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THE FSA, INTEGRATED REGULATION, AND THE CURIOUS CASE OF OTC DERIVATIVES

Dan Awrey*

With a view to better understanding the optimal structure of financial regulation, this paper tests prevailing theoretical hypotheses respecting the efficiency and overall desirability of integrated financial regulation relative to competing institutional models. This test is conducted through the lens of a comparative case study examining the approaches adopted by (fragmented) U.S. financial regulators and the (integrated) U.K. Financial Services Authority (FSA) toward the myriad of regulatory challenges posed by the emergence, growth, and systemic importance of over-the-counter (OTC) derivatives markets. More specifically, this paper examines why, despite the numerous theoretical advantages of integrated regulation, the FSA adopted a non-interventionist regulatory regime governing OTC derivatives markets which was both functionally equivalent to the fragmented U.S. regime and, arguably, socially sub-optimal. This paper argues that the FSA's approach to the regulation of OTC derivatives markets may potentially be explained on the basis of a combination of (1) poor coordination, (2) the FSA's attempts to balance competing regulatory objectives, (3) incentive problems which arise for national regulators in the context of global financial markets, and (4) the inherent limitations of financial regulation. Each of these potential explanations holds important insights for the ongoing debate respecting the optimal structure of regulation.

I. INTRODUCTION

The past three decades have been characterized by seismic changes in the structure of global financial markets. These changes have sparked a
pronounced shift in many jurisdictions toward greater integration of the public institutions responsible for financial regulation. This shift has been fueled by a perceived need for the structure of regulation to reflect the increasing integration, globalization, and complexity of financial markets themselves. Conspicuously, the momentum toward more integrated financial regulation has historically been met with resistance in the United States (U.S.), where responsibility has long been split between a cacophony of federal regulators including the Federal Reserve Board, Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), and Office of the Comptroller of the Currency (OCC). More recently, however, lawmakers, regulators, and pundits—including the Obama Administration itself—have criticized the "gaps," "weaknesses," and "loopholes" manifest within this fractured regulatory framework as having contributed to the market and regulatory failures that precipitated the global financial crisis. Many of these criticisms, if not for the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), have been accompanied by calls for regulatory reform founded upon the perceived superiority of integrated regulation.

In evaluating the merits of these proposals for structural reform, U.S. policymakers would be well advised to look across the Atlantic to draw lessons from the experiences—and criticisms—of the integrated regulator that many observers, not so very long ago, considered the blueprint for the

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3. Id. at 2.

4. Id.

5. Id. at 3.


8. See, e.g., Laurence Norman & Natasha Brereton, U.K. Regulator Defends Its Role – Conservatives Would Scrap FSA, Divide Its Duties; Creating a Lame Duck?, WALL ST. J., July 21, 2009 (describing the FSA’s defense of its regulatory model to Conservative Party threats); Rowena Mason, MPs Blame ‘Impotent’ FSA Over Icelandic Banks, TELEGRAPH, Apr. 4, 2009 (describing the FSA’s failure to act on strong warnings that Icelandic bank Kaupthing was not capable of running a U.K. business); and Tories Target U.K. Market Regulator, WALL ST. J., July 20, 2009 (describing the Conservative Party’s stance towards the FSA).
future of financial regulation: the now ill-fated United Kingdom (U.K.) Financial Services Authority (FSA). Amongst the wide ranging criticisms of the FSA stemming from the global financial crisis has been that the U.K.'s unified financial services watchdog failed to regulate over-the-counter (OTC) derivatives\(^9\) markets effectively. OTC derivatives—financial instruments, the value of which are derived from (hence the name) another asset commonly referred to as the 'underlying'\(^{10}\)—have in recent years emerged from relative obscurity to exert a profound influence on global financial markets. On the eve of the crisis, the outstanding notional value\(^{11}\) of all OTC derivatives stood at over USD\$516 trillion,\(^{12}\) up from USD\$80 trillion\(^{13}\) less than a decade earlier, and several times the global (M3) money supply. The growth and proliferation of OTC derivatives have also generated complex, systemically significant relationships between derivative, underlying, and related markets. However, despite their explosive growth and systemic importance—to say nothing of the foreshadowing provided by the derivatives-related collapses of, amongst others, Barings PLC, Orange County, and Long Term Capital Management—OTC derivatives markets remained, prior to the crisis, effectively (if not always legally)\(^{14}\) outside the perimeter of financial regulation in every major financial center. The relative dearth of public regulatory intervention into these markets can be explained in many jurisdictions, at least in part, with reference to pre-existing institutional

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9. The term OTC is used to denote those derivatives which do not trade on an organized or regulated exchange.

10. All derivatives are engineered from two basic financial building blocks: options and forwards. These building blocks can be combined in an infinite number of ways and with reference to an infinite number of underlying, thus facilitating the truly stunning diversity of instruments observed within OTC derivatives markets. See Ed Murray, UK Financial Derivatives and Commodities Markets, in FINANCIAL MARKETS & EXCHANGES LAW 265-300 (Michael Blair & George Walker eds., 2007). Given this diversity, it is perhaps not surprising that different types of OTC derivatives (bilateral swaps versus securitizations for example) may manifest different risks and, accordingly, pose different regulatory challenges. As will become apparent, the purpose of this paper is not to delve into the decidedly complex task of identifying the specific risks associated with each species of OTC derivative or the optimal regulatory response.

11. While illuminative of the size and growth of OTC derivatives markets, notional value—effectively the benchmark against which cash flows are calculated in the context of OTC derivatives transactions—is effectively a second-best proxy for their market value (which, from an accounting perspective, nets out at zero for bilateral instruments).

12. BANFOR INT'L SETTLEMENTS, BIS QUARTERLY REVIEW 24 (Dec. 2007) (presenting figures as of June 2007). The outstanding notional value of all OTC derivatives peaked at over USD\$683 trillion in June 2008, just three months before Lehman Bros. announced that it was filing for bankruptcy protection. BANFOR INT'L SETTLEMENTS, BIS QUARTERLY REVIEW 32 (Dec. 2008).


14. As we shall see, OTC derivatives fell squarely within the jurisdiction of the FSA.
pathologies. Most infamously, the 35-year long dispute between the SEC and CFTC has been frequently identified as a source of chronic regulatory failure.\textsuperscript{15} But what about the FSA? What about integrated regulation?

The purpose of this paper is to examine why, despite radically different institutional models (to say nothing of the perceived theoretical superiority of integrated regulation), financial regulators in the U.K. and U.S. generated functionally equivalent regulatory regimes governing OTC derivatives markets. The answer to this question in turn manifests potentially important implications for a broader question: Does the institutional structure of financial regulation matter? These questions will be examined through the lens of a historical and substantive comparison of the pre-crisis regulatory regimes governing OTC derivatives markets in both the U.S. and U.K. This inquiry yields three related contributions to the scholarly and public policy debates concerning the optimal structure of financial regulation. First, it tests prevailing theoretical hypotheses respecting the strengths and weaknesses of integrated regulation against the real world regulation—and regulatory outcomes—generated by regulators. Perhaps most importantly in this respect, insofar as the relevant scholarly and public policy debates have thus far centered around its potential efficacy within particular political or market contexts, the orientation of this inquiry in terms of examining the effectiveness of integrated regulation in response to a specific and pressing regulatory challenge is both novel and, as we shall see, illuminating. Second, this exploration builds incrementally upon our still-fledgling understanding of the institutional pre-conditions (and other potential impediments) to the effectiveness of integrated regulation. Finally, and more broadly, this exploration generates potentially valuable insights respecting both the incentive problems that arise in the context of the national regulation of global financial markets and the inherent limitations of regulation within highly complex and dynamic environments. Each of these contributions manifest potentially important lessons for policymakers seeking to identify the optimal structure of financial regulation.

This paper proceeds as follows. Part II provides a foundation for the present inquiry by canvassing the theoretical arguments both for and against integrated regulation. Part III begins by stating the case for why OTC derivatives markets represent a compelling case study within the context of the present inquiry. The remainder of Part III is then dedicated to a historical and substantive comparison of the pre-crisis regulatory regimes governing OTC derivatives markets in the U.S. and U.K. Drawing upon these foundations, Part IV explores potential explanations for the FSA's non-interventionist approach toward the regulation of OTC

\textsuperscript{15} See infra Part III(b).
derivatives markets and examines what lessons we can draw from these explanations in terms of the optimal institutional structure of financial regulation and, more broadly, its limitations.

II. INTEGRATED FINANCIAL REGULATION: A THEORETICAL OVERVIEW

A. Integrated Regulation Defined

Recent decades have witnessed a pronounced shift toward greater integration of financial regulation. Evidence of this shift can be observed in jurisdictions with such diverse financial and political systems as Germany, Japan, Thailand, Iceland, Estonia, and—before the recently announced break-up of the FSA—the U.K. However, for all the attention surrounding this shift, the various manifestations of integrated regulation have not yet coalesced—either in theory or practice—around a single institutional model. Broadly speaking, and for the purposes of this paper, integrated regulation refers to the integration of: (1) rule-making, supervision, and enforcement of prudential and conduct of business (and, potentially, consumer protection) regulation; and (2) regulation governing each of the banking, securities (including investment management), and insurance industries. It must be observed, however,

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17. See David Enrich & Laurence Norman, U.K. Shakes Up Its Bank Regulation, WALL ST. J., June 17, 2010, at C1 (describing the elimination of the FSA and the consolidation of power within the Bank of England) and George Parker & Brooke Masters, Osborne Abolishes FSA and Boosts Bank, FIN. TIMES, June 16, 2010 (describing the FSA’s elimination and the Bank of England’s consolidation of power). The proposal contemplates that the FSA will be brought under the umbrella of the Bank of England and split into two (and potentially more) regulators: one responsible for micro-prudential regulation of financial institutions, and the other for overseeing consumer protection and markets.

18. Cihak & Podpiera, supra note 16, at 6-7 (canvassing the broad range of institutional models exhibited within various countries).

19. The objective of prudential regulation is generally to manage risk within financial markets. Micro-prudential regulation refers to regulation aimed at managing risks (i.e. insolvency risk) to individual financial institutions, while macro-prudential regulation is aimed at managing systemic risks to the financial system.

20. The objective of conduct of business regulation is, broadly speaking, to ensure fair dealing between market participants.

21. Conspicuous in their absence from this list of functions are the monetary policy functions typically performed by central banks. While these functions clearly represent an integral aspect of financial regulation, to the extent that the integration of monetary policy and other regulatory functions manifest a largely distinct set of issues, and are not directly relevant in terms of the regulation of OTC derivatives, they reside beyond the scope of this paper.

that integrated regulators will frequently manifest important differences in terms of their regulatory objectives, supervisory responsibilities, enforcement powers, and jurisdictional scope. These differences will, in turn, affect the extent to which a particular regulatory regime will be able to translate the theoretical advantages of integrated regulation into practice.

The theoretical arguments in support of integrated regulation canvassed in Part II(b) are perhaps best understood when integrated regulation is itself compared alongside its principal institutional competitors: the institutional, functional, and objectives-based models of financial regulation. As described in Table 1.1, each of these competing models is premised on the existence of multiple specialist regulators. The institutional model contemplates the allocation of responsibility amongst specialist regulators on the basis of distinctions between particular species of financial institutions (i.e. banks, brokerage firms, or insurance companies), irrespective of the specific lines of business or activities individual institutions actually pursue. Conversely, the functional model allocates responsibility on the basis of distinctions between specific lines of business or activities. The functional model thus contemplates, for example, that a single specialist regulator might enjoy jurisdiction over the regulation of mortgage financing activities across all types of financial institutions. As Charles Goodhart et al. observe, the distinction between the institutional and functional models may prove insignificant where the activities of financial institutions are primarily focused within particular segments of the financial services industry. Where, however, financial institutions are engaged in activities across multiple industry segments, the distinction between these competing institutional models becomes simultaneously more meaningful and more complex.

The third principal institutional competitor of integrated regulation is the objectives-based model. As its name implies, objectives-based regulation divides responsibility between specialist regulators on the basis of specific regulatory objectives. Goodhart et al., for example, have


24. A number of potential variations of these basic institutional models—most notably those based on unified oversight boards and/or support functions—have been advanced. For a discussion of these variations, see Richard K. Abrams & Michael W. Taylor, Issues in the Unification of Financial Sector Supervision 22 (IMF Working Paper No. WP/00/213, 2000) (discussing the possible composition, purposes, and limitations of unified oversight boards).


26. Id.

27. Id. Thus, for example, banks as an institution are primarily engaged in the function of providing commercial banking and deposit-taking services.
articulated an objectives-based model premised on six objectives: systemic risk; non-systemic prudential; retail conduct of business; wholesale conduct of business; financial exchange; and competition regulation.\textsuperscript{28} A second subspecies is the so-called “twin peaks” model.\textsuperscript{29} The twin peaks model contemplates two regulators: one responsible for prudential supervision and the other for conduct of business regulation, consumer protection, and corporate governance. The division of responsibilities between the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) is an example of this model. Ultimately, as with integrated regulation, manifestations of each of these models vary widely in practice and—as illustrated by the current patchwork regulatory regime governing the U.S. financial services industry—may even be pursued concurrently.\textsuperscript{30}

| Table 1.1: Integrated Regulation and Its Principal Institutional Competitors |
|---------------------------------|-----------------|---------------------------------|-----------------|
| Institutional Model             | Number of Regulators | Basis for Allocating Responsibility Amongst Regulators | Examples |
| Integrated Regulation           | One              | n/a                             | U.K. (current), Germany, Japan |
| Institutional Regulation        | Multiple         | The species of financial institution (i.e. bank, brokerage firm, insurance company, investment fund, etc.) | U.S., Canada |
| Functional Regulation           | Multiple         | The lines of business or activities pursued (i.e. commercial banking, investment banking, retail brokerage, proprietary trading, investment management, life insurance, pensions, mortgage financing, etc.) | U.S., Canada |
| Objectives-based Regulation     | Multiple         | Identified regulatory objectives (i.e. prudential, conduct of business, consumer protection) | U.K. (proposed), Australia, U.S. |

\textsuperscript{28} Id. at 159.  
\textsuperscript{30} The author was thwarted in his attempts to identify a single jurisdiction that employed a regulatory structure premised \textit{exclusively} on either the institutional or functional approaches.
There are those who view the structure of financial regulation as a second-order issue. Pursuant to this view, the key determinants of regulatory efficiency and effectiveness are not related to institutional design, but are, rather, attributable to such variables as independence, accountability, articulation of clear regulatory objectives, allocation of sufficient financial and human capital, and effective enforcement powers. However, as illustrated in greater detail below, it is perhaps more accurate (and useful) to envision these variables as being intermingled with issues of institutional design. Furthermore, to the extent that institutional design plays a role in determining the efficiency and effectiveness of regulation, it is clearly important in its own right.

We begin our examination, therefore, by canvassing the primary sources of theoretical support for integrated regulation.

B. Principal Theoretical Support

The shift toward integrated regulation has taken place within an environment characterized by two broad trends: (1) the increasing international mobility of capital and the resulting globalization of competition within the financial services industry; and (2) the integration of banking, securities, and insurance markets. These trends have generated complex linkages within and between financial markets and blurred historical distinctions between many markets and instruments. The widespread use of securitization, for example, has both strengthened and rendered more complex the relationship between traditional commercial banking and capital markets. Many credit derivatives, meanwhile, exhibit

32. Id. at 6-9.
35. See Arthur Wilmarth, The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks, 2 U. ILL. L. REV. 215 passim (2002) (providing a detailed account of the emergence of financial conglomerates and arguing that current regulatory policies are inadequate for the purpose of policing them); Abrams & Taylor, supra note 24, at 8-11 (discussing the supervision of financial conglomerates and competitive neutrality as justifications for regulatory integration); GOODHART ET AL., supra note 25, at 142-144 (arguing that, inter alia, increasing internationalization has implications for institutional structure of financial regulation); Briault, supra note 34, at 12 (discussing how increased internationalization and competition has blurred the traditional distinctions separating types of financial products and firms); Cihak & Podpiera, supra note 16, at 3 (discussing integrated regulation as a response to the integration of banking, securities and insurance markets).
The ongoing globalization and integration of financial markets has made the gathering and analysis of market information by, and coordination amongst, financial regulators simultaneously more vital to the delivery of effective regulation, more complex, and, ultimately, more costly. It is within the context of such complex and dynamic global financial markets that the theoretical arguments in support of integrated regulation most strongly resonate. Broadly speaking, these arguments are premised upon the potential of integrated regulation to generate economies of scale and scope and thereby reduce the coordination, information and other transaction costs of regulation relative to institutional models contemplating a multiplicity of regulators.

The most prominent theoretical argument in support of integrated regulation is that it enables regulators to adopt more comprehensive or holistic approaches toward financial regulation, in essence reflecting the trends toward the globalization and integration of financial markets. This potential derives from two primary sources. First, the integration of market surveillance, registrant, compliance, disclosure, reporting, and other information systems facilitates the aggregation of data across a broader range of sources, generating an economy of scope equal to the resulting reduction in coordination costs relative to systems characterized by multiple regulators. To the extent that regulators are thereby able to build a more complete picture (and understanding) of various risks within and across firms, markets, and the financial system, one would expect the aggregation of these systems to contribute still further toward the fulfillment of regulatory objectives. Second, the integration of management functions within a single regulator manifests the potential to break down institutional barriers to effective communication and cooperation, thus reducing the coordination costs associated with, for

37. Briault, supra note 34, at 14.
38. A process which, while perhaps slowed by the global financial crisis, has by no means ceased.
40. Briault, supra note 34, at 18; Abrams & Taylor, supra note 24, at 13-14; Cihak & Podpiera, supra note 16, at 9.
41. Within which regulators would presumably need to negotiate and implement information-sharing mechanisms in order to achieve the same level of aggregation.
example, (1) the development and articulation of clear and coherent regulatory mandates, (2) the generation of integrated legal and regulatory frameworks which are both competitively neutral and free of gaps,\(^4\) (3) the evaluation and prioritization of risks, and (4) the allocation of scarce regulatory resources toward where they are likely to yield the greatest social benefits.\(^3\)

Integrated regulation, its proponents assert, thus facilitates the adoption of a broader, more comprehensive, and more nuanced regulatory outlook across firms, markets, and the financial system, ultimately with the objective of identifying, evaluating, and prioritizing risks and taking coordinated regulatory action. It is frequently argued, for example, that integrated regulators possess a comparative advantage with respect to the monitoring of financial conglomerates\(^4\) insofar as they are better positioned to ensure that these firms (1) are adequately capitalized across their various lines of business, and (2) have put in place sufficient organization-wide risk management systems.\(^5\) It is similarly argued that integrated regulators are better positioned to address cross-sectoral and industry-wide issues such as money laundering, financing of terrorism, consumer education, and, importantly for the present purposes, the regulation of OTC derivatives markets.\(^6\) On the same basis, integrated regulators find themselves, in theory, better positioned to understand and address potential systemic risks.\(^7\)

A second, and related, source of theoretical support for integrated regulation flows from the hypothesis that the lower information and coordination costs derived from the integration of information systems and management functions enable integrated regulators to more swiftly and effectively identify, evaluate, and respond to the emergence of new regulatory challenges.\(^8\) This hypothesis proceeds broadly as follows. First, to the extent that integrated regulators are engaged in market surveillance across all firms and markets, they are, in theory, more likely to observe new market developments.\(^9\) Second, once these developments

\(^{42}\) Abrams & Taylor, supra note 24, at 11; Cihak & Podpiera, supra note 16, at 9; and Martinez & Rose, supra note 22, at 7-8.

\(^{43}\) Ferran, supra note 39, at 284. This is precisely the premise underlying the FSA’s “risk-based” approach to regulation.

\(^{44}\) Firms operating across the full spectrum of financial markets.

\(^{45}\) Briault, supra note 34, at 14; Abrams & Taylor, supra note 24, at 10. This argument may be less persuasive with respect to jurisdictions with smaller or less advanced financial markets. Abrams & Taylor, supra note 24.


\(^{47}\) Martinez & Rose, supra note 23, at 2, 7.

\(^{48}\) Cihak & Podpiera, supra note 16, at 9.

\(^{49}\) There exists a potentially persuasive counterargument that specialist regulators are, owing to the narrower, more focused scope of their jurisdiction, more likely to identify
have come to light, integrated regulators (given their holistic outlook) are also more likely to appreciate the full nature and extent of both the attendant risks as well as the likely impact of regulatory (in)action. Indeed, one would expect this to be particularly true for developments which transcend historical distinctions between financial institutions and markets or, perhaps more to the point, jurisdictional boundaries between multiple specialist regulators. Finally, where a regulatory response to a particular market development is required, integrated regulators are likely to incur lower transaction costs in connection with the design and implementation of regulatory action relative to the more complex—and likely politicized—process of doing so within a regime characterized by multiple regulators.

The third principal theoretical argument in support of integrated regulation is that it imbues integrated regulators with *de facto* accountability. This argument proceeds from the observation that, relative to a system characterized by a multiplicity of competing regulators with potentially overlapping jurisdictions, the opportunity for integrated regulators to shift the blame for regulatory failures is effectively foreclosed. Proponents argue that this generates strong incentives for integrated regulators to articulate clear mandates, to pursue these mandates vigorously, and to instill within market participants clear expectations about the nature and level of regulatory protection they will receive. Perhaps more importantly, high levels of *de facto* accountability contribute (along with mechanisms which ensure sufficient *de jure* accountability) to the amelioration of concerns, discussed in Part II(c), that integrated regulators may be particularly susceptible to abuses of power and regulatory capture.

Proponents frequently advance several other, arguably secondary, theoretical arguments in support of integrated regulation premised on the generation of economies of scale and/or scope. It is often asserted, for example, that insofar as they represent a “one-stop shop,” integrateddriving

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50. Including, importantly in many cases, time.
51. Including any related internal reallocation of regulatory resources and/or responsibility.
52. GOODHART ET AL., supra note 25, at 152; Ferran, supra note 39, at 295; Abrams and Taylor, supra note 23, at 12, 15; Cihak and Podpiera, supra note 16, at 10. Once again, this is a consequence of the lower coordination costs flowing from the integration of management functions within a single regulator.
53. Ferran, supra note 39, at 295.
54. *Id.* at 279.
regulators generate transaction cost savings for both regulated firms (who need only deal with a single point of regulatory contact) and consumers (who are spared the potentially daunting prospect of having to navigate through an alphabet soup of regulators in order to acquire information or lodge a complaint). It has also been argued that the scale enjoyed by integrated regulators enables them to pursue large infrastructure investments, such as new market surveillance or information technology, which might be cost prohibitive for smaller specialist regulators. Finally, it has been observed that the reduced coordination costs flowing from the integration of management functions within a single regulator provide integrated regulators a comparative advantage in terms of their ability to pursue effective human resources strategies. Given the importance of developing and retaining human capital as a necessary pre-condition to the generation of effective public policy—especially in the context of complex, rapidly evolving global financial markets—this comparative advantage, if realized, might very well prove significant.

C. A Critical Perspective

The theoretical arguments in support of integrated regulation provoke three species of response from its critics. First, critics argue that integrated regulators face a host of potential challenges in connection with the extraction of the theoretical economies of scale and scope described above. Second, they argue that the integration of management functions may generate negative consequences in terms of diminished accountability and the sub-optimal balancing of competing regulatory objectives. Finally, critics advance that integrated regulation is itself sub-optimal to the extent that integrated regulators are, by their very nature, incapable of harnessing the potential benefits of regulatory competition. This third argument deserves particular attention because it is the only one of the three species

56. Abrams and Taylor, supra note 23, at 14. Specifically, integrated regulators may be better positioned to offer their personnel more varied and challenging opportunities, along with tailored internal training programs and career planning services. Id.
57. A fourth response, not examined here, is that the transition costs of migrating toward an integrated regulatory model (for those jurisdictions presently employing multiple specialist regulators) are likely to outweigh any savings generated by the information, coordination, or other transaction costs of regulation. These potential transition costs include those stemming from (1) the loss of key personnel and, as a result, human capital and institutional memory; (2) mismanagement of the integration process; (3) the prospect that the process will be captured by special interests; and (4) the integration of potentially divergent organizational and regulatory cultures. Australian Prudential Regulation Authority [APRA], Report to Messrs Corrs Chambers Westgarth from John Palmer, FCA, APRA Doc. S/1473964/1, § 5.5.2 (July 15, 2002); Taylor and Abrams, supra note 24, at 16; Cihak and Podpiera, supra note 16, at 11.
of response that can be viewed as providing a measure of positive theoretical support for institutional models characterized by multiple regulators. I begin, therefore, by examining the case for regulatory competition.

The salutary and deleterious effects of regulatory competition have been the subject of intense debate for decades. Proponents of regulatory competition argue that competitive pressures within a system characterized by multiple regulators will enhance innovation, choice, and efficiency, and ultimately result in the optimal level of regulatory intervention into


privately ordered markets. Implicit within this line of reasoning is the conviction that, by generating incentives for regulators to avoid poor decision-making, regulatory competition can act as an antidote to potential behavioral biases.\textsuperscript{59} It is similarly argued that, insofar as multiple regulators are able to give voice to a broader range of constituencies that might otherwise find themselves marginalized by an integrated regulator, regulatory competition represents something of a safeguard against both potential abuses of power and regulatory capture.\textsuperscript{60} In these latter two respects, the case for regulatory competition can be seen as addressing concerns, discussed in greater detail below, that an integrated regulator may exhibit characteristics of a monopolistic "regulatory leviathan." Indeed, the potential to constrain the actions of self-interested mega-regulators represents perhaps the most significant theoretical benefit of regulatory competition in this context.\textsuperscript{61}

Ultimately, however, the case for regulatory competition (and with it the positive case for institutional models premised on multiple regulators) is riddled with theoretical and practical shortcomings. First, there exists a threshold question as to precisely how a competitive environment will materialize within a system characterized by multiple regulators, each operating within clearly defined and mutually exclusive areas of responsibility. Within such an environment, it would be reasonable to expect regulatory "products" to exhibit low price elasticities, thus constraining the possibility of welfare enhancing regulatory arbitrage. What this suggests, perhaps surprisingly, is that regulatory competition within such systems requires a significant level of jurisdictional ambiguity and/or overlap in order to generate a market for regulation. However, as amply illustrated by the U.S. experience regulating OTC derivatives markets described in \textit{Part III}, such ambiguity and/or overlap provides fertile ground for inter-agency turf wars, potentially resulting in regulatory systems perceived by market participants as unduly complex, uncertain, unresponsive, and costly.\textsuperscript{62}


\textsuperscript{61} Choi, \textit{Channeling Competition}, supra note 59, at 112.

Furthermore, unlike regulatory competition for corporate charters within a federal system\(^6\) (where regulated actors may enjoy a significant degree of mobility and, thus, choice), the prospect of vibrant inter-jurisdictional (if not necessarily intra-jurisdictional, inter-regulator) competition for financial regulation is undermined by the reality that financial institutions will, generally speaking,\(^6\) find themselves subject to the applicable regulatory regimes in each jurisdiction in which they conduct business. Accordingly, the potential gains from regulatory arbitrage are, arguably, likely to be outweighed in many instances by the desire to access domestic financial markets—especially those of large, strategically important jurisdictions such as the U.S. and U.K.

A second shortcoming of the case for regulatory competition is the apparent blind spot it manifests with respect to the negative externalities associated with pervasive regulatory arbitrage.\(^6\) It seems reasonable to suggest that the benefits derived from regulatory competition will flow primarily\(^6\) to (1) the financial institutions which engage in regulatory arbitrage and (2) the regulators who offer the most competitive legal and regulatory frameworks. At the same time, however, and as vividly evidenced by the fallout from the global financial crisis, the costs of regulatory failure within a globally integrated financial system are all too often borne by a far broader cross-section of society. On the basis of this apparent disequilibrium and the enormous negative externalities it manifests, there appears to be some support for the proposition that regulatory competition may contribute to the production of socially sub-optimal regulation.

Finally, it is worth observing that the theoretical benefits of regulatory competition have not been empirically established and, generally speaking, do not appear to have translated well into the practical realm.\(^5\)

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63. This also would apply for quasi-federal systems such as the European Union.
64. Various “passport” systems currently in operation in jurisdictions such as Canada and the European Union being the most notable exception to this general rule. Broadly speaking, these systems contemplate that market participants can engage in activities within “host” jurisdictions provided that they are in compliance with the securities laws in their “home” jurisdiction.
65. Fox, Retaining Mandatory Securities Disclosure, supra note 58, at 1393. Regulatory competition theory implicitly relies on arbitrage as a mechanism for transmitting market information to regulators respecting the relative competitiveness of their regimes.
66. Although not exclusively, as it must be conceded that enhanced innovation, choice, and efficiency are likely to manifest potential positive externalities as well.
67. See Coffee, supra note 58, at 450, 457 (explaining that there are significant costs associated with regulatory competition, which, although not inherent in the “pure theory of regulatory competition,” ultimately present themselves in “institutionally complex environments”); Fox, Retaining Mandatory Securities Disclosure, supra note 58, at 1396-97 (noting that proponents of issuer choice have failed to show how regulatory competition enhances social welfare); Karmel, supra note 60, at 544-45 (listing several practical
Accordingly, assertions that systems characterized by regulatory competition possess competitive advantages in terms of their ability to address behavioral biases and regulatory capture may not ultimately be as persuasive as they initially appear. Furthermore, as explored in greater detail below, and in Part IV, problems of behavioral bias and capture can both be addressed, at least to a certain extent, via the judicious design and implementation of accountability, independence, and transparency mechanisms.

Beyond the positive case for regulatory competition, critics emphasize a number of potential deficiencies with the theoretical arguments in support of integrated regulation. First, critics observe that the theoretical economies of scale and scope derived from the integration of management functions will often prove exceedingly difficult to harness in practice. Extracting these economies will be at least partially contingent upon the extent to which integrated regulators are, for example, able to foster (1) healthy and functioning management structures and decision-making processes and (2) shared organizational cultures. Yet, fostering these organizational qualities may prove to be amongst the most difficult challenges facing integrated regulators, especially where integration is effected by way of the merger of multiple specialist agencies. Second, the scale of integrated regulators may result in excessive bureaucracy and other diseconomies of scale, representing yet another challenge to their effective management.

Even where integrated regulators successfully address these challenges, critics argue that the theoretical case for integrated regulation overstates the magnitude of the potential economies of scale and scope. Along this vein, several commentators have cautioned against overstating the trend toward integration within global financial markets. Indeed, while there certainly exists a (shrinking) cadre of true financial conglomerates, the business models of the vast majority of financial institutions are still built around core specialties in, for example, banking, problems observed among competing securities regulators but overlooked by economic theory).

68. Ferran, supra note 39 at 291-92; Abrams & Taylor, supra note 24, at 17.
69. Abrams & Taylor, supra note 24, at 18.
70. Cihak & Podpiera, supra note 16, at 11. But see Abrams & Taylor, supra note 24, at 17 (suggesting that diseconomies of scale more likely reflect the quality of management, rather than the size of the organization).
71. Interestingly, while integration of this sort might have once been considered horizontal consolidation, the blurring of traditional distinctions raises the question of whether, for example, the merger of a commercial bank (originating loans) and an investment bank (repackaging and distributing these loans via securitization) might not actually be considered a form of vertical consolidation.
securities, or insurance. Simultaneously, however, recent history suggests that it is precisely these financial conglomerates, along with more integrated markets, such as those for OTC derivatives, which pose the greatest systemic risks. Accordingly, they warrant the lion’s share of regulatory scrutiny. Nevertheless, insofar as the integration of firms and/or markets represents the exception rather than the rule, either now or in the future, there exists a legitimate question as to whether the adoption of more comprehensive or holistic approaches toward regulation, as facilitated by the lower information and coordination costs associated with integrated regulation, will yield real world benefits in terms of regulatory outcomes. Furthermore, as Eilis Ferran has observed, any potential economies realizable by regulated firms under an integrated legal and regulatory framework (stemming from, for example, a reduction in compliance costs) are likely to hinge not on institutional design (i.e. the number and complexity of rulebooks), but rather on the substantive requirements thereby imposed upon firms. This observation finds tentative support in preliminary findings that suggest that the economies of scale and scope generated by integrated regulators may in fact be relatively small when compared with the overall costs of regulation.

Critics also question whether the adoption of a comprehensive or holistic approach toward financial regulation necessarily requires an integrated institutional architecture. Integration is by no means the only mechanism available for enhancing market surveillance, risk assessment, or coordination. Committees of regulators, memoranda of understanding, and institutional models premised on a “lead regulator” may also prove effective in these regards. Nevertheless, to the extent that it reduces the transaction costs associated with these activities relative to such mechanisms (and competing institutional models), integrated regulation arguably enjoys a comparative, albeit contingent, advantage.

Finally, and perhaps most persuasively, critics of integrated regulation observe that the integration of management functions raises the prospect of significant unintended—and decidedly negative—consequences stemming from (1) diminished accountability and (2) the sub-optimal balancing of competing regulatory objectives. In terms of diminished accountability,
critics assert that the same concentration of power which imbues an integrated regulator with such a high degree of *de facto* accountability gives rise to a concomitant risk that it will become, in the words of one observer, "an overmighty bully, a bureaucratic leviathan divorced from the industry it regulates." This concentration of power gives rise to a related concern that integrated regulators are more prone to regulatory capture. Indeed, both logic and experience suggest that these risks are very real. In order to mitigate them, therefore, the *de facto* accountability associated with integrated regulation should ideally be accompanied by mechanisms that ensure sufficient *de jure* accountability. These mechanisms might include (1) clearly articulated regulatory objectives, (2) mechanisms which ensure that these objectives are pursued in a transparent manner, (3) benchmarks against which the performance of the regulator can be objectively evaluated, (4) formal reporting and performance review processes overseen by the legislature, and (5) an independent body with the jurisdiction to review regulatory action.

The integration of management functions is also the source of concerns respecting the sub-optimal balancing of competing regulatory objectives. It is unavoidable that integrated regulators will be charged with responsibility for pursuing a broad range of regulatory objectives. It is equally unavoidable that these objectives will frequently come into conflict with one another. An oft-cited example of this species of conflict is that which materializes in the context of a potential bank failure. While disclosure of the potential failure would further the objectives of market transparency and potentially consumer protection, disclosure might also undermine financial stability. An even more omnipresent conflict, and one which will be explored in greater detail in *Part IV*, is that between maintaining market confidence, protecting consumers, and deterring financial crime, on the one hand, and promoting globally competitive domestic financial markets, on the other. Indeed, wherever an integrated regulator is faced with the complex task of balancing competing regulatory objectives, there exists the risk that a sub-optimal balance will be struck, or that one or more of these objectives will be outright subordinated. Ultimately, however, it is contestable whether striking the optimal balance between competing regulatory objectives is a challenge at all unique to integrated regulation or whether, perhaps more realistically, it is one that

77. *Taylor*, supra note 29, at 15. *See also Goodhart et al.*, supra note 25, at 153-54 (noting that a regulator may become so large and powerful that its power may become excessive).

78. See Luis A. Aguilar, Comm’t, U.S. SEC, Putting Investors First in Regulatory Reform, Remarks at Compliance Week Annual Conference (June 3, 2009) (transcript available at http://blogs.law.harvard.edu/corpgov/2009/05/28/making-investors-a-priority-in-regulatory-reform/) (explaining that the conflict of duties, which arise from having a single consolidated regulator, may ultimately lead to certain duties being subordinated).
haunts regulators of all institutional stripes.

Having canvassed the sources of theoretical support for and against integrated regulation, along with the positive case for models based on multiple regulators, the time has come to test these theoretical hypotheses. The Petri dishes for these tests will be the pre-crisis regulatory regimes governing OTC derivatives markets in the U.S. and U.K.


A. The Regulation of OTC Derivatives Markets: A Case Study

The regulation of OTC derivatives markets represents a compelling case study against which to test the theoretical hypotheses explored above for two principal reasons. First, and most immediately, the (mis)use of certain types of OTC derivatives played a prominent role in the thick of the global financial crisis. Complex collateralized debt obligations (CDOs) underpinned the “originate and distribute” lending model that precipitated the U.S. sub-prime mortgage crisis and facilitated its spread throughout the financial system. The resulting correction unleashed a wave of uncertainty (and, consequently, illiquidity) within CDO and related markets. This liquidity crunch generated negative balance sheet implications for financial institutions and, ultimately, precipitated the flight of assets and collateral calls which triggered the near collapse of Bear Stearns in March 2008, and, in September, the bankruptcy of Lehman Brothers. September 2008, would also see AIG—putatively the world’s largest insurance company—brought to its knees as a result of massive speculative trading in credit default swaps (CDS) on CDOs. Each of these global financial titans was subject to regulatory oversight in both the U.S. and U.K.

It is AIG, however, that arguably represents the most intriguing case. Regulated primarily as an insurance company on both sides of the Atlantic, the downfall of AIG was ultimately attributable to OTC derivatives trading at its London-based (but French regulated) subsidiary, AIG Financial Products Corp (AIGFP). Given the scale of AIGFP’s derivatives-related operations, and its significance to AIG’s bottom line, both of which were apparent on the face of AIG’s public filings, it is curious that the

79. Rather than continuing to hold debt unhedged on their balance sheets the “originate and distribute” model contemplates that lenders will repackage the debt and distribute it to third party investors via securitization. Amongst other implications, this has the effect of reducing or even eliminating the lenders’ exposure to borrower default and, thus, reduces the incentives of lenders to invest resources in establishing and monitoring creditor quality.


81. For example, AIG’s 2007 Annual Report disclosed a USD$9.5 billion operating
operations of AIGFP did not attract greater regulatory scrutiny from either the FSA or the Office of Thrift Supervision, its primary U.S. regulator. As will be explored in greater detail in Part IV, examining the likely explanations for this apparent oversight yields potentially valuable insights regarding the optimal structure of financial regulation.

Secondly, and as amply illustrated by the global financial crisis, OTC derivatives markets pose numerous challenges for financial regulators. These challenges stem from, inter alia, (1) their size and systemic importance; (2) the complex linkages they generate between derivative, underlying, and related markets; (3) the opportunities they generate for opportunistic behavior, market manipulation, and welfare reducing regulatory arbitrage; and (4) the extent to which they defy "traditional" categorization as banking, securities, or insurance markets. These challenges span the entire spectrum of objectives pursued by financial regulators, from enhancing market efficiency and protecting consumers to ameliorating systemic risks. Indeed, OTC derivatives have become the very embodiments of the increasing integration and complexity of global financial markets. Perhaps not surprisingly, therefore, the nature of these challenges play strongly to the theoretical strengths of integrated regulation. Nevertheless, as will be explored in greater detail below, integrated regulation, in practice, has arguably proven no more effective in responding to the challenges of regulating OTC derivatives markets than other institutional models. Perhaps nowhere is this divergence of theory and practice more clearly evidenced than in the regulatory experiences of the U.S. and the U.K.

B. The U.S. Experience

The origins of OTC derivatives regulation in the U.S. can be traced back to the enactment of the Securities Act of 1933,\textsuperscript{82} Exchange Act of 1934,\textsuperscript{83} and Commodity Exchange Act.\textsuperscript{84, 85} Although modern OTC

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\textsuperscript{82} Securities Act of 1933, 48 Stat. 74 (1933) (codified at 15 U.S.C. § 77a (1933)).


\textsuperscript{85} The Future Trading Act (FTA) of 1921, Pub. L. No. 95-405, 42 Stat. 187 (1921) (enacting the first derivatives-related regulation to be enacted in the United States, imposing a prohibitive tax on grain futures not traded on an authorized board of trade, and giving the U.S. Secretary of Agriculture the authority to designate authorized boards of trade upon evidence that they would comply with statutory conditions respecting, inter alia, transaction recordkeeping, market manipulation and admission of members). The U.S. Supreme Court, however, found the enactment of the FTA to be an unconstitutional use of the taxing power to regulate exchanges; Hill v. Wallace, 259 U.S. 44 (1922). The FTA was subsequently
derivatives markets would not emerge for another four decades, the path dependency and resulting institutional schism created by these New Deal reforms would have a profound impact on subsequent developments.

Enacted in the wake of the Great Crash of 1929, the dual objectives of the Securities Act are to (1) require that investors receive material information concerning securities being offered for sale to the public; and (2) prohibit deceit, misrepresentations, and other fraud in the sale of securities to the public.\(^\text{86}\) The Securities Act governs the sale of securities in the primary market, mandating, subject to certain exemptions, the disclosure of material information through the registration of securities with the SEC and the issuance to investors of a prospectus in connection with any distribution of securities. The SEC itself was established under the Exchange Act, which, \textit{inter alia}, governs the trading of securities in the secondary market. Importantly, the requirements of both the Securities Act and Exchange Act are triggered, with certain prescribed exemptions, only with respect to instruments that fall under the definition of a "security."\(^\text{87}\)

Enacted in 1936, the Commodity Exchange Act conferred upon the U.S. Secretary of Agriculture the authority to designate authorized boards of trade (or "contract markets") and to license brokers trading futures contracts\(^\text{88}\) in commodities such as grain, butter, cotton, rice, mill feeds, potatoes, and eggs.\(^\text{89}\) Upon designation, the Commodity Exchange Act


\(^{87}\) Securities Act, 18 U.S.C. §§ 77a et seq, ss. 2(a)1, 3 (defining a security as "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities [including any interest therein or based on the value thereof], or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing"). None of these categories of security has historically been interpreted as encompassing OTC derivatives.

\(^{88}\) A futures contract is a type of derivative contemplating the purchase or sale of a commodity in the future at a pre-determined price.

\(^{89}\) The Commodity Exchange Act thus expanded upon (and superceded) the Grain Futures Act. See generally Daniel Fischel, \textit{Regulatory Conflict and Entry Regulation of New Futures Contracts}, 59 J. Bus. L. 885 (1986) and Roberta Romano, \textit{The Political Dynamics of Derivatives Security Regulation}, 14 Yale J. on Reg. 279 (1997) (discussing how the \textit{Commodity Exchange Act} did little to alter the process for contract market designation established under the \textit{Grain Futures Act}).
imposed upon contract markets requirements respecting, amongst other matters, transaction recordkeeping and the admission of members.\textsuperscript{90} The Commodity Exchange Act also introduced new penalties for fraud and market manipulation, set speculative position limits, and imposed conduct of business requirements.\textsuperscript{91} Administration of the Commodity Exchange Act fell to a new agency, the Commodity Exchange Commission, which was created as a division of the Department of Agriculture. Importantly, while the regulatory regime created under the Commodity Exchange Act was expressly designed to govern all contracts for the sale and future delivery of specified commodities, Congress made no attempt to define a "futures contract."

Following the watershed reforms of the 1930s, the structure and substantive regulation of U.S. derivatives markets remained largely unchanged until the early 1970s. Then, in 1972, in the wake of the collapse of the Bretton Woods fixed exchange rate system, the Chicago Mercantile Exchange (CME), a designated contract market under the Commodity Exchange Act, began trading futures contracts on foreign currencies.\textsuperscript{92} That same year, the Chicago Board Options Exchange (CBOE), an offshoot of the Chicago Board of Trade (CBOT), was created and registered with the SEC to trade in futures on individual securities.\textsuperscript{93} Motivated in large part by these developments,\textsuperscript{94} Congress enacted the Commodity Futures Trading Commission Act of 1974 (CFTCA).\textsuperscript{95} The primary thrust of the CFTCA was to create the CFTC as an independent agency (analogous to the SEC) for the purpose of regulating futures and commodity options markets. The CFTCA conferred upon the CFTC exclusive jurisdiction to regulate all transactions involving contracts of sale of a commodity for future delivery and all options thereon, subject to a savings clause designed to preserve the jurisdiction of the SEC.\textsuperscript{96} In addition, the CFTCA expanded

\textsuperscript{90} Fischel, \textit{supra} note 89, at S87; Romano, \textit{supra} note 89, at 17.
\textsuperscript{91} Romano, \textit{supra} note 89 (governing, for example, the segregation of customer accounts).
\textsuperscript{93} \textit{Id.} at 98.
\textsuperscript{94} Romano, \textit{supra} note 89, at 24-25 (enumerating the motivations behind the enactment of the \textit{CFTCA}. First, the moves by the CME, CBOE, and CBOT into new non-agricultural derivatives such as precious metals and currencies exposed both (1) the need to extend the scope of regulation to cover previously unregulated derivatives and (2) that these non-agricultural derivatives were beyond the traditional competence of the Department of Agriculture. Compounding matters, rapid food price inflation had resulted in a perception [fueled by vested interests] that better commodity markets regulation was required).
\textsuperscript{96} 7 U.S.C. §§ 1-15, s.2(a)1(A) (establishing that notwithstanding the introduction of this exclusivity clause, the \textit{CFTCA} did not provide any further clarity regarding the
the scope of the Commodity Exchange Act to include previously unregulated commodities and "all other goods and articles, and all services, rights, and interests in which contracts for future delivery are presently or in future dealt with." The CFTCA also required designated contract markets to demonstrate that trading in a proposed contract would not be contrary to the public interest.

Frictions between the CFTC and other federal regulators first emerged during the legislative wrangling that preceded the enactment of the CFTCA. The SEC lobbied vigorously for a carve-out from what it perceived as the CFTC's overly broad exclusive jurisdiction clause. On its face, the clause granted the CFTC jurisdiction over trading in futures and options contracts, not just on designated boards of trade, but also on "any other board of trade, exchange or market." The U.S. Treasury Department also lobbied to curtail the scope of the clause and ultimately obtained the so-called "Treasury Amendment," which stipulated that the CFTC's jurisdiction would not extend to transactions in foreign currencies, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, mortgages or mortgage purchase commitments (unless such transactions involved the sale thereof for future delivery conducted on a designated contract market).

Importantly, trading in these instruments was, at the time, almost exclusively the purview of large commercial and investment banks. The Treasury Amendment thus effectively carved out much of the fledgling OTC (inter-bank) market, as it then existed, from CFTC jurisdiction—much to the benefit of the U.S. banking industry. It would be the first, but by no means only, occasion on which federal banking regulators would intervene to oppose regulatory intervention into OTC derivatives markets.

The building jurisdictional tensions between the SEC and CFTC only intensified after the enactment of the CFTCA. In September 1975, the CFTC granted a CBOT application for designation as a contract market in respect of futures on Government National Mortgage Association (GNMA)
mortgage-backed pass-through certificates. This action provoked a letter from SEC Chairman Roderick Hills to the CFTC in which he asserted both that GNMA certificates and contracts for their future delivery constituted “securities” under the Securities Act and Exchange Act and that the CFTCA did not deprive the SEC of its jurisdiction over such instruments. In response to the letter, the CFTC issued a memorandum that detailed the statutory foundation of the CFTC’s exclusive jurisdiction and refuted Chairman Hills’s assertions. The CFTC would subsequently approve applications from the CBOT as well as other commodity exchanges for futures contracts on 90-day U.S. Treasury bills and, later, longer-term U.S. Treasury bonds.

Jurisdictional tensions would come to a head once again in the context of the CFTC’s 1978 reauthorization hearings. The SEC, along with the CBOE, General Accountability Office (GAO), and Office of Management and Budget (OMB) challenged the CFTC’s jurisdiction over futures contracts and options on securities. The SEC argued, inter alia, that (1) futures contracts and options on securities were functionally equivalent; (2) futures on securities affected the market in the underlying securities; and (3) the CFTCA had generated confusion around the extent to which persons purchasing securities could rely upon the protections of federal securities laws. For these reasons, the SEC argued that it was “appropriate and necessary that the SEC’s jurisdiction extend to futures contracts and options with respect to securities.” Once again, however, the SEC’s arguments failed to convince Congress: the Futures Trading Act of 1978 essentially reaffirmed the CFTC’s exclusive jurisdiction over trading in

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105. Id.
107. The CFTCA established the CFTC as a so-called “sunset agency,” requiring periodic reauthorization by Congress.
108. PHILIP JOHNSON & THOMAS HAZEN, COMMODITIES REGULATION 26 (Little, Brown, 2nd ed. 1989); Fischel, supra note 88, at S88; Gilberg, supra note 104, at 1638; Romano, supra note 89, at 34.
110. Id. at 216.
futures markets—including futures contracts and options on securities.\footnote{112} The 1980s represented a period of revolutionary change and dramatic growth within OTC derivatives markets. Perhaps most significantly, the 1980s would witness the emergence, growth, and proliferation of swaps markets.\footnote{113} It is widely believed that the first swap (a currency swap between IBM and the World Bank) was entered into in 1979.\footnote{114} The emergence of markets for interest rate (c. 1981), commodity (c. 1986), and equity (c. 1989) swaps would follow over the course of the next decade.\footnote{115} These markets would go on to grow and mature for several years, seemingly under the jurisdictional purview of neither the CFTC nor the SEC. At the same time, and irrespective of the fact that the vast majority of swap transactions involved federally regulated banks both as market makers and counterparties, the growth and proliferation of these markets were apparently not viewed by federal banking regulators as meriting regulatory intervention.

The 1980s also represented a period of increasing strain in the relationship between the CFTC and other U.S. financial regulators. In February 1981, the SEC granted a CBOE application to trade options on GNMA certificates, taking the position that the Commodity Exchange Act did not affect the SEC’s exclusive jurisdiction over options on securities traded on national securities exchanges.\footnote{116} The CBOT challenged the SEC’s approval of the application on the basis that GNMA certificates were commodities under the Commodity Exchange Act and, accordingly, that options on GNMA certificates fell within the CFTC’s exclusive jurisdiction. In a split decision, the U.S. Court of Appeals for the 7th Circuit ruled for the CBOT, finding that the SEC had violated the CFTC’s exclusive jurisdiction by authorizing the CBOE to trade the options.\footnote{117} While the SEC appealed the decision, the appeal was subsequently vacated.

\footnote{112} Id. § 2(13) (amending Commodity Exchange Act to require communications with the SEC, Treasury, and Federal Reserve with respect to areas of overlapping concern and to consider their views when approving applications for trading in futures on government securities).
\footnote{113} Fundamentally, a swap is simply a series of forward obligations to acquire or dispose of an asset in the future at a predetermined price.
\footnote{114} Willa E. Gibson, \textit{Are Swap Agreements Securities or Futures?: The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions}, 24 J. CORP. L. 379, 383 (1999) (citing \textit{JACK MARSHALL \& KEN KAPNER, UNDERSTANDING SWAPS} 6-7 (John Wiley \& Sons 1993)).
\footnote{115} Id.
\footnote{117} Bd. of Trade v. Sec. \& Exch. Comm’n, 677 F.2d 1137, 1161 (1982) (Cudahy, J., dissenting) (noting that the savings clause in the Commodity Exchange Act was designed to preserve the SEC’s jurisdiction over all security options—including options on GNMA certificates).
as moot as a result of the Shad-Johnson Accord.\textsuperscript{118}

In February 1982, the SEC and CFTC reached an armistice in the form of the Shad-Johnson Accord.\textsuperscript{119} Named after their respective chairmen, the Shad-Johnson Accord was ostensibly designed to preserve, to the extent practicable, the traditional roles of the feuding federal agencies.\textsuperscript{120} The Accord bifurcated jurisdiction over the regulation of derivatives markets, stipulating that (1) the CFTC would possess jurisdiction over futures contracts and options thereon on designated contract markets, along with futures contracts on exempted securities (other than corporate and municipal securities) and broad-based indices of securities, and (2) the SEC would possess jurisdiction over options on individual equities, foreign currencies traded on national securities exchanges, and non-exempt (non-U.S. government issued) bonds.\textsuperscript{121} The Accord also mandated consultation between the SEC and CFTC with respect to the approval of stock index futures and options on futures.\textsuperscript{122} The arrangements were subsequently codified in The Futures Trading Act of 1982 (FTA 1982)\textsuperscript{123} as part of the CFTC's second reauthorization. Notably, and over the strenuous objections of the CFTC,\textsuperscript{124} the FTA 1982 went beyond the terms of the Accord to confer upon the SEC a veto power over CFTC approval of stock index futures and options on such futures which were not broadly-based or which were otherwise susceptible to manipulation.

The enactment of the FTA 1982 was arguably followed by a period of relative inter-agency harmony. In 1984, for example, the CFTC and SEC issued a joint policy statement setting out the species of financial derivatives that the two agencies believed were suitable for trading.\textsuperscript{125} This harmony would, however, prove short-lived. The détente was initially threatened in 1987 when the CFTC launched an investigation into the commodity swap operations of Chase Manhattan Bank and announced a proposal to regulate hybrid and commodity swaps, suggesting that these

\textsuperscript{118} Sec. & Exch. Comm'n v. Bd. of Trade, 459 U.S. 1026 (1982).


\textsuperscript{121} Shad-Johnson Accord, supra note 119.

\textsuperscript{122} Id.


instruments might constitute unauthorized (and therefore illegal) off-exchange futures contracts. The threat of more burdensome exchange-style regulation imposed by a regulator with little formal expertise in banking—and, perhaps more importantly, with whom (unlike federal banking regulators and Congress) it had not previously cultivated a relationship—was understandably a source of anxiety for the U.S. banking industry and, in the view of many observers, a catalyst for the subsequent migration of commodity swaps markets to overseas financial centers such as London.

The simmering turf war between the SEC and CFTC would come to a rolling boil in 1988-89. In February 1988, SEC Chairman David Ruder testified before Congress that futures markets in stock indices had disrupted underlying markets in advance of the October 1987 stock market crash, and would continue to do so in the future unless brought within the jurisdiction of the SEC. That same year, the SEC approved an application for trading in index participation units ("IPs"), a hybrid security exhibiting characteristics of both securities and futures. The CME brought an action claiming that the SEC had impinged upon the CFTC's exclusive jurisdiction. As it had done with GNMA certificates, the 7th Circuit held that IPs were futures contracts falling within the exclusive jurisdiction of the CFTC and, accordingly, that they could only be traded on CFTC-designated contract markets.

The decision marked a low point in the dispute between the SEC and CFTC for two reasons. First, it appears that the CME brought its action not with the intention of itself offering a competing instrument, but rather simply to prevent the trading of IPs on SEC-regulated exchanges. Viewed in this light, the decision thus served simply to thwart innovation and competition. Second, the fight over IPs exposed the Shad-Johnson

127. Bair, supra note 126, at 700.
130. See Futures Trading Practices Act of 1991-S. 207: Hearing on S. 207 Before the S. Comm. on Agriculture, Nutrition, and Forestry, 102nd Cong. 161-90 (1991) (pointing to how the CME wrote to the SEC arguing that IPs were still considered futures and thus illegal). See also Russo & Vinciguerra, supra note 120, at 1437-38 (noting the SEC chairman's statement that futures exchanges had no desire to trade IPs).
Accord as fundamentally inoperable, requiring coordination and consensus that could not be obtained within the context of rapidly evolving derivatives markets. Each of these observations are clearly salient to the present exploration. The success of the CME in preventing the introduction of IPs illustrates how regulatory regimes characterized by multiple regulators can—rather than enhancing competition—be manipulated by market participants toward decidedly anti-competitive ends. The failure of the SEC and CFTC to give effect to the Shad-Johnson Accord, meanwhile, demonstrates the practical shortcomings of informal arrangements and memoranda of understanding between multiple specialist regulators within the context of complex and dynamic global financial markets.

Yet another significant point in the historical arc of U.S. derivatives regulation occurred later in 1989, when the CFTC issued a policy statement in which it purported to exempt swaps from its oversight. The policy statement, issued in response to industry concerns that swaps might be deemed futures (and thus illegal off-exchange contracts), acknowledged that swaps possessed certain features that distinguished them from futures contracts. The policy statement further explained that, while the CFTC also viewed swaps as possessing elements which mirrored futures and options contracts, the agency did not believe that it was the appropriate time to regulate these instruments. Proceeding on this basis, the policy statement established a non-exclusive safe harbor for swaps transactions based on identified distinctions between swaps and futures. The policy statement did not, however, address whether swaps constituted futures contracts under the Commodity Exchange Act and, thus, left open the possibility that a court might subsequently hold that these instruments constituted futures contracts. Furthermore, swaps that did not satisfy the

131. Romano, supra note 89, at 358-59.
135. The policy statement identified five criteria relevant to determining whether the safe harbor applied: (1) the existence of individually tailored terms, (2) the absence of an exchange-style offset, (3) the absence of a clearing organization or margin system, (4) that the transaction was undertaken in conjunction with a line of business, and (5) that the transaction was not marketed to the public. Id. at 30696-97.
136. Gibson, supra note 114, at 407-08. Indeed, this possibility became a reality when, subsequent to the issuance of the policy statement, a federal district court found that certain
requirements of the safe harbor continued to trade over-the-counter following the issuance of the policy statement. As a result, the statement was less than entirely successful in generating greater certainty around the regulatory treatment of swaps.\textsuperscript{137}

The year 1989 would also mark the beginning of a protracted series of Congressional debates in connection with the reauthorization of the CFTC.\textsuperscript{138} Swaps dealers lobbied vigorously during the reauthorization process for regulations reflecting the CFTC’s policy statement in order to avoid potentially burdensome regulation and reduce regulatory uncertainty.\textsuperscript{139} SEC Chairman Richard Breeden and Treasury Secretary Nicholas Brady meanwhile sought greater legislative clarity respecting stock index futures, ultimately resulting in a standoff with CFTC Chairwoman Wendy Gramm.\textsuperscript{140} After nearly three years of debate, this process culminated in the enactment of the Futures Trading Practices Act of 1992 (FTPA 1992),\textsuperscript{141} reauthorizing the CFTC and conferring upon it the authority to exempt certain exchanged-traded and OTC instruments from its oversight. Congress then instructed the CFTC to exercise its new exemptive authority with respect to, \textit{inter alia}, swaps and other hybrid instruments.\textsuperscript{142} In exercising its exemptive authority, the CFTC (once again) did not define swaps as futures or otherwise attempt to assert its authority. Indeed, the CFTC even acknowledged that, were a court to find that swaps fell within the CFTC’s exclusive jurisdiction, the exemption would still operate so as to render the instruments legal even if they failed to meet all the requirements of the exemption. While this acknowledgement provided market participants with some additional comfort, there remained lingering uncertainty insofar as there was nothing preventing the CFTC from subsequently revoking the exemptions, thus pulling the rug out from under the maturing swap and hybrid markets.

Any legal certainty provided by the FTPA 1992 was soon eliminated,

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138. See Romano, supra note 89, at 353-368 (describing the legislative history of the CFTC’s 1992 reauthorization).

139. Petzel, supra note 92, at 102.

140. Romano, supra note 89, at 362-65.


142. The CFTC granted the anticipated exemptions in 1993. See CFTC Regulation of Hybrid Instruments, 17 C.F.R. § 34 (1994). For swaps to be exempt they had to be between “appropriate persons” including commercial entities or wealthy, sophisticated counterparties. Regulation of Hybrid Instruments, 58 Fed. Reg. 5580, 5581 (Jan. 22, 1993); 7 U.S.C. §§ 6(c)(2)(B)(i), 6(c)(3) (2000). Notably, exempted instruments were not exempt from the manipulation and anti-fraud provisions of the \textit{Commodity Exchange Act}. Id.
however, when, in December 1994, the SEC and CFTC entered into simultaneous, yet separate, settlement agreements with BT Securities Corporation (BT). The settlements stemmed from BT's misconduct in connection with two leveraged swap transactions entered into with its client, Gibson Greeting Cards.\textsuperscript{143} That same month, the Federal Reserve Bank of New York entered into an agreement with Bankers Trust New York Corporation, the parent company of BT, respecting the future conduct of leveraged derivatives transactions.\textsuperscript{144} The CFTC asserted jurisdiction, alleging that BT had violated the anti-fraud provisions of the Commodity Exchange Act and had been acting as an unauthorized commodity-trading advisor.\textsuperscript{145} Conspicuous in its absence from the CFTC's claim, however, was any assertion that the swaps constituted futures contracts. The SEC also asserted jurisdiction on the basis that some of the impugned transactions included embedded options on securities. The SEC alleged that BT had failed to disclose information and provided incorrect valuations to Gibson, causing it to make material misstatements in its financial statements filed with the SEC.\textsuperscript{146} Less than a year later, the CFTC entered into a settlement agreement with Metallgesellschaft (MG) following allegations that MG sold illegal off-exchange energy futures.\textsuperscript{147} On one level, the BT and MG settlements can be viewed as laudable responses to questionable market conduct. On another level, however, these settlements served to highlight the jurisdictional tensions and resulting lack of coordination between the SEC, CFTC, and federal banking regulators, adding to the mounting regulatory uncertainty surrounding OTC derivatives markets.\textsuperscript{148}

Hostilities between the SEC and CFTC would flare up once again in 1997. The first salvo was fired when, much to the consternation of the U.S. banking industry, the CFTC attempted to assert jurisdiction over the OTC market in foreign currency options. The CFTC's incursion was ultimately


\textsuperscript{144} Bankers Trust N.Y. Corp., Current Report (Form 8-K) (Dec. 4, 1994).

\textsuperscript{145} Overdahl & Schachter, supra note 143, at 73.

\textsuperscript{146} Id.

\textsuperscript{147} MG Ref. & Mktg., Inc. et. al., CFTC No. 95-14 (July 27, 1995), 1995 CFTC LEXIS 190.

\textsuperscript{148} See Overdahl & Schachter, supra note 143, at 75 ("[T]he SEC's assertion of jurisdiction (like the CFTC's assertion of jurisdiction) is just that—an assertion[—and] could be challenged in the future"). See also Petzel, supra note 92, at 103 (describing the regulatory ambiguity engendered by the SEC and the CFTC entering into settlements with BT).
rejected by the U.S. Supreme Court, which held that options on foreign currencies fell squarely within the scope of the Treasury Amendment.\footnote{149} Then, in December 1997, the SEC announced a proposal contemplating the limited regulation of broker-dealers trading in certain OTC derivatives markets.\footnote{150} The proposal, referred to as “Broker-Dealer Lite,” was designed to attract OTC derivatives business—much of which had by this point fled to other jurisdictions—back to the U.S.\footnote{151} In a comment letter to the SEC, the CFTC objected to the proposal on the basis that it encroached upon the CFTC’s exclusive jurisdiction.\footnote{152} The final salvo of 1997 was fired by the SEC in December when it vetoed a CBOT application to trade futures and options on futures in two Dow Jones indices on the basis that they were not sufficiently broad-based to meet the requirements under the FTA 1982.\footnote{153}

Undaunted, the CFTC continued to press its case, issuing a Concept Release in May 1998 announcing its plan to re-examine its regulatory approach toward OTC derivatives markets and, specifically, swaps.\footnote{154} The Concept Release was framed by the CFTC as part of a comprehensive reform effort designed to update its oversight of both exchange-traded and OTC derivatives markets\footnote{155} and sought comment on a number of areas of potential reform.\footnote{156} The issuance of the Concept Release was motivated,

\begin{footnotes}
\item[149] Dunn v. CFTC, 519 U.S. 465 (1997).
\item[150] OTC Derivatives Dealers, 62 Fed. Reg. 67,940 (Dec. 30, 1997) (to be codified at 17 C.F.R. pts. 200, 249 and 249). The proposal contemplated, \textit{inter alia}, that broker-dealers selling certain OTC derivatives (including interest rate, currency, equity, and commodity swaps) would be permitted, under certain prescribed circumstances, to establish and register with the SEC designated subsidiaries for the purpose of engaging in such transactions. Designated subsidiaries registered with the SEC would, under the proposal, enjoy relaxed net capital and margin requirements.
\item[151] \textit{Id.} at 67,941.
\item[153] The veto was ultimately overturned by the 7th Circuit Court; Board of Trade v. SEC, 187 F.3d 713 (7th Cir. 1999).
\item[155] Over-the-Counter Derivatives, 63 Fed. Reg. at 26,114.
\item[156] \textit{Id.} The CFTC Concept Release sought comment with respect to, \textit{inter alia}, eligible transactions, eligible participants, clearing, transaction execution facilities, registration, capital, internal controls, sales practices, recordkeeping, and reporting.
\end{footnotes}
according to the CFTC, by substantial changes within OTC derivatives markets within recent years, including high profile derivatives-related scandals such as the BT and MG affairs and the 1995 collapse of Barings plc as a result of unauthorized (and undetected) OTC derivatives transactions conducted by trader Nick Leeson.\textsuperscript{157} The timing of the Concept Release—a matter of months after the announcement of Broker-Dealer Lite—suggests perhaps that the CFTC may have also been motivated by a desire not to cede jurisdiction to the SEC. The issuance of the CFTC Concept Release was seen by many as contrary to the intent of Congress in enacting the FTPA 1992 which, while conferring upon the CFTC exemptive authority with a view to promoting financial innovation, competition, and legal certainty, did not expressly confer upon the agency jurisdiction over OTC derivatives markets.\textsuperscript{158} Predictably, the CFTC Concept Release provoked a chorus of objections from market participants, the SEC, and federal banking regulators.\textsuperscript{159} Succumbing to the pressure from both industry and regulators, Congress ultimately introduced legislation to temporarily bar the CFTC from taking further regulatory action.\textsuperscript{160} In the end, the CFTC Concept Release thus only served to further compound the jurisdictional tensions and regulatory uncertainty surrounding OTC derivatives markets.\textsuperscript{161}

Not content simply to bar the CFTC from regulating OTC derivatives markets, Congress next turned its attention to the SEC. As part of the sweeping financial sector reforms introduced under the Gramm-Leach-Bliley Act (1999) (GLBA),\textsuperscript{162} Congress granted the SEC jurisdiction over swaps and other hybrid products.\textsuperscript{163} Simultaneously, however, the GLBA expressly excluded both security-based\textsuperscript{164} and non-security-based swaps\textsuperscript{165} from the definition of a “security” under both the Securities Act and Exchange Act and prohibited the SEC from, \textit{inter alia}, registering a security-based swap or promulgating, interpreting, or enforcing rules with

\begin{itemize}
  \item \textsuperscript{157} See \textit{supra} sources accompanying note 152.
  \item \textsuperscript{158} Gibson, \textit{supra} note 114, at 392.
  \item \textsuperscript{163} GLBA § 205.
  \item \textsuperscript{164} As defined in GLBA § 206(c).
  \item \textsuperscript{165} As defined in GLBA § 206(b).
\end{itemize}
respect to any security-based swap.\textsuperscript{166}

The state of affairs established under the GLBA would prove short-lived. Spurred by a report issued by the President’s Working Group (PWG) on Financial Markets in November 1999,\textsuperscript{167} Congress enacted the Commodity Futures Modernization Act of 2000 (CFMA).\textsuperscript{168} Concerned that “a cloud of legal uncertainty”\textsuperscript{169} was undermining the U.S.’s leadership in financial services, the PWG Report recommended additional deregulation and exemptions for OTC derivatives markets with a view to, \textit{inter alia}, (1) promoting innovation and reducing risk by enhancing legal certainty and (2) enhancing the competitive position of the U.S. within global OTC derivatives markets.\textsuperscript{170} The CFMA attempted to clarify—although effectively re-drew—the jurisdictional boundaries between the SEC and CFTC. Amongst other matters, the CFMA redefined hybrid agreements so as to re-confer upon the SEC jurisdiction over hybrids which involved a security (including security-based swaps), a jurisdiction which had been removed only the previous year under the GLBA. In addition, the CFMA repealed those portions of the Shad-Johnson Accord governing the regulation of single-stock futures, placing such instruments under the joint jurisdiction of the CFTC and SEC. The primary thrust of the CFMA, however, was to exempt OTC derivatives markets from the regulatory oversight of the SEC, the CFTC, and state regulators. Thus, after 25 years of jurisdictional feuding, U.S. regulators found themselves largely prohibited from regulatory intervention into OTC derivatives markets.

Not surprisingly, the enactment of the CFMA ushered in a period of relative inactivity in the U.S. with respect to the regulation of OTC derivatives markets. This regulatory stasis stood in stark contrast, however, with the precipitous growth and proliferation of OTC derivatives markets.\textsuperscript{171} Between December 2000 and June 2007, the notional amount of all outstanding OTC derivatives grew from USD$95.2 trillion to USD$516 trillion—an increase of 542%.\textsuperscript{172} In retrospect, this period would

\begin{flushleft}
\textsuperscript{166} See Securities Act, \textit{supra} note 82, § 2A(a), (b).
\textsuperscript{169} PWG Report, \textit{supra} note 167, at 1.
\textsuperscript{170} Id. at 1-2.
\textsuperscript{172} Serge Jeanneau, Derivatives markets, BIS Quarterly Review, 28, 31 (June 2001) and Ryan Stever et al., Highlights of international banking and financial market activity, BIS Quarterly Review, 19, 24 (Dec. 2007).
\end{flushleft}
prove the calm before the storm. Clouds would begin to gather in the summer of 2007 as rising defaults on U.S. sub-prime residential mortgages sent ripples through asset-backed securitization markets. The clouds opened up in March 2008 when investment bank Bear Stearns received a last minute bailout from the federal government (in the form of a forced sale to JPMorgan Chase) after two of its hedge funds accrued devastating losses on thinly-traded CDOs on sub-prime mortgages.\textsuperscript{173} The storm would reach hurricane strength in September 2008 when investment bank Lehman Bros. announced that it was filing for Chapter 11 bankruptcy protection following dramatic losses in its securitization business. Within a matter of days, the resulting liquidity crisis claimed AIG, which received the first of several federal bailouts on September 16, 2008.

The events of March-September 2008 spurred U.S. financial regulators to once again turn their attention to the regulation of OTC derivatives markets. In March 2008, in the immediate aftermath of the Bear Stearns bailout, the CFTC and SEC entered into a mutual cooperation agreement with a view to enhancing coordination and facilitating review of new derivatives products.\textsuperscript{174} In November 2008, the CFTC, SEC, and Federal Reserve Board entered into a memorandum of understanding to establish a framework for consultation and information sharing on regulatory issues related to centralized counterparties for CDS contracts.\textsuperscript{175} In December 2008, the CFTC announced that the CME had certified a proposal to clear CDS through the CME’s clearing facilities.\textsuperscript{176} Then, in August 2009, the Obama Administration unveiled the centerpiece of the U.S. federal government’s new approach toward the regulation of OTC derivatives markets: the Over-the-Counter Derivatives Markets Act of 2009, ultimately enacted in July 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).\textsuperscript{177}

\begin{itemize}
\item \textsuperscript{173} The $2 Bailout, 	extit{ECONOMIST}, Mar. 22, 2008, at 81; What Went Wrong?, 	extit{ECONOMIST}, Mar. 22, 2008, at 79.
\item \textsuperscript{174} Press Release, CFTC, CFTC, SEC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivatives (Mar. 11, 2008), http://www.cftc.gov/PressRoom/PressReleases/pr5468-08.html.
\item \textsuperscript{175} CFTC.gov, History of the CFTC, http://www.cftc.gov/About/HistoryoftheCFTC/history_2000s.html (last visited Sept. 17, 2010).
\item \textsuperscript{176} Press Release, CFTC, CFTC Announces that CME Has Certified a Proposal to Clear Credit Default Swaps (Dec. 23, 2008), http://www.cftc.gov/PressRoom/PressReleases/pr5592-08.html.
\end{itemize}
The Administration has characterized the objectives of its new approach toward the regulation of OTC derivatives markets as to (1) guard against excessive systemic risk; (2) promote transparency and efficiency; (3) prevent market manipulation, fraud, insider trading, and other market abuses; and (4) block inappropriate marketing to unsophisticated parties. The Act confers upon the CFTC and SEC the authority to require "swaps" and "security-based swaps," respectively, to be (1) centrally cleared through a CFTC-regulated derivatives clearing organization or SEC-regulated securities clearing agency and (2) traded on a regulated board of trade, exchange, or alternative swap execution facility. A (security-based) swap will be exempt from the central clearing and exchange trading requirements if one of the counterparties is not a "financial entity" or is using the instrument to hedge or mitigate commercial risk. In order to incentivize greater utilization of centrally-cleared and exchange-traded instruments, it is likely that the new regime will ultimately impose higher capital and margin requirements in connection with un-cleared (security-based) swaps. The Act further requires the registration of, inter alia, the centralized counterparties, swap repositories, and alternative swap...
execution facilities which have, over the course of time, emerged and matured into the private regulatory infrastructure supporting many OTC derivatives markets. These entities (other than centralized counterparties registered with the SEC) are then required to comply with a set of “Core Principles” and other requirements articulated in the Act and to design, implement, monitor, and enforce technical regulation in furtherance of these principles. While the Act does not articulate a similar set of core principles for SEC-registered centralized counterparties, it does mandate that the agencies adopt similar rules governing these registrants. The Dodd-Frank Act carves up jurisdiction over OTC derivatives markets by distinguishing between contracts for the sale of a commodity for future delivery and swaps (subject to CFTC jurisdiction), and security-based swaps (subject to SEC jurisdiction). Simultaneously, however, the Act mandates consistency and comparability between SEC and CFTC rules and regulations governing functionally or economically similar products and entities. To this end, the SEC and CFTC have been handed joint responsibility for fleshing out many of the technical details of the Act. The Obama Administration also requested that the two agencies produce a joint plan for harmonizing the regulation of OTC derivatives markets.

The success of the new U.S. regulatory regime governing OTC derivatives markets will hinge on a number of as yet unresolved issues. The approach ultimately adopted by the CFTC and SEC with respect to the determination of whether a particular group, category, type, or class of (security-based) swap be will subject to the clearing requirement, insofar as it will serve to demarcate the perimeter of the new regulatory regime, will clearly impact the extent to which the Act will be able to achieve its stated objectives. It appears unlikely, for example, that the tailored CDS on CDOs at the epicenter of AIG’s collapse would be deemed appropriate for central clearing. In the same vein, it is an open question as to whether

185. Id. § 728.
186. Id. §§ 733, 763; see also Dan Awrey, The Dynamics of OTC Derivatives Regulation: Bridging the Public-Private Divide 11:2 EUR. BUS. ORG. L. REV. 155 (exploring the costs and benefits of public and private systems of ordering within the context of OTC derivatives regulation).
187. Dodd-Frank Act §§ 725, 728, 733 & 763.
188. Id. § 712.
189. Id. §§ 712, 722, 761-763.
190. Id. § 712.
191. Id. These responsibilities include defining the terms “swap,” “security-based swap,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant,” and “eligible contract participant.” Id. § 712.
the capital and margin haircuts for un-cleared derivatives will effectively counterbalance the private incentives of dealers to circumvent centralized clearing and exchange-trading requirements. Furthermore, the success of the Act in terms of its systemic protection mandate will depend on whether centralized counterparties are themselves sufficiently well designed and capitalized to withstand systemic shocks and whether mechanisms are established ex ante to effectively manage their failure. Finally, only time will tell whether exchanges and alternative trading platforms will be able to deliver the liquidity, price transparency and low transaction costs promised by proponents of the Act. Each of these issues will, at least in part, ultimately be conditional upon the materialization of competitive markets for both trading platforms and centralized counterparties. For these and many other reasons, it is still too early to predict whether the Act will prove an effective response to the regulatory challenges posed by OTC derivatives markets.

The response of U.S. regulators to the emergence, growth, and proliferation of OTC derivatives markets yield a number of observations. First, the existence of multiple regulators within the field—each with uncertain and often overlapping jurisdictions—appears to have increased the overall costs of regulation. From the perspective of regulators, these costs include those stemming from, inter alia, the increased coordination and other transaction costs associated with the resolution of relatively frequent jurisdictional disputes, along with the attendant opportunity costs associated with the diversion of regulatory resources away from the design, promulgation, monitoring, and enforcement of substantive regulation in response to the myriad of challenges posed by OTC derivatives markets. From the perspective of market participants, meanwhile, the relevant costs include those incurred in connection with the interpretation of and compliance with the dense "thicket of complicated rules" which have been generated for the purpose of exempting OTC derivatives markets from regulatory oversight. Collectively, these costs have undermined both the effectiveness of U.S. financial regulation and the competitiveness of U.S. financial markets.

A second observation stems from the role played by the U.S. Congress, Treasury Department, and Federal Reserve Board in supporting the development of OTC derivatives markets. Despite the extensive involvement of the U.S. banking industry in these markets, federal banking regulators adopted a decidedly non-interventionist stance during

195. These costs also include switching costs for those market participants who do not wish to remain exposed to the resulting legal uncertainty.
196. Both in their capacity as dealers and as market counterparties.
the boom years leading up to the global financial crisis. Indeed, as evidenced by their opposition to, for example, the CFTC's exclusive jurisdiction clause and 1998 Concept Release, the Treasury and Fed actively intervened on multiple occasions to block regulatory intervention. Congress supported these efforts in each instance by enacting legislation—the Treasury Amendment, the GLBA and, finally, the CFMA—which constrained the ability of other regulators (the SEC and CFTC in particular) to legislate the field. The principal recipient of this beneficence was of course the U.S. banking industry itself, which derived potential private benefits from, amongst other sources, (1) lower overall costs of regulation and (2) the absence of market transparency vis-à-vis clients and non-bank counterparties. This observation lends support to the thesis, developed by Simon Johnson and others, that the U.S. banking industry has succeeded—primarily by inculcating a pervasive belief in the benefits of free markets and their importance in securing America’s global position—in capturing both federal banking regulators and Congress.¹⁹⁷

These observations have important implications for the present inquiry. As previously acknowledged, they support the theoretical hypothesis that systems premised on multiple regulators will incur higher coordination and other transaction costs. Simultaneously, and as proponents of integrated regulation might predict, the fragmentation of the U.S. regulatory regime (and resulting inter-agency conflict) has resulted in the perpetuation of a regulatory framework which has become increasingly unreflective of the structure of the markets which it regulates and chronically (perhaps terminally) slow in responding to new market developments.¹⁹⁸ The U.S. experience supports the case for integrated regulation in at least two other important respects. First, the failure of U.S. regulators to generate substantive regulation in response to risks associated with OTC derivatives markets resulted in a form of de facto convergence within the market for regulation, effectively foreclosing the prospect of welfare-enhancing regulatory competition.¹⁹⁹ Second, the role played by


¹⁹⁸ Russo & Vinciguerra, supra note 120, at 1451, 1460. As Russo and Vinciguerra observe, attempts in the U.S. to regulate OTC derivatives markets have frequently followed a discernible pattern: (1) innovation within derivatives markets, (2) falling outside the current regulatory framework, (3) spawning jurisdictional conflict between regulators, and (4) resulting in a regulatory compromise which does little to address risks associated with OTC derivatives markets or prevent future jurisdictional disputes. Id.

¹⁹⁹ The Dodd-Frank Act might change this. Specifically, centralized counterparties,
Congress and federal banking regulators in blocking regulatory intervention provides a potential rebuttal (albeit an anecdotal and largely inferential one) to those who assert that systems based on multiple regulators will prove less prone to capture. Finally, understanding the regulatory environment in the U.S. is a necessary pre-condition to understanding the competitive dynamic which developed between the U.S. and U.K. in the years leading up to the global financial crisis. As will be explored in greater detail below, this dynamic was highly influential in shaping the FSA’s approach toward the regulation of OTC derivatives markets.

C. The U.K. Experience

The U.K. has a long tradition of self-regulation. This tradition has been variously explained on the basis of the U.K.’s regulatory culture, broader political and cultural factors, and more grounded policy considerations such as the expertise, responsiveness, and cost-effectiveness theoretically associated with regulation generated by private actors. Perhaps nowhere has this tradition been more clearly observable—or had a more profound impact—than in connection with the regulation of U.K. financial markets. Indeed, before the dramatic structural changes ushered in by the so-called “Big Bang” and the enactment of the FSA 1986, the U.K. relied almost exclusively on private actors, informal measures, customary understandings, and moral suasion on the part of the Bank of England as sources of financial regulation.


202. “Big Bang” (never the “Big Bang”) refers to the October 27, 1986 restructuring of the London Stock Exchange (LSE). Formerly a private and autonomous association, Big Bang brought the LSE within the scope of the FSA 1986, abolished minimum commissions, and eliminated the longstanding distinction between stockbrokers and stockjobbers. Big Bang also saw the removal of restrictions respecting the organization and ownership of LSE member firms, thus facilitating for the first time the acquisition of significant interests in members by other financial intermediaries. Heidi Mandanis Schooner & Michael Taylor, United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets, 38 TEX. INT’L L.J. 317, 330 (2003).

203. Financial Services Act (FSA), 1986, c. 60 (Eng.).

204. Schooner & Taylor, supra note 202, at 320.

The FSA 1986 imposed for the first time a statutory framework on the U.K.'s self-regulatory infrastructure. At its core, the FSA 1986 contemplated a two-tiered system of "co-regulation." This framework proceeded from the delegation of specified powers by the Department of Trade and Industry (DTI) to private sector "designated agencies" (the first tier). The most important of the designated agencies under the FSA 1986 was, for the present purposes, the Securities and Investments Board (SIB). The SIB was responsible for setting the overarching regulatory framework and agenda through the issuance of Statements of Principle and Core Rules of broad application across all financial markets. Under the authorization and oversight of the SIB, day-to-day responsibility for promulgating, monitoring, and enforcing the vast majority of regulation fell to a small group of self-regulatory organizations (SROs), recognized investment exchanges, and professional bodies (the second tier). The SROs, which were funded and partially managed by their member firms, included the Securities and Futures Authority (SFA), Investment Management Regulatory Organization (IMRO), Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA), and Life Assurance and Unit Trust Regulatory Organization (LAUTRO).

206. See Cheffins, supra note 201, at 367 (employing the term as coined in John Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate 102 (Oxford Univ. Press 1992)).


208. FSA 1986, c. 60, § 114 (Eng.); Fin. Services Act 1986 (Delegation) Order, 1987, S.I. 1987/942 (Eng.); Financial Services Act 1986 (Delegation) (No. 2) Order, 1988, S.I. 1988/738 (Eng.). The SIB was a private company limited by guarantee incorporated pursuant to the Companies Act 1985. Nevertheless, the SIB exhibited several characteristics of a quasi-governmental agency. For example, the chairperson of the SIB was selected jointly by H.M. Treasury and the Bank of England. FSA 1986, c. 60, § 114, sched. 7 (Eng.). In addition, the agency accounted for the exercise of its powers through regular review meetings with H.M. Treasury. At the same time, however, the FSA 1986 explicitly affirmed that the SIB was not subject to the financial and organizational constraints which apply to government departments; FSA 1986, c. 60, § 116, sched. 9 (Eng.). For a more detailed description of the SIB, see Cheffins, supra note 201, at 366-367 (explaining the SIB's role within the regulatory structure, its powers, and the limits on its discretion).

209. The Statements of Principle articulated standards for any type of investment business done by any person. The Core Rules covered conduct of business, financial resources, treatment of client funds, and unsolicited calls. SROs could diverge from the Core Rules in certain circumstances with SIB permission. SRO rules would further explain, extend, or qualify the Core Rules as appropriate for the particular investments supervised by the relevant SRO. Companies and Securities Advisory Committee, Law of Derivatives: An International Comparison, at 68 (Jan. 1995) (Austl.).

210. The five original SROs under the oversight of the SIB would in 1994 be consolidated into three: the SFA, IMRO, and Personal Investment Authority (PIA). As discussed in greater detail below, much of the impetus for this change would be provided by dissatisfaction respecting overlaps and possible gaps in the areas of responsibility of the
Pursuant to the FSA 1986, persons or firms dealing in, arranging dealings in, and managing or advising on “investments” in the U.K. were deemed to be engaged in the “investment business.”^{211} Unless exempted, they were required to be authorized and registered either through membership in one or more SROs, as applicable, or by the SIB directly.\textsuperscript{212} The FSA 1986 cast a wide net around the definition of an “investment,” identifying an exhaustive list of instruments which included shares, debentures, government securities, and, importantly for the present purposes, options, futures, contracts for differences, and rights and interests in investments.\textsuperscript{213} Persons or firms whose business activities were captured within this net were subject to regulation by the SIB and/or the relevant SROs governing, amongst other matters, conduct of business, capital adequacy, financial and transaction reporting, segregation of client accounts, and custody of client assets.

The most important SRO in terms of the regulation of derivatives was the SFA. The SFA was responsible for regulating registrant persons and firms (1) dealing in, arranging dealings in, and advising on all types of investments, including futures, options and contracts for differences, (2) managing assets, some or all of which were derivatives instruments,\textsuperscript{214} and (3) managing or operating authorized unit trusts or recognized collective investment schemes, which were dedicated to derivatives.\textsuperscript{215} Other SROs played ancillary roles in regulating derivatives. The IMRO, for example, regulated derivatives transactions, which were ancillary or incidental to a registrant firm’s investment management or advisory business. FIMRA regulated options on securities and equity indices traded on or under the rules of a recognized or designated investment exchange and used only for hedging. LAUTRO, meanwhile, regulated the marketing of authorized unit trust schemes which invested in futures and options.\textsuperscript{216}

In addition to complying with general SIB Core Conduct of Business (COB) Rules and SFA Rules,\textsuperscript{217} registrant firms were required to comply with a number of requirements specifically targeted at derivatives. The primary thrust of these requirements was to ensure the suitability of derivatives instruments for investment by certain types of customers. As a starting point, both the SIB Core COB Rules and SFA Rules distinguished

\begin{itemize}
\item \textsuperscript{211} FSA 1986, c. 60, sched. 1, pt. II, s. 12. \textsuperscript{s} 211
\item \textsuperscript{212} FSA 1986, c. 60, pt. I, ch. 2, §§ 3, 4; FSA 1986, c. 60, pt. I, ch. 3, §§ 7, 25. \textsuperscript{s} 212
\item \textsuperscript{213} FSA 1986, c. 60, sched. 1. \textsuperscript{s} 213
\item \textsuperscript{214} Unless the investments managed were primarily securities. \textsuperscript{s} 214
\item \textsuperscript{215} Companies and Securities Advisory Committee, supra note 208, at 67. \textsuperscript{s} 215
\item \textsuperscript{216} Id. \textsuperscript{s} 216
\item \textsuperscript{217} In addition to the SFA rules, registrant firms need to comply with the relevant U.K. listing requirements with respect to exchange-traded or “securitized” derivatives. \textsuperscript{s} 217
\end{itemize}
between “customers” and “non-customers.” Customers were then further divided between “private customers” (primarily individuals and small business investors) and “non-private customers” (effectively reserved for sophisticated market counterparties). These classifications were highly significant in that they determined the nature and extent of a registrant firm’s obligations toward a given customer (or non-customer). The greatest obligations were owed to private customers, the least to non-customers.

Derivatives-specific regulations governing the relationship between registrant firms and their private customers included a prohibition against effecting, arranging, or recommending OTC derivatives to a private customer unless the registrant firm reasonably believed that the purpose of the transaction was to hedge against currency risk. Registrant firms were also required to (1) provide private customers with a Derivative Risk Warning Notice before trading in derivatives, (2) warn private customers of the potential difficulties associated with establishing a proper market price for, and disposing of, “non-readily realizable investments” such as OTC derivatives, (3) disclose any position knowingly held by the registrant firm, or any associate, in the same (or a related) investment, and (4) where the investment services involved derivatives, put in place a two-way customer agreement. The SFA also provided guidance that a customer should not be treated as an “expert” (i.e. a non-private customer) in options and futures unless the customer was experienced in derivatives of the relevant kind—not just in other investments or types of

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218. Companies and Securities Advisory Committee, supra note 209, at 75 (citing SFA Rule 9-1). Ed. note: many of the SFA, SIB, and IMRO rules are practically unavailable, except by reference to the report.

219. Id.

220. Companies and Securities Advisory Committee, supra note 209, at 74.

221. Companies and Securities Advisory Committee, supra note 209, at 81 (citing SFA Rule 5-44; IMRO Ch II Rule 3.13; and SIB Core COB Rule 27).

222. SECURITY AND FUTURE AUTHORITY BOARD, GUIDANCE NOTE TO SFA RULE 5-30. (Feb. 19, 1996). The Notice described various types of derivatives and sought to explain their risks. The Notice contained mandatory information respecting commissions, suspensions of trading, clearinghouse protections, and insolvency. Where relevant, the Notice also contained information respecting OTC transactions, foreign markets, contingent liability transactions, and collateral. Companies and Securities Advisory Committee, supra note 209, at 84-85.

223. Companies and Securities Advisory Committee, supra note 209, at 85 (citing SFA Rule 5-30(5)).

224. Id.

225. Id. at 88 (citing SFA Rule 5-23). A two-way customer agreement was required to include information, if applicable, regarding (1) whether derivatives transactions may be undertaken, and (2) the basis upon which the customer would incur any contingent liability. Id.
Lastly, with regard to collective investment schemes, SFA Rules contemplated marketing and investment restrictions for options and futures funds, along with special registration requirements for individuals engaged in their marketing. These rules were collectively designed to protect less sophisticated customers from the perils of trading in derivatives instruments. Simultaneously, however, these rules adopted a non-interventionist (effectively, a *caveat emptor*) approach toward the regulation of derivatives transactions between market counterparties.

The two-tiered framework established under the FSA 1986 formalized—without significantly altering—a historically fragmented self-regulatory regime which over time had resulted in the development of markedly different institutional arrangements and legal regimes governing banking, securities, and insurance markets. Registrant firms were often regulated by multiple SROs, precipitating a degree of confusion and legal uncertainty and generating significant inefficiencies. Indeed, almost from the outset, the framework was criticized as unwieldy and unduly bureaucratic. Compounding matters, the SIB was widely perceived as weak, its only leverage being its nuclear power to derecognize an SRO. This perception was reinforced by a series of high-profile financial scandals, culminating in the 1995 collapse of Barings plc. The Barings collapse in particular exposed the importance of effective coordination between banking and securities regulators within a fragmented regulatory system. These scandals also served to raise questions regarding the effectiveness of the SROs’ efforts to prevent misconduct amongst their members. Ultimately, these perceived weaknesses—along with pressure

226. Companies and Securities Advisory Committee, *supra* note 209, at 78 (citing SFA Guidance (February 1994)).

227. *See* Financial Services (Regulated Schemes) Regulations 1991, (incorporating amendments to regulations in releases 159, 169, 178, 189, 191, and 198); Companies and Securities Advisory Committee, *supra* note 209, at 81-82 (citing Financial Services Regulations 5.07(2), 5.21, 5.23, 5.25(3), and 5.63(1)).

228. One notable exception being the exemption of derivatives contracts from the application of the Gaming Act 1845. FSA 1986, c.60, pt. 1, ch. 8, § 86. This exemption is now contained in § 412 of the FSMA.


230. *Id.* at 265. *See* AYRES & BRAITHWAITE, *supra* note 206, ch. 2, (discussing the likely ineffectiveness of such “nuclear” powers when they represent the only weapon in a regulator’s enforcement arsenal).


234. *Id.* at 267; Jerry Markham, Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan, 28 BROOK. J. INT’L L. 319, 376-77 (2003).
from both the City (which saw greater formalization as a necessary response to increasing international competition)\textsuperscript{235} and Parliament (which anticipated pressure from the E.U. as a result of its entry into the field of financial regulation)—swung the tide in favor of greater formalization and less fragmentation. By the Spring of 1997, the table was thus set for a sea change in the regulation of U.K. financial markets.

The optimal structure of financial regulation—and, in particular, the appropriate policy response to the rapid evolution of financial markets and increasing international competition within the financial services industry\textsuperscript{236}—was very much a live issue in the 1997 U.K. general election.\textsuperscript{237} Within days of its electoral victory, the incoming Labour government announced its intention to move the U.K. toward a single, integrated financial regulator.\textsuperscript{238} As Ferran observes, the government justified the move toward integrated regulation on the grounds that (1) "[t]he existing system was failing to deliver [high] standards of investor protection and supervision . . . ;" (2) "[t]he two tier structure under the Financial Services Act 1986 was inefficient, confusing, and lacked accountability and a clear allocation of responsibilities;" and (3) there existed the need for a regulatory structure that would reflect the integrated nature of modern financial markets.\textsuperscript{239}

The U.K. government wasted little time in moving forward. In October 1997, the SIB was re-branded the Financial Services Authority (FSA). Over the course of the next several months, most of the existing designated agencies and SROs would be merged into the FSA “on a largely informal and ad hoc basis.”\textsuperscript{240} In July 1998, the government published the Financial Services and Markets Bill in draft form.\textsuperscript{241} After a “tortuous”\textsuperscript{242} legislative process, the Financial Services and Markets Act\textsuperscript{243} received Royal Assent in June 2000. The FSMA created the FSA as the single, integrated regulator for financial services in the U.K., thus formally

\textsuperscript{235} Baggott, supra note 200, at 448.
\textsuperscript{236} See Reforming the City, ECONOMIST, Feb. 15, 1997, at 19 (supporting the concept of an integrated regulatory regime in London).
\textsuperscript{237} See Schooner & Taylor, supra note 202, at 331 (discussing the central role of the debate over integrated regulation in the 1997 U.K. general election).
\textsuperscript{238} Ferran, supra note 39, at 260.
\textsuperscript{239} Id. at 271.
\textsuperscript{240} Id. at 273 (citing Howard Davies, Law and Regulation, 3 J. INT’L FIN. MKTS. 169, 169 (2001)).
\textsuperscript{241} Press Release, Financial Services Authority, Publication of the Draft Bill (July 30, 1998).
\textsuperscript{242} Grant Ringshaw, Editorial, Crackdown in the City: Slapped Wrists or Heads on Spikes? Grant Ringshaw Reveals the Plans of the World’s Most Powerful Financial Regulator, SUNDAY TELEGRAPH (London), Nov. 25, 2001, at 5.
\textsuperscript{243} Financial Services and Markets Act (FSMA), 2000, c. 8 (Eng.). The FSMA came into full force and effect in December 2001.
absorbing within it the jurisdiction and functions of the SIB, other designated agencies, and SROs. The FSMA identifies the objectives of the FSA as to maintain market confidence, promote public awareness, protect consumers, and reduce financial crime. The FSA is responsible for prudential conduct of business and market standards across, *inter alia*, the securities, insurance, and banking industries. It is also the U.K. Listing Authority.

The FSMA is frequently described as "framework" legislation in the sense that it is structured around (1) the articulation of high-level objectives and (2) the conferral upon the FSA of a wide latitude to design and implement a regulatory regime capable of achieving these objectives. Accordingly, much of the substantive regulation governing U.K. financial markets is located not within the FSMA itself, but within secondary legislation, instruments, and other guidance issued by H.M. Treasury and the FSA.

Following the same broad approach as the FSA 1986, the FSMA mandates that any person engaged in a "regulated activity" must, unless exempted, be authorized by the FSA. Regulated activities under the FSMA include (1) "dealing in investments," (2) "arranging deals in investments," (3) "deposit taking, safekeeping and administration of assets," (4) "managing investments," (5) "investment advice," (6) "establishing collective investment schemes," and (7) "using computer-based systems for giving investment instructions." The term investment is defined broadly so as to include, *inter alia*, "securities," "instruments creating or acknowledging indebtedness," "instruments giving entitlement to investments," "options," "futures," "contracts for differences," and "rights in investments."

Also like the FSA 1986, the FSMA prescribes regulation of both general and more targeted application to OTC derivatives. Regulation of general application (but nevertheless applicable to OTC derivatives) includes, for example, the liability imposed upon market participants in

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245. FSMA §2(2).
247. FSMA, §19.
248. *Id.* §22; *Id.* §§ 2-9, sched. 2.
249. *Id.* §§10-24, sched. 2.
250. See HUDSON, *supra* note 244, at 637 (characterizing them as, respectively, "macroscopic" and "microscopic" forms of regulation).
connection with making misleading statements, creating a false or misleading impression as to the market, insider trading, and market abuse. Similarly, securitized derivatives offered to the public and admitted to the Official List maintained by the FSA in its capacity as the U.K. Listing Authority are subject to the relevant prospectus and disclosure requirements, along with other continuing obligations under U.K. Listing Rules.

Registrant firms are also subject to the requirements set out in the FSA Conduct of Business Sourcebook (COBS). COBS rules flow from the categorization of clients as retail clients, professional clients, or eligible counterparties in accordance with, effectively, their ostensible level of financial expertise and sophistication. COBS rules require registrant firms to provide clients with a risk warning statement describing both the general and specific risks associated with certain designated investments (such as OTC derivatives) including, inter alia, those relating to leverage, volatility, and contingent liabilities. In addition, COBS rules require that registrant firms put in place two-way customer agreements in connection with transactions in such designated investments. Like their counterparts under the FSA 1986, these requirements are motivated by the desire to protect less sophisticated clients. Importantly, however, transactions in OTC derivatives between eligible counterparties are expressly exempted from these requirements, thus maintaining the non-interventionist approach adopted under the FSA 1986.

In contrast with the fractured U.S. regulatory regime, the scope of the FSMA has been framed broadly enough so as to clearly bring OTC derivatives markets within the perimeter of the FSA’s jurisdiction. Nevertheless, despite sweeping structural changes, the FSA’s non-interventionist approach has remained functionally equivalent to both the regime adopted by the SIB under the FSA 1986 and—even more importantly for present purposes—that perpetuated by the alphabet soup of

251. FSMA, §397(1).
252. Id. §397(3).
253. Id. §402(1).
254. Id. §118(1).
255. See HUDSON, supra note 243, at 650-656 (detailing the prospectus and disclosure requirements).
257. Id. at ch. 14, §14.3.2.
258. HUDSON, supra note 243, at 667.
259. See id. (noting that the requirement is part of a policy to protect customer rights).
260. COBS, supra note 256, at ch. 1, annex.
261. And, indeed, the FSA 1986.
262. HUDSON, supra note 243, at 663.
U.S. regulators. The salient question thus becomes: *Why, despite the numerous theoretical advantages of integrated regulation, did the FSA generate and adhere to a non-interventionist—and arguably sub-optimal—approach toward the regulation of OTC derivatives markets?*

IV. **Drawing Lessons from the FSA’s Non-Interventionist Approach Toward the Regulation of OTC Derivatives Markets**

There can be little doubt that the FSA has harnessed many of the theoretical strengths of integrated regulation. Through the articulation of regulatory objectives and principles of good regulation, the FSMA provides the FSA with a single, clear and, arguably, coherent mandate. Simultaneously, the FSMA confers upon the FSA a great deal of flexibility in terms of how it goes about achieving its mandate. The FSMA also establishes a number of mechanisms designed to ensure the *de jure* accountability of the FSA to both the U.K. Parliament and public. The FSA has pursued large infrastructure projects such as Integrated Regulatory Reporting (IRR) and the Advanced Risk Responsive Operating Framework (ARROW) with a view to reaping the potential economies of scale and scope associated with integrated regulation. Integration has also contributed toward the FSA’s consistently high ranking relative to its international peers—and especially the U.S.—in terms of the delivery of

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263. These mechanisms include the requirement in the FSMA that the FSA exercise its powers in a way which is compatible with its regulatory objectives. FSMA, §2(1)(a). As Briault observes, this requirement provides the foundation for the political and legal accountability of the FSA. See Briault, *supra* note 34, at 10 (discussing requirements for the FSA that increase accountability). Other accountability mechanisms established by the FSMA include (1) a requirement that the FSA make annual reports to H.M. Treasury, which must be put before Parliament (FSMA, §1, sched. 1), (2) the allocation of power to H.M. Treasury to appoint the FSA chairperson and board (Id.), and (3) the allocation of power to H.M. Treasury to order independent reviews of FSA’s financial affairs (Id. §12) and commission independent inquiries into financial failures (Id. §14).

264. These mechanisms include a requirement in the FSMA that the FSA engage in public consultation before exercising its rulemaking powers, including the publication of draft rules and cost-benefit analyses. Id. §§ 65, 121, 155. In addition, FSA decisions are subject to review by an independent financial services tribunal (Id. §55), while the effects of FSA regulation on competition are subject to review by the Director General of Fair Trading and the Competition Commission. Id. § 160.


266. In a nutshell, ARROW is the FSA’s integrated model for assessing risk, supervising registrant firms and targeting thematic work relating to consumers, sectors and multiple firms. See FSA, *What we do: regulatory approach*, http://www.fsa.gov.uk/Pages/About/What/Approach/index.shtml (last updated Sept. 28, 2010).
cost-effective regulation.\textsuperscript{267} This relative cost-effectiveness was, in turn, one of the key drivers underlying the growth of the U.K. financial services industry in the years building up to the global financial crisis. Finally, although not directly attributable to integration, the FSA arguably exhibits many of the other key determinants of regulatory efficiency and effectiveness: financial independence, adequate financial resources, and a comprehensive arsenal of enforcement powers. The FSA might at first blush thus appear to represent a model institutional framework—in particular relative to the fractured, and in many respects dysfunctional, U.S. regulatory regime.

Upon closer inspection, however, it would be unwise to herald the FSA as an unmitigated success for proponents of integrated regulation. The FSA is frequently described by market participants as overly bureaucratic, intrusive, and insensitive.\textsuperscript{268} In addition, the internal organization of the FSA—especially within the Risk Business Unit\textsuperscript{269}—still reflects in many respects historical divisions between the banking, insurance, and securities industries.\textsuperscript{270} Indeed, for much of its existence, the FSA’s organizational structure revolved more fundamentally around such sectoral divisions. Finally, there is reason to question the extent to which the FSA is, in practice, accountable to either the U.K. Parliament or public. In terms of \textit{de jure} accountability, the FSMA precludes H.M. Treasury from directly interfering with the affairs of the FSA outside the limited circumstance in which FSA regulation is found by the Competition Commission to have had a significant and unjustified adverse effect on competition.\textsuperscript{271} In terms of \textit{de facto} accountability, meanwhile, the fact that the FSA is wholly funded by industry levies constrains the ability of Parliament to exert influence over its affairs via the power of the purse string. Perhaps even more importantly, this funding model gives rise to the possibility that the FSA (as a supplier of regulation) may be influenced by an acute degree of \textit{de facto} accountability to market participants (as important consumers of regulation), thus raising the specter of welfare-

\textsuperscript{267} Indeed, the cost effectiveness of the FSA’s integrated institutional framework was arguably apparent from the outset. Specifically, despite the wider scope of its jurisdiction relative to its predecessor agencies, the FSA cost less in real terms between 1998 and 2002. Briault, supra note 45, at 16.

\textsuperscript{268} The Regulator Who Isn’t There, \textit{ECONOMIST}, May 16, 2002.

\textsuperscript{269} The FSA’s other major regulatory business unit, the Supervisory Business Unit, is organized on what might be characterized as a functional basis between small firms, retail firms, major retail groups, and wholesale firms.

\textsuperscript{270} Indeed, the Risk Group is divided on both a sectoral basis (between banking, insurance, asset management, and capital markets) and objectives-based basis (between prudential and conduct of business regulation). FSA Organizational Chart 2010, http://www.fsa.gov.uk/pages/About/Who/pdf/orgchart.pdf.

\textsuperscript{271} FSMA, §308.
reducing public choice and regulatory capture problems. Ultimately, however, these problems collectively provide a fundamentally incomplete—and thus unpersuasive—explanation for why, despite the numerous theoretical advantages of integrated regulation, the FSA generated a non-interventionist regulatory regime with respect to OTC derivatives markets.

A more robust potential explanation for the FSA’s pre-crisis approach toward the regulation of OTC derivatives markets is that it was a product of one, or more likely a combination, of (1) poor coordination, (2) the FSA’s attempts to balance competing regulatory objectives, (3) incentive problems which arise for national regulators such as the FSA in context of regulating globally integrated financial markets, and/or (4) the inherent limitations of regulation within highly complex and dynamic global financial markets. Each of these potential explanations manifest important lessons for policymakers contemplating structural reform of financial regulation. Perhaps most significantly, none of these potential explanations arise from challenges that are at all unique to integrated regulation.

A. Poor Coordination

The FSA has at times struggled to capitalize upon the theoretical potential of integrated regulation to enhance intra-agency coordination. An internal report of the FSA’s handling of the Equitable Life Assurance Company affair, for example, identified poor communication between individual regulators within the FSA as a deficiency in its regulation between 1999-2000.272 The FSA was also criticized by market participants in 2001 for failing to coordinate the approaches of its various specialist teams in connection with the introduction of the Integrated Prudential Sourcebook.273 More recently, the internal audit report of the Northern Rock crisis identified, inter alia, poor internal communication and information flow within the FSA, along with inconsistent implementation of rules and procedures, as contributing toward a sub-optimal supervisory strategy which allowed warning signs of the pending crisis at the bank to

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272. Ferran, supra note 39, at 295 (citing REPORT OF THE FINANCIAL SERVICES AUTHORITY ON THE REVIEW OF THE REGULATION OF THE EQUITABLE LIFE ASSURANCE SOCIETY FROM 1 JANUARY TO 8 DECEMBER 2000, WHICH HER MAJESTY’S GOVERNMENT IS SUBMITTING AS EVIDENCE TO THE INQUIRY CONDUCTED BY LORD PENROSE ¶ 6.2.5 (2001)).

273. Id. (citing Press Release, British Bankers’ Ass’n, BBA/LIBA Response to Consultation Paper 97 – The Integrated Prudential Sourcebook (Jan. 17, 2002)). To the extent that the events giving rise to these criticisms (and the Equitable Life affair) transpired within the first few years of the FSA’s existence, however, one might reasonably attribute any coordination problems to the growing pains (i.e. start-up costs) of a new and institutionally complex regulator.
go undetected. Given its record in this respect, it seems at the very least possible that the information necessary to fully evaluate the risks associated with the growth, proliferation, and complexity of OTC derivatives markets may not have been gathered, aggregated, analyzed, and/or directed to the FSA personnel capable of evaluating the probability and potential impact of these risks and, thereafter, initiating appropriate regulatory action. Indeed, while the FSA was not responsible under E.U. securities laws for the supervision of AIGFP, poor coordination—both internally and with AIGFP's French regulators—seems a likely (if only partial) explanation for why its USD$500 billion London-based CDS operations did not attract greater regulatory scrutiny. Ultimately, however, it is difficult to assess whether poor coordination was to blame for the FSA's failure to effectively monitor the operations of AIGFP or, more broadly, the extent to which it shaped the FSA's non-interventionist approach toward the regulation of OTC derivatives markets. Moreover, coordination problems likely represent at best only one piece of a much larger puzzle.

B. Competing Regulatory Objectives

A potentially more compelling explanation for the FSA's approach toward the regulation of OTC derivatives markets is that it was a product of the regulator's attempt to balance competing regulatory objectives. As the FSA itself acknowledges, its broad and complex remit invariably generates situations in which its statutory objectives will come into conflict with one another. As has already been observed, these statutory objectives are to maintain market confidence, promote public awareness, secure consumer protection, and reduce financial crime. Beneath these objectives, however, resides a second tier of regulatory objectives consisting of principles of good regulation, strategic aims, and outcomes that the FSA is expected to consider in pursuing its statutory mandate.

It is within this second tier that potential conflicts arise between the FSA's statutory objectives and the objectives of promoting efficient and internationally competitive financial markets. The principles of good regulation articulated in the FSMA mandate, for example, that the FSA discharge its functions with regard to, amongst other matters: (1) the desirability of facilitating innovation, (2) maintaining the competitive

274. See FSA, Lessons Learned Review of the Supervision of Northern Rock PLC During the Period 1 January 2005 to 9 August 2007: Executive Summary at 4-7 (March 2008) [hereinafter Executive Summary] (identifying, inter alia, (1) poor allocation of expertise, (2) lack of proper training for supervisory personnel, and (3) lack of expertise in prudential banking and financial analysis as contributing factors).

275. The author's request to interview FSA personnel was refused.

position of the U.K. within financial services and markets, (3) minimizing adverse effects on competition, and (4) the desirability of facilitating competition between those subject to FSA regulation. The FSA has further identified as strategic aims: (1) promoting efficient, orderly, and fair markets, and (2) improving its business capability and effectiveness. Amongst the FSA’s desired outcomes flowing from these strategic aims are that (1) the U.K. be internationally attractive, and (2) the FSA be easy to do business with. Indeed, the FSA has historically taken great pains to communicate to the marketplace that its general approach is to regulate in a way which supports competition and innovation with financial markets—with the promotion of competition, minimizing regulatory costs, making life easier for regulated actors, and restraint in regulatory intervention permeating FSA guidance and other literature prior to the global financial crisis. This approach should not ultimately be surprising given that, as has already been observed, the enactment of the FSMA, and with it the migration toward integrated regulation, was largely motivated by concerns regarding the international competitiveness of U.K. financial markets.

The trends toward globalization and integration within financial markets over the past several decades have sparked intense international competition within the financial services industry. This competition has fueled a transatlantic rivalry between New York and London for supremacy in the lucrative markets for investment banking, sales, and trading services. While New York has long been acknowledged as the global leader in these markets, recent years have seen Europe—and London in particular—attract a larger share of global investment banking revenues. Over this period, London has gained particular momentum in the markets for new public issuances of equity and debt and, importantly, the structuring of OTC derivative transactions. As of 2006, Europe (with London as its primary trading hub) accounted for 56% of the estimated USD$52 billion in global investment banking revenues derived from OTC derivatives transactions. Moreover, the increasing inter-relatedness of derivative and cash markets has conferred upon London an important strategic advantage relative to

277. FSMA, § 2(3)(d), (e), (f) & (g).
279. Id.
282. Id. at 54.
283. Id. at 13.
New York.284

London’s ascendency within the global financial services industry has been largely attributed to the relative attractiveness of the U.K.’s legal and regulatory environment. Specifically, the FSA’s integrated regulatory framework, responsiveness, flexibility, and accountability have been identified as key competitive advantages.285 Viewed from this perspective, the risks associated with the growth, proliferation, and complexity of OTC derivatives markets generated an acute conflict between the FSA’s regulatory objectives—any unilateral deviation from its non-interventionist approach in order to maintain market confidence, protect consumers, and/or reduce financial crime within OTC derivatives markets would potentially jeopardize the U.K.’s global competitiveness. Maintaining its non-interventionist approach can thus be explained as the by-product of the FSA’s attempt to balance these competing objectives. Perhaps most disconcerting in this respect is the lack of transparency accompanying this process—the FSA’s integrated structure having effectively driven this balancing act underground. That this balancing act may (with the benefit of hindsight) have proven socially sub-optimal286 ultimately only provides further fodder for critics of integrated regulation.

The nature of the conflict between the FSA’s regulatory objectives brings to mind Simon Johnston’s thesis respecting the “soft” capture of the U.S. Congress and financial regulators by the U.S. banking industry. The principles of good regulation, strategic aims, and outcomes described above are infused with language designed to emphasize the importance of minimizing the impact of FSA regulation on the operation of financial markets. This language reflects what was—prior to the crisis—a broader prevailing sentiment that unencumbered markets represented the optimal mechanisms for allocating societal resources. It can hardly be surprising, therefore, that FSA policy reflected this free market ethos with respect to, inter alia, the regulation of OTC derivatives markets. Indeed, the potential for “soft” capture may have been exacerbated in the case of the FSA by its funding model (which, as described above, relies on industry levies) and adherence to a “more principles-based” regulatory philosophy (which contemplates a high level of interaction and cooperation between the FSA and regulated actors).287

284. Id. at 54.
285. Id. at ii, 10, 12, 17, 54, 65, 80-81 & 86.
286. Which, it must be acknowledged, has not yet been established.
C. Incentive Problems: National Regulation, Global Markets

Prior to the onset of the global financial crisis, few would have argued that the U.K. had not reaped significant benefits—in the form of, *inter alia*, enhanced employment, personal and business incomes and, ultimately, tax revenues—\(^{288}\)—from the FSA’s non-interventionist approach toward the regulation of OTC derivatives markets. At the same time, however, as the effects of the crisis sent ripples through the global economy, the realization of many of the systemic risks associated with OTC derivatives imposed substantial costs on market participants and, ultimately, taxpayers residing outside the U.K. This negative externality exposes a third, and potentially powerful, explanation for the FSA’s approach: namely, that national regulators are unlikely to possess sufficient incentives to take unilateral action to address systemic risks within global financial markets. More specifically, while regulators will invariably incur significant direct and indirect costs when attempting to address systemic risks, the benefits thereby generated are likely to be negligible insofar as the jurisdiction will still be exposed to negative externalities stemming from the failure of regulators in other jurisdictions to adopt equivalent measures.\(^{289}\) From the perspective of national financial regulators, therefore, systemic risk regulation represents a bundle of potentially significant costs without the guarantee of any corresponding benefits. Viewed in this light, it is possible to see how the FSA may have reasonably dismissed unilateral intervention to ameliorate systemic risks within OTC derivatives markets—or to address regulatory gaps such as those exploited by AIGFP—as being fundamentally unappealing from a cost-benefit perspective.\(^{290}\)

D. The Inherent Limitations of Financial Regulation

While incentive problems and the challenge of balancing competing regulatory objectives provide compelling explanations for the FSA’s adoption of a non-interventionist approach toward the regulation of OTC

\(^{288}\) See *Bloomberg Report*, supra note 62 (describing some of the benefits that accrued to the U.K. as a result of the country’s regulatory regime).

\(^{289}\) Stemming from, for example, the promulgation, monitoring, and enforcement of systemic risk regulation.

\(^{290}\) Stemming from, for example, the marginal flight of business, and capital from the jurisdiction.

\(^{291}\) Simultaneously, any positive spillovers will flow at least in part to other jurisdictions.

\(^{292}\) Although in fairness to the FSA, the incentive problems manifested within this cost-benefit calculus were arguably compounded by a degree of ambiguity surrounding the extent to which the FSA had abrogated responsibility for systemic risk regulation to both the Bank of England and E.U. policymakers.
derivatives markets, there exists a potentially far more fundamental—and troubling—explanation. Modern financial markets are extremely complex. The frequency and complexity of interactions within and between financial markets, to say nothing of the nature and pace of change within these markets, make the timely and comprehensive evaluation of potential risks an exceedingly difficult, if not entirely unrealistic, prospect. Within such an environment, it is all but inevitable that regulators will be called upon to evaluate the probability and potential impact of a myriad of risks armed with imperfect information and, accordingly, deploy cognitive frameworks which exhibit elements of bounded rationality.

The current global financial crisis provides a vivid illustration of the informational challenges posed by the dynamism and complexity of modern financial markets. It is certainly the case that many of the factors which contributed to the onset and perniciousness of the crisis—including global trade imbalances, the growth and systemic importance of derivatives/securitization markets, increasing use of leverage, and evolving forms of maturity transformation—were more or less readily observable. Other factors, however—such as the flaws within the structure of derivatives markets and their pricing, over-reliance on sophisticated quantitative techniques for measuring and managing risk, hardwired procyclicality, the recycling of risk within the financial system, and the broader systemic implications of a liquidity crisis within wholesale credit markets—were arguably much less apparent, or at the very least contestable, until fairly late in the day. Furthermore, even in the circumstance where all relevant information was sufficiently observable ex ante, accurately predicting the probability, impact, and timing of the confluence of these factors would have still required a truly sophisticated understanding of the complex interactions within and between financial markets. Viewed from this perspective, it seems hardly surprising that the failure to initially identify, and then accurately assess the probability and likely impact of the growing systemic risks—indeed, in thinking that many of these factors were actually enhancing systemic resiliency—was


294. Id. at 11-23.

295. See FSA, Memorandum to the Treasury Committee, Recent Turbulence in Global Financial Markets and Northern Rock's Liquidity Crisis 2 (Oct. 9, 2007) (showing that as of January 2007, for example, while the FSA believed that a “market correction was likely,” it “attached a very low probability to a tightening of the speed, duration, and scale” which eventually occurred).

296. IMF, Global Financial Stability Report 51 (2006) (“The dispersion of credit risk by banks to a broader and more diverse set of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more
That this failure was not only one of regulators but also one of markets (as evidenced by, *inter alia*, the failure of pre-crisis CDS spreads to accurately reflect systemic risks) only further emphasizes the informational challenges posed within modern financial markets.

Historically, the informational challenges encountered within modern financial markets have been exacerbated within OTC derivatives markets by virtue of their opacity and the rapidity with which their counterparty exposures are capable of changing. These factors have combined to render it even more difficult for regulators to identify and evaluate potential risks within OTC derivatives markets. Nevertheless, the FSA, to its credit, was in fact able to identify a number of the risks associated with the growth, proliferation, and complexity of OTC derivatives markets prior to the onset of the crisis. More specifically, successive FSA Annual Reports and Financial Risk Outlooks identified, *inter alia* (1) the growth of credit derivatives markets; (2) the backlog of confirmations and other operational risk issues within OTC derivatives markets; and (3) the complexity of OTC derivatives and attendant risk management problems as issues of concern. Ultimately, however, the FSA failed both to foresee the role that OTC derivatives would play in the global financial crisis and to attach a sufficiently high probability and/or potential impact to their attendant risks so as justify the allocation of resources toward the implementation of rules designed to impose greater transparency, prevent market abuse, or mitigate potential systemic risks. It must be remembered, however, that all of this is apparent only with the benefit of hindsight. Accordingly, rather than viewing these failures as such, it may be more appropriate to view them (at least in part) as reflecting the complexity of modern financial markets, the informational challenges

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297. See *Turner Review*, supra note 293, at 85 (discussing the international failure to identify systemic risks).
298. *Id.* at 46, 109. In fact, CDS spreads within the financial services sector suggested that risks were at historically low levels. Indeed, it now seems that CDS prices—much like the insurance markets they so closely resemble—may systemically understate risks in upswings and overstate risks in downswings.
299. See Henry Hu, *Misunderstood Derivatives: The Causes of Information Failure and the Promise of Regulatory Incrementalism*, 102 Yale L. J. 1457, 1462-63 (1993) (discussing the difficulties posed to the financial system by the informational failures within banks and regulatory agencies); Wilmarth, *supra* note 35, at 467 (discussing the difficulties regulators face in monitoring OTC markets, which are particularly opaque and change rapidly).
303. Although in this final respect, it must be acknowledged that the FSA shared responsibility with the Bank of England.
posed thereby and, ultimately, the inherent limits of financial regulation.

There remains one final question: What lessons can policymakers in the U.S. and other jurisdictions draw from these potential explanations in terms of the optimal structure of financial regulation? First, as many critics of integrated regulation have suggested, the theoretical advantages of integrated regulation in terms of enhanced coordination may prove exceedingly difficult to operationalize. At the same time, as amply illustrated by the U.S. example, it must be acknowledged that barriers to effective coordination will likely exist within all institutional models. To the extent that the elimination of these barriers may prove less costly within the context of a single, integrated regulator with a unified management structure, integrated regulation as a whole may still represent a superior (if pareto-inferior) model. Ultimately, however, these potential savings must be weighed against the switching costs associating with any shift toward greater integration. Second, the results of the FSA’s attempt to balance competing regulatory objectives lend credence to concerns that integrated regulation may promote non-transparent decision-making processes which could result in the sub-optimal balancing—or even the outright subordination—of regulatory objectives. Inferentially, the FSA’s experience would also appear to provide a modicum of support for concerns regarding the vulnerability of integrated regulators to public choice and regulatory capture problems. The FSA’s experience in these regards thus serves to illuminate the potential desirability of proposals, such as those currently being pursued by the Conservative government in the U.K, which would see responsibility for prudential regulation, consumer protection, and competition split between separate specialist regulators. Third, the incentive problems faced by national regulators (which are ultimately deserving of a degree of attention which is beyond the scope of this paper) suggest that the benefits of integration—especially in terms of systemic risk (macro-prudential) regulation—may be the greatest if pursued at the supranational rather than the national level. This explanation, along with the failures of inter-jurisdictional regulatory coordination at the heart of the AIG debacle, bolsters the case for the development of a more robust global regulatory architecture.

Perhaps the most difficult potential explanation from which to derive lessons is that there may exist inherent limits on the potential efficacy of regulation within the context of highly complex and dynamic global financial markets. On one level, the FSA’s integrated “risk-based” approach to regulation, premised on evaluating the impact and probability of risks as a means of prioritizing them and allocating resources, seems a

304. See Enrich & Norman, supra note 17 (describing the elimination of the FSA and the consolidation of power within the Bank of England).
prudent course of action within such an environment. On another level, however, and as amply illustrated by the global financial crisis, the complexity and rapid pace of change within modern financial markets (along with our imperfect understanding of them) will almost inevitably undermine our attempts to accurately assess the probability and likely impact of potential risks. That the FSA has perhaps not fully grasped this possibility is evidenced by its recent statement that the crisis was "the crystallization of a low-probability, high-impact risk." Ultimately, it may not have been that the crisis was the crystallization of a low-probability risk, but rather that the FSA—along with other regulators and market participants—fundamentally misjudged its probability. In this light, perhaps the most important lesson stemming from the complexity and dynamism of modern financial markets is that we need to recalibrate our expectations of what financial regulation—irrespective of its institutional structure—is capable of achieving. As the FSA has long acknowledged, there will always be failures and it would be both impossible and, in any event, undesirable to seek to eliminate all risk from within financial markets.

V. CONCLUSION

The global financial crisis has prompted policymakers on both sides of the Atlantic to question their previous approaches toward financial regulation. The purpose of this paper has been to address a number of these questions as they relate to the efficiency and overall desirability of integrated regulation relative to competing institutional models, ultimately with a view to better understanding the optimal structure of financial regulation. More specifically, this paper has explored why, despite the numerous theoretical advantages of integrated regulation, the U.K. FSA adopted a non-interventionist regulatory regime governing OTC derivatives markets that was both functionally equivalent to the fractured U.S. regime and, arguably, socially suboptimal. There can be little doubt that the FSA has been able to translate into practice many of the theoretical strengths of integrated regulation. At the same time, however, the experience of the FSA has exposed some potential weaknesses of integrated regulation in terms of (1) poor coordination; (2) the sub-optimal balancing of competing regulatory objectives; (3) incentive problems for national regulators; and (4) the inherent limitations of regulation within the context of highly complex and dynamic global financial markets. Insofar as these potential weaknesses can be observed across all institutional models, the foregoing exploration manifest important lessons for those who view identifying the

305. Executive Summary, supra note 274, at 1.
optimal structure of regulation as key to preventing the next financial crisis. *Does the institutional structure of financial regulation matter?* Based on the foregoing examination, the optimistic answer, it would appear, is only to a point.