Transparency Regulation in Financial Markets – Moving into the Surveillance Age?

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In the wake of the global financial crisis, the trajectory of legal reforms is likely to turn towards more transparency regulation. This article argues that transparency regulation will take on a new role of surveillance as intelligence and data mining expand in the wholesale financial sector, supporting the creation of designated systemic risk oversight regulators.

The role of market discipline, which has been acknowledged to be weak leading up to the financial crisis, is likely to be eclipsed by a more technocratic governance in the financial sector. In this article, however, concerns are raised about the expansion of technocratic surveillance and whether financial sector participants would internalise the discipline of regulatory control. Certain endemic features of the financial sector will pose challenges for financial regulation even in the surveillance age.

I. Introduction

Transparency regulation is a mainstay in financial regulation, as disclosure regimes underlie much of product, intermediary and market regulation in both the wholesale and retail sectors. The global financial crisis 2008/9 is likely to be a milestone in financial regulation as regulators reflect upon how financial regulation may need to be reformed for the future. This article reviews the role of transparency in financial regulation, the rationales for its fundamental importance, and its trajectory in the "surveillance age".

Transparency regulation supports a system of market discipline which this article describes as "poly-opticonic", but the 2000s have shown flaws and cracks in the assumption of market discipline, from repeated financial market turmoil such as the Asian currency crisis, the dot.com bubble, the fall of Enron and the global banking crisis of 2008/9. Many commentators and regulators have delved into the failings in the disclosure regimes[1] of financial regulation, in order to point the way ahead, but this article suggests that regulatory overhaul will go beyond improving the quantity, quality or modus of transparency. Regulatory overhaul is arguably proceeding in the direction of changing the role of transparency. It will be argued that transparency will increasingly be seen as facilitative of surveillance, largely reposed in regulatory capacity instead of market discipline. This article will discuss what this means and the implications of transparency as surveillance in the future.

Part 2 of the article reviews the much-cherished role of transparency regulation as facilitative of market discipline in investment markets. Market discipline is based on the belief in the achievability of allocative efficiency in investment markets. This Part looks at both the wholesale and retail sectors and argues that transparency regulation is intended

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1 Barbara Crutchfield George, Lynn V. Dymally, Maria K. Boss, "The Opaque And Under-Regulated Hedge Fund Industry: Victim Or Culprit In The Subprime Mortgage Crisis?", 5 *NYU Journal of Law & Business* (2009), at p. 359, argues that the shortfall lies in insufficient disclosure in some sectors of the financial market, particularly the wholesale sector relating to complex structured products and sophisticated investment sectors such as hedge funds; Richard E Mendales, "Collateralized Explosive Devices: Why Securities Regulation Failed To Prevent The CDO Meltdown, And How To Fix It", *University of Illinois Law Review* (2009), at p. 1359, argues that the shortfalls in disclosure pertain to the quality of disclosure and insufficient relevant disclosure being provided of the underlying loan pools supporting the toxic CDOs which have ultimately corrupted banks' balance sheets.

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to support modern regulatory theories that look into multiple actors as forces of discipline and governance in the "regulatory space". However, the assumptions underlying the "poly-opticonic" structure is flawed.

Part 3 discusses how the global financial crisis 2008/9 has put into motion changes to the role of transparency regulation, underlined by a change in regulatory perspective of the objectives of financial regulation. Market discipline is likely to give way to surveillance as transparency becomes more complex, technocratic and macroscopic in nature. The reform measures enacted or proposed in the EU, UK and the US (where relevant) will be discussed. Part 4 then critically discusses the implications of embarking upon a surveillance age and the key concerns. Part 5 provides a short conclusion.

II. Transparency as a fundamental tenet in financial regulation

Brandeis' famous quote "Sunlight is said to be the best of disinfectants" underlies the disclosure regime in US securities regulation from the 1930s. In the securities law reform carried out by the EU since the Financial Services Action Plan 1999, disclosure regulation has also been embraced in many aspects of securities regulation. Prospectus disclosure for issuer products acts as the disinfectant against issuer fraud in investment markets, whether wholesale or retail, and continuous disclosure by issuers (including ad-hoc disclosure of price-sensitive information under Article 6, EU Market Abuse Directive, or where the US is concerned, as an obligation to avoid fraud-on-the-market) has further been imposed to support the efficient allocative functions of the secondary investment market.[2] Disclosure regulation is extended to collective investment products such as the UCITs in the EU, non-UCITS collective investment schemes in the UK,[3] structured complex products such as asset-backed securities in the US Regulation AB, as well as to intermediary regulation under the EU Markets in Financial Instruments Directive ("MiFID"). Certain sophisticated investment sectors however are exempt from mandatory disclosure regulation although contractual disclosure is often the norm, such as private placements in both the US[4] and EU,[5] and investments placed in alternative funds such as hedge and private equity funds, which are frequently formed offshore.[6] Transparency regulation is also extended to market transparency so that investors may be armed with price information across markets. This has been effected by the Consolidated Tape and Quotation system in the US,[7] further buttressed by Regulation NMS (National Market System) that allows investors to trade at the best discovered price on any venue.[8] In the EU, the MiFID and its supplementary Regulation[9] have provided for mandatory price transparency for large investment firms acting as "systematic internalisers", electronic trading platforms and traditional stock exchanges. In sum, the retail investment market is well flanked by product, intermediary and market transparency, while the wholesale sector is governed by greater flexibility in product and intermediary transparency[10] while perhaps enjoying a deeper extent of market transparency that is paid for by subscription.[11]

The retail market consists of myriad investors who are assumed to be rational[12] and will utilise transparency to look after their own interests and exert market discipline. As will be mentioned shortly, the private securities litigation industry in the US particularly supports the exercise of market discipline through class litigation against issuers. The wholesale

2 Milton H. Cohen, "Truth in Securities Revisited", 79 *Harv. L. Rev.* (1966) at p. 1340.

3 FSA Handbook COLL 1.2, 4.

4 Regulation D, Securities Act 1933.

5 Article 3(2), Prospectus Directive, see also H-Y Chiu, "'Not a Public Offer' – Where Does the European Commission's Draft Prospectus Proposal Leave Small Issuers?", 24 *Business Law Review* (Aug/Sep 2003), pp. 192 *et sqq*.

6 This may change with the EU Proposal to regulate alternative funds, see <http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#proposal> (last accessed on 21 July 2011).

7 Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 7, 89 Stat. 11 (codified at 15 U.S.C. § 78k-1(a)(2) (1976)).

8 SEC, Regulation NMS: Final Rule (Fed Register Vol 70 No. 124). Dean Seligman's 2002 committee recommendation to privatise the provision of market transparency was resisted in favour of market transparency as a public good, see Joel Seligman, "Rethinking Securities Markets: The Sec Advisory Committee On Market Information And The Future Of The National Market System", 57 *Business Lawyer* (2002), pp. 637 *et sqq*.

9 MiFID Commission Regulation (EC) No 1287/2006.

10 Under the MiFID, the categorisation of clients as "professional" may entail less imposition of disclosure and a lesser extent of duties owed under "suitability" or "appropriateness", see Article 24, MiFID and 27-33, MiFID Commission Directive 2006.

11 Iris H-Y Chiu, "Delegated Regulatory Administration in EU Securities Regulation", 40 *International Lawyer* (2007), pp. 737 *et sqq.*, discussing that the mandatory level of market transparency in the EU is a minimum level, and information providers such as exchanges and Reuters and Bloomberg provide much deeper levels of transparency as commoditised information products.

12 See Niamh Moloney, *How to Protect Investors: Lessons from the UK and EU* (Cambridge: CUP 2009), at chapters 1 and 2.

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sector is replete with sophisticated counterparties who may be in a position to exercise discipline on each other, such as counterparties to structured product, credit and derivative transactions, underwriters and issuers, gatekeepers such as auditors, rating agencies and stock exchanges, institutions and investment managers, issuers and analysts, and so on. In this wide "regulatory space",[13] there is potential for different actors in the wholesale financial sector to exert discipline upon one another, creating a multi-faceted structure of private market-based governance.[14] Werbach terms this structure as a "poly-opticon", where multiple actors may have the capacity to observe and influence each other's behaviour in even unexpected ways, such governance being diffuse but pervasive.[15] The regulatory framework in the wholesale financial sector in leading jurisdictions such as the US, EU including the UK arguably relies on the poly-opticonic forces for market discipline. However, as the global financial crisis unfolds, the assumption that market discipline is facilitated by transparency and is self-sustaining, is severely questioned.[16]

1. Product Transparency

Disclosure regulation of securities products is intended to correct information asymmetry between issuer and investor. Mandatory disclosure regulation, by providing a uniform template for product disclosure, also assists in improving comparability of information for investors.[17] Continuous disclosure further assists ongoing investment decisions on the secondary market by allowing investors to constantly evaluate buying and selling decisions.[18] Prospectus and continuous disclosure are also features of product transparency regulation in collective investment units that can be marketed to the retail sector. Hence, in a non-intrusive way, product transparency regulation is intended to provide for investor protection against information asymmetry and product fraud, but leaves the quality of investment products to be discerned by investors themselves. The "regulatory space" surrounding investment products consists of regulators and the market itself; regulators enforcing against non-compliance with disclosure standards, but the market providing two types of discipline. One, civil litigation for product misinformation or fraud, which could be a powerful form of market discipline especially in US private securities litigation,[19] and two, market forces of supply and demand that respond to information indicating signals of quality or otherwise in the performance of investment products. Ferrell in particular argues that mandatory continuous disclosure serves the purpose of informing investors of potential agency and expropriation problems so that market discipline could be meted out to corporations either through minority shareholder monitoring or exit.[20] Hence, product transparency is

13 Colin Scott, "Analysing Regulatory Space: Fragmented Resources and Institutional Design", *Public Law* (2001), pp. 329 *et sqq*.

14 Houman B. Shadab, "Counterparty Regulation And Its Limits: The Evolution Of The Credit Default Swaps Market", 54 *New York Law School Law Review* (2009/10), pp. 689 *et sqq*., reviews the reliance on counterparty discipline especially in the wholesale sector and points out the regulatory gaps; see also Iris H-Y Chiu, "Enhancing Responsibility in Financial Regulation – Critically Examining the Future of Public-Private Governance Parts I and II", *Law and Financial Markets Review* (2010), pp. 170 and 286 respectively where a comprehensive review of mixed regulatory strategies pre-global financial crisis is made.

15 Kevin Werbach, "Sensors And Sensibilities" 28 *Cardozo Law Rev* (2007), pp. 2321 *et sqq*.

16 Timothy A. Canova, "Financial Market Failure As A Crisis In The Rule Of Law: From Market Fundamentalism To A New Keynesian Regulatory Model", 3 *Harvard Law and Policy Review* (2009), pp. 369 *et sqq*.; John W. Head, "The Global Financial Crisis Of 2008–2009 In Context – Reflections On International Legal And Institutional Failings, 'Fixes', And Fundamentals", 23 *Pac. McGeorge Global Bus. & Dev. L.J.* (2010), pp. 43 *et sqq*.; Evan N. Turgeon, "Boom And Bust For Whom?: The Economic Philosophy Behind The 2008 Financial Crisis", 4 *Virginia Business and Law Review* (2009), pp. 139 *et sqq*.

17 See John C. Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System", 70 *Va L R* (1984), pp. 717 *et sqq*.; see also Joel D. Seligman, "The Historical Need for a Mandatory Corporate Disclosure System", *J of Corp Law* (1983), pp. 1 *et sqq*.

18 Marcel Kahan, "Securities Law and the Social Costs of 'Inaccurate' Stock Prices", 1991 *Duke L.J.* (1992), pp. 977 *et sqq*., and Jeffrey N. Gordon and Lewis A. Kornhauser, "Efficient Markets, Costly Information and Securities Research", 60 *NYU LRev* (1985), pp. 761 *et sqq*.; also Merritt B. Fox, "Rethinking Disclosure Liability in the Modern Era", *Wash U Law* Quarterly (1997), pp. 903 *et sqq*., all of whom support mandatory continuous disclosure as key to maintaining stock price accuracy according to the semi-strong form of the efficient capital markets hypothesis, such stock price accuracy is thus informationally enabling for investors.

19 Rafael La Porta, Florencio Lopez de Silanes and Andrei Schleifer, "What Works in Securities Laws?", NBER Working Paper (2004), available on the Internet at <http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/working_papers/WhatWorksInSecuritiesLaws/securities06112004complete.pdf> (last accessed on 21 July 2011), 61 *Journal of Finance* (2006), pp. 1 *et sqq*.; John C. Coffee, "Law and the Market: The Impact of Enforcement" (2007), available on the Internet at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=967482> (last accessed on 21 July 2011). The equivalent civil compensation regimes in the UK are under s90, 90A and Schedule 10A of the Financial Services and Markets Act, allowing civil compensation for dishonestly made or omitted disclosures, subject to proof of reliance.

20 Allen Ferrell, "The Case For Mandatory Disclosure In Securities Regulation Around The World", 2 *Brooklyn Journal of Corporate, Financial & Commercial Law* (2007), pp. 81 *et sqq*., and earlier article supporting the same point, Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems", *U Chi Law Rev* (1995), pp. 1047 *et sqq*.

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not a compliance-based strategy, but it seeks to enrol the market itself to provide feedback, discipline and hence correcting the performance or behaviour on the part of product providers.

In the EU and UK, the efficacy of product transparency would largely depend on the state of market discipline. The history of enforcement by the UK Financial Services Authority ("FSA") shows a dearth of enforcement actions for transparency breaches.[21] For the primary securities market, although disclosure regulation is comprehensive and thorough,[22] the market largely consists of institutional investors whose decision whether or not to invest is significantly influenced by underwriter "leaving the money on the table"[23] and analyst coverage.[24] It remains questionable as to how "embedded" the product transparency provided in issuers' prospectuses is, in the decision-making process of institutional investors.

Weil et al argue that user discipline in the market is only effective to support transparency regulation if the information disclosed is "embedded" in the user's decision-making process.[25] In the primary market, how much reliance do institutional investors place on issuer disclosure? Hanley and Hoberg[26] suggest that institutions do place reliance on a well-prepared and accurate prospectus, but issuers are frequently unwilling to engage in such a high level of product transparency beyond the standard mandatory requirements, as they prefer to keep proprietary information away from competitors and they perceive that offer pricing accuracy can be achieved in the bookbuilding stage after the issuance of the prospectus. Hence, the practice seems to be that where bookbuilding is dominant in the primary market, institutions' investment decisions would not be significantly helped by the prospectus. Where the retail market is concerned, some empirical research particularly from the behavioural school have suggested that retail investors also find it difficult to process the voluminous product transparency and prefer to rely on market sentiment and positive analyst coverage.[27]

Even continuous disclosure may not be rationally utilised and processed by both institutions and retail investors in the secondary market.[28] Although Fox et al argue forcefully that mandatory continuous disclosure does feed into stock price and hence assist in investor allocational decisions,[29] the sudden fall of Enron amidst positive buy-side recommendations[30] and the failure of credit rating agencies to see the coming of the plunge for Lehman Brothers, and troubled financial institutions such as RBS, Halifax BOS in the UK and AIG in the US during the global financial crisis show that there is a severe cognition gap in sophisticated players in the market grasping the true significance of certain publicly available

21 FSA Final Notice to Universal Salvage Plc (2004), available on FSA's website <www.fsa.gov.uk> (last accessed on 21 July 2011); "Photo-Me fined £500,000 for delay in disclosing inside information", 21 June 2010.

22 See Arts. 5 and 13, Prospectus Directive; further, the content of prospectuses are prescribed in copious detail in Level 2 Commission legislation, Commission Regulation ECNo. 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses. The Commission Regulation is further explained by guidance issued by the Committee of European Securities Regulators in CESR, CESR's recommendations for the consistent implementation of the European Commission's Regulation on Prospectuses nº 809/2004, January 2005 (available on the Internet at <www.cesr-eu.org>);and CESR's frequently updated Questions and Answers on the Prospectus Directive, also available on the same website.

23 R.P. Beatty and J.R. Ritter, "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings", 15 *Journal of Financial Economics* (1986), pp. 213–232; T. Loughran and J.R. Ritter, "Why don't Issuers Get Upset about Leaving Money on the Table in IPOs?", 15 *Review of Financial Studies* (2002), pp. 15 *et sqq.*; Steven M. Dawson, "Initial Public Offer Underpricing: The Issuer's View – A Note", 42 *Journal of Finance* (1987), pp. 159 *et sqq.*

24 François Degeorge, François Derrien and Kent Womack, "Analyst Hype in IPOs: Explaining the Popularity of Bookbuilding" (2005), available on the Internet at <http://ssrn.com/abstract=582963> (last accessed on 21 July 2011).

25 David Weil, Archon Fung, Mary Graham and Elena Fagotto, "The Effectiveness of Regulatory Disclosure Policies", 25 *Journal of Policy Analysis and Management* (2006), pp. 155 *et sqq.*

26 Kathleen Weiss Hanley and Gerard Hoberg, "The Information Content of IPO Prospectuses", 23 *Review of Finance Studies* (2010), pp. 2821 *et sqq.*

27 Troy A. Paredes, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation", 81 *Washington University Law Quarterly* (2003), pp. 417 *et sqq.*; Robert Prentice, "Whither Securities Regulation? Some Behavioral Observations regarding Proposals for Its Future", 51 *Duke Law Journal* (2002), pp. 1397 *et sqq.*; Thomas Gilovich, Dale Griffin and Daniel Kahneman (eds), *Heuristics and Biases: The Psychology of Intuitive Judgment* (Cambridge: Cambridge University Press 2002) generally.

28 Robert J. Schiller, *Irrational Exuberance* (New Jersey: Princeton University Press 2000); Werner F.M. De Bondt and Baruch Fischhoff, "Do Analysts Overreact?", in Thomas Gilovich, Dale Griffin and Daniel Kahneman (eds), *Heuristics and Biases: The Psychology of Intuitive Judgment* (Cambridge: Cambridge University Press 2002), at p. 678 and Jill Fisch, "Regulatory Responses to Investor Irrationality: The Case of the Research Analyst", 10 *Lewis & Clark Law Review* (2006), pp. 57 *et sqq.*

29 M. Fox, A. Durnev, R. Morck and B.Y. Yeung, "Law, Share Price Accuracy and Economic Performance: The New Evidence", available on the Internet at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=437662> (last accessed on 21 July 2011).

30 John C. Coffee Jr., *Gatekeepers* (OUP 2006), at pp. 245–253.

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information.[31] Dalley also argues that although sophisticated market participants often function as informediaries, interpreting informational signals and trends for the market, their interpretation may be affected by their vested interests, hence affecting the quality of the informational signals they emanate.[32] This is particularly acute for the retail market, as retail investors may rely on advisers, and investors in collective investment units implicitly rely on the expertise of portfolio managers to balance the risks and render a return.[33] Hence, the process of "embedding" product transparency in end-user decisions is a complicated and not often predictable process. Can market discipline then be relied on to provide a correcting impetus to sub-quality products?

Mendales argues that the failure of sophisticated investment banks and institutions to discern the quality of structured products such as the collateralised debt obligations ultimately proved to be toxic is due to insufficient disclosure of relevant matters as well as poor judgment.[34] Regulation AB in the US has been criticised to be too thin in its mandatory requirements, but the EU's disclosure regime for such products may be even laxer, as these products would generally benefit from a prospectus exemption under Article 3(2). The implosion of the global financial crisis as due to damaged balance sheets on banks carrying substantial amounts of such toxic assets shows that contractual discipline between counterparties in the wholesale market may not be sufficient[35] for either counterparty protection or for externalities generated to the wider society. The failure of market discipline in ascertaining product quality persists in both the retail and wholesale markets. In the EU and UK, retail investors are also unlikely to be able to engage in contingency funded private securities class actions against issuers, as the framework for contingency funding and class litigation are not developed.[36] Further the UK Financial Services and Markets Act frames issuer liability in continuous disclosure only where dishonest or reckless misstatements or omissions are concerned, and hence liability is not strict and negligence does not attract liability.[37]

Is reform needed in the intricacies of product transparency – i.e. type of disclosure,[38] quantity, quality or modus of delivery?[39] Or should we fundamentally rethink how disclosure is used and the capability of market discipline? In the wake of the crisis, regulatory tenor in the EU and in the US seems to be shifting from market discipline to greater prescription, especially in consumer protection for the retail market and prudential standards for financial institutions. With the rise of systemic risk oversight, the wholesale market will also see more disclosure regulation imposed- whether in terms of quantity or quality of disclosure. The article doubts that the disclosure is for the purpose of facilitating market discipline, perhaps to allow authorities to embark on regulatory surveillance. The role of transparency is likely to change in character as faith is increasingly weakened in the exercise of market discipline.[40]

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31 The failure of sophisticated intermediaries and informediaries in the investment market is discussed in Paul M. Healy and Krishna G. Palepu, "The Fall of Enron", 17 *Journal of Economic Perspectives* (2003), pp. 3 *et sqq.*; further, behavioural theorists posit that even sophisticated players on the secondary market rely heavily on market sentiment and noise trading to allocate capital, see Robert J. Shiller, *Irrational Exuberance* (NJ: Princeton University Press, 2000) generally.

32 Paula J. Dalley, "The Use And Misuse Of Disclosure As A Regulatory System", 34 *Florida State University Law Rev* (2007), pp. 1089 *et sqq.*

33 Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge: Cambridge University Press 2010), at chapters 1–5 generally. Chapters 1 and 2 depict the typical retail investor as a "trusting" investor, trusting and willing to be part of the investment landscape but should not be expected to be completely rational and powerfully informed.

34 Richard E. Mendales, "Collateralized Explosive Devices: Why Securities Regulation Failed To Prevent The CDO Meltdown, And How To Fix It", *University of Illinois Law Review* (2009), pp. 1359 *et sqq.*

35 Houman B. Shadab, "Counterparty Regulation And Its Limits", *supra* note 14, at p. 689.

36 Guido Ferranini and Paolo Giudici, "Financial Scandals and the Role of Private Enforcement: The Parmalat Case" (2005), available on the Internet at <http://ssrn.com/abstract=730403> (last accessed on 21 July 2011).

37 S90A.

38 Mendales above, and Barbara Crutchfield George, Lynn V. Dymally, Maria K. Boss, "The Opaque And Under-Regulated Hedge Fund Industry: Victim Or Culprit In The Subprime Mortgage Crisis?", 5 *NYU Journal of Law & Business* (2009), pp. 359 *et sqq.* would argue that the quantity of disclosure needs to be increased across the wholesale financial sector in particular.

39 After the fall of Enron, PwC also advocated reform in both quality of disclosure and modus of delivery to better enable information utilisation by the market, see Samuel A. DiPiazza and Robert G. Eccles, *Building Public Trust: The Future of Corporate Reporting* (NY: John Wiley & Sons 2002), at chapters 1,3, 5 and 7.

40 The excessive reliance on market discipline has been pointed out to be a flaw, as opined in M. Brunnermeier, A. Crockett, C. Goodhart, A.D. Persaud and Hyun Shin, "The Fundamental Principles of Financial Regulation" (Geneva Reports on the World Economy (2009)) and FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), but how should the change in gear move? Mallaby warns against excessive reliance on internal controls, see Sebastian Mallaby, "Capitalism and its Divided Critics", in the *Financial Times* (2 Sep. 2010) but there are also pitfalls in relying excessively on regulators, as Part 4 will discuss.

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2. Intermediary transparency

In the EU, the MiFID has completely reformed the regulatory framework governing financial intermediaries and has imposed disclosure as well as proscriptive and prescriptive duties in favour of retail investors. Articles 27-33 of the MiFID Commission Directive 2006 supplementing the primary legislation impose disclosure requirements where advice recommending products is given to retail clients.[41] An adviser must also inform the client of the nature of risks in the financial instruments,[42] the scope and nature of its intermediary services,[43] costs and charges,[44] and also for professional clients, the conflict of interest policy,[45] client money and assets handling policy,[46] client categorisation,[47] the receipt of inducements[48] the nature of investment research,[49] and execution policy.[50]

Such transparency is intended to assist clients in selecting investment products and services. But whether intermediary transparency may become embedded and useful, especially to retail investors, remains doubtful. Intermediary services are very much credence goods whose quality is difficult to discern.[51] Even a competitive market may not be able to generate market discipline in credence goods. Further, charisma and personal appeal are often important to an investor's choice of a trusted financial adviser or manager,[52] whether retail or sophisticated. The FSA's enforcement record especially for breaches of client money handling,[53] shows that market discipline is weak and possibly non-existent in the retail investor sector, hence the need for regulator enforcement. As Moloney has rightly argued, the regulatory framework in intermediary-investor relationships should go beyond disclosure to legal duties such as suitability and appropriateness,[54] and retail distribution in particular, is only just beginning to be reformed in the UK.[55]

As for professional clients such as institutions, the use of asset managers and intermediaries may be subject to internal performance criteria and benchmarks that are much more sophisticated than that which is provided by mandatory disclosure.[56] An intermediary's appointment may also depend on factors such as channelling business activities within the same group of companies, and retention due to personal relations.

3. Market Transparency

The EU MiFID has also ushered in price transparency regulation, compelling offer and transaction details on most markets to be made transparent. Systematic internalisers in a liquid stock must disclose quotations and closed transactions, and the Commission Regulation 2006 that supplements the primary Directive further sets out the disclosure levels expected of electronic trading platforms and stock exchanges for pre-trade and post-trade transparency.[57] Price transparency and competition in trading venues are

41 Art. 27.

42 Art. 31.

43 Art. 29.

44 Art. 33.

45 Arts. 22 and 30.

46 Arts. 30 and 32.

47 Art. 28.

48 Art. 26.

49 Art. 24.

50 Art. 45.

51 Defined as "having the characteristic that, even if consumers can observe the utility derived from the good ex post, they cannot judge if the quality received is the ex ante needed one", see Uwe Dulleck and Rudolf Kerschbaumer, "On Doctors, Mechanics and Computer Specialists or Where are the Problems with Credence Goods" (2001), available on the Internet at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=256694> (last accessed on 21 July 2011).

52 Steven Pressman, "On Financial Frauds and Their Causes: Investor Overconfidence", 57 *American Journal of Economics and Sociology* (1998), pp. 405 *et sqq*.

53 FSA, "FSA takes action against two insurance brokers for failing to protect client money and assets", 9 June 2010, available on the Internet at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/096.shtml> (last accessed on 21 July 2011); "FSA fines Close Investments Ltd £98,000 for client money breaches", 7 June 2010, available on the Internet at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/094.shtml> (last accessed on 21 July 2011); "FSA fines Rowan Dartington & Co Ltd £511,000 for client money breaches", 7 June 2010, available on the Internet at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/093.shtml> (last accessed on 21 July 2011); "FSA levies largest ever fine of £33.32m on J.P. Morgan Securities Ltd for client money breaches", 3 June 2010, available on the Internet at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/089.shtml> (last accessed on 21 July 2011), and at least 2 other instances in 2010.

54 Moloney, *How to Protect Investors, op cit.*

55 As will be discussed in the next Part.

56 Paul Cox, Stephen Brammer and Andrew Millington, "Pension Fund Manager Tournaments and Attitudes towards Corporate Characteristics", 34 *Journal of Business Finance and Accounting* (2007), pp. 1307 *et sqq*.; Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors", 63 *Journal of Finance* (2008), pp. 1805 *et sqq*.

57 Arts. 17, 21 *et sqq.* and 27.

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intended to facilitate user choice and discipline. Do these measures empower investors to find competitive prices in an array of trading venues ensuring best execution in their trades? In an earlier article I argued that market transparency is unlikely to empower investors in discerning the best prices and venues to trade, or whether best execution has been achieved by intermediaries.[58]

Market transparency as required under the MiFID may be reported to the markets or other recognised information service providers (as in the UK),[59] and there is currently no framework for consolidated information either at the EU level or nationally in many Member States. Hence, the transparency is fragmented and may not be practically accessible to retail investors. Further, many wholesale market investors subscribe to higher levels of market transparency offered as information products by exchanges, trading venues or information service providers, and the continued policy in the EU seems to lean towards supporting these revenue-generating interests of information providers rather than having a form of consolidated transparency as a public good.[60]

Both wholesale and retail investors would also have to rely on the execution carried out by brokers to finalise trades and hence, market transparency could arguably be used to empower investor discipline of brokers under the duty of "best execution". But the "best execution" requirement under the MiFID is a complex duty to interpret. For the professional client, best execution is based on a variety of factors,[61] and hence, the difficulty in objectively judging the quality of the execution would make the duty difficult to enforce,[62] not to mention that the subjective belief of the intermediary may also be relevant. For retail investors, although the price of the trade is *prima facie* indicative of best execution or otherwise,[63] the relevant price points for determining the discharge of the duty are those found in the list of venues stated in the firm's execution policy. As CESR does not disallow exclusive trading venues specified on a firm's upfront execution policy,[64] the best price obtained on that venue could be a discharge of best execution, and the investor may not be able to make a case for sub-optimal execution by just comparing with any other venue in the market. Hence, market transparency does not necessarily facilitate the opening up of venue choices for the investor, or assist in an allegation of sub-optimal execution.

In sum, although an explosion in transparency has been achieved in financial regulation, particularly in the EU following the enactment of Directives such as the Prospectus, Transparency, Market Abuse and MiFID, it is a tenuous argument that the transparency regulation relates directly to embedding user decisions, translating into market discipline for product providers, intermediaries and markets. Hence although transparency regulation relies on poly-opticonic observations in the market to facilitate market discipline, the above discussion sketches the relative difficulties for market discipline to be facilitated. Although the existing transparency infrastructure will remain post the global financial crisis, a change in character of transparency regulation may be discerned. The next Part will argue that the failings of transparency as supporting retail market discipline will pave the way for a more regulatory approach to consumer protection in the UK and EU, as well as perhaps the US with the establishment of a specific consumer protection agency at the federal level in the Dodd-Frank Act. Transparency regulation will also expand in the wholesale sector, taking on a new role of facilitating regulator surveillance.

III. The development of transparency as surveillance in the post crisis age

1. Prescriptive consumer protection in the retail sector

In the post-mortem of the global financial crisis, US policy has embarked on redressing consumer protection in financial markets.[65] This cue is likely to

58 Iris H-Y Chiu, "Delegated Regulatory Administration in EU Securities Regulation", 40 *International Lawyer* (2007), pp. 737 *et sqq*.

59 Art. 12, Commission Regulation 2006.

60 The same critique could be levied upon the recent CESR recommendation to allow OTC derivative transaction reporting to be channelled through trade repositories as well, not recommending a central information mechanism. See "Consultation on Transaction Reporting on OTC Derivatives and Extension of the Scope of Transaction Reporting Obligations" (24 August 2010), available on the Internet at <www.cesr-eu.org> (last accessed on 21 July 2011).

61 Art. 21, MiFID, Arts. 44–46, MiFID Commission Directive.

62 Jonathan R. Macey and Maureen O'Hara, "The Law and Economics of Best Execution", 6 *Journal of Financial Intermediation* (1997), pp. 188 *et sqq*.

63 Art. 44(3), MiFID Commission Directive 2006.

64 CESR, *Best Execution under MiFID: Questions and Answers* (May 2007).

65 By the establishment of the Consumer Financial Protection Agency.

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gain momentum in the EU,[66] as the UK regulator has already embarked on consumer protection reforms such as reforming investment advice[67] and improving consumer redress[68] such as in the payment protection insurance market.[69] Consumer protection has now gained fresh momentum as a regulatory objective, partly because the global financial crisis has culminated from the sub-prime mortgage market crisis,[70] where unsuitable mortgage loans have been sold to consumers who could not afford the products over the long term, and also because the crisis has significantly hit the "Main Street" in the economic slow-down in the US and EU. Gerding argues that although a financial crisis is often precipitated by the systemic failures at the level of the wholesale market, consumer protection is essential to mitigating systemic risk as it is an underlying layer of activity whose effects affect wholesale market transactions. Hence, (re)starting consumer protection regulation may have a long term benign effect upon financial markets in the future.[71] The future of financial regulation in the retail sector is likely to nudge away from equating mandatory disclosure to investor protection, and to embark on a more prescriptive form of consumer financial protection.

The newly established US Consumer Financial Protection Agency has a sufficiently wide remit to set standards and carry out enforcement in the interests of consumer protection.[72] Some prescriptive measures include the prohibition of sales of exotic products to consumers, so that consumers may only be exposed to plain vanilla products. The wisdom of such measures is still being debated,[73] as overreactions likely caused by the crisis may take some time to be reviewed or rolled back.[74] The Agency would nevertheless focus on consumer protection as its mission and become a player in the regulatory landscape.[75] Rutledge[76] is of the view that the dedication of a consumer protection agency to such matters is key to elevating the regulatory importance of consumer protection and developing the regulatory framework and toolkit for setting standards, meeting the needs of consumer redress and exercising enforcement.

In the EU, the emphasis is still on harmonising supervisory approaches and creating a supervisory infrastructure for the pan-European financial market. Three pan-European authorities are to be responsible for setting pan-European technical standards and achieving harmonised supervision.[77] The three pan-European authorities will focus on carrying out micro-prudential and bottom up analysis in order to support systemic risk oversight reposed in the European Systemic Risk Board (ESRB). As part of its role in micro-prudential management, the European Securities Markets Authority will have to consult a permanent Securities Markets Stakeholder Group consisting of 30 members drawn from across the industry and consumer base.[78] Hence, "processual" forms of consumer protection are becoming significant,[79] as substantive law reforms are also underway,

66 Susan Emmenegger, "Procedural Consumer Protection and Financial Market Supervision", in Harold James, Hans-W. Micklitz and Heike Schweitzer (eds), *The Impact of the Financial Crisis on the European Economic Constitution* (Florence: European University Institute, 2009), at p. 19.

67 FSA, *Distribution of Retail Investments* (March 2010).

68 FSA, *Guidance Note on Consumer Redress Schemes* (Oct. 2010).

69 FSA, *The Assessment and Redress of Payment Protection Insurance Complaints* (August 2010).

70 Susan L. Rutledge, "Consumer Protection and Financial Literacy Lessons from Nine Country Studies", World Bank Policy Research Working Paper (2010), pp. 5326 *et sqq*.

71 Erik Gerding, "The Subprime Crisis And The Link Between Consumer Financial Protection And Systemic Risk" (2009), available on the Internet at <http://ssrn.com/abstract=1291722> (last accessed on 21 July 2011).

72 Adam J. Levitin, "The Consumer Financial Protection Agency Pew Financial Reform Project, Briefing Paper #2, 2009", available on the Internet at <http://ssrn.com/abstract=1447082> (last accessed on 21 July 2011).

73 Joshua D. Wright and Todd J. Zywicki, "Three Problematic Truths About The Consumer Financial Protection Agency Act Of 2009" (2009), available on the Internet at <http://ssrn.com/abstract_id=1474006> (last accessed on 21 July 2011).

74 Saule Omarova and Adam Feibelman, "Risks, Rules, and Institutions: A Process for Reforming Financial Regulation", 33 *University of Memphis Law Review* (2009), pp. 881 *et sqq.* arguing that crisis containment is different from regulation for the long term.

75 Sharon Tennyson, "Analyzing the Role for a Consumer Financial Protection Agency" (2009), available on the Internet at <http://ssrn.com/abstract=1525603> (last accessed on 21 July 2011).

76 Susan L. Rutledge, "Consumer Protection and Financial Literacy Lessons from Nine Country Studies", World Bank Policy Research Working Paper (2010), pp. 5326 *et sqq*.

77 The European Securities Markets Authority (ESMA), the European Banking Authority (the EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). See the legislative proposals available on the Internet at <http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package> (last accessed on 21 July 2011). These authorities have been established by REGULATION (EU) No 1095/2010, No. 1093/2010 and No. 1094/2010, 24 Nov. 2010, respectively.

78 Art. 37, Regulation Of The European Parliament And Of The Council establishing a European Securities and Markets Authority.

79 Susan Emmenegger, "Procedural Consumer Protection and Financial Market Supervision" in Harold James, Hans-W. Micklitz and Heike Schweitzer (eds), *The Impact of the Financial Crisis on the European Economic Constitution*, *supra* note 66, at p. 19.

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such as the three pan-European authorities' mandate to set standards and provide for consumer financial protection,[80] and the commencement of the review of packaged investment products.[81]

In the UK, the consumer protection rhetoric is gaining pace with successive measures rolled out by the Financial Services Authority starting with the *Distribution of Retail Investments* final rules in March 2010. The FSA has reformed investment advice to retail customers such that firms will have to specify if investment advice is independent or restricted (i.e. where adviser charges may entail from product providers), and disclosure of adviser charges would have to be made. The FSA will also monitor the level of adviser charges in relation to the benefits of the product, and the disclosure made to customers. In August 2010, the FSA has also issued a new requirement for firms selling payment protection insurance to review their selling practices and consumer complaints, and consumers would be entitled to be refunded premiums paid if the firm fails to prove that the consumer would have wanted to purchase the insurance regardless of how they were sold.[82] The Mortgage Arrears review now protects mortgagors from being charged for arrears after entering into arrangements with mortgagee and that mortgagee institutions must treat customers fairly when they are in difficulties.[83] The Banking Conduct of Business Code (BCOBS) issued in 2009 also protects retail and small business customers of banks so that they may be treated fairly in difficulty and protected and refunded in the event of unauthorised payments out of their accounts.[84]

Consumer protection regulation is taking on an increasingly prescriptive character, as the MCOB[85] shows regulatory intervention even into matters of consideration beyond merely business practice. Campbell, Jackson et al have also argued that consumer protection regulation is unlikely to simply rely on disclosure and consumer choice or discipline, and that precise regulatory interventions are needed to assist consumers to obtain the reasonably expected benefit from particular financial services or products.[86] This article suggests that the tenor of consumer regulatory protection is likely to affect the regulatory tenor in the wholesale market as financial supermarkets such as large banking groups continue to dominate both sectors, allowing regulators to consider regulatory overhaul in the wholesale market where activities and risks in the wholesale market may become a threat to consumer protection or to systemic risk in general.

2. The rise of systemic risk oversight in the wholesale sector

Systemic risk has become a fashionable fear although early foresighted calls to heed it[87] have rung even before signs of the US subprime mortgage market crisis began to surface. Getmansky, Lo et al explain that "[s]ystemic risk can be realized as a series of correlated defaults among financial institutions, occurring over a short time span and triggering a withdrawal of liquidity and widespread loss of confidence in the financial system as a whole."[88] Systemic risk is thus a risk of magnitude due to contagion of failure in market institutions, or in market instruments.[89] As the subprime mortgage crisis demonstrates, contagion can work through the retail to the wholesale sectors, and hence, research and policy are now focussed on developing proxy indicators and measurements for

80 Art. 9, Regulation establishing the European Securities and Markets Authority, mirrored in the Regulations establishing the European Banking Authority and European Insurance and Occupational Pensions Authority.

81 Available on the Internet at <http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/20091215_prips_en.pdf> (last accessed on 21 July 2011) on standardising key issues of pre-contractual information and selling practices for optimal consumer protection.

82 FSA, *The Assessment and Redress of Payment Protection Insurance Complaints* (August 2010).

83 FSA, *Mortgage Market Review: Arrears and Approved Persons* (June 2010), the rules now found in MCOB of the FSA Handbook.

84 BCOBS 5.1 generally. This position is an improvement from the pro-bank standard provisions issued by the British Bankers' Association's Banking Code.

85 FSA Handbook.

86 John Y. Campbell, Howell E. Jackson, Brigitte C. Madrian and Peter Tufano, "The Regulation of Consumer Financial Products: An Introductory Essay with Four Case Studies" (2010), at <http://ssrn.com/abstract=1649647> (last accessed on 21 July 2011).

87 Kern Alexander, Rahul Dhumale, and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford Univ. Press, 2006).

88 Monica Billio, Mila Getmansky, Andrew W. Lo and Loriano Pelizzon, "Measuring Systemic Risk in the Finance and Insurance Sectors" (March 2010), available on the Internet at <http://web.mit.edu/alo/www/Papers/billio_etal.pdf> (last accessed on 21 July 2011).

89 Onnig H. Dombalagian, "Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation", 85 *Indiana Law Journal* (2010), pp. 777 *et sqq.*, at p. 798.

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systemic risk in order to better inform regulatory oversight.[90]

Schwarz also opines that "[w]ithout regulation, the externalities caused by systemic risk would not be prevented or internalized because the motivation of market participants "is to protect themselves but not the system as a whole .... No firm ... has an incentive to limit its risk taking in order to reduce the danger of contagion for other firms."[91] As individual firm risk management is inherently unable to take into account its impact on systemic risk, the ownership of systemic risk oversight has to be reposed in a body with an overall bird's eye view. But it may not be sufficient that such a body be a national regulator, and the international connectedness of financial markets may require that systemic risk oversight be undertaken at a transnational or international level.[92]

Systemic risk oversight demands that regulators know the industry and what is taking place in firms and markets. Omarova rightly points out that regulators have not kept up with the developments in the financial sector, in particular the wholesale sector.[93] Lo proposes that certain proxy indicators[94] be developed in order to kick-start information trawling and analysis by regulators to detect signs of systemic risk. First, it is observed that reforms in the US and EU would open up the way for more information to be returned to regulators, in particular, of activities in the wholesale sector. Second, reforms in the US and EU have also established institutional structures to have systemic risk oversight and to deal with and analyse the information returns.

3. Expansion of regulatory intelligence capacity

The US Dodd-Frank Act 2010[95] contains a gamut of data collection powers. Although not all data collection is expressly stated to pertain to systemic risk oversight and not directly returnable to the new Financial Stability Oversight Council, data collected by the SEC may be accountable to the Council and to Congress and Senate under s961-4, and hence, it is proposed to treat all data collection as potentially pertaining to regulatory if not systemic risk oversight purposes. The data collection powers are targeted at firms as well as markets. The Act now abolishes the status of exempt private investment advisers to hedge funds and requires them to register with the SEC. Section 404 authorises the collection of data pertaining to the fund management and assets under management. Credit rating agencies are also to submit to mandatory disclosure of their ratings methodologies, due diligence and performance, and to facilitate public comparability. They are also required to report annually to the SEC in order to facilitate supervision over internal control management and management of conflicts of interest.[96] Product providers of asset-backed securities are likely to be subject to enhanced disclosure to the SEC under section 942. Corporate issuers are also subject to enhanced disclosure such as of whether directors and employees are carrying out hedges vis a vis the corporate securities [97], and corporate governance arrangements in respect of the separation of the Chairman from the Chief Executive.[98] Sections 727 and 766 compel all swap transactions on or off exchange to be publicly reported, or reported to the Commission where no swap data repository is relevant, and the data collected by exchanges which may also act as swap data repositories may then be open to inspection by the SEC. As for data directly returnable to the Financial

90 Monica Billio, Mila Getmansky, Andrew W. Lo and Loriano Pelizzon, "Measuring Systemic Risk in the Finance and Insurance Sectors", *supra* note 88; Xin Huang, Hao Zhou and Haibin Zhu, "A framework for assessing the systemic risk of major financial institutions" (2009), available on the Internet at <http://ssrn.com/abstract=1335023> (last accessed on 21 July 2011).

91 Steven Schwarz, "Systemic Risk", 97 *Georgetown Law Journal* (2008), pp. 193 *et sqq.*, at p. 206.

92 Kern Alexander, Rahul Dhumale, and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk*, *supra* note 87; John Goddard, Phil Molyneux and John O.S. Wilson, "The Financial Crisis In Europe: Evolution, Policy Responses And Lessons For The Future" (2010), available on the Internet at <http://ssrn.com/abstract=1414935> (last accessed on 21 July 2011).

93 Saule Omarova and Adam Feibelman, "Risks, Rules, and Institutions: A Process for Reforming Financial Regulation", *supra* note 74, at p. 881.

94 Looking at leverage, liquidity, concentration, correlation, connectedness and sensitivities, see Andrew Lo's testimony to the U.S. House of Representatives Committee on Oversight and Government Reform, November 2008, available on the Internet at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217> (last accessed on …). See also John Y. Campbell, Howell E. Jackson, Brigitte C. Madrian and Peter Tufano, "The Regulation of Consumer Financial Products: An Introductory Essay with Four Case Studies", *supra* note 86, a more technical paper on measuring liquidity, leverage, losses and linkages as being crucial to indicating signs of systemic risk.

95 Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111–203, H.R. 4173).

96 S932 of the Dodd-Frank Act, above.

97 S955, *ibid.*

98 S972, *ibid.*

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Stability Oversight Council, s620 requires all investment banks to report the state of their activities and management for a one-off comprehensive review. The Council may also require collection of data from central counterparties and clearing and settlement facilities under s809. Congress and Senate may call the SEC to account for overseeing investment advisers, stock exchanges and self-regulating associations to which brokers and broker-dealers belong.[99] The Council is thus able to access firm-level, market-level and regulator-level data. In relation to retail market oversight, the new Consumer Financial Protection Bureau may also engage in data collection such as data pertaining to equal opportunities to credit for small businesses under s1071.

The EU has also embarked on regulatory reform to expand data collection particularly with respect to the wholesale sector. Articles 35 and 36 of the Regulation establishing the ESMA allows ESMA to request for information from any public authorities or from the regulators in Member States, and to support the work of the ESRB with the information it receives. Credit rating agencies are compelled to disclose their rating methodologies and assumptions,[100] whether the ratings are solicited or otherwise, the information upon which the ratings are based and for structured products, a more comprehensive analysis to show how the rating has been arrived at.[101] Rating agencies are also required to provide ESMA directly with periodic reports of the historical performance of ratings.[102] As for alternative investment funds such as hedge and private equity funds, the Directive for Alternative Investment Fund Managers would require them to report to the competent authority on a regular basis on the principal markets and instruments in which they trade, their principal exposures, performance data and concentrations of risk. The funds will also be required to notify national regulators of the identities of the funds managed, the markets and assets in which the funds will invest and the organisational and risk management arrangements established.[103] Funds with high leverage are further required to report levels of leverage and breakdown of the leverage regularly to regulators.[104] Private equity funds acquiring controlling stakes of 30 % in listed companies or non-listed companies above a significant employment/asset/turnover threshold are also required to report their activities, plans and how their involvement may affect stakeholder interests such as employee interests.[105] On market data, CESR/ESMA has recommended greater standardisation and on exchange trading of derivatives and the expansion of the price transparency regime to include even OTC transactions.[106] The intelligence quality of such data has been acknowledged.[107] However, a significant carveout for non-financial corporates to continue operating off-exchange may be agreed to in order to prevent the escalation of costs for businesses not in the financial sector using derivatives.[108] The EU has also enacted a Regulation in short selling that compels short sales to be disclosed, and enhanced data may be required in adverse circumstances in the financial sector.[109]

The US and EU reforms proceed along similar lines by using the expansion of transparency to bring the shadow banking system and unregulated transactions such as derivatives to become on-market, in order to facilitate regulatory understanding, analysis and action. The expansion of firm level information is achieved by extending disclosure to alternative investment funds and credit rating agencies, and the expansion of market level information is to be achieved by compelling more on-exchange derivative transactions so that transactional transparency may be achieved.

4. Regulatory surveillance as oversight

Information mining is arguably relevant to the surveillance role of regulators. "Surveillance" may be understood as a process for creating visibility by the collection, checking and processing of myriad data, to identify matters of interest relevant to policy or poli-

99 S961-964, *ibid*.

100 Art. 8, Regulation on Credit Rating Agencies 2009, OJ l302/1.

101 Art. 10 and Section D of Annex 1, *ibid*.

102 Arts. 11 and 12, *ibid*.

103 Art. 21, proposed Directive on Alternative Investment Funds.

104 Art. 24, *ibid*.

105 Arts. 28 and 29, *ibid*.

106 CESR Technical Advice on the Review of MiFID (Oct 2010), available on the Internet at <http://www.cesr.eu/popup2.php?id=7279> (last accessed on 21 July 2011).

107 *Ibid*., at p. 73.

108 "Derivatives Reform", *Financial Times* (2 Sep 2010).

109 Regulation on short selling, Arts. 5–6, 16, available on the Internet at <http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf> (last accessed on 21 July 2011).

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tics.[110] Older ideas of surveillance include Bentham's pan-opticon where total transparency is achieved in a hypothetical prison by having a centrally placed prison guard watch everything happening in prison cells.[111] Typical conceptions of surveillance may lie in CCTV cameras watching social and civic life. Transparency regulation also creates visibility and allows monitoring. In the Pan-opticon, the transparency further causes the watched to internalise the knowledge of being watched, entailing a behaviour of compliance. In Foucaultian terms, "[the Panopticon is] at once surveillance and observation, security and knowledge, individualisation and totalisation, isolation and transparency".[112] However, contemporary understandings of surveillance would pertain to the element of bureaucratic control.[113]

This article suggests that the enhanced powers to collect data in the US and EU, coupled with the dedication of a regulatory institution to have systemic risk oversight are designed to augment surveillance structure and capacity, and this would likely become a dominant regulatory modus for monitoring systemic risk, and perhaps more.

In the US, the new Financial Stability Oversight Council established under the Dodd-Frank Act is responsible for systemic risk oversight.[114] The Council is a cross-sectoral committee consisting of all the relevant sectoral regulators such as the SEC and CFTC as well as the Consumer Financial Protection Bureau and the Secretary to the Treasury. Under s112, the Council is tasked with identifying risks to the US financial system and threats to financial stability, and promoting market discipline. The means to achieving the aims of the Council would be by the collection of information to be analysed by the newly established Office of Financial Research, such analysis may then inform monitoring, supervision, discipline, rule-making and other regulatory actions.[115] The Office of Financial Research is established to collect, use, analyse and share data, and it is expressly legislated that the Office would have a data centre as well as research and analysis capacity.[116] The Office is also financially supported by a Financial Research Fund.[117]

The UK also proposed a Council of Financial Stability to consist of the Treasury, Bank of England and the FSA in the Financial Services Bill of 2010. This was dropped and the Coalition government proposes that systemic risk oversight should be reposed in a Prudential Authority nested within the Bank of England by 2012, while the FSA should be turned into a Consumer Protection and Markets agency.[118] At the EU level, the ESMA, EBA and EIOPA will be responsible[119] for supporting the systemic risk oversight reposed in the ESRB. The ESRB, residing within the structure of the European Central Bank, is established as an independent outfit with cross-sectoral EU institutional representation, tasked with "macro-prudential oversight of the financial system within the Community in order to prevent or mitigate systemic risks ..., so as to avoid episodes of widespread financial distress, contribute to a smooth functioning of the Internal Market and ensure a sustainable contribution of the financial sector to economic growth."[120] The ESRB also has powers to require information from European and national agencies and to share such data,[121] as well as to make recommendations for regulatory action.[122]

The EU institutional infrastructure of intelligence and surveillance is arguably fragmented, as data collection primarily rests with national regulators, and there is no harmonised framework in the EU in relation to the capacity, powers and scope of national intelligence mining. This fragmentation could arguably be levelled where market data is concerned, as the MiFID provides the level of market data that apply to all markets. But the powers national regulators may

110 David Lyon, "Editorial. Surveillance Studies: Understanding Visibility, Mobility and the Phenetic Fix", 1 *Surveillance and Society* (2002), pp. 1 *et sqq*.

111 Discussed in James Theodore Gentry, "The Problem of Monitoring Private Prisons", 96 *Yale Law Journal* (1986), pp. 353 *et sqq*.

112 Michel Foucault, *Discipline and Punish: The Birth of the Prison* (1977), at p. 249, as quoted in Neil Selwyn, "The National Grid for Learning: Panacea or Panopticon?", 21 *British Journal of Sociology of Education* (2000), pp. 243 *et sqq*.

113 Elia Zureik, "Review: Surveillance Studies: From Metaphors to Regulation to Subjectivity", 36 *Contemporary Sociology* (2007), pp. 112 *et sqq*.

114 S111.

115 S112.

116 S153 and 154.

117 S155.

118 Available on the Internet at <http://www.hm-treasury.gov.uk/consult_financial_regulation.htm> (last accessed on 21 July 2011).

119 Art. 22, Regulation establishing the European Securities and Markets Authority; Art. 20, Regulation establishing the European Banking Authority and Art. 20, Regulation establishing the European Insurance and Occupational Pensions Authority.

120 Art. 3, Regulation on Community Macro Prudential Oversight of the Financial System and Establishing a European Systemic Risk Board, Regulation No. 1092/2010, 24 Nov 2010.

121 Art. 15, *ibid*.

122 Arts. 16–18, *ibid*.

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exercise vis a vis firms may be different between jurisdictions. The UK Financial Services Authority for example, has enacted new rules allowing the FSA to demand information and documents to be supplied in exercise of a "financial stability information power".[123] However, the landscape of national regulators' investigative powers may be in need of supervisory harmonisation. Hence, it remains to be seen how ESMA, EBA and EIOPA may be able to coordinate the issues of supervisory powers and capacity for national regulators.

Hence, the groundwork may be broadly laid for the fostering of a global intelligence and surveillance capacity, but there are some differences in the powers and capacity of the systemic oversight bodies in the US and EU, that could affect their efficacy. Although the ESRB may be the EU counterpart to the US Council of Financial Stability Oversight, the intelligence collection and processing capacities in the EU are less clear. The ESRB may require data provision from European and national authorities, but it is limited to the quantity and quality of data provided by these agencies. Further Article 15 of the Regulation establishing the ESRB does not allow it to collect data that individually identifies any particular financial institution. Although this may be understandable in terms of protecting any financial institution from premature reputational risk, it also constrains the ESRB from making a judgment on whether any individual institution may be important in contributing to systemic risk. The ESRB may also consult private stakeholders for advice under Article 14 but this does not seem to extend to gathering intelligence from beyond the European agencies and national authorities. It remains to be seen how far the ESRB Secretariat may be supported financially, technologically and with workforce expertise to actually carry out data sorting and analysis. The ESRB may rely on its Advisory Scientific Committee established under Article 12 and its Advisory Technical Committee established under Article 13. However, the Scientific Committee consists of only 15 experts and it remains to be seen the breadth of views they may be able to represent. The Technical Committee comprises largely of central bank and EU institutional representation and possibly deals with the considerations from the political and overall social side of things. One concern is whether or not the ESRB's perceptions are likely to be defined by bureaucratic input instead of having a direct bird's eye view across the industry and markets. The European agencies assisting the ESRB, the ESMA, EBA and EIOPA may have data collection powers but these are addressed to national regulators. Hence, data collection is highly reliant on national regulators expanding their own capacities in this regard. This area, as previously mentioned, is unharmonised and left to national regulators to implement. The ESMA, EBA and EIOPA have been "Level Three" committees assisting in policy-making, legislation drafting and recommending technical standards and guidelines. It is envisaged that they would likely place emphasis on these roles as their respective establishing Regulations now make such standards binding in order to foster a harmonised supervisory culture. Although they are tasked to study and examine systemic risk issues by maintaining a permanent capacity to collect and analyse information,[124] it remains uncertain therefore how far these agencies may be devoted to intelligence mining and data analysis where they are tasked with multiple objectives. Where the EU is concerned, there would likely be more concerns as to whether the regulatory infrastructure is equipped to deliver the purported functions of systemic risk oversight by intelligence and surveillance.

Intelligence and surveillance also remain challenging issues at the international level. Alexander, Eatwell and Dhumale have argued for an international systemic risk regulator as financial institutions have become global and interconnected but there are informational gaps in respect of their global operations, activities and risk profiles, and also supervisory gaps over them as a whole.[125] However, Giovanoli argues that the international architecture has nevertheless become more robust post the global financial crisis, with the Financial Stability Board actively coordinating harmonisation of prudential standards and improving global supervisory coordination.[126] Nevertheless, the sharing of information and supervisory coordination may be reactive and event-based and standard setting bodies such as the Basel Commit-

123 FSA Handbook, FINMAR 1.2.

124 Arts. 23, 24 and 32 of the Regulation establishing the European Securities and Markets Authority, mirrored in the Regulations establishing the European Banking Authority and European Insurance and Occupational Pensions Authority.

125 Kern Alexander, Rahul Dhumale, and John Eatwell, *Global Governance of Financial Systems*, *supra* note 87.

126 Mario Giovanoli, "The Reform Of The International Financial Architecture After The Global Crisis", 42 *New York University Journal of International Law and Politics* (2009), pp. 81 *et sqq.*

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tee and IOSCO work rather independently. Can international coordination and perhaps even surveillance evolve from how national and transnational structures such as the ESRB perform in systemic risk oversight?

If we look at the example of regulatory surveillance in anti-money laundering regimes, perhaps we could observe an increasingly coherent though devolved structure of global surveillance. Regulatory surveillance in anti- money laundering has arguably intensified post the 9/11 disaster in the US which involved terrorist financing. The international convergence of anti-money laundering laws, and the convergence of institutional reform in states each having a Financial Intelligence Unit has paved the way for global intelligence and surveillance.[127] The networking of FIUs upon the international platform of the Financial Stability Board, and supported by information exchange and cooperation, may provide a template for how a global surveillance capacity may be fostered for systemic risk oversight. However, anti-money laundering surveillance has a clear objective and rides on already established networks in payment systems, although other money transfer platforms outside of banks remain a challenge. The oversight of firm and market developments in monitoring systemic risk spans a wider range of potential indicators and business landscape. Nevertheless, the wholesale financial sector may see a fundamental sea change in regulatory tenor as the stage is laid out not only for national, transnational but also for international intelligence and surveillance to become an important tenet of financial regulation. Part 4 will now discuss the implications of this regulatory trajectory.

IV. The implications of transparency as surveillance

Although I have discussed some reservations on how the surveillance capacity in the EU would pan out, this article nevertheless intends to offer some thoughts on the implications of moving into a surveillance age in financial regulation. Two common objectives of surveillance, as mentioned earlier, are bureaucratic control and the internalisation of Foucaultian discipline. This article will argue that, despite the prospect for global intelligence and surveillance, both aims are likely to remain elusive in the wholesale financial sector. First, this article will argue that the technocratic demands on financial surveillance are severe and the “remoteness” of the systemic risk regulator in the regulatory framework will pose challenges for regulators designing “control” mechanisms based on surveillance results. Second, this article will argue that it is unlikely that the framework for surveillance *per se* will instil in financial market participants in the wholesale sector a sense of internalised Foucaultian discipline.

1. Surveillance and regulatory control

Zureik has discussed the contemporary objective in surveillance as equipping regulators and authorities with information in order to decide on mechanisms of control.[128] The US and EU, in extending intelligence over hitherto unregulated and sophisticated financial market entities such as credit rating agencies, alternative investment funds (or their advisers, as in the Dodd-Frank Act) and providers of asset-backed securities, are braced for understanding the technical intricacies of the wholesale sector in order to determine parameters of regulatory control. Although these technical disclosures are also made to the public, it is queried whether, given their well-discussed heuristics, biases and market practice, institutions and sophisticated investors may be credibly relied upon to exercise market discipline. The intended audience of such disclosures would more likely be the regulators and bodies having systemic risk oversight. Systemic risk oversight would structurally consist of two functions, the studying and analysing of data and the higher- level decision-making on what the data analysis may mean for regulatory control. The pan-EU agencies would be responsible for collecting and analysing intelligence, as would be the Office of Financial Research in the US, supporting the decision-making by the ESRB/US Council for Financial Stability Oversight.

127 The Forty Recommendations of the Financial Action Task Force and 9 Special Recommendations Against Terrorist Financing, which have been legislated in the EU Money Laundering Directive 2005, Directive 2005/60/EC and subsequent legislation, and the UK Proceeds of Crime Act 2002 and subsequent amendments.

128 Elia Zureik, “Review: Surveillance Studies: From Metaphors to Regulation to Subjectivity”, 36 *Contemporary Sociology* (2007), pp. 112 *et sqq*.

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2. Challenges for the intelligence function

The intelligence agency would be exposed to a massive influx of new and technical data, and it is likely that technology will be developed to sift out the most relevant data. Hence, systemic risk research is likely to gain importance in its contribution to practical technology development.[129] In doing so, it is queried whether the lessons from the global financial crisis will so dominate research and regulator mindsets, resulting in a backward-looking approach to developing systemic risk indicators.

Further, questions may remain as to how intelligence and surveillance may feed into systemic risk oversight. Firm level information is mined under different pieces of legislation in the EU supporting a variety of regulatory objectives. For example, the disclosure proposed to be made by hedge funds in relation to risk management and portfolio valuation are for investor protection, although they could be useful in systemic risk monitoring. The disclosure of credit rating methodologies and historical performance etc has also to do with investor protection in facilitating investor evaluation of the credibility of a rating. Would these necessarily help in systemic risk surveillance? Would the ESRB be able to derive an aggregate picture of trends in product development and demand in the wholesale market in order to ascertain product, investment and perhaps systemic risk? It is queried whether much of firm level information is designed towards particular investor protection objectives at a transactional level, rather than facilitating a bird's eye view of industry developments in accordance with systemic risk indicators. It may be queried whether the disclosure regulation continues to be tailored along the lines of facilitating market discipline when such discipline has been weak in the recent crisis.[130]

Secondly, systemic risk surveillance arguably needs an integrated analysis of both firm and market level data, but it remains to be seen if such an approach will be taken. Market-level data is often returned to the markets themselves, and the volume of such data makes one wonder to what extent regulators would look for systemic risk signs in the raw data, or would regulators ask for consolidated reports from markets, therefore smoothing over individual transactional data? The surveillance methodologies are possibly being explored at the moment, and in Karmel's view the analysis is the most crucial aspect of the new surveillance framework.[131] This article suggests that the intelligence would need to relate to systemic risk indicators so that firm level and market level surveillance can be integrated according to systemic risk indicators, for meaningful analysis to be carried out.[132]

The intelligence agency arguably needs resources and personnel with intelligence expertise that knows and understands market practices.[133] Staffing the agency may be a challenge given pay disparities between the private and public sector which impacts on recruitment of adequately knowledgeable staff. However, the need to keep the regulators up to par with the developments in the financial markets, is particularly acute.[134] Besides competence, sound analysis of intelligence also depends on the independence of the agency from political capture,[135] or other organisational and behavioural limitations. Williams warns against regulators applying a closed mind to financial surveillance by adhering only to legal compliance signals or signals relevant to the agency's remit or jurisdiction.[136] Williams[137] and Bamberger[138] also warn against excessive reliance on automated generation of signals for concern, as these may be outdated and incomprehensive, given the pace of innovation in the financial sector. Hence, the efficacy of data collection, processing and analysis must constantly be reviewed in order that technocratic expertise may

129 Monica Billio, Mila Getmansky, Andrew W. Lo and Loriano Pelizzon, "Measuring Systemic Risk in the Finance and Insurance Sectors", *supra* note 88.

130 Part II. above.

131 Roberta S. Karmel, "The Future Of The Securities And Exchange Commission As A Market Regulator", 78 *University of Cincinnati Law Review* (2009), pp. 501 *et sqq*.

132 William Mock, "On The Centrality Of Information Law: A Rational Choice Discussion Of Information Law And Transparency", 17 *John Marshall Journal of Computer and Information Law* (1999), pp. 1069 *et sqq.*; Olufunmilayo B. Arewa, "Risky Business: The Credit Crisis And Failure (Part I And II)", 104 *Nw. U. L. Rev. Colloquy*, at pp. 398 and 421.

133 D.N. Ghosh, "Quirks of the Market Regulator", 39 *Economic and Political Weekly* (2004), pp. 1550 *et sqq*.

134 Cary Coglianese and Robert A. Kagan, "Regulation and Regulatory Processes", available on the Internet at <http://papers.ssrn.com/abstract=1297410> (last accessed on 21 July 2011).

135 Amitai Etzioni, "The Capture Theory of Regulations – Revisited", 46 *Society* (2009), pp. 319 *et sqq*.

136 James W. Williams, "Envisioning Financial Disorder: Financial Surveillance and the Securities Industry", 38 *Economy and Society* (2009), pp. 460 *et sqq*.

137 *Ibid*.

138 Kenneth A. Bamberger, "Technologies of Compliance: Risk and Regulation in a Digital Age", 88 *Texas Law Review* (2009/10), pp. 669 *et sqq*.

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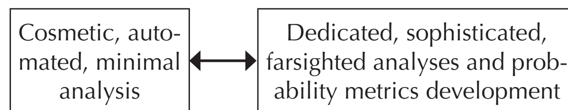
be of an adequate level and sufficiently dynamic to match market developments.

The implications of the above discussion would be that an agency engaged in surveillance and analysis would likely show the following spectrum of behaviour, with the two ends showing an extreme outcome in terms of agency behaviour and output:



3. Remoteness of intelligence and systemic risk agencies

It would be arguably inevitable that an effective data mining and analysis agency would be a technocratic bureaucracy.[139] The nature of the intelligence as well as the financial, economic, legal and technological expertise required to sort and analyse the intelligence would characterise the role and work of the agency as technocratic. This may lend an elitist character[140] to the agency that may not be readily understandable to the community at large, hence entailing questions of transparency and public accountability (even if political channels of accountability such as the ESRB's accountability to Council and Parliament exist). Harfield, commenting on the Serious Organised Crime Agency in the UK, opines that agencies with an intelligence capacity tend to be "shielded from public scrutiny"[141] and hence an aura of remoteness around it. It is perhaps important to maintain the perceived independence or objectiveness of these agencies. However, it may be argued that a technocratic financial intelligence agency may become limited if its elitist character entails a closed culture. An open culture allowing stakeholder and public input or participation could bring about more dynamic understanding and insights into market developments assisting the intelligence role.[142].

Further, the higher level systemic risk oversight body such as the ESRB or the US Financial Stability Oversight Council supported by the intelligence agency would appear to be doubly remote to the industry, market and consumers The structural position of the systemic risk oversight agency ensures remoteness from the industry and community as it is high level and does not usually have direct consulting or accountability channels outside the governmental or political structure. In the US, the Financial Stability Oversight Council is a high level cross-sectoral committee with political accountability, and the Office of Financial Research responsible for intelligence and analysis reports to the Council, therefore insulated from public scrutiny. The ESRB in the EU is nested with the European Central Bank and is also a high level committee supported by governmental input through the advisory technical committee.

Macey and Boot, commenting on the dilemma of proximity versus independence and objectivity in the case of independent directors in corporate governance are of the view that this dilemma is frequently difficult to overcome as remoteness brings about objectivity and independence, but may be at the cost of intimacy of knowledge and understanding.[143] This dilemma arguably exists for the systemic risk oversight body and their intelligence support. In another article[144] I have argued that the future of financial regulation lies heavily in understanding the realities of industry and market practice, and in that process of understanding, it may be necessary to open up the space for intelligence to stakeholder communities and the public. The remoteness of systemic risk agencies and their intelligence support may undermine their future capacity to be effective interpreters of risk in the financial sector. The concerns regarding the technical expertise of the intelligence agency, its possibly technocratic closedness and the remoteness of systemic risk governance are all pertinent to the

139 Technocracy is defined as "the government (or control) of society by scientists, technicians, or engineers-or at least the exercise of political authority by virtue of technical competence and expertise in the application of knowledge", John Gunnell, "The Technocratic Image and the Theory of Technocracy", 23 *Technology and Culture* (1982), pp. 392 *et sqq.*

140 Gunnell, *ibid.*

141 Clive Harfield, "SOCA: A Paradigm Shift in British Policing", 46 *British Journal of Criminology* (2006), pp. 743 *et sqq.*, at p. 755.

142 Tal Z. Zarsky, "Thinking Outside The Box: Considering Transparency, Anonymity, And Pseudonymity As Overall Solutions To The Problems Of Information Privacy In The Internet Society", 58 *University of Miami Law Review* (2004), pp. 991 *et sqq.*

143 A. Boot and J.R. Macey, "Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance", 89 *Cornell L. Rev.* (2004), pp. 356 *et sqq.*, at pp. 366–378.

144 Iris H-Y Chiu, "Enhancing Responsibility in Financial Regulation – Critically Examining the Future of Public-Private Governance Parts I and II", *Law and Financial Markets Review* (2010), at pp. 170 and 286; and see also Erik F. Gerding, "Code, Crash and Open Source", 84 *Washington Law Review* (2009), pp. 127 *et sqq.* who doubt that proprietary firm measures for internal controls and regulatory monitoring over those are adequate for risk management, and proposes a move away from such insular forms of risk management to one that is "open source", allowing for public participation and de-proprietisation of systems.

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question of whether regulators and policy-makers may be able to meaningfully design effective parameters of control based on the expanded surveillance.

4. The remote prospect of Foucaultian discipline

The other objective of surveillance may be to foster a form of internalised Foucaultian discipline- making financial markets players internalise sound behaviour as a result of the knowledge of being watched. A number of commentators[145] have however written on the tendencies of financial market participants to look for arbitrage opportunities or to get around regulatory constraints in structuring products and transactions, and hence, it may be inherent in the industry's pathology of devising innovations around the parameters of control, and to be unenthusiastic about delivering intelligence to bureaucracies. Private placements have been designed to mitigate compliance with public prospectus rules, hedge funds are incorporated offshore and cater to sophisticated investors in order to avoid onerous consumer protection rules for retail marketed funds. The continued power of the financial industry to lobby for lenient regulatory reforms remains in the US and EU, although there are also increasing calls for the industry to embrace ethical behaviour and to reflect upon its social effects.[146]

Painter however argues that the problem is not merely a matter of ethics in the financial sector, but also ethics in government. The failure in government managing conflicts of interest in its close relationship with the financial sector through lobbying, and the revolving door of key personnel between government and private sector top jobs,[147] remain key concerns that may undermine policy-makers' resolve to exert more meaningful regulatory controls through expanded surveillance.

V. Conclusion

In the wake of the global financial crisis, the trajectory of legal reform is likely toward more transparency regulation. This article argues that transparency regulation will take on a new role of surveillance as intelligence and data mining expand in the wholesale financial sector, supporting the creation of designated systemic risk oversight regulators. The role of market discipline, which has been acknowledged to be weak leading up to the financial crisis, is likely to be eclipsed by more technocratic governance in the financial sector. This article however doubts that the expansion of technocratic surveillance, intelligence and systemic risk oversight is likely to translate into effective exertion of regulatory control. This is due to concerns with the sufficiency of technocratic expertise in surveillance and the remoteness of systemic risk governance from the market, industry and consumers. This article also doubts that the rise of the surveillance regulatory framework will achieve a Foucaultian effect such that financial sector participants would internalise the discipline of sound behaviour. Innovation, risk-taking, efficiency and low-cost seeking behaviour dominate the industry, coupled with systemic problems of governments' close relationships with the financial sector. These endemic features of the financial sector will pose challenges for financial regulation even in the surveillance age.

145 D.N. Ghosh, "Quirks of the Market Regulator", 39 *Economic and Political Weekly* (2004), pp. 1550 *et sqq.*; Onnig H. Dombalagian, "Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation", *supra* note 89.

146 Claire Moore Dickerson, "Ozymandias As Community Project: Managerial/Corporate Social Responsibility And The Failure Of Transparency", 35 *Connecticut Law Review* (2003), pp. 1035 *et sqq*.

147 Richard W. Painter, *Getting the Government America Deserves: How Ethics Reform Can Make a Difference* (Oxford: OUP 2010, forthcoming), available on the Internet at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1334872> (last accessed on 21 July 2011).

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