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Citation Details

Cristie Ford, "Financial Innovation and Flexible Regulation: Destabilizing the Regulatory State" ([forthcoming in 2014]) 18 NC Banking Inst J 27.

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FINANCIAL INNOVATION AND FLEXIBLE REGULATION: DESTABILIZING THE REGULATORY STATE

BY CRISTIE FORD*

Cristie Ford examines the regulatory failures leading up to the financial crisis, the rise of "flexible regulation," the effects of financial innovation on regulation, and three different case studies that illuminate the drastic effects of that innovation: the Basel II banking regulations, the Canadian Asset-Backed Commercial Paper market, and the process for writing the Volcker Rule. Finally, Ford examines the underlying assumptions that should be re-examined in order to create more effective regulatory policies.

I write in the fields of securities and financial regulation, but I am primarily a scholar of regulation and governance. For the last few years I have been trying to take stock of the zeitgeist not only in finance, but also in regulation.

I do not let financial institutions off the hook for their own egregiously bad conduct in the era leading up to the financial crisis, and I do not mean to underplay the direct causal link between that poor conduct and the crisis itself. However, my focus here is on the regulatory failures and gaps that also existed in the time leading up to the financial crisis. In our post-mortem analyses of pre-crisis regulation, there has been a lot of talk about the impact of market fundamentalism on financial regulation; about overreliance on the efficient market theory; and about excessive adherence to Hayekian political philosophy,[1] which asserts that information is always decentralized and therefore no central regulator (unless it is part of a totalitarian state) could possibly have enough information to actually regulate well. I think all of these are important factors, which materially contributed to substantial deregulation both nationally and internationally in the lead-

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1. See FRIEDRICH A. HAYEK, THE ROAD TO SERFDOM (1944) (arguing that adherence to classical economic liberalism and minimal government interference are the best safeguards against tyranny).

up to the crisis. Along with these factors, those years also saw regulators bend to intense pressure to reduce the so-called "regulatory burden" in light of transnational competition for capital markets business. David Skeel's argument that financial regulation in this era was corporatist — that it was premised on a problematic sort of elite partnership between government and financial institutions — is also persuasive.[2]

Yet some of the things that were wrong with regulation, roughly between the fall of Enron in 2002 and the height of the financial crisis in fall 2008, were also of a different nature. I think it is clear that market fundamentalism, regulatory competition and neo-Hayekian thinking contributed to an erosion of regulation, but there were also a lot of progressive, non-Hayekian regulatory scholars who were advocating new forms of regulation in this era. Generally speaking, their prescriptions also accorded substantially more freedom to private actors than had been the case previously. I want to think about why that was the case.

Scholarship on regulation and governance exploded, and changed, starting in the early 1990s. This was the post-Thatcher, post-Reagan era of Al Gore's Reinventing Government initiative, Tony Blair's Third Way, and important new scholarly contributions like Ian Ayres's and John Braithwaite's 1992 book, *Responsive Regulation*.[3] An increasingly sophisticated regulatory tool kit emerged transnationally, which continued to evolve through the early years of this millennium and which evolves today. In securities regulation, the conversation took the form of a debate about the relative merits of "rules based" and "principles based" regulatory strategies. In the United States, there was a lot of interest in the distinction following the fall of Enron (sometimes blamed on overly bright line, rules-based accounting standards) and the rise of London as a financial center (sometimes attributed to its more principles-based regulatory approach). The rules-versus-principles conversation, along with a separate conversation about corporate social responsibility and ways to enlist corporate actors into the service of broader social norms, can be understood as contextual examples of a

2. DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2010).

3. IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992).

broader trend in scholarship and policy making toward what I call "flexible regulation."

Regulatory scholarship is a big tent. At the same time, a move toward more flexible regulation has been discernible across topic areas over the last two decades or so. Flexible regulation comes in different varieties too, but one commonality is a new emphasis on regulatory sensitivity to, and tailoring to, context. The idea is that it is possible to move away from one-size-fits-all, prescriptive regulation toward an approach that is more context sensitive, pragmatic, and data-driven. Flexible regulation also aims to be better at recognizing and leveraging other compliance-enhancing forces in society. It treats different regulated entities differently: it collaborates with private actors where possible and accords them a great deal of freedom to comply with regulatory goals as they see fit, but it ratchets up the oversight on non-cooperative actors. It pulls in non-state actors. It tends to accept that state regulators do not always have the same access to or quality of information as regulated actors, which is one reason that it tries to "steer not row" or (using another phrase) to "regulate at a distance." It tends to be permeable and interactive, not top-down and directive. As a result, the idea is that flexible regulation can reach out to and incorporate community norms, individual morality, market forces, market or media pressure, and any other forces that can help strengthen the arm of regulation.

In addition, I would argue that flexible regulation is characterized by a notion that regulation ought to be dynamic and iterative. The idea is that regulation should be able to learn from its own experience, and modify its own behavior in light of that learning. Under the broad flexible regulation umbrella are some approaches, like meta-regulation, management-based regulation, or safety case regulation, that especially embrace contingency and a learning-by-doing approach. Meta-regulation is the term used by Christine Parker, an Australian scholar, to describe her "triple loop learning" approach to corporate governance and corporate social responsibility.[4] Management-based regulation is David Lazer's and Cary Coglianese's term to describe a similar approach across several regulatory sectors in the United States, which "directs regulated organizations to engage in a planning process

4. CHRISTINE PARKER, THE OPEN CORPORATION: SELF-REGULATION & CORPORATE CITIZENSHIP (2000).

that aims toward the achievement of public goals, offering firms flexibility in how they achieve public goals."[5] Some of the work I have done on principles-based securities regulation is probably analogous.[6] The claim is that, rather than trying to manage the details in a particular regulated entity, regulators should be able to approach their task at a systems level. Compliance systems and industry conditions are in a constant state of flux, so the trick for regulators is to focus on the meta-level — on how well regulated entities manage themselves, learn from experience, and respond to new challenges. This focus also frees the regulator from having to worry about the compliance details within any particular regulated entity, though the regulator will still have to be able to make good judgments at the meta-level. Christine Parker calls this the "regulation of self-regulation."[7]

For example, a financial regulator should be able to assess the quality of the internal compliance and risk management mechanisms that a financial institution has in place. The regulator would assess whether or not the firm has in place effective policies and procedures to detect and prevent internal violations of law, and to model and then mitigate the risks it is running in the course of its business. So long as the regulator can identify what a good compliance system looks like and determine whether the firm has one, and so long as the firm's compliance outcomes fall within a range of permissible outcomes, broadly defined, then the firm should be able to regulate itself within those bounds. It should be able to devise its own systems — its own processes for meeting the prescribed regulatory goals — with the benefit of its fine-grained understanding of its own business.

This "regulation of self-regulation" approach was a characteristic of some important regulatory initiatives in financial regulation in the pre-crisis era. In fact, quite a lot of rhetoric at the time suggested that more meta-regulatory, principles-based methods had the potential to improve regulatory performance along all matrices at once. This was not just a deregulatory or market fundamentalist project — it was far more broad-based than that. For example, John Tiner, CEO of

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5. Coglianese & Lazer, *Management-Based Regulation*, 37 LAW & SOC'Y REV 691, 691 (2003).

6. Cristie Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, 55 MCGILL L. J. 257 (2010).

7. PARKER, *supra* note 4.

the U.K. Financial Services Authority during this era, said in 2006 that principles-based regulation could produce simply "better" regulation, which would mean *simultaneously* "(1) a stronger probability of statutory outcomes being secured, (2) a lower cost, and (3) more stimulus to competition and innovation all at once."[8] (Note the reference to stimulating innovation.) This was part of what was going on in this time period.

Tiner's quote points to another way to understand our regulatory choices in this time period, which really derives from the new regulatory drive to be dynamic and context-sensitive, and to pull private actors' own contextual knowledge into the regulatory process. An important but under-examined factor is the relationship between regulation and the phenomenon of private sector innovation. Flexible regulation is built to function in the midst of constant change. Pulling in contextual information from firms' matters because that information is complex and constantly changing. Firms' internal compliance strategies are of interest to regulators because firms know more about their fast-moving businesses than regulators ever could. Regulators are seeking to link to firms' internal compliance mechanisms, which in turn are trying to keep up with business risks — and in financial firms, those business risks were very often the constantly shifting byproduct of fast-moving financial innovation. So, without consciously trying to, some regulatory regimes of the meta-regulatory variety ultimately lost any purchase from which to question private actors' for-profit innovations, and even ended up embedding them into their very regulatory processes and standards in an effort to create regulatory architecture that could channel and keep up with that innovation.

In finance, the particular form of private sector innovation I'm interested in really has to do with the disaggregation and recombination of what were formerly tightly bundled bits of property, and therefore risk. While flexible regulation appreciated the need to keep up with a changing field, what it did not appreciate was just how profoundly destabilizing that degree of innovation would be for regulation itself. It

8. John Tiner, Chief Executive, FSA, Speech at the SII Annual Conference: Better Regulation: Objective or Oxymoron (May 9, 2006), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_jt.shtml; *see also* Clive Briault, Managing Director, Retail Markets, FSA, Speech at ABI 2007 Conference: Principles-Based Regulation — Moving from Theory to Practice (May 10, 2007), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0510_cb.shtml.

was destabilizing to the boundaries of regulatory arenas and destabilizing to some of the assumptions that underpinned regulatory regimes.

In this talk, I point briefly to the Basel II Accords around capital adequacy as an example of a meta-regulatory regime that embraced private sector innovation and private ordering around it, without appreciating how destabilizing that innovation actually was. A second category of regulatory approaches to innovation are those that attempt to establish boundaries and preconditions to innovation through a series of parameters on the scope of the market. These strategies assume that innovation can be contained, and that within pre-set boundaries the market can be counted on to produce predictable and manageable sorts of innovation outcomes. This is mistaken too. In this second category would fall the securities law regime around asset-backed commercial paper ("ABCP") in Canada, and there are similar mechanisms in the United States. A third category would include older regulatory structures that do not actually try to respond to the impact of innovation in the same conscious way, but nevertheless are affected by it. Notice and comment rulemaking under the U.S. Administrative Procedure Act, particularly around the so-called Volcker Rule, is my example here.

I use the term "innovation framing regulation" to try to foreground the relationship between regulatory structure and private sector innovation. This helps demonstrate that the failure to appreciate the nature and significance of privately generated innovation, within the regulatory regimes designed to work with that innovation, was really an important factor in regulatory failure leading up to the financial crisis. Structures like the Basel II capital adequacy regime were premised on the conviction that private sector innovation was inevitably and appropriately going to be fast-moving and complex, so that regulators only needed to steer (not row), and to channel this fast moving force at the systems level, without actually having to understand it in any detailed way.

Thinking about regulation in terms of its innovation framing qualities also allows us to question the sense, within regulation and regulatory scholarship, that it is actually possible through regulatory technique to channel and harness private sector innovation in public welfare-enhancing directions — to tweak incentives here and bring in private standards there, and thereby build a system that will generate

predictable, positive outcomes out of industry-driven change. I think there was considerable overconfidence about the capacity of good meta-level regulatory design to achieve "simply better" results in all directions, and inattention to the broader context in which regulation was located. There was also a crucial failure to recognize the feedback loop between regulatory structure and private sector innovation itself. Innovation and regulation are in a reflexive relationship. Regulation constitutes its environment, its regulatory field, the market. If you constitute an environment based on the sense that private sector innovation will inevitably be a fast moving, complex, fundamentally beneficial thing, and that all that regulators really need to do is to try not to fall too far behind or get in the way, then you will have an environment in which innovation will have a license to accelerate and regulators will not have a principled basis on which to challenge it.

Bourdieu and other scholars of power would point to the influence of a form of large-scale cognitive capture in this story.[9] There is a broader, contemporary social and political conversation that really sees innovation as ultimately beneficial, supremely important, and not something that regulation should be obstructing. Whether we think of it as capture or not, a pro-innovation worldview affected many of the regulatory structures we are looking at in this time — whether they were consciously innovation-framing, like Basel II, or whether they were operating in the context of a broader political conversation around the Volcker Rule. What that background pro-innovation consensus did in the Volcker Rule context was to limit the political conversation at the level of the legislative process, but it also meant that the conversation at the level of the regulator would inevitably take place in highly technical terms, which were not accessible to members of the public that wanted to participate. The standard concerns that everybody has about public input in the notice and comment rulemaking function are only exacerbated when you are trying to have that conversation around highly technical details, like those surrounding the Volcker Rule and its implementation. I suggest that there has been a general failure to have an important normative conversation about the trade-offs we are making, when we put innovation in front and center among our priorities. In my view it is unrealistic to think that we can transcend

9. PIERRE BOURDIEU & LOÏC J.D. WACQUANT, AN INVITATION TO REFLEXIVE SOCIOLOGY (1992).

some of the difficult, normatively contested issues that underlie financial regulation just through better regulatory technique.

Basel II is my specific example of a meta-regulatory structure.[10] Basel II incorporates clear meta-regulatory elements and typifies the outcome-oriented, principles-based turn that financial regulation took between about 2002 and 2008. Basel II tried to improve on Basel I through its three pillar strategy. Pillar 1 imposed a minimal capital requirement. Pillar 2 provided for financial institution supervision by national bank supervisors, and Pillar 3 imposed enhanced disclosure requirements. The idea behind Pillar 3 was to try to activate market forces to buttress the capital adequacy requirements, on the assumption that better-informed market participants would decide whether or not to buy your product. Under Pillar 1, the largest financial institutions were allowed to use a so-called "advanced approach" to capital adequacy. Essentially they were allowed, within limits, to use their internal, proprietary risk modeling software to assess the risks associated with the products they were carrying and marketing, and therefore to determine for themselves how much capital they had to keep on hand. Of course, as it turned out, this promoted a behavioral cascade toward excessive risk taking, which was exacerbated by the failure of proper supervision by some national regulators under Pillar 2. The Pillar 3 market discipline idea did not work either. Disclosure does not work if, in spite of the disclosure, market participants cannot understand the product, and disclosure does not work well during a bubble. The failure of all three of those Pillars really could be understood, in part, as a function of the unanticipated disruptive impact of private sector innovation on a structure designed to deal with it.

The summer 2007 ABCP crisis in Canada[11] was not globally significant in terms of impact, but it is an interesting regulatory case study to illustrate a second category of innovation framing regulatory strategy. The ABCP crisis in Canada foreshadowed some of the financial crisis events that happened later, and it was similar in nature. Commercial paper is a short term (less than 270 days), unsecured IOU.

10. *See* THE BANK FOR INTERNATIONAL SETTLEMENTS, www.bis.org (last visited Oct. 11, 2013).

11. *See* John Chant, *The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets, A Research Study Prepared For the Expert Panel on Securities Regulation*, http://www.expertpanel.ca/documents/research-studies/The%20ABCP%20Crisis%20in%20Canada%20-%20Chant.English.pdf.

"Asset backed" commercial paper is commercial paper secured by an underlying asset. Under Canadian securities laws, commercial paper could be sold under an exemption from the normal disclosure obligations associated with securities regulation, on the belief that it was extremely safe.[12] There were four reasons it was assumed to be safe. The first was that it was assumed that no rational investor would buy commercial paper, that is, basically an unsecured IOU, from anything other than a reputable organization. There would be no market for commercial paper issued by some fly-by-night entity. Thus, the marketability of the product itself was an indication of its safety. As well, commercial paper matures after only 270 days. The likelihood that a reputable organization would suffer some kind of default event within 270 days would be minimal. Third, the commercial paper had to receive an approved rating from an approved credit rating agency, which would vouch for its soundness. Finally, like the products sold in the rest of the exempt market, the idea was that commercial paper would only be sold to sophisticated investors who did not need the disclosure the securities regulation regime would otherwise provide.

Each of those assumptions proved to be flawed, and I argue that they were flawed largely as a function of the impact of innovation. First, the fact that ABCP was marketable bore no relationship to its safety as an investment. ABCP was actually issued by conduits that had been created by banks, and the banks used those conduits to move long-term credit obligations off their own balance sheets. So, there was no relationship there (at least on paper, and before reputational forces kicked in). You were not actually buying blue chip stock from the Royal Bank of Canada. It was highly marketable, especially internationally, primarily because it offered a better return than a lot of other investments did. Second, the short 270 day window was irrelevant because the entire ABCP market was constantly being rolled over. Maturing ABCP was paid out using new ABCP. It operated like a short-term credit facility. ABCP was only going to be a meaningful instrument so long as it could continually be rolled over. What happened in the ABCP crisis was that parties became nervous about the

12. *See* Paula Toovey & John Kiff, *Developments and Issues In The Canadian Market for Asset-Backed Commercial Paper*, THE FIN. SYS. REVIEW (2012), http://www.bankofcanada.ca/wp-content/uploads/2012/02/fsr-0603-toovey.pdf.

assets underlying some ABCP, and particularly about whether some Canadian ABCP was exposed to U.S. subprime mortgage debt. It became harder to roll ABCP over and ultimately the market froze completely. So the 270 day window was not a meaningful timeframe. Third, credit rating agencies were not effective assessors of product quality.[13] Finally, purchasers of ABCP were not always sophisticated investors. A lot of retail investors owned ABCP as part of managed portfolios. Each of these fundamental assumptions about the asset-backed commercial paper market was undermined as a function of the kind of smashing of the atom of property that was effected by private sector innovation around derivatives and securitization.

Regarding the Volcker Rule in the United States, I rely substantially on Kim Krawiec's wonderful piece, *Don't "Screw Joe the Plummer [sic]": The Sausage-Making of Financial Reform.*[14] What I argue, extrapolating from her account, is that there was no possibility of having a really meaningful conversation at the political level around limiting private sector innovation in finance. As a result, the Volcker Rule and decisions about how it would be implemented fell to the regulators. This turned it into a highly technical conversation. Krawiec's work does a wonderful job of cataloging and analyzing the thousands of letters written by members of the public to the FSOC and other regulators around the Volcker Rule. Largely, these letters from the public made emotional or political pleas — they said things like "don't screw Joe the plummer" — meanwhile, financial industry members were having one-on-one meetings with top regulators, writing cogent letters about technical matters, and providing the kind of input that could actually move the needle in terms of how the rule would be implemented.

These three examples suggest three misperceptions around the impact of innovation and regulation that deserve more attention. While obviously each of these case studies is different, in each one the regulatory regime exhibits a lack of understanding about the phenomenon of innovation that it is grappling with.

The first assumption we need to examine is that the role of

13. Although in Canada, a Canadian credit rating agency blew the whistle and hastened the crisis.

14. Kimberly D. Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform*, 55 ARIZ. L. R. 55-103 (2013).

regulators is simply to get out of the way of fast moving, complex financial innovation, which (as the U.K.'s Turner Review suggested) is assumed to be beneficial virtually by definition.[15] Whether regulators are trying to get out of the way through high level meta-regulatory architecture (as with Basel II) or by ceding the field to the market (as with the ABCP regime), a consequential underlying idea was that regulators needed to regulate from a greater distance to account for the beneficial, unstoppable, massively complex force of innovation that was operating. This enforced humility on the part of regulators (or was it complacency about the rationality and wisdom of markets and market actors, and optimism about regulatory technique?) really meant that in the run-up to the financial crisis, private sector bankers' quantitative skills were understood to be more central than larger policy conversations. This left broader social questions about the nature and implications of innovation — who is innovating? for what purposes? with what larger consequences? — substantially insulated from interrogation. The perception that financial innovation was going to be beneficial overall meant that it was virtually impossible for regulators to articulate concerns, or even to have concerns, about, for example, the growth of the over-the-counter derivatives market. They no longer considered it their role to ask these sorts of broader, normative questions. This regulatory stance, while not intentionally deregulatory, prohibited proper examination of the kinds of varieties of innovations and the purposes they served. I would suggest, as well, that though the default assumption that financial innovation is beneficial has been challenged since the financial crisis, as scholars of regulation we have still not undertaken the kind of careful inquiry into the nature of innovation that is needed, if we are to design more effective regulation going forward.

The second assumption challenged by these three narratives is that the regulatory moment is the crucial one. Of course I think regulatory structure matters or I would not be a scholar of regulation, but we may also need to broaden our view to include the moments *before and behind* the regulatory moment, where the atom of property is being smashed through financial innovation, as well as developments *after* the highest-profile regulatory moments as demonstrated, for

15. Fin. Servs. Auth., The Turner Review: A regulatory response to the global banking crisis (Mar. 2009), http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

example, in the Volcker Rule rulemaking process. At this later stage we need to ask ourselves who is still in the room in the subsequent moments where the fundamental details of rule implementation actually get determined? Focusing only on the formal regulatory moment misses the broader temporal landscape that affects regulators' scope for action at that point, and beyond.

Third, we need to question the assumption that regulation somehow sits outside innovation and is not directly implicated by it. It is not the case that we can design elegant regulatory architecture that will be impervious to the highly destabilizing forces of innovation on the ground. The reflexive relationship between innovation framing regulatory architecture, and innovation, is significant and demands more study. I am not saying that we should return to bright line, old style, top down, traditional rulemaking on a large scale. Innovation has shown itself to be very adept at getting around bright line rules, which is one of the reasons that flexible and principles-based regulation emerged in the first place. There is no putting the genie back in the bottle now. At the same time, we need to appreciate how disruptive innovation can be to regulation, and in particular how it can pry open unexpected spaces within a regulatory regime, through which some parties' interests are advanced at the expense of others.

At a technical level, effective regulation of private sector innovation requires a clearer and more nuanced understanding of innovation than it currently has — a better sense of how and for whose purposes innovation develops; and of what effects innovation might have on regulation itself. However, we should not imagine that there will be some magical step change in regulatory technique that will harness private sector innovation without tradeoffs, that will avoid hard normative choices, or that can make everyone happy at once. The regulation of financial sector innovation in recent years in no way counts as successful if what we care about is transparency, accountability, or the bending of the arc of private innovation toward greater social benefit than the market can produce on its own. I hope that thinking about financial regulation in terms of its innovation-framing qualities will help us chart a clearer path forward.