Regulating Financial Innovation

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Niamh Moloney, *The Legacy Effects of the Financial Crisis on Regulatory Design in the EU*, *in* Eilís Ferran, Niamh Moloney, Jennifer G. Hill & John C. Coffee, Jr., **The Regulatory Aftermath of the Global Financial Crisis** (International Corporate Law and Financial Market Regulation Series, Cambridge University Press, 2012).

Books sometimes occupy a different ecological niche in legal scholarship than do articles. The fact that books are the main scholarly medium in the UK, while articles dominate in the US, imposes an unfortunate hurdle to communication. Differences in legal regimes and regulatory structures exacerbate the problem. Readers unfamiliar with another jurisdiction's regime may not be able to appreciate the rich comparative insights that come from evaluating different treatments of shared post-financial crisis regulatory challenges. One of the benefits of a website like Jotwell is that it can help bridge the gaps imposed by geography, institutional structure, and medium, and potentially enlarge the audience for important work that otherwise does not appear online.

Niamh Moloney's chapter in this book is exceptional in the degree to which it considers financial regulation in terms of regulatory design, as evaluated prospectively. (In the book's first chapter, coauthor Eilis Ferran lucidly covers existing financial regulatory reforms in the EU. Coauthors Jennifer Hill and Jack Coffee also provide thoughtful chapters, respectively covering why Australia fared relatively well through the financial crisis, and the political economy of Dodd-Frank in the US.)

In her words, Moloney's chapter "shifts the frame from the first-generation, stability-driven prudential measures which have received extensive attention in the literature and instead examines the spillover or legacy effects of the crisis and the initial stability agenda on the second-generation reforms. It considers whether the crisis has led to productive regulatory innovation in EU market regulation and in EU consumer protection regulation." (P. 115.) Moloney focuses on the traditional realm of securities regulation – fostering fair and efficient capital markets, or "market regulation", and consumer protection – in order to understand the torque that the current preoccupation with prudential regulation exerts on these areas. Her concern is a version of that expressed by Ethiopis Tafara in the book's introduction: that we face decisions, in post-crisis regulatory reform, about where we should extend the traditional tools of the banking regulator, and where we should extend those of the securities regulator (P. xxiv). For Moloney, the question is less where the line will be drawn, than what the spillover effects on the traditional realm of securities regulation will be of the expansive new prudential regulatory agenda.

Notably, Moloney enters the post-crisis financial regulation conversation at what Julia Black has described as the "third level" of regulatory innovation – the cognitive or normative level, producing transformative effects on regulation, paradigm shifts, and a resetting of the policy goals of regulation.[1] In particular, Moloney considers the potential impact of an emergent policy suspicion of market innovation and market intensity, with attendant implications for technical regulatory choices and institutional structures. She suggests that this new policy suspicion of market innovation may lead to a "radical and untested resetting" of securities regulation's traditional policy goals (P. 122).

Moloney canvasses the various ways in which market and consumer protection regulation differ from prudential regulation, and provides an interesting example of the relative importance of regulatory competition in each sphere. She accepts that some resetting of policy goals was necessary following the clear and considerable failures of market regulation that the crisis exposed. She dissects market regulators' failures carefully, including not only the familiar points about the limits of disclosure-based regulation, flawed assumptions about rationality and market efficiency, and regulators' inability to understand or respond to risk, but also the fact that securities regulators failed to build on lessons about incentives and internal governance from the Enron era, focusing on research analysts and auditors while not addressing analogous incentives problems across a whole range of financial market actors.

Moloney notes the rise of a new body of post-crisis scholarship that questions the essential social utility of markets. She canvasses the pushback in the EU, at the OECD, and in scholarship questioning the extent to which markets should be completed, and questioning whether or not markets (as opposed to regulation) are able to manage innovation productively. She notes a new skepticism about the goal of promoting innovation in finance at all, a new policy suspicion of self-regulation in general, and a newly strong conviction that regulated actors will always exploit regulatory gaps. In place of the pre-crisis order that favored markets and celebrated innovation, she suggests, is a new "default assumption" that innovation inevitably generates risks, which by their nature require regulatory intervention (P. 137). (Many of us will have noticed this rhetoric in the UK in particular, but the same suspicions appear in the US as well, often in populist terms.) At a meta-level, Moloney suggests the dangers inherent in the current reform movement include risks of international "groupthink", regulatory over-reaction, the disabling of market mechanisms including trust and reputation, and reliance on international and transnational institutions and networks with poor governance.

Moloney then launches into an incisive and illuminating inquiry into the specific effects of the new normative order, specifically in the EU but concerning questions that are now globally relevant. Through multiple specific examples, Moloney points out the significant expansion of the "regulatory perimeter" of market regulation over a wider range of trading venues (exchanges and other trading platforms) and a wider set of asset classes including fixed income securities and derivatives. She suggests that the moves often entail under-analyzed effects for liquidity, including in the sovereign debt markets. Moreover, extending regulation to a wider range of venues, including the OTC markets, and seeking to apply the same set of rules to this wider set, have both tightened the loosely-regulated OTC space and limited the freedom of regulated entities to self-regulate.

While recognizing that high frequency trading seems ripe for regulatory attention, she suggests that HFT-related reforms have acquired momentum by having become a flashpoint in the debate on the social utility of markets overall. Similarly, new efforts to ease capital market entry for SMEs are a convenient but collectively incoherent proxy, fueled by the contemporary concern about the social utility of markets, for the much broader reforms, including to tax policy, that are actually called for.

In the consumer protection sphere as well, Moloney argues that the new suspicion of markets and innovation has prompted UK and EU regulators to consider an energetic new suite of retail market regulatory tools related to what the UK FSA calls "product intervention", particularly around complex or simply new financial products. Given the regulatory challenges the retail sector presents, Moloney suggests that product regulation may be a promising reform. At the same time, it is an "unwieldy and untested tool" (P. 196) with political and judgmental overtones. It may also have deleterious regulatory effects, particularly for supervisory effectiveness and investor responsibility / choice. Moloney also challenges the automatic assumption that complex products, like synthetic ETFs, are inevitably bad for investors.

Moloney's careful argument offers a corrective to what she suggests is a collective post-crisis rush to judgment and action. Even for those of us that believe (and Moloney is surely one of them) that financial innovation is neither monolithic nor an unmitigated good, this sophisticated analysis forces us to think more carefully about our reasons for believing so and the actual evidence on which we rely. Particularly in the midst of a highly charged shift in assumptions about the social utility of innovation and markets, we are well advised to look carefully at what we think we know.

1. Julia Black, "What is Regulatory Innovation?" in Julia Black, Martin Lodge and Mark Thatcher, eds., *Regulatory Innovation: A Comparative Analysis* (2005), at 9-11. [?]

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