of financial industry groups at the national and the transnational level in support of market-based measures and their capacity to bolster their lobbying with

[98] Gill 1990; van der Pijl 1998; van Apeldoorn 2002; Graz 2003.
[99] Lake and Khaler p.427; Haufler 2001.
[100] Fuchs 2007.
[101] See also Johnson & Kwak 2010; Robotti 2007; Tett 2009.

self-regulatory measures provide an important explanation of the pre-crisis pattern of delegating regulatory functions to the private-sector, how can the theoretical approach explain the significant shift along the public-private divide triggered by the financial crisis?

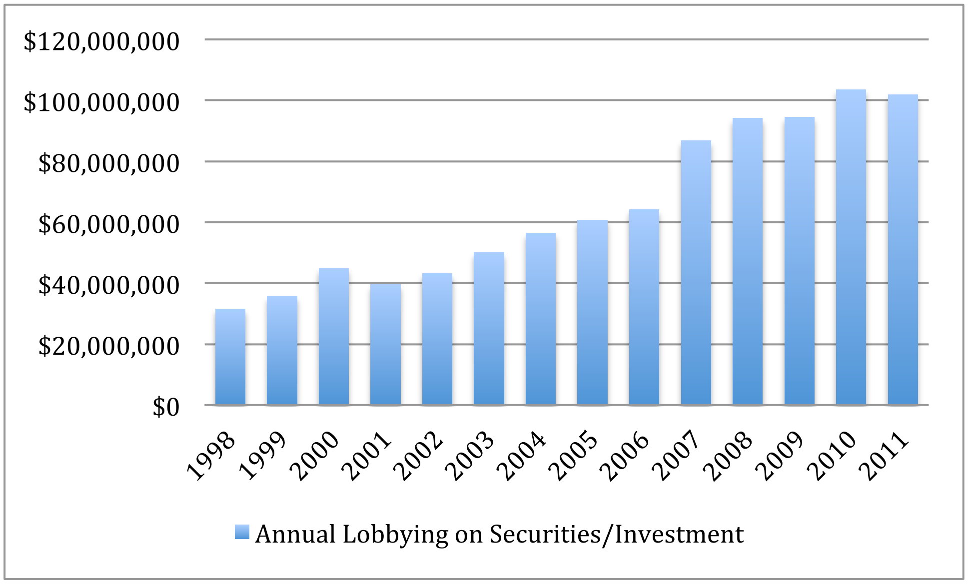
This outcome is puzzling for regulatory capture theories. The large majority of the authors discussed above have described the financial industry as akin to a dominant class, "power elite",[102] or an "oligarchy"[103] whose dominance is not likely to be challenged by other groups at the domestic or transnational level. These authors therefore discounted the possibility that regulators might openly challenge their preferences. Some authors that explored the regulatory response to the crisis have argued that this position has not been undermined and that financial industry groups have continued to play a key role in limiting the extent of the regulatory response to the crisis.[104]

However, the empirical evidence presented in this study reveals how the beefed up lobbying efforts of derivative dealers groups, rating agencies, hedge fund associations were not sufficient to prevent the international regulatory institutions' endorsement of measures to bring these markets and institutions under direct regulatory oversight, an approach that these industry groups had opposed before the crisis.

One potential explanation would point towards the weakening in the resources financial industry associations deployed towards lobbying policymakers as the crisis has weakened the position of their member firms. However, the data does not support this case. The data collected by the Centre for Responsive Politics reveals how the crisis significantly increased resources directed towards lobbying Congress on securities and investment issues, with financial institutions representing the major contributors.

Figure 1 - Lobbying on "Securities/Investment" per year - US Congress[105]

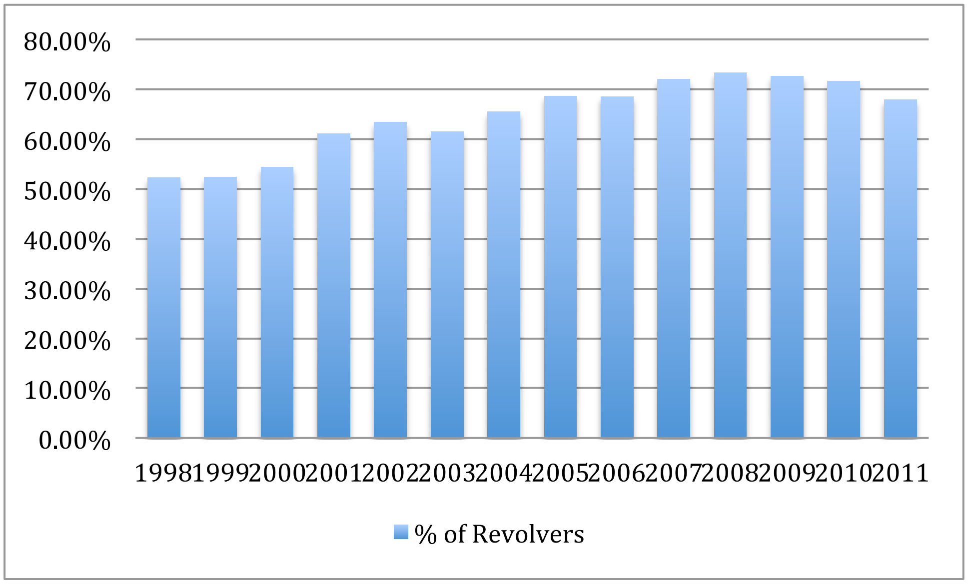
[102] Bhagwati 1998.
[103] Johnson 2009.
[104] Tsingou 2009; Johnson 2011; Johnson & Kwak 2010; Lall 2011.
[105] Author's elaboration on data available from the Centre for Responsive Politics: http://www.opensecrets.org/



In 2010, the International Derivatives and Swaps Association mobilized $2,406,000, an amount eight times greater than the resources employed to lobby Congress in 1998 at the time the Congress decided to exempt derivatives from the overview of federal regulatory agencies.[106] US rating agencies spent almost $2.7 million on lobbying in the first 9 months of 2009 alone.[107] The crisis does not seem to have forestalled another key resource in the hands of financial firms, that is the revolving doors between regulators and financial industry.[108]

Figure 2 – Revolving doors in Lobbying US Congress on Securities/Investment

[106] Author's elaboration on data available from the Centre for Responsive Politics: http://www.opensecrets.org/lobby/clientsum.php?id=D000052310&year=1998
[107] Protess & Sebert 2010
[108] Author's elaboration on data from the Centre for Responsive Politics: http://www.opensecrets.org/



For instance, the main hedge fund associations have boosted their lobbying efforts hiring senior public officials, central bankers, and Congressmen, such Portuguese central banker Antonio Borges, who became the head of the HFSB, and the Congressman Richard Baker, who became at the beginning of 2008 the new head of the MFA. The former chairman of the SEC Harvey Pitt and former Commissioner Roel Campos became directors at a major US hedge fund.[109] Two former member of Congress (Sen. Lauch Faircloth and Rep. Vic Fazio) have joined the ranks of rating agencies to lobby regulators and Congress during the crisis.[110]

Another factor identified by regulatory capture theorists as potentially limiting the capacity of financial industry groups to keep their regulation outside of the public umbrella is the presence of intra-industry conflict. Mugge has argued that in those cases where different regulatory solutions along the public-private divide impose asymmetrical costs upon different firms, groups disadvantaged by the existing transnational private regulation may call on public authorities, thus leading to a move away from self-regulation towards more direct state regulatory oversight.[111] Helleiner in his analysis of derivatives regulation has argued that the support for market-based regulation that had informed the position of derivative dealers was challenged during the crisis by institutional investors as well as by exchanges.[112] Disagreements between managers

[109] Brush 2009.
[110] Protess & Sebert 2010.
[111] Mügge 2006a. See also Levy & Prakash 2003; Porter & Ronit 2006.
[112] Helleiner 2010.

and investors and between rating agencies and investors have also characterized the debate over the regulation of hedge funds and rating agencies before and throughout the crisis.

However, as Helleiner also notes, this resurgence of intra-firm struggles has not undermined the capacity of derivative dealers, rating agencies, and hedge funds to design self-regulatory policies required by the international regulatory community. As argued above, the same international regulatory community has in different circumstances acknowledged the success of these self-regulatory initiatives in meeting the requests advanced by the international regulatory community at the outset of the crisis.[113]

Finally, an alternative explanation of the weakened influence of the financial industry groups in shaping the regulatory reforms introduced after the crisis points towards the emergence of countervailing coalitions from outside the financial industry groups. Indeed Mattli and Woods have argued that crises produce a 'demonstration effect' which revealed the distributional implications of poor regulation and its political stakes, making it more likely that a broader segment of interest groups besides the financial industry will mobilize.[114] In fact, the work of Helleiner and Clapp on the regulation of commodity derivatives,[115] and the survey of the responses to financial regulatory consultations in the US, Europe and at the international level conducted by Pagliari and Young reveals that the regulatory response to the crisis has triggered a greater mobilization interest groups from outside the financial industry.

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[113] Senior Supervisors Group 2009; IOSCO 2009e.
[114] Mattli & Woods 2009a.
[115] Clapp & Helleiner 2012.

Table 6 - Percentage of Respondents to Financial Sector Consultations[116]

Respondent	*Pre-Crisis*	*Post-Crisis*	*% Difference*
Trade Unions	0.31	2.02	+548
Consumer Protection	1.48	1.00	-32.41
Research Institutions	4.40	3.29	-25.07
NGOs	2.26	8.77	+288.73
Financial Groups	75.14	60.28	- 19.78
Non-Fin. Business Groups	16.42	24.22	+ 47.5

However, as the case studies will discuss in more detail, this mobilization of non-financial groups has not necessarily constituted a countervailing force to the preference of financial industry groups for the continuation of the self-regulatory approach. On the contrary, the vast majority of non-financial business groups and financial groups beyond dealers, rating agencies, and hedge funds that have responded to the regulatory consultations launched by the European Commission or participated to Congressional hearings has opposed the introduction of measures to directly regulate hedge funds and rating agencies in Europe.

In order to explain this variation in the capacity of financial industry groups to insert their preferences into the international regulatory agenda, the findings in this study will challenge a central assumption of the "regulatory capture" literature. Most analyses falling under this rubric maintain that the capacity of financial industry groups to shape regulatory policies remains determined primarily by factors endogenous to the financial sector or to the broader configuration of interest groups, such as the preferences of different groups, the resources they can deploy in the policymaking process, and the depth of intra-industry struggles. These works assume that regulators or public authorities will systematically respond to the requests of the most powerful groups. On the contrary, the analysis developed in the case studies will highlight how the crisis has significantly altered the receptiveness of regulators and elected politicians to the preferences of the financial industry. This element is important to explain how the

116 Pagliari & Young 2012b. For a list of the consultations coded see Pagliari & Young 2012a.

capacity of derivative dealers, rating agencies, and hedge funds groups to secure their preferences has weakened despite the fact that they have increased the resources deployed in the policymaking process and formed alliances with a broader range of interest groups within and outside the financial sector. While the empirical evidence presented in this study does not question the general point made by regulatory capture theories regarding the extraordinary influence of financial industry groups in the design of regulatory policies, at the same time it calls for a more contingent conceptualization of the capacity of the financial groups to "capture" the policymaking process, based on the incentives policymakers face.

2.6 Constructivist Explanations

Constructivist literature provides a fifth and final explanation for the change of in the public-private divide. From a constructivist perspective, the division of regulatory responsibilities among public regulators and private market actors is influenced by the dominant ideas among policymakers regarding the desirability of market mechanisms vis-à-vis the public intervention in the regulation of financial markets.

This set of beliefs has varied across time with the changes in the prevalent ideological paradigm. For instance, while the rise of Keynesianism provided a justification for a more active involvement of state actors in the management of the economy, the ascent of neoliberalism as a political doctrine since the 1970s created an intellectual climate favorable to a governmental retreat from activities that were described as handled more efficiently by private market actors.[117] Constructivist authors have analyzed how this intellectual sea change affected the attitudes of governments and international organization towards the governance of international financial markets, focusing in particular on the issue of capital account liberalization.[118]

Ideas are also an important driver of change in international prudential financial regulation. For instance, Walter and Foot have theorized the emergence of a new norm in global financial regulation beginning in the 1990s. Besides promoting financial stability and reducing competitive inequalities among nations, a third emerging core norm in the international agenda was that financial stability could be best pursued through increasing reliance on market-based regulation, both within individual financial institutions and in

[117] Blyth 2002; Graz & Nolke 2008a.
[118] Abdelal 2007; Chwieroth 2009.

the overall financial markets. [119]

The intellectual bedrock for this ideational shift in the approach to the regulation of financial markets was represented by the idea that market participants were generally rational in their assessments, so that prices would tend towards a rational equilibrium.[120] This assumption also had significant implications for the regulatory approach, creating a strong rationale for regulators to seek to leverage market forces in regulating and overseeing complex financial products and activities. As the Turner Review presented by the UK Financial Services Authority during the crisis stated, from the notion that markets were efficient and rational derived the assumption that "the risk characteristics of financial markets can be inferred from mathematical analysis, delivering robust quantitative measures of trading risk."[121] Regulators could have therefore enhanced financial stability by replacing rigid output requirements with measures allowing financial institutions to take advantage of financial institutions' increasingly sophisticated methods of modeling, monitoring and managing risks.[122]

Moreover, the same assumption of market efficiency and rationality also fueled the belief that, provided with the proper information and incentives, private counterparties would penalize a financial institution taking excessive risks without the need for the intervention of supervisors by, for instance, influencing the cost of funding its activities or by varying the volume of business undertaken with that financial institution.[123] This discipline imposed by market forces was described as "forward-looking and inherently flexible and adaptive … continuous, impersonal and non-bureaucratic," in contrast with the discipline imposed by regulators described as "rule-based, episodic, bureaucratic and slow to change."[124] Regulators should have leveraged market discipline by creating an environment conducive for private counterparties to perform this monitoring and steering function. This objective could be achieved, for example, by prompting financial intermediaries to publicly reveal various types of information.[125] Moreover, since market prices were conceived as "good indicators of rationally evaluated economic value,"[126] different academics and regulators called for making use of this information conveyed by markets (e.g. securities prices, credit ratings, CDS spreads) to supplement traditional

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[119] Foot & Walter 2010.
[120] Fox 2009; FSA 2009b, p. 39.
[121] FSA 2009b, p. 39.
[122] Strulik 2006; Alexander et al. 2006; Dhumale 2000.
[123] Flannery 2001; FSA 2009b, p. 39.
[124] Herring 2004, p. 365.
[125] De Ceuster & Masschelein 2003; Flannery 2001; Kwast 1999; Rochet 2008; Hamalainen et al. 2005; Majone 1997; Rochet 2008.
[126] FSA 2009b, p. 39.

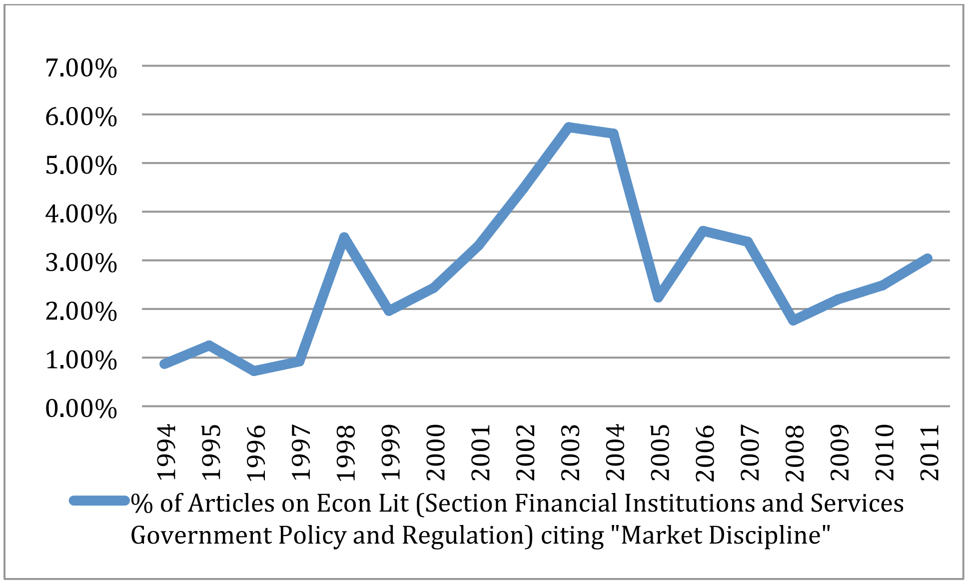
supervisory tools and identify financial firms' risk exposures, as well as for "hard-wiring" them into regulatory policies to replace standardized regulatory requirements.[127]

Most importantly, the assumption that financial markets are efficient and rational created a strong predisposition towards scaling back the use of the visible hand in correcting market failures. The direct intervention of regulators in the financial markets was seen as introducing a distortion in the functioning of markets by creating moral hazard, inducing market actors to reduce their due diligence and relax their risk-management standards, and stifling innovation. As the Turner review put it, from the efficient market hypothesis derived the notion that financial innovation was "by definition beneficial" and contributed to strengthening financial stability since "market competition would winnow out any innovations which did not deliver value added."[128] There would then be no need for regulators to judge and regulate innovative instruments, such as structured finance and credit derivatives, particularly in wholesale markets where customers were seen as "sophisticated" and therefore not in need of protection. On the contrary, as the Turner Review argued, the assumption that the financial markets are efficient and rational derived the notion that "a key goal of financial market regulation is to remove the impediments which might produce inefficient and illiquid markets."[129]

As the Figure 3 illustrates, since the mid-1990s, financial economics literature has devoted increasing attention to the importance of market discipline in financial regulation.

[127] For a review, see Flannery 1998, 2001.
[128] FSA 2009b, p. 39.
[129] FSA 2009b, p. 39.

Figure 3 - "Market Discipline" in the Literature on Financial Regulation[130]



However, debates about how financial markets could be leveraged in support of financial regulatory policies have not been confined to the academic community. Instead, Rochet has argued that the notion that market discipline could be used to assist supervisory authorities in their work became a “mantra” over this period within the financial regulatory community.[131]

Throughout the 1990s and early 2000s, the US Federal Reserve represented the most important advocate of market-based regulatory mechanisms, encouraging the incorporation of banks’ internal risk-assessment schemes into the Basel II agreement[132] and supporting market-based approaches for regulating hedge funds and OTC derivatives in the late 1990s.[133] Several authors have argued that the Federal Reserve’s support for market-based regulatory mechanisms was highly influenced by ideological considerations rather than simply being an example of capture. For instance, Tsingou has argued that the Federal Reserve “did not just accept self-regulation but believed in it.”[134] Similarly, Foot and Walter have argued that while the position of the US regulatory during the negotiations of the first Basel Accord was influenced by the need to reconcile

[130] Author’s calculations based data accessed from Econlit (online archive of economics literature).
[131] Rochet 2008 For an example, see Hamalainen et al. 2005; Caruana 2003; Greenspan 2001; Kwast 1999; Meyer 1999a.
[132] Tarullo 2008. See also Walter 2008.
[133] Greenspan 1998; Bernanke 2007; Greenspan 2005.
[134] Tsingou 2003.

the rising threats to the US bank competitiveness and financial sector stability,[135] Basel II was launched and negotiated during a period of continuing high bank profitability and stability, during which regulators did not respond to credible threats to their autonomy from the US Congress. According to Foot and Walter, the position of the Fed "was driven by a growing concern that the existing bank capital framework was ill-suited to the risks entailed by modern banking, and by an ideological presumption that market actors were better positioned than regulators to manage risk."[136]

Several authors have highlighted how Alan Greenspan's charismatic leadership influenced this position.[137] Greenspan, who headed of the Federal Reserve from 1987 to 2006, has been perceived as "much more ideologically predisposed towards market solutions than his predecessor Paul Volcker."[138] Consistent with his self-professed faith in free markets,[139] in several public speeches Greenspan highlighted his distrust for regulation and his beliefs in the capacity of financial markets to develop increasingly sophisticated methods to monitor and manage risks. For instance, Greenspan argued in 1997: "As we move into a new century, the market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective governments structures. This is a likely outcome since governments, by their nature, cannot adjust sufficiently quickly to a changing environment, which too often veers in unforeseen directions."[140] According to Greenspan, the support for greater reliance on self-regulation through internal bank controls and external monitoring by third-party creditors was also supported most Fed officials.[141] In fact, very similar positions have consistently been expressed by other senior members of the Federal Reserve such as Fed Vice Chair Donald Kohn,[142] Vice President of the Federal Reserve of Kansas City Thomas Hoenig,[143] Governor Laurance Meyer,[144] research staff,[145] even Ben Bernanke - Greenspan's successor at the helm of the Federal Reserve. Only a few months before the outbreak of the crisis in 2007, Bernanke gave a speech titled "Financial Regulation and the Invisible Hand" where he argued that leaving the burden of ensuring the safety of a bank uniquely in the hands of public authorities with no support from market forces

[135] Singer 2007.
[136] Foot & Walter 2010, p. 244.
[137] Johnson & Kwak 2010
[138] Foot & Walter 2010, p. 252; Johnson & Kwak 2010, p. 102.
[139] Greenspan 2007.
[140] Greenspan 1997; Greenspan 2001.
[141] Foot & Walter 2010, p. 235; Greenspan 2007.
[142] Kohn 2005.
[143] Hoenig 1996.
[144] Meyer 1999a.
[145] Board of Governors of the Federal Reserve System 2000.

would have been dangerous as regulators may lack the political will or financial resources complete their mission. Supplementing regulatory oversight and direct regulation with a substantial amount of market discipline could – according to Bernanke - support regulators in achieving their goals. Bernanke argued at the wake of the crisis that both in the case of commercial banks and in the case of hedge funds, "market-based regulation has proven an effective supplement to (or substitute for) conventional command-and-control approaches."[146]

This ideological bias towards the benefits of self-regulation in the years before the crisis has also been discovered ex-post in senior regulators from other regulatory institutions such as the UK FSA[147] and the US SEC. The chairman of the SEC Mary Schapiro argued in 2010: "everybody a few years ago got caught up in the idea that the markets are self-correcting and self-disciplined, and that the people in Wall Street will do a better job protecting the financial system that the regulators would. We do think the SEC go diverted by that philosophy."[148]

Beyond the influence in shaping the position of key policymakers, the changed ideological landscape also enhanced the trust placed in the expertise of the financial industry and increased its political legitimacy.[149] Different authors have theorized how the influence of corporate actors over the policymaking process also rests on the dominant beliefs on the superiority of the private sector way of operating.[150] Tsingou argues that with rare exceptions, policymakers in Western countries regarded business actors as having the right or obligation to voice their opinion on political issues and considered their opinions as valuable.[151]

In sum, from a constructivist perspective, the growing tendency in the period before the crisis to delegate regulatory functions to the private sector could be attributed to the emergence of a widespread normative consensus about the rationality and efficiency of markets, which strengthened the legitimacy of market-based mechanisms while delegitimizing more intrusive forms of regulatory intervention.

However, how can we use this perspective to explain the significant reassertion of public control over the regulation of activities that were left to private market actors in response

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[146] Bernanke 2007.
[147] FSA 2009b; Briault 2012.
[148] Wyatt 2010; Barth, Caprio, & Levine 2012, p. 104.
[149] Fuchs 2005.
[150] Blyth 2002; Porter 2005c; Tsingou 2006. For the concept of "normative private authority" see Hall & Biersteker 2003.
[151] Tsingou 2004; Fuchs 2005.

to the crisis? From a constructivist perspective, this significant change in the public-private divide could be the product an equally significant ideational change.

Different constructivist authors have long held that crises are exactly the moment when dominant norms about the role of the state and the definition of the public and private domains are called into question.[152] The financial crisis of 2007-10 has certainly triggered a significant learning process by clearly demonstrating the limitations of markets as regulatory mechanisms. As Foot and Walter argue, “the rising prominence of the third norm of self-regulation suffered a serious setback in US regulatory and political circles as it did elsewhere.”[153]

First, as the FSA acknowledged in the Turner Review, the crisis has revealed the limitations of methodologies and techniques used by market actors to infer future risk from previous patterns. The short horizon observed by market actors in their decisions, their underestimation of small probability high impact events as well as systemic risk places doubt on the desirability of relying on financial firms’ self-regulating skills in regulatory policies.[154] Second, the crisis also demonstrated how in previous years markets prices and market pressures had failed to detect the build up of risk-taking and, as the Turner review argues, they “may have played positively harmful roles.”[155] This failure laid the basis for a critique of the extent to which regulatory authorities should rely on market discipline to mitigate the incentives of financial institutions to engage in excessive risk-taking. Third, important regulatory authorities have openly criticized recent patterns of financial innovation and the consequent expansion in the size of the financial services industry as not necessarily benefitting the real economy, thus contradicting the pre-crisis assumption that financial innovation was by definition beneficial.[156]

Also some of the same authorities that had the most influence in charting the pre-crisis regulatory paradigm have publicly acknowledged the fallacies of the ideological building that underpinned the delegation of regulatory responsibilities to the private sector. Speaking in front of a Congressional panel, Alan Greenspan argued that the credit crisis has exposed a "flaw” in the ideology underlying his support for leaving derivatives markets outside of the government regulatory oversight. Greenspan argued that trust in

[152] Blyth 2002.
[153] Foot & Walter 2010, p. 245.
[154] FSA 2009b.
[155] FSA 2009b, p. 45.
[156] Turner 2009.

the capacity banks and other institutions' self-interest to bolster financial stability was misplaced and that "those of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief."[157] Also the Chairman of the UK FSA Lord Turner conceded in front of the UK Parliament that "before the current crisis prompted a rethink of regulation, FSA staff had not considered whether banks' business models were sufficiently robust because the watchdog had left that to industry and did not consider that its job."[158]

According to Foot and Walter, the international regulatory community's critical re-examination of the self-regulation norm that had emerged before the pre-crisis has also influenced the regulatory response to the crisis. For Helleiner, an ideational shift has also occurred in the views of leading figures in the private financial industry that argued during the crisis that more stringent regulation was in the long-term material interest of the derivatives industry given crisis' economic costs.[159]

However, this interpretation ascribing the shift in the international regulatory agenda to an ideational shift regarding the benefits of market mechanisms within the international regulatory community faces some important limitations. First, on a methodological ground, it is challenging to empirically determine the extent of this ideational shift and the extent to which the change in the position of important regulatory authorities and the support for greater public intervention during the crisis reflect an ideational change rather than a response to outer pressures. For instance, only three years after his famous *mea culpa* in front of Congress, Alan Greenspan criticized the Dodd-Frank Act for creating the "largest regulatory-induced market distortion" in the US since the imposition of wage and price controls in the early 1970s and reaffirmed the advantage of relying on the invisible hand of markets over the use of regulation. According to Greenspan, while regulators could "never get more than a glimpse at the internal workings of the simplest of modern financial systems" while on the contrary the "invisible hand" "with notably rare exceptions (2008, for example)… has created relatively stable exchange rates, interest rates, prices, and wage rates."[160]

Second, this hypothesis seems to clash with the timing of the decision by the international regulatory bodies to extend their regulatory oversight to derivatives markets, hedge funds, and rating agencies. As described in the previous chapter, the

[157] Clark & Treanor 2008.
[158] Cited by Foot & Walter 2010.
[159] Helleiner 2010.
[160] Greenspan 2011.

approach informing the international regulatory response to the crisis initially continued to rely on market-based measures consistent with the pre-crisis regulatory paradigm, before suddenly reversing this approach and extending the official regulatory oversight over OTC derivatives markets, hedge funds, and rating agencies since the last quarter of 2008. In the case of hedge funds, the reversal of the position of the G20 from the support of an industry-driven mechanism at the London Summit in November 2008 to an open criticism at the next summit in March 2009 occurred in only 5 months.

This rather sudden reversal in the course of action cannot be easily be explained as the product of an ideational change, since, as some constructivist literature has argued, ideas tend to be "sticky" and a more wide-ranging ideational changes are likely to manifest themselves only over the medium-term. As the recent literature on ideational change has pointed out, in the short term authorities are more likely to respond to a shock by constructing actions based on their pre-constructed ideas to fit the changing circumstances, what Carstensen calls "bricolage."[161]

A prominent example of the resilience of ideas in the face of crisis can be found in the literature documenting how the support among central bankers for the Gold Standards and the use of monetary policy to defend this international regime from domestic priorities was not undermined by shocks such as the World War I and the onset of the Great Depression.[162] Therefore, even if the crisis did trigger a deep and widespread rethinking within the international regulatory community on the role of market and market-based mechanisms and an ideational shift away from the paradigm did emerge in the years before the crisis, the effects of such an ideational turn are more likely to materialize in full only over the medium-term rather than in the middle of the crisis.

Third, and most importantly, the strength and scope of the ideational consensus around the benefits of self-regulation and market-based mechanisms that emerged before the crisis within academia and the regulatory community are debatable. Indeed, significant disagreements about the capacity of market mechanisms to replace or supplement traditional forms of regulation remained within the financial economics literature, which increasingly praised the benefits of market-based regulatory mechanism but never gave its unconditional endorsement.[163]

[161] Carstensen 2011.
[162] Eichengreen & Temin 1997.
[163] See for instance Eichengreen 2002; Rochet 2008.

Moreover the regulatory paradigm building upon the EMH was contested not only within the academics community, but also within the regulatory community. While the Federal Reserve certainly performed the role of "norm-entrepreneur" in encouraging the diffusion of market-based regulatory measures, other regulatory agencies within the US did not share the same kind of ideological support for such an approach. For instance, in the case of Basel II, the ideologically-charged support by the Federal Reserve for allowing banks to use internal risk-assessment schemes to calculate the reserve capital banks were supposed to hold was not fully shared by other US regulatory agencies. Both the FDIC and the OCC expressed serious reservations about the incorporation of these mechanisms in the regulatory framework.[164] Foot and Walter argue that while the Fed "largely won its battle to put market-based regulation at the heart of the Basel framework," the other regulatory agencies "were able to fight a rearguard action in the subsequent battle over domestic implementation."[165] Similarly, the CFTC headed by Brooksley Born put itself on a collision course with the Federal Reserve and the SEC in 1999 by denouncing the opacity of the OTC derivatives markets and argued in favor of bringing these markets under the oversight of federal regulators.[166]

The support for market-based forms of regulation was even weaker outside of the United States in Continental European countries and East Asia. The predominant interpretation of the East Asian financial crisis that emerged in most emerging countries pointed towards the danger of being exposed to the vagaries of financial markets, and regulatory authorities from these countries often demanded for the introduction of more stringent regulations of financial markets.[167] The cases in this study will highlight how a similar skepticism characterized the approach of French and German representatives in this area, with the UK and US representatives remaining those most vehement supporters of market-based regulatory solutions.

In sum, contrary to what important regulatory authorities such as the FSA argued during the crisis, the norm stressing the efficiency of financial markets and the benefits of market-based mechanisms remained highly contested before the crisis. Therefore, instead of assuming a pre-crisis rise of a "global" norm and its sudden demise during the crisis, a more plausible interpretation of the rather sudden change brought by the crisis in the public-private divide is a shift in the relative position between those actors that

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164 Barr & Miller 2006; Foot & Walter 2010; Tarullo 2008.
165 Foot & Walter 2010.
166 Tett 2009.
167 Helleiner & Pagliari 2010; Sheng 2009.

before the crisis had supported the introduction of market-based mechanisms and those who had opposed them. This position is partially shared by Foot and Walter, who have argued that since the beginning of the crisis, the weakening of market-based regulation norms "has further strengthened the position of critics such as Sheila Bair and necessitated a retreat by the Fed."[168] The empirical evidence presented in the case-studies below will reveal how the crisis has weakened the position of those actors that had been the main advocate of a self-regulatory approach in the design of the international regulatory regime governing derivatives, rating agencies, and hedge funds, particularly the Federal Reserve. However, the cases will also reveal how the conduct of those actors that have instead acquired a more prominent role in setting the regulatory response to the crisis, such as US Congress and more broadly elected officials in US and Europe, have responded to a very different set of incentives than the ones theorized by the constructivist literature.

2.7 Conclusion

The literature reviewed in this chapter has gone a long way in identifying the main forces that drove the emergence of a market-based regulatory paradigm in the fifteen years prior to the crisis and the reassertion of public control over a number of financial sectors in response to the crisis. However, these theoretical explanations do not seem to be fully capable of adequately explaining the patterns that have characterize the evolution of the public-private divide in the international regulation of OTC derivatives, hedge funds, and rating agencies in Europe and in the US.

The crisis has not led to a reversal of the twin processes of financial globalization and financial innovation that have been presented by some scholars as at the origin of the greater reliance on market-based measures before the crisis. In contrast with other functionalist explanations, the extent of the regulatory failures revealed by the crisis are not directly correlated with the scope and timing of the regulatory response. Realist theories based on market power seem to be inadequate to explain the shift in the preferences of the most powerful countries away from the support of self-regulation and market discipline. Historically institutionalist works have regarded the institutional context and the respective varieties of capitalism as evolving only incrementally, and are better equipped to explain incremental changes than the kind of sudden shift in the

[168] Foot & Walter 2010.

international agenda. Pluralist theories of international financial regulation have described financial industry groups as playing an overwhelming influence over the policymaking process. These theories cannot easily explain how the measures to directly bring hedge fund managers, rating agencies, and derivative markets under the direct public oversight have occurred despite the opposition of the main financial industry groups. Finally, while the crisis has certainly triggered a reevaluation of the faith in market efficiency and its implications for regulatory policies, this can explain neither the timing of the shift in the approach of the international regulatory community, nor the uneven patterns that brought upon this shift.

In order to explain the evolution of the public-private divide in the international regulation of derivatives, rating agencies, and hedge funds, the next chapter outlines a complementary explanation which will center around the analysis of an element that has been largely neglected by the literature reviewed in this chapter, that is, the level of public attention directed towards different regulatory issues.

Chapter 3. Issue Salience and Financial Regulation

3.1 Plan of the chapter

This chapter will present a complementary explanation of the politics of international financial regulation. It will highlight the importance that the degree of attention paid by the public towards different financial domains has in shaping state preferences towards financial regulatory policies. Existing explanations of the politics of international financial regulatory change have failed to adequately analyse the importance of public opinion. Different scholars argued that the high complexity of financial regulatory issues and their indirect and opaque impact over actors outside financial groups directly targeted by the regulatory policy constrain the amount of attention the general pays towards financial regulation.[1]

The public's capacity to understand financial regulatory policies is further constrained in the case of internationally coordinated policies. International institutions such as the Basel Committee and IOSCO are further removed from domestic scrutiny and are often described as secretive.[2] Moreover, the membership of these institutions and the key actors driving the international financial cooperation process are independent regulatory agencies not embedded in the executive hierarchy and thus not subject to direct political pressures, rather than elected politicians seeking to maximize their probability of reelection by appeasing the public opinion.[3] As a result, numerous analyses have not regarded public opinion as a meaningful constraint on the development of international financial regulatory policies. These works have instead drawn upon the literature on "policy communities", analysing the symbiotic relationship between bureaucratic regulatory agencies and the financial industry under their purview.[4]

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[1] Baker 2010; Mattli & Woods 2009a.
[2] Underhill & Zhang 2008/
[3] While regulators are not totally insulated from the demands of their political masters, as Singer argues, "it is unreasonable to assume that regulators respond to electoral pressures in the same way – or with the same alacrity – as elected officials". Singer 2007, p. 6. See also Kapstein 1989. For an analysis of the rising importance of independent regulatory agencies, see Quintyn & Taylor 2004; Walter 2008.
[4] Lall 2011; Tsingou 2008.

Other works have instead taken the nature of regulators as bureaucrats nested in different domestic contexts more seriously, and modelled the way in which the domestic political environment shapes the patterns of international cooperation differently.[5] These studies on the domestic bases of international financial regulation have acknowledged that public opinion may come to play an important role in shaping international regulatory policies in the aftermath of a financial crisis or other shock that suddenly brings finance into mainstream media.

However these works have presented different accounts of this kind of impact. For instance, Singer argues that a crisis may create incentives for regulators to coordinate regulatory policies at the international level in order to restore confidence in the financial markets and appease their political masters.[6] For Oatley and Nabors instead a crisis will trigger a response from politicians that will promote new international regulatory policies, or try to alter the existing ones, when this will help them to reconcile the competing demands by different groups and voters.[7] In other words, the existing literature has presented conflicting accounts for how different kinds of crisis will generate a response from regulators or their political masters.

This section will build upon the literature on the domestic foundations of international regulatory policies by exploring the contribution of the literature on "issue salience". These works (reviewed in Section 3.2 and 3.3) have explored the impact that varying degrees of public attention to a certain issue area have over the behaviour and preferences of different actors, as well what factors could trigger a shift in the degree of salience. While this literature has been applied to investigate a variety of international domains such as security politics or regional integration, this is to the best of my knowledge the first work extending the contribution of this literature to the making of international financial regulation. Section 3.4 and 3.5 will present a model that identifies in the degree of public attention towards a specific financial domain as a key determinant of how that country will delegate regulatory functions to market actors or not. This section will theorize on the impact different degrees of issue salience will have over the preferences of elected politicians (the intervening variable analyzed in this study). Finally, the final part of this chapter (Section 3.6) will assess empirically how the level of public attention towards financial regulation, as well as towards derivatives markets,

[5] Kapstein 1994; Oatley & Nabors 1998; Singer 2007; Fioretos 2010.
[6] Singer 2004.
[7] Oatley & Nabors 1998, p. 45.

hedge funds, and rating agencies evolved in the years before and during the global financial crisis.

3.2 The Impact of Public Salience on the Policymaking Process

The issue of salience for specific policy domain could be defined as the importance that the general public will assign to a specific issue compared to other issues on the political agenda.[8]

This concept has been developed primarily within the electoral studies literature, where a significant body of scholarly works has since the 1960s investigated the impact that the salience of different issues has in conditioning voting behaviour.[9] These works typically build on the insight from the cognitive studies regarding the capacity of voters to process only a small amount of information when making decisions. Since the cognitive capacities of voters are limited, they only pay attention to a limited range of issues when deciding for whom to vote and will employ cognitive short cuts to select information for making these decisions.[10] They will not spend time and resources to process information on themes that they do not regard as salient, nor they will assess the capacity of different candidates to handle these issues.[11]

From this perspective, electoral competitions are not presented as the battle between different positions on the same issues. Rather, they are shaped as the struggle between parties seeking to emphasize the issues that would benefit them the most.[12] As Hayes argues: "in a political campaign, little is more fundamental to a candidate's success than controlling the election's issue agenda."[13] A wide range of studies have investigated the struggle between political elites to shape voters' perception of the relevance of political problems,[14] candidate strategy seeking to increase attention to advantageous issues,[15] and their interaction with the media in the agenda-setting strategies of candidates.[16]

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8 Oppermann & Viehrig 2009; Wlezien 2005; Kollman 1998.
9 Edwards III et al. 1995; Fournier et al. 2003; Krosnick 1990; Damore 2004; RePass 1971; Belanger & Meguid 2008; Mayer & Tiberj 2004.
10 Simon 1985; Kahneman, Slovic, & Tversky 1982.
11 Damore 2004.
12 Budge & Farlie 1983.
13 Hayes 2008.
14 Erbring, Goldenberg, & Miller 1980; McCombs 1993.
15 Hayes 2008; Simon 2002.
16 Hayes 2008.

In the past, numerous political scientists have also extended these insights beyond the analysis of electoral competition to investigate the impact that the relative salience of different issues has over the broader policymaking process beyond the electoral process. In particular, Wlezien has theorized that the public constantly functions as a "thermostat", taking notice of what policymakers do and responding to these policy decisions by signaling its preferences for "more" or "less" spending or policy intervention.[17] In particular, it is possible to identify three ways in which the attention paid by public towards a certain policy domain is likely to influence the outcome of policies that have relevant for the literature on financial regulation.

First, in those policy domains where the public notices and reacts, elected policymakers that are interested in remaining in office will face stronger pressures to fall in line with the electorate's preferences outside of elections for fear of being sanctioned.[18] Different studies, particularly within the American political science literature, have provided empirical support to the argument that the congruence between policy outcomes and public preferences tend to be higher on issues that are highly salient for the public than on non-salient issues.[19] Furthermore, members of Congress[20] and the US President tend to represent their constituencies differently on salient and non-salient issues.[21] Indeed, different views remain regarding the extent of public attention that can constrain domestic policymaking leeway that governments enjoy in choosing between different policies. While for some authors public opinion simply defines a "region of acceptability" that limits politically feasible options,[22] for other authors the attempt of elected politicians to gain an advantage at the polls by enacting policies favored by the public may have a more significant influence over policy decisions.[23]

Second, the level of attention that the public pays towards a certain issue will also be a crucial determinant of whether elected politicians will decide to get directly involved in the governance of a certain area or whether they will delegate to bureaucrats and experts. According to Gormley, politicians seeking reelection are more likely to engage substantially in highly salient and non-complex issues whose impacts citizens are

[17] Wlezien 1995; Soroka & Wlezien 2005.
[18] Soroka & Wlezien 2005; Page & Shapiro 1983; Oppermann & Viehrig 2009; Wlezien 2004. Moreover, policy decisions that are unpopular towards the broader public are likely to erode the political capital of a government and president and weaken its prospects to conduct its agendas. According to Knecht and Weatherford, this also affect "lame-duck presidents" or politicians not seeking a reelection, which may still be interested in enhancing their public support or set the stage for their "heir". See Knecht & Weatherford 2006.
[19] Page & Shapiro 1983.
[20] Erikson 1978; Hill & Hurley 1999.
[21] Cohen 1997; Hill & Hurley 1998.
[22] Russett 1990, p.110, cited by Knecht & Weatherford 2006.
[23] Page & Shapiro 1992. For a review see Knecht & Weatherford 2006, p. 707.

expected to be capable of understanding.[24] In these areas, bureaucrats and interest groups are expected to play a lesser role. On the contrary, policymaking in areas that are highly technical and that lack salience are unlikely to attract significant public attention, thus generating low incentives for the political leadership to influence the direction of policies. In these areas, business groups, bureaucrats, and a few key politicians are likely to play an active role in the development and implementation of policies, a configuration described by Gormley as "board room" politics.[25] The balance between politicians and experts is more uncertain in those areas that are both highly salient and highly complex. These areas are described by Eshbaugh-Soha as presenting "conflicting incentives for political leadership, as they need for both accountability and expertise are present."[26] In these cases, according to Gormley, politicians will seek to reconcile these conflicting incentives by providing procedural rather than substantive solutions.

Different levels of issue salience are also likely to affect the conduct of the same bureaucrats and how they will relate to their political masters. Gormley puts forward the hypothesis that bureaucrats are most responsive to elected officials and likely to be most active on highly salient policies, since changes in the oversight and the budget are more likely when politicians are highly engaged in an issue.[27]

Finally, the attention of the public towards a certain policy area may have an "indirect effect"[28] over public policies by influencing the relative influence of different interest groups. Interest group theorists have suggested that, in modern democracies, the political system often favours well-organized business and professional groups, while the organization of more diffuse interests is likely to be weakened by collective action problems.[29] While this insight has acquired strong empirical support over the years, different studies have showed how the nature of competition among interest groups, their lobbying strategies, and ultimately who wins and loses are significantly affected when the public pays attention to that area.

[24] Eshbaugh-Soha 2006; Gormley 1986. Further deepening this analysis in the US context, the analysis of the activism by the US President and Congress conducted by Eshbaugh-Soha reveals how these actors will have a strong incentive to engage in issues that are salient, and choose policies that are are easy to explain to the public, avoiding to engage in the technical details of a policy. Unlike the President, Congressmen are more likely to hold committee hearings on policies that are more complex, independently from their level of salience.
[25] Gormley 1986.
[26] Eshbaugh-Soha 2006, p. 226; See Provost 2010.
[27] Gormley 1986.
[28] Risse-Kappen 1991, p. 511.
[29] Olson 1965; Schattschneider 1960.

Policy areas that remain largely outside public scrutiny are described as favouring the emergence of an environment where only a few interest groups lobby policymakers and where the insiders are capable to advance their interests with only limited opposition.[30] On the contrary, a greater salience has been presented as favouring the mobilization of a wider variety of interest groups, including business groups, trade unions, and NGOs, while weakening the influence of any individual group.[31] A high degree of salience has often been described as tilting the balance of influence between those interest groups seeking to preserve the status quo, and those seeking to challenge it.[32] Baumgartner et al. argued that market incumbents seeking to defend the status quo "benefit from keeping an issue out of the public eye and limited to as small a group as possible".[33] Culpepper has argued that under conditions of low issue salience, business insiders are in a superior position thanks to their "access to superior weapons for battles that take place away from the public spotlight," primarily their expertise and privileged access to policymakers.[34] On the contrary, a greater degree of public scrutiny favours those sides seeking to challenge the status quo, which benefit from the attention of the public "in order to create enough momentum to overcome the friction in the policy process."[35]

Finally, the salience of a given issue will also affect the advocacy strategy adopted by different groups. As Victor argues, "an interest group will assess how knowledgeable the public is on an issue before selecting a lobbying tactic."[36] Low issue salience areas have been associated primarily with "direct" lobbying tactics (or "insider lobbying") occurring through close consultation with regulatory agency officials and rank and file members of legislative assembles and their staff, disseminating research, and relying extensively on substantive expertise.[37] Instead, Kollman and others demonstrated how in the case of high issue salience areas, groups are more likely to engage in "outside lobbying", that is, tactics seeking to influence the general public's views.[38] Since a high degree of public attention on a certain issue will make it difficult for policy-makers to listen to the demands of interest groups whose preferences go against public opinion,[39] these will

[30] C. Mahoney 2007; Klüver 2011.
[31] C. Mahoney 2007 p.40. A high level of salience is also likely to decrease the influence of any individual interest groups. Mahoney argues that "if a topic is of interest to large proportion of the public, policymakers should be less likely to take the advice of a single advocate regardless of the actual scope of the issue". Mahoney 2007, p.40.
[32] Baumgartner et al. 2009; Klüver 2011.
[33] Baumgartner et al. 2009, p. 126.
[34] Culpepper 2011, p.4.
[35] Baumgartner et al. 2009, p. 120.
[36] Victor 2007, p. 831.
[37] Gais & Walker 1991, p. 103; Baumgartner et al. 2009.
[38] Kollman 1998. See also Victor 2007, p. 831; Hojnacki & Kimball 1999.
[39] Klüver 2011. See also Risse-Kappen 1991, p. 511; Victor 2007, p. 831; Risse-Kappen 1991.

have an incentive to frame the public debate in a way that ties their interests to the general interests.[40] Other authors have argued that in the case of high issue salience, interest groups will have a greater incentive to build coalitions with other interest groups[41] or to engage in "forum-shopping" seeking to shift the policymaking process into an environment that would favour their strengths. For instance, Culpepper argues that during periods of high salience, business groups may shift their attention and efforts to shape policies towards the implementation phase or to issues of judicial interpretation, especially in those cases when they regard public scrutiny as only temporary.[42]

3.3 The Issue Attention Cycle

The previous section showed how high levels of salience have an important influence over the policymaking process by shaping the engagement of elected politicians into the governance of that area, the role and discretion of bureaucrats, as well as the relative influence and advocating strategies that different groups seeking to lobby policymakers follow. But how widespread are these implications?

As the literature on public opinion has demonstrated, only a restricted number of policy areas are salient at a given time. During normal times, the general public usually focuses its attention on 'bread and butter' issues such as unemployment and inflation, while paying little attention to issues like foreign trade, foreign aid, nuclear arms control, international trade and monetary policy, environmental protection, and international issues more generally that seem remote to the electorate. According to Wleizen, in those policy domains where information is less readily available, 'public responsiveness is likely to be less specific; in some domains the public may be entirely unresponsive to policy".[43]

Knecht and Weaterford argue that the public tends to be less responsive to so-called "non-crises", that is, events that remain on the political agenda for decades and have no definitive conclusion. While public awareness of these issues can be stimulated from

[40] Culpepper 2011, p. 49.
[41] Kluver argues that "depending on the relative size of their lobbying coalitions, salience has a positive or negative impact on the probability of interest groups being successful in their lobbying attempts". More specifically, she argues that the larger coalitions will benefit more from a greater level of issue salience as the new interest groups entering the legislative debate are more likely to join the dominant coalition and increase its relative strength. Klüver 2011, p. 488.
[42] Culpepper argues that when the level of salience increases "business organizations should expect to do better by conserving resources spend on legislative battle they are likely to lose, unless they have lots of allies. Instead they ability to wield disproportionate influence – and so not to have to rely on allies – goes up if they can ride out the storm of public attention and shift to a technical battle over bureaucratic regulations that is uninsteresting to newspaper readers." Culpepper 2011, p.190.
[43] Wlezien 1995, p. 984.

time to time, non-crises "seldom gain the public's attention immediately, nor do they hold it beyond the period of the government's most visible action."[44] In the case of issues such as financial regulation, as well as other areas, the public's attentiveness is further hindered by the complexity of the issue. According to Knecht and Weatherford, in the case of complex issues "the public is likely to sense that a problem exists but lack the desire or capacity to develop an informed opinion."[45] Culpepper has also argued that it remains difficult for the media to translate complex issues into concepts that will hold the attention of news consumers. According to Culpepper, "the combination of low salience and high complexity means that both journalists and political entrepreneurs have difficulty convincing the general public to pay attention to an issue".[46]

In these areas that are characterized by low salience and high complexity, the impact of public opinion on policies remain "latent and inconsequential",[47] while policymakers retain considerable latitude in the selection of policies implemented.[48] On the contrary, areas that are characterized by a low salience such as security and foreign policy are likely to be dominated by special interests or "power elites", which are frequently described as capable of steering public opinion in their direction through the dissemination of information and over-ride or manufacture public perception.[49]

However, the salience of an issue should not be regarded as static. Different studies have highlighted systematic different in the public salience of the same issue across countries, as well as within countries across subnational governments.[50] What could cause an issue area that is usually non-salient to attract a significant attention from the public?

While a large range of policies usually remain outside of the spotlight, these can rise to one of the main priorities on general public's agenda as a result of "crises". Oppermann and Viehrig describe crises as events conveying "a sense of urgency, threat to basic values and novelty conveyed by them", and which are therefore likely to give an issue of

[44] Knecht & Weatherford 2006, p. 709.
[45] Knecht & Weatherford 2006, p.710.
[46] Culpepper contrasts this with other areas such as the regulation of the car industry, which according to Culpepper "remain more straightforward and easily grasped, even for those who are not mechanics". Culpepper 2011, p.8.
[47] Oppermann & Viehrig 2009, p. 926. See also Knecht & Weatherford 2006.
[48] Rosenau 1961.
[49] Herman & Chomsky 1988; Margolis & Mauser 1989.
[50] As Soroka and Wleizen argue, "Whether due to different institutions, policy processes or political culture, both public reactions to public policy and policy makers' responses to public preferences may vary across both policy domains and across countries (and within countries across subnational governments)". Soroka & Wlezien 2005, p. 686. For instance, defense issues tend to have a higher issue salience in the US and in the UK than in other countries. See Eichenberg & Stoll 2003. Similarly, research on the process of European integration has demonstrated different levels of public attention toward the same issue. See Franklin & Wlezien 1997.

high news value for journalists and publishers.[51] Moreover, events that have the characteristics of "crises" are more likely to generate public salience when the public considers this event as bringing some tangible repercussions on the daily lives of citizens For instance, Oppermann and Viehrig argue that "foreign and security policy should on average be more salient in countries which generally tend to be strongly engaged in international affairs by virtue of their geopolitical position or an internationalist foreign policy outlook than in countries which are less exposed to international events".[52]

While these works have discussed the greater salience of a non-crisis issue as determined primarily by some exogenous events, other scholars have argued that the level of issue salience can be endogenous to the same policymaking process, influenced by country-specific factors such as "coalition-building processes"[53] or the patterns of "domestic elite dissent."[54] Other studies have highlighted how interest groups and political entrepreneurs may strategically seek to raise the issue salience of an issue area.[55] These actors may spend considerable resources seeking to raise public awareness around an issue and to influence public opinion to favor their position.[56] While actors disadvantaged by the status quo are more likely seek to increase the level of public attention, those seeking to defend the status quo will have an incentive to limit the visibility of the policymaking process surrounding a certain issue in order to keep its policymaking out of the public eye and to limit the number of groups engaged.[57]

Indeed, exogenous and endogenous determinants of salience are likely to act in tandem. On the one hand, policy entrepreneurs are likely to take advantage of crises to strengthen their arguments regarding the seriousness of a problem. On the other hand, crises may not be enough to raise the salience of an issue in the absence of policy

[51] Oppermann & Viehrig 2009, p. 929; Knecht & Weatherford 2006.

[52] For instance, Oppermann and Viehrig argues that the issue of international terrorism reached a greater level of issue salience in the UK vis-à-vis other European countries as a result of the London bombings of 7 July 2005 but also given Britain's role as the main ally of the US in Iraq. On the contrary, the Kosovo war generated a greater level of public salience in Germany as a result of the intense domestic debate that the war fuelled within the newly elected government. Oppermann & Viehrig 2009, p. 930.

[53] Risse-Kappen 1991.

[54] Oppermann & Viehrig 2009, p. 938. From this perspective, these authors argue that greater increases in the level of issue salience are more likely to be found in majoritarian political systems that favour more confrontational patterns of debate among the elites than in consensus-oriented political systems Oppermann & Viehrig 2009, p. 930. See also Lijphart 1999.

[55] Kollman 1998; Wilson 1980; Baumgartner et al. 2009, p.121.

[56] Holyoke 2011. According to Baumgartner et al. this strategy is more likely to be pursued by those policy advocates "who are disadvantaged by the dimensions of conflict associated with the status quo may benefit from broadening the scope of attention to an issue". Baumgartner et al. 2009, p.121.

[57] As Knecht and Weatherford argue, in the area of foreign policy presidents often seek to obscure decision making and to mark policy commitments in order to avoid public scrutiny: "covert action, for instance, is often a valuable resource for presidents in that it provides a means of accomplishing foreign policy goals outside the strictures of legislative review and electoral accountability". Knecht & Weatherford 2006, p. 712.

entrepreneurs. As Baumgartner et al. argue: “if efforts to change the definition of an issue or to attract the attention of allies in government were not already in the works, crises or focal events might pass by without any policy change. Such crises do offer opportunities for the advocates of change, and if they are ready to seize on them, then major change becomes far more likely.”[58]

In sum, while most policy areas are characterized by low salience, the general public may occasionally take interest in them as a result of exogenous shocks or the endogenous work of policy entrepreneurs.

However, increased public attention is not infinite, and different authors have theorised the existence of an “issue attention cycle”. As Downs argued in his study of environmental politics, “problems suddenly leaps into prominence, remains there for a short time, and then - though still largely unresolved - gradually fades from the center of public attention.”[59] Knecht and Weatherford argue along the same lines that the pattern of attention to such issues follows “a stylized cycle in which the public exhibits ‘‘alarmed discovery’’ at the introduction of a new issue, resulting in a high level of attention and public demands for government to ‘‘do something’’ about the problem. Peak attentiveness is not sustained long, however, as the public becomes disillusioned or bored with the problem, and concern focuses elsewhere.”[60]

In the case of areas that develop more slowly, the public will only pay attention to the policy selected, but will largely ignore both the process preceding this selection as well as the implementation process that will follow the policy decision. In this case, policymakers will enjoy greater autonomy during implementation.[61] In the case of crises, “the public’s attention builds steadily, the relative importance of public opinion will be at its peak during the later stages, such as the implementation phase, when policymakers will need to pay attention to the demand of the public and “sacrifice strategic effectiveness to pacify a highly attentive domestic audience.”[62]

To sum up, this section has briefly reviewed the literature on issue salience and highlighted two aspects that are directly relevant to the literature on international financial regulation. First, the level of public attention towards an issue remains a crucial determinant not only of who will win the elections, but also of the politics surrounding the

[58] Baumgartner et al. 2009, p.122.
[59] Downs 1972, p. 38.
[60] Downs 1972; Knecht & Weatherford 2006, p. 710.
[61] Knecht & Weatherford 2006, p. 712.
[62] Knecht & Weatherford 2006, p. 712.

regulation of different areas, influencing the incentives and influences of politicians, bureaucrats, and key interest groups. Second, while only a minority of issues attracts consistent attention from the public, those areas that are traditionally described as low-salience areas can gain the spotlight as a result of exogenous crises or the agency of different actors.

3.4 Financial Regulation as a Low Salience Area

Building on the insights from issue salience literature reviewed in the previous section, this section will present a model of domestic financial regulatory politics seeking to explain how financial regulatory policies allocate regulatory responsibilities between public and private actors. This section will also discuss how elected officials' preferences and mobilization vary according to three different levels of public attention towards financial regulation (default state; temporary increase in salience; long-lasting increase in salience). This section will discuss the "default state" in which financial regulatory politics take place.

Authors that have analysed the politics of financial regulation have not regarded public opinion as a meaningful constraint on the development of different domestic and international regulatory policies. During normal times, the complexity of regulatory policies and the frequently indirect impact they have over stakeholders outside the financial industry place a structural constraint on the general public's capacity to understand and pay attention to financial regulatory debates. As a result, most financial regulatory debates remain almost completely outside of the mainstream media.

This opaqueness has had some very direct implications on the politics of financial regulation that have long been recognized by the literature. For instance, in line with the view informing much of regulatory capture literature, the low salience of financial regulatory policies enhances the financial industry's privileged position in the policymaking process by limiting outside scrutiny and hindering the creation of active countervailing forces from other societal actors.

Existing literature has placed significant attention on financial industry actors' influence over politicians stemming from the financial resources they can mobilize to finance campaigns or to lobby politicians. However, different authors have acknowledged that the financial industry's influence is greatest when it directly interacts with regulators instead of openly lobbying elected policymakers.[63] Different analyses of financial regulatory policymaking have detailed the emergence of relatively closed policy communities between financial sector private interests and autonomous regulatory authorities that share similar skills, training, and knowledge.[64] Indeed, several authors have argued that financial industry groups are the most important interlocutor of independent regulatory agencies in the design of regulatory policies, while policy concerns from other interest groups usually do not features in the close dialogue between regulators and financial industry groups.[65] While public consultations have become a central component of the policymaking process in financial regulation, the technical nature of these issues had the effect of confining the debate to those actors with sufficient technical expertise and incentives, a group therefore mostly made up of financial services providers.[66]

Under conditions of low salience, market incumbent's privileged position strongly favours preserving the status quo for several reasons. First, groups that are incumbents in a determined market will prefer to preserve their autonomy from the interference of public authorities and prefer self-regulatory and other market-based solutions to overly prescriptive, and costly, forms of regulation. An important exception may derive from conflicts on regulation within the industry, a condition that will not be analyzed in this model, which assumes that the financial industry is capable of preserving its unity in support of lighter regulation.[67]

A second factor favoring the preservation of self-regulation is regulators' bureaucratic incentives. Different studies of international financial regulation have regarded regulators not as simply vehicles for the preferences of the legislatures but rather as actors with an independent set of preferences deriving from their position of bureaucrats within government.[68] According to Singer, regulators will seek to preserve their positional power by balancing requests from their political masters and the financial industry with measures capable of ensuring the financial system's competitiveness and stability.

[63] Quintyn & Taylor 2004. For a more general point, see Culpepper 2011.
[64] Moran 1991; Claessens et al. 2008; Underhill & Zhang 2008.
[65] Baker 2010.
[66] For an application to the European context, see Weber 2006.
[67] Only in the case of strong intra-industry competitive conflicts, those financial firms that are disadvantaged by the status quo are likely to call for the intervention of policymakers and support the introduction of more stringent forms of regulation. However, barring the presence of intra-industry conflicts, it is safe to assume that the short-term interests of financial industry groups will be for less stringent forms of oversight. See Mügge 2006a. The preference of financial industry groups directly targeted by the regulation for lower regulatory standards will be treated as a given in this model.
[68] Kapstein 1992; Singer 2007.

However, regulatory authorities do not equally weigh these two competing pressures. Instead, during non-crisis times, regulators face strong bureaucratic incentives to second the financial industry's preferences for market-based regulatory measures. If regulators had imposed more stringent regulatory policies excessively burdening the domestic financial industry, elected politicians may have directly intervened.

Most importantly, the low salience of financial regulation during normal times will have an impact over elected officials' incentives. This aspect will be the central focus of this analytical framework.

According to Thomas Oatley and Robert Nabors, politicians will propose new regulatory policies, or try to alter the existing ones, when this will help them to reconcile competing demands from different interest groups, particularly the financial industry and voters.[69] However, during normal times, low public attention means that voters will not pay significant attention to their elected representatives' stance on financial regulatory policies. As a result, under these circumstances, elected officials will face no strong incentives for taking actions that may go against the financial industry's preferences. After all, the financial industry is an important political constituency in many jurisdictions. Furthermore, support for zealous reform would expose politicians to accusations of over-interfering in the economy. As Culpepper puts it, "politicians do not want a risk messing up the economy unless there is a big political reward for doing so," nor they do want "to disrupt the economy on whose performance they remain dependent for re-election." [70]

A second element limiting the incentives of elected politicians to get involved in financial regulatory policies is their degree of complexity. The low salience of financial regulation will limit the incentives for politicians motivated by electoral concerns to develop the expertise required to engage in financial regulatory debates. Instead, the combination of low salience and high complexity increases the likelihood that politicians will defer to experts when making policy decisions.[71] As Culpepper argues in the area of corporate governance, "political parties have few incentives to invest in the development of expertise and the promotion of reforms, so long as these questions are of low political salience. Neither voters nor the media care, which means it is not rational for politicians to thwart the political initiatives of managers. Politicians do not generally have the

[69] Oatley & Nabors 1998, p. 45.
[70] Culpepper 2011, p.178.
[71] Eshbaugh-Soha 2006, p. 226.

stomach for a fight that will generate little in the way of electoral rewards."[72] Culpepper argues that this position is independent from the amount of money that financial firms will spend on campaign. In fact, "when the public is not paying attention to issues, politicians will defer to business interests anyway, faced with business arguments that state intervention could adversely affect the economy."[73]

While Culpepper highlights the incentives for politicians to defer to business interests, financial regulation's low salience and high complexity have also favoured the delegation of responsibility for setting and monitoring the implementation of financial regulations to independent regulatory agencies not embedded in the executive hierarchy and thus not subject to direct political pressure.[74] Indeed, most accounts of financial regulatory politics have described politicians as largely uninvolved in the work of international coordination that is undertaken by regulatory agencies. The insulation of regulatory authorities from the dynamics of electoral politics is further reinforced by the fact that international regulatory standards remain 'soft law' and do not require ratification from domestic legislatures. While elected politicians may occasionally interfere in regulators' activity, their involvement in international regulatory debates is described as episodic, indirect, and frequently directed towards appeasing the demands of powerful financial industry groups rather than those of voters.

As a result, during normal times, the low salience and high complexity of financial regulatory policies deters elected politicians from challenging the status quo. This does not exclude a restricted number of elected officials that have a particular expertise and a stake in financial regulatory policies who act as policy entrepreneurs and seek to introduce more extensive regulatory policies. However, the characteristics of financial regulatory policies discussed in this section make it more difficult for these proposals to gather the required support among other elected officials.

3.5 Crises and their Impact on the Salience of Financial Regulation

While periods of "quiet politics" do not create significant incentives for regulators and elected politicians to challenge dominant financial industry groups' preferences for maintaining self-regulation during normal years, these incentives may be altered by a financial crisis or corporate scandal. Most models of financial regulatory policymaking

[72] Culpepper 2011, p.145.
[73] Culpepper 2011, p.145.
[74] Quintyn & Taylor 2004; Walter 2008.

take an exogenous shock as the most common factor capable of bringing an area that was previously under the radar to the attention of the public by highlighting market and regulatory failures, conflicts of interest, and other areas that demand the policymakers' attention.

According to functionalist approaches, crises that reveal a certain regulatory failure spur demand for regulatory change. A crisis will generally increase media coverage and public awareness a certain financial area. As discussed in more details later, the media's increase in coverage is not always correlated with the severity of the crisis.

While voters are usually unaware of financial regulatory debates, their interest could increase in the aftermath of a high-profile financial failure or scandal because of media coverage. In this case, voters typically demand regulatory policies that restore "confidence" in the safety of the financial system.[75] While the general public does not have the expertise to influence the kind of regulatory change, they can signal their preferences for "more" or "less" policy intervention, as theorized by Wlezien in his "thermostatic" analysis of public opinion.[76]

A crisis that increases the media coverage of the mishaps of a financial sector will pose a regulatory and reputational threat to this industry.[77] In order to limit the risk that regulators or lawmakers may react by introducing more stringent regulations or that investors may lose confidence, financial industry groups affected by the scandal are likely to react by designing self-regulatory measures. From this perspective, self-regulatory measures are not only market actors' attempt to solve a substantive problem, they also help decrease an issue's salience in such a way as to send a signal to regulators, politicians, and the general public that the issue has been taken care of and that no further regulatory action is needed.

A crisis that raises the salience of regulatory policies will also have a direct impact over regulatory agencies' bureaucratic incentives. As Singer argues, the bureaucratic nature of regulatory agencies implies that a crucial priority for regulators will be to prevent their autonomy and prestige from being threatened by legislative interventions aimed at reclaiming previously delegated regulatory authority.[78] When a crisis increases media

[75] Singer 2007.
[76] Wlezien 1995; Soroka & Wlezien 2005.
[77] Haufler 2001.
[78] According to Singer, "political intervention is the bane of a regulator 's existence. When politicians attempt directly to influence regulatory policy—for example, by holding hearings and publicly criticizing the decisions of regulators, or by legislating new regulations—they threaten the agency's autonomy and prestige. Intervention may also affect regulators' future job prospects, especially for an agency head who is forced to resign". Singer 2004, p. 535.

coverage of regulatory gaps a give sector, regulatory agencies will face strong bureaucratic incentives to introduce measures capable of satisfying their political superiors and conveying the message that the issue has been “taken care of”. According to Singer, regulators will seek to introduce policies capable of preserving a certain degree of confidence in the stability of the financial system without at the same time creating excessive costs for their domestic financial systems and, thus, endangering their competitive position.

In many circumstances, regulators may see industry self-regulation as an optimal solution to reassure their political overseers that the private sector has “taken care of” the issue, while at the same time preventing the introduction of more prescriptive regulations that could be burdensome for the competitiveness of their primary stakeholders, the financial industry.[79] Regulators may also have an incentive to proactively promote the emergence of self-regulatory measures introduced by the financial sector. They can do so either *directly* by informally encouraging private actors to intervene or by formally delegating regulatory authority to them, or *indirectly*, by threatening to introduce more stringent regulations as a strategy to solicit a private sector response.

Regulators could also intervene ex-post by providing a “seal of approval” to regulations established by private bodies. They could do so by incorporating them into their national regulatory frameworks or international regulatory arrangements. While from a constructivist perspective this behavior is indicative of an ideological-driven preference for market-based solution, it may also reflect the desire to hold the interferences from lawmakers at bay. On the other hand, regulators are unlikely to support industry-driven regulatory measures that are unlikely to satisfy the preferences of their political overseers. In order to avoid the possibility that lawmakers could openly challenge regulators’ position and seize back control over the regulatory process, regulators may face bureaucratic incentives should justify the choice of regulators to throw their weight behind the introduction of more stringent regulatory measures.

In order to understand if a crisis will trigger a self-regulatory response or a more formal regulation we need to assess the impact that the shock will have on the preferences of elected politicians. The literature on the domestic foundations of international financial regulation is ambiguous in this respect. According to Singer, crises will create strong

[79] Robotti 2007; Helleiner & Pagliari 2010.

pressure for legislatures to intervene to appease their constituents, but in reality, altered incentives for regulators will have a greater impact over the international agenda. Oatley and Nabors have argued that a crisis will lead elected politicians to directly promote regulatory changes at the national and international levels.[80] Along the same lines, different authors that have analyzed the reforms introduced since the crisis have cited "politicization" as an important characteristic of the policymaking process during this period.[81] For instance, Helleiner's analysis of derivatives regulation highlights how the increase in "public anger about the financial crisis" has led many members of Congress to introduce a number of proposals to regulate derivatives, as well as a triggered a turnaround in the position of important regulatory agencies. In other words, while different authors writing before and since the crisis have acknowledged the impact of public opinion on altering the incentives of elected politicians, the dynamics and conditions through which enhanced public attention comes to shape regulatory policies have remained under theorized. This study builds on work on the domestic bases of international financial regulation while integrating issue salience literature analyzed in the first part of this chapter. The argument presented in this section maintains that the extent to which elected politicians will defer to regulatory agencies or play the lead role in shaping the content of regulatory policies in the aftermath of a crisis depends largely on the crisis' impact on the issue's level of salience.

As the analysis in the previous section has discussed, a crisis is in itself not sufficient to make a significant number of elected politicians pay attention to a highly technical issue like financial regulation. Politicians will engage in financial regulatory issues only in cases where the crisis has increased the attention of the electorate to the extent that the electoral rewards from direct interference in regulatory affairs will costs of devoting time and resources in forming a position, and of alienating the support of important interest groups.

These conditions are unlikely to emerge in a crisis that increases the degree of public attention towards financial regulatory issues weakly or for a short period of time – what Culpepper defines "temporary high salience".[82] While such a crisis will increase the involvement of policy entrepreneurs with a pre-existing expertise and interest in financial regulation, the majority of politicians will face only weak incentives to enter the regulatory

[80] Oatley & Nabors 1998.
[81] Foot & Walter 2010; Helleiner 2010.
[82] Culpepper 2011, p.8.

debate and acquire the expertise required to form their own position. Regulators and the financial industry's preferences will act as a cognitive shortcut for most politicians who will defer to their combined expertise. Under conditions of temporary issue salience, it is likely that by transferring regulatory responsibilities to private market actors and colluding with the financial industry, regulators will be able to pass the message that the problem was taken care, allowing the issue to exit the spotlight.

However, incentives for elected politicians change considerably when a shock creates a situation of "durable high salience".[83] As Culpepper argues in his analysis of corporate governance, voters' sustained attention towards a policy domain will create "a powerful incentive for politicians to develop the tools to intervene, so that they can be seen to respond to the concerns of voters."[84] Culpepper also argues that voters will pressure governments to intervene more heavily to regulate high salience policy domains that are governed through informal governance arrangements, such as self-regulation.[85] Increasing public regulatory oversight over certain financial activities and overturning existing self-regulation regimes represent a very visible way of for politicians to signal to voters that they are committed to respond to their concerns. In a high salience environment, the costs of challenging the preferences of the financial sector are likely to be lower than the electoral rewards that lawmakers could gain by demonstrating their commitment to introduce more extensive regulations.

In sum, as Culpepper argues in his analysis of the politics of corporate governance, the resilience of self-regulatory arrangements over the governance of certain markets is dependent on a certain level of public inattention, which makes politicians more likely to defer to the expertise of the financial industry.[86] The higher and the more lasting the level of financial regulation's salience, the more likely that the regulatory status of a financial sector will be moved towards the right end of the public-private divide spectrum for politicians seeking to gain electoral benefits by "tap[ping] into public outrage".[87]

We can derive some testable hypotheses from this argument to ask when a country's position on international financial regulation will move from supporting the status quo of self-regulation towards endorsing more direct regulation, as happened during the global

[83] Culpepper 2011, p.8.
[84] Culpepper 2011, p.54.
[85] Culpepper 2011, p.54.
[86] Culpepper 2011, p.178. Culpepper argues that given the advantage that insider firms have over areas of low political salience, these are "are structurally more likely than issues of high political salience to be governed through informal institutions – that is, rules made by private actors outside of Parliament". Culpepper 2011, p.54.
[87] Culpepper 2011, p.198.

financial crisis. This chapter's argument presented holds that this shift is likely to occur after a shock that triggers a significant and long-lasting increase in the level of public attention towards that specific issue.

This hypothesis differs from more traditional accounts of financial regulatory policymaking that link this change crises revealing regulatory failures. In fact, a severe crisis that reveals important regulatory failures will not necessarily lead to a long-lasting increase in issue salience. As argued above, financial industry groups directly threatened by the crisis will have an incentive to reduce the salience of financial regulation by adopting self-regulatory mechanisms. Instead we may expect a long-lasting increase in the salience of financial regulation only when the financial institutions at the center of the crisis do not entirely internalize the costs created by the crisis. This is for instance the case when these reverberations also spill over to other societal actors, such as investors, end-users, clients, or impose broad costs on society. From this perspective, bailouts or crisis requiring the deployment of taxpayers money in support of financial institutions represent a very visible signal of the socialization of these costs. These events are more likely to generate a high degree of issue salience than more severe scandals and crisis that do not trigger the same sort of public intervention or whose costs are internalized by the financial industry.

Moreover, when the directly affected financial groups do not internalize the costs generated by corporate scandals and crises, a permanent rise in issue salience will occur only where spillovers are widespread. If a crisis generates a deep but concentrated impact on a limited electoral constituency or area, only a limited number of politicians will face strong electoral incentives to demand more stringent regulatory measures. In less widespread crises, a majority of elected policymakers representing jurisdictions where financial regulation has remained a low salience issue will face only weak incentives to challenge the status quo.

At the same time, unlike traditional account of financial regulatory policymaking, this model allows for a significant departure from the self-regulatory status quo in the absence of significant regulatory failures. Different analyses of the role of the public in influencing policies have stated that the public will not be able to collect information about a specific policy or industry. As Wlezien argues in his study of budgetary policies, "specific information about appropriations for those programs is not regularly and widely available to the public." As a result, "the public still may responds to appropriations for social programs, but in a general way, with support for more (less) spending across social programs in response to cuts (increases) in appropriations for the set of programs taken together."[88] Similarly, Stimson, MacKuen, and Erikson argue that the general public does not have preferences for specific policies in particular domains but they have preferences "over the general contours of government activity."[89]

Thus, a crisis that significantly increase the salience of financial regulatory policies may also generate greater public appetite for more stringent regulatory policies towards sectors that were only marginally involved in the origin of the crisis. Wlezien argues: "Although survey organizations ask about specific programs, people's responses in these domains reflect a single underlying preference for more (less) government, broadly defined … By implication, we should expect politicians to respond to the signal for policy change across domains; any apparent responsiveness to preferences in particular domains only conceals this more general responsiveness."[90]

It is also important to acknowledge some important limitations of this argument as an explanation of international regulatory change.

First, while the explanation presented in this section identifies the main channel through which different levels of salience affect policies using elected officials' electoral incentives, it is not the only one. As the literature on issue salience reviewed in the first part of this chapter argued, different degrees of salience will have a significant impact over the levels of influence and advocacy strategies that different interest groups and bureaucracies will adopt. Changes in the preferences and behavior of financial lobbies and regulatory agencies will represent an important part of the cases analyzed in this study. At the same time, the analytical contribution will focus on the impact that salience has over officials' electoral incentives. This approach is the most direct way through which public opinion can shape regulatory policies, while changes in the conduct of interest groups and bureaucracies tend to derive from changes in the political context.

Second, electoral incentives as determined by the level of public attention do not represent the only factor shaping elected officials' position. On the contrary, any legislative assembly has members who usually occupy key positions in financial committees and whose preferences tend to consistently be shaped by a number of elements highlighted by other theoretical explanations, such as ideas or their support for specific vested interests. However, these "specialists" with pre-determined policy

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[88] Wlezien 1995, p. 993.
[89] Stimson, MacKuen, & Erikson 1994.
[90] Wlezien 2004, p.4.

preferences usually remain a minority. The majority of the members of any legislative assemblies usually lack the sufficient expertise to form an independent opinion on regulatory policies. They will therefore rely on proxies such as the preferences of regulators, the industry, or other experts.

The degree of salience will play an overwhelming role in determining how difficult it will be for policy entrepreneurs within any given legislative body to gather majority consensus around their policy proposals. During periods of low salience, policy entrepreneurs will face difficulties in gathering support for proposals that go against the preferences of powerful constituencies, an issue that is not the case during periods of high salience. One of the most common dynamics through which a long-lasting increase in the level salience affects regulatory change is increased momentum for policy entrepreneurs to put their long-standing priorities back on the legislative agenda, not to create new legislative solutions.

Third, similarly to other domestic theories of international regulatory change,[91] this theory is purely an explanation of regulatory change at the domestic level and does not provide an explanation of the domestic preferences that will shape the international agenda. In order to explain international regulatory change, it needs to be complemented with different power analyses of international financial regulatory policies reviewed in the previous chapter. If we accept the argument presented by most realist scholars that market size is the primary determinant of a country's influence over the international agenda, a shift in the international regulatory agenda is likely to occur only after a crisis has aligned the preferences of the most powerful countries in support of a new approach.

Fourth, the degree to which politicians will be responsive to public opinion is not fixed but instead varies across time and institutional contexts. As different authors have argued, the electorate's capacity to shape policy decisions will depend on "the credibility of their threat to sanction the government for these decisions."[92] From this perspective, proximity to elections is a factor shaping the likelihood that politicians will respond to the public opinion. Electoral payoffs will vary across different kind of political parties, with political parties on the left of the political spectrum more likely to reap the electoral benefits from financial regulatory issues during periods of high salience. From this perspective, acknowledging the importance of issue salience in the development of regulatory policies opens important opportunities of dialogue between this literature and the

[91] Singer 2004; Fioretos 2010.
[92] Oppermann & Viehrig 2009, p. 926.

important literature on the electoral and partisan cycles.[93] These works have argued that "partisan electoral competition induces observable, regular cycles of electoral-calendar timing and incumbent-partisan nature in economic policies and outcomes."[94] While some of these insights will be addressed in the case studies, they remain outside of the scope of the argument developed in this study.

Fifth, this domestic model does not account for how institutional variations in different domestic contexts affect public opinion's role in shaping the behavior of elected politicians and other actors. It has long been recognized that institutions mediate the impact of the public opinion over the policymaking process. For instance, Risse-Kappen has argued that public opinion will have a lower impact in "strong states" whose institutions are highly centralized and whose political elite is capable of overcoming domestic resistance and a higher impact in "weak states that more open to pressures by societal interest groups and political parties."[95]

For the sake of parsimony, the analysis conducted in this study remains explicitly actor-centric and does not explore how the impact of the public opinion on financial regulatory policies differs in countries with diverging domestic institutional contexts, traditions, varieties of capitalism, or financial system structures. However, this trade-off is important to highlight the common dynamics that change financial regulation's public salience will generate in the relationship between unelected regulators, elected politicians, and their respective domestic financial industries in very different institutional contexts.

3.6 An Empirical Analysis of the Salience of Financial Regulation

Given that issue salience is the explanatory variable investigated in this study, the main challenge is to empirically assess how receptive public opinion is towards a certain area. While different methods have been developed within the literature to achieve this

[93] Alesina & Rosenthal 1995; Alvarez, Garrett, & Lange 1991; Rogoff & Sibert 1998; Simmons 1996.
[94] Franzese 2002, p. 370.
[95] Risse-Kappen 1991. Risse-Kappen argues that as a result of these different domestic structures, mass public opinion matter to very different degrees in different countries. In particular, mas public opinion is more likely to limit the range of options for implementing policy goals in countries such as the US and Germany. This author concludes that "in countries with centralized political institutions byt polarized societies and rather weak social organizations, the policy network is likely to be state-dominated…. By contrast societal control of the policy network is to be expected in countries with comparatively homogeneous societies and a high degree of societal mobilization but weak stracture…. Countries with political institutions and a social organizations of comparable strength are likely to have a policy network characterized by democratic corporatism".Along these lines, he argues that the US could be characterized by a decentralized political system, heterogeneous and weak societal organizations, and a society-dominated policy network, Germany as a political system characterized by an intermediate level of centralization, strong societal organizations, and corporatis policy network, and France characterized by a centralized political system, weak societal organizations, and state-dominated policy networks. According to Risse-Kappen, "the comparatively open and decentralized American political system and its society-domianted policy network should provide public opinion with ample opportunity to affect policy outcomes". In contrast, "French public opinion is likely to play only a marginal role in the foreign policy-making process".

objective, the approach that has gained more widespread acceptance in recent years infers an issue's level of salience through the amount of media coverage it attracts.[96]

Important literature has discussed how the media represents the primary mechanism through which the public learns about most issues. As a result, media contributes significantly to shaping voters behavior.[97] As Cohen argues, while the media may not tell the public what to think, ''it is stunningly successful in telling its readers what to think about.''[98] From this perspective, media coverage of an issue is the prerequisite for the public to take notice and react to certain news or policy decisions.[99] Moreover, the academic literature has described amount of media reporting as the primary causal mechanism through which policymakers will gauge the public's receptiveness to an issue.[100] From this perspective, policymakers are particularly attentive to how prominent certain issues are in the media, as they realize that greater media attention is likely to produce greater public attention, while policy makers assume that the absence of a debate in the media means that there is very little public attention towards the issue.[101]

Different studies have therefore sought to infer the level of issue salience of different issues by measuring their coverage in the media, either by tracking the minutes of nightly network news broadcasts devoted to different areas,[102] or by counting the articles in different national newspapers.[103] This approach is not without its limitations. For instance, works using media coverage as a proxy for public salience assume that newspapers cover issues in proportion to how much voters care about them.[104] Moreover, the results of this kind of analysis may be subject to media-bias, as different media sources are frequently characterized as being biased in their topic selection.[105] However, according to Epstein and Segal, the study of media coverage maintains important advantages compared to other methods and it represents a "reproducible, valid, and transportable measures" of citizen attention to political issues."[106]

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[96] Epstein & Segal 2000. For instance, different studies have relied on public opinion polls, asking open-ended questions to the respondents regarding what they perceive as the 'most important issue' on the agenda. See Oppermann & Viehrig 2009.
[97] Miller & Krosnick 2000; Page et al. 1987.
[98] Cohen 1963, p.13.
[99] Wlezien 1995, p. 998.
[100] Oppermann & Viehrig 2009.
[101] Powlick 1995.
[102] Knecht & Weatherford 2006, p. 713.
[103] Baumgartner et al. 2009; Culpepper 2011; Jones & Baumrgartner 2005.
[104] See Culpepper 2011, p.56.
[105] See Culpepper 2011, p.20; Helbling & Tresch 2011.
[106] Epstein & Segal 2000.

Given this approach's advantages over other methods, this study will also use coverage from major national newspapers to identify different levels of issue salience at the domestic levels associated with the different stages in the governance of derivatives markets, rating agencies, and hedge funds. To limit the media bias associated with the reliance on a single national newspaper, this study will analyze a larger pool of sources accessed through "Factiva", an online repository of newspapers and other sources of information. The sources consulted in this study have been selected among those newspapers and magazine identified by Factiva as "major newspapers" in four major countries (US, UK, Germany, and France).

From this pool of newspapers, this analysis has excluded newspapers with a clear financial focus (Financial Times, Wall Street Journal), as well as major newswires agencies (Reuters, Dow Jones), since the coverage of financial regulatory issues by these sources is largely independent from their salience and they are a poor indicator of the level of public attentiveness towards financial issues. US and UK sources have been consulted for the period between 1994 and 2011, while the analysis of German and French newspapers begins in 1998 because of Factiva's limited earlier French and German archive.

Table 7 - Newspapers Consulted through Factiva (number of articles within bracket)

US	**UK**	**Germany**	**France**
Period: 1994-2011	Period: 1994-2011	Period: 1998-2011	Period: 1998-2011
The New York Times (1,127,242)	The Times (1,955,109)	Süddeutsche Zeitung (928,633)	Les Echos (699,596)
Washington Post (891,938)	The Guardian (1,519,213)	Frankfurter Rundschau (658,926)	Le Figaro (684,296)
The Times-Picayune (854,701)	The Daily Express (526,417)	Stuttgarter Zeitung (589,163)	La Tribune (489,842)
Pittsburgh Post-Gazette (780,605)	The Independent (926,123)	Berliner Zeitung (473,920)	Libération (395,234)
Tampa Bay Times (710,196)	The Herald (487,850)	taz - die tageszeitung (456,823)	Le Temps (178,106)
The Boston Globe (657,551)	The Telegraph (724,411)	Der Standard (317,185)	La Tribune.fr (75,512)
The Atlanta Journal-Constitution (593,222)	The Scotsman (404,503)	Tages Anzeiger (253,000)	Le Temps (59,723)
St. Louis Post-Dispatch (506,266)	Daily Mail (345,902)	Die Welt (245,303)	L'Expansion (17,377)
New York Post (377,541)	The Observer (322,636)	Wirtschaftsblatt (188,132)	
New York Daily News (353,128)	Evening Times (205,167)	Der Tagesspiegel (95,836)	
Denver Post (312,488)	Sunday Express (114,069)	SDA - Schweizerische Depeschenagentur (64,420)	
The Philadelphia Inquirer (279,364)	The Mail on Sunday (110,059)	Tages Anzeiger (1,892)	
USA Today (246,227)	Citywire (88,722)		
The Christian Science Monitor (126,902)	The Economist (76,777)		
The Philadelphia Daily News (63,269)	Sunday Herald (57,407)		
Barron's (48,164)	Sunday Telegraph Magazine 'Seven' (7,378)		
Newsweek (31,624)	Public (2,221)		
Forbes (19,431)	Economist Intelligence Unit (536)		
New Yorker (12,286)			
Newsweek International (12,020)			
The Atlantic (992)			
Total: 8,045,282	**Total 7,874,525**	**Total: 4,273,233**	**Total: 2,599,527**

The focus on these four jurisdictions is justified by combined market power that the US and the EU exercise over international securities markets and which has already been documented in the review of the "Anglo-Dominance thesis" in Chapter 2. While Mahoney in her comparison of issue salience in the US and EU has relied on the coverage of a single newspaper per each institutional context (New York Times and Financial Times),[107] this approach seems to be inappropriate given the diversity in the domestic agenda of different European countries and the coverage of different European newspapers. This analysis has therefore focused on the three major European economies, as well as the three countries that have been identified by the literature as

[107] Mahoney 2007.

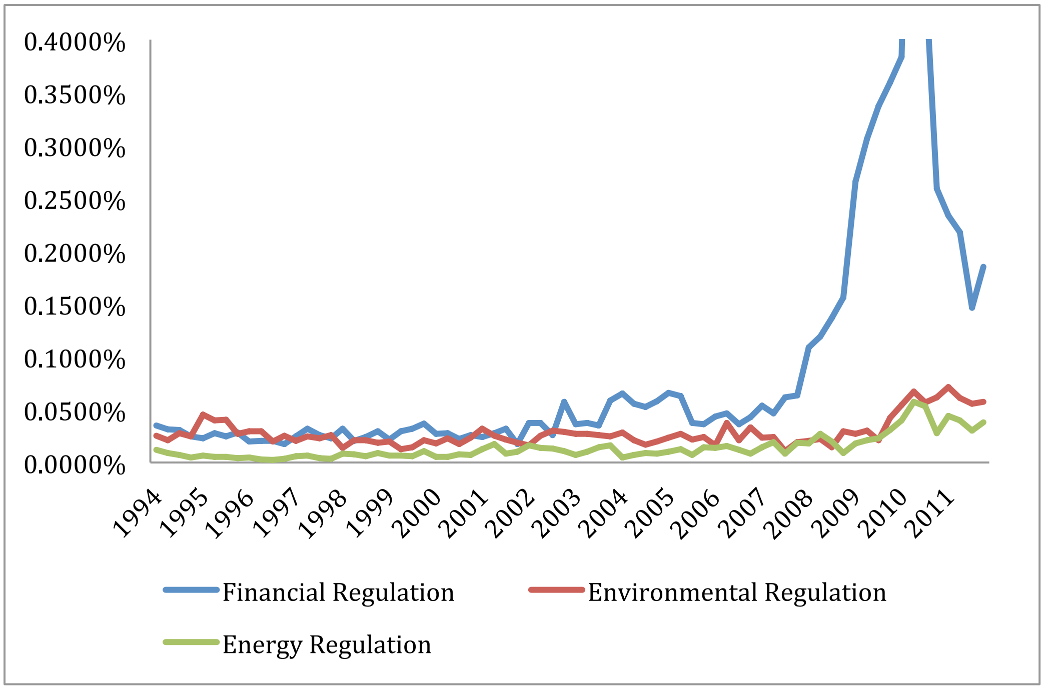
playing the main role in international financial regulatory issues (UK, France, and Germany).[108]

What can media coverage analysis of financial regulatory issues in these four jurisdictions tell us regarding the domestic conditions that sustained the market-based regime that characterized the international approach to the regulation of finance before the crisis and the departure from this approach after the crisis?

The argument presented in the previous section maintains that the resilience of such an approach relies on a certain degree of public inattentiveness, and the lack of incentives for politicians to challenge the preferences of the financial industry. The analysis of the coverage of financial regulatory issues in the US press broadly supports this hypothesis. As Figure 4 illustrates, in the years before 2007 financial regulation received the same level of public attention as other areas described by the literature as "low salience", such regulation of the energy markets and environmental regulation.

[108] Fioretos 2010.

Figure 4 – Coverage of financial, environmental, and energy regulation in the US press[109]



The limited attention from the domestic public towards financial regulation during this period is in part surprising when we consider how the period from the early 1990s to the financial crisis of 2007-10 is by many account not a quiet one in the financial system's history. Numerous crises in emerging countries occurred during this period, such as the Mexican crisis of 1994, the East Asian financial crisis of 1997-98, and the Argentine crisis of 2001. These crises triggered important debates at the national and international levels on reforming international financial architecture.[110] However, the very limited to non-existent costs that these crisis posed on US citizens (with the exception of the increase in IMF resources following the Mexican and East Asian crisis) limited the coverage of financial regulatory issues by the US mainstream media.

The second aspect that emerges from the analysis of the American media's coverage of financial regulation during this period concerns the impact of the financial crisis of 2007-

[109] This chart presents the articles discussing financial regulation, environmental regulation, and energy regulation, as a percentage of all the article published during a quarter by the sample of newspapers selected. The following keywords have been used. For financial regulation: "regulat* w/5 financ*". For environmental regulation: "regulat* w/5 environment*". For energy regulation:
"regulat* w/5 (energ* or oil or gas))". W/5 stands for "within 5 words of". The search has been limited to the title and first paragraph of the articles.

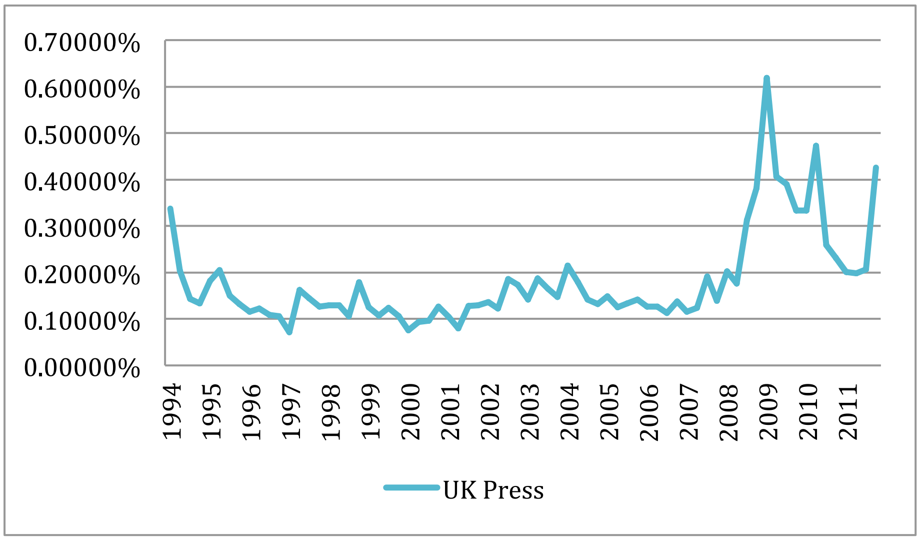
[110] Eichengreen 1999.

2010 in focusing the US public's attention on financial regulatory issues. The financial crisis has not only had the effect of revealing substantial market and regulatory failures in the eyes of the regulatory community and experts, it has also contributed to brought financial regulation to the attention of mainstream media on an almost daily basis.

However, the analysis of American press coverage reveals how the timing of public attention towards financial regulation differed from the timing of the regulatory community's attention toward financial regulation. The breakdown of the crisis in the summer of 2007, as well as the regulatory initiatives introduced at the end of 2007 and throughout 2008 in the US and internationally, did not significantly raise the salience of financial regulatory issues in the US. This is illustrated by the fact that the coverage of financial regulatory issues by the US press is not significantly higher than in the pre-crisis period. The intensification of the crisis and the deployment of taxpayers money in support of ailing financial institutions in the last quarter of 2008 have contributed to increasing the salience of financial regulation in the US, which has increased steadily since the end of 2008, peaking in the first half of 2010 with the passage of Dodd-Frank Act. Media coverage of this legislation and of the Congressional debate that preceded it stands in contrast with the lack of attention paid towards the important pieces of legislation passed by Congress before the crisis to dismantle the regulatory framework built during the Great Depression. The level and length of salience characterizing regulation during this period is more similar to high salience areas such as budgetary policies and unemployment than to a traditionally low salience area such as financial regulation.

However, the impact of the crisis in turning financial regulation into a "high issue salience" area has not been limited to the US despite the fact that the crisis originated within its borders. When we expand this analysis to the main European countries we find a sizeable increase in the media's coverage of financial regulation around the time of the crisis. As Figure 5 illustrates, in the United Kingdom financial regulation had attracted a significantly higher level of public attention before the crisis, probably as a result of the greater weight that the financial sector has in the economy compared to the US. However, this difference may reflect a media bias in the pool of British newspapers analyzed in this study. Like in the US, the outbreak of the crisis in the summer of 2007 and high profile events such as the first bank run in more than a century (Northern Rock) have not significantly increased the attention towards financial regulation. Public attention significantly increased the end of 2008 when British authorities were forced to take unprecedented actions to extend a wider public net in support of several domestic financial institutions. Unlike what occurred in the US, media coverage in the UK has decreased since the first quarter of 2009, which represent the peak of public attention in this country.

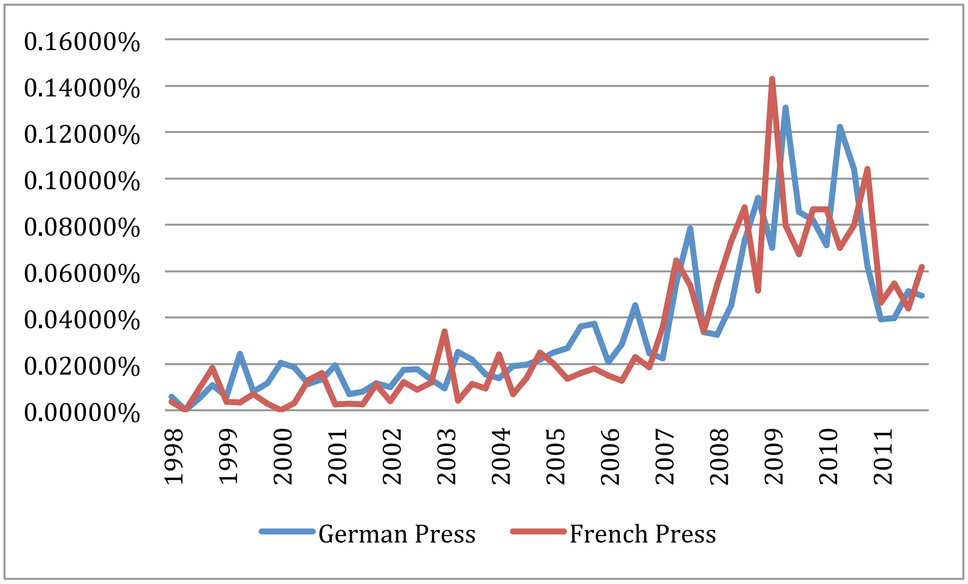
Figure 5 - Coverage of Financial Regulation in the UK Press[111]



Moreover, the crisis also turned financial regulation into a high salience issue in countries where the financial sector occupies a smaller space in the national economy, such as Continental European countries, as Figure 6 illustrates. In these countries, the initial spike in the media coverage of financial regulation was followed by a weakening during the rest of the first year of the crisis, and a significant and steady increase since the second quarter of 2008. Unlike in the US, the mutation of the banking crisis into a sovereign debt crisis prolonged the attention of the media towards financial regulatory issues until the end of 2010, when the dominant narrative of the Eurozone crisis turned more towards the institutional and macroeconomic failures in that area.

[111] The following keywords have been used “regulat* w/5 financ*”. The search has been limited to the title and first paragraph of the articles.

Figure 6 - Coverage of Financial Regulation in the German and French Press[112]



However, while these figures are indicative of the general attention towards financial regulation in these countries and towards the impact of the crisis, how has public attention been distributed across different markets and institutions?

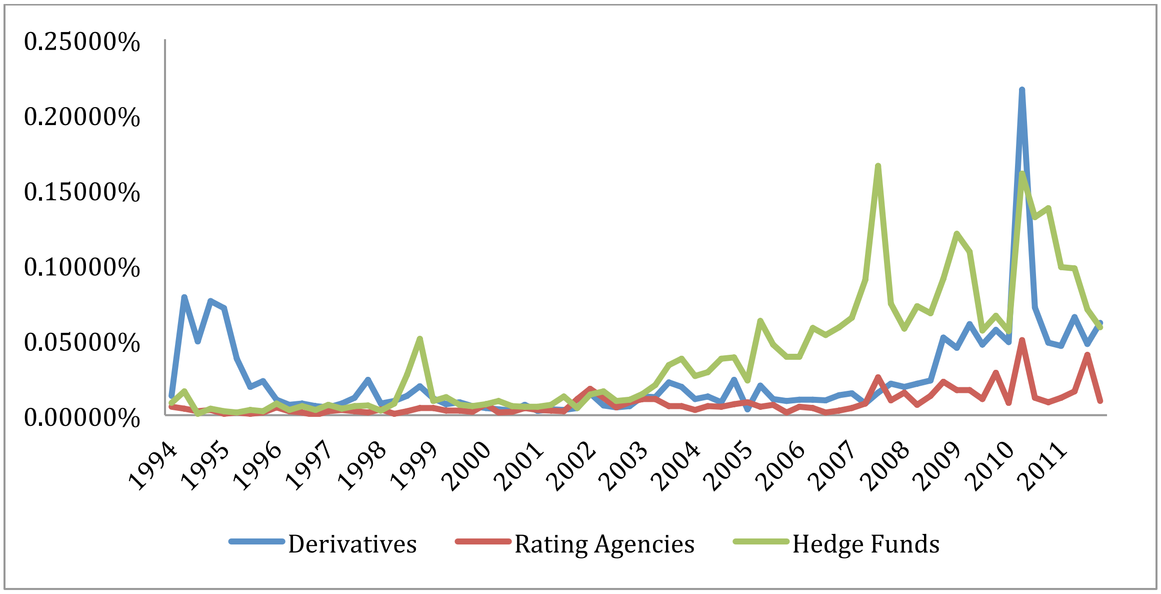
A closer analysis of the media coverage of derivatives, hedge funds, and rating agencies is still supportive of the general notion that the crisis increased public attention towards these market actors in a long-lasting way. However, a closer look at the data reveals three important points.

First, despite the fact that these three sets of markets and institutions did not attract the kind of sustained attention that they triggered in the 2008-2010 period prior to the crisis, their public profile rose significantly in the years preceding the crisis as a result of different shocks and corporate scandals. Derivatives entered the US public debate in 1994 when a sudden turn in interest rates generated important losses for Orange County Municipality (see Figures 7). This episode was followed by two corporate scandals during the same year involving the use of OTC derivatives, the first one involving a transaction between Gibson Greetings and Bankers Trust and the second between the same Bankers Trust and a larger corporation, Proctor & Gamble. A few months later, in 1995, Barings bank collapsed because of the work of a derivatives trader. However,

[112] The following keywords have been used. For France: "régul*" w/5 "financ*" . For Germany: "Finanzmarktregulierung" or "Haushaltsordnung" or "finanz* w/5 regular*" or "finanz* w/5 regler*". The search has been limited to the title and first paragraph of the articles.

since then the issue has disappeared from the domestic media, and the key legislation passed by the US Congress in 1999 to exempt derivatives from the federal regulatory oversight went largely unnoticed.

Figure 7 - Coverage of Derivatives, Rating Agencies, and Hedge Funds in the US Press[113]



Rating agencies had also acquired a significant public profile in the years before the crisis. Enron's bankruptcy at the end of 2001 raised the profile of rating agencies in the US media above those of the other two sectors considered in this study, although less than the peak of public attention towards derivatives in 1994. Enron had remained highly rated until a few days before the collapse. The outrage triggered by the Enron scandal was reinforced by the Worldcom scandal only a few months later. According to Culpepper, these two events "caught public attention and ignited public anger" and Enron became "an informational short-cut for corporate excess", making "a class of scandals easier to explain to the wider public."[114]

Enron was perceived primarily as a US scandal and it failed to significantly raise the public attention towards rating agencies in Continental European countries (see Figure 9 and 10). There, it was instead another corporate bankruptcy – the collapse of the Italian

[113] These are the keywords used for this search: "derivatives", "rating agenc*", and "hedge fund*"
[114] Culpepper 2011, p. 159.

conglomerate Parmalat in 2003 – and the failure of rating agencies to detect this event — that increased media coverage of rating agencies, particularly in France (see Figure 10).

In the case of hedge funds, the international regulatory community had started to debate the regulation of these market actors during the East-Asian financial crisis. However, this crisis failed to generate significant attention from the US public, which focused on the regulation of the hedge fund industry only in the aftermath a more US-centric shock, that is, the collapse of the US hedge fund Long-Term Capital Management in 1998, a collapse that was averted at the 11th hour through a private bailout orchestrated by the Federal Reserve (see Figure 7). While this event was highly covered by the US media, hedge funds disappeared from the eyes of the media until 2005/06 when different frauds combined with the growing influx of pension funds and other institutional investors in the hedge funds' customer base increased attention towards these investment vehicles. Moreover, during the same period, hedge funds also become particularly salient within Continental European countries. The main debate was triggered in January 2005 when Deustche Böerse AG's takeover of the London Stock Exchange failed as a result of the interference of the London-based "Children's Investment Fund" (see Figure 9).

Figure 8 - Coverage of Derivatives, Rating Agencies, and Hedge Funds in the UK Press[115]

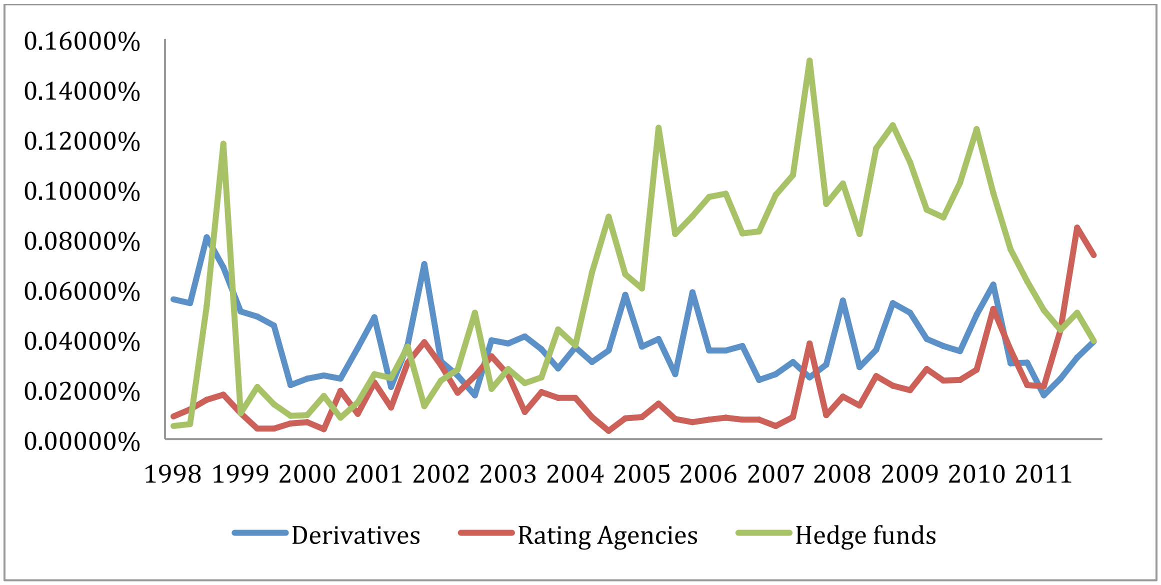
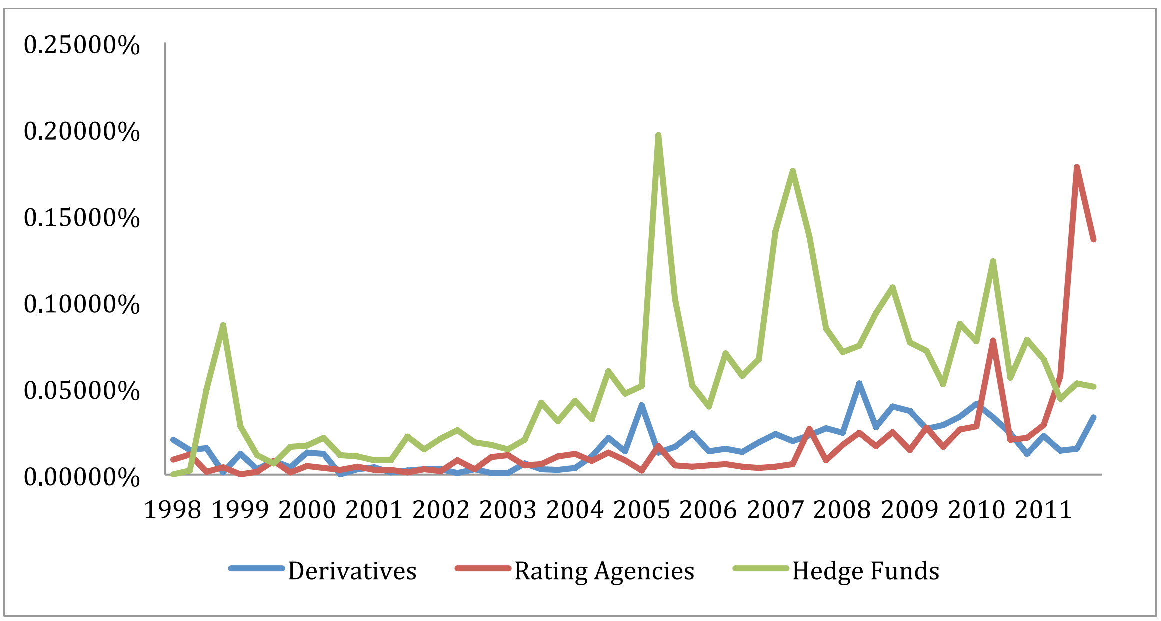
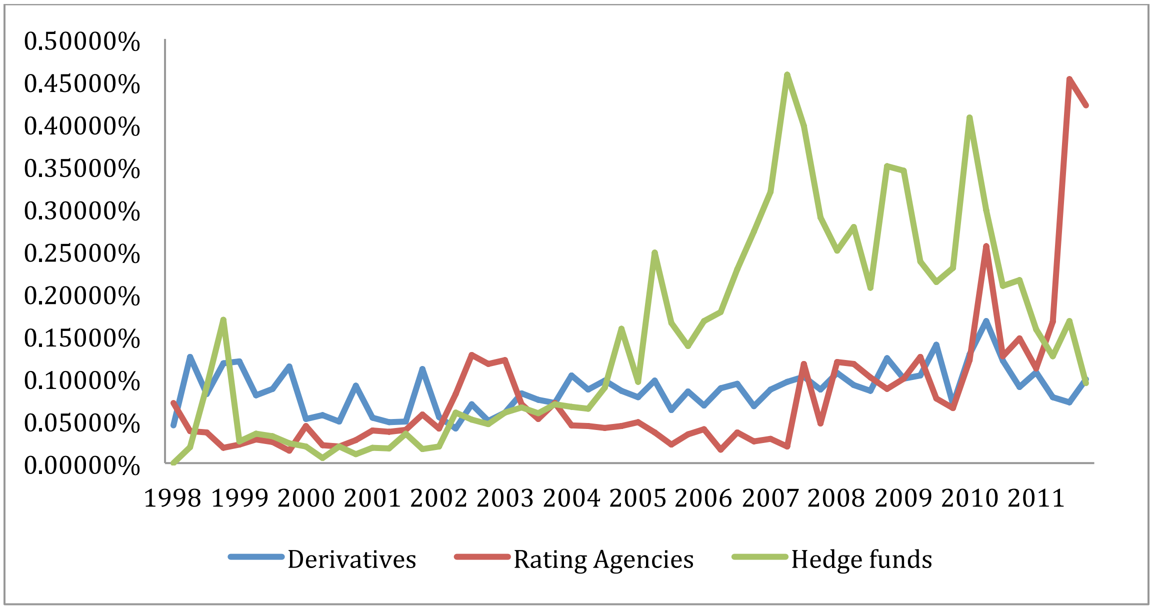


Figure 9 - Coverage of Derivatives, Rating Agencies, and Hedge Funds in the German Press[116]



[115] These are the keywords used for this search: “derivatives”, “rating agenc*”, and “hedge fund*”
[116] These are the keywords used for this search: “derivate”, “Ratingagentur*”, and “Hedgefond* or hedge funds”

Figure 10 - Coverage of Derivatives, Rating Agencies, and Hedge Funds in the French Press[117]



However, these figures also reveal how these increases in public salience were in most cases short lived, lasting no more than a quarter.[118] Public scrutiny during the 2008-2010 period has not only been more intense, but, above all, more long-lasting.

The keywords used in this analysis of media coverage do not allow the differentiation of the extent to which media attention focused on the underlying problems in the three markets and institutions or simply documented the policy response by regulators, politicians, or other actors. Indeed, it is important to acknowledge that important feedback loops may be in play in different circumstances. For instance, renewed public attention towards a policy domain as measured by the media exposure will create incentives for policymakers to introduce regulatory proposals or publicly take a position on this issue. This will further increase the coverage of that area, thus reinforcing the public's attention and generating new incentives for other policymakers to take action.

As the case studies will detail, this dynamic was clearly on display within the US Congress during the latest stage of the Congressional debates over the Dodd-Frank Bill, where public attention and media coverage had significantly increased the incentives of members of Congress to be perceived as active on the legislation. At the same time,

[117] These are the keywords used for this search: "produits dérivés", "agences de rating or agences de notation", and "fonds spécultatifs or hedge funds".
[118] The only exception in this regard is the public attention towards the regulation of derivatives following the different corporate scandals involving these products in 1994.

policymaker initiatives seeking to regulate a certain sector are not sufficient to attract media attention and generate this feedback loop. This is clearly demonstrated by the lack of media coverage in the years preceding the crisis of legislative proposals similar to the ones included in the Dodd-Frank bill.

Second, it is important to notice that the increase in the salience of different financial sectors is not directly related to their role in causing the crisis. During the crisis, significantly higher media coverage was directed towards hedge funds rather than rating agencies, despite the fact that hedge funds were not directly involved in originating the crisis (see Figure 7, Figure 9, Figure 10). Hedge funds have also attracted significantly greater media coverage than ratings agencies in Europe.

The third and final point is the increase in the level of salience documented above has varied significantly across countries. The difference between the level of public attention before and after the crisis is more significant in the US across the three sectors analyzed in this study than it is in the United Kingdom, France, and Germany. Most importantly, when we compare the sectors that have been the most salient in each of the four countries, important variations emerge. In particular, US-centric crises such as the collapse of Lehman Brothers and other scandals have focused the attention of the US public on derivatives, which the US media has covered more than the other two sectors. In Europe the public debate has concentrated primarily on the activities of rating agencies and hedge funds, with derivatives coming in at a distant third.

3.7 Conclusion

This chapter has explored the impact that the degree of attention that the general public pays towards different financial issues has over international financial regulatory politics. The theoretical argument presented in the first part of this chapter suggested that the likelihood that regulatory policies will rely on mandatory regulatory mechanism rather than industry-driven solutions will be influenced by the impact that different degrees of salience of financial issues have over the incentives of elected officials.

The second part of this chapter started to empirically assess this model's capacity model to explain the shift in the public-private divide triggered during the crisis by inferring the different degree of salience surrounding the regulation of derivatives, rating agencies, and hedge funds – the main independent variable in this study - from their coverage in the media. This analysis provided early support to the working hypothesis by showing how the resilience of the industry-driven regime that informed the governance of these markets and institutions before the crisis coincided with a period of what Culpepper calls "quiet politics" in the major jurisdictions interrupted by different shocks that failed to significantly impact the salience of these domains. Instead, the departure of the market-based regime triggered by the crisis has coincided with a period of heightened and sustained public attention towards markets and institutions as well as across sectors within each of the four countries analyzed in this study, although this attention was different in the US and Europe.

Indeed, the evidence presented in this chapter is important to shed lights over two important characteristics of the international shift in the public-private divide described in the first chapter. The first is about the timing of this shift. The main international regulatory institutions' endorsement of a direct regulatory approach coincided not with the beginning of the crisis and the discovery of market-failures, but rather with the heightened degree of public attention triggered by the intensification of the crisis in the second half of 2008. The second is about the extent to which this shift also affected sectors such as hedge funds that were not responsible for the crisis. The data presented in this section has revealed how despite hedge funds' marginal role in the crisis, their governance has attracted unprecedented attention in the main countries.

At the same time, the analysis of public salience through the media coverage does not provide conclusive evidence in support of the argument presented in the early part of this chapter. The argument presented in chapter has not directly linked public salience and international outcomes. On the contrary, different degrees of issue salience will impact international regulatory policies by altering the domestic policymaking process in the jurisdictions that exercise the greatest influence over the international agenda, particularly the incentives faced by elected officials.

In order to assess the mechanisms through which the changes in the level of public salience have come to influence the international regulatory agenda, the rest of this study will now qualitative analyze three case studies. The media analysis of issue salience in this chapter has helped identify the "turning points" in the public salience of different financial domains and highlight noticeable differences in the level of public attention across the different cases and across national contexts. The rest of this study will analyze the impact that these variations in the degree of public attention had over the policymaking process. How has the increase in the public salience of derivatives, hedge funds, and rating agencies altered the incentives of elected officials in the jurisdictions that exercise the greatest influence over the international agenda? To what extent did the conduct of elected officials during the crisis differ from the past? How have different degrees of public salience in Europe and in the US influenced dynamics between politicians, regulators, and their respective industries in these two contexts? These are some of the questions that will be addressed in the analysis of the three case studies in rest of this study.

Chapter 4. OTC Derivatives

4.1 Plan of the Chapter

This chapter will discuss the evolution of the international regime governing derivatives markets in light of the theoretical model presented in the previous chapter. Although many of the regulatory approaches covering these instruments also apply to other classes of derivatives, the particular focus of this chapter will be one class of these instruments, that is, credit derivatives (CDS). Credit derivatives are instruments used to transfer the credit risk of an obligation without transferring the ownership of the underlying asset. There are two reasons for this specific focus. First, in the years preceding the crisis, credit derivatives were one of the fastest-growing corners of the derivatives markets. Since the creation of the first “credit derivative swap” (CDS) contract by Bankers Trust in 1993, the size of the market has exploded, growing to $4 trillion by the end of 2003 and over $60 trillion at the end of 2007.[1] However, the exponential growth in the volume of OTC derivatives markets has occurred outside of the direct oversight of public regulatory authorities in the major jurisdictions. In fact, the regulation of derivatives markets has been presented as one of the main examples of private governance in the regulation of finance.[2]

Second, the regulation of these markets has occupied a central place in the regulatory agenda triggered by the global financial crisis, as credit derivatives were at the heart of some of the most pivotal events associated with the crisis. For instance, the emergency bailout of the US bank Bear Stearns in March 2008 was influenced by alarm over how the failure of a major counterparty in these markets might affect the market. Such risks materialized themselves only six months later with the failure of Lehman Brothers on September 15, 2008. Lehman was also an actively traded reference entity, and the lack of transparency regarding the total amount of CDS that had been written on its debt and who owned these contracts contributed to spreading panic in the markets.[3] A third case came with the quasi-collapse of insurance AIG, the result of the severely mispriced risk attached to the $440 billion in swaps underwritten by its Financial Products division,

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[1] The outstanding notion amount on these markets have later halved during the crisis as a result of the “compression” operations put in place by the industry to eliminate the offsetting contracts. See Kiff, Elliott, Kazarian, Scarlata, & Spackman 2009.

[2] Tsingou 2006.

[3] For a review of the role of derivatives in the case of Bear Stearns and Lehman Brothers, see European Commission 2009a; Jeffs, Schultes, & Vaughan 2008.

many of which were selling protection to other institutions on losses on their holdings of CDOs. The systemic importance of AIG and the losses that its failure would have imposed upon other banks led the US Federal Reserve to provide it with an $85 billion line of credit.

Besides these three institutions, CDS were also involved in the case of other financial institutions that triggered CDS contracts, such as the three leading Icelandic banks, Glitner, Landsbanki, and Kaupthing; the US bank Washington Mutual; as well as Freddie Mac and Fannie Mae, where the decision by the US government to put them under conservatorship triggered CDS contracts. Moreover, the end of the banking crisis has not driven credit derivatives to fall out of the regulatory agenda. In particular, during the European debt crisis of 2010-11 different European policymakers denounced how financial institutions were deliberately manipulating the price of credit derivatives for Greek sovereign debt in order to influence the price of funding in the Greek bond markets.

These events highlighted the potential for systemic disruption that could emerge if one of the parties in a derivative transaction could not meet its side of the bargain (so-called "counterparty risk"), and the possibility that the fear of such occurrence may trigger a "run" and also generate losses for market actors that had no direct exposure to the original derivative counterparty.[4] More generally, the crisis put into question the notion of credit derivatives as instruments capable of mitigating credit risk in the financial system. On the contrary, credit derivatives are now often described as "manufacturing" risk" increasing the level of leverage,[5] increasing much of the interconnectedness between financial institutions,[6] and creating opportunities for market manipulation and for market actors to speculate on a borrower's credit quality.[7]

Despite the risk surrounding CDS, the reversal of the international market-based approach that had governed derivatives markets before the crisis and the negotiation of a wide set of international commitments to shift the authority for regulating these markets into the hands of public regulatory authorities during the crisis cannot be easily explained by the theoretical explanations presented in Chapter 2. While the crisis has revealed significant risks associated with derivatives markets, this event cannot be regarded as the unique cause of the decision to address these challenges through direct regulation

[4] Kiff et al. 2009; Duffie, Li, & Lubke 2010.
[5] Das 2009.
[6] G30 2009, p. 59.
[7] Kiff et al. 2009.

rather than market-based mechanisms. Previous episodes of instability associated with the derivatives markets had led policymakers to solicit a market-based response, and this approach in fact dominated the initial response to the crisis. Moreover, as argued in chapter 2, the dynamics that have informed the shift in the international agenda are somewhat puzzling. The key role in promoting this change in the international agenda has been played by US authorities, who should have the greatest stake in the maintenance of a market-based regime built by the mostly US-based firms dominating the derivatives markets.

Most existing accounts of the transnational private regime governing derivatives before the crisis have focused on the role of financial industry groups in designing this market-based architecture. However, the first part of this chapter (4.2) will investigate the sources of this regime in the domestic political economy of the United States, where the majority of derivatives dealers are based and whose regulatory authorities exercise the greatest influence over the international regulatory agenda. In line with the theoretical framework presented in the previous chapter, this part of the chapter will investigate the sources of a set of political decisions taken since the early 1990s by the US Congress to leave OTC derivatives markets largely outside the purview of federal regulatory authorities. Section 4.3 will analyze the sources of the continuation of this market-based regulatory approach during the initial regulatory response to the crisis. Section 4.4 will then explore the changes brought within the US policymaking process by the heightened public attention towards the regulation of derivatives markets brought by the collapse of Lehman Brothers in September 2008 and subsequent events. This section will discuss the impact that this increase in the level of scrutiny had in altering the electoral incentives for US Congresspersons and other elected officials to assert public oversight over these markets. The final parts of this chapter (4.5 and 4.6) will shift and look at how similar developments occurred in Europe, where the approach of regulators has closely mirrored the US one. Section 4.6 will specifically discuss how the Eurozone debt crisis has re-opened the debate over the regulation of derivatives in Europe. The domestic realignment of preferences within the United States and Europe in favor of extending direct regulatory oversight over the main actors operating in OTC derivatives markets is the primary source of the shift in the international agenda.

4.2 The US Roots of the Transnational Private Regime Governing OTC Derivatives

As argued before, derivatives markets, and in particular credit derivatives, represented one of the fastest growing segments in financial markets in the years before the crisis. The growth of these markets, however, did not arise in a complete regulatory vacuum. Since the late 1980s, a set of self-regulatory initiatives designed by the same banks that have acted as dealers in derivatives markets has played a critical role in providing the legal bases on which the growing volume of transactions has flourished outside of regulated exchanges, in the so-called OTC markets. The leading role in coordinating these measures has been played by an association of dealers created in 1984 under the name of the International Swap Dealers Association, and later renamed the International Swaps and Derivatives Association (ISDA).[8] ISDA initially focused on standardizing swap documentation in order to increase the legal certainty of these transactions, providing a first "Code of Standard Working Assumptions and Provisions for Swaps," which later evolved in 1988 into a "Master Agreement" for swaps transactions.[9]

While the Master Agreement provided the cornerstone of the new self-regulatory regime, ISDA was not alone in solidifying the self-regulatory foundations of OTC derivatives markets. The initiatives of other industry associations gradually complemented the work of the ISDA, expanding this self-regulatory regime to different corners of growing derivatives markets. For instance, the Emerging Markets Traders Association adapted the Master Agreement to the needs of emerging markets derivatives transactions. This continued in 1995, when the US-based Financial Industry Association published a series of guidelines to address credit and operational risk in the industry, as well as convening a "Global Task Force on Financial Integrity", where the main exchanges and clearing organization established a framework to share information after the occurrence of certain events.[10] Also in 1995, six major derivative dealers forming the Derivatives Policy Group published a "Framework for Voluntary Oversight of the OTC Derivatives Activities of Securities Firm Affiliates to Promote Confidence and Stability in Financial Markets," detailing a set of standards to promote better disclosure of information to the counterparties as well as to regulators.[11] In 2000, several different financial markets trade associations developed a Cross Product Master Agreement in order to improve the management of counterparty risk.

[8] Coleman 2003.
[9] Coleman 2003; Tsingou 2006.
[10] Coleman 2003.
[11] Faerman, McCaffrey, & Van Slyke 2001; Tsingou 2003.

Besides these dealer groups, Tsingou has also highlighted the role played by the G30, a private sector group of high profile individuals whose membership comprised both industry representatives and experts from outside the private sector.[12] The G30 produced an influential report in 1993 entitled "Derivatives: Practices and Principles," a set of recommendations directed both at private market actors and policymakers. These recommendations in turn provided the framework for the publication of further guidelines by the Institute of International Finance and the London Investment Banking Association, and they were incorporated into the practices of a large number of financial institutions.[13]

These self-regulatory measures not only played a crucial role in favoring the growth of OTC derivatives markets in the years before the crisis but also were instrumental in preserving the status of these markets outside of the public regulatory umbrella. ISDA and other industry-driven bodies increasingly sought to convey the message that the industry was sufficiently capable of taking care of the regulation of the sector and no additional public regulation was required. According to Tsingou, "the industry was keen to establish that OTC derivatives required no special treatment but instead constituted one of several instruments used by financial institutions for risk-management purposes. In this context, the private sector seized the initiative and appeared to be dealing with the subject of OTC derivatives responsibly, thus pre-empting regulatory interference."[14]

While the steps taken by the industry to provide order to these growing markets and keep them free from burdensome regulatory requirements are the primary cause of the emergence of the transnational regulatory regime that sustained OTC derivatives markets before the crisis, the acceptance of this regime by international regulatory institutions is more puzzling. The growing size of the OTC derivatives markets and their popularity beyond the financial institutions that first created them, including less sophisticated users, generated new concerns since the early 1990s regarding the suitability of these products and the risks they posed. Nevertheless, the initiatives adopted over this period by international regulatory institutions never sought to challenge the market-based nature of OTC derivatives markets regulation, nor did they seek to assert direct regulatory oversight.

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[12] Tsingou 2003.
[13] Tsingou 2003.
[14] In particular, Tsingou argues that the G30 report played an important role in shaping the policy discussion and making self-regulation the "focal point". The G30 report conveyed the message that "responsible and efficient self-regulation was key to the use of derivatives, as intrusive rule-based regulation can render these instruments rigid and hamper financial innovation", and it was instrumental in demonstrating "that the private sector had the expertise, capacity and incentive to self-regulate". Tsingou 2006, p. 169-175.

In 1994 both the BCBS[15] and the Technical Committee of IOSCO[16] released a set of recommendations concerning OTC derivatives markets. However, as Tsingou documents, the focus on self-regulation that characterized the industry-driven initiatives also informed these reports. Neither of these two reports called for regulatory authorities to interfere directly in the derivatives markets, instead endorsing an approach based on enhanced self-regulatory measures by the industry.[17] The recommendations released by the BCBS and IOSCO summarized the best practices of the major financial institutions and provided further guidance to the industry. Tsingou argues, "The reports show that both the Basel Committee and IOSCO have accepted a role of limited involvement; they have centered their work on promoting a better foundation for self-regulation, which amounts to reviewing progress in the area of disclosure".[18] Despite such limited reccomendations, since these IOSCO and BCBS initiatives in the early 1990s, derivatives have remained on the agenda of international regulatory bodies. From 1996, the BIS has regularly monitored the size of the OTC derivatives markets and published annual surveys about derivatives activities of banks and securities firms.[19] However, throughout this period no major official international initiatives challenged the self-regulatory status of the derivatives markets.

In order to explain the acceptance of this market-based approach during this period, we need to investigate the preferences brought to the table of these international regulatory institutions from the country where the majority of derivative dealers are based, that is the United States.

Derivatives regulation entered into the US domestic agenda in 1994, when the sudden turn in interest rates created significant losses for Orange County Municipality, which had entered in a complex set of transactions involving derivatives in order to raise additional revenues.[20] The blow to the reputation of OTC derivatives markets was further amplified by two other corporate scandals concerning the use of OTC derivatives occurred in the same year. The first involved the transaction between Gibson Greetings and Bankers Trust; the second was between the same Bankers Trust and a larger corporation, Proctor & Gamble, which resulted in losses of $160 million for P&G.[21] In

[15] Basel Committee on Banking Supervision 1994.
[16] IOSCO 1994.
[17] Tsingou 2006.
[18] Tsingou 2006.
[19] Coleman 2003.
[20] Faerman et al. 2001; Huang, Krawiec, & Partnoy 2001; Tsingou 2003.
[21] Tsingou 2003.

both cases, later investigations demonstrated that the bank had not acted in the interest of the less sophisticated client.

These scandals raised the public profile of derivatives and increased the momentum behind different initiatives to regulate derivatives markets that had already made their way into the agenda of the US Congress.[22] Two years before the Orange County scandal, Rep. Markey had asked the Government Accountability Office (GAO) to analyze the implications of the growth in derivatives markets. With words that in many ways predicted what occurred with the collapse of Lehman Brothers 14 years later, a 1994 GAO report warned that the "combination of global involvement, concentration, and linkages means that the sudden failure or abrupt withdrawal from trading of any of these large US dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole."[23] The report acknowledged that in this case the government "would be likely to intervene to keep the financial system functioning in cases of severe financial stress," and this could "result in a financial bailout paid for or guaranteed by taxpayers."[24] The GAO report denounced how the most significant activities on the OTC derivatives markets were conducted by unregistered affiliates of US banks and therefore remained outside of the oversight of federal regulators, and it urged Congress to rectify this gap and bring derivatives under regulatory authorities.[25]

In the following months, different members of Congress introduced four different legislative proposals to rectify the gaps highlighted by the GAO report, which would have effectively ended the self-regulatory status of the industry. In May 1994, Congressmen Henry Gonzalez and James Leach introduced a bipartisan bill ("Derivatives Safety and Soundness Supervision Act of 1994") to mandate increased regulatory oversight of derivatives by banking and other federal regulatory agencies, as well as to require the Treasury to request a study examining the international supervision and regulation of derivatives in an effort to improve international regulatory coordination[26]. This bill was

[22] Maxfield 2011.
[23] GAO 1994, p. 2.
[24] GAO 1994, p. 2.
[25] The GAO report stated: ""Given the gaps and weaknesses that impede regulatory preparedness for dealing with a financial crisis associated with derivatives, we recommend that Congress require federal regulation of the safety and soundness of all major US OTC derivatives dealers. The immediate need is for Congress to bring the currently unregulated OTC derivatives activities of securities and insurance firm affiliates under the purview of one or more of the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across regulatory agencies. We also recommend that the financial regulators take specific actions to improve their capabilities to oversee OTC activities and to anticipate or respond to any financial crisis involving derivatives". See GAO 1994, p. 3.
[26] The bill is available at: http://www.archive.org/details/hrderivativessa00insugoog. The proposed legislation would have imposed on federal regulators these requirements: "consistent regulations on capital, disclosure, accounting, and

followed by the “Derivatives Limitations Act of 1994,” presented by Senators Byron Dorgan and Barbara Mikulski to prohibit federally-insured depository institutions from engaging in any significant derivatives activity.[27] The “Derivatives Supervision Act of 1994,” presented in July by Senator Donald Riegle, required the introduction of standards for capital, accounting, disclosure, suitability, and internal oversight of institutions involved with derivatives, in addition to prohibiting federally-insured depository institutions from engaging in derivatives transactions for their own account. Moreover, Sen. Riegle’s bill also addressed the problem of the systemic risk posed by OTC derivatives markets, requiring regulators to “promulgate appropriate regulations to require regulated entities and major dealers to increase use of clearinghouses and multilateral netting agreements; reduce intraday debit positions; shorten intervals between financial transactions in cash markets and their final settlement; shorten intervals between delivery of and payment for financial products; and otherwise reduce payments and settlement risk."[28] Finally, in July 1994 Rep. Edward Markey introduced a legislative proposal (“Derivatives Dealers Act of 1994”) to amend the Securities Exchange Act of 1934 in order to expand the jurisdiction of the SEC over OTC derivatives, subjecting all the previously unregulated dealers to SEC oversight.[29] Despite the severity of the charges against derivatives markets, neither these legislative proposals nor similar proposals presented in the following years were turned into legislation.[30] How can we explain the refusal by the Congress to seriously consider proposals to regulate derivatives and the overall support for self-regulation that characterized the US Congress during this period?

A closer look at the debates surrounding these bills is helpful to identify what concerns and forces shaped the position of the majority of the US Congress. First, the legislative proposals coming from Congress to regulate OTC derivatives markets were unsurprisingly resisted by the banking industry, which defended the self-regulatory initiatives taken by the industry on the basis of the recommendations released by the G30. In particular, Tsingou has argued that dealers were able to capitalize on the

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suitability; consistent examination guidelines across agencies; enhanced supervision of risk management processes and systems; and, additional reporting requirements for derivatives participants”

[27] The bill is available at: http://thomas.loc.gov/cgi-bin/bdquery/D?d103:28:./temp/~bdghos:
[28] The bill is available at: http://archive.org/details/hr4503derivative1994unit/
[29] Culp & Mackay 1994.
[30] A similar outcome also characterized other legislative proposals introduced in Congress in a later period, such as the bill introduced almost a decade later in the aftermath of the Enron scandal (march 2003) by Sen. Dianne Feinstein to give the CFTC the authority to investigate and punish manipulation in the energy derivatives markets. Also in this case, Congress decided not to take up this legislative proposal.

superior expertise demonstrated in the G30 report and their self-regulatory initiatives. This report proved to be a particularly important resource for the industry in such a technical area as derivatives regulation and helped to convince policymakers to accept the expertise of the private sector.[31]

Furthermore, besides praising the effectiveness of the self-regulatory measures taken by the industry, financial lobbies also highlighted the implications that regulating derivatives would have on the competitiveness of US financial firms and the risk that bringing OTC derivatives markets under a more stringent regulatory regime would have the effect of shifting highly mobile market activities such as derivatives away from New York towards London.[32] These concerns resonated heavily in the report presented in 1999 by the President's Working Group on Financial Markets, which argued that any attempt to regulate OTC derivatives markets would have the effect of moving a share of the market towards London.[33] Indeed, given the importance of the financial industry as a source of political contributions across both the Republican and Democratic parties and its weight in the economy, Congressmen maintained an interest in not introducing regulatory measures that may have damaged the US financial sector. Indeed, the promoter of the Commodity Futures Modernization Act, Sen. Phil Gramm, justified the initiative by stating that the bill would "keep our markets modern, efficient and innovative, and it guarantees that the United States will maintain its global dominance of financial markets."[34]

A second element surrounding Congressional debates was that the complexity of the issue and the limited expertise of US Congress in this area created strong incentives for individual Congressmen not to deviate from the position of regulatory agencies. The example of Sen. Trent Lott during the 2002 Congressional debate regarding whether OTC energy markets should be brought under the oversight of the CFTC is significant, as he told that most in Congress did not understand what a derivatives contract was: "We don't know what we are doing here. I have serious doubts how many senators really understand [this] and it sounds pretty complicated to me".[35] Indeed, during this period federal regulatory agencies were among the most important advocates of keeping OTC derivatives market outside of their oversight. The Office of the Comptroller of the Currency, the FDIC, the Office of Thrift Supervision, and the Federal Reserve in turn

[31] Tsingou 2006.
[32] Coleman 2003.
[33] PWG 1999b.
[34] Lugar & Gramm 2000.
[35] Jeremy Grant & Flood 2008. Mr Lott turned to his colleagues with a warning: "We don't know what we are doing here. I have serious doubts how many senators really understand [this] and it sounds pretty complicated to me."

denied in front of Congress that legislation was necessary and expressed their belief that the existing regulatory framework was adequate, praising the self-regulatory initiatives undertaken by the industry.[36]

Since the mid-1990s, the Federal Reserve has also encouraged market-based improvements in the governance of derivatives markets by releasing different supervisory letters to guide banks' treatment of credit derivatives in their capital requirement regulation as well as to direct attention towards different risks associated with derivatives markets.[37] The SEC went even further in promoting self-regulatory solutions for OTC derivatives. Following the increase in Congressional scrutiny towards derivatives, SEC Chairman Arthur Levitt called the main firms involved in the marketing of OTC derivatives to address derivatives' regulatory gaps collectively and "voluntarily." The initiative by the SEC led to the formation of the Derivatives Policy Group, which in March 1995 released its "Framework for Voluntary Oversight."[38] According to Maxfield, the SEC acted in this circumstance "as a buffer between the industry and Congress" in order to prevent the introduction of direct regulation.[39] Faerman, McCaffrey, and Van Slyke argue that "the SEC and CFTC wanted to get a tighter grip on the OTC derivatives market without being asked to implement what they thought would be crude legislation, although they were willing to ask for legislation if the industry was uncooperative."[40]

Authors seeking to explain the position of the Federal Reserve and other federal regulatory agencies on the subject have frequently referred not only to the close relation with the financial industry, but also the ideological viewpoint that dominated in these agencies, in particular the Federal Reserve headed by Alan Greenspan. Johnson and Kwaw have also argued, "For Greenspan, the rapid growth of the derivatives market was proof that they were socially beneficial. He believed, like many free market purists, that markets are self-regulating, and that as long as market participants have sufficient information, they will be aware of any potential dangers and protect themselves from them, and therefore outcomes in an unregulated market are necessarily good."[41] This view informed the position of the Federal Reserve for the entire tenure of Alan Greenspan. As Tsingou points out, even in 2003 when the BIS and other institutions had started to raise the alarm regarding the risks created by OTC derivatives markets,

[36] Tsingou 2003.
[37] Maxfield 2011.
[38] Faerman et al. 2001.
[39] Maxfield 2011.
[40] Faerman et al. 2001, p. 378.
[41] Johnson & Kwak 2010, p. 103.

Greenspan continued to advocate the view that derivatives were beneficial instruments that allowed risk to spread around the financial system.[42] In the words of Greenspan in front of Senate Banking Committee in 2003: "Derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so… The vast increase in the size of the over-the-counter derivatives markets is the result of the market finding them a very useful vehicle." According to Greenspan, it would have been a mistake going beyond the existing degree of regulation, since "derivative transactions are transactions amongst professionals."[43]

However, the extent of the ideological consensus among US regulatory agencies regarding the benefits of the existing self-regulatory model should not be overstated, as disagreement remained among these agencies. In particular, in 1997 Brooksley Born, the new head of the CFTC, called for a study on the growing range of OTC transactions occurring outside the public oversight to evaluate whether these should be brought under the federal regulatory umbrella. She also published a concept paper analysing how the CFTC could regulate the sector. In May 1998, the CFTC issued a report advocating greater disclosure in derivatives markets.[44]

The view expressed by the CFTC under Born was nevertheless directly opposed by the other major Federal regulatory agencies, in particular Greenspan's Federal Reserve, the SEC headed by Arthur Levitt, and the US Treasury under Secretary Robert Rubin. In a join statement, Greenspan, Rubin, and Levin raised "grave concerns" regarding the proposal presented by the CFTC.[45] In the end, the disagreement between the different regulatory agencies was won by those opposing the regulation of the industry, and Born resigned in May 1999 from her position as CFTC chairman. After her departure, the President's Working Group issued a report in November 1999 recommending legislation to exempt most derivatives from federal oversight.[46] Following this report, Congress passed the "Commodity Futures Modernization Act" in 2000. This act, passed at the end of the 106th Congress, solidified the self-regulatory status of OTC derivatives markets by explicitly prohibiting regulators from regulating them.[47]

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[42] Tsingou 2009.
[43] Johnson & Kwak 2010, p. 102. See also Greenspan 1997; Greenspan 2001.
[44] CFTC 1998.
[45] Barth et al. 2012, p. 98.
[46] PWG 1999b.
[47] Tett 2009.

Certainly, the common front created by financial industry groups and regulatory authorities in support of a self-regulatory regime goes a long way in explaining the limited support for measures seeking to directly regulate these sectors. However, it would be wrong to consider lawmakers as passively accepting the preferences expressed by the financial industry and regulators. Instead, it is important to consider how the low policy salience of this debate for most of the 1990s weakened the electoral incentives for most members of the US Congress to deviate from the preferences expressed by regulators and industry. As Figure 11 illustrates, while the events described above generated attention towards the regulatory status of derivatives, the issue saliency remained short-lived or regionally focused. The collapse of the hedge fund LTCM in 1998 failed to galvanize the attention of the public towards the regulation of derivatives despite the fact that these products weighed heavily in the trading strategy of the US hedge fund.

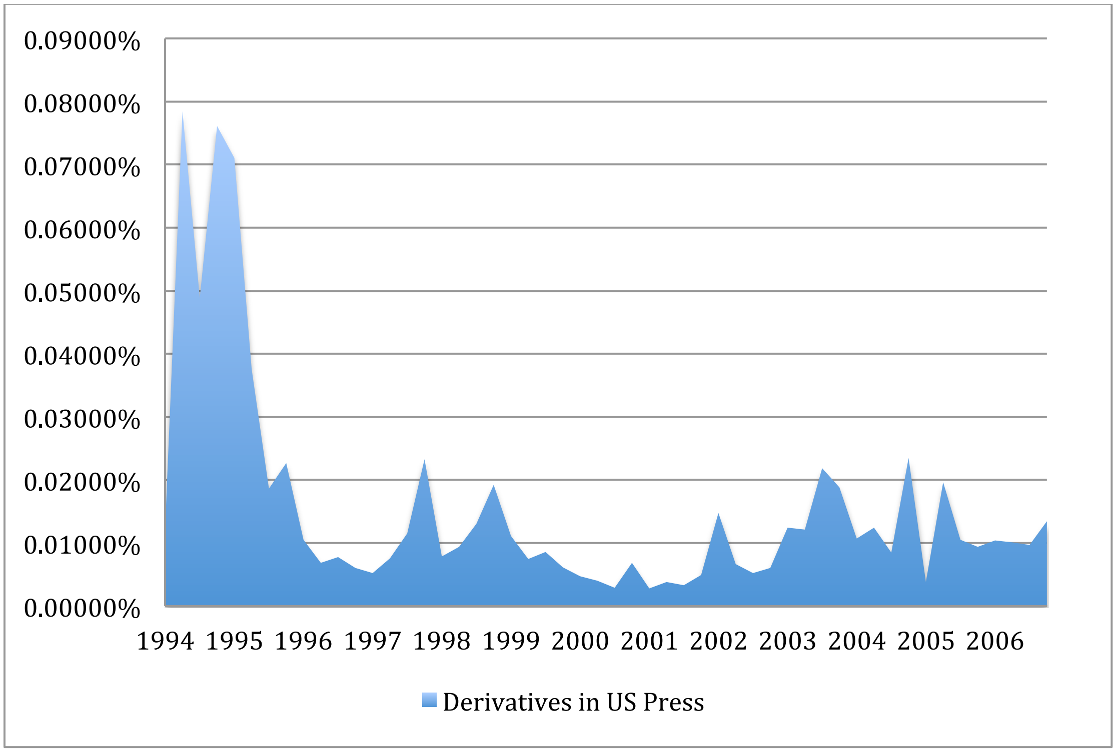
The lack of sustained public attention limited the incentives for the Democrats who controlled the Congress in 1994 to pass any proposed legislation. As Maxfield argues, "Democrats were on the political defensive and scared to move any controversial legislation." [48] This substantial degree of public inattentiveness towards derivatives throughout the 1990s also informed the passage of the Commodity Futures Modernization Act. The bill was was introduced at the end of 106th Congress into an 11,000 page omnibus appropriations bill during a lame-duck session, only four minutes before the beginning of the final considerations of the report. Neither the majority of Congressmen nor the public through the press paid significant attention to this initiative, which was approved by the Senate on a voice vote. [49]

In a nutshell, the decision by US Congress not to support different legislative proposals seeking to bring OTC derivatives markets within the purview of federal regulatory authorities was as important as the measures adopted by the financial industry in creating the bases for the emergence of the transnational private governance regime that governed derivatives markets before the crisis. In seeking to identify the sources of these choices, this section has highlighted not only the preferences of the financial industry and most US regulatory authorities in favor of self-regulation, but also it has shown the limited incentives for elected politicians to challenge this position given the low salience of the issue throughout most of the period before the crisis of 2007-2010.

[48] Maxfield 2011.
[49] Read the Bill 2011.

The continuation of this configuration of preferences within the US in the decade that preceded the crisis is one of the key factors explaining the lack of attempts to regulate derivatives markets at the international level after 1994, despite the growing alarms regarding the risks in these markets launched by organizations such as the BIS. [50]

Figure 11 - Coverage of Derivatives in the US Media Before the Crisis (1994-2006)



4.3 The Continuation of Self-Regulation under the Shadow of the Fed

In April 2007, the G7 finance ministers and central bank governors stated that "the emergence of advanced financial techniques, such as credit derivatives, have contributed significantly to the efficiency of the financial system."[51] Only a few months later, however, the emergence of new instability forced the international regulatory community to reconsider their optimism towards the contribution of derivatives to the functioning of financial markets.

When the Financial Stability Forum presented the first internationally coordinated response to the crisis in April 2008, derivatives figured prominently in the agenda. The

[50] Kiff et al. 2009.
[51] G7 2007b.

FSF acknowledged that "initiatives are required to make the operational infrastructure for over-the-counter (OTC) derivatives more robust". In particular, the FSF called for amendments to the documentation of credit derivatives to allow for cash settlement of obligations, greater automation of trades, and for measures to strengthen the infrastructure supporting OTC derivatives markets.[52]

However, it is important to note that regulators did not abandon the emphasis on industry-driven solutions that had emerged before the crisis. These recommendations were directed respectively to "market participants" and to the "financial industry" rather than to regulatory authorities.[53] During its initial report in April 2008, the FSF self limited the role of public authorities to that of "encourag[ing] market participants to act promptly to ensure that the settlement, legal and operational infrastructure for over-the-counter derivatives is sound."[54] Similarly, in the follow-up report published in October 2008, the FSF envisioned the role of authorities as "maintaining momentum in developing and implementing the recommended actions effectively and in full."[55]

Indeed, the continuation of the support towards a market-based solution that characterized the international regulatory community in their initial regulatory response reflected the fact that the outbreak of the crisis did not undermine the domestic configuration of interests in the US that had supported the market this arrangement before the crisis. The same US federal regulatory authorities that before the crisis had demanded Congress to exempt derivatives from federal oversight returned to the issue of derivatives at the outset of the crisis. The report published at the beginning of 2007 acknowledged that the infrastructure designed by the industry before the crisis had not kept pace with the explosion in these instruments complexity and the surging trading volumes. In line with the approach adopted before the crisis, however, US federal authorities did not call for an extension of the regulatory net over these markets but rather invited the industry to address shortcomings in the infrastructure of derivatives markets through self-regulatory initiatives.[56]

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[52] FSF 2008b, p.21. More specifically, the FSF demanded "market participants" to "amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a credit event, in accordance with the terms of the cash settlement protocol that has been developed, but not yet incorporated into standard documentation." The FSF also asked market participants to "automate trade novations and set rigorous standards for the accuracy and timeliness of trade data submissions and the timeliness of resolutions of trade matching errors for OTC derivatives". Finally, the FSF also called upon the "financial industry should develop a longer-term plan for a reliable operational infrastructure supporting OTC derivatives."

[53] FSF 2008b, p.12.

[54] FSF 2008b, p.6.

[55] FSF 2008c, p. 3.

[56] The language adopted by the President's Working Group is explicit in avoiding to recommend that federal regulators should be put in charge of overseeing derivatives markets. The task of federal regulators is to "*insist* that the industry

US regulatory agencies played a very active role in guiding the numerous self-regulatory changes in the operation of derivatives markets undertaken by the financial industry during the initial stage of the crisis. The Federal Reserve Bank of New York especially took a leading role in spurring these self-regulatory improvements. Since before the crisis, the Federal Reserve Bank of New York had expressed concern over the rapid growth of the credit derivatives markets and the operational risks that emerged from the difficulty of the existing market infrastructures in supporting this. Then head of the New York Federal Reserve Timothy Geithner organized the first of a series of meetings with representatives of major market participants on September 15, 2005 to push them to address those vulnerabilities that could prove destabilizing should a crisis hit, such as the significant backlogs of unconfirmed or unprocessed trades.[57]The outbreak of the crisis reinforced the urgency of these self-regulatory improvements to the governance of derivatives markets, and the Federal Reserve Bank of New York summoned a senior industry leadership group called the Operations Management Group in a series of closed-door meetings. This group was formed by the major derivatives dealers, buy-side actors, and major financial industry groups such as the International Swaps and Derivatives Association, the main US hedge fund managers' group (the Managed Funds Association), and the Securities Industry and Financial Markets Association (SIFMA), collectively accounting for more than 90% of all credit-derivatives trades.[58]

These market actors quickly took steps to deliver the improvements in the operational infrastructures of the markets demanded by the Federal Reserve Bank of New York. Over the course of 2008, industry participants publicly committed to implement self-regulatory measures to enhance the processing of derivatives traded over-the-counter, to expand automation of credit derivatives trade processing, and to submit a greater number of electronically eligible credit derivatives on electronic confirmation platforms [59] in order to reduce OTC trade confirmation backlogs. [60] Derivatives dealers also committed in June 2008 to reduce counterparty credit exposure and operational risk by decreasing the enormous volume of outstanding credit derivatives trades through a

promptly set…", to "*urge* the industry to amend…" and "*ask* the industry to develop…" regulatory initiatives to address these shortcomings. PWG 2008

[57] Federal Reserve Bank of New York 2005.

[58] Two weeks after the publication of the PWG report, the Federal Reserve Bank of New York welcomed the commitments announced by the major derivatives dealers. See Federal Reserve Bank of New York 2008c

[59] Federal Reserve Bank of New York 2008c; 2008e.

[60] Industry-driven initiatives to achieve these goals had been developed since 2005, and at the beginning of the crisis the industry claimed to have made significant progresses in this direction. The number of credit derivatives traded on electronic platforms has increased from 53% to more than 90%, while the number of credit derivatives confirmations outstanding more than 30 days had been reduced by 86%. Federal Reserve Bank of New York 2008d; See also Operations Management Group 2008b.

process called “portfolio compression”—tearing up contracts that have essentially opposite positions over the same risk—and to execute daily collateralized portfolio reconciliations for collateralized portfolios.[61]

Further demonstrating the direction of US regulators, the focus of the Federal Reserve at the outset of the crisis progressively shifted from strengthening the plumbing through which derivatives markets flow (i.e. operational infrastructures) towards taking initiatives to redirect these flows through central counterparties where bilateral trades could be cleared in order to mitigate counterparty risk.[62] At the end of July 2008 the major dealers committed to support these clearing platforms, declaring that they would “(i) support a clearing platform and (ii) utilize such platform to clear all eligible products where practicable.”[63] After the collapse of Lehman Brothers, the Federal Reserve Bank of New York extended the invitation to its series of closed-door meetings to the representatives of four potential CDS counterparties (Eurex, NYSE Euronext, CME Group/Citadel, and IntercontinentalExchange/The Clearing Corporation), together with the major dealers and buy-side firms, in order “to accelerate market adoption of central counterparty services.”[64] This intervention of US regulatory authorities in steering the self-regulatory response went as far as seeking to shift the balance of power between different private actors. In particular, the Federal Reserve Bank of New York sought to dilute the role of derivative dealers (the sell-side), which have traditionally dominated the market, in favour of buy-side actors by manipulating the composition of the private sector

[61] Operations Management Group 2008a,
[62] By standing between the two counterparties in a transaction and becoming the buyer to the seller and the seller to the buyer, CCPs have been presented as mitigating the counterparty risk highlighted by the collapse of Lehman Brothers by the collective credit of the clearinghouse and all its members to the credit of a single counterparty. Moreover, CCPs were presented also as buffering the markets by requiring members to have a sufficient amount of capital in their accounts, to post initial margin requirements depending on the risk to which the CCP is exposed, as well as to post on an ongoing basis additional risk-related variation margin against variation their portfolio, preventing in this way build-up of significant losses and maintaining records of all transactions. IOSCO 2009f; Kiff et al. 2009
[63] Federal Reserve Bank of New York 2008b. Some of the major dealer banks had announced in May 2008 the establishment of a central platform for clearing certain types of OTC credit derivatives – called ICE US Trust, followed by the creation of other clearing ventures. Other participants entering this clearing race were a joint venture between the Chicago Mercantile Exchange, the world’s largest futures exchange, and Citadel, a Chicago-based hedge fund, Frankfurtbased Eurex, and NYSE Euronext.
[64] Federal Reserve Bank of New York 2008a. On October 31, 2008, the Federal Reserve Bank of New York stated: “As the primary authorities with regulatory responsibility over U.S. CDS CCP proposals, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the Federal Reserve have strongly encouraged CCP developers and market participants to accelerate their efforts to bring a CDS CCP to market. The U.S. regulators are cooperatively reviewing the risk management designs of the U.S. CDS CCP proposals with the objective of granting regulatory approvals as soon as they are determined to meet risk management standards”. In this circumstance, the NY Fed argued to be “hopeful that one or more CCPs can begin operations in November or December 2008, enabling market participants to rapidly move trades onto a CCP”. Federal Reserve Bank of New York 2008b.

contingent invited to the closed-door meetings.[65] In June 2009, invitations were also extended to buy-side clients and hedge fund associations for the first time.[66]

On balance, the continuation of the self-regulatory approach that informed the early international response to the crisis occurred in the shadow of the New York Federal Reserve. At the same time, it is important to point out that the Federal Reserve and other US federal regulators continued during this period to downplay the need for any action by Congress to give them greater oversight and regulatory authority over OTC derivatives markets. In the period that preceded the collapse of Lehman Brothers, the SEC, Federal Reserve, and CFTC did not demand any new legislation from Congress. Kathryn Dick of the Office of the Comptroller of the Currency, the body that oversees some of the largest banks dealing in the CDS markets, was explicit on this point during a Senate Banking subcommittee hearing in July 2008: “[W]e do not see a need for legislative intervention to supplement our ability to regulate the credit derivatives of national banks".[67] Clearly, the continuous leadership role played by federal regulatory agencies within the US domestic political process during this period and their preference for self-regulation were an important determinants of the continued reliance on self-regulation that also informed the international agenda during this period.

4.4 Derivatives in the Congressional Agenda

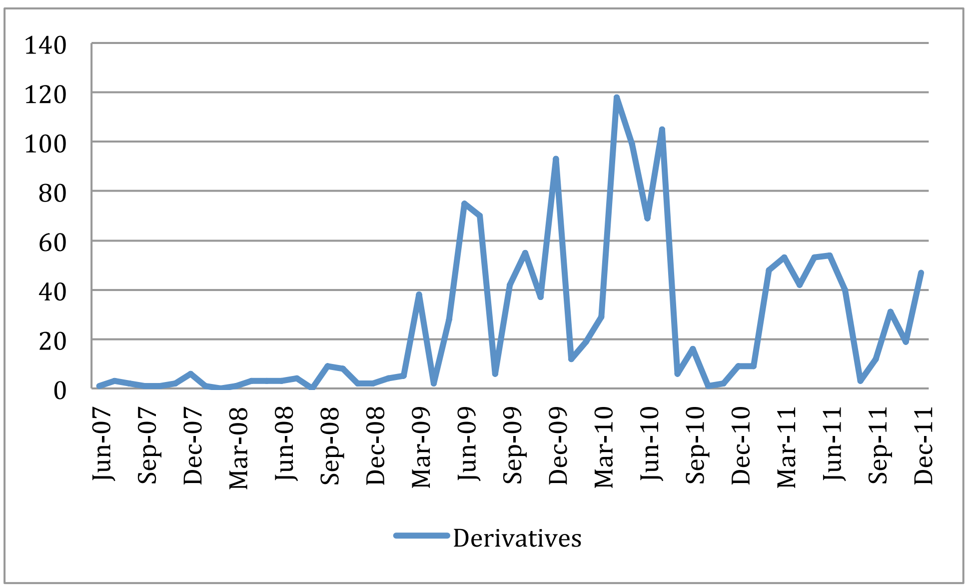
While during the initial regulatory response to the crisis, regulatory agencies continued to interpret their role in the regulation of derivatives primarily as that of steering the self-regulatory measures of the industry, this approach came to be questioned by the US Congress. The first shot fired against this approach came from the influential Sen. Charles Schumer, who in June 2008 questioned whether the plan presented by the main derivative dealers of voluntarily clearing their CDS trades through a central counterparty (CCP) was sufficient to mitigate systemic risk. In a letter directed to the chairmen of the CFTC, SEC, and Federal Reserve, Schumer argued, "I am very concerned that the regulatory oversight of the credit derivatives market, like the regulatory oversight of the housing market, has been too lax for too long...We cannot wait for the next crisis before we act to rein in this risk. It is clear that the hands-off approach that U.S. financial

[65] Federal Reserve Bank of New York 2009a.
[66] Federal Reserve Bank of New York 2008d.
[67] Robb 2008.

regulators have long taken towards over-the-counter (OTC) credit derivatives is no longer appropriate in today's global and interconnected markets."[68]

Despite this early concern, the issue of derivatives regulation formally re-entered the Congressional agenda only after the default of Lehman Brothers, as Figure 12 illustrates. The Emergency Economic Stabilization Act of 2008 passed by Congress at the beginning of October to bailout banking institutions in trouble also explicitly demanded the Treasury to review the regulation of over-the-counter swaps market and to provide recommendations on "(A) whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system; and (B) enhancement of the clearing and settlement of over-the-counter swaps."[69]

Figure 12 - Number of Articles mentioning "Derivatives" in "Congressional Documents and Publications"[70]



Besides spurring the US Treasury to act, the greater attention towards derivatives triggered by Lehman encouraged different Congressmen to present legislative proposals to regulate the sector. In October 2008, Sen. Tom Harkin announced a hearing on the

[68] Schumer 2008.
[69] The text of the bill is available at: http://www.govtrack.us/congress/bills/110/hr1424
[70] The "Congressional Documents and Publications" a wide variety of documents concerning the activity of US Congress, including legislative proposals, transcript of hearings, and press releases from individual Congressmen. It has been accessed through Factiva.

issue of derivatives regulation. In the statement announcing this hearing, he argued: "Financial swaps or over-the-counter financial derivatives had been exempt from most regulations since 1993 …I firmly believe we have to revisit and examine very carefully how these financial swaps and derivatives are regulated – or really not regulated." After a second hearing on October 14, Harkin stated, "It's clear we made a terrible mistake in 2000 in excluding credit-default swaps from the CFTC."[71]

Similarly to what occurred during the same period in other sectors, the crisis also created incentives for different Congressmen to reintroduce bills that had originally been introduced in previous sessions before the crisis but had failed to become law, some of which closely mirrored the proposals presented in the early 1990s. For instance, at the beginning of October 2008, Rep. Edward Markey announced its plan to reintroduce legislation he had first pushed for in 1994 to instruct the SEC to directly regulate derivatives. [72] In November, Sen. Harkin presented the "Derivatives Integrity Act of 2008."[73] According to its sponsor the bill was an attempt to "undo…what was done in the early '90s and late '90s in terms of exempt [markets] and exclusions," as well as to "end the unregulated 'casino capitalism' that has turned the swaps industry into a ticking time bomb".[74] This legislative proposal was followed by numerous other bills seeking to eliminate statutory exclusion of swap transactions from legislation, such as the "Financial Regulation Reform Act of 2008," introduced by Sen. Susan Collins in November; the "Derivatives Markets Transparency and Accountability Act of 2009," introduced by Rep. Collin Peterson in February; the bipartisan "Authorizing the Regulation of Swaps Act," introduced in May 2009 by Sen. Carl Levin and Sen. Susan Collins; and the "Prevent Unfair Manipulation of Prices Act of 2009," presented by Rep. Bart Stupak in May.[75]

As the response to the Orange County scandal in 1994 demonstrates, this kind of legislative activism following an episode of financial instability was not unprecedented in the Congressional landscape. However, this time around, the default of Lehman Brothers and the bailout plan announced by the US Treasury created a political climate within the US Congress more favorable to these proposals. The default of Lehman Brothers also triggered a reverse in the position of the SEC and the CFTC. Blamed for having fallen "asleep at the wheel" in the aftermath of the bankruptcy of Lehman

[71] Lynch 2008b.
[72] Markey 2008.
[73] The text of the bill is available at http://www.govtrack.us/congress/bills/110/s3714
[74] Oil & Gas Journal 2008.
[75] The text of the Collins bill is available at: http://www.govtrack.us/congress/bills/111/hr977. The text of the Levin and Collins bill is available at: http://www.govtrack.us/congress/bills/111/s961. The text of tie Stupak bill is available at http://www.govtrack.us/congress/bills/111/hr2448

Brothers, both the SEC and CFTC lamented their lack of authority over OTC derivatives. Speaking in front of the Senate Banking Committee a few days after the collapse of Lehman Brothers, the chairman of the SEC, Christopher Cox, urged Congress "to provide in statute the authority to regulate these products to enhance investor protection and ensure the operation of fair and orderly markets."[76] The acting chairman of the CFTC, Walter Lukken, also recommended to the House Agriculture Committee that "regulatory reform should provide for clear enforcement authority over these products to police against fraud and manipulation."[77]

The same request to Congress to be granted oversight over derivatives markets was also put forward by the new chairmen of SEC and CFTC appointed by President Barak Obama, Mary Schapiro. She stated during her confirmation hearing in Congress that credit-default swaps "absolutely" needed to come under federal regulation, and she requested a legislative act to grant her agency oversight over credit derivatives markets.[78] The newly appointed head of the CFTC Gary Gensler also expressed his regret for not having pushed harder to bring OTC markets under greater regulation a decade earlier. Gensler acted as undersecretary of the Treasury in 2000 when Congress exempted OTC markets from regulatory oversight with the Commodity Futures Modernization Act. Gensler vowed he would take a harder stance on bringing OTC derivatives trading under stricter controls.[79] This reversal in the position of the SEC and CFTC helped in solidifying support within the main Congressional Committees for the legislative proposals seeking to regulate derivatives markets.

The main point where the legislative proposals presented over this period differed was not whether to reverse the pre-crisis lack of regulation, but rather which regulator should be in charge of overseeing derivatives markets. One of the primary cleavages within Congress did not run across party lines, but rather between the House and Senate Financial Services and Banking committees on the one hand and the House and Senate Agriculture committees on the other hand. These committees defended the prerogatives of the regulatory agencies under their direct oversight, the SEC and CFTC respectively, by seeking to grant them primary responsibility to regulate these markets.[80] This turf war

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[76] Chung, van Duyn, & Davies 2008.
[77] Lynch 2008a.
[78] Crittenden 2009. Moreover, Schapiro went even further and presented in June 2009 a plan for bringing over-the-counter derivatives under federal securities laws. See Schapiro 2009.
[79] Marron 2009.
[80] The House Agriculture Committee Chairman Collin Peterson also raised doubts about the desirability of granting the SEC or the Federal Reserve the primary responsibility to regulate these markets, and its Derivatives Markets Transparency and Accountability Act of 2009 gave the CFTC the primary oversight over these markets derivatives. Also

was further broadened when the Energy and Commerce Committee entered the debate over the regulation of OTC derivatives markets, protesting that these legislative proposals would interfere with the authority of the Federal Energy Regulatory Commission.[81] In the end, this turf war among different regulatory agencies was settled by splitting the jurisdiction over the supervision of the clearing of OTC derivatives between the SEC and CFTC.[82] Nevertheless, none of the legislative proposals sought to defend the continuation of the self-regulatory approach endorsed by Congress with the Commodity Futures Modernization Act of 2000. While certain aspects of these legislations were opposed by Congressmen from the ranks of the Republican Party and a part of the Democratic Party known as "New Democrat Coalition," the main alternative legislation coming from the other side of the aisle did not oppose the departure from the self-regulatory principle that informed the pre-crisis regulatory paradigm.[83]

The proposals voted by the Congressional majority within both the House and the Senate quite closely followed the path presented by the US Treasury and did not challenge its expansion into the regulatory oversight over derivatives markets.[84] The Wall Street Transparency and Accountability Act of 2010, which is Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act approved by both houses of Congress, removed the provisions of the Commodity Futures Modernization Act of 2000 that left the derivatives markets largely unregulated. It also introduced a comprehensive framework that would expand the grip of regulators over the main participants in the

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another important legislative proposal debated by the Senate Agriculture Committee, that is the "Financial Regulation Reform Act of 2008" introduced by Senator Susan Collins, requested to report over-the-counter contracts to the CFTC. These proposals were instead opposed by the House Financial Services Committee and the Senate Banking Committee, the two committees sharing oversight over the SEC. The bill introduced in the Financial Services Committee by Rep. Edward Markey (the "Derivatives Market Reform Act") requested derivative dealers to register with the SEC, thus granting this body "exclusive jurisdiction regarding accounts, agreements, transactions, and markets in derivatives". The Chairman of the House Financial Services Committee Barney Frank has suggested instead limiting the authority of the CFTC to commodities that are "edible" (e.g. futures on agricultural products), while letting everything else under the jurisdiction of the SEC. See Lynch 2009a; Scannell 2009; Pagliari 2010; Davies 2009.

[81] Platts 2009; Lynch 2009b.

[82] Abbott 2009; Bloomberg 2009.

[83] Chambliss, Shelby, & Gregg 2010.

[84] Within the House, the task of reconciling the tension between the Financial Services Committee and the Agriculture Committee fell on the shoulder of the two chairman, Rep. Barney Frank and Rep. Collin Peterson. The two congressmen presented a shared draft in July 2009, before submitting two different bills to their respective committees. The "Over-the-Counter Derivatives Market Act of 2009" was approved by the House Financial Services Committee on October 15 2009, while the House Agriculture Committee passed its legislation the following week (21 October). The two bills coming from the Financial Services and Agriculture Committee were reconciled at the beginning of December 2009. In the Senate, the leadership was instead taken by the Chairman of the Banking Committee Chris Dodd who presented on Nov 11 2009 a first legislative proposal directly building upon the US Treasury proposal, and dividing the authority to regulate these markets between the SEC and CFTC. This bill entitled "Restoring American Financial Stability Act" was approved by the US Senate Banking Committee in March 2010 (22 March 2010). Similarly to what occurred in the House, the bill presented by the Senate Banking Committee had to be reconciled with another bill out of the Agriculture Committee chaired by Sen. Blanche Lincoln. Sen. Lincoln presented her "The Wall Street Transparency and Accountability Act of 2010" on the 9th of April 2010 and this bill was voted by the Senate Agriculture Committee on the 21st of April 2010. The Dodd bill voted by the Senate Banking Committee and the Lincoln bill voted by the Agriculture Committee were later reconciled and voted by the whole Senate. In May 2010, a committee of Congressmen met to reconcile the bills approved by the House and the Senate

derivatives markets, including derivatives dealers, major market participants, clearinghouses, and trade repositories. Besides requiring these market actors to register with federal regulators, the bill also subjected dealers to capital requirements, business conduct standards, reporting requirements, and initial margin requirements, as well as mandated the central clearing and trading of standardized derivatives.[85] Moreover, the bill did not limit itself to regulating credit derivatives at the center of the crisis, but rather it encompassed nearly all commonly traded OTC derivatives, including options on interest rates, currencies, commodities, securities, indices, and various other financial or economic interests or property.[86]

The activity of Congress and the US set the parameter not only for US legislation but also for the international agenda. When the US Treasury presented its legislative proposal, Treasury Secretary Geithner stated its intention to "continue to work with our international counterparts to help ensure that our strict and comprehensive regulatory regime for OTC derivatives is matched by a similarly effective regime in other countries."[87] Indeed, when G20 leaders met for the first time after the announcement of the legislation at the Pittsburgh Summit in September 2009, their commitments did not depart from the parameters set up by the US Treasury, including the mandatory trading and clearing requirement for standardized contracts.[88] Therefore, the main turning point in the international approach towards the regulation of derivatives, that is the extensive set of commitments adopted by G20 leaders at the Pittsburgh Summit, found its roots in the preferences towards this issue of US Congress and the US Administration.

How can we explain the successful bid by Congress to regulate derivatives while in the past similar legislative proposals had failed to gather the same support? The central element to be considered is the different issue salience of derivatives regulation in the 1990s versus during the global financial crisis. As discussed before in this chapter, legislative debates concerning the regulation of derivatives in the late 1990s were characterized by only very limited public attention towards the issue, thus limiting the incentives for the majority of the members of Congress to challenge the status quo supported by the financial industry and increasing their incentives to defer to the preferences of regulators and the financial industry. As demonstrated in the previous

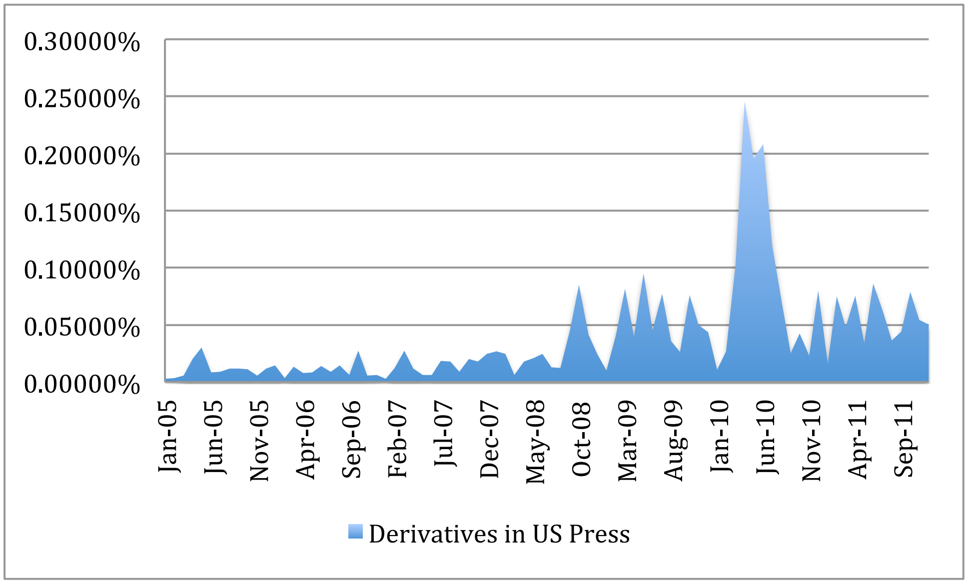
[85] Clearing organizations would be subject to margin and risk management requirements, default rates and procedures, settlement procedures and corporate governance, as well as record-keeping requirements, that is, to maintain records of all activities related to their clearing businesses and to report such information to regulators.
[86] The bill excluded commodity futures and physically settled sales of nonfinancial commodities for deferred shipment.
[87] Geithner 2009b.
[88] G20 2009b.

chapter, the analysis of the media coverage of derivatives during the crisis reveals how the level of public attention towards the issue did not increase significantly during the first stage of the crisis. However, the public attention towards the issue increased markedly from the last part of 2008, continuing to rise steadily during the final stage of the Congressional debate surrounding the Dodd-Frank bill, as illustrated in Figure 13.

Besides the bailouts of October 2008, other events also raised the prominence of the regulation of derivatives and decreased the importance of the support of the financial industry. A key turning point was the suit presented by the SEC against Goldman Sachs for its failure to disclose the role played by a major hedge fund in selecting a portfolio for a derivatives product it issued in 2007.[89] As Bill Galston of the Brookings Institution commented, "In its timing and political value, the Goldman Sachs case is to financial reform what the Anthem Blue Cross [healthcare insurer] premium rate increases was to healthcare reform in February."[90] These episodes significantly turned public opinion against the attempts by the financial industry to limit the extent of the regulation of derivatives and therefore weakened the incentives for Congressmen—in particular in the Democratic Party—to adopt positions that could be perceived as too cosy with the financial industry. In a major reversal of the rhetoric that surrounded derivatives regulation in the 1990s and early 2000s, Congressmen supporting the legislation of derivatives frequently justified their position as in defense of taxpayers against the interests of financial institutions. In the same vein, President Obama intervened in person to declare that he would veto a bill that did not severely regulate derivatives[91] and that his administration would stand "firm against any attempt by the financial sector to avoid their responsibilities: in any future crisis the big financial companies must pay, not taxpayers."[92]

[89] The Sec alleged that Goldman Sachs had committed fraud in marking this product, where customers had lost billions while Goldman had made money by betting against the product.
[90] Luce 2010.
[91] Favole 2010.
[92] Marron 2010.

Figure 13 - Coverage of Derivatives in US Press (2005-2011)



Unlike in the pre-crisis period, the Congressional debate that followed the US Treasury proposal was characterized by a more adversarial tone between Congressmen and derivative dealers, and different proposals presented within Congress directly challenged the preferences of the dealers. For instance, derivative dealers supported the market-based approach adopted by the Federal Reserve Bank of New York to push trades negotiated privately between counterparties through a central counterparty, which relied extensively on the input of market actors in determining which contracts should be cleared into CCPs and which ones kept outside of them.[93]However, when the regulation of derivative entered the Congressional agenda at the end of 2008, the main legislative proposals mandated the use of clearinghouses. The Derivatives Markets Transparency and Accountability Act of 2009, circulated by Rep. Peterson in January, required all OTC transactions to be cleared through a regulated clearinghouse, while giving the CFTC the authority exempt certain transactions from this requirement. The Derivatives Trading Integrity Act of 2009, introduced in January 2009 by the Chairman of the Senate Committee on Agriculture, Senator Tom Harkin, went beyond Peterson's bill by

[93] In particular, the Federal Reserve Bank of New York announced its expectation that market participants would "set increasingly stringent targets over time" and it has worked throughout the crisis to push the dealers to expand the fraction of contracts cleared beyond the initial focus on credit derivatives market. Federal Reserve Bank of New York 2010 In September 2009, the major derivatives dealers made a series of individual commitments to submit at least 95% of their eligible trades to a central clearinghouse, while these targets were further increased in January 2010. See Federal Reserve Bank of New York 2010 In March 2010, ISDA announced that "more than 90 percent of new dealer-to-dealer volume of clearing-eligible Interest Rate Derivative products is now cleared through central counterparty clearing facilities (CCPs). In addition, more than 90 percent of total dealer-to-dealer volume of clearing-eligible Credit Derivative products is now cleared through CCPs".See ISDA 2010a.

proposing to force all derivatives contracts onto regulated exchanges, and therefore also onto central clearinghouses.[94]

These proposals raised almost unanimous opposition from the interest groups that presented their views in front of Congress (see Table 8) and were ultimately not adopted. However, the legislative plan presented by the US Treasury in March 2009 still forced the central clearing of OTC derivatives with contracts that were regarded as sufficiently "standardized," while promoting a greater use of CCPs by subjecting non-standardized contracts to stricter capital requirements.[95] This approach was opposed by the majority of derivative dealers, and some firms reportedly complained that the US Treasury has intentionally blindsided them in an attempt to maintain control of the legislative output, giving them almost no opportunity to review the proposal presented to Congress before its publication.[96]In sum, Congress had curtailed the control of dealers and clearinghouses regarding what contracts should be centrally cleared and significantly extended the responsibilities of regulators, although they did not push the intervention of regulation as far as covering all derivatives transactions.

[94] More specifically, the Harkin bill would terminate the authority of the CFTC to exempt swap transactions from the requirement to be traded on a regulated board of trade. In order to achieve this goal, the bill would amend the Commodity Exchange Act to eliminate the distinction between "excluded" and "exempt" commodities and transactions, and commodities and transactions traded or conducted on regulated exchanges. By forcing all the derivatives onto exchanges and clearinghouses, the bill would mark not only the end of the derivatives that are traded bilaterally over-the-counter but also significantly curtail the market for "customized" derivatives, since only derivatives that are sufficiently "standardized" can be centrally cleared.

[95] The proposal presented by Treasury Secretary and former head of the New York Fed Timothy Geithner in May 2009 empowered the same central clearinghouses with the authority to decide what contracts are eligible for central clearing. Numerous policymakers, as well as the same derivative dealers comprising ISDA criticized this approach on the ground that for-profit clearinghouses may have an incentive to bolster their volume of contracts cleared by accepting contracts that are not safe to be cleared. Conversely, others denounced a different conflict of interest deriving from the fact that the largest clearinghouse for credit default swaps (ICE Trust) was controlled by a consortium of derivative dealers with an incentive to keep the most profitable swaps cleared bilaterally. See US Treasury 2009c; Morgenson 2009. This approach was altered by Congress which divided this power between rating agencies and regulators which required clearing organizations to submit all swaps that it sought to clear to the CFTC or SEC, which would determine whether the clearing requirement would apply to such swap or not.

[96] Derivatives Week 2009; Harper, Leising, & Harrington 2009.

Table 8 - Preferences of Participants to Congressional Hearings regarding Central Clearing

Witness	Sector	Date	Comm	Position on Clearing
Craig Donohue - CME	Infrastructure	9-7-08	S-Bank	Demand regulators to foster competition among CCPs and exchanges.
Robert Pickel - ISDA	Banks	9-7-08	S-Bank	No reference to central clearing.
Robert Pickel - ISDA	Banks	15-10-08	H-Ag	No reference to central clearing. Pickel argues that the role of CDS in the crisis has been "greatly exaggerated."
Jonhathan Shoft - ICE	Infrastructure	15-10-08	H-Ag	Support creating incentives for central clearing through higher capital requirements.
Kimberly Taylor - CME	Infrastructure	15-10-08	H-Ag	Support for use of clearinghouses beyond inter-dealer trades. No position on regulation.
Terence Duffy - CME	Infrustructure	8-12-08	H-Ag	Support mandatory CDS clearing. Specify that some trades are not clearable.
Jonhathan Shoft - ICE	Infrastructure	8-12-08	H-Ag	Supporte mandatory CDS clearing. Specify not every instrument should be cleared.
John O'Neil - Liffe Euronext	Infrastructure	8-12-08	H-Ag	Support encouraging clearing of CDS contracts. Against mandatory clearing of non-standardized contracts.
Thomas Book - Eurex	Infrastructure	8-12-08	H-Ag	Support mandatory clearing.
Robert Pickel - ISDA	Banks	8-12-08	H-Ag	Support private-public dialogue as "the best way to achieve a high degree of clearing." Against clearing of custom-tailored transactions.
John Damgard - Futures Industry Association	Banks	8-12-08	H-Ag	Support encouraging clearing on standardized CDS.
Don Thompson - JP Morgan	Banks	8-12-08	H-Ag	Against mandatory clearing solutions that would impede capacity to serve end-users. Support existing self-regulatory commitments.
Gerald Corrigan - Goldman Sachs	Banks	8-12-08	H-Ag	In favour of mandatory clearing requirement.
Murtagh - UBS Securities	Banks	8-12-08	H-Ag	In favour of mandatory clearing requirement.
Tom Buis - National Farmers Union	End-Users	3-2-09	H-Ag	Generic endorsement of clearing all OTC transactions.
John Damgard - Futures Industry Association	Banks	3-2-09	H-Ag	Against mandatory clearing of all OTC transactions that would "trigger a rush to overseas OTC markets and would be counterproductive to our national economic interests." Defend the importance of customized derivatives. Support measures encouraging of clearing through higher capital requirements.
Michael Greenberger, University of Maryland	Academia	3-2-09	H-Ag	Support mandatory clearing.
Michael Gooch - GFI Group	Inter-dealer broker	3-2-09	H-Ag	Against mandating clearing of all CDS.
Sean Cota - Petroleum Marketers Association of America	End-Users	3-2-09	H-Ag	Generic support clearing requirements to the OTC Trades.
Terrence Duffy - CME	Infrastructure	3-2-09	H-Ag	Support mandatory clearing, but admit that some products may not be cleared.

Raniel Roth- National Futures Association	Banks	3-2-09	H-Ag	Express concerns for the mandatory clearing of OTC derivatives. Call for granting regulators power to exempt contracts from mandatory clearing customized products.
Slocum Tyson - Public Citizen	Consumer's Group	3-2-09	H-Ag	Support mandatory clearing.
Michael Masters - Masters Capital Management	Hedge Fund	4-2-09	H-Ag	Call for mandatory clearing and exchange trading of ALL OTC transactions.
Jonathan Short - ICE	Infrastructure	4-2-09	H-Ag	Support encouraging clearing of standardized CDS. Call for leaving customized OTC instruments outside clearinghouses.
Gary Taylor - National Cotton Council and American Cotton Shippers Association	End-Users	4-2-09	H-Ag	No action should be taken to discourage over-the-counter transactions with legitimate commercial purposes.
Robert Pickel - ISDA	Banks	4-2-09	H-Ag	Oppose mandating clearing of all OTC contracts. Clearing should only be encouraged.
Christopher Concannon - NASDAQ OMX	Infrastructure	4-2-09	H-Ag	Support mandatory clearing, but call giving regulators the power to exempt customized products.
William Hale - Gargill	End-Users	4-2-09	H-Ag	Against mandatory clearing as it would "stifle activity in the OTC market and reduce hedging opportunities in the agricultural and energy markets."
Karl Cooper - NYSE Liffe	Infrastructure	4-2-09	H-Ag	Oppose mandatory clearing for all OTC contracts. Support empowering regulators to exempt customized products from centralized clearing.
Paul Cicio - Industrial Energy Consumers of America	End-Users	4-2-09	H-Ag	Call for exempting commercial end-users from the clearing requirement. Only "speculator bilateral OTC transactions should be cleared."
Mar Brickel - Blackbird Holdings	Inter-dealer broker	4-2-09	H-Ag	????
Thomas Book - Eurex	Infrastructure	4-2-09	H-Ag	Support mandatory clearing for suitable contracts but wide power for regulators to exempt contracts.
Stuart Kaswell, MFA	Hedge Fund	4-2-09	H-Ag	Against mandatory clearing requirement for all OTC derivatives. Congress should "promote" central clearing and remove obstacle to creation of clearinghouses.
JD Rosen, SIFMA	Banks	4-2-09	H-Ag	Against mandatory clearing. Clearing requirement defined as "unworkable" and "adversely affecting mainstream American companies."
Brent Weisenborn, Agora-X	Infrastructure	4-2-09	H-Ag	Support for clearing all OTC commodity contracts.
Donald Fewer, Standard Credit Group	Broker/Dealer	4-2-09	H-Ag	Central clearing should be encouraged by facilitating access to clearinghouses.
David Dines - Cargill	End-Users	4-6-09	S-Ag	Against mandatory clearing of customized derivatives since this would "reduce hedging activity" and "greatly restrict working capital at a time." Call for exempting from clearing requirement CDS that have not created systemic risk.

Daniel Driscoll - National Futures Association	Banks	4-6-09	S-Ag	????
Mark Lenczowski - JP Morgan	Banks	4-6-09	S-Ag	All standardized OTC derivatives transactions between major market participants should be cleared through a regulated clearinghouse.
Michael Masters - Masters Capital Management	Hedge Fund	4-6-09	S-Ag	Support US Treasury position in favour of mandatory clearing. Argue that it would lower costs for corporations.
Donald Fewer - Standard Credit Group	Broker/Dealer	9-6-09	H-Fin	Support encouraging use of CCP by providing open acces to clearinghouses.
Robert Pickel - ISDA	Banks	9-6-09	H-Fin	Highlight the importance of preserving customized OTC derivatives. Not all OTC products can be cleared.
Timothy Murphy - 3M	End-users	9-6-09	H-Fin	Against moving all derivatives into a clearinghouses. Call for exempting commercial end-users from margin requirements.
Dan Thompson - JP Morgan	Banks	9-6-09	H-Fin	Call for clearing of all standardized derivatives transactions between systemically significant institutions.
Christopher Ferreri - ICAP	Inter-dealer broker	9-6-09	H-Fin	Support mandatory clearing for the vast majority of trades, but argue that not all OTC can be cleared. Support continuous bilateral clearing for these contracts, while dealers could be incentivised to reduce the level of customized contracts.
Thomas Callahan - NYSE Euronext	Infrastructure	9-6-09	H-Fin	Support mandatory clearing for standardized derivatives.
Terrence Duffy - CME	Infrastructure	9-6-09	H-Fin	Oppose mandating clearing of OTC contracts because they would "induce certain market participants to transfer this business offshore, resulting in a loss to the US economy". Support incentives in the form of capital relief.
Christopher Edmoncs - International Derivatives Clearing Group	Infrastructure	9-6-09	H-Fin	Against mandating clearing of all CDS. Argues that "the vast majority of transactions" is not suitable for central clearing.
Jeffrey Sprecher - ICE	Infrastructure	9-6-09	H-Fin	Against forcing the clearing of all OTC derivatives since it would increase market risk.
Larry Thompson - DTCC	Trade Repository	9-6-09	H-Fin	????
Kenneth Griffin - Citadel	Hedge Fund / Infrastructure	22-6-09	S-Bank	Call for incentivizing use of central clearing through higher capital requirements. Advocate the continued use of customized derivatives. Against exempting end-users from posting margins.
Robert Pickel - ISDA	Banks	22-6-09	S-Bank	Against measures mandating clearing of all OTC products.
Christopher Whalen - Institutional Risk Analytics	Analysts	22-6-09	S-Bank	Favorable to move OTC derivatives into exchanges.
John Hixson - Cargill	End-Users	17-9-09	H-Ag	Call for expanding exemptions of end-users from clearing requirements.
Glenn English - National Rural Electric Cooperatives Association	End-Users	17-9-09	H-Ag	Demand to be exempted from clearing requirement and for removing higher capital requirements on non-standardized CDS.

Dave Schryver - American Public Gas Association	End-Users	17-9-09	H-Ag	Support mandatory clearing of standardized derivatives but rejects that this requirement be extended also to transactions with end-users. Defend the importance of non-cleared transactions for end-users.
Richard Hirst - Delta Air Lines	End-Users	17-9-09	H-Ag	Call for removing regulatory burdens over transactions where one counterparty is a physical hedger in commodity markets.
Gary O'Connor - International Derivatives Clearing Group	Infrastructure	17-9-09	H-Ag	Support for mandatory clearing of standardized transactions. Against exempting end-users from clearing requirements ("Nor do we see why Corporate America should be immune from being part of the solution to the crisis we find ourselves in").
John Damgard - Futures Industry Association	Banks	17-9-09	H-Ag	Call for replacing mandatory central clearing with incentives to trade through a CCP. Call for exempting end-users from clearing requirements.
Terrence Duffy - CME	Infrastructure	17-9-09	H-Ag	Warn that mandatory clearing may shift OTC business operations overseas.
Robert Pickel - ISDA	Banks	17-9-09	H-Ag	Argue that not all standardized contracts can be cleared. Importance of retaining customization of derivatives for end-users to manage their risks. Regulatory framework should be defined by regulators. Call for exempting end-users from definition of major swap participant.
Jonathan Short - ICE	Infrastructure	17-9-09	H-Ag	Mandating clearing would have unintended consequences, increasing risk to clearinghouses and increasing cost to commercial companies.
Daniel Budofsky - SIFMA	Banks	17-9-09	H-Ag	SIFMA does not believe there is any reason for the government to mandate that business be transacted in this particular manner. Call for exempting end-users from definition of major swap participant.
John Hixson - Cargill	End-Users	7-10-09	H-Fin	n/a
Scott Sleyster - Prudental Financial, American Council of Life Insurers	Insurance	7-10-09	H-Fin	Against "any bias toward compulsory clearing." This would increase the cost to end-users of hedging their risk.
David Hall, Chatham Financial Corp	Adviser	7-10-09	H-Fin	Call for exempting end-users from clearing and trading requirements and to avoid requirements that would "create an extraordinary and unnecessary drain on working capital."
James Hill - SIFMA	Banks	7-10-09	H-Fin	Support measures encouraging more clearing, but express concerns for the imposition of new capital requirements to cleared swaps. Oppose granting regulators the power to extend margin requirements upon end-users.

Stuart Kaswell - MFA	Hedge Funds	7-10-09	H-Fin	Demand legislation to do more to promote central clearing, extending the requirements to more participants.
Steven Holmes - Deere & Company	End-Users	7-10-09	H-Fin	Against granting regulators powers to expand regulatory requirements to end-users. Argue against capital requirements for non-centrally cleared transactions with end-users.
Christopher Ferreri - Wholesale Markets Brokers Association	Inter-dealer broker	7-10-09	H-Fin	Focus on ensuring Non-Discriminatory Access to Central Counterparty Clearing Facilities.
Rob Johnson - Americans for Financial Reform	Consumer's Group	7-10-09	H-Fin	Warn against potential loopholes from exempting end-users and argue that end-users should not refrain from regulating derivatives. Reject the argument that standardizing derivatives would leave end-users without protection.
Peter Axilrod - DTCC	Trade Repository	2-12-09	S-Ag.	Argue for focusing on the trades among dealers.
Terence Duffy - CME	Infrastructure	2-12-09	S-Ag.	Clearing should be encouraged through capital charges.
Blythe Masters - JP Morgan	Banks	2-12-09	S-Ag.	Support mandatory central clearing but not for all OTC market participants and for all contracts. Support mandatory central clearing only for dealers and major swap participants.
Jiro Okochi - Reval.com	End-Users	2-12-09	S-Ag.	Standardization of OTC derivatives limiting the capacity of end-users to hedge their risk. Call for exempting swap sold to end-users from additional capital and margin requirements. Call for narrowing the scope of who may benefit from the exemption.
Jonathan Shor - ICE	Infrastructure	2-12-09	S-Ag.	Against mandating central clearing of all OTC transactions. Focus on unintended consequences and costs posed for end-users. Regulation should focus on the transactions between dealers and major swap participants.

The role of electoral incentives in driving the progress of legislation and in directly running against the preferences of derivative dealers is typified by one of the most prominent instances in which the US Congress introduced a piece of derivatives regulation going well beyond the international commitments adopted within the G20. While the G20 leaders had followed the US Treasury in proposing the extension of regulatory requirements upon derivative dealers, these had been limited to minimum capital requirements and minimum initial and variation margin requirements. The Congressional debate that followed the G20 Pittsburgh Summit significantly departed from this by bringing Congress to adopt a proposal potentially limiting the financial institutions accessing the derivatives markets. Presented by Sen. Lincoln on April 9, 2010, this amendment to the Dodd-Frank bill would force banks operating in the derivatives market either to spin off their derivatives trading activities into independently capitalized entities or to give up federal protections such as deposit insurance and access to Federal Reserve discount window..

Sen. Lincoln's proposal, introduced the same day that the SEC announced its lawsuit against Goldman,[97] was quickly recognized as the "most stringent bill so far" in the regulation of derivatives[98] and a direct challenge to the banks dominating the markets. As Sen. Cantwell commented, "She is the daughter of a farmer, she knows the difference between farmers legitimately hedging and Wall Street speculators cooking up toxic assets. It looks to me as though Sen. Lincoln is proposing a real stare down of Wall Street."[99] But opposition to the bill extended well beyond the same derivative dealers that were the primary target of the legislation, expanding to smaller community banks and regional banks[100] as well as the corporate end-users of derivatives.[101]

In order to explain the formulation of her proposal, it is important to consider not the desire to appease powerful interest groups but rather the impact on Sen. Lincoln's chances for reelection. During the campaign for the primary elections that Sen. Lincoln was fighting in Arkansas, she had been attacked for being too soft on Wall Street. Her main challenger, Bill Halter, ran a campaign to the left of Sen. Lincoln, primarily with the support of trade unions, and he frequently publicized contributions Lincoln received from Wall Street banks. Halter attacked Lincoln for her support of the Troubled Asset Relief Program in 2008, arguing that by voting for the $700 billion bank bailout in 2008, Lincoln had "already voted to side with Wall Street and big banks." According to Halter, "Derivative transactions were at the root of the financial meltdown…As a member of the Agriculture Committee, Sen. Lincoln had jurisdiction over derivatives for years but did nothing to provide appropriate oversight."[102] The so-called "Lincoln Amendment" was therefore widely perceived as an attempt to regain the electoral support of the most progressive part of her electorate. Indeed, the bill and the strongly anti-Wall Street

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[97] Cantwell 2010.
[98] Kevin McPartland described this measure as "a back-door way to reinstate Glass-Steagall without actually doing so". Cited in Comlay & Abbott 2010.
[99] Cantwell 2010.
[100] Burne 2010.
[101] Coalition for Derivatives End-Users 2010. The Coalition for Derivatives End-Users demanded the removal of the Lincoln amendment as this measures "presents a number of practical problems for end users, including reducing or eliminating available counterparties, increasing the cost to hedge and possibly preventing some end users from hedging certain risks … Such a requirement could exacerbate a problem many end users already face, as fewer banks will offer derivatives, including many community and regional banks, thereby eliminating the only counterparties with which many smaller businesses hedge risk".
[102] Swindell, Hagstrom, & Friedman 2010; Daniels 2010.

rhetoric adopted by Lincoln in its defense[103] allowed Lincoln to receive national attention and to score important points for her re-election bid in Arkansas, where polls showed a majority of voters supported Wall Street reform.[104]

The public resonance of the amendment made it difficult for elected politicians to openly oppose the proposal. The US Treasury decided not to take a position on the most controversial part of the bill despite the widespread concern regarding its impact and feasibility.[105] Sen. Dodd proposed but then withdrew an amendment to postpone the proposal for two years.[106] As a commentator argued, “The problem is that everybody in Congress wants it out, but nobody wants the responsibility of taking it out.”[107] Similarly, a House Democratic aide stated, “No one has wanted to step up and take it out of the legislation for fear of appearing to weaken the legislation.”[108] Sen. Judd Gregg argued that his amendment to strip the most salient elements of the Lincoln proposal may have failed because of the fears of political backlash from defending the large banks.[109] In the end, the Lincoln Amendment was approved by the entire Senate despite the widespread opposition of interest groups and concerns expressed by regulators and several Congressmen.

The impact of electoral incentives in driving this part of the legislation became even clearer once the level of public attention towards derivatives decreased. Sen. Lincoln’s victory in her primary election weakened the incentives to maintain a hard-stance against any amendment to her bill. When the legislation moved into the reconciliation committee between House and Senate, Lincoln agree to forge a compromise, allowing banks to retain the bulk of their swap trading operations on their books and to spin off only the trading of those derivatives perceived as riskier.[110] Most importantly, in February 2012, not long after the approval of the Dodd-Frank and with the focus of the US public significantly moving away from derivatives, the House Financial Services Committee approved a bipartisan bill by voice vote to remove the Lincoln amendment. In its place, they voted to allow banks to keep commodity and equity derivatives in their balance

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103 Lincoln presented her bill as an attempt to defend small community banks from the excesses of the five largest banks most active on risky swaps activity - “activity that should never have been part of their operation in the first place”. See Lincoln 2010.
104 Reuters 2010b.
105 Kaper 2010.
106 Dennis 2010.
107 Harper & Kopecki 2010.
108 Montgomery & Merle 2010.
109 Kaper 2010.
110 Revised version of the bill forced banks to move into independently capitalized subsidiaries only commodity, equity, and credit default swaps, accounting only 10% to 20% of their derivatives portfolio.

sheet, while only a swap tied to asset-backed securities comprised of subprime mortgages would still be pushed out.[111]

The Congressional debate that surrounded this decision was characterized by a return of some of the rhetoric that characterized discussions over the regulation of derivatives before the crisis. In particular, different Congressmen pointed out how the lack of similar requirements in Europe and other countries would put US firms at a competitive disadvantage. Rep. Judy Biggert stated that the Lincoln amendment would “place U.S. financial institutions at a competitive disadvantage, because non-U.S. jurisdictions have not implemented similar regulations.”[112] Her statement was followed by that of Rep. Grimm, who stated, “In order to maintain the competitiveness of the U.S. financial markets, we must ensure that our regulatory structure does not put us at a disadvantage relative to the rest of the world.”[113]

Here we can see that the same electoral dynamics that had propelled a tightening in the legislation of derivatives in 2009-2010 had declined since the passage of the Dodd-Frank bill. It is not surprising, therefore, that the proposal that more than any other reflected the politicization of the debate was also the first to be dismantled once public attention started to drift away from this subject.

4.5 Lagging Behind: the Regulation of Derivatives in Europe

While the previous section discussed the dynamics that led US policymakers to actively champion a reversal in the international approach towards the regulation of derivatives, this section will explore the impact that the crisis had over the regulation of derivatives in Europe.

European regulatory authorities have long participated as junior partner in the effort led by the Federal Reserve Bank of New York to foster the emergence of an industry-driven regulatory solution to address the weaknesses in the infrastructures of derivatives markets. In particular, France's Commission Bancaire, the UK's Financial Services Authority (FSA), the German Bafin, the Swiss Federal Banking Commission, and the European Central Bank (ECB) coordinated informally with the New York Federal

[111] The bill entitled “H.R. 1838: To repeal a provision of the Dodd-Frank Wall Street Reform and Consumer Protection and Consumer Protection Act Prohibiting any Federal bailout of swap dealers or participants” was sponsored by Representatives Jim Himes of Connecticut and Carolyn Maloney of New York, both Democrats, and Nan Hayworth, a New York Republican. The text of the bill can be found here: http://www.govtrack.us/congress/bills/112/hr1838. At the moment of writing (30 July 2012), the bill has not returned yet to the House. See Brush & Mattingly 2012.
[112] US House of Representatives 2011, p.3.
[113] US House of Representatives 2011, p.6.

Reserve, interactions that were formalized in September 2009 with the formation of the OTC Derivatives Regulators' Forum.[114]

Similarly to the US, however, the intensification of the market panic since the collapse of Lehman Brothers also represented a turning point for the regulation of derivatives in Europe. As the initiatives to introduce a direct regulation of derivatives started to gain steam in the US, and as US regulatory authorities demanded the authority to regulate these markets from Congress, the European Commission followed in the footsteps of US authorities. On the October 17, 2008, Commissioner McCreevy stated that there was a "pressing need" for greater use of central clearinghouses.

Calls for clearinghouses notwithstanding, just like the approach endorsed by the Federal Reserve during the first stage of the crisis, the Commission sought to promote a market-led solution by engaging in consultations with the main stakeholders in derivatives markets.[115] To do this, the European Commission created the Derivatives Working Group, bringing together representatives from derivative dealers, central counterparties, trade repositories, and other European (ECB, CESR, CEBS and CEIOPS) and national (AMF, Bafin and FSA) regulatory authorities. During its first meeting in 2008, the Working Group set up a roadmap to ensure that CDS were cleared through a central clearing counterparty by the end of the year.[116] At the same time, the Commission threatened that in the case this market-led solution did not emerge, it would be forced to legislate. As Oliver Drewes, a spokesman for McCreevy stated, "[McCreevy] also explained to them that he believed that solutions would now be essential and that he would not refrain from imposing a legislative one if the industry did not deliver."[117] Similar attempts to engage with market actors in order to achieve a market-based solution to establish central counterparties for CDS were also undertaken by the ECB, which hosted a meeting on November 3, 2008 with the potential providers of this CCP, their regulators, and the main dealers and buy-side users.[118]

While in the US progress towards central clearing of CDS derivatives was steady and regulators simply "pushed on an open door,"[119] according to Richard Metcalfe, head of policy at the ISDA, in Europe the relation between public authorities and private market actors was more difficult, so the Commission was not able to achieve the same

[114] Federal Reserve Bank of New York 2009b.
[115] McCreevy 2008i.
[116] European Commission 2008c.
[117] Bradbery 2008.
[118] ECB 2008b.
[119] Price 2009.

commitment by private market actors. The main stumbling block in the negotiations between the European Commission and derivatives dealers remained the priority placed by the former of having one CCP for credit derivatives located in Europe. The European Commission recognized that letting the market decide the location of the CCP would have in all likelihood concentrated these trades into one clearinghouse located into the US. The European Commission and other European policymakers opposed this outcome on the ground that it would have left European trades cleared in the US outside the regulatory oversight of European authorities. Moreover, this solution would have left Europe with very limited powers to intervene should this US-based clearinghouse run into trouble, as central banks do not provide direct access to their liquidity facilities to financial institutions located outside their currency areas. As a Brussels official argued, "Can we afford the luxury of having a CCP clearing the whole world, over which we have no regulatory and supervisory powers or guaranteed access to information? And what if it goes belly up?"[120]

Derivative dealers, for their part, described this geographical mandate as impracticable, and claimed that it would have been costly and ineffective to split the credit derivatives market according to geographical lines. They favoured instead a "global solution," that is, clearing their CDS contracts through a single CCP independently of its location. When the major international dealers left the negotiating table, McCreevy declared on January 20, 2009 that since "in the very last minute the industry gold cold feet," the Commission was prepared "to go the legislative route if necessary" to set up a central clearing counterparty for swaps.[121]

The European Commission looked for support from the European Parliament. Speaking in front of the European Parliament, McCreevy stated, "We also need to act urgently and close the deal. The response of the industry has been disappointing. Time is running out."[122] McCreevy urged the members of the European Parliament to pass an amendment to the Capital Requirements Directive to impose higher capital requirements on credit default swaps not processed through a European clearing house.[123] The

[120] Jeremy Grant & Tait 2009 In July 2009, the European Commission has justified its preference for CCP clearing being located in Europe on the basis of "regulatory, supervisory and monetary policy concerns". According to the Commission, "If a CCP is located in Europe, it is subject to European rules and supervision. Supervisors accordingly have undisputed and unfettered access to the information held by CCPs. It is also easier for European authorities to intervene in case of a problem at a European CCP. For example, central banks do not provide direct access to their liquidity facilities to financial institutions located outside their currencyareas." See European Commission 2009c.
[121] McCreevy 2009b.
[122] McCreevy 2009a.
[123] McCreevy 2009a. The bill in question is Amendment 59 Pervenche Berès - Proposal for a directive – amending act Recital 19 b (new) Such amendment was presented by the French socialist chair of the European Parliament's economic

Commission also looked for support from the ECB. On December 18, 2008 the Governing Council of the ECB "welcomed initiatives by the European Commission aimed at introducing European central counterparty clearing facilities for OTC credit derivatives," and it also emphasized the "need for at least one European CCP for credit derivatives and that, given the potential systemic importance of securities clearing and settlement systems, this infrastructure should be located within the Euro area."[124] In particular, the ECB justified the need to have a CCP within the Euro area on the basis that in the case of a major liquidity problem, the ECB would not be able to provide emergency liquidity if the clearinghouse was located outside of the Eurozone. Similarly to what was done by the European Commission, the ECB also took steps to establish a European central clearinghouse by engaging in negotiations with those banks less hostile to a European-based clearing initiative. (e.g. European Banking Federation and the European Savings Banks Group). At the same time, the ECB excluded the major American investment banks in what was perceived as an attempt to segment the dealers community. [125] The agenda of the meeting included a discussion on "whether and under which conditions, individual banks would be prepared to take a stake in a European CCP."[126]

This push for a "European solution" coming from the European Commission was supported by some member states. In January 2009 the French government and the Banque de France supported the establishment of a Eurozone solution under the supervision of the ECB, a proposal already endorsed by the ECB.[127] Unlike the case made by the European Commission, the support coming from the French government for a European solution reflected competitive concerns, especially the risk that letting the market decide the location of the CCP would likely lead to the clearing solution supported by the major US banks (US-based Intercontinental Exchange (ICE)). In addition, this might allow US counterparties to take control of the European market at the expense of smaller European competitors.[128] This possibility raised concerns not only in

and monetary affairs committee Pervenche Berès on January 19, 2009. This amendment presented as its formal justification "After the industry's failure to reach an agreement on the set-up of a European clearinghouse, the Commission should come up with appropriate proposals to regulate this sector for the sake of financial stability and transparency … In order to ensure financial stability, the Commission should put forward appropriate legislative proposals to regulate credit-default swaps (CDS). CDS on European entities should be processed through a European clearing house (CCP) to mitigate the counterparty risks and more generally to reduce the overall risks. Only CCP-cleared CDS should benefit from favourable capital requirement treatment".

[124] ECB 2008a.

[125] Tait 2009.

[126] ECB 2008a.

[127] B. Hall 2009.

[128] A confidential report prepared by the Banque de France warned of the risk that the clearing business could move to

France, about also in Germany, where the German government supported the Deutsche Boerse's Eurex in the derivatives clearing race.[129]

The possibility of imposing a Eurozone clearing solution that would exclude any London-based clearer from the European markets was opposed by the British banking industry, which would be excluded from this solution,[130] as well as by the British Treasury[131] and the FSA[132]. However, British authorities did not oppose the introduction of an EU-wide clearing requirement, despite the costs this would inevitably pose upon the numerous derivative dealers housed in London, as this "European solution" would both prevent the US banks operating in London from shifting their clearing business to the US and not endanger the advantage of London over other European financial centers.

This legislative threat from the Commission and the European Parliament, on top of the threat of a Eurozone clearing solution, was ultimately successful in twisting the arm of the major transnational dealers. These committed in February 2009 to clear their EU-eligible credit derivatives trades in Europe through a European-based clearinghouse by 31 July 2009.[133] This commitment set the stage for the creation of different European CDS clearinghouses, such ICE Clear, Eurex Clearing, and LCH Clearnet. The concession made by the main dealers helped them in deflecting the regulatory threat of being forced into a Euro-zone clearing requirement. However, these self-regulatory commitments were not sufficient to avoid the introduction of a broader regulatory framework for the industry in Europe. Shortly after the agreement, the European Commission committed in March 2009 to present a set of regulatory initiatives to increase transparency and to address financial stability concerns.[134] Mario Nava, head of market infrastructure at the DG Internal, Market stated in March that the commitment

London or the United States, and it called for the creation of a clearing house for the eurozone with sufficient critical size to face off the challenge that business could be absorbed by London and New York in order to promote the interests of Paris. In particular, the report called for the creation of a "consortium of eurozone banks and shareholders of major infrastructures with the objective of developing a common strategy for the integration of several of the eurozone's principle clearing houses". The confidential document was written by a working group headed up by the Banque de France and prepared for the Haut Comite de Place, a body formed by French finance minister, Cristine Lagarde, to promote Paris' position in the financial markets. See de Teran 2009b.

[129] Uhlig 2008.

[130] BBA 2009.

[131] HM Treasury 2009a.

[132] The Turner Review stated that "proposals that euro-denominated CDS must be cleared 'within the Euro zone' are unnecessary for financial stability reasons which requires only that robust and well regulated arrangements are in place regardless of location". See FSA 2009b, p. 83.

[133] European Commission 2009f. Barclays Capital 2009The signatories of the letter were AIMA, CEA, EBF, ISDA, LIBA, SIFMA, WMBA and representatives from Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Morgan Stanley, Nordea and UBS. This commitment followed a similar set of commitments made by the European Banking Federation European Banking Federation 2009.

[134] European Commission 2009b.

achieved by dealers did not mean the legislative initiatives were complete.[135] Following the industry's commitment, the Commission formed a Member States Experts Working Group on Derivatives and Market Infrastructures in order to prepare further legislative measures and monitor compliance by the industry with its commitments.[136]

On July 3, 2009, the European Commission presented its first Communication containing possible measures to be adopted for the regulation of derivatives that went beyond the use of central clearinghouse.[137] The Commission described its approach as informed by a "paradigm shift…away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly."[138] The "paradigm shift" announced by the European Commission was welcomed by the European Council[139] as well as by the European Parliament, which approved in June 2010 a report presented by the Rapporteur Werner Langen.

The legislative proposal presented by the Commission in September 2010 praised the initiatives taken by the main derivative dealers in increasing the use of central clearing platforms. While it was also positive on commitments to increase contract and processes standardisation and also to improve the transparency of these markets, it denounced the limited scope of these initiatives, confined only to the main dealers, and the non-binding nature of the commitments. The regulation introduced by the Commission (EMIR) mirrored in scope and main requirements the Dodd-Frank Act adopted in the US. In addition, the regulation fulfilled the commitment assumed by European governments within the G20, mandating the central clearing of standardized contracts, introducing regulatory requirements for the CCPs and trade repositories, and giving the newly created European Securities Markets Authority (ESMA) a central role in regulating derivatives markets. Similar to the US legislation, the European regulation covered not only credit derivatives but also all OTC derivative contracts conducted by both financial and non-financial institutions domiciled in the European Union. Covered contracts included interest rate derivatives, FX derivatives, and commodities derivatives, which had played no direct role in the context of the financial crisis.

[135] de Teran 2009a.
[136] European Commission 2010b.
[137] European Commission 2009c.
[138] European Commission 2009d, p.2.
[139] European Council 2009.

Furthermore, the attempt by the European Commission to regulate OTC derivatives markets also included four other pieces of legislation. The first was the revision of the Capital Requirements Directive in order to introduce a differentiation of capital charges between CCP cleared and non-CCP cleared contracts.[140] The second piece of legislation was a revision of the Market in Financial Instruments Directive to regulate the trading of standardized contracts on organized trading venues.[141] The third piece of legislation was a revision of the Market Abuse Directive to increase the power of regulatory authorities to investigate market abuses in derivatives markets.[142] The final piece of legislation was a regulation of short-selling also covering the use of credit default swaps.[143]

On balance, the evolution of derivatives regulation within Europe has followed a path with important similarities with that in the US. The initial focus of the European Commission at the beginning of the crisis in promoting a market-based solution to the problem of shifting bilaterally negotiated contracts into a central clearinghouse was followed by the introduction of a more extensive regulatory framework. This brought derivative dealers and major participants in the derivatives markets, as well market infrastructures such as counterparties, exchanges, and trade repositories, under the direct oversight of regulators, thus departing from the pre-crisis approach.

While the two jurisdictions reached a similar end-point, the analysis in this section has shown how the US represented the driver in this process and was the main determinant of the international regulatory agenda, while Europe frequently lagged behind. Indeed, after having presented his legislative proposal to regulate derivatives, US Treasury Secretary Geithner declared that one of his priorities would be “to work with authorities abroad...so that achievement of our objectives is not undermined by the movement of derivatives activity to jurisdictions without adequate regulatory safeguards."[144] After the approval of Dodd-Frank, US regulatory authorities publicly expressed concerns regarding the lag of Europe in implementing commitments similar to the one introduced in the US and the possibility that this may confer a competitive advantage to European institutions.[145]

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[140] European Commission 2011e.
[141] European Commission 2011d.
[142] European Commission 2011c.
[143] European Commission 2010d.
[144] Geithner 2009a.
[145] CFTC 2011.

Different reasons can explain this pattern. One explanation points towards the fact that US regulatory authorities had developed a greater expertise on the area than had their European counterparts, as the Federal Reserve Bank of New York had held regular meetings with derivative dealers since 2005 to discuss possible improvements in the regulatory infrastructure of these markets. The existence of dialogue before the crisis between US regulators and derivative dealers certainly can explain how the approach adopted by US authorities largely informed the initial international regulatory reaction by the FSB.

However, it is important to acknowledge how the different level of public salience acquired by derivatives regulation in the two contexts also created different incentives for the respective governments to get involved in the international agenda. The analysis of the media coverage of different financial sectors developed in Chapter 3 has revealed that while after the crisis derivatives regulation rose to become one of the top issues covered by the US press, the same was not the case in Europe. With the exception of the UK, the outbreak of the crisis led the media in Continental European countries to focus primarily on other areas that had attracted the attention of the public before the crisis rather than derivatives, whose relevance for the voters remained more difficult to explain. The lack of a Lehman-like event directly linked to derivatives in Continental Europe was important to limit the attention of the general public to the issue. As a result, European authorities largely followed rather than led the efforts of their US counterparts to regulate derivatives.

4.6 The Eurozone debt crisis and the regulation of sovereign credit derivatives

The main instance in which European authorities played an active role in expanding the international agenda came in pushing for an international agreement over the regulation of sovereign derivatives in 2010. At the same time that the US Congress started to turn the page on the design of new norms concerning the regulation of derivatives, the emergence of turbulence in the sovereign debt markets in 2010 had the effect of politicizing the debate over regulation of derivatives in Europe and increased the attention on this issue among European policymakers. In particular, the first sign of woes in the European debt markets raised the possible use of CDS to speculate on these markets and on the extent to which so-called “naked” trading of these tools could influence the prices of the underlying sovereign bonds. This practice of trading in CDS without owning the underlying obligations has received significant attention during the crisis and has been criticized by different commentators, who have called for making this practice illegal.[146]

The decision by European leaders to pledge support for Greece in February 2010 was followed shortly after by a statement from French finance minister Christine Lagarde, who argued that European leaders should take a united approach towards "speculators" and that "what we are going to take away from this crisis is certainly a second look at the validity, solidity of sovereign [credit default swaps],"[147] whose movements she described in front of the French Parliament as "disconnected from the underlying economic situation."[148] After having singled out a handful of British and American financial institutions for speculating on the Greek debt during the crisis,[149] Lagarde publicly stated her opinion that "the CDS on sovereign debt have to be at least very, very regulated, rigorously regulated, limited or banned."[150]

French politicians were not the only ones to call for a crackdown on the trading of sovereign derivatives. On 10 March 2010, French President Sarkozy, German Chancellor Merkel, Greek Prime Minister Papandreou, and Prime Minister of Luxembourg Junker wrote to President of the Commission Barroso to demand an official inquiry at the European level "into the role and impact of speculative practices in connection with CDS trading in the government bonds of European countries." They also pushed for the introduction of measures including "introducing minimum holding periods for CDS trading, banning speculative CDS trading as well as banning the acquisition of CDS which are not being used for hedging purposes".[151] Similar requests were also supported by the European Parliament, which in June 2010 approved a resolution both pressing "for a ban on CDS transactions with no underlying credit which are purely speculative transactions involving bets on credit defaults" and calling "on the

[146] For instance FT columnist Munchau has described the trading of "naked CDS" as "purely speculative gamble". Munchau argued: "It is a purely speculative gamble. There is not one social or economic benefit. Even hardened speculators agree on this point. Especially because naked CDSs constitute a large part of all CDS transactions, the case for banning them is about as a strong as that for banning bank robberies." According to Munchan, while CDSs are insurance products that allow the buyer to insure himself against the default of an underlying security, these products defied "a universally accepted aspect of insurance regulation is that you can only insure what you actually own". Münchau 2008. See also Soros 2009.

[147] Tett 2010.

[148] Donahue 2010.

[149] Parussini, Cohen, & Dalton 2010.

[150] Wendlandt 2010.

[151] Sarkozy, Merkel, Papandreou, & Juncker 2010. This request was followed by others calls from the same French and German leaders to speed up the investigation on the impact that as naked credit default swaps on sovereign bonds The two leaders said the "return of high market volatility raises legitimate questions specifically about certain financial techniques and the use of certain derivative products, such as short-selling and credit default swaps" Sarkozy & Merkel 2010.

Commission to consider upper risk limits for derivatives, particularly CDSs, and to agree on them with international partners".[152]

These calls were taken further in May 2010, when German regulatory authorities (Bafin) surprised the world by unilaterally introducing a ban over naked transactions of CDS traded in Germany where the debt of a Eurozone member state served as a reference liability.[153] This was followed by the introduction of a legislative proposal, theAct on the Prevention of Improper Securities and Derivatives Transactions,which became effective at the end of July 2010. While the original ban applied to naked CDS on all Eurozone government bonds, the legislation extended the ban to cover CDS on regional and municipal bonds of Eurozone countries traded in Germany, including a ban on currency derivatives referencing the Euro.[154]

This introduction of an outright ban on naked trading of CDS on Eurozone sovereign debt caught other countries by surprise, and it was not coordinated at the European level.[155] Indeed, this policy decision was puzzling in three ways. First, it was difficult to explain on an efficiency ground. Different regulatory authorities, including the British FSA and even the German Bafin itself, had not found significant evidence that CDS trades were affecting bond markets.[156] Most importantly, since the leading site for sovereign CDS trading remained in London rather than Frankfurt, a ban on naked CDS traded in Germany would have very limited impact without being coordinated at the European level. In fact, the ban had no discernible effect on mitigating the source of the crisis.[157]

The second reason that this policy measure was puzzling is that it was strongly opposed by the quasi-totality of interest groups and societal actors. The main opposition came from the banking industry and the financial actors directly involved in the trading of sovereign credit derivatives. For instance, ISDA argued that the line of reasoning holding that CDS markets were influencing the bond market was "flawed and inconsistent," since the market for sovereign CDS ($9 billion) was significantly smaller than the underlying market for government bonds ($400 billion).[158] ISDA and other banking associations

[152] European Parliament 2010.
[153] In a statement, BaFin justified this move, saying it was necessitated by what it called "the extraordinary volatility of debt securities of countries from the euro zone". See Lesova 2010.
[154] BaFin 2010.
[155] French Economy Minister Christine Lagarde regretted the unilateral nature of the decision and announced that it would not have followed the German lead, while the European Commissioner Barnier openly criticized the unilateral nature of the move H. Jones & O'Donnell 2010.
[156] Duffie 2010; Hughes, Tett, & Mackintosh 2010.
[157] Banks such as Credit Suisse also argued later that the unilateral ban implemented by the German government had backfired, reducing liquidity in the German financial markets and causing the number of shares traded in the 10 banned financial stocks to fall compared to other stocks. See H. Jones 2010.
[158] ISDA 2010b.

argued that the German government was "shooting the messenger" and CDS markets were simply signaling the real sources of the troubles faced by countries such as Greece rather than being the source of those problems.[159] In addition to banks, the decision of banning naked CDS trading was also opposed by end-users of derivatives, which argued that restricting CDS trades to those owning the underlying bonds would have the unintended consequence of making it more difficult for those market players wanting to buy protection to find a seller. Indeed, as the responses to the Consultation launched by the European Commission on this subject[160] reveal (see Table 9), the policy introduced by German regulators was opposed among a wide range of German interest groups.

[159] In particular, banking associations have sought to dispel the notion that CDS were used in a speculative way to bet against the creditworthiness of individual companies or governments, arguing that the majority of short CDS positions were held as a hedge against long positions in the underlying bonds or in Greek stocks and for entities that have significant real estate or corporate holdings in Greece. ISDA also rejected the analogy comparing CDS to fire insurance, and writing naked CDS as equivalent to buying such insurance and committing arson. According to ISDA "these claims also ignore short selling activity in Greek government bonds, which certainly has a greater effect on Greek bond prices as it involves selling the actual instruments in the market." ISDA 2010b.
[160] European Commission 2010f.

Table 9 - Responses by interest groups to the Consultation by the European Commission on Short-Selling

Respondent	Sector	Country	Q14: need for permanent ban?	Q24: should the restrictions be limited in time?	Q27: restriction only during emergency?
ACI (Financial Markets Association)	General Finance	International	No	Yes	Yes
AFME, ISLA, and ISDA	Banking	International	No	Yes	Yes
Allianz SE	Insurance	Germany	Yes	Yes (longer time)	No
AMAFI and Association Francaise des Marches Financiers	General Finance	France	Yes (based on definition)	Yes (shorter time)	Yes
Association of British Insurers	Insurance	UK	No	Yes	Yes
Association of Foreign Banks in Germany	Banks	International	No	Yes	
Association Francaise des Investisseurs Institutionnels	Institutional Investors				
Alternative Investment Management Association	Hedge Funds	France	No	Yes (shorter period)	Yes
Association Française de la Gestion financière	Asset Managers	France	Yes	Yes (shorter period)	Yes
Association of Private Client Investment Managers and Stockbrokers	Asset Managers	UK	No	Yes	Yes
Assogestioni	Asset Managers	Italy			
Assosim	Securities	Italy	No		
Austrian Federal Economic Chamber	Bank	Austria	Yes	Yes	
Barclays Capital	Bank	UK	No	Yes (shorter period)	Yes
BATS Trading Limited	Securities	UK	No	Yes	Yes
BDI - Federation of German industries	Corporate	Germany	Yes	Yes (Longer period)	Yes for CDS, no shares
Bloomberg Tradebook	Investment Firm	UK			
BME	Securities	Spain	No	Yes	
British Bankers Association	Bank	UK	No	Yes (shorter period)	Yes
Bundesverband Alternative Investment	Asset Managers	Germany	No	Yes	Yes
Bunderverband Investment und Asset Management	Asset Managers	Germany	No		
he Bundesverband der Wertpapierfirmen an den deutschen Börsen	Securities	Germany	No	Yes	Yes
Business Europe	Corporate	International	No	Yes	Yes
CFA France	General finance	France	No	No (no limits in time)	Yes
CFA UK	GeneralFinance	UK	No	Yes	Yes
Chi-X Europe	Securities	UK	No	Yes (shorter	Yes

				period)	
Confederation of Swedish Enterprise	Corporate	Sweden			
Credit Agricole Cheuvreux	Securities	France	Yes (with qualified definitio n)	Yes	Yes
Daimler	Corporate	Germany			
Danish Mortgage Banks Associations	Bank	Denmark	No		
Danish Shareholder Association	Shareholders	Denmark		Yes	
Deustsches Aktieninstitut	Corporate	Germany		Yes (longer period)	Yes
Deutsche Bank	Bank	Germany	No	Yes (shorter period)	Yes
Deustscher Industrie und Handelskammertag	Corporate	Germany	No	Yes	Yes
DGB	Trade Union	Germany			
Eumedion	Institutional Investors	Netherland			
Euroclear	Clearing	International			
European Association of Public Banks	Bank	International	No	Yes	Yes
European Banking Federation	Bank	International	No	Yes	Yes
European Fund and Asset Management Association	Asset Managers	International	No	Yes	Yes
European Savings Banks Group Register	Banks	International	No	Yes	
European Trade Union Confederation	Trade Union	International	Yes	No (more flexible time)	
Europeanissuers	Mixed	International			
Federation of European Securities Exchanges	Exchange	International		Yes	Yes
Flow Traders	Securities	Netherland	No	Yes	Yes
Fogain	Securities	Spain	No	Yes	Yes
French Banking Federation	Bank	France	No	Yes (more limited)	Yes
Futures and Options Association	Securities	UK		Yes	
GETCO	Securities	Internatioanl			
German Insurance Association	Insurance	Germany	No	Yes	Yes
Hedge Fund Standards Board	Hedge Fund	UK	No	Yes	Yes
HSBC	Bank	UK			
ICE	Clearinghouse	US			
IG Bau	Trade Union	Germany	Yes		No
International Capital Markets Association	Securities	International			
IMC Trading	Securities	Netherland	Yes (with qualified definitio n)	Yes	Yes
Interest Capturing System	Infrastructure	US			
Internatioanl Centre for Financial Regulation	Think Tank	UK	No	Yes	Yes

IntesaSanPaolo	Bank	Italy	No	Yes (shorter time)	Yes
INVERCO	Institutional Investors	Spain		Yes	Yes
Investment Adviser Association	Investment Adviser	US			
Investment Management Association	Asset Managers	UK	No	Yes	Yes
Investment Quotient	Asset Managers	UK	No	No	
Irish Stock Exchange	Exchange	Ireland			
Italian Banking Association	Bank	Italy	No	Yes	Yes
KDPW	Infrastructure	Poland	not clear	Yes	Yes
Legal and General Investment Management		UK	No	Yes	Yes
London Metal Exchange	Infrastructure	UK			
London Stock Exchange	Infrastructure	UK	No		Yes (oppose also emergency ban)
Luxembourg Bankers Association	Bank	Luxembourg	No	Yes	Yes
Managed Funds Association	Hedge Funds	US			
Man SE	Insurance	Germany			
Mouvement des Enterprises de France	Corporate	France	Yes (specific definition)	Ues (shorter period)	Yes
Nasdaq	Infrastructure	US	No	Yes	Yes (Oppose also emergency ban)
NFU (Confederation of the Nordic Bank, Finance, and Insurance Unions)	Trade Union	Sweden			
NYSE Euronext	Infrastructure	International	No	Yes	Yes
Oesterreichs Energies	Corporate	Austrian			
Optiver	Securities	Netherland	No		
REB	Securities	Netherland			
Rivoli fund Management	Asset Managers	France		Yes	
Rolls-Royce	Corporate	UK			
Societe Generale	Bank	France	No	Yes (shorter period)	Yes
Spanish Banking Association (AEB)	Bank	Spain			
State Street	Bank	US	No	Yes	Yes
Stuggart Stock Exchange	Exchange	Germany		Yes	
Unicredit	Bank	Italy			
Wolkswagen	Corporate	Germany			
World Economy, Ecology, and Development (WEED)	Think Tank	Germany	Yes	No	
Zentraler Kreditausschuss	Bank	Germany	No	Yes	Yes

Third, the decision by naked trading solution introduced by German regulators was opposed not only by the British authorities, the country where most derivatives trading occurs in Europe,[161] but also by numerous other European authorities (see the summary of the responses from regulatory authorities to EC Consultation in the Table 10). Neither France nor other Continental European countries with the exception of Austria followed the German example.

[161] The chairman of the FSA Lord Turner admitted that there were "major questions" about the utility of the market for credit-default swaps but also stated that banning the trading of CDS on the Greek debt would not address the causes of the problem and the volatility in the Greek debt markets. See Hannon 2010.

Table 10 - Responses by public authorities to the Consultation by the European Commission on Short-Selling

Respondent	Sector	Country	Q14: need for permanent ban?	Q24: should the restrictions limited in time?	Q27: should restrictions introduced only during emergency?
Authorite des Marches Financierers	Regulator	France	Yes (naked short sales)	Yes	No
Bank of Italy	Central Bank	Italy	No	Yes	Yes
Banque de France	Central Bank	France	Yes	Yes (more flexibility)	No (permanently)
Advisory Board of the National Securities Market Commission (CNMV)	Regulator	Spain	Yes	Yes	Yes
Consob	Regulator	Italy	No	Yes	
Czech National Bank	Central Bank	Czech Republic	No	No (against emergency powers)	No (against emergency powers)
Danish Ministry of Economic and Business Affairs	Ministry of Finance	Denmark	No		
Denmark Nationalbank	Central Bank	Denmark	No	Yes	Yes
European Central Bank Eurosystem	Central Bank	Europe			
Finnish Ministry of Finance	Ministry of Finance	Finance	No		
Germany Ministry of Finance	Ministry of Finance	Germany	Yes	No (longer time)	No (permanently)
Italian Treasury Department	Ministry of Finance	Italy			
Latvian Minsitry of Finance	Ministry of Finance	Latvia	No	Yes	Yes
Hungary Ministry for National Economy	Ministry of Finance	Hungary	No		
Ministère français de l'Economie, de l'Industrie et de l'emploi	Ministry of Finance	France	Yes		Yes
Norwegian Ministry of Finance	Ministry of Finance	Norway	Yes (specific definition)	against time restriction	No
Swedish authorities	Reg + Central Bank + Minsitry of Finance	Sweden	No	Yes	Yes
FSA + HMT	Reg + Ministry of Finance	UK	No	Yes	Yes

While the unilateral move by German authorities cannot be attributed to efficiency considerations, interest group pressures, or emulations of other European authorities, it is important to consider the unique domestic political context in which German policymakers found themselves operating during this period. The measure was introduced at a moment in which the deterioration of the Greek debt crisis had opened a debate over the creation of a Euro zone bailout fund, with Germany as the main financial contributor. The need to achieve the consent from a reluctant Bundestag created pressures upon the German government to demonstrate a commitment to tackle the sources of the crisis, including the role of "speculation" in the derivatives markets. Ralph Brinkhaus, a lawmaker from Merkel's party, described this regulatory measure as "symbolic politics:" "Sometimes it's important, alongside facts, also to send signals."[162] Sharon Bowles, an influential Member of the European Parliament, stated, "It was done for political purposes not technical purposes--that is absolutely clear. It was done to show people they were clamping down on speculation in order to get political votes through to approve an E.U. bailout regime."[163]

The lack of similar domestic constraints in other European countries impeded the formation of a consensus around this policy approach at the European level. The Committee of European Securities Regulators did not support the German ban and instead announced its intention simply to step up its monitoring of derivatives because of the "exceptional volatility" associated with the Greece's debt crisis.[164] In addition, the European Commission created an internal taskforce in March 2010 to address the concerns expressed by German and French regarding the impact of sovereign CDS on the underlying sovereign bond markets.[165] President of the Commission Barroso announced that the Commission was examining "the relevance of banning purely speculative naked sales on credit default swaps of sovereign debt,"[166] but the proposed regulation presented by the European Commission in June 2010[167] and confirmed in September[168] stopped short of proposing the kind of permanent ban introduced in Germany. Instead, the regulation approved in Europe allowed regulators to introduce this ban only in emergency situations and for a limited time—up to a three month period.[169]

[162] Cited by Moulson 2010.
[163] McGlinchey 2010.
[164] CESR 2010.
[165] Gowling 2010.
[166] Barroso 2010.
[167] European Commission 2010f.
[168] European Commission 2010c.
[169] This ban could then be "extended for further periods of three months at a time" after having received an opinion from ESMA regarding to what extent such restriction is justified (p.9, see also Article 18). ESMA would be given a role in coordinating action in exceptional circumstances, in particular to avoid that countries could abuse of their powers of restricting trades in exceptional circumstances. Besides the coordinating role, ESMA would also be given power to take action in situations with cross border implications and where "competent authorities have not adequately addressed the threat". In this case, "any measure taken by ESMA in such situations would override measures by competent authorities if there is any inconsistency". See European Commission 2010d; European Commission 2010c.

Not only did the opposition of other European countries prevent German authorities from exporting their approach to the European level, but also the regulation of sovereign CDS failed to appear in the international agenda. This happened despite the fact that the German government announced in February 2010 its intention to push for a discussion at the international level over the regulation of sovereign CDS,[170] while the German Chancellor Merkel openly called for the US to support an international regulation of the sector.[171] Also Greek Prime Minister Papandreou demanded that the US President support an international regulation of sovereign derivatives during an official visit to the US, blaming them for exacerbating Greece's problems.[172]

As argued above, during the first part of the crisis, the US had been the main country to promote an international agreement within the G20 over the central clearing and exchange trading of derivatives, the policy solutions to the failures revealed by the collapse of Lehman Brothers. However, the risks associated with the trading of derivatives tied to the sovereign debt did not raise the sort of public attention in the US that they did in the initial stage of the Eurozone debt crisis. As a result, over this period US authorities faced less domestic pressures to cave to the requests of Continental European countries for an international agreement over the regulation of sovereign derivatives and acted primarily as a veto player in the international agenda.

4.7 Conclusion

This chapter has investigated the sources of the evolution of the international regime governing derivatives markets from the industry-driven arrangements that characterized the pre-crisis period to the decisions to bring these markets firmly under the oversight of public authorities. In particular, this chapter has argued that the origin of this shift is to be found primarily in the impact that the crisis had in altering the incentives of the US Congress by raising domestic public attention towards the issue.

In the fifteen years preceding the crisis, the low degree of public salience created strong incentives for Congress to support the market-based mechanisms endorsed by the main US dealers and regulatory agencies. However, the unprecedented degree of public attention towards this issue during the crisis reinforced the electoral incentives for the majority of Congress to regulate the sector and challenge the preferences of the

[170] Thomas & Bartha 2010.
[171] Parussini, Thomas, & McGroarty 2010.
[172] Wearden 2010.

financial industry. The timing of the increase in the public salience of derivatives is important to explain the timing of the involvement of Congress and of the shift in the international agenda, which continued to rely at the beginning of the crisis on market-based solutions.

At the same time, the lower degree of salience that derivatives occupied in the agenda of European countries compared to other sectors is important to explain why during this period European authorities, at least until the Eurozone crisis, largely lagged behind US authorities in promoting changes in the international agenda. As the next two cases will show more in depth, during this same period, Europe has exercised a more significant role in driving change in two sectors that became more salient over this period: rating agencies and hedge funds.

Chapter 5. Credit Rating Agencies

5.1 Plan of the Chapter

This chapter will explore the evolution of the public-private divide in the international approach towards the regulation of credit rating agencies (CRAs).

From the publication of the *Manual of Railroads and Corporation Securities* by John Moody in 1900, CRAs have remained largely outside the direct purview of national regulatory authorities for more than a century. Their conduct has been guided primarily by self-regulatory initiatives rather than government-imposed rules. Indeed, when rating agencies entered into the international regulatory agenda for the first time in the early 2000s, the International Organization of Securities Commissions (IOSCO) signaled its approval of the self-regulatory status of the industry. The trigger that brought the regulation of rating agencies into the agenda of the international securities regulatory bodies was a series of corporate scandals at the turn of the millennium that were not detected by the main rating agencies. The bankruptcy of Enron in 2001 in particular focused the attention of policymakers on the shortcomings of rating agencies.

Instead of attempting to implement direct supervision, though, the international initiative coordinated by securities regulators through IOSCO sought to place the responsibility to correct the failures revealed by these corporate scandals in the hands of rating agencies. Reflecting this, the 2004 IOSCO Code of Conduct Fundamentals for Credit Rating Agencies was a set of non-binding recommendations intended to be a model that rating agencies could include in their individual codes of conduct.[1]

This approach persisted into the global financial crisis of 2007-09, as the initial regulatory reaction of IOSCO at the beginning of 2008 did not depart from the reliance on self-regulation that characterized the international response to Enron. While IOSCO urged rating agencies to incorporate a revised version of its Code into their self-regulatory practices, the role of public actors was limited to monitoring the level of implementation. However, throughout the course of the crisis this approach came to be challenged to the point that, as IOSCO acknowledged in May 2010, “A consensus emerged that the IOSCO CRA Code, as an industry code that promoted CRAs to implement internal controls and processes designed to give effect to the IOSCO CRA

[1] IOSCO 2004a. This was preceded by a consultation report: IOSCO 2004b.

Principles, should be supplemented with regulation of CRAs by national competent authorities."[2]

How can we explain the decision taken by international securities regulators before the crisis to rely on the self-regulatory initiatives of the rating agencies and on market discipline imposed on market participants as the primary mechanisms to address the regulation of rating agencies after the collapse of Enron? And why was this approach abandoned in the aftermath of the global financial crisis?

Section 5.2 will discuss how the self-regulatory nature of the international regime that emerged before the crisis reflects the preferences of securities regulators both in the United States and in Europe, and it will examine their attempts to deflect the pressures from their respective political administrators in the aftermath of the Enron and Parmalat scandals. However, the United States and Europe diverged in their approach towards the implementation of this international commitment. Section 5.3 will explain how while in the years following these scandals the US Congress rejected the self-regulatory approach and decided to regulate rating agencies directly, self-regulation had remained the status quo within Europe.

The second part of this chapter will shift to look at the evolution of the public-private divide in the regulation of rating agencies after the crisis. Section 5.4 will analyze the political dynamics in the United States and Europe that led the initial international response to the crisis to rely once again on a self-regulatory approach. Section 5.5 will discuss how the greater public salience of financial regulation in the United States led Congress to intervene progressively more in the regulation of the industry. However, the lower level of public attention paid to rating agencies compared to the regulation of derivatives described in the previous chapter did not push Congress to depart significantly from the recommendations of securities regulators.

Section 5.6 will turn to Europe and analyze how heightened public attention there created strong incentives for key policymakers within the EU policymaking process to oppose the continuation of the market-based approach endorsed by IOSCO and European securities regulators. This change within Europe aligned the position that emerged among EU politicians with that of their US counterparts and therefore set the stage for a shift in the international agenda via the G20.

[2] IOSCO 2010b, p.10.

5.2 Enron, Parmalat and the Regulation of Rating Agencies before the Crisis

Despite their long history dating back since the early 20th century, rating agencies have remained largely outside of the international regulatory agenda. This lack of international regulatory initiatives persisted despite key developments that affected the industry over time. The first of these was the liberalization of world financial markets starting in the 1970s, which spurred a limited number of rating agencies whose activities up to that point had been limited to US markets to begin to play a crucial role in international markets.[3] The second was the involvement of rating agencies in one of the most severe episodes of financial instability of the post-war period, the 1997 East Asian financial crisis. Different commentators denounced the failure of rating agencies to predict the crisis and the incorrect ratings of East Asian countries at the outset of the crisis, while others argued that rating agencies had further aggravated the crisis by downgrading East Asian countries more than the deterioration in their economic fundamentals had justified.[4]

While these developments did not trigger the emergence of international regulatory initiatives concerning the regulatory status of rating agencies, this changed in the early 2000s. The turning point bringing rating agencies into the international regulatory agenda was their failure to properly identify a series of corporate defaults during this period, including those of Enron in 2001, Worldcom in 2002, and Parmalat 2003. The financial and human costs of these corporate bankruptcies, however, certainly could not rival those of the East Asian financial crisis. In order to understand why these events had the effect of bringing rating agencies into the international regulatory agenda, we need to investigate the impact that these events triggered at the domestic level in the United States, where the most important rating agencies are located..

In the United States, the East Asian crisis was perceived as primarily a failure of the East Asian model of capitalism, and no significant initiatives by US regulators or the US Congress were launched to probe the involvement of these agencies in the crisis. On the contrary, the bankruptcy of Enron and the significant resonance that this event had with the American public had the impact of catalyzing the attention of the US Congress on a number of financial regulatory issues. Ten different congressional committees probed the company over this period.

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[3] Sinclair 2005; Abdelal 2007; Bruner & Abdelal 2005.
[4] Ferri, Liu, & Stiglitz 1999.

While rating agencies where not the main focus of this Congressional activism, they were nonetheless not left unscathed. In an investigation into the role of private sector watchdogs in the Enron collapse, launched by the Senate Committee on Governmental Affairs in January 2002, several Congressmen blamed rating agencies for not having identified Enron's financial condition despite their privileged access to company's books.[5] As Rep. James Greenwood argued, "I'm considering asking them how it was that they rated the credit so high, up until just days before the collapse of the company, and how they would have missed that."[6] The Congressional offensive was also directed at the regulatory status of rating agencies, and several Congressmen denounced the lack of formal oversight of rating agencies in the United States. Since 1975 the US SEC had identified those agencies that could be relied upon to judge the creditworthiness of securities under federal securities laws by granting them the status of "Nationally Recognized Statistical Rating Organization" (NRSRO). However, this limited action during this period was indeed never extended to overseeing or regulating directly the operations of rating agencies.[7]

The chairman of the Senate Committee on Governmental Affairs, Joseph Liberman argued, "I think it's appropriate, as we try to learn the lessons of Enron, to ask if the agencies should have some sense of accountability—some oversight, from the SEC perhaps–to ensure they properly perform their function as watchdogs."[8] The report released by the Committee in October 2002 denounced how the little, if any, formal regulatory oversight of rating agencies made it very difficult to hold them accountable for future mistakes. The report recommended the SEC to develop "a set of standards and considerations that the rating agencies must use in deriving their ratings" and "standards for training levels of credit rating analysts," making the NSRSO designation conditional on compliance with these and assuming responsibility for monitoring compliance.[9]

A provision regarding the regulation of rating agencies was also incorporated in the Public Company Accounting Reform and Investor Protection Act of 2002, better known as Sarbanes-Oxley Act, the main legislation passed by the US Congress in response to the Enron scandal. While the focus of the scandal and the legislation was on corporate governance issues and auditors, the bill also involved the regulation of rating agencies,

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[5] US Senate 2002. During this hearing "concerns had been expressed regarding the significant market power of the three NRSROs, their privileged access to nonpublic issuer information, their apparent lack of care and diligence in the Enron situation, and their very limited regulatory oversight". See SEC 2003b, p. 16.
[6] Drawbaugh 2002.
[7] For a review of US regulatory regime see Duff & Einig 2007; SEC 2007.
[8] Cited in Wetuski 2002 .
[9] Staff of the Senate Committee on Governmental Affairs 2002.

demanding federal regulators to look into the regulation of these markets actors. Title VII of the Act required the SEC to conduct a study of the role and function of CRAs in the operation of the securities markets and to submit a report discussing possible measures required to improve the dissemination of information or prevent conflicts of interest in the operation of CRAs.

In response to the requests contained in the Sarbanes-Oxley Act, the SEC launched an investigation to ascertain the appropriate level of regulatory oversight of rating agencies.[10] In the report, submitted to Congress in January 2003, the SEC announced that it would investigate in more detail "whether more direct, ongoing oversight of rating agencies is warranted and, if so, the appropriate means for doing so (and whether it is advisable to ask Congress for specific legislative oversight authority)." [11] This was followed in June 2003 by the issuance of a Concept Release to seek comments from market participants on different options ranging from eliminating the NRSRO designation from the SEC's rules to implementing more direct ongoing oversight of rating agencies and imposing minimum standards to which rating agencies should adhere.[12]

This was not the first time that the failure of rating agencies to warn investors before the default of a rated company had triggered discussions within the SEC about the adequacy of their regulatory status.[13] However, similar to past instances, at the end of this consultation in July 2003, the SEC did not take a formal position on whether additional legislation should be forthcoming.[14] Divisions emerged across the five SEC Commissioners regarding the desirability of this solution.[15] According to Davies and Green, "Majority opinion among the regulators was that the [rating] agencies should themselves be responsible for policing conflicts of interest and ensuring the integrity of their analysis".[16]

[10] SEC 2002a.
[11] SEC 2003b.
[12] SEC 2003a.
[13] The SEC first considered the possibility of extending its oversight authority over credit rating agencies in 1992, after that Rep. John Dingell and the Justice Department denounced the lack of competition and accountability among the agencies. However, the SEC failed to reach a consensus on the need for regulation. The revival of Congressional interest only two years later led the SEC to issue a concept release to solicit public comments about "whether the Commission should take further steps regarding NRSROs in order to increase its regulatory oversight role, including seeking legislative authority if necessary" ad on "whether NRSROs should be required to register with the Commission". This initiative resulted three years later in a proposal in 1997 by the SEC to formalize the criteria for designating NRSRO, but this initiative stalled due to a lack of consensus and the SEC failed to take final action on the proposal. See SEC 1994. For a summary of previous regulatory attempts see SEC 2002b; Hume 2002 .
[14] SEC 2005.
[15] Burns 2004b; Peterson 2004; SEC 2005.
[16] Davies & Green 2008 p. 70

Instead of invoking the legislative intervention of Congress, the SEC tried to work out an agreement with the major CRAs over a voluntary code of conduct that would rely on these agencies to adopt measures to avoid conflicts of interest, ensure the protection of companies' confidential information, and address other concerns. The SEC repeatedly defended the benefits of this proposal, arguing that "a strong and effective industry-led regime could prove to be a constructive and reasonable approach to address a number of concerns involving the credit rating industry that have been raised in recent years by Congress, the Commission, and others, such as the International Organization of Securities Commissions."[17]

Even outside the United States, when international scrutiny triggered by Enron, Worldcom and Parmalat brought the regulation of rating agencies into the agenda of the IOSCO Technical Committee, the self-regulatory solution endorsed by US regulatory authorities at the domestic level also came to inform the international approach. IOSCO published a set of high-level principles in September 2003 in order to guide the conduct of rating agencies, listing four distinct mechanisms through which these principles should be enforced. Each mechanism allocated the responsibility to regulate rating agencies differently among public and private actors: "1) Government regulation; 2) Regulation imposed by non-government statutory regulators; 3) Industry codes; and, 4) Internal rating agency policies and procedures."[18]

IOSCO itself did not formally take a position on whether rating agencies should fall under the regulatory oversight of public authorities. However, securities regulators leaned decisively towards the fourth option when they drafted the 2004 IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.[19] In line with the regulatory paradigm analyzed in the first chapter, this was a non-binding set of recommendations intended to be a model that rating agencies could include in their individual codes of conduct. IOSCO also sought to place the task of monitoring the enforcement of these recommendations primarily in the hands of the market participants. In fact, it solicited rating agencies to disclose publicly any deviation from the Code (so called "comply or explain" mechanism) in order to permit market participants and regulators to assess to what extent CRAs had implemented the Code of Conduct and to react accordingly.[20]

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[17] SEC 2005

[18] IOSCO 2003. IOSCO stated that it "would await future consideration of these alternatives in the major jurisdictions and take account of preferences of other sector supervisors before considering its preferred method of implementation"

[19] IOSCO 2004a. This was preceded by a consultation report: IOSCO 2004b

[20] While disclosure remained the main compliance mechanism, in the consultation report IOSCO envisioned different strategies to enforce compliance. IOSCO "envisioned that securities regulators may decide to incorporate the CRA Code

The reliance on market-based mechanisms informing the IOSCO Code of Conduct certainly mirrored the preferences of US regulators. At the same time, US authorities did not have to exercise their power to impose this solution over reluctant European regulators. On the contrary, a market-based solution to the regulation of rating agencies was also endorsed collectively by securities regulators in Europe. As a matter of fact, the collapse of Enron had triggered dynamics in Europe similar to those described in the US. In particular, the heightened public attention towards rating agencies in Europe had brought elected politicians to question the lack of a formal regulation of rating agencies and to solicit a response from regulators. At the Oviedo Informal Ecofin Council in April 2002, European finance ministers required the European Commission to investigate this issue.

The incentives for European politicians to enter the debate over the regulation of rating agencies were further reinforced by the failure of rating agencies to detect the collapse of the Italian conglomerate Parmalat in 2003. Indeed, the bankruptcy of Parmalat set the stage for a greater involvement of the European Parliament in the debate over the regulation of rating agencies. A report presented to the Committee on Economic and Monetary Affairs at the end of 2003 by MEP Giorgos Katiforis argued that the Enron and Parmalat scandals "showed the agencies were subject to little formal regulation or oversight" and called on the EU to follow the US authorities in investigating CRAs in the context of recent corporate scandals.[21] The report suggested that rating agencies active in Europe should register with a European Union Ratings Authority in order to introduce greater accountability and oversight. The initial draft of the report also encouraged the EU to consider championing the creation of a European rating agency as a counterweight to the US-based agencies dominating the world markets: "In the light of the predominantly American character of existing rating agencies, the creation of a new European rating agency must be considered."[22] The final version of the report approved by the European Parliament in January 2004 removed any reference to the creation of a European Union Ratings Authority but still called on the European Commission to

of Conduct Fundamentals into their own regulatory oversight of CRAs, may decide to oversee compliance of the CRA Code of Conduct Fundamentals directly, may decide to provide for an outside arbitration body to enforce the CRA Code of Conduct Fundamentals, or may rely on market mechanisms to enforce compliance if an individual CRA's own code of conduct fails to adequately address the provisions outlined by the CRA Code of Conduct Fundamentals". See IOSCO 2004b.

[21] European Parliament 2003a.

[22] European Parliament 2003b.

produce its assessment of the need for appropriate legislative proposals and to consider whether rating agencies should register with European regulators.[23]

In turn, the European Commission requested the Committee of European Securities Regulators (CESR) to provide technical advice regarding the introduction of a European regulation of rating agencies.[24] However, European regulators in their response dismissed the desirability of introducing direct regulation of the industry, arguing that the benefits of this solution would not outweigh the negative aspects.[25] According to CESR, direct regulation would have "the potential to create barriers to competition and innovation," and it could lead "to an increase in the cost of ratings thereby potentially discouraging the access of smaller issuers to rating and therefore the European Capital market." CESR also pointed out that regulatory involvement "could risk inadvertently giving a quality seal to ratings and might threaten the perception of their independence/credibility," as possibly generating the risk that ratings could be treated differently in Europe from other jurisdictions, thereby creating an un-level playing field.

On the other hand, European securities regulators praised the benefits a market-based approach. The CESR argued that rating agencies already "face[d] significant incentives to maintain the highest possible standards, particularly as they rely heavily on their good reputation with issuers and users of ratings," concluding that "the perception that a CRA was not fully compliant with the fundamentals of the IOSCO Code could lead to market sanctions that would severely impair its business." Moreover, this solution would avoid the problems associated with regulation described above such as the impression of an absolute guarantee of quality of ratings. While acknowledging that a market-based solution would not be foolproof,[26] European securities regulators still regarded self-regulatory improvements based on the recommendations released by IOSCO as the most desirable solution and recommended to the European Commission that the role of regulators should be limited to monitoring for the time being how rating agencies were adopting the IOSCO Code of Conduct.[27]

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[23] European Parliament 2004.
[24] European Commission 2004.
[25] CESR 2005a.
[26] European securities regulators acknowledged the weaknesses of this approach, most importantly "the risk that CRAs will choose not to implement it effectively, thereby undermining its value", and that "if some kind of problems exist in the market for the provision of ratings, selecting this option will allow these problems to exist for a longer period of time". However, these weaknesses were regarded as smaller than the advantages.
[27] Similarly to the "comply or explain" mechanism introduced by IOSCO, European securities regulators required each CRA operating in the EU to sent a public annual letter to regulators describing how it had complied with the IOSCO Code of Conduct and any deviation from it, to meet with the CESR to discuss issues related to the implementation of the IOSCO Code, and to provide an explanation to national regulatory authorities in the case of any major incident occurring with a certain issuer. Only in the case self-regulation failed, CESR acknowledged that there might be a need for statutory

In sum, the emergence of an international regulatory regime based around self-regulation before the crisis reflected not only the preferences of US regulatory authorities and their attempt to deflect the pressures from US Congress in the aftermath of Enron but also similar dynamics in Europe, where this solution was fully supported by European regulators.

5.3 Diverging paths between the US and Europe

How can we explain this support for self-regulation among regulatory agencies on both sides of the Atlantic? One popular interpretation in the literature points towards the influence of the rating industry and its privileged relation with its potential overseers. A self-regulatory regime based on the voluntary implementation of high level principles such as those incorporated within the IOSCO Code of Conduct remained throughout this period the preferred solution of the rating agencies themselves. Following the bankruptcy of Enron and the renewed attention towards their regulatory status, rating agencies in the United States intensively lobbied both the SEC and Congress against the introduction of mandatory regulatory requirements. The industry argued that direct regulatory requirements would compromise the quality and independence of their analysis, erect barriers to entry in an oligopolistic market, stifle innovation, and "infringe on the NRSROs' well-established rights under the First Amendment of the U.S. Constitution."[28] According to rating agencies, the market should remain the primary judge of the credibility and reliability of their opinions. Rating agencies supported instead the SEC plan to develop a voluntary oversight framework.[29] Their lobbying of in favor of a market-driven regulatory solution was not confined to the United States, but it also extended to Europe, where rating agencies supported reliance on the IOSCO Code of Conduct as the primary European regulatory mechanism.[30]

Rating agencies also extended their mobilization directly to the transnational level. Following the publication of the IOSCO Principles in 2003, rating agencies were among those who demanded IOSCO to develop a more specific code of conduct giving guidance on how these guidelines could be implemented. Rating agencies were also active participants in the public consultation launched by the IOSCO to solicit the input of

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regulation. Only a minority of CESR members supported a distinct "EU voluntary recognition system along with a subsequent reporting on the compliance with the IOSCO code". CESR 2005a, p. 1.

[28] S&P's 2003; Moody's 2003.

[29] Layfield 2005.

[30] S&P's 2005a; Moody's 2005; Fitch 2005.

market actors regarding the appropriate allocation of regulatory responsibilities between market actors and public authorities.[31]

Moreover, beyond stating their support for self-regulation, rating agencies also contributed to the affirmation of this solution by promptly implementing these self-regulatory measures by incorporating the Code of Conduct recommendations into their internal guidelines, as requested by the CESR and IOSCO. Indeed, when the CESR and IOSCO reviewed the self-regulatory steps undertaken by rating agencies in the years preceding the crisis, they both concluded that rating agencies had made significant progress in incorporating the Code of Conduct into their internal codes of best practices.[32]

Nevertheless, while the preferences of the US-based rating agencies are likely to have played an important role in shaping the preferences of their home-country regulator, the SEC, the same argument cannot explain the preferences of regulators in European countries, which do not house any of the major international rating agencies. This is particularly the case for domestic regulators of European countries. Different authors have described the rising importance of rating agencies in international markets as standing at odds with the reliance on bank-funding and patient capital that characterize "coordinated" market economies more characteristic in Europe. Moreover, during the negotiations of the Basel II Agreement, German authorities challenged the inclusion of ratings in the calculation of capital requirements, presenting this as incompatible with the German model of capitalism.[33]

However, an analysis of the mobilization of interest groups across Europe reveals how the support for self-regulation in Europe went well beyond the American rating agencies dominating the European markets and included the majority of business groups that responded to the consultation launched by the CESR.[34] For instance, the imposition of direct regulatory requirements was opposed by all the European banking groups participating in the CESR consultation—the European Banking Federation,[35] the British Bankers' Association,[36] the International Banking Federation[37], the German Banking industry (ZKA), and the European Association of Public Banks[38]—with the exception of

[31] Moody's 2004; S&P's 2004.
[32] CESR 2006; IOSCO 2007.
[33] Wood 2005.
[34] CESR 2005b.
[35] European Banking Federation 2005.
[36] British Bankers' Association 2005.
[37] International Banking Federation 2005.
[38] European Association of Public Banks 2005.

Italian Banking Federation, where banks were more exposed to the collapse of the Italian conglomerate Parmalat.[39]

As the British Bankers' Association argued, "Banks are not putting forward an agenda of self-regulation for CRAs as a single interest group but rather as part of a majority consensus with the financial community."[40] Regulation of rating agencies was also opposed by insurance firms (the Association of British Insurers,[41] the German Insurance Associatio[42]), institutional investors (the Investment Management Association[43]), and securities firms (the International Securities Market Association and the International Primary Market Association,[44] the Bond Market Association[45]) in addition to interest groups outside of the financial industry, such as corporate actors involved in the credit ratings business as issuers of rated obligations (the US Association for Financial Professionals, the Association Française des Trésoriers d'Entreprise, the British Association of Corporate Treasurers,[46] the European Association of Corporate Treasurers,[47] the Mouvement des Enterprises de France,[48] and the Union of Industrial and Employers' Confederation).[49] The only dissonant voice in the corporate world was the European Association for Listed Companies.[50]

These groups denounced how regulation by official bodies would make European financial markets less attractive as a result of over-prescriptive measures, reduce the quality and availability of ratings, and impose costs to the rating agencies that would then be borne by investors and issuers. European direct regulation of the industry would also ignore the global nature of the financial services industry and undermine international consistency. On the contrary, financial and corporate interest groups

[39] Italian Banking Association 2005.
[40] British Bankers' Association 2005.
[41] Association of British Insurers 2005.
[42] German Insurance Association 2005.The German Insurance Association endorsed a monitoring of the market developments and an assessment of the compliance with the IOSCO Code of Conduct by the supervisory authorities. However, they stressed the importance that some supervisory authorities could collect the respective information, "since otherwise a review of the Code seems hardly possible". At the same time, the German Insurance Association also endorsed the creation of an external arbitration body. "
[43] Investment Management Association 2005. IMA argued that "the role of regulators should be encourage transparency and the development by rating agencies themselves of proper procedures to deal with the issues raised". According IMA "any form of registration/regulation will raise barriers to entry and that it should be the role of the regulator to encourage more competition with respect to credit ratings assessments". Moreover, "there is a real danger of the investor being mislead as to the quality of a rating if there appears to be some formal regulatory "endorsement" of the CRA"
[44] International Securities Market Association, International Primary Market Association, Danish Securities Dealers Association, London Investment Banking Association, & Swedish Securities Dealers Association 2005.
[45] Bond Market Association 2005.
[46] Association for Financial Professionals, Association Française Des Trésoriers D'Entreprise, & Association of Corporate Treasurers 2004.
[47] European Association of Corporate Treasurers 2005.
[48] Mouvement des Enterprises de France 2005.
[49] UNICE 2005.
[50] European Association for Listed Companies 2005.

supported the claim of the rating agencies that the market was ultimately the best regulator and that market pressures would be sufficiently capable of disciplining rating agencies. As the summary of the preferences of the respondents to the CESR consultation illustrates in Table 1, support for self-regulation came not only from interest groups in the UK but also from most respondents from France and Germany.

Table 11 - Responses to 2005 CESR Consultation on Rating Agencies

Respondent	Industry	Country	Preference for direct regulation/self-regulation
European Banking Federation	Banking	International	Self-regulation
British Bankers' Association	Banking	UK	Self-regulation
Association of British Insurers	Insurance	UK	Self-regulation
German Insurance Association	Insurance	Germany	Self-regulation + External arbitrator
Investment Management Association	Securities	UK	Self-Regulation
International Securities Market Association + International Primary Market Association	Securities	International	Self-regulation
Bond Market Association	Securities	US	Self-regulation
European Association of Corporate Treasurers	Corporate	International	Self-regulation
Moody's	Rating Agency	US	Self-regulation
S&P's	Rating Agency	US	Self-regulation
Fitch	Rating Agency	US	Self-regulation
Danish Shareholders' Association	Shareholders	Denmark	No position taken
Department of Economics, University of Bari	Academia	Italy	No position taken
European Association of Public Banks	Banking	International	Self-regulation
HVB Group	Banking	Germany	Self-regulation + external arbitration body
Institutional Money Market Funds Association	Securities	International	Self-Regulation
International Banking Federation	Banking	International	Self-Regulation
Italian Banking Association	Banking	Italy	Direct Regulation
German Zentraler Kreditausschuss	Banking	Germany	No position
BdRA (Federal Association of Rating Analysts and Rating Advisors)	Rating	Germany	Self-Regulation + some form of public oversight
European Association for Listed Companies	Corporate/Users of derivatives	International	Direct Regulation
Mouvement des Enterprises de France	Corporate	France	Self-regulation
Union of Industrial and Employers' Confederation	UK	International	Self-regulation

This unified front in support of self-regulation constituted by regulatory authorities, rating agencies, and the quasi-totality of financial and corporate interest groups convincingly explains why the European Commission announced its intention not to present new legislative proposals in the regulation of rating agencies in January 2006. The European Commission affirmed its confidence that the self-regulation by the CRAs on the basis of the newly adopted IOSCO Code would provide an answer to concerns raised by the European Parliament. According to the Commission this was consistent with its the principles of “Better Regulation,” maintaining that “legislative solutions should be applied only where they are strictly necessary for the achievement of public policy objectives.”[51]

This endorsement of self-regulation by the European Commission was backed up, however, by the threat of regulatory intervention. The European Commission asked the CESR to monitor compliance with the IOSCO Code and explicitly threatened “introducing legislative proposals if new circumstances arise—including serious problems of market failure…The ratings industry should be aware that the Commission may have to take legislative action if it becomes clear that compliance with EU rules or the Code is unsatisfactory and damaging EU capital markets.”[52] When the first review conducted by CESR in 2006 confirmed the substantial compliance of rating agencies with the IOSCO Code of Conduct,[53] Internal Market Commissioner McCreevy welcomed the report as confirming “that the self-regulation by CRAs functions reasonably well,” “the right regulatory balance had been struck,” and “the case for new legislation in this area remains unproven”.[54]

While in Europe regulators and market actors were successful in triggering the emergence of a market-based regulatory regime, in the United States the attempt by the SEC to negotiate a voluntary oversight framework failed to appease Congress. On the contrary, in many circumstances Congress criticized the reluctance of the SEC to take action in introducing regulation of rating agencies.

In April 2003, the House of Representatives Subcommittee on Capital Markets held a hearing to investigate the SEC’s role in policing credit rating agencies and its relationship with the agencies.[55] As Rep. Christopher Shays argued in a contentious house hearing in April 2003, "I get the feeling, basically, that you all are pretty much asleep."[56] In September 2004 the influential Congressman Richard Baker,Chairman of the Committee, and the leading Democrat on the House panel, Rep. Paul Kanjorski, threatened to shift the task of regulating rating agencies to another regulatory agency such as the Federal Reserve if the SEC did not act within the following year.[57] Kanjorski declared that he was considering a bill telling the SEC to "get going and, in a year, if you don't act, your authority by the act itself will be put in another agency." [58] Rep. Baker

[51] European Commission 2006a, 2006b.
[52] European Commission 2006a European Commission 2006b.
[53] CESR 2006.
[54] European Commission 2007.
[55] U.S. House of Representatives 2003.
[56] Klein 2003.
[57] Burns 2004a.
[58] Drawbaugh 2004.

stated that if the SEC did not propose a viable solution soon, there existed bipartisan support to introduce legislation.[59]

In its reply, the SEC still defended the benefits of an industry-led regime as “a constructive and reasonable approach to address a number of concerns involving the credit rating industry that have been raised in recent years by Congress.” At the same time, the SEC acknowledged that the negotiations with the rating agencies had failed in delivering an “agreed-upon voluntary oversight framework.”[60] Nevertheless, if Congress wanted more extensive regulatory oversight, the SEC stated, then it should have explicitly granted this authority to the SEC via legislation; although the SEC explicitly refused to take a “formal position on whether additional legislation should be forthcoming.”[61]

Facing the option of supporting the market-based approach defended by the SEC and IOSCO or imposing direct regulation, Congress moved decisively towards the latter option, rejecting the desirability of relying on voluntary standards and hosting in June 2005 a hearing on "Legislative Solutions for the Rating Agency Duopoly.”[62] Rep. Mike Fitzpatrick introduced a bill to bring to an end the self-regulatory status that characterized the industry and to give the SEC inspection, examination, and enforcement authority over CRAs.

This bill found significant opposition within the US Congress[63] as well as from the rating agencies, which urged Congress to wait before legislating for market-driven initiatives already underway, such as the international Code of Conduct and the voluntary framework developed by SEC.[64] Despite this opposition, the US Congress approved in September 2006 the Credit Rating Agency Reform Act of 2006 (CRA Reform Act). This bill replaced the previous NRSRO status with the new status of Statistical Rating Organization. Most importantly, the CRA Reform Act brought registered CRAs under the

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[59] Klein 2004.

[60] SEC 2005.

[61] SEC 2005 Asked if Rep. Kelly if the SEC was “seeking authority from Congress to rate the raters”, Nazareth responded: “No. We are not seeking authority. We have no official position on seeking authority. What is being discussed is granting the Commission authority to have an oversight regime for those entities who fit the definition and who have applied for recognition”. Answering a similar question by Rep. Brown-Waite, Nazareth responded: “The Commission has not yet taken a position on whether it is requesting statutory authority. What the Commission has done is make clear that it believes that to do more would require statutory authority”.

[62] US House of Representatives 2005. See also Hume 2005a; Hutnyan 2005.

[63] For instance, the influential NY Senator Charles Schumer, who in 2006 encouraged the SEC to revive a voluntary oversight plan”. Fitzpatrick, who initially introduced the bill, later argue that the bill had been significantly been watered down, blaming in particular Sen. Schumer. Protess & Sebert 2010.

[64] S&P's 2005b. S&P’s reacted declaring "We think the self-regulatory approach is the way to go. We think that there's been substantial progress made [on a system of voluntary standards] and that anything that requires registration could run into real constitutional concerns." Cited in Hume 2005b.

oversight of the SEC and required them to comply with record-keeping and disclosure requirements, provisions on management of conflicts of interest and other procedures, and provided the SEC with authority to take action against a rating agency that failed to comply with these requirements.[65]

In sum, while in the United States the regulatory framework that eventually emerged after the collapse of Enron placed the responsibility to set the rules governing rating agencies and enforce compliance in the hands of public authorities, the regulatory approach in Europe and at the international level instead continued to rely on self-regulatory efforts by rating agencies and on the discipline of markets. In the European context, the more modest role of public authorities was to be that of monitoring the self-regulatory efforts by rating agencies.

How can we explain the emergence of two frameworks allocating regulatory responsibilities so differently among public regulators and private market actors? And how can we explain the fact that the more stringent regime emerged in the United States rather than in Europe, thus challenging the expectation of the literature holding that liberal market economies should be supportive of a light approach to the regulation of rating agencies?

One possible interpretation would point towards the different impact that the collapse of Enron had on the balance of influence between regulators and policymakers in Europe and in the United States. In both the United States and Europe, the bankruptcy of Enron and subsequent corporate scandals generated incentives for politicians to enter the regulatory debate and to question the lack of formal regulation of rating agencies, in turn leading securities regulators to endorse market-based improvements in order to satisfy the concerns of political overseers.

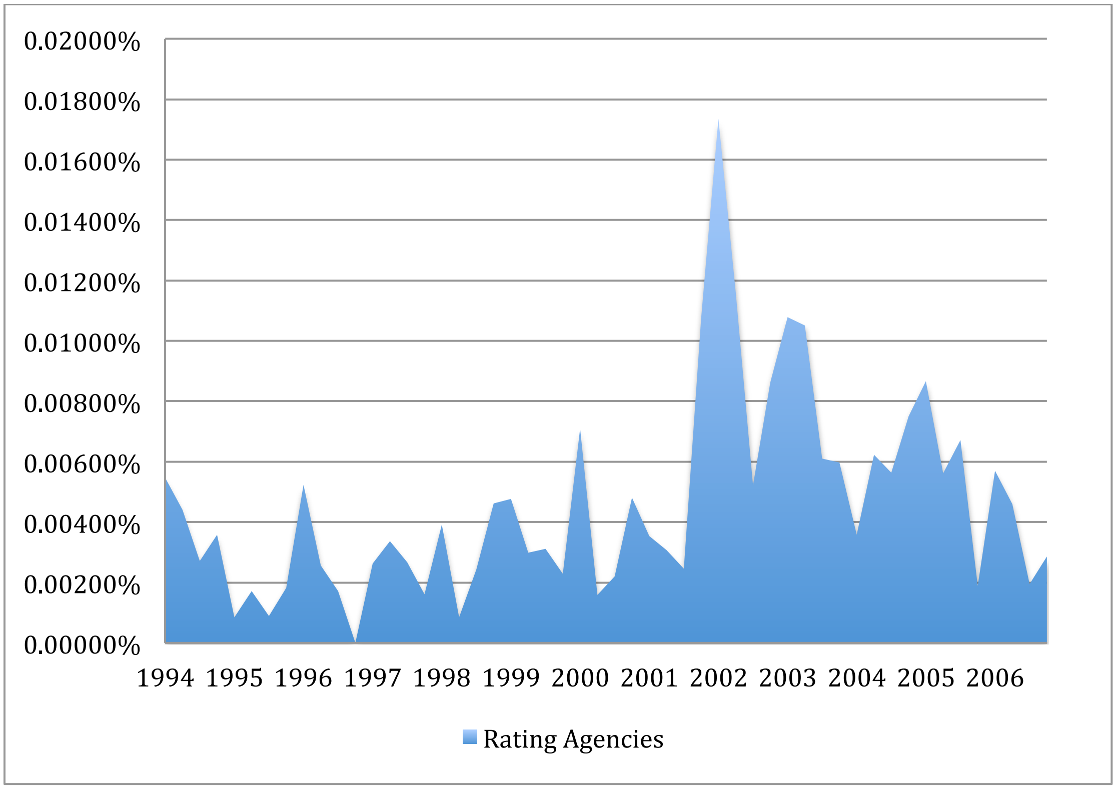
However, the collapse of Enron had no direct impact over European markets, while the bankruptcy of Parmalat remained a more localized shock, largely restricted to the Italian market. As a consequence, these shocks failed to generate sufficient incentives for policymakers in European countries to challenge the preference of regulators and of the large majority of interest groups both within and outside the finance industry for a self-regulatory solution.

On the other hand, according to Culpepper, the Enron and the Worldcom scandals “caught public attention and ignited public anger” in the United States, becoming “an

[65] Text of the bill is available here: http://www.govtrack.us/congress/bills/109/s3850

informational short-cut for corporate excess" and making "a class of scandals easier to explain to the wider public."[66] The Enron scandal had the effect of "forc[ing] a reluctant Congress to act" and to pass the Sarbanes-Oxley act.[67] As Culpepper argues, "In the US, the sharp increase in the political salience of executive pay in the post Enron period created an incentive for politicians to intervene with formal legal proposals, and political entrepreneurs in the Democratic party responded to this incentive."[68]

Figure 14 - Coverage of Rating Agencies in the US Press (1994-20007)

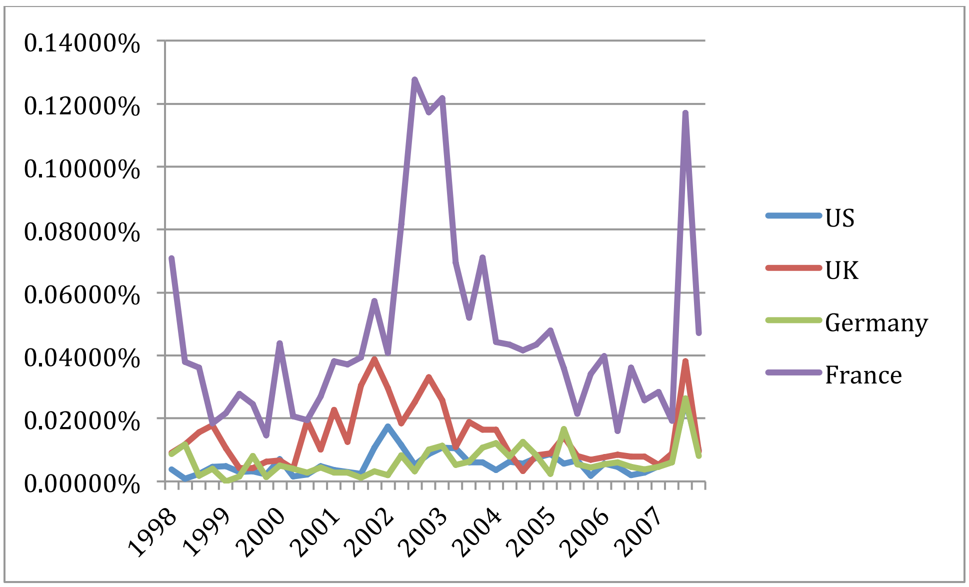


The analysis of coverage of rating agencies in the US media in Figure 14 illustrates the impact of this shock in raising the salience of these actors more than did previous corporate bankruptcies that went undetected by rating agencies. The significant attention raised by Enron towards the shortcomings in the regulation of corporate firms and securities markets generated strong momentum for Congress to be involved in these areas even beyond the passage of Sarbanes Oxley.

[66] Culpepper 2011 P. 159.
[67] Culpepper 2011 P. 159.
[68] Culpepper 2011 P. 166.

At the same time, the analysis of the degree of public salience of rating agencies does not fully support that the momentum coming from the public opinion represented the only or even the main factor at play in explaining the different approach in the US and in Europe. It is true that the bankruptcy of Enron increased the profile of rating agencies more than any other corporate bankruptcy of the past, but as Figure 15 illustrates, while the level of media attention towards rating agencies was higher in the United States than in Germany during most of this period, it was significantly lower than in France.

Figure 15 - Media Coverage of Rating Agencies in the US, UK, Germany, France before the Crisis



In addition, the decision of Congress to reject the market-based approach devised by the SEC and to regulate rating agencies directly occurred not at the peak of the public attention in 2002, but rather three years later in 2005. At the time of the passage of the CRA Reform Act, the level of public attention towards rating agencies in the US had declined to pre-Enron levels.

It is therefore important to consider additional factors that may explain the different attitude of elected officials in the United States and in Europe. One possible interpretation points towards the fact that US regulators could not fully deliver on their promise to introduce a voluntary oversight mechanism, as the negotiation with rating agencies hit a deadlock. This weakened the capacity of the opponents of the direct regulation to point towards the existence of a viable self-regulatory alternative to direct regulation, and it facilitated the attempt to gather support within Congress for a legislation to directly regulate the sector. This is a clear difference from the debates regarding the desirability of regulating derivatives during the same period, when the financial industry and the defenders of the status quo were able to demonstrate the existence of numerous industry-driven alternatives. Contrary to the situation in the United States, when the European Commission assessed the desirability of relying on the market-based implementation of the IOSCO Code of Conduct, rating agencies were able to demonstrate a greater commitment towards implementing these principles.

Competitive concerns may also have played an important role in explaining the greater appetite of Congress for regulating rating agencies than for derivatives. In the case of derivatives discussed in the previous chapter, the threat that direct oversight of the sector would have favored a migration of derivatives trading from New York to London was an important argument used in support of self-regulation. In the case of rating agencies, the global dominance of US rating agencies and lack of strong competitive concerns strengthened the appetite of Congress to "go it alone" in regulating the industry. Over this period, the United States did not pressure its European counterparts to follow by introducing an equivalent regulatory framework, given that the self-regulatory framework that emerged in Europe was directly in the interests of US firms.

As the next section will show, the more extensive impact that the crisis of 2007-09 had in increasing the salience of derivatives regulation in Europe also had the impact of triggering dynamics resembling those in the United States after Enron, thus setting the stage for a shift in the public-private divide in the regulation of rating agencies both in Europe and at the international level.

5.4 The Initial Response to the Crisis in the Regulation of Rating Agencies

Since the early stages of the crisis in the summer of 2007, many analysts have identified rating agencies as one of the main culprits. Several commentators pointed a finger towards the function of "gatekeepers" that rating agencies performed for most products at the core of the financial crisis, such as the mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). The fact that 62% of all the securitized products issued in the US and 75% of those issued in Europe were AAA-rated instilled significant confidence among investors in the safety of these structured finance products. This also led these structured finance instruments to be widely bought by investors subject to regulatory requirements explicitly linked to ratings. [69]

However, from the outset of the crisis it became evident that most of these ratings had overlooked the problems in structured finance markets. When mortgage defaults began to accelerate, rating agencies quickly started in July 2007 to downgrade securities that were once highly rated to below investment grade, with S&P downgrading more than two-thirds of its investment grade ratings and Moody's over 5000 investment-grade ratings.[70] This widespread downgrading of subprime-related securities that occurred in 2007 and 2008 generated significant market distress, as investors lost confidence in the accuracy of the ratings of a wide range of MBS and CDOs and all looked to sell off in a market with no buyers.

By demonstrating how rating agencies had severely underestimated the risks attached to MBS and other structured finance products, the crisis once again focused the attention of politicians and regulators on the adequacy of their regulatory status.[71] One main interpretation of the rapid downgrades of MBS and other structured credit products stressed important errors in the ratings of these tools. For instance, different reports revealed severe shortcomings in the methodologies, models, and key rating assumptions used by rating agencies;[72] their failure to incorporate in their analyses significant pieces of information regarding the quality of the assets underlying structured finance products they rated;[73] and the inherent differences between the reliability of ratings of structured products and those of traditional debt issues. An alternative interpretation of the inflated ratings provided by rating agencies prior to the crisis pointed to the importance of the skewed incentives faced by rating agencies. In particular, policymakers and commentators identified in the "issuer-pays" business model the source of several conflicts of interests potentially undermining the accuracy of ratings.[74]

[69] The role of rating agencies in the securitization process and in the creation of structured finance products is well analyzed in ESME 2008; Coval, Jurek, & Stafford 2009; European Commission 2008a; CGFS 2008; Fons 2008.
[70] Waxman 2008.
[71] FSF 2008b; CESR 2008b; PWG 2008.
[72] For instance, these models frequently involved excessively optimist assumptions, relying on a historical data available only to the relatively recent years, without sufficiently accounting for the possibility that the benign economic outlook and rising house prices could change significantly. See for instance SIFMA 2008b; CGFS 2008; PWG 2008.
[73] In particular, rating agencies failed to detect and incorporate into their credit assessment the rapid deterioration in underwriting standards for subprime mortgage loans which occurred over a very short period from the 2001. Congressional Oversight Panel 2009; SIFMA 2008b.
[74] Since the large majority of the rating agencies are being paid by the same issuer of the security that is being rated or the originator of the issue, they have an incentive to provide favourable ratings in order to avoid that issuers could bring future rating business to other rating agencies. This threat to the agency's independence is particularly acute in structured

Moreover, most reports denounced how this conflict of interest was heightened by the nature of the interaction between credit raters and underwriters during the rating of structured finance products.[75] Finally, observers highlighted how the objectivity of rating agencies could be further undermined by their provision of so-called "advisory" and "ancillary" services to the issuers of the securities.[76]

And so rating agencies returned in the international regulatory agenda as early as September 2007, when IOSCO invited them for a meeting in Washington to obtain greater information on their role in the emerging market turmoil.[77] However, despite the severity of both the market shock and the shortcomings in the work of rating agencies revealed by the crisis, the initial international regulatory response did not significantly depart from the self-regulatory approach that had dominated the international agenda since the Enron scandal. Following a request from the Financial Stability Forum (FSF), IOSCO's Technical Committee had already by the beginning of 2007 started to discuss the need to amend its Code of Conduct to address specific problems related to the role of rating agencies in rating structured finance. The turmoil that originated in the US subprime mortgage market increased the urgency of this revision.

After a brief consultation with market participants launched on 26 March 2008,[78] IOSCO amended the Code of Conduct Fundamentals for Credit Rating Agencies in May 2008 to better address the regulatory issues raised by the role of rating agencies in structured finance.[79] The changes represented a comprehensive set of regulatory proposals, with a range of recommendations on enhancements to the quality of the rating process, the independence of rating agencies and avoidance of conflicts of interest, transparency and timeliness of ratings disclosure, and communication with market participants. However, this initiative from IOSCO did not challenge the allocation of regulatory responsibilities

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finance where fees for rating agencies are heftier than in the case of corporate ratings and the dependency of rating agencies is increased by the limited number of investment banks requesting their services. CESR 2008b; Smith 2008.

[75] As the CESR has argued "the rating of structured finance transactions distinguishes itself from the rating of traditional instruments by the greater flexibility to adapt the features of the transaction in order to achieve the rating level desired for each tranche of the structure. As opposed to traditional ratings, the rating of a structured finance transaction is a target, not the outcome of the rating process." See CESR 2008b. Several commentators have raised concerns that this close interaction between rating agencies and issuers has become advisory in nature. The conflicts of interests inherent in this advisory role were aggravated by the fact that analysts were also taking part in fees negotiation, and they were often attractive recruitment target for investment banks and other originators/issuers. Therefore, they could be tempted to give more favourable ratings to securities issued by their future employers. See Coffee 2007; Lardner 2009; Morgenson 2008.

[76] Examples are pricing services for structured finance securities that do not have a liquid market, risk-management consulting, and rating assessment services, providing issuers with a preview of what ratings they are likely to receive after certain hypothetical events or if structured in different ways. At the outset of the crisis commentators have denounced the lack of clarity regarding what ancillary services are and the lack of operational and legal separations between the analysts and other business of the rating agencies. Since these services represent an important source of revenues for rating agencies, they have an incentive to continue this profitable relationship with their clients by providing favourable ratings.

[77] Grantin 2007.

[78] IOSCO 2008b.

[79] IOSCO 2008a.

between public and private actors that had emerged internationally prior to the crisis, nor did it alter the focus on self-regulation. As the Chairman of IOSCO's Technical Committee, Michel Prada, admitted when IOSCO met in Amsterdam in February 2008 to decide their course of action, "There's still hesitation within some regulators to [introduce] formal regulation."[80]

Similar to the first set of best practices drafted in 2004*,* the amended Code of Conduct remained non-binding, relying on ratings agencies to incorporate these recommendations voluntarily into their individual codes of conduct "according to each CRA's specific legal and market circumstances." Moreover, just as with the 2004 initiative, the amended version of the Code relied on discipline imposed by other market participants—investors and issuers to be the unique mechanism to ensure compliance. In order to improve the ability of market participants to judge whether a CRA had satisfactorily implemented the Code fundamentals, IOSCO required rating agencies to publicly disclose how each provision of the Code was addressed in their own codes of conduct.

The FSF also provided its endorsement to this market-based approach. When it firstly took the lead in coordinating an international regulatory response to the crisis in April 2008, the FSF urged rating agencies to "quickly revise their codes of conduct to implement the revised IOSCO CRA Code of Conduct Fundamentals." The role of public authorities would have been to "monitor, individually or collectively, the implementation of the revised IOSCO Code of Conduct by CRAs, in order to ensure that CRAs quickly translate it into action".[81]

As in the past, this initiative triggered an immediate response from rating agencies. In October 2007 a group comprising five major rating agencies (A.M. Best Company, Inc.; DBRS Limited; Fitch, Inc.; Moody's Investors Service, Inc.; and Standard & Poor's Ratings Services)[82] began cooperating to develop a joint response to concerns being raised by policymakers. These agencies jointly responded to the consultation launched by IOSCO in March 2008, largely welcoming IOSCO's revised Code of Conduct and affirming their commitment to move swiftly to incorporate its recommendations in their respective codes of conduct. They also noted how many of these recommendations had

[80] Tett, Hughes, & van Duyn 2008; Giles, Tett, & Grant 2008.

[81] FSF 2008b, p.34.
[82] CESR 2008b.

already been adopted by rating agencies through their previous self-regulatory steps.[83]

In addition, in their collective response to the CESR's "Consultation Paper on the Role of Credit Rating Agencies in Structured Finance," rating agencies defended a regulatory response based on market discipline, arguing that "market disciplinary forces have proven effective in persuading [rating agencies] to implement the existing IOSCO Code and [to] propose changes to it or their own codes where market participants and/or regulators have raised concerns or identified limitations in the scope of the IOSCO Code."[84]

Indeed a review published by IOSCO in March 2009 "found that a larger proportion of the CRAs reviewed were aware of the IOSCO CRA Code, and have taken steps to incorporate its provisions into their codes of conduct, than when they were previously surveyed for IOSCO's first implementation review in 2007."[85] Moreover, besides jointly committing to incorporate the recommendations made by IOSCO in their own codes of conduct, rating agencies individually adopted additional self-regulatory commitments to counter the rising criticisms regarding their conflicts of interest and the weaknesses in their methodologies and data.[86]

How can we explain the continuous reliance on a market-based solution despite the severity of the shortcomings in the activities of rating agencies demonstrated by the crisis? The continuation in the international approach during this period reflects the continued leadership of the same US and European securities regulators that had promoted self-regulation during the pre-crisis period.

In the US, the SEC reacted to the first signals of the crisis at the end of July 2007 by announcing an investigation into the causes that had led to the inflation of the rating of subprime MBS and CDOs.[87] The results of this investigation, released in July 2008, showed that rating agencies had struggled to stay abreast of the increase in the number

[83] A.M. Best, DBRS, Fitch, Moody's, & S&P's 2008b.
[84] A.M. Best, DBRS, Fitch, Moody's, & S&P's 2008a.
[85] IOSCO 2009e, p. 15.
[86] Tett 2008b; Moody's 2008; S&P's 2008b. S&P's has established an Office of the Ombudsman in charge of addressing concerns related to potential conflicts of interest that may be raised by issuers and investors, a public annual review of governance processes by an independent firm, established a rotation of analysts and decided to study the track record of analysts leaving to work for issuers to identify unusual patterns. This was followed by Moody's, which reorganized its internal organization to formalize the separation of its ratings-related and non-rating activities into two different business units, to separate the Credit Policy function from parts of the rating agency with revenue-generating responsibility. Fitch separated its non-rating businesses into a separate division, implemented senior management changes in its structured finance operations, and revised its approach to the rating of mortgage-backed securities and collateralized debt obligations. Also the three rating agencies have also announced measures to improve the effectiveness of their analytical methodologies, to review their methodologies and assumptions for rating structured financial products, to incorporate items currently excluded from credit ratings, and to improve the rating process in the face of the unprecedented market changes.
[87] SEC 2007.

and complexity of subprime mortgage-backed securities and collateralized debt obligations since 2002, they lacked comprehensive written procedures for rating these instruments, and they neither appropriately managed their conflicts of interest in relation to these deals nor effectively monitored these ratings.[88]

Similarly to what occurred in other past circumstances, the SEC initially sought to address these shortcomings not by expanding its regulatory oversight of rating agencies but rather by soliciting an industry-driven response. The first recommendations regarding the regulation of rating agencies, in a report published in March 2008 by the President's Working Group on Financial Markets (PWG), were directed primarily to rating agencies themselves.[89] In particular, the PWG urged rating agencies to reform their rating processes for structured credit products to ensure integrity and transparency, welcoming the self-regulatory steps already taken.

Additionally, the PWG sought to encourage this industry-driven solution by announcing its intention to "facilitate formation of a private-sector group (with representatives of investors, issuers, underwriters, and CRAs) to develop recommendations for further steps that the issuers, underwriters, CRAs, and policy makers could take to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment."[90] This "carrot" offered to the industry in the form of public endorsement of an industry-led reform was accompanied by the "stick" of threatening to "revisit the need for changes to CRA oversight if the reforms adopted by the CRAs are not sufficient to ensure the integrity and transparency of ratings".[91]

This approach was supported by the rating agencies, seeking to avoid a more formal regulatory response. Speaking before the US Senate on September 26, 2007, Managing Director of Moody's Michael Kanef declared to be "eager to work with other market participants on broader *market-based* reforms and solutions that would enhance the transparency and effectiveness of the global credit markets".[92] As S&P's Chairman Deven Sharma argued in a hearing before the House of Representatives, "We have

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[88] SEC 2008b.
[89] PWG 2008.
[90] PWG 2008, p.4. A group with representatives of different members of the financial services industry, assets managers, issuers, and underwriters and led by the Securities Industry and Financial Markets Association (SIFMA) issued in July 2008 a set of recommendations to address the issue raised by the PWG report, which placed the onus entirely in the hands of credit rating agencies and other market actors. SIFMA 2008b.
[91] Paulson 2008.
[92] Moody's 2007.

learned from this experience and we have made major changes ourselves to restore confidence in our ratings."[93]

The subprime mortgage crisis also triggered dynamics in Europe similar to those created by the bankruptcy of Enron and Parmalat almost a decade earlier. When the outbreak of the crisis led different policymakers to demand a reassessment of the self-regulatory status of the industry, the European Commission once again responded to these demands by requesting the CESR to investigate whether recent developments in structured finance would cause a reassessment of the need to regulate CRAs. In a letter to the CESR, McCreevy argued that the crisis had raised doubts on whether rating agencies had adequate resources to understand the "rapidly changing and growing complex structured finance market," and he asked regulators to analyze the "apparently slow response" of rating agencies to the problems with structured finance products.[94]

Mirroring what occurred after the bankruptcy of Enron and Parmalat, the response from European securities regulators solicited a market-driven regulatory response. Speaking before the European Parliament in January 2008, the chairman of the CESR, Eddy Wymeersch, declared that "on the question of self-regulation or government regulation, it's too early to make a decision about that…We should give a chance to rating agencies to put their house in order."[95] At the same time, European regulators sought to encourage rating agencies to self-regulate by threatening regulatory intervention. The head of the French Autorité des Marchés Financiers (and chairman of IOSCO's Technical Committee) Michel Prada declared in the same month, "Credit rating agencies have to do their homework and provide us with relevant answers to the issues (we are worried about), and this needs to be done now. We are in the middle of a crisis and we cannot wait….What the regulators do next will very much depend on what the rating agencies do…the more they provide good answers, the less we will need to step in."[96] Prada also urged rating agencies to create an industry organization that would allow them to speak with a single voice in order to better coordinate their attempts at self-policing.[97]

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[93] S&P's 2009a.
[94] McCreevy 2007a .
[95] H. Jones 2008.
[96] Tett 2008a.
[97] Tett 2008a. Prada declared: "One of the concerns is that over the past two years we have had some hesitation from the rating agencies in dealing with our questions. It has not been easy to talk to them collectively - it is the only profession which does not have a global organisation and it is hard to understand why." Prada reiterated similar requests in June 2008. See Baird 2008.

Indeed, the failure of rating agencies to create such a self-regulatory organization led the CESR to recommend to the European Commission in May 2008 the creation of a CRAs standard setting and monitoring body, formed by senior representatives of CRAs as well as of investors, issuers, and investment firms. This body would be in charge of developing international standards for the rating industry and of "naming and shaming" rating agencies not in compliance with these standards. For the majority of European securities regulators, this form of enhanced self-regulation represented the appropriate regulatory response to the deficiencies of the existing self-regulatory regime, in particular the lack of clear market sanctions in case of transgressions of the IOSCO Code.[98]

At the same time, European securities regulators rejected the desirability of directly regulating rating agencies. In its recommendations to the European Commission, the CESR argued that it "still believe[s] that there is no evidence that regulation would have had an effect on the issues which emerged with ratings of US subprime backed securities."[99] Indeed, as in the pre-crisis period, a self-regulatory solution built around an amended IOSCO Code of Conduct represented the regulatory solution supported not only by European securities regulators but also by the large majority of the market actors that participated to the latest consultation launched by CESR.[100]

This section has identified the source of the continuous support for a market-based approach that characterized the initial response of the international regulatory community, which can be found in the continuous support for this approach among securities regulators both in the United States and Europe. The next two sections will discuss how the intensification of the salience of financial regulation would then lead to a shift in the balance of influence in setting the domestic regulatory agenda between regulators and elected politicians both in the United States and in Europe.

5.5 Congress and the Regulation of Rating Agencies

Echoing the dynamics surrounding derivatives described in the previous chapter, the monopoly of US federal regulators in setting the agenda for the regulation of rating agencies began to come under threat as the intensification of the crisis triggered the growing attention of the US public towards the mishaps of the financial sector, including

[98] CESR 2008b.
[99] CESR 2008b. Among the advantages of this approach highlighted by market participants there was the greater degree of flexibility, the greater cost effectivness. CESR argued that "all respondents agreed that a key measure to improve the current regime would be the amendment of the IOSCO Code".
[100] CESR 2008b.

rating agencies. This strengthened the incentives for the US Congress to increase its engagement in the regulation of rating agencies. Regulation of rating agencies made its appearance back into the Congressional agenda for the first time since the beginning of the crisis in September 2007, when the House Subcommittee on Capital Markets held a hearing on "The Role of Credit Rating Agencies in the Structured Finance Market."[101]

This was only the first of several hearings held by Congress during this period to investigate the role of rating agencies in the financial crisis. During these hearings, severe criticisms were directed by different Congressmen at the inability of the SEC to identify their mistakes of the rating agencies.[102] During the hearing on rating agencies in October 2008, the Chairman of the Government Oversight Committee, Henry Waxman, argued, "The story of the credit rating agencies is a story of colossal failure. The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent, objective assessments. The rating agencies broke this bond of trust, and federal regulators ignored the warning signs and did nothing to protect the public. The result is that our entire financial system is now at risk."[103] At the same time, Congressmen also questioned the capacity of rating agencies to self-police themselves and urged regulators to step up their oversight of rating agencies.

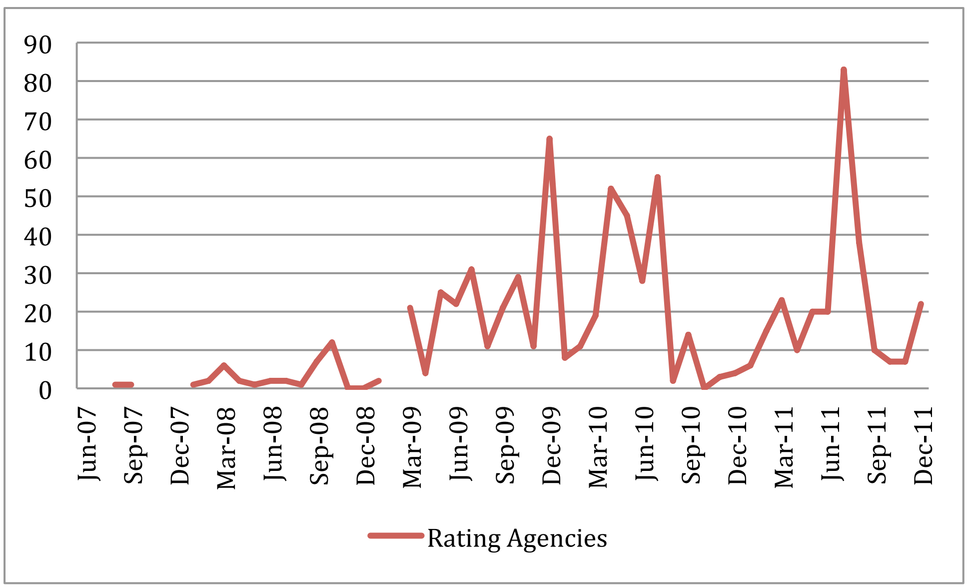
In line with the expectation of the theoretical model presented by David Singer that has been discussed in Chapter 3,[104] the greater Congressional scrutiny triggered a reaction from the SEC. Starting from June 2008, the SEC moved from simply soliciting a self-regulatory response to using the authority conferred by the CRA Reform Act of 2006 and incorporating into its rule-book several of the principles suggested by the amended IOSCO Code of Conduct to limit rating agencies' conflicts of interest; to increase their disclosure; to better differentiate between structured, corporate, or municipal securities;[105] and to strip references to NRSRO in most of its rules in order to reduce excessive reliance on credit ratings.[106] The SEC also stepped up its oversight of rating agencies by allocating resources in February 2009 to establish a branch of examiners dedicated specifically to conducting examination of rating agencies and by announcing

[101] U.S. House of Representatives 2007.
[102] Three distinct bills were introduced in January of 2009 by Rep. Darrell Issa (Financial Oversight Commission Act of 2009 - H.R. 74), and by Senator Johnny Isakson (Financial Markets Commission Act of 2009 - S. 298), and in May 2009 by Rep. Willliam Delahunt (Financial Markets Commission Act of 2009 - H.R. 2253) to ask the establishment of a commission to investigate the role of credit rating agencies in the financial crisis.
[103] Waxman 2008.
[104] Singer 2007.
[105] SEC 2008a. An additional set of rules was approved in November 2009. See SEC 2009b.
[106] SEC 2008c; SEC 2009e.

in July 2009 the creation of a monitoring group to enhance the oversight of rating agencies.[107]

These regulatory initiatives, however, failed to appease the US Congress. As New York Sen. Charles Schumer said after the SEC disclosed an additional set of rules in December 2008, "None of the rules adopted today are a substitute for the larger regulatory reform that is coming next year."[108] As Figure 16 illustrates, starting from the fall of 2008, Congressmen began to play a much more direct role in shaping the regulation of rating agencies, using their legislative authority not only to pressure regulators to intervene but also to directly set the rules governing different aspects of the rating business.

Figure 16 - Number of Documents mentioning "Rating Agencies" in "Congressional Documents and Publications"[109]



These proposals sought to strengthen the regulatory oversight of public authorities over rating agencies beyond what had been suggested by securities regulators.Demonstrating this, a bill introduced in July 2009 by Rep. Keith Ellison (H.R. 3128) suggested addressing the “wholly inadequate” current oversight of rating agencies

[107] US Treasury 2009b.
[108] Scannell & Lucchetti 2009.
[109] The “Congressional Documents and Publications” a wide variety of documents concerning the activity of US Congress, including legislative proposals, transcript of hearings, and press releases from individual Congressmen. It has been accessed through Factiva.

by giving the Federal Reserve authority over the CRAs when they analyze and rate structured financial products.[110]

While this proposal was rejected, several legislative proposals sought to broaden the oversight of securities regulators over rating agencies by requiring the SEC to establish an office to administer its rules with respect to the practices of rating agencies;[111] to conduct an annual audit of each NRSRO to ensure rating methods and procedures are sound, adhered to, and disclosed;[112] or to empower the SEC to discipline executives at rating agencies for failures to supervise.[113] Some of these provisions were later included into the Wall Street Reform and Consumer Protection Act passed by the US Congress in the summer of 2010, which strengthened the powers of public authorities to regulate rating agencies by establishing an Office of Credit Ratings within the SEC.[114]

In addition to reorganizing the SEC, Congressional involvement also contributed to expand the degree of SEC regulatory intervention beyond the measures already adopted or proposed by the agency. The reforms already introduced by the SEC during the crisis had largely fallen within the perimeter of measures negotiated internationally within the IOSCO Code of Conduct. In particular, the SEC had introduced into its rule-book several of the disclosure requirements coordinated at the international level to assist investors in understanding the actual performance of credit ratings, the procedures and methodologies used the determine credit ratings, and the extent they could be undermined by conflicts of interest deriving from the issuer-pays model and the oligopolistic nature of the market for ratings. In addition, it had barred rating agencies from providing advice on how to structure the same products that they rate.[115] Finally, legislation introduced detailed regulatory requirements regarding the internal governance of rating agencies, for instance dictating the composition, compensation, and duties of

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[110] Ellison 2008. This authority would build upon powers that the Federal Reserve has already assumed as part of its administration of the Term Asset-Backed Securities Loan Facility (TALF) program, expanding the authority of the Fed to oversee all asset-backed securities, not just those financed through TALF.

[111] See the Rating Accountability and Transparency Enhancement (S. 1073) introduced on May 19 2009 by Sen. Reed. The text of the bill is available online at: http://www.govtrack.us/congress/bills/111/s1073

[112] See the Credit Rating Agency Responsibility Act of 2009 (S. 927) introduced on April 29, 2009 by Sen. Mark Pryor. The text of the bill is available online at: http://www.govtrack.us/congress/bills/111/s927

[113] See the Accountability and Transparency in Rating Agencies Act (HR 3890) introduced on 21 April 2009 by Rep. Paul Kanjorski.

[114] See Section 932 of the legislation. This Office would also have the mandate to "conduct an examination of each nationally recognized statistical rating organization at least annually", and make the essential findings of this inspection available to the public.

[115] The SEC als prohibited anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it and from receiving gifts, and requiring agencies to disclose information on the source and magnitude of their revenues that could allow investors to assess potential conflicts of interests. SEC 2008a; 2009a; 2009b; 2009f SEC 2009d; SEC 2009a SEC 2009c; SEC 2008a; 2009a; 2009b; 2009f.

the board of directors of rating agencies as well as removing the legal protection traditionally granted to rating agencies under the freedom of speech principle.[116]

However, Congress did not go so far as to challenge the principle codified in the CRA Reform Act of 2006 and informing the actions of the SEC and IOSCO holding that regulation should not directly interfere with the methodologies employed by rating agencies or the substance of their credit ratings. This principle had been questioned by a report presented by the Congressional Oversight Panel, established by Congress when it provided the US Treasury with the authority to spend $700 billion to implement the Troubled Asset Relief Program. The January 2009 report had suggested the creation of a "Credit Rating Review Board" in charge of endorsing any rating before it took on regulatory significance,[117] later codified in a bill presented in February 2009 by Rep. Gary Ackerman and Rep. Michael Castle.[118] However, the Ackerman and Castle bill failed to gather significant support and was not incorporated into the Dodd-Frank Wall Street Reform and Consumer Protection Act.[119]

The same dynamics are clearly visible in the approach towards the regulation of conflicts of interest associated with the work of rating agencies. The regulatory paradigm developed prior to the crisis, the same approach adopted by IOSCO in response to the crisis, did not encourage regulators to interfere directly with credit rating agencies'

[116] The WSRCPA Act requires half of the board of directors to be independent, with a compensation not linked to the performance of the firm, a non-renewable fixed term not to exceed five years, and a specific set of duties. The bill also required the SEC issue rules to regulate the training of the person employed by rating agencies to ensure they meet "standards of training, experience, and competence necessary to produce accurate ratings". Moreover the legislation has also challenged the protection, introduced a provision making easier for investors sue rating agencies if they can show that the agency "knowingly or recklessly" failed "to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk" or it failed "to obtain reasonable verification of such factual elements … from other sources".

[117] Congressional Oversight Panel 2009 The Report stated that: "Ideally, the board would be given direction by lawmakers to favor simpler (plain vanilla) instruments with relatively long track records. New and untested instruments might not make the cut". While this solution would not prevent new instruments from being be actively bought and sold in the private marketplace, institutional investors that follow rating guidelines would be able to buy exclusively to those instruments whose ratings were approved by the review board.

[118] The bill requested the SEC to set new rules defining the types of structured finance investments eligible to receive ratings from credit rating agencies, thus placing regulators in charge of directly defining what products could or could not be rated. This legislative proposal envisioned that only structured finance investments whose future performances could be reasonably predicted (e.g. securities with established track records and proven default rates, and securitizations that are comprised of homogeneous securities) could be eligible to receive ratings US House of Representatives 2009.

[119] The Dodd-Frank Act however still grants regulators the authority to revoke the authorization to agencies that had "failed over a sustained period of time, as determined by the Commission, to produce ratings that are accurate for that class or subclass of securities".While the bill approved by the US Congress does not put regulators in the position of arbiter of the performance of rating agencies, the bill gives the SEC the power to temporarily suspend or permanently revoke the registration of a rating agency if regulators find that this does not have the resources "to consistently produce credit ratings with integrity". In making this determination, the WSRCP Act requires regulators to consider "whether the nationally recognized statistical rating organization has failed over a sustained period of time, as determined by the Commission, to produce ratings that are accurate for that class or subclass of securities".

business models, nor did it suggest supporting the emergence of rating agencies following alternative models in order to break the oligopolistic nature of the market.[120]

The greater involvement of the US Congress also had the effect of widening the range of regulatory proposals to address conflicts of interest. While Congress did not seek to promote the emergence of rating agencies funded by investors[121] or government-run agencies,[122] it did seek to sever the direct link between issuers and rating agencies at the core of the conflicts of interest created by this business model.

In August 2009, the influential Democratic Sen. Charles Schumer proposed that when an issuer contracted an agency, the SEC should randomly choose another CRA to provide a second, back-up random rating, thus providing additional checks.[123] Two distinct amendments introduced on the House floor by Rep. Brad Sherman and Rep. Stephen Lynch in October 2009 and on the Senate floor by Sen. Al Franken in May 2010 sought to give the SEC the power to establish an independent self-regulatory organization to be called the Credit Rating Agency Board, which would act as a middleman between issuers seeking ratings on structured securities and the rating agencies, allocating issuers to different agencies.[124]

However, while this bill was approved by the US Senate with a 64-35 vote, the measure was stripped only a few weeks later as the House and Senate compromised on their respective bills within a reconciliation committee—outside of public scrutiny. The Dodd-Frank Act instead asked the SEC to conduct a two-year study to examine “the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products.”[125]

[120] The IOSCO Code of Conduct was instead directed towards CRAs relying on different business models.

[121] One of the leaders of the legislation on credit rating agencies, Rep. Kanjorski, in a first moment described that this option of promoting more investor-pays agency was “worthy of our consideration”, to later retreat and declare that when lawmakers had looked into solution to change the model, they found it was impractical. See Kanjorski 2009.

[122] Key lawmakers within Congress also rejected the possibility of a government-run credit rating agency. Rep. Barnkey Frank said he has contemplated introducing this kind of solution but he was “skeptical that you could insulate a government-run rating agency from pressure from the people being rated”. See Protess 2010.

[123] Schumer described this proposal in this way: "It would be done randomly and secretly and the pool would be a lot greater than the big three rating agencies, so there would be some incentive to get it right…This proposal would provide a check against ratings shopping and other conflicts of interest inherent in the system."According to one version of this proposal, every tenth debt security produced by a corporation would be subject to a second rating produced by a random issuer. According to a second approach instead, every tenth security produced by all the rating agencies would be subject to a second rating. See Schumer 2009.

[124] The board would evaluate different mechanisms to assign rating agencies, including by rotation or a lottery, but it would also have to take into account agencies' accuracy and technical capacity, so that rating agencies with the best track record over time would be rewarded with a greater share of business.

[125] The US Congress required the SEC also to study: “(A) an assessment of potential mechanisms for determining fees for the nationally recognized statistical rating organizations; (B) appropriate methods for paying fees to the nationally recognized statistical rating organizations; (C) the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government”.

The legislation passed by the US Congress also required the SEC to examine "alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings."[126] Under this pressure from Congress, the SEC invited industry representatives, investors, and academics to a roundtable to discuss alternative compensation models beyond the issuer-pays model.[127] However, at the moment of writing, the SEC has failed to endorse such an approach.[128] The Government Accountability Office, in its study of alternative models for compensating CRAs, has acknowledged that "there is little incentive to continue developing these models because it appears unlikely they will receive attention from regulators or legislators."[129] Instead, the SEC has so far adopted a market-driven mechanism to favor the entry of more rating agencies, requiring the rating agencies hired by issuers to disclose all information provided by the issuer in order to encourage other rating agencies that are not paid to rate the security to step forward and to issue their own unsolicited ratings.[130]

In sum, while the intervention of Congress had the effect of extending the range of regulatory requirements imposed upon rating agencies beyond the focus on disclosure requirement that characterized the initial approach by the SEC and IOSCO, Congress has not challenged the preferences of regulators concerning two key principles at the core of this regulatory paradigm: that the intervention of regulatory authorities should interfere directly neither with the methodologies employed by rating agencies and the content of ratings nor with their business models.

This deferral to the preferences of CRAs represents a contrast with the conduct of Congress in the regulation of derivatives described in the previous chapter. A partial explanation for this divergence comes from the evolution of the public opinion towards the two sectors. In the case of derivatives, the final stages of the Congressional debate attracted greater attention from the media, a development that created strong incentives for Congress to support proposals going beyond the position previously endorsed by regulators and major market actors, as demonstrated by the Lincoln amendment. Instead, rating agencies consistently exhibited lower salience than did derivatives

[126] At the end of this period, the SEC would be required to implement the proposed new clearinghouse "unless the Commission determines that an alternative system would better serve the public interest and the protection of investors".
[127] SEC 2009g.
[128] See Section 939F of the Dodd-Frank Act. In response to this proposal, the SEC issued a Solicitation of Comment on 10 May 2011 "Solicitation of Comment to Assist in Study on Assigned Credit Ratings". See Franken & Wicker 2011; SEC 2011.
[129] GAO 2012.
[130] SEC 2009f.

throughout the entire crisis, and in particular during the concluding phases of the Congressional debate over the passage of Dodd-Frank Act. As a result, this limited the incentives for Congress to deviate too much from the preferences of regulators by supporting a measure highly interfering in the structure of the rating markets, such as a rating clearinghouse.

To conclude, the primacy of the SEC in charting the initial regulatory response to the crisis in the United States was an important component of the continuity in the initial international regulatory response with the market-based approach centered on the first IOSCO Code of Conduct that had emerged after Enron. Nevertheless, the shift that occurred at the domestic level within the United States and the greater activism of Congress in strengthening the oversight of rating agencies are not sufficient to explain the shift in the public-private divide that would next occur at the international level and the decision by the G20 to bring rating agencies firmly under the perimeter of public regulation. In fact, the principle that rating agencies should register with national securities regulators had already been introduced in the United States before the crisis. However, this had not triggered an equivalent shift in the international agenda, as European authorities had not yet abandoned their reliance on a market-based enforcement of the IOSCO Code of Conduct.

In order to explain the shift in the international agenda towards the support of direct regulation, the next section will analyze impact that the crisis had in altering the domestic baswes of the regulation of rating agencies in Europe.

5.6 The Regulation of Rating Agencies in Europe

The previous section argued that the outbreak of the subprime mortgage crisis did not undermine the support for a market-based approach from European securities regulators, which denied that the crisis justified the introduction of a direct regulatory framework. However, a key difference this time from the regulatory response that followed the bankruptcy of Enron was the political response that the crisis solicited within Europe.

As argued in the first part of this chapter, in 2006 the proposal presented by the CESR for a market-driven regulatory response had been endorsed by the Commission and was not challenged by other relevant policymakers. On the other hand, the global financial crisis of 2007-2010 triggered a different response.

European Commissioner McCreevy had initially urged credit rating agencies to strengthen their self-regulatory efforts,[131] threatenjng to move forward in introducing regulatory measures only in the case rating agencies failed to deliver meaningful self-regulatory measures.[132] However, starting from June 2008, the European Commission gradually abandoned this position and openly criticized the emphasis on industry self-regulation that informed the recommendations presented by European securities regulators and IOSCO. McCreevy himself publicly questioned this self-regulatory approach, declaring, "I am flabbergasted at the naivety of anyone who thinks these same credit rating agencies should be trusted to abide by a non-legally enforceable voluntary code of conduct drawn up under palm trees—A code that has proven itself to be toothless, useless, and worthless time and time again. Fool me once shame on you, fool me twice shame on me."[133] McCreevy described the IOSCO Code of Conduct as a "toothless wonder."[134]

The European Commission moved forward in July 2008 by presenting a proposal to directly regulate the activities of rating agencies in Europe. The Commission described this regulatory proposal as motivated by "the manifest failure of self-regulatory efforts, both formal and informal, to ensure high standards of independence, integrity and professional diligence."[135] The European Commission did acknowledge that rating agencies had recently presented several self-regulatory proposals to address the concerns of regulators. However, according to the European Commission, the status quo based on rating agencies self-regulating their internal organization, processes, and mechanisms by adopting the revised IOSCO code was not a viable option because of the deficiencies in this code and, above all, the lack of mechanisms besides market discipline of external enforcement and sanctioning of the CRAs actual compliance with the Code.[136]

Unlike in the period preceding the crisis, this time the European Commission openly attacked reliance on market discipline, arguing that, "given the oligopolistic structure of the CRAs' market, it is highly unlikely that market pressure alone is sufficient to discipline the CRAs to change their conduct."[137] The European Commission also rejected the proposal coming from the CESR for the creation of an external oversight body

[131] McCreevy 2008h.
[132] McCreevy 2008a; McCreevy 2008b; Kelly 2008.
[133] McCreevy 2008g.
[134] McCreevy 2008c.
[135] European Commission 2008b, p.2.
[136] European Commission 2008b; European Commission 2008a.
[137] European Commission 2008a, p. 44.

composed of market actors to monitor CRA self-regulation, since this industry-driven monitoring body would have the authority neither to effectively supervise rating agencies nor to enforce compliance as public authorities would. The Commission even found that "recent events have unveiled that the reputational risk is not sufficient for CRAs to abandon harmful practices."[138]

The regulatory framework formally proposed by the European Commission in October 2008 required rating agencies that were to issue credit ratings intended to be used for regulatory purposes in the European Union to register with the relevant public authorities and to comply with different rules regarding their conflicts of interest, the quality of their rating methodology and their ratings, and their transparency. Moreover, the regulatory plan would also put European regulators in charge of supervising these credit rating agencies, giving the regulators the necessary powers to ensure compliance with the regulatory requirements associated with the registration.[139]

The European Commission acknowledged that the registration regime would pose new compliance and administrative costs upon rating agencies and be less flexible and less capable to adapt to market innovation than a self-regulatory solution. Unlike in the past, though, the European Commission downplayed the impact of these shortcomings, arguing they would not outweigh the benefits of having in place legally binding rules and enforcement mechanisms.[140] Indeed, the Regulation presented by the Commission also departed from the approach endorsed by IOSCO and European securities regulators by relying on a more extensive set of detailed regulatory requirements interfering with the internal procedures sustaining the rating process[141] and by addressing conflicts of interest in the rating business.[142]

One example of interference with the internal practices included a measure requiring the introduction of a rotation mechanism for analysts on a four-year basis to avoid the risk

[138] European Commission 2008a, p. 46.
[139] European Commission 2008d.
[140] European Commission 2008a.
[141] In particular, Article 8 requires rating agencies to review its credit ratings and methodologies "at least annually", in particular "where material changes occur that could have an impact on a credit rating", as well as "to establish internal arrangements to monitor the impact of changes in macroeconomic or financial market conditions on credit ratings". Moreover, the regulation address in detail the steps a CRA must take when its methodologies, models, or key rating assumptions used in credit rating activities are changed. In this case, "a credit rating agency shall "immediately… disclose the likely scope of credit ratings to be affected" and "review the affected credit ratings as soon as possible and no later than six months after the change", and "re-rate all credit ratings that have been based on those methodologies, models or key rating assumptions if, following the review, the overall combined effect of the changes affects those credit ratings". The regulation introduced by the European Commission also includes provisions requiring rating agencies to allocate a sufficient number with appropriate knowledge and experience to its credit rating activities.
[142] The assessment of this approach from the European Commission was that "the existing general approach in the IOSCO Code has not been sufficiently effective to manage the CRAs' conflicts of interest. It does not guarantee certainty for stakeholders and CRAs. It essentially leaves to the CRAs to decide what is effectively prohibited and what safeguards are necessary in their internal structures and procedures". European Commission 2008a.

that long-lasting relationships with the same rated entities could compromise the independence of these rating analysts. In addition, the Regulation detailed organizational requirements dictating the mandate, composition, and compensation of a rating agency's administrative or supervisory board.[143]

What explains such a change in the position of the Commission from self-regulation to direct regulation of rating agencies? Why, unlike in the period preceding the crisis, did the European Commission this time reject the advice from European securities regulators? This shift is particularly puzzling when we consider how the departure from self-regulation and the prescriptive nature of the Regulation proposed by the Commission were contested not only by securities regulators[144] but also by the majority of interest groups that responded to the consultation launched by the European Commission and the CESR.[145]

The decision by the Commission was opposed by the main rating agencies operating in Europe. S&P's stated that it was "premature for the Commission to now conclude that the IOSCO Code is a failed initiative," and it criticized the Regulation proposed by Commission for "contain[ing] a detailed set of prescriptive rules that go well beyond the standards of best practice currently advocated by IOSCO, or beyond the standards of regulations that are in place in any other countries (including the current standards enforced by the US SEC)."[146] Its main competitor, Moody's, criticized the Commission for having "discounted the steps that industry participants and regulatory authorities have already taken over the past year," attacking the excessive level of detail of the proposed regulation: "We fear that it will establish a cumbersome and potentially unworkable regime".[147]

The continuation of the self-regulatory approach was supported not only by rating agencies but also by the large majority of financial groups. Interestingly, this position

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[143] In particular, Annex I (2) required rating agencies "at least one third, but no less than two, of the members of the administrative or supervisory board of a credit rating agency shall be independent members who are not involved in credit rating activities", their compensation "shall not be linked to the business performance of the credit rating agency", and their term of office "shall be for a pre-agreed fixed period not exceeding five years and shall not be renewable". Moreover "at least one independent member and one other member of the board shall have in-depth knowledge and experience at a senior level of the markets in structured finance instruments". The board was given the task of monitoring the effectiveness of the measures instituted by the agency to manage conflicts of interest.

[144] CESR criticized the regulation proposed by European Commission for placing in the hands of regulatory authority the task of enforcing excessively prescriptive obligations, "giv[ing] rise to a very considerable liability for competent authorities and a possible undesirable moral hazard". See CESR 2008.

[145] Similarly to the CESR, different financial market respondents denounced the "haste with which this measure appears to have been designed" and the lack of coordination between the European Commission and regulators, in Europe and in foreign jurisdictions See for instance, SIFMA 2008a; European Banking Federation 2008a.

[146] S&P's 2008a.

[147] Moody's 2008.

was not expressed uniquely by financial groups representing the City of London, such as the British Bankers' Association and the London Investment Banking Association.[148] In fact, a similar opposition to the introduction of direct regulation also informed the position of important interest groups in the same countries whose governments had been most vocal in promoting a direct regulatory approach within the European agenda, such as the French Banking Federation,[149] the Association Française de la Gestion financière,[150] and the four main German banking associations.[151] The pan-EU European Banking Federation criticized several aspects of the proposal, including "the intrusiveness of the proposals, which would allow interference with individual ratings; the potential extra-territorial effects, which would put at risk the international regulatory dialogue; and the approach to corporate governance, which we do not believe should be prescribed in this manner."[152]

Criticisms towards the approach adopted by the Commission also came from non-financial groups, such as the European Association of Corporate Treasurers, which argued that there had "been only limited market failures as far as CRAs are concerned," further claiming that market discipline was "already causing the needed behavioral changes among CRAs without extensive interventionist new regulation."[153] Along these same lines, the French Association of Corporate Treasurers criticized the intrusiveness and rule-based nature of the regulation.[154] The position of all the respondents in the consultation launched by the CESR regarding the desirability of preserving a self-regulatory approach (Question 177) is summarized in the Table 12.

[148] British Bankers' Association & London Investment Banking Association 2008 British Bankers' Association, International Capital Market Association, & London Investment Banking Association 2008; SIFMA 2008a.
[149] French Banking Federation 2008.
[150] Association Française de la Gestion financière 2008.
[151] German Banking Industry Associations 2008.
[152] European Banking Federation 2008b.
[153] European Association of Corporate Treasurers 2008.
[154] French Association of Corporate Treasurers 2008.

Table 12 - Responses to the 2008 CESR Consultation on Rating Agencies[155]

Name	Sector	Country	Position on Q #177
Association Italiana degli Analisti Finanziari	Asset Management, Investment Advice	Italy	Call for Direct regulation for conflicts of interest and transparency.
CFA Institute	Financial Education	UK	Call for a "more rigorous self-regulatory' regime.
Rating Evidence	Rating Agency	Germany	N/A
Reuters	Media	International	N/A
Association of Corporate Treasurers	Non-financial corporates	UK	N/A
British Bankers Association and London Investment Banking Association	Banking	UK	Call for maintenance of self-regulatory regime.
European Savings Banks Group	Banking	International	Support for self-regulation
European Banking Federation	Banking	International	Support for self-regulation (IOSCO Code of Conduct + Market pressures).
Federation Bancaire Francaise	Banking	France	Support for self-regulation.
Intesa San Paolo	Banking	Italy	Call for a "light regulatory regime" provided by an external auditor.
Zentraler Kreditausschuss (ZKA)	Banking	Germany	Support for self-regulation.
Ferli	Rating	Germany	N/A
Moody's, S&P's, Fitch, A.M. Best, DBRS	Rating	International	Support for self-regulation.
Association of British Insurers	Insurance	UK	Support for self-regulation.
Association Francaise de la Gestion Financiere	Asset Management	France	Support for self-regulation based on IOSCO CoC + monitoring role of regulators.
Bundesberband Investment un Asset Management	Asset Management	Germany	Support for self-regulation.
European Fund and Asset Management Association	Asset Management	International	No consensus among EFAMA Members.
German Insurance Association (GDV)	Insurance	Germany	Support for arbitration and enforcement procedures for IOSCO Code of Conduct.
Institutional Money Market Funds Association	Securities	International	Support direct regulation.
Investment Management Association	Asset Management	UK	Support for self-regulation.
European Federation of Financial Analysts Societies	Investment Advice	International	Support for direct regulation.
Securities Industry and Financial Markets Association + European Securitisation Forum	Securities	International	Support for self-regulation.

Even though proposals to directly regulate rating agencies faced the widespread opposition of interest groups as well as regulators, the Proposal presented by the Commission reflected instead the preferences of the two main political bodies dominating the EU policymaking process, the European Parliament and the European Council.

As argued above, the European Parliament had been a long-standing advocate of introducing the direct regulation of rating agencies since the publication of the Katiforis

[155] The responses made available have been published on the CESR/ESMA website (http://www.esma.europa.eu/consultation/Consultation-role-credit-rating-agencies-structured-finance#responses)

Report in 2003, which invited the Commission to study the possibility of directly regulating rating agencies.[156] The outbreak of the crisis and the increased politicization of financial regulatory issues created momentum for MEPs to support more vocally the need to regulate financial firms and to bring this issue back into the EU agenda.

At the beginning of the crisis in April 2008, different members of the European Parliament drafted two reports renewing pressure on the European Commission to bring the regulation of rating agencies firmly into the hands of public authorities. The initial formulation of the first report, drafted by Poul Nyrup Rasmussen, called on the European Commission to "formulate rules by which to deal with the conflicts of interest inherent in their current business models, and arising from the interplay among actors in today's financial markets." [157] The report was approved by the European Parliament in September 2008.[158] The second report, drafted by Ieke van den Burg and Daniel Dăianu, urged the Commission to be more assertive in regulating rating agencies. The report stated that the "vague promise to regulate Credit Rating Agencies [is] all but an appropriate policy response to the current crisis."[159] An amended version of this non-legislative resolution was approved in October 2008, criticizing the continuation of a self-regulatory approach as "yet untested and probably insufficient to meet the pivotal role they play in the financial system".[160]

Indeed, the regulatory solution proposed by the European Commission largely mirrored the proposal for a "European Registration Scheme" contained in the Katiforis Report and approved by European Parliament in 2004. The debate within the European Parliament regarding the Regulation proposed showed strong support among all the major parties for ending the self-regulation of rating agencies in Europe.

For instance, the MEP Gianni Pittella argued, "The regulation also has a strong symbolic value, however. We are in fact regulating a sector that like others—I am thinking for example of speculative funds—has benefited in recent years from a total legislative void. The outcome of this kind of self-regulation is clear for all to see, and it is terrible. Now is the time to take courage and build a new structure for the financial markets." Sahra Wagenknecht, on behalf of the European United Left/Nordic Green Left group opened her speech by pointing out, "The crisis has shown only too clearly that voluntary self-

[156] European Parliament 2003a.
[157] European Parliament 2008c.
[158] European Parliament 2008e.
[159] European Parliament 2008f.
[160] European Parliament 2008a; European Parliament 2008d.

regulation has failed." Margaritis Schinas stated, "Why did we need to wait for all this to happen in order to introduce rules? The answer will be given by the citizens, by rewarding those who are calling for legislation and punishing those who wanted to persuade us that self-regulation is the panacea for all the evils we are experiencing today."[161]

While the rhetoric against the dangers of self-regulation was certainly stronger on the left-end of the political spectrum, the legislation for the Regulation proposed by the Commission was approved by a very large majority in April 2009, with 569 votes in favor and 47 against,[162] and the European Parliament sought to strengthen the proposal by granting the CESR/ESMA a more central role in the registration of rating agencies.[163]

Alone, the preference of the European Parliament for direct regulation of rating agencies over self-regulation is not sufficient to explain the shift in the public-private divide that occurred in Europe, since it is consistent with the pre-crisis period. Equally if not more important was the support for ending the self-regulation of rating agencies coming from the governments of the European member states that comprise the European Council.

The most vocal advocates of the need to regulate rating agencies among the European governments were German Chancellor Angela Merkel and French President Nicolas Sarkozy, who in a joint letter in August 2007 urged the European Commission to investigate the role of rating agencies in the market turmoil.[164] In August, members of Merkel's party called for a revision of the regulatory status of rating agencies, arguing that German supervisors would either have to stop using rating agencies' assessments, "or we'll fold the ratings agencies' voluntary code of conduct into a reform by law."[165]

However, their call for a European regulation of the industry clashed with the preference of countries such as the UK, which resisted the centralization of financial regulatory policies at the EU level. When the main European prime ministers and heads of state addressed the regulation of rating agencies jointly for the first time in January 2008, the compromise that emerged still called upon rating agencies to address the shortcomings revealed by the crisis, further strengthening the incentives for rating agencies to self-regulate through the threat of regulatory intervention. The joint statement declared, "While preferring market-led solutions, such as the amendment of the IOSCO code of

[161] European Parliament 2009.
[162] European Commission 2009e.
[163] Agence Europe 2009.
[164] Sarkozy 2007.
[165] Sobolewski 2007.

conduct, if market participants prove unable or unwilling to rapidly address these issues we stand ready to consider regulatory alternatives." [166]

The greater public attention towards financial issues triggered by the intensification of the crisis had the effect of shifting this compromise. On the one hand, the increased salience of financial regulatory politics has strengthened the incentives for policymakers from Continental European countries to bring forward their regulatory agenda. In May 2008, after IOSCO published its revised Code of Conduct, French finance minister Christine Lagarde announced that she planned to push for bringing CRAs more formally under the authority of supervisors by introducing the registration of CRAs operating in Europe when France took over the presidency of the European Union in July 2008.[167]

On the other hand, the deepening of the crisis made it increasingly difficult for the British government and regulators to resist a European regulation that would also cover the activities of the City of London, the host of the European operations headquarters of the main rating agencies. The failure of the British bank Northern Rock in September 2007 brought rating agencies under investigation by the House of Commons' UK Treasury Select Committee, which blamed rating agencies for having reacted slowly to the Northern Rock debacle and not having warned of the risks ahead of time.[168] The British governments thus came to support the introduction of a European registration system to ensure effective compliance with the IOSCO Code,[169] while criticizing other provisions that could hamper financial markets and disadvantage the position of the City of London.[170]

The consensus among European leaders regarding the public-private balance in the regulation of rating agencies thus progressively shifted. When the ECOFIN met on July 8, 2008, European finance ministers stated, "The Council shares the Commission view that the current initiatives do not fully address the challenges posed, that further steps are needed and that regulatory changes might be necessary." In order to introduce a strengthened oversight regime for rating agencies, they declared to be "support[ing] the principle envisaged by the Commission that the rating agencies should be subject to an

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[166] Sarkozy, Brown, Merkel, Prodi, & Barroso 2008.
[167] Hughes & Davies 2008.
[168] House of Common 2007; see also Chinwala 2007.
[169] See for instance Treanor 2008; FSA 2009b; Watson & Duncan 2008.
[170] HM Treasury, FSA, & Bank of England 2008. British authorities criticized the solutions proposed by the Commission regarding which authority should be incharge of supervising CRAs (proposing to strengthen the role of a lead-regulator in the regulation and supervision of rating agencies), and called for having in place mutual recognition arrangements of other CRA regulators, as well as they criticized substantive requirements contained in the regulation described as non-proportionate and involving unnecessary restrictions on a CRA's corporate governance structures and internal organization.

EU registration system." According to ECOFIN, the revised IOSCO Code of Conduct could only work as a "minimum benchmark for the actions that credit rating agencies should take to address concerns about their activities in the market for structured products."[171]

The support coming from the European Council and the European Parliament for placing the oversight and regulation of rating agencies operating in Europe directly in the hands of regulators allowed the Regulation proposed by the Commission to be approved after a three-party negotiation, and it became effective in 2010.[172]

In sum, the primary role occupied by the European Parliament and key European governments in openly challenging the support by European regulators and key interest groups for self-regulation reveals the importance that political forces had in driving this shift in the public-private divide in Europe. While the degree of public salience of rating agencies was not significantly higher than it was in the years after the Parmalat scandal, it nonetheless provided an opportunity for political entrepreneurs within the European Parliament and European Council to bring back their long-standing priorities.

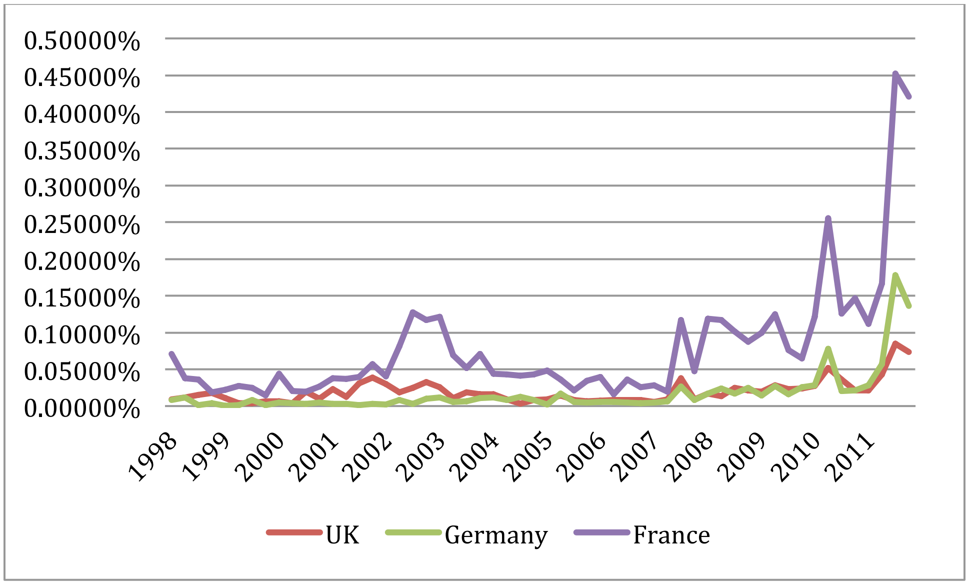
Moreover, this shift in the public-private divide at the European level also set the stage for an analogous shift at the international level. As the EU regulation aligned the regulatory status of rating agencies in Europe with that already in place in the United States since 2006, the US government and European members of the G20 now had an interest in exporting to the international level the principle that rating agencies should be registered with national authorities. Only a few months after the European Council endorsed this principle and the European Commission presented its regulatory proposal, the same principle was endorsed by G20 leaders at the Washington Summit in November 2008, which overturned the preference of IOSCO for a market-driven solution.[173]

Furthermore, the importance of political pressures and electoral politics in driving the European agenda on rating agencies can be found in developments that occurred after the approval of the European regulation on rating agencies described in this section. As illustrated in Figure 17, the focus of the media returned prominently to the activities of rating agencies upon the downgrade of the obligations of the Greek government to

[171] ECOFIN 2008.
[172] The European Parliament has approved the proposal on 23rd April 2009 2009 while the European Council has approved it on 27th July 2009. The negotiations between the Council and the Parliament altered the provisions regarding the treatment of ratings issued in third countries, but they did not questioned the turn in the division of regulatory responsiblities between public and private actors impressed by the Commission.
[173] G20 2008.

below investment grade in January 2010, followed by the downgrade of the debt of other European governments and banks throughout the first half of 2010. These measures affected the capacity of Greek banks to access liquidity from the ECB and highlighted the vulnerability of European markets to the decisions of American rating agencies.

Figure 17 - Press Coverage of Rating Agencies in Europe (1998-2011)



These events have provided new window of opportunity for different political actors within the EU to call for the creation of a European rating agency. The proposal to create a public European rating agency capable to challenge the duopoly created by S&P's and Moody's had already been discussed by the European Parliament in 2003, when the Katiforis Report encouraged the European Commission EU to consider championing the creation of a European rating agency as a counterweight to the US-based agencies dominating the world markets.[174]

The Greek debt crisis has led several members of the European Parliament to urge the European Commission and the European Council to take steps to reduce the power of these agencies and to support the creation of an "EU body which is seen to act objectively and with neutrality so as to avoid the speculative tendencies of companies from the USA."[175] For instance, Member of European Parliament Udo Bullmann

[174] European Parliament 2003b.
[175] Sosa Wagner 2009; Martin 2010; Papastamkos 2010; Chountis & Klute 2010.

highlighted the role played by rating agencies in aggravating the recent sovereign debt crisis and asked the Commission, “Is the Commission considering the creation of a European Public Credit Rating Agency, not only to compete with existing ones but also to overcome the shortcomings in their business models? Has the Commission considered the possibility that existing national public bodies issuing ratings could be entitled to rate the economic situation of Member States?”[176] At the height of the Greek debt crisis, MEP Antolin Sanchez Predo asked, “Does it [the Commission] think that private bodies governed by the profit motive have the necessary independence and the required governance for their ratings to be allowed to influence the public interest in such a decisive way?”[177]

The creation of a European rating agency had also been advocated in the early stages of the crisis by French President Sarkozy[178] and German Chancellor Merkel.[179] The intensification within Germany of the debate over the European debt crisis led the key German political figures such as the Foreign Affairs Minister Guido Westerwelle and Chancellor Merkel to explicitly declare in April and May 2010 their support for creating a European agency to counter the dominance of the US-based firms.[180] Speaking in May, Merkel claimed, "We will press for the creation of a rating agency in Europe so that European financial markets become more stable and reactive.”[181]

The galvanization in the level of attention paid by the European Parliament and key politicians in Continental countries towards rating agencies in the spring of 2010 once again forced the European Commission to take action. In May 2010 the European Commission announced its intention to investigate the rapid downgrading of the Greek debt by the US agencies.[182] Only one month later, the European Commission launched a new regulatory initiative, proposing amendments to the European regulation of rating agencies. Among the motivations for this initiative, the Commission stated, “The level of competition in the rating industry is a real concern. The Commission believes the CRA market is too concentrated, and more competition and diversity would be positive. The Commission is examining structural solutions including whether a European credit rating

[176] Bullmann 2010.
[177] Sánchez Presedo 2010.
[178] European Parliament 2008b.
[179] Merkel argued that while Europe had developed a certain independence in thanks to the creation of the Euro, “the robust currency system of the euro has not yet secured sufficient influence over the rules governing financial markets." She thus supported the creation of a European ratings agency to challenge the dominance of Moody's and Standard & Poor's. See Barber, Benoit, & Williamson 2008.
[180] Associated Press Newswires 2010.
[181] Agence France Press 2010; Reuters 2010a.
[182] Stonestreet 2010.

agency would be beneficial and whether independent public entities should have a stronger role in the issuing of ratings."[183]

Following a public consultation launched at the end of the 2010 exploring different options for how diversity in the rating industry could be increased,[184] the Commission proposed a new Regulation and a Directive in 2011.[185] In two important aspects these measures moved significantly beyond what was previously agreed by securities regulators within IOSCO. First, responding to the greater attention towards the rating of sovereign debt catalyzed in Europe by the Eurozone debt crisis, the Commission introduced specific disclosure requirements for the rating of sovereign countries, requiring rating agencies to publish these ratings outside the working hours of the stock exchanges. Second, responding to the concerns regarding the excessive concentration of the rating business in the United States and the excessive influence of S&P's and Moody's in Europe, the Commission introduced different measures to favor a greater degree of competition in the rating business. In particular, the regulation introduced a "rotation rule," requiring corporate issuers to regularly change rating agencies every three years, introducing a cooling-off period of four years after this, and limiting cross-shareholdings between rating agencies to limit further concentration in the rating business.

The Regulation proposed by the European Commission did not, however, propose to set up a European rating agency, arguing that "setting up a credit rating agency with public money would be costly, could raise concerns regarding the CRA's credibility especially if a publicly funded CRA would rate the Member States which finance the CRA, and put private CRAs at a comparative disadvantage." The regulation proposed by the Commission would rely instead on the rotation requirement as the primary strategy to promote diversity in the market for ratings.[186]

A central factor explaining the decision not to pursue the establishment of a European rating agency advocated by Germany and France remains the opposition of different countries, starting from the British government and authorities.[187] The opposition of London to this measure certainly reflected the traditional suspicion of British authorities towards any European solution perceived as potentially subjecting the City of London to

[183] European Commission 2010a.
[184] European Commission 2010e.
[185] European Commission 2011e.
[186] European Commission 2011b.
[187] FSA, HM Treasury, & Bank of England 2011.

the influence of Continental European countries. At the same time, we also need to consider the more limited impact that the Eurozone debt crisis had in politicizing the debate over financial regulation in Britain compared to the banking crisis of 2007-2010. As a result of this divergence, the Eurozone debt crisis has failed to create significant incentives for British politicians to accept the solution endorsed by Continental European countries.

Finally, it is important to acknowledge how the different salience in different countries of the regulation of rating agencies triggered by the Eurozone debt crisis impacted the international agenda. As argued above, unlike the banking crisis of 2008-2009, the Eurozone debt crisis has not significantly impacted the salience of financial regulation in the United States. So, during the same period when rating agencies have returned to the public eye in Europe, their activities have not occupied a prominent space in the US media, with the exception of the downgrade of the US sovereign debt by S&P's in August 2011. As a result, the regulatory initiatives adopted by the European Commission have failed to create strong incentives for US politicians and regulators to get involved. During this period international agenda has failed to return to rating agencies, and neither the G20 nor IOSCO has discussed the regulation of sovereign ratings.

5.7 Conclusion

This chapter has discussed the importance that the public salience of rating agencies in the United States and Europe had in shaping the way the international regulatory agenda has allocated regulatory responsibilities between public and private actors. More specifically, the analysis of this case has explored the impact that different degrees of public attention had in shaping both the incentives of elected officials on both sides of the Atlantic and the balance between regulators and politicians.

In the period between the bankruptcy of Enron and the financial crisis of 2007-2010, the market-based international regulatory regime centered on the IOSCO Code of Conduct still reflected the preferences of securities regulators both in Europe and the United States in response to the corporate bankruptcies of the early 2000s. The predominant position exercised by securities regulators in the debate over the regulation of rating agencies both in Europe and the United States during the initial stage of the financial crisis can explain why the initial international regulatory reaction to the financial crisis did not challenge the self-regulatory paradigm that had emerged prior to the crisis.

This chapter has also explored the hypothesis that different degrees of public salience of rating agencies over this period created different incentives for politicians in the United States and Europe to accept or to oppose market-based approaches. In the years before the crisis, European politicians did not challenge the preferences of both securities regulators as well as of the majority of interest groups for a market-based approach. On the other hand, the implications of the Enron scandal raised the salience of rating agencies in the United States to an unprecedented extent, leading the US Congress to oppose the status quo based on self-regulation in the years before the crisis. However, the analysis in this chapter presented only inconclusive evidence that this divergent path could be attributed uniquely to the different electoral incentives triggered by different degrees of public salience.

The second part of this chapter has explained how the global financial crisis of 2007-2010 led Europe to endorse a direct regulation of rating agencies, thus setting set the stage for an equivalent shift in the international agenda. However, this shift in the regulatory approach did not reflect a change in the position of securities regulators, which on the contrary continued to support a continuation of the pre-crisis market-based approach. It was instead the greater attention towards rating agencies among the European that created strong incentives for European politicians to reject the advice from European securities regulators in favor of the continuation of the market-based status quo.

Chapter 6. Hedge Funds

6.1 Plan of the Chapter

This chapter will explore the evolution of the international regime governing the regulation of hedge funds. Since the first hedge fund was created in 1949, the industry has been able to avoid an international agreement to directly regulate its activities for six decades. Indeed, the lack of a specific regulatory framework has come to represent one of the most common ways to define an increasingly variegated group of investment vehicles employing different strategies, leverage, and instruments. The lack of a formal regulatory regime cannot easily be explained in functionalist terms, as two distinct international shocks at the end of 1990s raised the concerns of different commentators and policymakers regarding the impact of hedge funds over the stability and integrity of international financial markets. The first shock focusing the attention of financial regulators on the hedge fund industry was the East Asian financial crisis of 1997-98, which led policymakers from several emerging countries to denounce the destabilizing effect that hedge funds had in these countries.

While the responsibility of hedge funds in causing the crisis in the four East Asian countries was contested, the risks posed by the sector for the stability of financial markets became clearer one year later when the long wave of the East Asian crisis and the unilateral declaration of a debt moratorium by Russia in August 1998 caused the near collapse of Long-Term Capital Management (LTCM). LTCM was the world's largest hedge fund, holding more than $125 billion in total assets at the moment of its crisis, and above all it was one the most highly leveraged funds. The quasi-collapse of LTCM in 1998 opened the eyes of the global regulatory community towards the possible systemic risk generated by the hedge fund industry. While hedge funds were regarded up to that point as primarily minor players in the financial markets, LTCM demonstrated the possibility that the collapse of a highly-leveraged fund—or several funds—could cause heavy losses to banks which act as its counterparties through its prime brokerage activity, trade with it in over-the-counter markets, or provide it with leverage.[1]

[1] Bernanke 2006; Kambhu, Schuermann, & Stiroh 2007; PWG 1999a.

However, while the East Asian crisis and LTCM brought the issue of how to regulate hedge funds into the agenda of the G7 and of the newly created Financial Stability Forum (FSF), the report released by the latter institution in 2000 did not recommend the introduction of regulatory measures to directly regulate hedge funds.[2] Instead, the FSF recommended that the risks posed by hedge funds could be regulated by focusing on the banks and prime brokers that provide hedge funds with leverage, what has come to be known as the "indirect" approach to the regulation of hedge funds. This market-based paradigm continued to inform the approach of the international regulatory community through the 1990s and 2000s. When in 2007 the FSF updated its recommendations, the new report still focused on the already-supervised counterparties while demanding that hedge funds update their industry codes of best practices.[3]

Unlike the collapse of LTCM, the international financial crisis that started with the US subprime mortgage in the summer of 2007 was recognized by regulatory authorities from all around the world as not primarily a "hedge fund crisis."[4] With the exception of a few commentators who argued that hedge funds were partially responsible for the origin of the crisis,[5] most analysts identified the primary culprit of the crisis in the banking sector.

Instead, it was hedge funds that fell victims to the turmoil in the banking industry when hostile market conditions following the collapse of Lehman Brothers in September 2008 triggered the liquidation of an unprecedented number of hedge funds.[6] In contrast to the LTCM episode, this time the failure of even a large number of hedge funds did not cause significant damage to the banking sector, primarily as a result of the success of the

[2] FSF 2000.
[3] FSF 2007c.
[4] De Larosière 2009.
[5] In particular, they pointed out that hedge funds had contributed to amplifying the asset price bubble at the core of the crisis (instead of acting counter-cyclically and shorting overvalued assets as frequently claimed), and how they were among the main players providing liquidity and demand for the most exotic structured finance products associated with the core of the crisis. See for instance Rasmussen, cited in M. Turner 2009b; Rasmussen 2009.
[6] The turbulence in the credit markets that followed the collapse of Lehman Brothers in September 2008 created a hostile environment for hedge funds. Investment banks and prime brokers reacted to the distress in some financial markets by scaling back lending, thus making it more costly for hedge funds to obtain the credit necessary to conduct their traditional trading strategies. The losses registered by hedge funds in 2008 (in average -21.7%), besides undermining the belief that hedge funds would generate positive returns in all market conditions, have also reinforced the "flight to quality" among investors, who have massively withdrawn their investments. Many hedge funds have reacted by putting up "gates" in order to stop their investors taking out their investments, but these measures have not been sufficient to stem the wave of redemption. The panic in the market has caused an implosion of the hedge fund industry, whose size has halved from the peak of around $2 trillion worth of assets under management in the summer of 2008 to around $1 trillion at the beginning of 2009, and forcing between 1500 and 2000 funds to go out of business in 2008. IOSCO 2009b.

measures introduced after LTCM to collateralize banks' exposures to hedge funds and to reduce the leverage in the hedge fund industry.[7]

This is not to say that hedge funds did not contribute to the crisis. The forced liquidation of hedge funds' positions in order to meet the margin calls from banks and redemption calls from their investors had a direct impact on the financial markets beyond the impact on their bank counterparties, and according to different analyses still contributed as a "transmission mechanism" or "amplifier" of problems originated in the already regulated banking system.[8]

However, despite the secondary role played by hedge funds in the context of the crisis, the international regulatory community responded by departing from the approach that emerged after LTCM that kept hedge funds outside of the direct purview of public regulatory agencies. Instead the regulatory approach presented by the G20 Leaders at the London Summit of 2009 announced that "hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively."[9]

How can we explain this shift in the international approach towards the regulation of hedge funds despite their secondary role in the crisis? In line with the theoretical framework introduced in Chapter 3, this chapter will analyze how the East Asian crisis, the collapse of LTCM, and the global financial crisis of 2007-2010 raised the public attention towards hedge funds in the United States and Europe and how this has altered the incentives of the hedge fund industry, regulators, and elected politicians. In particular, the first part of this chapter (Section 6.2) will discuss the focus on indirect regulation and market-based mechanisms that was codified in the first FSF report in 2000 and characterized the international agenda before 2009. The section finds the origins of this focus in the preferences of US federal regulators and their attempt to

[7] Since the collapse of LTCM, the average leverage ration for the hedge fund industry has fallen significantly (it was 1.7 times at the beginning of the crisis in 2007), but average leverage changes significantly across fund types (e.g. it is 10 times for relative value/fixed-income arbitrage funds). See IMF 2008, p. 41.

[8] The pressure of hedge funds' selling drove prices further down, triggering another round of margin calls, and thus another round of forced selling, in a vicious cycle that created instability in financial markets. Hedge funds have been blamed for contributing to a "downward spiral of deleveraging and declining asset prices, in particular in markets where there has been crowding of positions in similar assets", thus increasing volatility in the markets and impairing the functioning of some markets in which they were significant players FSA 2010. On the systemic risk posed by hedge fund, see King & Mayer 2009; Bernanke 2006; Danielsson 2004; IOSCO 2009b. Also in the case a single hedge fund may not be big or leveraged enough to individually create systemic risk, analysts have pointed out that hedge funds could collectively create risk because of their "herding", that is their tendency to mimic other funds. Meyer and King have denounced the risk related to "crowded trades", that is when many hedge funds hold similar or closely correlated positions

[9] G20 2009a.

satisfy the demand of the US Congress for a regulatory response in the aftermath of LTCM. Section 6.3 will detail how in the period before the crisis this international approach came to be challenged on the international stage by Continental European countries such as Germany and France.

The second part of this chapter will explain the subsequent international regulatory response to the financial crisis of 2007-10 and the reversal of the market-based approach from before the crisis. Section 6.4 will discuss the impact that the crisis had within Europe in creating incentives for policy entrepreneurs within the European Parliament. It will also examine how the crisis allowed the German and French governments, which had in the past promoted a change in the regulation of the sector, to reassert their long-standing priorities. However, as discussed in Section 6.5, equally important to explain the change in the international agenda was the impact that the politicization of financial regulation triggered by the crisis had in altering the incentives of elected politicians in the United States, the country that had vetoed this solution prior to the crisis.

6.2 LTCM and the Emergence of the International Self-Regulatory Regime

As argued in the introduction to this chapter, the regulation of hedge funds entered into the international agenda for the first time during the East Asian financial crisis. More specifically, Malaysia's Prime Minister Mahathir blamed hedge funds for actively contributing to the currency crises in East Asia at the 1997 IMF meeting in Hong Kong. Following this speech, the Malaysian constituency at the Fund requested an investigation into the role of hedge funds in the East Asian crisis. The concerns voiced by Mahatir regarding the destabilizing impact of hedge funds were supported by the authorities in some emerging countries as well as those from industrialized countries, such as Australia and New Zealand, where hedge funds had been active during the crisis.[10] Following the request of these countries, the IMF issued a report investigating the role of hedge funds in the crisis, which concluded both that these funds represented only a small portion of the broader family of investors active in the East Asian markets during the crisis and that their capital under management were too small to represent a threat to the financial system. The report concluded, "The analysis…does not suggest a strong case for supervisory and regulatory measures such as these targeted specifically

[10] Robotti 2006; Eichengreen et al. 1998; Eichengreen 2003.

at hedge funds."[11] When the discussion over the regulation of hedge funds reached the agenda of the IMF Board, the Fund decided to take no further action concerning hedge funds.[12]

The lack of international initiatives supporting the regulation of hedge funds in the aftermath of the East Asian crisis reflects the main interpretation of the crisis in the country that was not only the major stakeholder in the IMF but also the host of the large majority of hedge fund managers in the world, the United States. As several authors have acknowledged, the fact that the large majority of hedge fund managers in the world are based in the United States has granted US regulators significant market power in setting the international agenda on this issue.[13]

Indeed, while the East Asian crisis raised widespread attention towards the action of hedge funds in the countries more directly targeted by their action, the same concerns did not resonate within the United State, and the crisis did not lead to significant discussions within the United States regarding the regulation of hedge funds. Instead, regulatory authorities within the United States and most other industrialized countries saw the role of hedge funds during the East Asian crisis as nothing more than simply "symptoms of a problem caused by weak national policies."[14]

However, concerns regarding the impact of hedge funds re-emerged only a few months later, when the long-wave of the East Asian financial crisis propelled the financial instability from emerging countries to the heart of Wall Street. LTCM was founded in 1994 by John Meriwether, a famous Salomon Brothers trader, and included among its associates the Nobel Prize Laureates Robert Merton and Myron Scholes.[15] The fund was extremely successful in its first years, achieving annual rates of return of around 40 percent by the end of 1997, and its assets had grown to about $120 billion, with a capital base of only about $7.3 billion, an asset-to-equity ratio of over 16-to-1, which later rose to 25-to-1.[16]

As market conditions deteriorated following the East Asian financial crisis, so too did the position of LTCM. In particular, the unilateral declaration of a debt moratorium by Russia in August 1998 and the devaluation of the ruble led to a large increase in the spreads

[11] Eichengreen et al. 1998, p.4.
[12] Chwieroth 2009; Eichengreen 2003.
[13] Fioretos 2010; Woll 2011. According to Woll, the US accounted for 68% of hedge fund management in the world. The second largest centre remains Europe (23%), where fund management is highly concentrated in London (76% of European funds).
[14] Eichengreen 2003
[15] For a discussion of LTCM see PWG 1999a; Lowenstein 2001; MacKenzie 2008.
[16] Dowd 1999.

between the prices of Western government and emerging-market bonds, while LTCM had bet on those spreads' narrowing. By the end of that month, the fund had lost over half of the capital it had at the beginning of the year, and its leverage ratio had risen to over 45-to-1.[17] As the losses mounted and LTCM had problems meeting its obligations to counterparties, the Federal Reserve felt obliged to intervene to prevent LTCM's failure. The intervention of the Fed was principally by the fear that letting LTCM go into disorderly fire-sale liquidation would cause market liquidity to dry up, impairing the US economy as well as those of other nations. In September 1998, the Federal Reserve Bank of New York orchestrated a bailout of LTCM consisting of a consortium of 14 prominent banks and brokerage houses that were LTCM's counterparties.

Unlike what occurred after the East Asian crisis, the averted collapse of LTCM and the threat it had posed to the integrity of the US financial system had the impact of both significantly raising US public attention towards the regulation of hedge funds and bringing the issue into the agenda of the US Congress. The House Committee on Banking and Financial Services held a hearing on the issue, inviting among the others to testify the President of the New York Federal Reserve, William McDonough, and the Chairman of the Federal Reserve Board, Alan Greenspan. In front of the main regulatory authorities, several Congressmen questioned the decision by the Fed to intervene to rescue LTCM and its potential implications of public cost, whether it created an implicit Government guarantee of large hedge funds, and its moral hazard implications for too-big-to-fail institutions. Rep. Sanders challenged Greenspan and McDonough to "explain to the Members of this committee why the global economy remains unstable, why the Federal Reserve has organized a $3.5 billion bailout for billionaires, why Americans should be worried about the gambling practices of the Wall Street elites."[18]

The Federal Reserve rejected the claim that LTCM had been "bailed out." Instead McDonough defined it as "a private sector solution to a private-sector problem, involving an investment of new equity by Long-Term Capital's creditors and counterparties." He further argued, "No Federal Reserve official pressured anyone, and no promises were made. Not one penny of public money was spent or committed."[19] A similar interpretation was provided by Greenspan, who compared the role of the Federal Reserve in the rescue of LTCM to the intervention of J.P. Morgan convening the main bankers in his

[17] Dowd 1999.
[18] US House of Representatives 1998.
[19] Dowd 1999; McDonough 1998.

library to plan a resolution to the financial crisis of 1907.[20]

Congress also questioned regulators on the next steps they would undertake to prevent the need for another rescue of large hedge funds and the implications for the regulatory oversight of hedge funds.[21] Rep. Baker declared, "When and how, for example, did the concept of market self-regulation fail us in this instance, which has been regulators' views until this point in time?…How is it that that convoluted process can be engaged in without regulators recognizing the credit extensions by the insured and regulated institutions?…I hope that we are going to be comforted that the regulators do now in fact have plans in place that would help to avert such unfortunate circumstances in our future."[22]

Greenspan responded to these criticisms arguing that it was "questionable whether hedge funds can be effectively regulated in the United States alone." According to the Chairman of the Federal Reserve, the fact that "most hedge funds are only a short step from cyberspace" would have inevitably led "any direct US regulations restricting their flexibility…[to] induce the more aggressive funds to emigrate from under our jurisdiction." Greenspan recommended instead a different market-based approach to the regulation of hedge funds: "The best we can do…is what we do today: regulate them indirectly through the regulation of the sources of their funds." [23]

The approach delineated by Greenspan in front of Congress was further delineated by US federal regulators and the US Treasury in a report entitled, "Hedge Funds, Leverage, and the Lessons of the LTCM," released in April 1999 by the President's Working Group on Financial Market (PWG).[24] In this report, US authorities identified that the need to constrain excessive leverage was "the principal policy issue arising out of the events surrounding the near collapse of LTCM" but rejected the option of placing this task directly in the hands of public actors.

The PWG Report argued that "enforcing a meaningful regulatory capital requirement or leverage ratio for a wide and diverse range of investment funds would be a difficult undertaking," further saying that simply imposing a cap on balance sheet leverage would only result in hedge fund managers "mov[ing] to off-balance sheet risk-taking strategies

[20] Dowd 1999; Greenspan 1998.
[21] Leach 1998.
[22] US House of Representatives 1998.
[23] Greenspan 1998. Since "most hedge funds are only a short step from cyberspace", Greenspan argued that "any direct US regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction".
[24] PWG 1999a.

such as through the use of derivatives."[25] According to the PWG, excessive leverage and risk-taking would be better constrained not by directly regulating hedge funds but rather by strengthening the discipline imposed by their already-regulated financial intermediaries and private counterparties, such as banks and investors.[26] For the PWG, creditors, counterparties, and investors generated powerful economic incentives for hedge funds to constrain their risk-taking of hedge funds by raising the cost of credit or reducing availability of funds.[27]

At the same time, the PWG recognized how in the case of LTCM, these market-based constraints had largely broken down, and creditors had continued to grant LTCM very generous credit terms despite the exceptional degree of risk the fund was taking. The solution proposed by US authorities thus focused on strengthening market discipline by calling upon regulated banks that supplied credit to hedge funds to "enhance their practices for counterparty risk management," for instance by developing policies to better collateralize their exposure to hedge funds, on the ground that this would impose greater discipline on hedge funds.[28]

Moreover, the PWG report argued that the inadequacy of the market discipline exercised by investors and counterparties was also due to the fact that these actors were not sufficiently aware of the risk profile of LTCM, which disclosed only minimal information to its private counterparties.[29] The PWG report urged initiatives both to ensure that more frequent and meaningful information on hedge funds was made public and to disclose greater information regarding the material exposure of financial institutions and other public companies to significantly leveraged institutions.

In order to improve market discipline, the PWG report urged Congress to "enact legislation that authorizes mechanisms for disclosure."[30] It is important to point out that the PWG did not recommend enhanced disclosure of information to regulators, but rather "such legislation should be solely for the purpose of promoting public disclosure" in order to allow private counterparties to better monitor their exposures to hedge funds.

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[25] PWG 1999a, p.24. The PWG Report stated that "For any given leverage ratio, the fragility of a portfolio depends on the market, credit, and liquidity risks in the portfolio".

[26] PWG 1999a, p.26.

[27] PWG 1999a, p. 25. The PWG mentioned several arguments to justify its strong belief in the effectiveness of private market discipline, such the incentives and capabilities that banks and securities had in using their risk management practices to protect their capital, the pressures exerted by their shareholders on management to reduce excessive risk-taking, the interest of investors to withdraw from hedge funds that are perceived to be taking excessive risks.

[28] The PWG called upon banks to "enhance their practices for counterparty risk management", for instance by developing policies to better collateralize their exposure to hedge funds and regulators to "monitor and encourage improvements in the risk management systems of regulated entities".

[29] PWG 1999a, p.25.

[30] PWG 1999a, p.33.

As Eichengreen argues, the report expressed the view that placing regulators in charge of analyzing the position of hedge funds on a continuous basis would have strained the capacity of regulators.[31]

As can be seen here, the roots of the market-based regulatory approach that dominated at the international level emerged after the collapse of LTCM can be found in the preferences of US regulatory authorities and their attempt to head-off a legislative intervention by strengthening the market discipline provided by private counterparties.

The market power of the United States ensured that this approach also informed the international approach when, shortly after the quasi-collapse of LTCM, the G7 brought the regulation of hedge funds back in the international agenda by requesting the newly created FSF to study the role of hedge funds in the emerging market crises of 1997-1998 and to formulate an appropriate regulatory response. The analysis conducted by the FSF on the experiences of six small and medium economies where hedge funds had been active during the East Asian crisis supported the interpretation advanced by US authorities, highlighting the "unsettled and fragile conditions" of these countries and arguing that "even in the absence of HLI (highly leveraged institutions) activity, there would certainly have been considerable market pressure in these economies at the time because of vulnerabilities in their economic structures or financial systems or the size of external shocks they faced."[32]

The FSF discussed but ultimately rejected many of the proposals brought to the table to regulated hedge funds. For instance, the FSF dismissed the proposal advanced by Australia and Hong Kong, invited to the FSF Working Group as representatives of the countries where hedge funds had been more active during the crisis, to introduce mandatory disclosure of hedge funds' trades and positions.[33] Along the same lines, the FSF rejected the proposals brought to the table by France and Germany respectively to enhance aggregate disclosure on positions in foreign exchange markets and other key markets or to create an international credit register containing centralized information

[31] According to the PWG, "improving transparency through enhanced disclosure to the public should help market participants make better, more informed judgments about market integrity and the creditworthiness of borrowers and counterparties". For a discussion see Eichengreen 2003

[32] FSF 2000, p.1. The report thus concluded that: "although the Working Group was concerned about some of the practices of HLIs identified in the six case studies, it was not able to reach a firm conclusion on their scale and the implications for market integrity" P.2. According to the FSF, "the most effective defense that any economy has to discourage or deal with large speculative pressures against its exchange rate is the establishment and maintenance of credible macroeconomic, financial, supervisory and structural policies". FSF 2000, p. 38.

[33] This solution was dismissed by the FSF on the ground that such disclosure of information would have to occur on a real-time basis, raising concerns about the ability of regulators to process this information, as well as it would have to be implemented at the same time in all the major jurisdictions where HFs operated, in order to prevent funds from evading them by booking their transactions offshore. Eichengreen 2003; FSF 2000.

regarding the exposure of all significant banks to hedge funds.[34]

Most importantly, the FSF Working Group considered but ultimately rejected the case for directly regulating hedge funds through a "régime for their authorisation and on-going supervision and regulation," and it also decided against imposing "minimum capital and liquidity standards, large exposure limits, minimum standards for risk management arrangements and other systems and controls, together with 'fit and proper' tests for senior management." While acknowledging that these measures could "minimize the risk of repetition of the market turbulence of 1998," the FSF Report argued that this approach "would raise practical and philosophical problems."[35] In particular, the FSF discussed the risk that regulating hedge funds could create moral hazard by leading investors and counterparties to relax their due diligence and creating pressures to extend lender of last resort support to hedge funds as well. The FSF also expressed fear that regulation might weaken the efficiency of the markets in which hedge funds are active participants, in addition to creating the risk that hedge funds could move to offshore jurisdictions.[36]

While rejecting these approaches to directly regulate hedge funds, the FSF Report followed closely in the footsteps of the PWG Report by presenting a series of recommendations to control the risks posed by hedge funds by strengthening the discipline imposed by their counterparties, the investors and banks upon which hedge funds depended for credit and prime brokerage services. The FSF urged these already-regulated entities to improve their risk management procedures and processes, exposure measurement, and collateral management in their dealings with hedge funds, while calling upon national regulators to intensify their supervisory and regulatory oversight on hedge funds' credit providers "to ensure that sound practices are pursued and recent improvements in practices are locked in."[37]

[34] The FSF rejected the French proposal citing "the difficulty in obtaining compliance, the feasibility of producing the data in a timely manner, and the substantial costs involved". The German proposal was rejected on the ground that it would have not been possible to collect comprehensive information, and information would have to be provided frequently given the speed in the changes of the position of hedge funds FSF 2000; Robotti 2006 p. 40 Based on the interviews conducted with participants to the negotiations, Robotti argues: "other FSF members argued that the proposal was 'politically and technically doable and that, despite some difficulties, it could have been implemented given the current state of technological advance". See Robotti 2006.

[35] FSF 2000 no. 117, p. 37. Therefore, the FSF Working Group concluded: "the Working Group is therefore not recommending applying a system of direct regulation to currently unregulated HLIs at this stage, though the possibility of establishing such a régime cannot be definitively rejected" See particularly the statement under no. 119, p. 38.

[36] See no. 117, p. 37 of the 2000 FSF Report. See p. 36-38 of the 2000 FSF Report.

[37] Moreover, the FSF report recommended national regulators to better scrutinize the risk-management systems of banks and other counterparties of hedge funds, and to "take appropriate steps to determine the extent of institutions' compliance

Another important factor in consolidating the market-based approach proposed by the US regulatory authorities and endorsed by the FSF was the reaction of the hedge fund industry itself and their bank counterparties. Shortly after the averted collapse of LTCM, the threat of legislative intervention by Congress had immediately triggered a reaction from the banking industry. Twelve of the major banks and securities firms that act as counterparties for hedge funds created the "Counterparty Risk Management Policy Group" (CRMPG) in January 1999, which released a set of voluntary guidelines to strengthen counterparty discipline in dealing with hedge funds.[38] Indeed, this group built directly upon the experience of the Derivatives Policy Group (see discussion in Chapter 4), created in the aftermath of the rise Congressional interest in the regulation of derivatives in 1994.

Not only were the six institutions forming the Derivatives Policy Groups also part of the CRMPG, but also the former co-chair of the Derivatives Policy Groups played a key role in mobilizing the banking industry to design a self-regulatory response.[39] Similar initiatives to strengthen risk management practices in dealing were developed by the International Swaps and Derivatives Association and by the Institute of International Finance.

Unlike the banking industry, the more diffuse nature of the hedge fund industry had represented an obstacles to its capacity to engage in the policy making process and to coordinate a self-regulatory response. In this case, the PWG, besides praising the self-regulatory initiatives taken by banking industry, urged a group of hedge funds to adopt similar self-regulatory measures by "draft[ing] and publish[ing] a set of sound practices for their risk management and internal controls."[40] Following this request, a group of five hedge funds, including the fund managed by George Soros, emulated the example of the banks by drafting a set of sound practices for their risk management and internal controls in February 2000.[41]

The support for self-regulatory improvements by the hedge fund industry and the steps taken by the five hedge fund managers were also endorsed at the international level by

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with the Sound Practices promulgated by the Basel Committee and IOSCO (in conjunction with the recommendations of the CRMPG) and take action where they identify deficiencies". See FSF 2000, p.2.

[38] Counterparty Risk Management Policy Group 1999.

[39] Faerman et al. 2001.

[40] According to the PWG report "Such a study should discuss market risk measurement and management, liquidity risk management, identification of concentrations, stress testing, collateral management, valuation of positions and collateral, segregation of duties and internal controls, and the assessment of capital needs from the perspective of hedge funds. In addition, the study should consider how individual hedge funds could assess their performance against the sound practices for investors and counterparties". See PWG 1999a.

[41] These "Sound Practices for Hedge Fund Managers" emphasizing that "the most effective form of oversight is self-evaluation combined with self-discipline" (Sound Practices for HF Managers 2000). See Eichengreen 2003.

the FSF. In fact, the FSF Report stressed the need for hedge funds to improve their risk management practices and to provide greater information to their credit providers and trading counterparties regarding the funds' risk profiles, encouraging an industry-driven solution coming from the hedge fund industry. Most importantly, the FSF "welcome[d] the steps taken by the hedge fund community to meet some of the concerns," and in particular it endorsed the "Sound Practices for Hedge Fund Managers" that emerged from the five hedge funds, encouraging these kind of self-regulatory improvements to become standard practice in the rest of the hedge fund community as well.[42] Moreover, four of the same hedge funds that had drafted the set of best practices participated in the work of the *Multidisciplinary Working Group on Enhanced Disclosure*,[43] a group created by the FSF to encourage hedge funds to release more information on a voluntary basis and to define a voluntary framework to identify relevant information.[44]

Some commentators have questioned the real impact of these voluntary initiatives, arguing that there is no evidence they significantly altered the conduct of the industry.[45] However, the initiatives were certainly successful in achieving another goal: reducing the appetite for legislation in the United States and other industrialized countries.[46]

Indeed, the intervention of US regulatory authorities to solicit the emergence of a market-based regulatory approach and the response by hedge funds and their bank counterparties were important to strengthen in the eyes of Congress the case that the industry was sufficiently taking care of the issue, thus decreasing the appetite for further legislative measures. While the two bills that had been introduced within Congress in 1999 to require hedge funds to disclose more information—the Hedge Fund Disclosure Act introduced by Rep. Richard Baker and the Derivatives Market Reform Act introduced by Congressman Edward Markey—both bills died with the end of the 106th Congress.[47]

In 2001, the Chairman of the FSF Working Group, Howard Davies, assessed the progress in implementing the FSF recommendations, and he noticed that progress towards introducing mandatory public disclosure requirements had been limited: "Although the US introduced proposed legislative and regulatory provisions that would

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[42] FSF 2000, p.24.
[43] FSF 2000, p. 31; MWGED 2001.
[44] Eichengreen 2003; Robotti 2006.
[45] Robotti 2006.
[46] Robotti 2006.
[47] Robotti 2007. The "Hedge Fund Disclosure Act" required hedge funds with a capital of $3bn to report every quarter to Federal Reserve information regarding their total assets, total notional amount of their derivatives position, their leverage ratio of assets to liabilities, meaningful and comprehensive measures of market risk and any other information that regulators may require. The "Derivatives Market Reform Act' lowered the threshold from 3 to 1 billion dollar, but it proposed an amendment to the Investment Company Act in order to allow the SEC to enforce public disclosure.

mandate greater disclosure after the near-collapse of LTCM, US representatives informed the Working Group that they may reconsider whether such measures are still necessary in light of industry progress to increase information flows both to investors and to counterparties, as well as structural changes in the hedge fund industry itself."[48] Eichengreen has also argued that "the absence of more radical measures [after LTCM] by the US and European governments can be understood as a response to concessions by hedge funds intended in part to head off this threat."[49]

However, other scholars have contested the extent of the interest of Congress towards regulating hedge funds in the first place. According to Robotti, one of these bills "was never intended to become law. Congressman Baker did not want to see HFs regulated, but to send a warning message to HFs and banks. Baker implicitly said to the HF community: 'other people want to restrict HFs more than I do. There is pressure on the part of the public to do something, so it is better if you do it your way.' ….The Congress did not want to tackle hedge funds but give them a change to take the self-regulatory route before public regulators could clump down on them."[50]

In addition, the Chairman of the House Banking and Financial Services Committee, Rep. James Leach, argued in the hearing on LTCM that he was "well aware the Congress is not the optimal institution for setting precise supervisory standards" and that it would have be "wiser to give discretion to establish restraints of this kind to an institution such as the Federal Reserve Board rather than attempt to design an arbitrary approach within Congress, a body that lacks the necessary sophistication on matters of this nature. But Congress cannot duck its oversight responsibility of those charged with supervision of these markets."[51] Congress also shared the concerns expressed by regulators that the imposition of any kind of direct regulation would have unintended consequences by forcing hedge funds offshore into unregulated countries.

As we can see, in order to understand this reluctance of Congress to intervene more extensively in the regulation of hedge funds despite the severity of the threat to the financial markets posed by the averted collapse of LTCM, we certainly need to consider the capacity of regulators and the financial industry to respond promptly to this shock and to promote both nationally and internationally a market-driven solution consistent with the interests of the US firms active in the sector.

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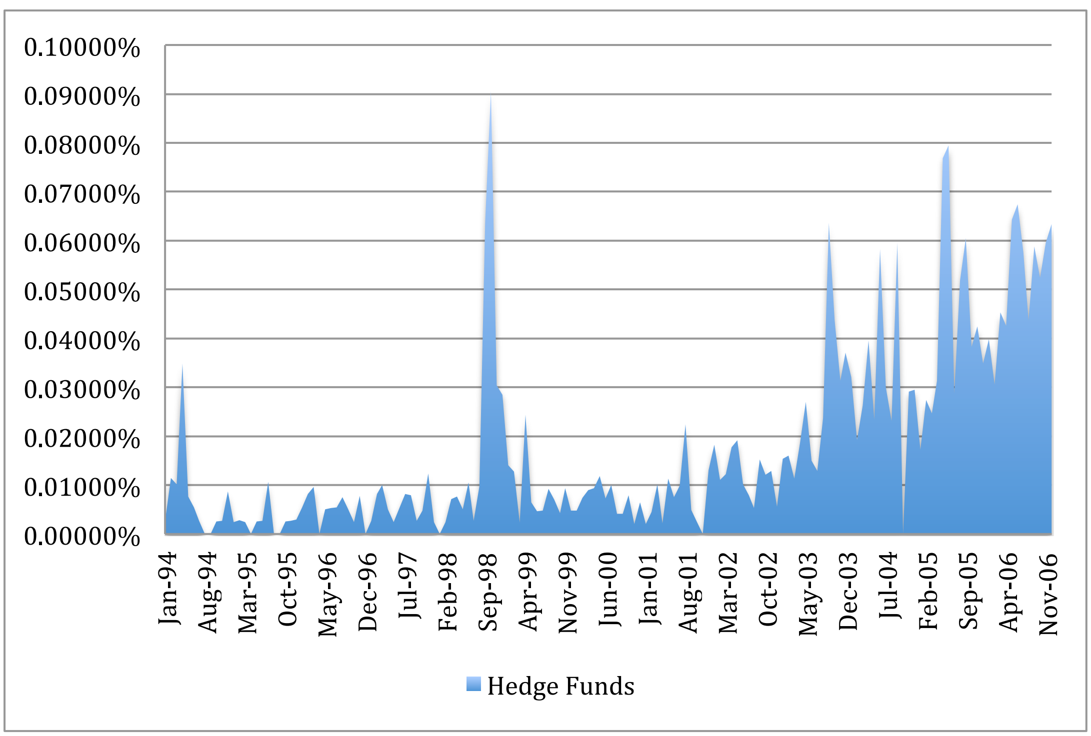
[48] Davies 2001.
[49] Eichengreen 2003.
[50] Robotti 2007.
[51] Leach 1998.

Another important factor shaping the attitude of Congress over this period, however, was the degree of public attentiveness towards the regulation of hedge funds. The averted collapse of LTCM raised the coverage of hedge funds by the US press to an unprecedented level, not matched until the recent financial crisis. At the same time, Figure 18 illustrates how this period of high public attention around hedge funds proved to be extremely short-lived. An important factor in determining this level of public inattentiveness is the fact that the "bailout" of LTCM remained a "private" bailout, orchestrated by the Federal Reserve but without the use of public money.

The low salience that characterized the national and international debates over hedge fund regulation in the United States are therefore important to explain not only the incentives for the US Congress to accept the market-based approach endorsed by regulators and the industry but also their reluctance to support other legislative proposals to regulate hedge funds that were tabled in the following years (see discussion in Section 6.5).

Figure 18 - Hedge Funds in US Press Before the Crisis (1994-2006)



6.3 Hedge Funds in Europe before the Crisis

While the report released by the FSF in 2000 and the self-regulatory initiatives launched by the hedge funds and their bank counterparts had the effect of solidifying a market-based approach as the dominant approach at the international level, the regulation of hedge funds returned forcefully in the international agenda almost a decade after its first appearance in the aftermath of the East Asian financial crisis. In 2007 the G7 declared that "the assessment of potential systemic and operational risks associated with these activities has become more complex and challenging." [52] Similarly to what occurred in the aftermath of the collapse of LTCM, the G7 gave the FSF the task to present recommendations and to update its report.

In this case the pressures to re-open the international file over the regulation of hedge funds came not from the developments occurring within the United States, as with the case of the Congressional interest towards the industry after LTCM, but rather from events within Germany.

As argued in the previous section, German officials had already opposed some of the market-based measures endorsed by US representatives during the negotiations within the FSF that followed the collapse of LTCM. The German representative had instead proposed the creation of an international credit register containing centralized information regarding the exposure of all significant banks to hedge funds. This solution would have allowed regulators to "identify those regulated institutions with large exposures to the respective HLIs and react in a timely fashion to avoid disruptive effects of the failure."[53]

As Robotti argues, some participants to the negotiations had talked of "an unbridgeable 'philosophical division'" between the United States and Germany.[54] Different authors who have analyzed the origins of these differences have highlighted the tensions existing between the activities of hedge funds and the dominant economic framework in Germany, frequently summarized as a coordinated-market economy by the "varieties of capitalism" literature. From this perspective, the activism of hedge funds and their short-term aims have been presented by various commentators as representing a threat both

[52] G7 2007b; FSF 2007c.

[53] FSF 2000, p.33; see also Robotti 2006.

[54] While US representatives had argued that disclosure of information regarding hedge funds' activities should be directed to the markets, German delegates instead proposed the introduction of an international credit register to track counterparties' exposures to hedge funds. However, US representatives opposed this proposal on the ground that it would have not been possible to collect comprehensive information.According to Robotti, "several FSF members argued that the proposal was 'politically and technically doable'. The proposal was instead abandoned 'without even verifying the claims of the private sector". See Robotti 2006 p.1.

to the medium- to long-term industrial planning that characterizes the German model and to the established close ties between industry and the banks that represent the main provider of capital in Continental Europe.[55] Other explanations of the position of German and French policymakers on the regulation of hedge funds have pointed towards the "deeply ingrained dislike of 'casino capitalism,' which was seen as serving the fortunes of the City of London" among the elites in Continental European countries.[56]

In line with these arguments, Continental European countries have historically adopted a different approach towards the regulation of hedge funds from the one in place in liberal-market economies such as the United States and UK. In fact, while in the latter group of countries hedge funds have been by-and-large unregulated, in Continental European countries hedge funds have been subject to more restrictive measures including registration, disclosure, and reporting requirements,[57] and, in the case of Germany, they were prohibited until 2004.[58]

At different moments throughout the 2000s, German companies and trade unions had also voiced their concerns regarding the growing impact that hedge funds had over German companies, using stakes in listed companies to agitate for change. These concerns were reignited in 2005 by a different kind of shock than the failure of a fund, such as in the case of LTCM. In January 2005, the takeover of the London Stock Exchange by the Deustche Böerse AG failed as a result of the interference of the London-based Children's Investment Fund, and the CEO of the German group was forced to resign. The chairman of the Frankfurt Stock Exchange accused hedge funds of "ripping the heart out of the German economy."[59]

The debate this event triggered regarding the impact of hedge funds and financial speculation on the German economy resonated with the German public. More significantly, the impact of the increased level of public attention was amplified by the fact that the failed takeover coincided with the electoral campaign for the German federal elections of 2005.

The regulation of hedge funds became an electoral issue during this campaign when Frank Muentefering, the leader of the German Social-Democratic Party (SPD), famously attacked those financial investors who "remain anonymous, have no face and descend

[55] Fioretos 2010; Quaglia 2011; Zimmermann 2009.
[56] Quaglia 2011; Quaglia 2010.
[57] IOSCO 2006.
[58] Woll 2011.
[59] Quaglia 2011, p. 674.

on companies like swarms of locusts."[60] The issue was also addressed by Chancellor Schroeder, who during the electoral campaign announced his intention to re-open the discussion on the regulation of hedge funds at the G8 summit in Gleneagles, thus adding an international dimension to what had been so far only a German debate.[61]

While the attempt of Chancellor Schroeder to push for a new international agreement over the regulation of hedge funds at the G7 Summit was ultimately vetoed,[62] the newly-elected Chancellor Angela Merkel also supported this commitment and announced in January 2007 at the World Economic Forum in Davos that Germany would used its chairmanship of the G7 in 2007 to re-open the discussion on how to regulate hedge funds.[63] When the German government did bring the regulation of hedge funds back into the international agenda at the Finance Ministers meeting in Essen on February 10, 2007, G7 Finance Ministers asked the FSF to review its 2000 Report on Highly Leveraged Institutions.[64]

While the United States accepted discussing measures to enhance transparency of the industry, the position brought by US authorities to the international table did not depart from their previous support for a market-based regulatory solution. Once again, the task of defining of the US stance on the regulation of the hedge fund industry was taken by the US regulatory authorities comprising the PWG, which released a new report on hedge fund eight years after the first one. This report reaffirmed the commitment of US regulators to the indirect approach based on the "market discipline" enforced by counterparties and investors that had been advanced after the quasi-collapse of LTCM, arguing that this strategy had been successful in mitigating industry risks.[65]

Resistance to the German call for an international agreement over the regulation of hedge funds did not come uniquely from the United States; it also came from within Europe. In May 2007, German Finance Minister Steinbruck used the German Presidency of the European Council to promote a European common position in support of hedge fund regulation. This request was opposed by the British authorities, which presided over the most important hedge fund mangers' hub in Europe.

The UK FSA expressed confidence in its capacity to oversee hedge fund managers, arguing that its regime "for hedge funds is at least as rigorous, and probably more

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[60] MacAskill & Czuczka 2010.
[61] Cremer 2005.
[62] Quaglia 2011.
[63] Spalter 2007.
[64] G7 2007b.
[65] PWG 2007a.

rigorous, than that in other jurisdictions."[66] The statement on the issue released by European finance ministers in May 2007 maintained that the current system of indirect supervision of hedge funds by their counterparties remained adequate.[67] The defense of the market-driven approach that emerged among European finance ministers also informed the position of the European Commission, which during this period rejected the need for greater regulation of hedge funds.[68]

While opposing an international agreement over a government-imposed solution, the British and US governments affirmed that that they would accept a code of conduct generated “spontaneously” and “voluntarily” from the hedge fund industry itself.[69] In order to secure an international agreement, German authorities scaled back their ambitions and openly supported the possibility of a voluntary code from the industry.

As a result of this mutual accommodation, the update to the FSF’s 2000 Report on Highly Leveraged Institutions, published on May 19, 2007, did not depart from the market-based approach that had dominated the previous report. The FSF praised the progress that had been made since the LTCM crisis by hedge funds and their counterparties in improving their risk management practices. Moreover, just as in the previous report, the FSF explicitly reached out to the hedge fund industry, requesting that it “review and enhance existing sound practice benchmarks for hedge fund managers in the light of expectations for improved practices set out by the official and private sectors.”[70]

Despite this approach, the intervention of public authorities in this period eventually went beyond simply endorsing a market-driven solution. The slow pace with which the hedge fund industry responded to the calls for adopting further self-regulatory measures led G7 countries to deploy different carrots and sticks in order to “bail in” the private sector. On the one hand the G7 threatened the private sector with intervention by giving the FSF mandate to review the regulatory framework for hedge funds; on the other hand it directly engaged with the hedge fund industry groups and encouraged them to take the initiative. US and German authorities invited approximately 20 delegates of the main hedge fund groups to participate in meetings with deputy ministers from the G7 countries on the margins of the IMF/WB meeting in Washington in April 2007.[71]

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[66] Wessel 2006; Benoit 2006.
[67] ECOFIN 2007.
[68] McCreevy 2007b.
[69] Atkins & Williamson 2007.
[70] FSF 2007c, p.2.
[71] G7 2007a; Benoit & Mackintosh 2007b.

In Britain, the Bank of England initiated discussions with London-based hedge funds on a voluntary code of conduct in February 2007.[72] A former Deputy Governor of the Bank of England, Sir Andrew Large — at the time head of the UK fund Marshall Wace—led a group of 14 of London's biggest hedge funds, including one Swedish fund and the London arm of a large US fund, in creating the "Hedge Fund Working Group" (HFWG). In January 2008 the HFWG released a report containing a set of best practices for hedge fund managers, describing it as an "exercise in industry-led market discipline, based on disclosure.[73]

The main stated goal of the initiative was that of strengthening "the confidence of investors, lenders, regulators, and other market participants" by allowing investors to make well-informed decisions. However, in an attempt to convince other hedge fund managers to comply, the report admitted that it represented an insurance against a regulatory clampdown: "Failure by the industry to take the initiative now runs the serious risk of leaving the field open to more restrictive intervention in the future." According to the report, the success of the initiative would bring two kinds of benefits. First it stated, "If the regime is successful, regulators are less likely to introduce external regulation of the industry." Second, in the case a future scandal or collapse of a hedge fund put mandatory rules back at the top of the agenda, "the Standards could well be a realistic blueprint for external regulation and reduce the chances of a regulatory regime being imposed which the industry considers unpalatable."[74]

A second set of voluntary best practices emerged in parallel in the United States. In this case, US regulatory authorities intervened even more directly than their British counterparts by creating two advisory groups formed respectively by hedge fund managers and institutional investors with the mandate of creating and publicly releasing a private sector-driven set of best practices for hedge funds and their investors.[75] The same short period saw the emergence of a flurry of other industry-driven voluntary codes of best practices in response to the FSF Report, including a November 2007 update of the "Sound Practices for Hedge Fund Managers" that had constituted the first self-regulatory response of the hedge fund industry in 2000.[76]

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[72] Spalter 2007.

[73] The HFWG released its first consultation draft in September 2007, and it received 75 written responses. It also undertook 26 consultation events that involved more than 300 institutional investors, hedge fund managers, prime brokers, rating agencies, supervisors, lawyers, accountants, and industry associations. HFWG 2007.

[74] HFWG 2008, p.16.

[75] PWG 2007b.

[76] MFA 2007. The London-based Alternative Investment Management Association (AIMA) has published in January 2008 not only a guide for HF managers ("Offshore Alternative Fund Director's Guide"), but also a guide for professional

These self-regulatory initiatives from hedge fund groups in the United States and UK were immediately welcomed by the FSF.[77] The FSF also asked the newly created Hedge Fund Standards Board to release regular reports on the adoption of the initiatives by the industry.[78] G7 leaders, including the German government, also publicly endorsed these self-regulatory measures when they met at their Washington meeting on 19 October 2007. This was the first governmental seal of approval for the self-regulatory initiative of the HFWG, describing it as "in line with our own recommendations."[79] The German government in particular claimed credit for having secured an international agreement to address the regulation of the sector and for forcing the industry into opening up through these self-regulatory measures. Deputy Finance Minister Thomas Mirow argued, "We don't want to shout it on the roofs, but we think we have changed the nature of the international conversation about hedge funds."[80]

While the new international measures were used by the German government to claim international success in front of their domestic audience, in reality the outcome of the international German offensive was remarkably similar to the regulatory response that unfolded after the collapse of LTCM. Similarly to the regulatory response to LTCM, regulatory authorities limited their role to that of strengthening market discipline while more explicitly soliciting self-regulatory improvements from the hedge fund industry.

To sum up, this section has discussed how the international market-based regime that emerged in the aftermath of LTCM came to be challenged in the years immediately preceding the crisis, primarily as a result of the greater politicization of the regulation of hedge funds in Germany during the electoral campaign of 2005. However, the bid by the German government to promote a more stringent regulation of the hedge fund industry was vetoed at the international level by the United States and at the European level by the UK, both of which over this period continued to defend the continuation of a market-based approach.

6.4. The Regulation of Hedge Funds in Europe during the Crisis

The previous section provided an explanation for the origins and resilience of the

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investors to explain what elements should be considered before investing into a HF, and to head off concerns of smaller pension funds that had invested in HFs. See AIMA 2008b.

[77] FSF 2007a. The FSF also stated that the draft best practice standards presented by the UK-based HFWG and its "comply or explain" system was "a notable step towards improved transparency and discipline and a recognition by the sector of its responsibilities as a significant force in the financial system". See FSF 2007b.

[78] FSF 2008a.

[79] Benoit & Mackintosh 2007a.

[80] Benoit & Mackintosh 2007a.

international self-regulatory regime that governed hedge funds starting in the late 1990s. This section will explain what factors led the international regulatory response to the financial crisis of 2007-10 to reverse this approach and to endorse the direct regulation of hedge fund managers. This section will focus on developments over this period in Europe, while the next will focus instead on what occurred in the United States.

After the collapse of LTCM, different commentators predicted that the next large financial crisis would likely emerge from the unregulated hedge funds. Contrary to these expectations, the crisis seemed to emerge in the very core of the financial system—the "regulated" banking system. While the experience of LTCM had demonstrated the risk that the banking system could be impaired by the failure of a large hedge fund to repay its borrowing, during the crisis it was instead hedge funds who suffered the most from the market turmoil originated in the banking sector.

The panic in the credit markets triggered by the collapse of Lehman Brothers caused an implosion of the hedge fund industry, whose size halved from a peak of around $2 trillion worth of assets under management in the summer of 2008 to around $1 trillion at the beginning of 2009. Between 1500 and 2000 funds were forced out of business in 2008. [81] It was only after the collapse of Lehman Brothers in September 2008 that many regulators and commentators acknowledged that hedge funds' attempts to quickly unwind positions in order to meet significant requests for redemption by investors and collateral requirements from banks had further depressed prices and amplified the consequences of the crisis.[82]

Most international regulatory bodies accepted this interpretation of hedge funds as victims rather than culprit of the crisis. When the FSF met for the first time since the beginning of the crisis on 25-26 September 2007, it argued that "the hedge fund sector has not been the primary source of recent market turmoil" and welcomed the industry-driven self-regulatory initiatives described in the previous section.[83] Moreover, when the FSF delineated the first internationally coordinated regulatory response to the crisis in April 2008, hedge funds were mentioned only indirectly. The FSF recommended that the

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[81] The turbulence in the credit markets that followed the collapse of Lehman Brothers in September 2008 created a hostile environment for hedge funds. Investment banks and prime brokers reacted to the distress in some financial markets by scaling back lending, thus making it more costly for hedge funds to obtain the credit necessary to conduct their traditional trading strategies. The losses registered by hedge funds in 2008 (in average -21.7%), besides undermining the belief that hedge funds would generate positive returns in all market conditions, have also reinforced the "flight to quality" among investors, who have massively withdrawn their investments. Many hedge funds have reacted by putting up "gates" in order to stop their investors taking out their investments, but these measures have not been sufficient to stem the wave of redemption. IOSCO 2009b.
[82] IOSCO 2009b.
[83] FSF 2007a.

supervisory guidance on counterparty exposure to hedge funds to be extended to exposure to other high leveraged counterparties.[84]

The first year since the beginning of the financial crisis was characterized by a strengthening of the international self-regulatory architecture emerged in late-1990s and confirmed by the FSF in the immediate wake of the crisis. When hedge funds reached the international agenda for the first time in the middle of the crisis at the G20 Washington Summit in November 2008, G20 leaders once again reached out to the industry. The statement released by the G20 leaders asked the hedge fund bodies that had already developed codes of best practices to "bring forward proposals for a set of unified best practices." The role of public authorities as envisioned by the G20 was limited to "assess[ing] the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies."[85]

Even before they entered formally into the international regulatory agenda, the main hedge fund associations had reacted to the potential threat to their regulatory status posed by the market turmoil by updating their self-regulatory codes of conduct or drafting new ones. Besides individually updating their individual self-regulatory initiatives,[86] the most important hedge fund associations, in particular the Washington-based Managed Funds Associations (MFA) and the London-based Alternative Investment Management Association (AIMA), took steps to meet regulators' demand for a unified set of best practices as requested by the G20 leaders.[87] In November 2008 these hedge fund groups, together with the International Organization of Securities Commissions, also created a website with the voluntary codes of conduct for the hedge fund industry, described as a first step towards harmonization of existing hedge fund industry sound practices.[88] As was seen with the cases of OTC derivatives and rating agencies described in the previous chapters, the initial international regulatory response did not

[84] FSF 2008b.
[85] G20 2008.
[86] MFA updated its "Sound Practices for Hedge Fund Managers" originally drafted in 2000 in the aftermath of the collapse of LTCM in order to incorporate the recommendations provided in the final President's Working Group's. See MFA 2009c. In the UK the Hedge Fund Standards Board, created at the outset of the crisis in response to the FSF 2007 Report, has toughened the standards and rushed to announce that it had expanded the base of funds adopting the standards1 July 2009 HFSB 2009. AIMA released different industry-driven codes of best practices touching upon hedge funds' internal risk-management practices, insider dealing and market abuse ("Market Ethics Guidance Note"), or seeking to educate institutional hedge fund investors ("AIMA's Roadmap to Hedge Funds), and funds of hedge funds managers ("Guide to Sound Practices for Funds of Hedge Funds Managers"). See AIMA 2009c; AIMA 2008a; AIMA 2008d.
[87] Since April 2008, AIMA and MFA entered into an alliance to cooperate on the "adoption of a global, principles-based regulatory system which will unify our members across jurisdictions and foster industry-wide compliance with the highest levels of sound business practices and integrity." AIMA 2008c. These hedge fund groups have delivered to the FSB on 24 June 2009 a set of harmonised Principles of Best Practices for Hedge Fund Managers, as requested by the G20 leaders. See AIMA 2009b.
[88] The website is named "Hedge Fund Matrix" (www.hedgefundmatrix.com). This initiative followed a request from the European Parliament.

alter the division of regulatory responsibilities between public and private actors but rather continued to rely on market-based regulatory solutions.

The resilience of the market-based approach to the regulation of hedge funds can be found not only in the initial international regulatory response to the crisis but also in that of Europe, where this approach was more contested before the crisis.

Within the European policymaking context, the continuation of a self-regulatory regime over this period found its biggest and most outspoken sponsor in the European Commission. At the beginning of the crisis, Commissioner McCreevy claimed to be relieved to have resisted the pressure for more stringent regulation in the period prior to the crisis: “This time 15 months ago I nearly had to go to an ear nose and throat specialist for a check up because I feared my ear drums were getting bruised in Brussels by the army of pro-regulation junkies and lobbyist who wanted me to ‘tackle’ private equity, hedge funds, and sovereign wealth funds for what they considered was the damage they could do to the European economy. I determinedly resisted this pressure—as I have resisted much other pressure for more regulation.”[89]

According to McCreevy, the crisis had revealed hedge funds to be “savours…in the current market turmoil” rather than “demons” jeopardizing the European economy, while the roots of the crisis were sown in regulated sectors such as banks rather than in the unregulated hedge funds.[90] When pressures to regulate hedge funds started to re-emerge during the crisis, McCreevy praised the measures being taken by hedge fund associations, arguing that the role of public authorities “should be to monitor closely these and other developments in the market and be ready to respond if and when necessary.”[91]

The origins of the crisis outside of the hedge fund industry strengthened the support for the continuation of a market-based approach from the European Commission. However, the growing public attention triggered by the crisis towards finance and financial regulation gave momentum to different policy entrepreneurs who had challenged this approach before the crisis to renew their calls for a more direct regulation of the sector in Europe. It is important to identify two sets of actors pushing for a change in the regulation of hedge funds: the European Parliament and the alliance between the French and German government.

[89] McCreevy 2008e.
[90] McCreevy 2008e.
[91] McCreevy 2008d.

The regulation of hedge funds had entered the agenda of the European Parliament different times before the crisis. This had primarily been the product activism from a key policy entrepreneur, President of the Party of European Socialists Poul Nyrup Rasmussen. Rasmussen took advantage of the crisis within Economic and Monetary Affairs Committee of the European Parliament to present a measure requesting the Commission to present a regulatory proposal on hedge funds based.[92] This proposal was largely based on a report he had presented in April 2007, only a few months before the crisis. This report denounced the risks posed by hedge funds to financial stability, as well as the effects on long-term growth of the firms and industries in which they invested, and it advocated for a rethinking of the dominant approach of indirect regulation of hedge funds through their bank counterparties.[93]

During the same post-crisis period, MEP Klaus-Heiner Lehne presented a second report requesting the European Commission to introduce new rules to enhance transparency in the investment policies of hedge funds and private equity funds.[94]

In the past, similar initiatives had failed to garner sufficient support within the European Parliament. However, the intensification of the crisis in the second half of 2008 altered the political climate in a manner more favorable to the claims advanced by Rasmussen. Watered-down versions of both reports were thus approved on September 23, 2008 by a very large majority of members of the European Parliament.[95] While the regulatory frameworks suggested in these two reports were not binding, the vote by the European Parliament forced the European Commission to present a legislative proposal within three months to regulate hedge funds in Europe. In response to this initiative, on December 1, 2008, the European Commission launched a public consultation on risks attached to hedge funds and the appropriate level of oversight in order to meet the requests coming from the European Parliament.[96]

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[92] The draft report denounced the inadequacy of the regulation of hedge funds and private equity firms, and the fact that "excessive debt required by much of the activities of hedge funds and private equity threatens financial stability, prejudices the realisation of the long-term investment, growth and jobs agenda and is, moreover, unfairly favoured in national tax regimes". See European Parliament 2008c.

[93] Rasmussen & van de Burg 2007, p.18. According to the PES Report, relying on the bank counterparties was insufficient given their strong dependence on hedge funds for their business volumes and profits, and the fact that the same banks were increasingly active themselves in owning and managing hedge funds. The report called instead for the creation of a European framework, focusing on "registration" of hedge funds managers, "minimum capital requirements and minimum rules on valuation of assets", as well as the creation of a "centralised mechanism to allow for consolidated assessment of market positions and analysis of systemic risk" and an "international credit register" to track all counterparties' exposure on individual hedge funds. Rasmussen & van de Burg 2007, p. 159-160.

[94] Quaglia 2011.

[95] European Parliament 2008e. A revised version of the Rasmussen report was approved with 562 votes in favour and 86 against (25 abstentions) by the European Parliament in September 2008. The Lehre report instead was approved by the European Parliament by 513 to 43, with 117 abstentions on 23 September 2008.

[96] McCreevy 2009c.

Moreover, when Commissioner McCreevy was appearing to drag his feet in presenting a regulatory framework for hedge funds as requested by the European Parliament, Rasmussen and influential members of the Party of European Socialists directly lobbied the president of the Commission, Manuel Barroso. In a letter dated December 16, 2008, Rasmussen and other socialist members wrote to "express [their] dismay at the increasingly obvious fact that Commissioner McCreevy is trying to avoid implementing the demands of the European Parliament for regulation covering all financial players."[97] Rasmussen described the conduct of McCreevy as "more appropriate for a paid lobbyist of the finance industry than a European Commissioner".[98]

The influence of the European Parliament over the conduct of the Commission was also due to the fact that Barroso was seeking re-election, which was conditional on the support of the European Parliament, where Rasmussen's party controlled 184 MEP, 25% of the total. Ramussen explicitly criticized the conduct of Barroso, arguing that if he were up for re-election as Commission president, he would have "an ambition level a bit higher."[99]

The demands from the European Parliament during this period were not the only political pressures exercised on the European Commission in favor of directly regulating hedge funds. In fact, similar resolutions adopted by the European Parliament in the past (15 January 2004, 27 April 2006, 11 July 2007, 13 December 2007) had failed to bring the European Commission to adopt a regulation of the industry.[100] Indeed, to explain post-crisis policy outcomes, it is also important to analyze the influence of the major European governments on the European Commission regarding the regulation of hedge funds in Europe.

As argued in the previous section, the support for a market-based approach that informed the position of the European Commission in the years before the crisis reflected both the equilibrium among European governments within the European Council and the veto posed by the British government to the German attempt to promote European regulation of the sector.[101] The beginning of the crisis did not alter this

[97] Rasmussen, Schulz, & Berès 2008.
[98] Rasmussen and other Socialist party leaders also lobbied Barroso to strengthen the proposal once this was presented.They described the initial draft as filled with loopholes ("the proposal for a Directive is just one of a series of major loopholes which makes the proposed Directive almost worthless"). According to Rasmussen, the draft initially proposed by the Commission was "not up expectations; it will only satisfy industry and those (still) favourable to minimum regulation". Commentators have argued that the intervention of Rasmussen on Barroso had an impact over the content of the regulation. See Rasmussen, Schulz, & Berès 2009.
[99] Collins 2009.
[100] European Parliament 2008c.
[101] ECOFIN 2007.

equilibrium. On the contrary, at the end of January 2008 German Chancellor Merkel and French President Sarkozy joined the British government in welcoming a set of voluntary best practice standards presented by a group of 14 of London-based biggest hedge funds.[102]

However, the apparent convergence of preferences among European governments in favor of self-regulation broke down during the second half of 2008. Starting in September 2008, Chancellor Merkel publicly criticized the US and the UK governments for having vetoed the previous attempts by the German government to introduce closer supervision over the hedge fund industry within the G8 and for placing excessive confidence in the capacity of financial markets to regulate themselves.[103]

Merkel claimed that she would not repeat the error made in the past of not pushing through regulation of hedge funds on an international level. When the first G20 Leaders' Summit was convened in November 2008 to discuss international financial regulation, Angela Merkel called to introduce regulations to abolish "blind spots" in international financial markets, such as off-balance sheet vehicles and hedge funds.[104] The German priority of the regulating hedge funds was immediately supported by French President Nicholas Sarkozy, who intervened in person to re-introduce the regulation of hedge funds into the international agenda, claiming that "no financial institution should escape regulation and supervision."[105] In addition, Italian Finance Minister Tremonti argued that the rewriting of financial market rules should target "absolutely crazy bodies, like hedge funds which have nothing to do with capitalism," and that policymakers should launch a discussion about the need to ban them.[106]

A British diplomat has compared the behavior of France and Germany to a pugilist in a bar brawl, saying, "You wait until a fight breaks out and then take a swing at the guy you have always wanted to hit…whether or not he had anything to do with starting the fight is not the point."[107] However, while it is true that the crisis has created an opportunity for the two governments to bring back into the agenda their long-standing priority of regulating hedge funds, it also significantly increased the incentives for these political actors to do this.

[102] Sarkozy et al. 2008.
[103] Erdem 2008.
[104] Reiermann 2008 .The German negotiating position is based on a paper prepared by an expert group headed by former European Central Bank chief economist Otmar Issing.
[105] Sarkozy 2008.
[106] G. Jones 2008.
[107] Cited in Beattie 2009.

The coordinated attempt of France and Germany to restart the conversation on regulating hedge funds did not coincide with the beginning of the international regulatory response to the crisis but rather with the intensification of the crisis from a primarily US-centric shock to a transatlantic crisis in September 2008. The increased public attention towards financial regulatory issues and the greater sensitivity of the electorate in these two countries towards the activities of hedge funds reinforced the incentives for the French and German governments to intervene in this area despite hedge funds having not represented key actors in the ongoing financial turmoil. This is particularly the case in Germany, where the Chancellor Angela Merkel faced federal elections in September 2009, but electoral incentives also played an important role in shaping the French regulatory response. As Woll argues, "French President Nicolas Sarkozy, in turn, sought to capitalize on the financial crisis to become the founding father of a new financial architecture he intended to push under the French presidency of the EU in the second half of 2008, and later under the French presidency of the G20 from 2010 to 2011, just months before his upcoming election."[108] During this period the French regulatory priorities came to be heavily influenced by the political leadership, and French government representatives received instructions from Sarkozy and the highest levels of the government to support the German position.[109]

The initial demands advanced by Sarkozy and Merkel were crucial to bring hedge funds back in the agenda of the G20 at the 2008 Washington Summit. At the same time, it is important to recognize that the international agreement still reflected the preference for a market-based approach brought to the table by UK and US policymakers.

Despite this failure, the Franco-German bid to secure an international agreement over the regulation of hedge funds continued at the beginning of 2009. In particular, in February 2009 the French Finance Minister, Christine Lagarde, proposed a compulsory registration of hedge funds with supervisory authorities in the country where they are marketed,[110] and this proposal immediately met the support of German Finance Minister Steinbrueck.[111] The breakthrough came ten days later at a summit hosted by Merkel in Berlin in order to forge a common European stance. In this circumstance, the leaders of France, Germany, UK, Italy, Spain, and the Netherlands agreed that "all financial markets, products and participants—including hedge funds and other private pools of

[108] Woll 2011, p. 14.
[109] Woll 2011, p. 14.
[110] B. Hall & Mackintosh 2009.
[111] Thomas 2009.

capital which may pose a systemic risk—must be subjected to appropriate oversight or regulation."[112] This rebalancing in the position of main European countries paved the way for an agreement at the international level within the G20 Leaders' Summit. The language adopted by G20 finance ministers and central bankers in March 2009 and by G20 leaders in London in April largely mirrored that used by European leaders one month before.

This agreement represented a reversal of the compromise that had emerged among European government at the beginning of the crisis in favor of status quo, and it was portrayed as a Franco-German success in overcoming the resistance of the British government to the introduction of greater regulation of hedge funds in Europe.

However, this account neglects the significant the shift in the position of the British government during the last quarter of 2008 and the beginning of 2009. During the initial phase of the crisis, British regulatory authorities had opposed calls for bringing hedge funds into the European agenda. In fact, the FSA repeatedly defended the adequacy of the regulatory framework in place in England where the FSA already authorized and directly monitored the largest UK domiciled hedge fund managers more extensively than other regulatory authorities, collecting aggregate information on their exposures and targeting outliers by regularly surveying their prime brokers.[113] According to FSA, it was the rest of global regulatory community that had to catch up with the UK.[114] Moreover, British regulators also sought to deflect calls for regulating hedge funds by praising the self-regulatory steps taken by the same hedge funds.[115] In particular the Bank of England had played an important part in bringing together the main London-based hedge funds that constitute the HFSB, while the FSA announced its intention to take compliance with these standards into account in its oversight of hedge fund managers.[116]

However, the intensification of the financial crisis in the fall of 2008 raised the public profile of hedge funds in the UK as well. Hedge funds were accused in the mainstream media of having taken significant short selling positions in the shares of British banks that later came to demand public support.[117] The temporary ban on shorting of financial

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112 Federal Government of Germany 2009; see also Quaglia 2011.
113 Fletcher 2009.
114 Compliance Reporter 2009.
115 Sants 2008.
116 Sants 2008.
117 In particular, in September 2008, some international hedge funds have come under scrutiny in the UK for having bet hundreds of millions of Euro on the fall in the stocks of important European financial institutions. A research by Goldman

stocks imposed by the UK Financial Services Authority in September 2008 was seen as mostly directed towards hedge funds. The Prime Minister, Gordon Brown, justified this action in public by singling out hedge funds and arguing, “The interests of savers and homeowners and mortgage holders came before the interests of a few hedge funds.”[118]

The criticisms towards short selling by hedge funds did not come uniquely from the government. A prominent critique came for instance from the Archbishop of Canterbury, who publicly attacked hedge funds, "Given that the risk to social stability overall in these processes has been shown to be so enormous, it is no use pretending that the financial world can maintain indefinitely the degree of exemption from scrutiny and regulation that it has got used to."[119]

The role played by hedge fund in the intensification of the market turmoil in the fall of 2008 .also brought them into the agenda of the British Parliament, where the Parliamentary Treasury Select Committee hosted a hearing focused on questioning the role of hedge funds in the crisis. Here, different MPs questioned the reliance on industry-codes of best practices by hedge funds, denouncing the limited success of the Bank of England-sponsored Hedge Fund Standards Board in gaining acceptance within London’s hedge fund community. In the words of MP McFall, “Out of 1,000 potential members, you've only got 34.…Of the 34, 14 were those who drew it up in the first place. If I were a recruitment manager with a record like that, I'd be sacked".[120] The head of the Liberal Democrats, Vince Cable, called for the creation of a hedge fund regulatory body in charge of monitoring hedge funds and their activities.[121]

The increasing backlash against the financial sector within the UK in 2009 made it politically unpopular for UK politicians to stand up for the City of London and continue to defend the pre-crisis model of “light-touch” regulation as the most appropriate approach for finance. This paradigm change also affected the position of British regulators, as highlighted by the publication of the “Turner Review” in March 2009. This report, drafted by the FSA, announced a radical shift from the pre-crisis regulatory philosophy, and it discussed under what conditions hedge funds may pose a systemic threat and therefore be regulated as banks.[122]

Sachs has showed that shared popular with hedge funds have been hit in September/October 2008 far harder than those in which hedge funds too little interest. See Mackintosh & Johnson 2008.

[118] Mackintosh 2008.

[119] Gray 2008.

[120] House of Commons 2009; M. Turner 2009a.

[121] Flaherty 2009.

[122] FSA 2009b.

The domestic pressures to take action against financial speculation in the middle of the crisis were reinforced by an external constraint: the desire of the British government to deliver significant commitments at the forthcoming London G20 Summit. Agreement on the regulation of hedge funds represented one of the key "diplomatic side-payments"[123] made by the British Prime Minister Brown to his European counterparts within the G20 in return for their consent on other issues, such as endowing the IMF with more resources and participation in a "global New Deal," a measure described by Buller and Lindstrom as "crucial to Labour's electoral prospects in 2010."[124]

In sum, changed domestic and international conditions during the crisis forced a shift in the position of the British government, which removed its previous veto to an agreement over the regulation of hedge fund managers at the European and international level.

The change in the British position and its support for regulation of the industry thus deprived the European Commission of the main political supporter for the continuation of the existing self-regulatory approach. In February 2009, the European Commission announcement that it would be bringing forward new rules to regulate the hedge fund industry. While discussing this step, Commissioner McCreevy reaffirmed his belief that hedge funds were "easy scapegoats for more deep-rooted problems" but claimed that the crisis had "profoundly altered the economic and political context in which decisions on the regulation of hedge funds and private equity will be made. The ground has shifted in this debate. Closer, direct regulatory and supervisory oversight of hedge funds and private equity is inevitable."[125] The Commission presented its proposal to directly regulate hedge funds in April, a record time given the breadth and complexity of the proposal.[126]

The Alternative Investment Fund Managers (AIFM) Directive was based around the principle that hedge fund managers should be subject to the direct oversight of regulatory authorities and should comply with an extensive and detailed set of regulatory requirements regarding elements such as their level of leverage, their internal governance, and their use of custodians and valuators.

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[123] Buller & Lindstrom 2012.
[124] Buller & Lindstrom 2012; Quaglia 2011; Buller and Lindstrom argue: "To be clear, we are not suggesting that the Brown government tried to boost its popularity by sacrificing the interests of the alternative invest- ment industry at a time when the City of London was widely being criticised for its part in the credit crunch. Rather, the interests of hedge fund managers and private equity firms appear to have been caught up in a broader political strat- egy whereby Number 10 hoped to use an international agreement for a global fiscal stimulus as a pretext for announcing similar actions at home". Buller & Lindstrom 2012, p.15.
[125] McCreevy 2009c.
[126] European Commission 2009g.

The publication of the Directive provoked a strong reaction by the hedge fund community. The London-based AIMA claimed that the drafting of the Directive had "been rushed through in a very tight timeframe without anything like the usual standards of consultation that we expect from the Commission," and it had "been subjected to undue political pressure. There has been much rhetoric from various political organisations on the directive, most of which appears designed to satisfy domestic audiences ahead of the forthcoming European elections rather than to secure an effective and sensible solution to identified problems."[127]

British hedge funds have launched an intense campaign to denounce the costs imposed by these regulatory requirements upon their activities and upon London's position as the world's number two hub for hedge funds. A few hedge funds even threatened to relocate to more friendly jurisdictions such as Switzerland if the British government was not successful in toning down the most stringent elements of the Directive.[128] AIMA welcomed a report highlighting that the tax revenue already coming from the UK hedge fund and private equity industries was "enough to pay for more than 200,000 nurses, 45,000 hospital consultants or 165,000 teachers."[129]

Moreover, the opposition to different aspects of the Directive also extended to important clients of hedge funds. In England, the UK National Association of Pension Funds,[130] and a coalition of charitable foundations—including the Church of England—denounced how "the Directive as currently drafted will significantly restrict our ability to generate funds to pursue our charitable missions and thus reduce our impact for public good."[131] The opposition to the directive coming from a large range of interest groups in the UK led the British government to increase its involvement in the European arena, seeking to steer the content of the emerging regulatory framework as close as possible to the regulatory framework in place in Britain.

While British authorities sought to limit the extent of the Directive, the French and German government sought to strengthen the regulation. German Finance Minister Peer Steinbrueck declared that the plan didn't "go far enough,"[132] adding that he would "not let

[127] AIMA 2009e. See also AIMA 2009b.
[128] AIMA 2009i; S. Jones 2009a; Walker & Elliott 2009.

[129] AIMA 2009h.
[130] Walker 2010.
[131] S. Jones 2009b.
[132] Barkin 2009; T. Barber 2009.

this directive be adopted in this state,"[133] while his French counterpart, Christine Lagarde, called for a "maximalist" regulation.[134]

The discussion above has highlighted how the Franco-German attempt to bring the regulation of hedge funds into the European and international agenda was significantly influenced by public opinion. At the same time, their position over the details of the Directive during the lengthy negotiation that followed publication of the initial text also reflected the contours of traditional interest group politics. For instance, the position of the French government has been described by Woll as heavily influenced by an attempt to protect the retail mutual funds (UCITS) located in France from the competition of less regulated funds, pushing the pursuit of a regulatory framework similar to the one that had sustained this industry.[135] While the German government did not have the same stake in protecting its domestic fund industry, German policymakers sought to defend their corporate model by promoting measures restricting the capacity of private equity funds to buy a company with the intention to sell some of its assets (so-called "asset stripping").[136]

The negotiations over the details of the Directive triggered the re-emergence of the two coalitions that had characterized the politics of hedge funds regulation in Europe before the crisis. However, British policymakers were successful in winning the support on various issues of some smaller European countries such as Ireland, Luxembourg, Finland, Czech Republic, Malta, Cyprus, Sweden, thus creating a blocking minority capable of stalling the process of the Directive.[137] The mobilization of pension fund associations, such as the Dutch and Irish national associations and the pan-EU European Federation for Retirement Provision, denouncing the loss of returns caused by the Directive also extended the opposition to the Directive to parties without a significant hedge fund base.[138]

Nevertheless, after a long "trialogue" between the European Parliament, European Council, and European Commission, the British authorities found themselves isolated and outvoted within the European Council.[139] By this time, though, the British government had achieved significant success in narrowing down the gap between its

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[133] Willard 2009.
[134] Vidaillet & Toyer 2009. Lagarde stated: "The Commission's proposal is way below European's demands. It is minimum regulation. We need to have a maximalist position from the start". See Agence France Press 2009
[135] Woll 2011.
[136] Woll 2011.
[137] Prosser 2010; The Irish Examiner 2009; Inman & Moya 2009; Reuters 2009; Woll 2011; Hutchings 2010.
[138] EFRP 2009; Kreijger 2009; Borsen-Zeitung 2009.
[139] Helm & Kollewe 2010; A. Cohen & Norman 2010.

own regulatory regime and the initial draft presented by the Commission. For instance, the initial draft of the AIFM Directive presented by the European Commission in April 2009 gave the Commission the power to set broad-brush restrictions to the level of leverage hedge fund managers could employ, a measure opposed both by hedge funds and the British government. The final text of the Directive, approved in November 2010, empowered domestic financial regulatory authorities to impose limits on leverage only on a temporary basis during exceptional circumstances.[140]

British authorities also successfully challenged some of the most burdensome draft provisions regarding the regulation of valuators, depositories, and custodians, all of which have subsequently been significantly watered down.[141]

Most importantly, the British government was able to win important concessions regarding the capacity of third country hedge funds and managers to market in Europe.[142] The initial proposal presented by the European Commission allowed managers domiciled in non-EU countries to market their services throughout Europe for only three years after the new rules took effect and only if their home countries met standards "equivalent" to the stringent conditions set out in the Directive.[143] The difficulty for a third country to meet these conditions led the main international hedge fund associations to oppose the directive on the ground that it would have restricted access to EU markets for non-EU funds.[144]

These measures were also criticized by the British government for threatening the status of London as the main hedge fund hub in Europe and the City's capacity to attract funds based in the many British Crown dependencies that act as offshore financial centers. The diplomatic offensive by the British government thus focused on preventing what the

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[140] European Commission 2009g. The article 25 also stated that "in exceptional circumstances, the competent authorities of the home member state may impose additional limits to the level of leverage that managers can employ" (Article 25). Hedge funds argued that a single cap on leverage to cover very different investment strategies and asset classes would be ineffective since leverage was not a good proxy for risk, and it could also create systemic risk in the case hedge funds were forced to deleverage quickly and simultaneously when their capital base is eroded by a common shock, thus exacerbating the fall of asset prices in a procyclical way. AIMA 2009b British authorities, which stated that regulators should simply retain "powers to intervene in a tailored way when they identify particular risk". Waters 2009The FSA stated: "We should avoid leading regulators into prescriptive product regulation for alternative investment funds, so we think that 'hard limits' on leverage, as are proposed in the Directive, are inappropriate, unworkable and could result in considerable unintended consequences – particularly for the European hedge fund sector". FSA 2009a.

[141] The draft proposal presented by the Swedish presidency in November 2009 removed the requirement to appoint an independent "valuator". This provision was instead replaced with a more general principle requiring "that appropriate and consistent procedures are in place to provide proper valuation of the assets", and a requirement, where appropriate, to ensure the functional independence of the valuation and portfolio management function. Also the provisions regulating depositories have been significantly altered. The Swedish compromise stated that the depository might be a MiFID firm authorized to carry out safekeeping and administration. The Swedish compromise also made easier for fund managers to delegate portfolio management and risk management functions to third parties, as it removed the need for prior authorization from regulators

[142] Pagliari 2012

[143] European Commission 2009g, Article 35-9.

[144] AIMA 2009g.

Minister for the City, Lord Myners, called the “building of a wall around Europe.”[145] British authorities were able to safeguard the capacity of London-based managers to market non-EU funds in individual European countries through their national placement regime, and, through the inclusion in the Directive of a “third country passport,”, to market throughout Europe after a period of three years.[146]

This represented a significant shift in the content of the Directive, whose initial draft had been perceived as burdensome for the British hedge fund industry and described by Lord Myners as an attempt of “other European countries to make political capital out of demanding intrusive regulation of an industry of which they have little or no direct experience.”[147] Instead, as Myners acknowledged in May 2010 before the final approval of the Directive, "There isn't anything left in this directive which will threaten the viability of the UK hedge fund industry or the long-term position of London as the centre of that activity…We worked hard to stop the worst excesses of this directive."[148]

6.5 The Regulation of Hedge Funds in the United States During the Crisis

The capacity of the French and German governments to win support from the British government over the regulation of hedge funds and the shifting consensus within Europe away from self-regulation are certainly an important component of the agreement within the G20 in favor of more direct intervention. However, the developments triggered by the crisis in Europe cannot by themselves explain this shift in the international agenda.

As the analysis of the pre-crisis period has demonstrated, previous attempts by these governments to challenge the international market-based regime emerged after LTCM but were vetoed by the UK and especially the United States. This section will therefore seek to explain why US policymakers came to accept an international agreement bringing hedge fund managers under the oversight of public authorities at the G20 London Summit. This section will discuss how this decision did not represent a capitulation to the diplomatic offensive from Continental European countries, but rather it has emerged as a result of the impact that the crisis had over the domestic policymaking

[145] H. Jones 2009.
[146] At the same time, Continental European countries were able to preserve quite restrictive conditions under which the third-country hedge funds would be granted such passport. The passport would not be accessible to funds based in off-shore centres not complying with international standards on anti-money laundering, terrorist financing and tax cooperation, or countries whose authorities had failed to sign a supervisory agreement with a European regulator. Moreover, the directive allowed individual countries to preserve barriers against non-EU funds included in their national private placement regimes for at least five years after the transposition of the directive. See European Commission 2011a, recital 61-69, see also Chapter VII. See also Buller & Lindstrom 2012.
[147] HM Treasury 2009b.
[148] Pagano 2010.

context in the United States.

The principle that hedge fund managers should register with their national securities regulator emerged within the United States long before the crisis in response to the growing investor protection concerns associated with hedge fund markets. The report presented by the PWG after the collapse of LTCM focused uniquely on the systemic risk posed by hedge funds and downplayed investor protection concerns, stating that “these vehicles generally have not been associated with traditional investor protection issues.”[149] The rationale presented to justify this neglect is that the investor base for hedge funds usually comprised “sophisticated investors,” that is, high net worth individuals and institutional investors that are regarded as sufficiently capable of understanding the risks implicit in investing in hedge funds and to absorb the loss in the case of a hedge fund failure.

These defining characteristics of the hedge fund industry have progressively come to an end in the years following the collapse of LTCM. In these years, the growth in the investor base of hedge funds in the United States has been boosted no just by high net worth individuals but also increasingly by the inflow of pension funds, university endowments, and other institutional investors seeking alternatives and more profitable strategies in the wake of the bursting of the equity bubble in 2000.[150]

The increased “retailization” of the hedge fund industry made hedge funds available to a broader range of investors than had ever been intended by regulators. This occurred either directly through funds or indirectly through pension funds, leading the SEC to increase their scrutiny of the hedge fund industry in the years preceding the crisis. From 2001, the SEC devoted large efforts to detect cases of insider trading, fraud, conflict of interest, misleading disclosure, and faulty asset valuation. In 2004, 400 hedge funds and at least 87 hedge fund advisers were under investigation by the SEC.[151]

The greater attention towards investor protection issues raised by hedge funds has created strong incentives for the SEC to take action to bring hedge fund advisers more directly under its oversight. To achieve this goal, the SEC eliminated in October 2004 the exemption in the Investment Advisers Act of 1940 that allowed hedge fund advisers to avoid registering with the SEC and exempted them from periodic SEC examinations, as

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149 PWG 1999a, p. B-13.

150 FSF 2007c While the share of high-net-worth individials has declined from 61% in 1997 to 40% in 2006 penson funds' share of HF capital has grown threeforld, from 5% in 1996 to 15% in 2004 Danielsson 2004; MacHarg 2004.

151 Robotti 2007.

well as compliance with reporting, record keeping, and disclosure requirements.[152]

This measure was highly contested within the SEC, as demonstrated by the opposition of two SEC Commissioners, Paul Atkins and Cynthia A. Glassman. The two Commissioners argued that requiring hedge fund advisers to register would spread SEC inspection resources too thin without sufficient cause, and it would give investors an undeserved sense of security about investing in registered hedge funds.[153] Most importantly, this initiative by the SEC was opposed by the majority of hedge fund managers, who were concerned with the cost of compliance, as well as with the possibility that this would be the first step of broader regulation of the industry.[154]

Ultimately, hedge funds were successful in deflecting this regulatory threat. Philip Goldstein, manager of the New York fund Bulldog Investors, took exception to the regulation and filed a lawsuit to challenge its enforcement. In June 2006, the United States Court of Appeals for the District of Columbia ruled in "Goldstein vs. SEC" that the SEC's hedge fund rule was going beyond the statutory authority of the SEC and that it was arbitrary in the absence of a clearer mandate by Congress to require the registration of hedge funds.[155]

After the "Goldstein vs. SEC" case, no further effort was made by federal authorities to directly regulate hedge funds. The SEC did not appeal the decision, believing that hedge funds would nevertheless register on a voluntary basis.[156] The reluctance of the SEC to demand the authority to regulate hedge funds from Congress also reflected the broader climate on the issue of the period and the anticipation of limited interest from Congress to fill the legislative vacuum.

Nevertheless, different legislative proposals were indeed introduced in Congress after the "Goldstein vs. SEC" ruling. Rep. Barney Frank introduced the Securities and Exchange Commission Authority Restoration Act of 2006 in June to amend the definition

[152] This act presented a series of regulatory measures designed to protect retail investors, such as investor redemption rights, application of auditing standards, asset valuation, portfolio transparency and fund governance. Hedge funds achieved an exemptions from these requirements by either limiting themselves to 100 total investors or permitting only "qualified purchasers" to invest. The SEC contested the exemption that allowed hedge fund managers to count a single fund with hundreds of millions under management as one "client". The SEC redefined the term "client" used under the Investment Advisers Act and it required hedge fund advisers to "look through" the funds in counting the number of investors in the fund as clients.

[153] P. S. Atkins 2006; SEC 2004.

[154] The MFA argued that "the implementation of the SEC proposal will result in unnecessary, burdensome costs to the hedge fund industry, potentially causing a chilling effect on hedge fund activities that will adversely impact hedge fund investors and the financial system as a whole". See MFA 2004.

[155] Veit 2008.

[156] Robotti 2007.

of “client” in line with the SEC proposal. However, this bill failed to raise sufficient support within Congress and died in committee.[157]

Shortly after, with the collapse in September 2006 of Amaranth Advisors, a hedge fund that lost $6.5 billion in its bets on natural gas, Sen. Charles Grassley presented another legislative initiative to mandate registration of hedge fund advisers. Grassley denounced how “tens of millions of Americans are exposed to the risk of hedge funds through intermediaries such as pension funds, endowments, and other investment pools.”[158] Grassley declared it was up to Congress to act in order to create greater transparency for hedge funds, as “the average Joe has a stake as pension funds are invested in hedge funds.”[159]

However, similarly to the legislative proposal presented by Rep. Frank, the Hedge Fund Registration Act introduced by Sen. Grassley in May 2007 was referred to the Senate Committee on Banking but never brought up for consideration.[160]

This episode shows how despite the idea that hedge fund managers should register with securities regulators originated in the United States and entered the Congressional agenda before the crisis, it failed to receive adequate support from US politicians. The lack of significant and widespread losses caused to investors and taxpayers by hedge funds and the aversion to alienating the support of one of the major sources of campaign contributions made it unpopular for most Congressmen to support this regulatory intervention.

This kind of support instead emerged during the global financial crisis of 2007-2010. Similarly to what occurred in Europe, this shift did not occur during the initial regulatory response to the crisis. Hedge funds regained the headlines on the mainstream US press almost a decade after the collapse of LTCM when, in June 2007, two funds established by the US investment bank Bear Stearns ran into trouble. Although not particularly large, these two hedge funds were heavily invested in complex financial instruments tied to subprime mortgages. When the market for US subprime mortgages rapidly declined in the summer of 2007, the two funds lost nearly all of their value, and Bear Stearns, as their parent bank, was forced to bail them out. The two managers were later arrested on charges of securities fraud and conspiracy.

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[157] Ruane & Seitzinger 2010. The text of the bill is available here: http://www.govtrack.us/congress/bills/109/hr5712

[158] S. C. Grassley 2006.

[159] Together with Sen. Max Baucus, Grassley has also asked in March 2007 the General Accountability Office to investigate the scope of public and private pension plan investments in hedge funds, and what returns and risks are likely for workers' retirement funds.1 March 2007. See Baucus & Grassley 2007.

[160] C. Grassley 2008.

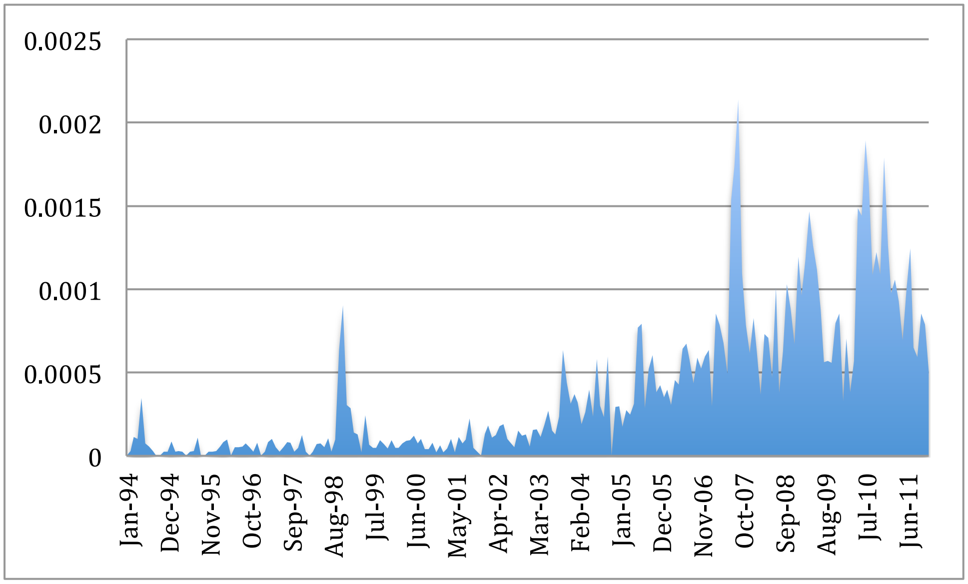
This event signaled to the US media the beginning of the subprime mortgage crisis and refocused attention towards financial issues. At the same time, the public salience of hedge funds was rather short-lived, and the attention of the US media shifted quickly away from hedge funds and towards other financial sectors.

As a result, the outbreak of the crisis in the summer of 2007 did not lead to a return of hedge funds in the Congressional agenda, nor did it undermine the support for the "indirect" regulatory approach that had emerged after the collapse of LTCM. On the contrary, as argued above, in September 2007 the PWG intervened directly to foster the emergence of a more effective self-regulatory regime by creating two advisory groups, one composed of investors in hedge funds and the other composed of hedge funds managers, with the mandate of creating and publicly releasing a private sector-driven set of best practices for HFs and their investors.[161]

However, the level of public attention towards hedge funds increased significantly in the second half of 2008. Two developments explain this change. The first is the panic that unfolded in the markets after the collapse of Lehman Brothers in September 2008 and the subsequent use of public money to bailout financial institutions. Hedge funds did not directly benefit from the use of public funding in support of Wall Street, but they did not remain unscathed from the political repercussions of these bailouts, which significantly politicized financial regulatory politics across the board (see Figure 19).

[161] PWG 2007b.

Figure 19 - Hedge Funds in the US Press (1994-2011)

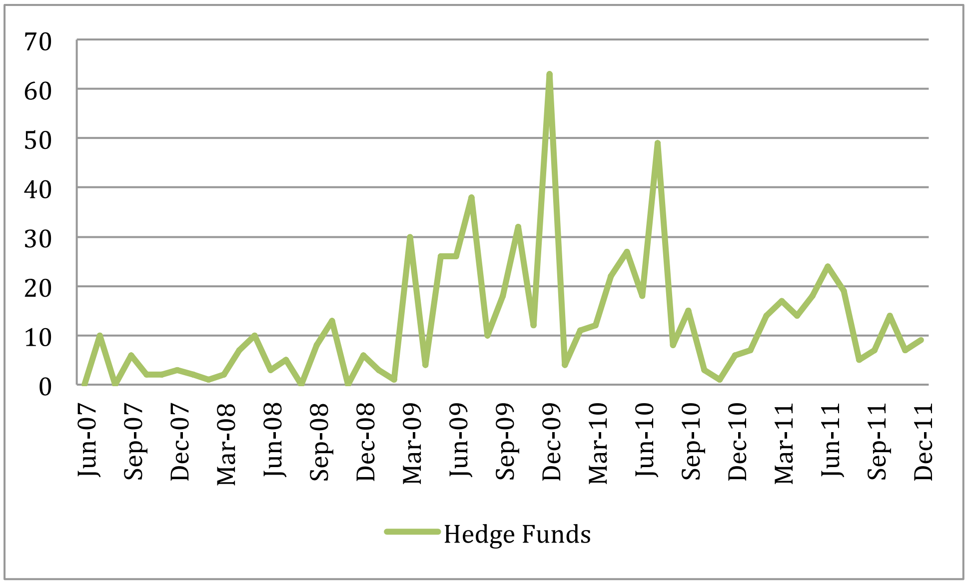


The second event that brought hedge funds back in the headlines was the Madoff scandal. In December 2008, US investment manager and stockbroker Bernard Madoff was arrested for conducting what has been described as the largest Ponzi scheme in history. Madoff was not a hedge fund manager; rather, he executed trades for other "feeder funds" through his brokerage firms. Although Madoff was registered with the SEC, the scandal provoked a backlash against the lack of oversight of hedge fund managers.

The increased public attention towards hedge funds had the effect of increasing the involvement of Congress in this area, as illustrated by Figure 20. In November 2008, the House Oversight Committee launched a series of hearings in which it questioned the actors that were regarded as most directly responsible for the crisis, such as credit rating agencies, bankers, and regulatory authorities. During one of these hearings, five of the most highly compensated hedge fund managers were questioned by lawmakers about the risks their firms posed to the stability of the financial system and the need for regulatory reforms.[162]

[162] House of Representatives 2008.

Figure 20 - Number of Publications Mentioning "Hedge Funds"in "Congressional Documents and Publications"[163]



The response of the hedge fund industry in the United States over this period focused on proving the innocence of the industry to the growing market turmoil. As hedge funds frequently claimed, it was the main investment and commercial banks who had designed the products at the core of the crisis and who were operating with significantly higher leverage than the supposedly "highly-leveraged" hedge funds. Meanwhile, they argued, the assets managed by the entire hedge fund industry (estimated at $1.5-2 trillion) were smaller than the balance sheets of some individual banks involved in the crisis.[164] Moreover, hedge fund managers have often argued that they had "not required, nor sought, federal assistance despite the fact that our industry, and our investors, have suffered mightily as a result of the instability in our financial system and the broader economic downturn."[165]

However, the lobbying from the hedge fund industry over this period was not sufficient to forestall the introduction of legislative proposals to bring hedge funds under the direct oversight of regulators. On the same day that Madoff was arrested, Congress began to legislate on the regulation of hedge funds. Sen. Dorgan introduced the Derivatives and

[163] The "Congressional Documents and Publications" a wide variety of documents concerning the activity of US Congress, including legislative proposals, transcript of hearings, and press releases from individual Congressmen. It has been accessed through Factiva.
[164] The average leverage ration for the hedge fund industry was only 1.7 times in 2007 and it fell to 1.4 in 2008, and to 1.15 at the beginning of 2009 (although the leverage changes significantly across fund types), thus well below that of banks. See IMF 2008 p. 41.
[165] MFA 2009b.

Hedge Fund Regulatory Improvement Act of 2008, which requested federal regulators to extend the requirements governing the safety and soundness of the financial system applicable to mutual funds to hedge funds.[166] While this bill died with the end of the 110th Congress at the end of 2008, the 111th Congress immediately demonstrated a greater assertiveness in legislating the regulation of hedge fund industry.

In January 2009, Sen. Grassley reintroduced his 2007 legislative proposal to close the loophole previously used by hedge funds to escape the definition of an "investment company" under the Investment Company Act of 1940, allowing avoidance of registration with the SEC. As Grassley argued, "There was not much of an appetite for this sort of common sense legislation when I first introduced it before the financial crisis erupted. Hopefully, attitudes have changed given all that has happened since the collapse of Bear Stearns last March."[167] The co-sponsor of the bill, Sen. Carl Levin, argued in his floor statement, "History has proven time and again that markets are not self-policing. Today's financial crisis is due in part to the government's failure to regulate key market participants, including hedge funds that have become unregulated financial heavyweights in the U.S. economy."[168]

Grassley's initiative was not the only bill introduced in Congress to regulate hedge funds. Another bipartisan bill was introduced in the House of Representatives at the end of the same month by Republican Mike Castle and Democrat Mike Capuano.[169] Unlike the Grassley-Levin Bill, the Castle-Capuano bill sought to eliminate the exemption from registration for hedge fund managers with fewer than 15 clients contained in the Investment Advisers Act. The principle of hedge fund advisers' registration also informed other legislative drafts presented within Congress, such as the Private Fund Investment Advisers Registration Act of 2009 introduced by Rep. Kanjorski and the Private Fund Transparency Act of 2009 introduced by Sen. John Reed.

As argued above, the introduction of legislative proposals to bring hedge funds under the purview of the SEC was not unprecedented. However, while only two years before Congress had been reluctant to endorse hedge fund manager registration with securities regulators, the changed political climate triggered by crisis brought the majority of Congressmen to support this regulatory solution.

[166] The text of the bill is available at: http://www.govtrack.us/congress/bills/110/s3739
[167] C. Grassley 2009; US Senate 2009.
[168] Levin 2009.
[169] The text of the Hedge Fund Adviser Registration Act of 2009 is available at: http://www.govtrack.us/congress/bills/111/hr711

The changed consensus within Congress in favor of directly regulating hedge funds was further solidified by the election of President Barack Obama. This led to an immediate change at the helm of the SEC and a reversal of the position held by the organization. Following the elections and criticism addressed towards the SEC for having failed to detect the $65 billion Ponzi scheme orchestrated by Madoff,[170] the new nominee to head the SEC, Mary Schapiro, immediately supported the registration of hedge fund managers in January 2009.[171]

Also the new Treasury Secretary, Timothy Geithner, departed from the support for the indirect approach to the regulation of hedge funds that had informed the position of the US Treasury under the previous administration. On the contrary, the legislative proposal delivered to Capitol Hill by the US Treasury fell largely in line with the previous Congressional proposals and required all hedge funds above a minimum threshold to register with the SEC, while at the same time adding a second tier of regulatory requirements for those funds deemed to be systemically relevant.[172]

The changed political climate within Congress and the increasing consensus around bringing hedge funds under the purview of the SEC forced hedge funds to alter their position as well. In the past, hedge funds had opposed any proposal that would force them to register with the SEC and to be subject to its oversight, on the ground that this would result in burdensome costs to the industry.[173] At the beginning of 2009, the main US hedge funds association, the Managed Funds Association, changed its position and threw its weight behind the proposals to force hedge funds to register with the SEC and their associated disclosure requirements.[174]

The shift in the position of hedge funds from their strenuous defense of self-regulation to their support for direct regulation centered on the principle of the registration of hedge fund managers represented in part a response to change in the political climate. In particular, hedge fund managers expressed concerns that the public outrage that

[170] SEC Office of Inspector General 2009.

[171] During a confirmation hearing the nominee to head of the SEC, Mary Schapiro declared in January 2009 that she would consider requiring hedge fund managers to register with the SEC so that they would required to open up their books for periodic inspections in an effort to "bring transparency and accountability to all corners of the marketplace" Labaton 2009; Aguilar 2009.

[172] US Treasury 2009a, 2009c.

[173] MFA 2004.

[174] MFA 2009d. According to the MFA, a "smart" regulatory approach would be based on the coexistence of industry best practices with the registration of hedge fund managers. MFA 2009e. MFA 2009a Also the London-based AIMA abandoned its opposition to direct regulation and it announced in February 2009 a new policy platform, supporting "a global manager-authorisation and supervision template based on the UK's FSA model" and the "principle of full transparency and supervisory disclosure of systemically significant positions and risk exposures by hedge fund managers to their national regulators". AIMA 2009a; 2009. fAIMA also supported the US legislation. See AIMA 2009d.

followed the collapse of Lehman and the bailout of AIG, and the need for Congress and other policymakers to respond to pressure from voters could also trigger restrictive legislative actions towards hedge funds.

Throughout the course of the crisis, hedge funds became increasingly aware that escaping closer scrutiny from regulators was no longer tenable. As a hedge fund manager put it, "It was inevitable that this would happen. From the time Congress had the industry's top hedge fund managers testify late last year, we knew something was coming."[175] While only 8% of the hedge fund managers surveyed by a consultancy firm at the beginning of 2008 expected increased regulation of the hedge fund industry, in February 2009 this percentage had risen to 98%.[176]

As hedge funds came to perceive the introduction of some sort of official regulation as inevitable after Lehman, they decided to publicly put their weight behind the form of public regulatory oversight that they regarded as most acceptable for the industry, that is, some form of registration of hedge fund managers. In fact, according to a report presented by the Government Accountability Office in 2008, 1,991 hedge fund advisers, including 49 of the largest US hedge fund advisers accounting for one-third of the hedge funds' assets under management in the United States, were already voluntary registered with the SEC.[177] The costs posed by this registration and the associated regulatory requirements were estimated as significant for some smaller funds. However, the regulatory burden was more manageable for the larger funds, which usually already had compliance officers in place, for instance.

The strategy pursued by hedge fund associations of endorsing hedge fund adviser registration as a way to forestall the imposition of more intrusive forms of regulation was successful. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 removed the exemption for hedge fund managers from the requirement to register with the SEC.

Besides the registration requirement, the legislation required hedge fund managers to comply with a number of recordkeeping and reporting requirements concerning the identity of their funds, their internal governance arrangements, and key service

[175] Herbst-Bayliss 2009; Mackintosh 2009.
[176] According to the same survey, in April 2008 96% of senior partners of US-based firms did not think regulation would increase in 2008. In November 2008, 98% of hedge fund managers expected tigher regulation under an Obama administration. As Roger Hollingsworth, managing director of MFA, argued in February 2009, Congress could be "aggressive" in 2009 responding to pressure from voters "to find out who to blame" for the financial crisis. Rothstein Kass 2009.
[177] GAO 2008.

providers, as well as their trading activities.[178] While before the crisis these disclosure requirements were directed towards the markets in order to enhance market discipline, these disclosure requirements were now designed to assist the SEC in policing hedge funds and identifying market abuses (e.g. insider trading and market manipulation). Moreover, the Dodd-Frank Act authorized the SEC to share certain systemic-risk data with the Financial Stability Oversight Council in order to permit an informed assessment of whether any fund has become so large, leveraged, or interconnected that it requires regulation for financial stability purposes.

However, as contemplated by the Dodd-Frank Act, under normal circumstances the action of regulators would not interfere with the investment and trading strategies of a hedge fund, nor would it seek to extend to hedge funds prudential regulatory requirements similar to those designed for banks. Similarly to the pre-crisis approach, the new regulatory framework continued to rely on the discipline imposed by bank counterparties as the primary strategy to restrict their risk-taking and the use of leverage. Overall, the US approach towards the regulation of the hedge fund industry has been described as more akin to "enhanced oversight" of hedge funds managers than a "granular approach" to closely regulate and constrain their investment activities.[179]

While the US legislation did not seek to limit the risk taking of hedge funds in normal circumstances, it introduced a second layer for those funds deemed to pose a threat to the stability of the financial markets.[180] In the case the Financial Stability Oversight Council determines that a single hedge fund or collectively a group of hedge funds pose systemic risk, these funds would be subject to prudential regulatory requirements that could increase leverage restrictions, capital requirements, or place restrictions upon their

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[178] This included the amount of assets under management, counterparty credit risk exposures, their trading and investment positions, the level of leverage, valuation policies and practices, types of assets held, and any other information that regulator may deem necessary.

[179] Richard Baker, president of the Managed Funds Association, quoted Gordon 2009.

[180] According to the US legislation, the SEC would share the information received on a confidential basis by the hedge funds regarding their trades with the Federal Reserve and the newly created Financial Services Oversight Council. In the case the Council determined that the size, leverage, and interconnectedness of a hedge funds or a group of funds could pose a threat to financial stability, they would be identified as "Tier 1 FHC", and therefore be subject to regulation and oversight by the Federal Reserve, which could impose requirements similar to those existing for banks, such as to place limits on the its activities and leverage, or impose liquidity standards. Similarly to banks, they would also be required to establish "living will", that is rapid resolution plans in the case the firm was victim of severe financial distress.Once registered with the SEC, this regulatory agency would collect on a confidential basis information with respect to amount of assets under management, borrowings, off-balance sheet exposures, counterparty credit risk exposures, trading and investment positions, and other important information. These disclosure requirements were meant not only to police hedge funds but also to collect data "that would permit an informed assessment of how such funds are changing over time and whether any such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes". The SEC would then share this information with a systemic-risk regulator, in particular the Federal Reserve and the newly created Financial Services Oversight Council. See US Treasury 2009b.

market activities. The granting of these “emergency” powers to regulators would allow regulatory authorities to intervene in those situations where market discipline fails, and it also represented an attempt to place the unprecedented measures that had been taken during the crisis by regulatory authorities in different countries on a more sound legal basis.

6.6 Conclusion

This chapter has analyzed the evolution of the international regime governing hedge funds since the late 1990s, explaining in particular the shift from the market-based regime that emerged after the failure of LTCM in 1998 to the direct regulation regime that emerged during the global financial crisis.

In particular, the first part of this chapter explored the source of the reliance on the indirect regulation and industry-driven codes of conduct that was codified in the first report released by the FSF in 2000 and would characterize the international agenda before 2009. It identified the origin of this reliance in the preferences of US federal regulators and their attempt to satisfy the demands of Congress for a regulatory response in the aftermath of LTCM. During this period, the decision to leave hedge funds outside of the direct scrutiny of regulators market-based arrangement was challenged both from the outside, especially from the German and French governments, and from various proposals emerging from within Congress. However, the weak salience of hedge funds within the United States weakened the incentives for Congress to introduce direct regulatory measures that were opposed by the hedge fund industry.

As the second part of this chapter discussed, the greater salience of financial regulation triggered by the crisis created a window of opportunity and reinforced the incentives for the French and German governments, as well as for policy entrepreneurs within the European Parliament, to reassert their long-standing priorities and to promote direct regulation of the industry at the international and European level. The agreement reached at the G20 London Summit on the regulation of hedge funds has therefore been interpreted as a victory of Continental European governments over the market-based approach endorsed by the countries where most hedge fund managers are located, the United States and UK.

This chapter has demonstrated that this shift in the public-private divide in the international agenda also needs to be understood as the product of the changes triggered by the crisis within the United States and UK. The key factor to interpret the shift in the international agenda and the new consensus around the principle of hedge fund manager registration was therefore the impact that the increase in the public attention towards financial regulation triggered by the crisis had in altering the incentives of elected officials, particularly members of Congress in the United States.

Moreover, a closer inspection reflects how the regulatory framework that was endorsed at the international level, based on the registration of hedge funds or their managers and the disclosure of information to assess the systemic risk, reflects very closely the approach brought to the negotiating table by US and British authorities.

The predominance of the preference for a relatively minimalist approach based on the regulation of hedge fund managers is visible not only in the content of the respective legislations introduced in Europe and in the United States, but also from the international agenda. In fact, the international standards drafted by IOSCO to inform the approach of its members to the regulation of hedge funds acknowledged that "some IOSCO Technical Committee members would favour the introduction of regulatory requirements at the level of the funds themselves to facilitate obtaining fund specific information and to get an overall picture of the risks posed by the funds."[181] However, the standards set by IOSCO have targeted hedge fund managers without presenting prudential regulatory requirements directed at the underlying funds.[182]

Indeed, these findings are consistent with those of Fioretos and others arguing that the positions of different countries on the international stage have been influenced by the attempt to defend their respective domestic regulatory approaches.[183] However, this analysis has highlighted how the differing levels of public attention towards the regulation of hedge funds have influenced changes in the position of policymakers across different "varieties of capitalism."

[181] IOSCO 2009b, p. 9.
[182] IOSCO justified this by arguing that not all IOSCO members are prudential regulators, and deferred this task to other standard setters and regulators.
[183] Fioretos 2010.

Chapter 7. Conclusion

7.1 Plan of the Chapter

What explains international financial regulation's shift towards greater direct public oversight of financial markets since the 2007-2010 crisis? The first chapter illustrated how, during the crisis, the main international regulatory institutions moved away from the market-based approaches that had emerged before the crisis. This analysis showed that international regulatory community's response to the crisis extended oversight for market actors and markets that were among the main culprits of the crisis, such as OTC derivatives markets and rating agencies, but also actors that played a rather peripheral role, such as hedge funds. Moreover, this study also revealed how the outbreak of the crisis in the summer of 2007 initially reinforced rather than undermined the market-based approach that had emerged before the crisis, as the response by international institutions such as the FSF repeatedly turned to the same market actors and demanded they make self-regulatory improvements.

In order to explain this shift in the international regulatory agenda, the previous three chapters traced through within-case analyses of the origins of the international regulatory regime governing OTC derivatives, rating agencies, and hedge funds before and after the crisis. This concluding chapter will instead look across cases to identify common patterns that may explain the shift in the public-private divide triggered by the 2007-2010 global financial crisis. The first part of this chapter (Section 7.2) will review the empirical evidence presented in the previous cases to explain the reliance on market-based governance measures that characterized the approach of international regulatory institutions before the crisis. Section 7.3 will then review the evidence presented in the three cases in order to explain the steps the international regulatory community took during the crisis to bring OTC derivatives markets, hedge funds, and rating agencies within the perimeter of public regulation.

While these two sections discuss to what extent the empirical evidence presented in the three cases supports the theoretical framework presented in Chapter 3, the final section of this chapter (Section 7.4) analyzes the implications of the argument for the broader literature on the politics of financial regulation.

7.2 "Quiet Politics" and the Pre-Crisis International Regulatory Regime

The empirical evidence presented in the three case studies provides some significant insights for evaluating different theories that explain the market-based nature of many international financial regulatory agreements in the fifteen years prior to the crisis. Analyzing the origin and resilience of an international market-based approach for regulating OTC derivatives, hedge funds, and rating agencies cannot be adequately explained by those functionalist theories of regulation that have traced the origin of these approaches in the characteristics and evolution of the financial markets being regulated. On the contrary, the empirical evidence presented in the three cases provides support to state-centric analyses that regard the emergence of international market-based governance mechanisms as reflecting the preferences of those countries that exercised the greatest influence over the international regulatory agenda. In line with realist arguments reviewed in Chapter 2, the cases traced the primary source of support for market-based solutions that characterized the agenda of international regulatory institutions such as the FSF and IOSCO over this period: regulatory authority preferences from the country hosting the greater number of derivative dealers, rating agencies, and hedge fund managers: the US. US authorities were not only able to internationally export homegrown market-based regulatory approaches, they also to vetoed proposals running against their position.

The empirical evidence presented in the three cases also provides some support to a number of explanations that have been presented in the literature to explain these national preferences. Similar to the arguments in historical institutionalist literature, US regulatory authorities have in different circumstances been able to form a common front with British authorities in opposing proposals from countries with a more extensive tradition of state intervention in the governance of markets. As argued by constructivist literature, the empirical evidence presented in the different cases confirms the ideological component that influenced certain regulatory authorities. The Federal Reserve repeatedly expressed its skepticism of what direct regulation could achieve in the area of derivatives and hedge funds and praised the capacity of markets to play a positive role in supplementing the limits of regulatory intervention. In fact, different regulatory authorities inside and outside these international regulatory institutions contested this view. German authorities called for directly regulating hedge funds and the CFTC in the US attempted to directly regulate OTCM derivatives. However, the privileged position of the Federal Reserve – described by Foot and Walter as a "first among equals" within the Basel Committee over this period[1] – and the market power of US regulators played a crucial role in vetoing these proposals and swaying the international approach towards market-based regulatory mechanisms.

Moreover, in line with "regulatory capture" theorist predictions, financial industry groups' lobbying and self-regulatory initiatives were among the most important factors that tilted the public-private divide towards greater reliance on market-based regulatory solutions. Transnational derivative dealers groups, hedge funds associations, and rating agencies benefiting substantially from avoiding a more formal regulatory regime have played a crucial role in deflecting calls for bringing these sectors under the direct regulatory oversight of public authorities. Not only have these actors directly lobbied at the transnational and domestic level, they also self-regulated their activities in order to address regulators' concerns and demonstrate the capacity of the financial industry to self-police itself. The failure of rating agencies to agree with US securities regulators on a voluntary framework in the US contributed to Congress' decision to reverse the industry's self-regulatory status.

International regulatory bodies' receptiveness to calls coming from the private sector to leave the regulation of OTC derivatives, rating agencies, and hedge funds in their hands was further strengthened by the dominance of ideas regarding the superiority of private sector expertise in the context of increasingly complex and dynamic markets, as stressed in the constructivist literature. International regulatory bodies such as the Basel Committee and IOSCO repeatedly sought out the views and expertise of financial industry groups. As Foot and Walter argue, since the dominant industry lobbies lost different battles, this could not be described as straightforward regulatory capture. However, these lobbies clearly exercised significant influence over the work of international regulatory bodies, whose regulatory policies went in the general direction favored by the regulated financial institutions.[2]

In sum, the dominance of US regulators in international regulatory bodies, the set of dominant ideas regarding the limits of traditional regulatory approaches for governing increasingly complex markets and regarding the benefits of market mechanisms, as well as the preferences and self-regulatory initiatives pursued by transnational financial

[1] Foot & Walter 2010, p. 244.
[2] Foot & Walter 2010.

industry groups, combined to create a strong force in favor of market-based regulation before the crisis. The strength of these forces is demonstrated by the fact that when several episodes of financial instability and corporate scandals brought OTC derivatives, hedge funds, and rating agencies into the regulatory agenda throughout the 1990s and early 2000s, these events did not result in the introduction of policies to directly regulate these markets and institutions. Johnson and Kwak argued (about the regulation of derivatives in the US): "Someone familiar with the history of the financial system might have expected this record of disaster to lead to greater skepticism of financial innovation and closer oversight of the industry. Instead the 1990s witnessed the final dismantling of the regulatory system constructed in the 1930s."[3]

While the case studies analyzed in this study provide strong empirical support to some of the main explanations presented within the IPE literature, they also point towards the level of public salience as a key enabling condition for the persistence of market-based regulatory mechanisms that this literature has neglected. The lack of sustained public attention towards the regulation of derivatives and hedge funds in the US has weakened the incentives for the US Congress to support more direct regulatory approaches opposed by their domestic financial industry, while increasing the incentives to defer to regulatory agencies, which have rather consistently supported market-based solutions over this period.[4]

A closer analysis of different regulatory initiatives' roots reveals the impact of this "quiet politics" environment on the direction of international governance arrangements. The initiatives, including the 1994 IOSCO and BCBS standards on derivatives published in 1994, the 2004 IOSCO Code of Conduct for Rating Agencies, and the 1999 FSF report on hedge funds regulation, cemented the market-based approach towards the regulation of OTC derivatives, rating agencies, and hedge funds in the years before the crisis.

The roots of these international standards can be traced to different shocks that temporarily increased the level of public awareness over the activities of these markets and institutions in the US. These shocks are respectively the Orange County derivatives scandal of 1994, the Enron bankruptcy in 2001, and the averted bankruptcy of LTCM in 1998. These shocks generated very a similar reaction pattern from politicians, regulators, and interest groups in the US that can be summarized in three steps.

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[3] Johnson & Kwak 2010. p. 89.
[4] Foot & Walter 2010, p. 245.

First, heightened public attentiveness created incentives for different members of Congress to present legislative proposals seeking to bring these markets and institutions under more formal regulatory oversight. In 1994, different bills were presented to directly regulate derivatives markets in the US, such as the Derivatives Supervision Act of 1994 (H.R. 3748), the Derivatives Safety and Soundness Act of 1994 (H.R. 4170), the Derivatives Limitations Act of 1994 (S. 2123), and the Derivatives Dealers Act of 1994 (H.R. 475). The collapse of the hedge fund LTCM in 1998 led the House Committee on Banking and Financial Services to hold a hearing on the issue, questioning the president of the New York Federal Reserve, William McDonough, and the chairman of the Federal Reserve Board, Alan Greenspan, on the implications for the regulatory oversight of hedge funds. Similarly, the Enron scandal had the effect of "forc[ing] a reluctant Congress to act" by passing the Sarbanes-Oxley Act.[5] While the scandal and subsequent legislation focused on corporate governance issues and auditors, the bill also demanded that federal regulators to study regulatory possibilities for ratings agencies.

Second, the appearance of derivatives, hedge funds, and rating agencies on the Congressional agenda altered regulatory agencies' incentives and forced them to take action in order to reassure their political controllers. However, in none of these cases did US regulatory agencies urge lawmakers to bring these three sectors within the perimeter of public regulation. On the contrary, their recommendations were directed primarily at the financial industry by endorsing self-regulatory steps to improve the safety of these markets or to solicit further measures. In the case of OTC derivatives, the major federal regulatory authorities, starting with Alan Greenspan, testified in front of Congress and endorsed the steps taken by private market actors to establish a self-regulatory infrastructure. These witnesses opposed calls for direct oversight. The SEC convened the five firms who accounted for the most derivatives business to form the Derivatives Policy Group. In the case of rating agencies, the SEC considered directly overseeing rating agencies did in the end did not ask Congress to grant it authority to do so. The SEC decided instead to work with the rating agencies to develop a voluntary oversight framework. In the case of hedge funds, the President's Working Group in 1999 released a report that rejected direct industry regulation but asked hedge fund managers to draft codes of best practices to improve their risk management.

[5] Culpepper 2011, p.159.

Third, the market power and prestige of US regulatory authorities during these periods allowed them to export their preference for a market-based approach at the international level when the shocks described above brought the regulation of derivatives, hedge funds, and rating agencies on to the agenda of the main international regulatory bodies. The market-based approach towards the regulation of derivatives endorsed by federal regulatory authorities in the aftermath of the scandals of 1994 also informed the approach endorsed at the international level by the Basel Committee and IOSCO later that year. In 1999, the Financial Stability Forum's recommendations and its rejection of a direct regulatory approach closely resembled the approach presented in the US by the President's Working Group. IOSCO did not recommend a government-based implementation for its Code of Conduct for Rating Agencies, although the same European regulatory authorities did endorse this market-based solution.

In other words, the origin of the different international regulatory initiatives in the two decades before the crisis solidified the market-based approach to the regulation of derivatives, rating agencies, and hedge funds at the international level can be found in the preferences of US regulators and the measures taken at the domestic and international level in order to restore the confidence in these markets and reassure their politicians. These dynamics are compatible with Singer's model of international regulatory cooperation.[6]

However, we also need to consider US Congressional deference to the preferences of federal regulators and the financial industry in order to understand the resilience of these market-based approaches before the crisis. The case studies have revealed how the market-based solutions supported by the Federal Reserve and SEC to improve the regulation of derivatives and hedge funds were embraced also by Congress without pushing for more stringent measures.

The different legislative proposals introduced within Congress to directly regulate derivatives markets in the eve of the scandals of 1994 and to regulate hedge funds in the eve of LTCM never left their respective Congressional committees. Moreover, while other legislative proposals seeking to force hedge fund managers to be subject to the direct oversight of securities regulators were presented within Congress in 2005-2006, these proposals failed to gain traction within the Congress at large.

[6] Singer 2007.

The Clinton administration's admiration of Greenspan and the weight of the financial sector's contribution to federal election financing[7] during this period explains Congress' deference towards securities regulators' position.[8] However, an additional factor explaining the attitude of Congress during this period is the fact that the different shocks and scandals over this period generally failed to raise the public salience of these sectors in a long-lasting way. Therefore, Congress had no to interfere with arrangements designed by the financial industry and endorsed by regulators.

The losses provoked by the scandals involving derivatives in 1994 remained limited and geographically localized, failing thus to raise significant support for the introduction of formal regulation across the whole Congress. Similarly, while the main investment banks' private bailout that prevented LTCM's collapse from impairing US financial markets was orchestrated by the Federal Reserve, it did not require the use of taxpayers' money. In other words, the decision of international regulatory institutions over this period to delegate regulatory responsibilities to the private market actors and the resilience of the international self-regulatory regime governing these markets and institutions in the years before the crisis remained in part dependent on a certain level inattentiveness from the public, thus confirming Culpepper's analysis of the politics of corporate governance.

Rating agencies are the key exception in the analysis of pre-crisis years. The US Congress has contested the plan pursued by the SEC to create a voluntary regulatory framework for ratings agencies and, in 2006, it passed a bill (Credit Rating Agency Reform Act) that ended the industry's self-regulatory status in the US. This decision is puzzling when analyzed through the lens of the theoretical argument developed in this study. On the one hand, the Enron and Worldcom scandals increased rating agencies' public salience more than any other past scandal involving rating agencies, derivatives or hedge funds during the pre-crisis period. At the same time, Congress' decision to legislate came at a moment when the degree of public salience had decreased significantly. It is therefore important to consider complementary explanations for Congress' decision bringing rating agencies under the SEC's direct oversight, such as the fact that the Sarbanes-Oxley Act had already set in motion the legislative process, that the legislation raised only limited international competitiveness concerns, and that

[7] Foot & Walter 2010, p. 253.
[8] Foot & Walter 2010, p. 252.

the ratings agencies and securities regulators had failed to negotiate a viable self-regulatory alternative.

However, with the important exception of Enron, the fact that the different shocks and corporate scandals involving hedge funds, rating agencies, and OTC derivatives over this period did not generate significant negative externalities beyond the market actors directly involved limited the public salience of regulatory debates over these industries. As a result, the domestic and international debates concerning their regulation received very limited attention and scrutiny outside of the regulatory authorities and the market players more directly affected by the regulation.

In a nutshell, this environment of domestic "quiet politics" in the dominant country – the US - was an important, although silent, enabling factor for the delegation of international regulatory responsibilities to private market actors.

7.3 The Financial Crisis of 2007-2010 and the Politicization of Financial Regulation

The global crisis of 2007-2010 undermined the domestic bases of international regulatory cooperation that emerged during this period of "quiet politics". The case studies and media coverage analysis have highlighted how the financial crisis had revealed substantial market and regulatory failures not only to regulatory community and experts, but also to the broader public. However, the pattern of public attention to financial regulation has not necessarily mirrored that of the regulatory community. The initial breakdown of the crisis in the summer of 2007 did not significantly raise the salience of financial regulatory issues in the US press.

The initial US regulatory response to the financial crisis closely resembles the dynamics described in the pre-crisis period. US regulatory authorities occupied the driving seat and, like in the pre—crisis period, their initial response to the regulatory shortcomings primarily relied on soliciting self-regulatory improvements from the financial industry. Along the same lines, numerous financial industry groups also responded to the initial shock by introducing different self-regulatory measures to deflect the threat of more stringent regulation. These measures contributed to deflecting Congress' attention. During first year of the crisis, Congress largely deferred to regulators in charting its regulatory response and remained largely uninterested in financial regulatory issues.

However, unlike the episodes of financial instability and corporate scandals that had triggered only a short-lived increase in the level of public attention, the intensification of the financial crisis in 2008 contributed to a steady increase public attention towards financial regulatory issues. This pattern of rising public attention towards financial regulatory issues significantly altered the incentives for elected policymakers to get involved in financial regulatory debates.

In the United States, the crisis' overlap with the Presidential election in the summer of 2008 made financial firms an issue during the electoral campaign. The Republican candidate John McCain promised to act in a decisive way against those "very greedy people that happen to be in Wall Street today"[9], while the Democrat candidate Barack Obama accused his opponent of endorsing the same free-market philosophy that was at the origin of the crisis.[10]

The collapse of Lehman Brothers in September 2008 and the passage of the Troubled Assets Relief Program had the effect of bringing financial regulation directly onto Congress' agenda. Moreover, unlike the corporate scandals of 1994 that triggered the first wave of Congressional activism in the regulation of derivatives and the collapse of LTCM in 1998 which focused Congress' attention on regulating hedge funds, the decision to bailout financial institutions using government funds represented a very visible socialization of the costs imposed the crisis. These costs were not concentrated on a single constituency, nor internalized by the financial firms involved. As the figure below shows, debates on the regulation of sectors for which no immediate public money had been disbursed (hedge funds, rating agencies) also entered prominently the Congressional agenda at the beginning of 2009.

A series of Congressional hearings following the bailouts led Congress to question the role of different market actors in the crisis, as well as regulators in preventing this from happening. However, Congress' role went beyond simply questioning regulators' inaptitude in preventing the crisis. Since the fall of 2008, numerous Congressmen have introduced new legislative proposals to regulate derivatives, rating agencies, and hedge funds. In some cases, lawmakers took advantage of the changed political climate to re-introduce legislative proposals firstly presented during previous Congressional sessions.

While in the past these legislative attempts had failed to gain significant support, the different political climate triggered by the bailouts ensured a different outcome. It became electorally unpopular for most members of Congress to openly oppose measures to extend the regulatory net over markets and institutions involved in the

[9] Quoted in Ward 2008.
[10] Kiely 2008.

crisis, or to support the delegation of regulatory functions to the same market actors that had so spectacularly failed during the crisis. As Foot and Walter argues, “in a now Democrat-controlled Congress, many politicians turned with a vengeance against the philosophy of market-based regulation that had played an increasingly influential role in the Greenspan years. The large public sector bailouts of leading Wall Street banks and the political furor over financial sector compensation practices also undermined the legitimacy of the Fed-money center bank coalition that was now widely seen as having dominated regulatory outcomes over the previous decade”.[11]

In line with partisan theories of regulatory politics, the Democratic party had a larger capacity of reaping electoral rewards by promoting stringent reforms. Republican Congressmen have frequently denounced – in the words of the Republican Senator Gregg – the existence of “a movement in this country and in this Congress, unfortunately, which I call pandering populism, which just simply dislikes anything that has to do with Wall Street”.[12]

Mainstream media coverage of the legislation’s progress in Congress has played an important role in driving the passage of the Dodd-Frank “Wall Street Reform and Consumer Protection Act”. This bill completed its lengthy legislative itinerary in July 2010, at the peak of public attention towards financial regulation, and the role of the public opinion in shaping the bill was acknowledged by the same Rep. Barney Frank, who has argued: "once public opinion got engaged, it blew away the lobbyists, the money, campaign contributions. Public opinion drove that bill."[13]

However, the crisis’ impact for turning financial regulation into a “high issue salience” area has not been limited to the US. The crisis’ global reach also increased coverage of financial regulatory issues in Europe. Like in the US, Europe saw an initial spike in media coverage of financial issues followed by a weakening in the end of 2007 and a significant and steady increase since the second quarter of 2008. Unlike in the US, the mutation of the banking crisis into a sovereign debt crisis prolonged the attention of the media towards financial regulatory issues also after the middle of 2010.

Moreover, unlike the previous shocks that raised the level of attention around derivatives, hedge funds, and rating agencies, the crisis’ intensification in the fall of 2008

[11] Foot & Walter 2010, p.245.
[12] Gregg 2010; Lakshman 2010.
[13] Montgomery & Merle 2010.

significantly shifted elected European policymakers' incentives both at the European and national levels.

The crisis particularly enhanced policy activism in Continental European countries, that is those governments that in the past had been more active on the European stage in criticizing the lack of more stringent regulations and calling for more stringent regulations of rating agencies and hedge funds. More specifically, key figures such as the French President Nicolas Sarkozy and the German Chancellor Angela Merkel criticized the US and the UK governments for having placed excessive confidence in the capacity of financial markets to self-regulate.[14]

Not only did the crisis open a window of opportunity for these actors to bring in the European and international agenda positions expressed before the crisis, but financial regulators' higher public salience strengthened politicians' incentives to intervene directly and to be perceived as championing these measures. Moreover, the greater salience of regulation within Europe also altered the incentives for politicians within what had been in the past the main veto-player within the European Union on financial regulatory policies: the UK. The crisis has made it more difficult for the British government to maintain its traditional opposition to any attempt to regulate these sectors at the European level in order to defend the position of the City of London, especially after the British government was forced to extend an unprecedented safety net to the British banking system.

In a nutshell, the unprecedented level of public attention towards financial regulatory issues significantly altered the conditions that had in the past led politicians in the US and in Europe to support market-based regulatory mechanisms. Instead, the crisis created strong electoral incentives for domestic elected policymakers to introduce visible measures to increase the regulatory oversight of financial markets. It is important to point out how the main mechanism through which the changed political climate triggered regulatory change was not primarily by favoring the emergence of new regulatory approaches. Rather, it was to create greater political momentum behind proposals and initiatives that had in many cases emerged before the crisis. From this perspective, the US's leadership in the international derivative regulation does not only reflect the greater salience of the issue in that country, but also the fact that a debate over the regulation of this sector had taken place within Congress and among US regulatory agencies before

[14] Cody 2008; Erdem 2008.

the crisis. Similarly, European leadership in promoting an international agreement over the regulation of hedge funds reflected the fact that the regulation of the sector had been an important issue within the European Parliament and for the German and French government. The impact of the greater salience of financial regulation triggered by the crisis has therefore been primarily of generating momentum behind these proposals by altering the incentives of elected politicians.

Existing models of international regulatory cooperation in finance had focused primarily on periods of temporary high salience, and are therefore not relevant to these particular circumstances. Since 2008, elected politicians have gone beyond simply altering the incentives of regulatory authorities and indirectly affecting the process of international regulatory coordination within technocratic bodies, as described by Singer. They have instead designed regulatory policies that in some cases went openly against the preferences of regulatory authorities.

It is important to notice how this shift in the balance of influence over the content of regulatory policies between elected politicians and regulators has not been limited to the national level, but has also extended to the international level. During the initial phase of the crisis transnational regulatory bodies composed by regulatory authorities operated largely insulated from direct political pressures. Indeed, when the G20 leaders met for the first time at the Leaders' level at the Washington Summit in November 2008, their agenda closely resembled the one previously identified by the Financial Stability Forum, while their conclusions did not depart significantly from the preferences of regulators.[15] As the crisis progressed, subsequent G20 meetings interfered more significantly transnational technocratic bodies by defining their agendas and assigning stringent deadlines.[16]

This dynamic also informed the regulation of the three industries analyzed in this study. G20 leaders meeting for the first time at leaders' level at the Washington Summit in November 2008 departed from market-based approach that informed the IOSCO Code of Conduct for rating agencies, demanding instead that regulators work towards a regime based on the registration and direct oversight of rating agencies with securities regulators. During the next summit in London in April 2009, G20 Leaders abandoned the indirect approach that had characterized the regulation of hedge funds and endorsed a regime based on the direct regulation of hedge fund or their managers. Finally, at the

[15] Helleiner & Pagliari 2009c.
[16] Helleiner & Pagliari 2011.

following summit in Pittsburgh in September 2009, G20 leaders set some stringent guidelines regarding the mandatory trading and central-clearing of OTC derivatives. In all these circumstances, the G20 leaders openly departed from the approach formally supported by technocratic bodies such as the FSF and IOSCO.

This focus on the level of issue salience and the impact in shaping the incentives of elected politicians is important to explain two important aspects of the international regulatory changes that cannot be adequately explained by the other theoretical explanations reviewed in Chapter 2. One of these is the timing of the shift in the public-private divide. As argued above, the outbreak of the crisis in the summer of 2007 and the acknowledgment of important regulatory failures did not coincide with a shift in the public-private divide and the initial international regulatory response was characterized by the continuation of the same market-based regulatory approach that had emerged before the crisis. This continuity with the pre-crisis period in the international approach across the three cases reflected the continued primacy of regulatory authorities in setting the parameter of the initial regulatory response to the crisis at the domestic and international level, before the bailouts and the intensification of the crisis in the last part of 2008 significantly increased the public attention towards finance.

Moreover, the increase in the salience of finance issues across the board is important to explain why the international regulatory community has departed from the pre-crisis focus on market-based regulation in sectors that had played a rather peripheral in the crisis but which came to attract significant attention during the crisis.

In sum, the impact that the varying degrees of heightened public salience of financial regulation had over the incentives of elected politicians in the main jurisdictions that dominate international financial negotiations represent a key element in explaining the changes in the international regulatory agenda and the reversal of the market-based approach that had been endorsed by international regulatory institutions before the crisis.

7.4 Implications for the Literature

The theoretical framework presented in this study and the empirical evidence presented the cases not only to shed light over the nature of the change in the international regulatory agenda triggered by the crisis, but also have broader implications for the literature on the politics of international financial regulation.

This study's first contribution is on the domestic political foundations of international regulatory cooperation. As argued in Chapter 3, this is not the first study to investigate how domestic public opinion might influence international financial regulatory coordination. However, the existing literature has presented very different accounts of this influence. One element of disagreement is the extent to which international regulatory policies are constrained by public opinion. Some authors highlight how international regulatory policies are designed within transnational policy communities insulated from the broader public, while other argue that this influence may be significant but only in the aftermath of crises. Another element of disagreement pertains to the mechanisms through which public opinion will shape the content of regulatory policies, with some authors focusing on the way this will alter the incentives of regulators and others instead paying attention to the electoral incentives of their political overseers.

This study has sought to complement this literature by illustrating the impact that different degrees and lengths of public salience have over the incentives of elected officials, and therefore on the balance of influence between bureaucratic regulatory agencies and their political overseers. The analysis has revealed how, during periods of sustained high salience, public opinion's impact international regulatory cooperation is more significant than most accounts of financial regulatory politics acknowledged. It goes beyond simply altering the incentives of regulators as in the scenario depicted by Singer.[17]

Instead, the empirical evidence presented in this study has demonstrated that the shift in the international approach towards the regulation of rating agencies, hedge funds, and derivatives is primarily the product of the greater activism of politicians. During a period of lasting high salience, politicians have not only placed constraints upon the regulators' actions of regulators at the domestic level, but taken upon themselves the role of rule-setters.

This study has also discussed how this shift in the balance of influence between regulators and political masters during periods of high salience is not limited to the domestic level as discussed in existing accounts of international regulatory politics. It

[17] Singer 2007.

can also extend to the transnational level.[18] The evidence presented in this study reveals how the G20 has interfered more extensively in the activities of transnational regulatory bodies. In sum, the degree of public salience of different financial domains represents an important variable influencing ideas behind the policymaking process that develops and implements financial rules.

Besides representing an additional driver of change in international regulatory policies, regulatory policies' salience also influences the conditional scope for some of the other factors identified by the literature reviewed in Chapter 2. For instance a number of studies have highlighted the capacity of trans-governmental regulator networks to leave an independent mark on international regulatory change. The evidence presented in this study suggests that regulatory authorities' influence over international regulatory coordination is dependent on regulation's public salience level. During periods of "quiet politics", regulators will enjoy significant autonomy in setting the regulatory agenda at the domestic and international level. For instance, they can determine how regulatory policies will allocate regulatory responsibilities between public and private actors. However, during periods in which financial regulatory politics are highly salient, transnational regulatory networks' autonomy from domestic political constraints, and the constraints posed by the public opinion, will decrease.

As a result, the degree of salience conditions the influence of other elements that the main IPE theories have identified as shaping these institutions' work. For instance, while functionalist accounts of regulatory policies describe regulators as responding to efficiency considerations when determining the extent of regulatory intervention, during periods of high salience politicians responding directly to electoral incentives may demand that regulators implement more extensive regulatory policies than those justified purely on grounds of efficiency.

Moreover, the degree of salience will also affect the influence of the financial industry. As reviewed in Chapter 2, an important literature has investigated the different mechanisms through which the financial industry influences the regulatory process. While these works have highlighted numerous factors explaining this influence, they are less equipped to explain why financial industry groups sometimes lose. This study's findings are puzzling for this literature, since the reassertion of direct regulatory oversight during the crisis occurred against the preferences expressed by the main derivative

[18] Helleiner & Pagliari 2011.

dealers groups, hedge fund associations and rating agencies in the years before the crisis.

The analysis in this study suggests that public salience conditions financial groups' influence. As argued by different interest group theorists, groups seeking to defend the status quo will benefit from a lack of sustained public attention. This was also the case in areas analyzed in this paper. The main US derivative dealers, rating agencies, and hedge fund groups benefited from close relationships with their home-country regulators. But the increase in the level of public salience disrupted this pattern and increased politicians' engagement in the regulatory process, politicians that were subject to strong electoral pressures to endorse more extensive forms of regulation.

The change in public salience also directly affected the financial industry' advocacy strategy. The case studies revealed how during periods of low salience derivative dealers, hedge fund groups and rating agencies have reacted to different shocks that threatened their regulatory status by introducing incremental adjustments on a self-regulatory basis. The change in the level of salience has led leading financial industry groups to alter their lobbying strategy to this high salience environment.

With their sector's mishaps in the public spotlight, derivative dealers, hedge fund managers, and rating agencies have found it strategically counterproductive to resist attempts to bring their activities under the direct oversight of regulatory agencies. Instead, the increase in salience during the second stage of the crisis has led the main associations representing derivative dealers, hedge fund managers, and the same rating agencies to provide support for official regulatory frameworks. [19] In 1994, when different legislative proposals to regulate derivatives entered the Congressional agenda, a coalition of financial sector groups claimed that the Bill was "unnecessary" and that, if passed, it would increase the cost of risk management, and that market liquidity would decline.[20] This time around, however, the changed political climate within Congress forced financial dealers to abandon their opposition to mandatory regulation of the sector. For instance, the International Swaps and Derivatives Association (ISDA) immediately endorsed the legislation introduced by the US Treasury, describing it as "an important step toward much-needed reform of financial industry regulation."[21]

[19] Pagliari & Young Forthcoming.
[20] Brickell 1994.
[21] ISDA 2009.

In the beginning of 2009, the main hedge fund association – the MFA – also changed its position and threw its weight behind the proposals to force hedge funds to register with the SEC and meet disclosure requirements,[22] a move that MFA had opposed during the crisis.[23] When the regulatory clampdown started to appear inevitable, rating agencies endorsed the principle that their activities should fall under national authorities' regulatory oversight.[24] In sum, it is true that the financial industry remains the most important societal stakeholder in financial regulatory politics. Nonetheless, this analysis' focus on issue salience suggests that its capacity to "capture" must be regarded as contingent on politicians' receptiveness of to its claims.

Finally, the analysis of the emergence and decline of the market-based approach towards the regulation of finance has some implications for the broader literature on global governance. More specifically, a number of authors have in recent years investigated the sources of the greater reliance on "private authorities" in the global economy[25], or a "privatization of regulation in the world economy"[26], or the rise of "transnational private governance".[27] While presenting different interpretations of the origins of this turn, most of these analyses tended to describe it as a structural shift in the governance of the global economy. Few authors have openly discussed and theorized on the possibility of a return towards more state-based forms of governance in the global economy.[28]

The reassertion of a more state-based form of regulation in the governance of international financial markets comes with an important cautionary note. This study provides empirical support for the argument made by Culpepper at the domestic level regarding the importance of a certain degree of inattentiveness from the public as a condition for the resilience of informal or industry-based governance arrangement.[29] Most importantly, it suggests that the insights presented by Culpepper are also important to understand how international policies allocate regulatory functions between state-based and market-based mechanisms. A crisis or other large-scale event that significantly raises the level of public salience of a certain domain in the countries that

[22] MFA 2009d.
[23] MFA 2004.
[24] S&P's 2009b; Moody's 2009.
[25] Cutler et al. 1999c; R. B. Hall & Biersteker 2003.
[26] Buthe & Mattli 2011.
[27] Graz & Nolke 2008b.
[28] Pauly 2003.
[29] Culpepper 2011.

dominates the international regulatory process is likely to represent an important threat to the resilience of other global private governance arrangements.

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