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MACRO- AND MICRO-LEVEL EFFECTS ON RESPONSIVE FINANCIAL REGULATION

CRISTIE FORD[†]

I. INTRODUCTION

There are several obvious and directly causative reasons why the global financial system nearly collapsed in late 2008. Consider, for example, striking regulatory gaps, the limited reach of national regulators in the face of global banks and shadow banks, inadequate regulatory staffing and capacity, moral hazard and the developments of perverse incentives toward excessive risk-taking, the masking of risk-shifting as risk-management, and the conviction in some quarters that self-interested, market-driven private action could substitute for regulatory oversight. A large and ever-growing body of multidisciplinary scholarship has been unearthing and investigating the roots and catalysts of the financial crisis of 2007–2009.

Different scholars have taken different approaches to the question of where to go in the wake of the financial crisis—that is, how to design a regulatory system that is simultaneously robust, credible, and flexible; that better incentivizes firms toward socially beneficial goals without completely renouncing regulatory capitalism;¹ that “sees around corners” better than any regulator and most of those in industry have managed to do in the last dec-

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¹ David Levi-Faur, “The Global Diffusion of Regulatory Capitalism” (2005) 598 *Annals of the American Academy of Political and Social Science* 12.

ade;² and that rewards expertise and innovation, without permitting the alarming concentrations of power that make banks too big to fail and regulators too cowed (or too captured) to further their public-regarding mandate. Saule Omarova, for example, notes that the lack of workable alternative methods for regulating global financial players compels a defense of ongoing self-regulation in the financial markets. Analogizing from the “Responsible Care” initiative in the chemical industry, Omarova argues that financial firms’ recognition of their common destiny, and of the broad reputational damage that could be inflicted on all of them as a result of catastrophic error, will push the financial industry toward more responsible self-regulation.³

Many other scholars, though fully aware that self-regulation will have to play a central part in an industry as fluid, powerful, fast-moving, and global as the financial industry, are now putting more emphasis on the need for stronger state or public oversight to put a brake on short term and self-interested industry conduct. The calls for regulatory restructuring have been many over the last few years.⁴ Among other innovative proposals is John Braithwaite’s for a restorative justice model for banks, with negative licensing as a key element.⁵ Ken Bamberger has also advocated a more activist regulatory model as a response to the problems of accountability, transparency, and

² The injunction to “see around corners” dates from the immediate post-Enron era: *Testimony Concerning Resource Allocations and Strategic Planning*, James M McConnell, before the House Government Reform Subcommittee on Efficiency and Financial Management, Committee on Government Reform (20 April 2004), online: US Securities and Exchange Commission <<http://www.sec.gov>>.

³ Saule T Omarova, “Wall Street as Community of Fate: Toward Financial Industry Self-Regulation” (2011) 159 U Pa L Rev 411 at 449–53. The analogy with the Responsible Care program is Omarova’s, but see also Neil Gunningham, “Environment, Self-Regulation, and the Chemical Industry: Assessing Responsible Care” (1995) 17:1 Law & Pol’y 57.

⁴ See e.g. Lucian A Bebchuk & Holger Spamann, “Regulating Bankers’ Pay” (2010) 98 Geo LJ 247; Robert Hockett, “A Fixer-Upper for Finance” (2010) 87:6 Wash UL Rev 1213; Andrew W Lo, “Regulatory Reform in the Wake of the Financial Crisis of 2007–2008” (2009) 1:1 Journal of Financial Economic Policy 4; Luigi Zingales, “The Future of Securities Regulation” (2009) 47:2 Journal of Accounting Research 391.

⁵ John Braithwaite, “Restorative Justice for Banks Through Negative Licensing” (2009) 49:4 Brit J Crim 439 [Braithwaite, “Negative Licensing”].

reasoning introduced, in particular, by computer code-based internal risk management systems.⁶ Calls for reform in the United States were responded to, in part, through the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.⁷ Of course, new regulatory initiatives still need to grapple with the difficult problems of innovation, dynamicism, and complexity that characterize this industry.

Within the body of scholarship on the financial crisis, a particular subset has been preoccupied with the implications of the crisis for those modern regulatory approaches that moved away from rigid, prescriptive regulatory standards, toward more dynamic and context-specific standards developed in concert with regulated actors. Among these is Ian Ayres and John Braithwaite's concept of "enforced self-regulation".⁸ This is an important avenue for inquiry, though one where the scope for misunderstanding may be substantial. The regulatory regimes that permitted the financial crisis to occur were predominantly *not* enforced self-regulatory regimes. In many cases they were self-regulatory or even outright deregulatory. Nor were the gaps in real life regulatory spheres of responsibility prescribed by the enforced self-regulatory approach, or by the broader concept of "responsive regulation" that Ayres and Braithwaite developed almost two decades ago, and in which enforced self-regulation is embedded.⁹ For scholars of regulation, to ask about the relationship between responsive regulation and the recent financial crisis risks being seen as ascribing the blame for the crisis to these regulatory approaches, rather than to the broad problems identified above. This would

⁶ Kenneth Bamberger, "Technologies of Compliance: Risk and Regulation in a Digital Age" (2010) 88:4 *Tex L Rev* 669 at 729–38. See also Erik F Gerding, "Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis" (2009) 84:2 *Wash L Rev* 127 at 189–94, responding to a similar problem of the "new financial code", Gerding argues for more public input and transparency, in the sense of having regulators promote "open source" software in codes or models used to market financial products.

⁷ Pub L No 111-203, 124 Stat 1376 (2010).

⁸ "Enforced self-regulation" and related approaches are described more fully in Part II, below.

⁹ Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992).

be to misunderstand the crisis, responsive regulation itself, and the sometimes considerable distance between intent and implementation.¹⁰

That said, the financial crisis does demand that some careful work be done to investigate the essential preconditions for enforced self-regulation and other similar approaches.¹¹ As this paper attempts to demonstrate, certain elements of contemporary financial regulation, particularly the emphasis on partial delegation of interpretive and definitional matters to industry, contain insights relevant to responsive regulation—even though these methods were so poorly implemented in this context as to hardly resemble the theoretical original. The precise nature of the relationship between the regulator and the financial industry also deserves attention. Regulation cannot be understood without reference to the broader social, political, and institutional contexts that contain it. Beyond pure regulatory design, the financial crisis makes clear that questions about the appropriate regulatory mix of strategies do not take place in isolation from questions of power and influence, which directly affect feasibility and effectiveness in practice. It also makes clear that actually operationalizing any regulatory method is bound to meet entirely unexpected challenges.

The purpose of this article is to consider what the experience of the financial crisis can teach scholars of enforced self-regulation and related approaches, by widening the scope of inquiry and considering the broader set of forces that operate on any regulatory structure. The article argues that enforced self-regulation and other process-based regulatory approaches would benefit from building in, at a structural level, greater attention to both “macro” forces, such as the background influence of power, and “micro” forces, such as the form, nature, and drivers of incremental change within the interstices of any flexible regulatory process. It closes with a few observations

¹⁰ Reportedly, at a *festschrift* for Gunther Teubner in April 2009, Teubner was jokingly described as having caused the financial crisis through the widespread adoption of his theoretical approach.

¹¹ See e.g. Gráinne de Búrca, “New Governance and Experimentalism: An Introduction” [2010] *Wis L Rev* 227 at 237–38 (considering how scholars of new or experimentalist governance may interpret practical failures of their theory).

about potential tools available to responsive regulators for addressing the problems identified.

II. RESPONSIVE REGULATION AND THE SCHOLARSHIP IT HAS INFLUENCED

The goal of Ian Ayres and John Braithwaite's influential 1992 book *Responsive Regulation: Transcending the Deregulation Debate* was exactly that: to "transcend the intellectual stalemate between those who favour strong state regulation of business and those who advocate deregulation."¹² The model that Ayres and Braithwaite put forward envisions a more flexible, responsive, and iterative relationship between regulator and industry, and a less dogmatically drawn distinction between the public and private spheres. The key mechanism is "enlightened" delegation,¹³ meaning careful allocation of regulatory functions to specific actors (public interest groups,¹⁴ unregulated competitors of regulated firms,¹⁵ or regulated firms themselves¹⁶) reinforced all the while by a credible and intelligent public regulatory presence operating along tit-for-tat-based regulatory¹⁷ and enforcement¹⁸ pyramids, and holding in reserve a "benign big gun".¹⁹ At the crucial intermediate layers of the regulatory pyramid is "enforced self-regulation," an arrangement under which firms are required endogenously to develop their own set of context-specific conduct rules, which are then publicly ratified and capable of public enforcement.²⁰

¹² Ayres & Braithwaite, *supra* note 9 at 3.

¹³ *Ibid* at 4.

¹⁴ *Ibid* at 54–100.

¹⁵ *Ibid* at 101–32.

¹⁶ *Ibid* at 133–57.

¹⁷ *Ibid* at 38–40.

¹⁸ *Ibid* at 35–38.

¹⁹ *Ibid* at 19–30, 40–51.

²⁰ *Ibid* at 101–16.

The responsive regulation approach, along with the larger body of John Braithwaite's work, has been seminal to the development of what Sharon Gilad recently characterized as a "family" of "process-oriented" regulatory approaches.²¹ Gilad's typology is a useful framework (though I express a few quibbles below) for locating John Braithwaite's responsive regulation work in the context of the more recent regulatory scholarship it has helped to generate. Distinguishing between regulatory design approaches permits precision. It also suggests that this article's observations about micro- and macro-level effects on regulatory design are relevant to other, similar contemporary regulatory models.

In her article, Gilad classifies regulatory institutional models into three ideal forms, which she goes on to compare based on such criteria as the degree of rule adaptation to individual circumstances, costs incurred by regulators, regulatory learning and long-term capacity building, and mechanisms shaping firms' cooperation and performance.²² The first institutional form is the prescriptive form, consistent with what is generally recognized as command-and-control regulation. The second institutional form is outcome-oriented regulation, which includes performance-based, standards-based, and principles-based regulation.²³ Within the outcome-oriented ideal type, regulators develop output specifications, which are closely associated with regulatory goals and generally cast at a high level of generality, and evaluate regulated actors' compliance based on whether they achieve acceptable results. As such, it is a model that can function in situations where the regulated industry is heterogeneous and background conditions are subject to change. Note, however, that Gilad's pure form of outcome-oriented regulation puts all of its eggs in the outcome-oriented basket, meaning that it contains no explicit requirement that outcomes be achieved through defensible processes or mechanisms. To make it work, what regulators (and, ideally, regulated actors) need is some reasonable understanding of what "good" outcomes look like.²⁴

²¹ Sharon Gilad, "It Runs in the Family: Meta-Regulation and Its Siblings" (2010) 4:4 Regulation & Governance 485 at 486 [Gilad, "Family"].

²² *Ibid.*, especially table 3 at 494–95.

²³ *Ibid.* at 486–89.

²⁴ *Ibid.* table 1 at 487.

The third institutional form in Gilad's typology is process-oriented regulation. Process-based models focus on systems and controls, rather than outcomes. Like outcome-oriented regulation, process-oriented regulation is well-suited to environments in which regulated actors are heterogeneous and background conditions are unstable, meaning that one-size-fits-all regulatory prescriptions and rigid rules are unworkable. Included in the process-based category are management-based regulation,²⁵ enforced self-regulation,²⁶ "new governance" principles-based regulation,²⁷ and meta-regulation.²⁸ Gilad's approach focuses particularly on two representative forms: management-based regulation and meta-regulation.

In terms of the availability and soundness of the information they are built around, Gilad describes management-based regulation as a "second best solution" relative to outcome-oriented regulation. Unlike outcome-oriented regulation, management-based regulation is viable where regulators do not have a reasonable understanding of what good outcomes look like, but (along with regulated actors) do at least have a reasonable understanding of what good *control systems* look like. Management-based regulation thus designs process specifications around what constitutes acceptable planning and implementation of systems and controls. Meta-regulation, the other version of process-oriented regulation, inhabits an even more indeterminate space. Here, neither regulators nor regulated actors have more than a limited, provisional, and contingent understanding of what good outcomes or even good control systems might look like.²⁹ Meta-regulation therefore focuses on learn-

²⁵ See Cary Coglianese & David Lazer, "Management-Based Regulation: Prescribing Private Management to Achieve Public Goals" (2003) 37:4 *Law and Soc'y Rev* 691.

²⁶ See Ayres & Braithwaite, *supra* note 9; John Braithwaite, "Enforced Self-Regulation: A New Strategy for Corporate Crime Control" (1982) 80:7 *Mich L Rev* 1466.

²⁷ Cristie Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45:1 *Am Bus LJ* 1 [Ford, "New Governance"]. Note that Gilad locates the author's version of principles-based regulation within meta-regulation, not outcome-oriented regulation: Gilad, "Family", *supra* note 21 at 502.

²⁸ Christine Parker, *The Open Corporation: Effective Self-Regulation and Democracy* (Cambridge: Cambridge University Press, 2002).

²⁹ Gilad, "Family", *supra* note 21, table 1 at 487.

ing, rather than knowing. That is, it focuses on determining whether the systems and controls being used are designed to both generate and respond to ongoing learning, thereby improving outcomes as measured by reference to a high-level set of principles.³⁰ Both forms of process-based regulation require substantial regulatory capacity.

Gilad's typology is useful and insightful. Even so, one might question whether her description of outcome-oriented regulation has been narrowed too much, for the sake of distinguishing it from meta-regulation in particular. Specifically, it may be misleading to describe outcome-oriented regulation as based on a greater degree of certainty or knowledge than management-based regulation, the "second best solution", can lay claim to. For one thing, means and ends continually and mutually revise themselves. A feedback relationship exists between what counts as a good control system and what counts as a good outcome, meaning that outcomes and processes are not so clearly distinguished. Moreover, outcome-oriented regulation, when characterized by careful attention to revisability and contingency and when outcomes are defined in multifactorial and nuanced ways, can be richer than Gilad's presentation permits.

Even accepting the distinction, it is not necessarily the case that a regulator is operating in a more certain universe if she has a good understanding of what a good outcome looks like, as opposed to having a good understanding of what a good control system looks like. When comparing outcome-oriented and management-based regulation, the question is not degrees of certainty so much as what one has knowledge about. Management-based regulation makes sense when one has a good understanding of control systems, even if not of outcomes. Outcome-oriented regulation makes sense where one has a good understanding of outcomes, even if not (perhaps because of limited regulator knowledge or industry heterogeneity) of the control systems most suited to reaching those outcomes. Both management-based regulation and outcome-oriented regulation focus on the aspect they know relatively more about, or that they can better measure.

The second, related question is whether it makes sense to situate meta-regulation and management-based regulation within an overarching category

³⁰ *Ibid.*

of process-based regulation, rather than distinguishing meta-regulation from all other categories. This is because unlike outcome-oriented and management-based regulation, Gilad's meta-regulation (and this approach also spans experimentalism and new governance)³¹ directly confronts what the regulator does not know, and tries to build learning systems to work with it. Seen from this perspective, the most significant distinction is between meta-regulation and everything else.

Especially in the context of the fast-moving and complex financial markets, it may make more sense to assess regulatory approaches not in terms of the information they work with, but rather in terms of the strategies they possess to grapple with uncertainty and lack of information. Certainly, one would prefer an environment not characterized by pervasive uncertainty, where one had a good appreciation of what either a good outcome or a good control system looked like. However, an approach that focuses on what is known may not do an especially good job of dealing with the unknown. The financial markets, of course, have been and continue to be characterized by vast areas of Knightian uncertainty.³² In the financial crisis, it was not the *known* that was the problem but rather the *unknown*. Regulators using man-

³¹ Experimentalism and new governance share features, including some degree of delegated decision-making to regulated actors and an emphasis on information-based decision-making that is capable of evolving through time. See e.g. Orly Lobel, "The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought" (2005) 89:2 Minn L Rev 342; Bradley C Karkkainen, "New Governance in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping" (2005) 89:2 Minn L Rev 471. What Gilad calls process-based approaches (including Braithwaitean enforced self-regulation) tend to look beyond the dyadic regulator/regulated actor relationship, envisioning a more general breakdown of the public/private divide and a larger and more varied group of players participating in governance. See e.g. Lester M Salamon, ed, *The Tools of Government: A Guide to the New Governance* (Oxford: Oxford University Press, 2002); Jody Freeman, "The Private Role in Public Governance" (2000) 75:3 NYUL Rev 543.

³² See Frank Hyneman Knight, *Risk, Uncertainty and Profit* (Boston: Houghton Mifflin, 1921), discussing the difference between risk and uncertainty. On the impact of uncertainty in the financial crisis, see e.g. Steven L Schwarcz, "Regulating Complexity in Financial Markets" (2010) 87:2 Wash UL Rev 211; Jeffrey M Lipshaw, "The Epistemology of the Financial Crisis: Complexity, Causation, Law, and Judgment" (2010) 19:2 S Cal Interdisciplinary LJ 299.

agement-based and outcome-oriented methods, but not meta-regulatory methods, are not equipped with the tools to deal with significant uncertainty. Consciously or unconsciously, they may overestimate the degree of knowledge they have, or ignore troubling uncertainty because they lack the tools to confront it. To make outcome-oriented or management-based methods work, regulators may consciously or unconsciously fail to acknowledge gaps in knowledge, paper over them, or fill them in an ad hoc, nontransparent, and unsystematic manner. It would be far better to design a system that is capable *ab initio* of recognizing and responding to the unknown as well as the known.

Some elements of Ayres and Braithwaite's responsive regulation approach, such as the "benign big gun" or the "tit-for-tat" approach, are ecumenical (when taken out of the context of the rest of the book) and could apply across Gilad's typology. The enforced self-regulation piece, however, is perhaps the original form of management-based regulation. It describes a process of negotiation between regulator and each regulated actor, to establish regulations that are particularized to that actor. It is therefore sensitive to institutional heterogeneity and evolving conditions. Each firm proposes its own regulatory standards (that is, outcomes) to the regulator. Consistent with Gilad's narrative, the regulator requires the firm to do its own self-regulation for epistemological and resource-based reasons. Enforced self-regulation is underpinned by convictions about the utility and wisdom of regulator/industry dialogue, and the prudent use of regulatory resources, such that regulators "steer rather than row" (to use the language of the early 1990s).³³ The assumption is that the regulator itself is in an inferior position, relative to industry, to establish regulatory rules, monitor for noncompliance, or punish and correct episodes of noncompliance. Nevertheless, the self-regulation is "enforced" in that it is embedded within an escalating regulatory pyramid model. If the firm fails to propose and realize its own regulatory standards, it is subject to harsher default standards imposed by the state.

³³ David Osborne & Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector* (Reading, MA: Addison-Wesley, 1992).

Where an intransigent actor sets standards but subsequently fails to self-regulate, its internally developed standards are also publicly enforceable.³⁴

The reason the distinction between meta-regulation and everything else matters to the Ayres and Braithwaite approach is that while responsive regulation circa 1992 embraces sensitivity to context, as do outcome-oriented and management-based regulation, it does not explicitly locate systematic learning at the core of the regulatory project in the way that meta-regulation does. While it envisions an ongoing, tit-for-tat engagement between regulatory staffer and regulated actor, enforced self-regulation does not stipulate that a dedicated mechanism be established for systematically glean insights from regulatory experience and ploughing those insights back into regulatory practice.³⁵ The main thesis of this article is that in the absence of carefully designed structures for learning-by-doing, lacunae in understanding can be filled in in ways that reflect “macro level” power relationships and “micro level” idiosyncrasies in implementation, rather than regulatory intention. This is a problem that the next section of this article seeks to describe in greater detail.

Significantly, John Braithwaite’s updated description of responsive regulation in this volume emphasizes learning to a much greater degree.³⁶ The new article proposes a “clarification of the core of the theory” and a “simple reformulation of the theory as nine principles of responsive regulation.”³⁷ In fact, it is both a clarification and an evolution. Abiding is the theory’s emphasis on dialogue, contextual sensitivity, and an escalating range of sanctions with an initial preference for the most collaborative forms of interaction (e.g. support and education).³⁸ Newly emphasized are the needs to engage those who resist with fairness and respect, to network pyramidal governance, and

³⁴ Ayres & Braithwaite, *supra* note 9 at 101–09.

³⁵ *Ibid* at 111–12 (enforced self-regulation would foster regulatory innovation, but “[a] combination of regulatory vigilance, tripartite accountability, and civil liability for damages to victims would have to be counted on to control the excesses of experimentation”).

³⁶ Braithwaite, “The Essence of Responsive Regulation” (2011) 44:3 UBC L Rev 475 [Braithwaite, “Essence”].

³⁷ *Ibid* at 476.

³⁸ *Ibid* at 503.

to learn.³⁹ In these respects, the nine principles of responsive regulation identified in Professor Braithwaite's new work show the clear imprint not only of his ongoing work on restorative justice, but also the influence of meta-regulation.

III. TWO CHALLENGES FOR FLEXIBLE REGULATION

Enforced self-regulation, management-based regulation, meta-regulation, and any nuanced version of outcome-oriented regulation (collectively called "flexible regulation" below) all require substantial regulatory capacity to operate effectively. Over and above capacity challenges, however, flexible and iterative regulatory strategies like these are also far more porous to external influence than prescriptive regulation would be. In subtle and overt ways, these regulatory methods are open to the influence of forces from different planes of action. In this section, I describe those external influences as coming from the macro plane of power and political agenda-setting, and the micro plane of variability, contingency, and imperfection within the incremental moments of implementing regulation. In addition to being supported by adequate regulatory capacity, in order to be effective, flexible regulation must be capable of registering these factors and their influence on formal regulatory design, and responding to them. While all four forms of flexible regulation are built to evolve through time, I contend that only meta-regulation (including the updated version of responsive regulation in this volume) has been designed to manage the change process in an adequately conscious way, because of its focus on learning from experience.

In the years leading up to the financial crisis, financial and securities regulation had evolved significantly in the direction of flexible and, especially, devolved and iterative regulation, in ways that were at least superficially consistent with responsive regulation and flexible regulation generally. A particular history exists around the development of flexible regulation in securities regulation. In contrast to the standard image of the administrative agency bureaucracy, modern financial regulation, and especially securities regulation, was not a classic command-and-control system to start with. Since the inception of modern securities regulation in the Depression era, it

³⁹ *Ibid.*

has been a disclosure-oriented, rather than merit-based, system, reflecting deep support for market mechanisms and for the basic autonomy of the public companies that raise capital in those markets. In this environment, it has always been a given that centralized bureaucracies are too distant from corporate practice and too lacking in information to prescribe detailed rule-based requirements concerning key aspects of business operation.⁴⁰ The notion of moving toward a more collaborative, responsive, and flexible regulatory structure seemed to dovetail especially well with this regulatory environment.

The conversation around principles-based securities regulation captured the way in which contemporary thinking about the wisdom and viability of flexible regulation was translated into this context.⁴¹ Principles-based regulators such as the UK's Financial Services Authority (FSA) and the British Columbia Securities Commission argued that prescriptive, one-size-fits-all regulatory requirements produced a mismatch between regulatory goals and regulatory methods, because they encouraged firms to focus on detailed compliance rather than on exercising sound judgment with a view to the broader best interests of their clients. Detailed and "top-down" requirements also calcified the regulatory system to reflect a particular version of industry practice at a particular point in time. By contrast, these regulators argued, general obligations subject to industry-driven reflection and amendment were built to ensure sustainability, and to allow industry practice to evolve unhindered by over-regulation. Principles-based drafting also ensured flexibility, in that emerging issues that called for regulation could be addressed in the general course, because market participants needed to consider the purpose of the rules in the context of the objectives of securities regulation when making any compliance decision.⁴²

⁴⁰ This is not to say that every securities regulatory provision is drafted in equally principles-based terms. On the distinction between, for example, principles-based provisions around fraud and rules-based provisions around administrative accountability, see Cristie Ford, "Principles-Based Securities Regulation" (Report for the Expert Panel on Securities Regulation: 2009), online: <www.expertpanel.ca> [Ford, "Expert Panel"].

⁴¹ This section draws on Ford, "New Governance", *supra* note 27 at 11–21.

⁴² BC Securities Commission, *New Proposals for Securities Regulation: A New Way to Regulate* (2002), online: <<http://www.bcsc.bc.ca>>. In the same vein, the Securities Commis-

At the BC Securities Commission, outcome-oriented regulation was the essential correlate to principles-based regulation. Outcome orientation was seen to be more congruent with regulatory goals, mandate, and capacity. Because industry innovation was so fast-moving, the perception was that regulators that sought to enforce detailed process-based requirements would inevitably find themselves playing catch-up and reacting to Enron-style loophole behaviour. Because granular information was decentralized across multiple industry actors, centralized prescriptive requirements were viewed as cumbersome, and understood as less likely to be consistently effective and congruent with regulatory goals. Far better be it for regulators to focus on articulating and achieving high level regulatory goals, while leaving the detailed articulation of content to industry itself.

The result in these jurisdictions was a move toward an approach that permitted firms to determine for themselves what was required to meet broadly defined regulatory goals, such as the need to “[m]aintain an effective system to manage the risks associated with [their] business.”⁴³ There was a similar shift toward more principles-based language in the Treating Customers Fairly initiative at the FSA,⁴⁴ and in the BC Securities Commission’s recommendations for allowing investment dealers to use their own proprietary software, rather than existing rules imposed by self-regulatory organizations, to supervise client account handling for churning (excessive trading to in-

sion argued that the misconduct underlying the recent financial crisis could mostly be addressed through stronger compliance oversight and enforcement of existing statutory provisions, rather than by promulgating new detailed rules: BC Securities Commission, *Annual Report 2008–2009*, online: <<http://www.bsc.bc.ca>> at 3.

⁴³ BC Securities Commission, *Securities Regulation in British Columbia: Guide for Dealers and Advisors* (2004), online: <<http://www.bsc.bc.ca>> at 31 (BC’s original, never-in-force, principles-based regulatory model would have replaced detailed rules of conduct for dealers and advisers with an overarching Code of Conduct consisting of 28 rules arranged under eight broad “standards” of which this is number 20).

⁴⁴ See Financial Services Authority, *Treating Customers Fairly*, online: <<http://www.fsa.gov.uk>>. For a history of the uptake of the Treating Customers Fairly initiative, see Sharon Gilad, “Enlisting Commitment to Internal Compliance via Reframing and Delegation” (2010) Center for Analysis of Risk and Regulation (London School of Economics and Political Science), Discussion Paper 64, online: <<http://www.lse.ac.uk>>

crease broker commissions) and other misuse of client funds.⁴⁵ The theoretical intent of initiatives such as these goes precisely to this power to interpret detailed content for high level regulatory principles.⁴⁶ Effectiveness aside for now, the aim of each of these programs was to develop a regulatory system that recognized that firms had greater capacity and contextual knowledge relative to regulators. It envisioned distinct roles for regulators and industry: regulators would set outcomes and establish broad, principles-based requirements, while industry would fill in the detailed procedural strategies by which those goals would be reached.

As measured by the fact of the financial crisis, financial regulation must be deemed to have failed generally in this time period. The reasons for failure were multiple, and affected both more principles-based and more prescriptive regimes, though the nature of the failure took on a particular cast with respect to principles-based regulation.⁴⁷ The point for current purposes is that from that failure, we may glean broader lessons about the ways in which flexible regulation is susceptible to the effects of power on the large scale, and the particularities of implementation on the small.

⁴⁵ Christina Wolf, "Strong and Efficient Investor Protection: Dealers and Advisors Under the B.C. Model—A Regulatory Impact Analysis" (2003), online: BC Securities Commission <<http://www.bcsc.bc.ca>>.

⁴⁶ *Ibid.* A model closer to self-regulation (or outright deregulation) was the now entirely discredited Consolidated Supervised Entities (CSE) program at the US Securities and Exchange Commission (SEC), which allowed the major investment banks to assess their own risks and to establish their own capital adequacy thresholds. The fact that the CSE program was voluntary, and that staffers charged with overseeing it were so few in number and so geographically dispersed, meant that both in design and operationalization the program was purely self-regulatory: see *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program*, Report No 446-A, (Chairman Cox's comments, 25 September 2008), online: Securities and Exchange Commission <<http://www.sec.gov>> at 81. In terms of firms' ability to define the content of terms themselves, however, the difference between the FSA, BC Securities Commission, and SEC programs is a matter of degree.

⁴⁷ See e.g. Cristie Ford, "Principles-Based Securities Regulation in the Wake of the Financial Crisis" (2010) 55:2 McGill LJ 257 [Ford, "Principles"] (on implications of the financial crisis for principles-based regulation).

A. THE MACRO LEVEL: POWER/INFLUENCE AND AGENDA-SETTING

1. REGULATION AND THE OVERT EXERCISE OF POWER

In focusing on the technical design of regulatory strategies, scholars of flexible regulation sometimes bracket and sometimes back into the very real problem of power.⁴⁸ In the United States, among some politically conservative scholars, devolutionary mechanisms such as the principle of subsidiarity (which argues that social problems should be addressed at the most local level that is capable of addressing them) may be indirect methods for taking power away from the state and returning it to private actors.⁴⁹ Other regulatory scholars are relatively silent about power. While they speak about delegation or (less generously) “outsourcing”, they may not fully engage with the potential political and normative ramifications of a choice to delegate decision making authority, which, practically speaking, entails a significant shift in the balance of power. Speaking about delegation without referencing this connection leaves the background power framework operating implicitly. A third group of flexible regulation scholars, drawn to versions of participatory or republican democratic theory, are optimistic about the emancipatory and imaginative potential of delegated decision making. They argue that wicked power problems can be, or can *only* be, solved through carefully regulated dialogue.⁵⁰ The acknowledged difficulty is that far too often, this potential fails to be realized in practice.

⁴⁸ But see e.g. Susan Sturm, “The Architecture of Inclusion: Advancing Workplace Equity in Higher Education” (2006) 29 Harv J L & Gender 247. Sturm’s institutional design recommendations are specifically aimed at addressing hard-to-detect effects of power inequality. According to Mike Feintuck, American scholarship and regulatory practice is more influenced in general by politico-economic analyses than the UK scholarship: Mike Feintuck, “Regulatory Rationales Beyond the Economic: In Search of the Public Interest” in Robert Baldwin, Martin Cave & Martin Lodge, eds, *The Oxford Handbook of Regulation* (Oxford: Oxford University Press, 2010) 39 at 54.

⁴⁹ Robert K Vischer, “Subsidiarity as a Principle of Governance: Beyond Devolution” (2001) 35:1 Ind L Rev 103.

⁵⁰ See e.g. Michael C Dorf & Charles F Sabel, “A Constitution of Democratic Experimentalism” (1998) 98:2 Colum L Rev 267 at 404–18.

Linking the technical scholarship on flexible regulation with accounts of power from philosophy and other disciplines would develop it and help to unearth some of its assumptions. This is not an easy project, due to problems of scope and fit. Power is a contested concept, and the literature on the subject is vast.⁵¹ Colloquially, for example, power is sometimes under-theorized, sometimes deterministic, sometimes very abstract, and sometimes part of a conversation about politics, not policy. Moreover, the terminology and assumptions around power in political philosophy often seem somewhat orthogonal to those in the regulatory literature. Gramsciesque views of power as monolithic and determinative have little to offer to more evolutionary, as opposed to revolutionary, flexible regulatory strategies. Drawing from the same tradition are certain streams of “anti-neoliberalism”, which make no allowance for the possibility that a devolved and dialogue-based regulatory system can be public-regarding.⁵² Particularly for advocates of process-based regulation, very static definitions of power somewhat miss the point. On the other end of the spectrum from the determinists are the Foucauldians, though what Foucauldian theory might signify for actual concrete regulatory prescriptions is difficult to specify.⁵³ In any case, the conversation often seems to operate at some distance from the specifics of regulatory design.

Beginning to incorporate a more precise and explicit story about power into the literature around flexible regulation, in the context of financial regulation, would help us to be realistic about likely outcomes. For example, the enforcement pyramid envisioned by responsive regulation requires that a regulator be credible with industry. A stark imbalance of power between in-

⁵¹ For helpful introductions see e.g. Steven Lukes, *Power: A Radical View*, 2d ed (Basingstoke: Palgrave MacMillan, 2005); Mark Haugaard, ed, *Power: A Reader* (Manchester: Manchester University Press, 2002).

⁵² Perhaps the central definition of power within the anti-neoliberal tradition is Pierre Bourdieu's. See Pierre Bourdieu & Loïc J. D. Wacquant, *An Invitation to Reflexive Sociology* (Chicago: University of Chicago Press, 1992 at 119; see generally Pierre Bourdieu, *Distinction: A Social Critique of the Judgment of Taste*, translated by Richard Nice (New York: Routledge, 1984).

⁵³ See Michel Foucault, *Discipline and Punish: The Birth of the Prison*, translated by Alan Sheridan (New York: Pantheon, 1977) for an elaboration of the Foucauldian concept of power.

dustry and regulator affects that credibility. Even where the regulator consciously seeks to behave rationally, predictably, and responsibly in a manner that inclines people to obey the law in a Tyleresque world,⁵⁴ credibility will be affected where regulators have inadequate staff, inadequate political support, or for whatever other reason are unable to enforce their will vis-à-vis powerful players. Identifying the problem in terms of the precise kinds of power that we are concerned about makes it possible to develop strategic responses that provide an answer to the background power landscape. In turn, reference to actual regulatory design and practice has the potential to enrich the power conversation by moving beyond static and deterministic definitions of power, to consider the ways in which regulatory design, especially around respectful and highly participatory dialogue, can influence background conditions and effect change.

This article makes no attempt to develop such a nuanced account of power. Nor does it suggest that the story of recent financial regulation can be entirely explained through the lens of explicit politico-economic power. Certainly, the volatility of public attention and what Anthony Downs described almost four decades ago as the “issue-attention cycle”⁵⁵ played a role as well. Over the last twenty or more years, prudential regulation in particular had fallen into a period of “low politics”, during which policy choices were left in the hands of a semi-closed epistemic community of bankers, their lawyers, and their regulators. Institutionalized norms and assumptions went largely unquestioned.⁵⁶ Other areas of securities regulation—consumer protection in the United Kingdom, for example,⁵⁷ or post-Enron legal reform in the

⁵⁴ See Tom Tyler, *Why People Obey The Law* (Princeton: Princeton University Press, 2006).

⁵⁵ Anthony Downs, “Up and Down with Ecology—The ‘Issue-Attention Cycle’” (1972) 28 *The Public Interest* 38.

⁵⁶ See e.g. Frank R Baumgartner & Bryan D Jones, *Agendas and Instability in American Politics*, 2d ed (Chicago: Chicago University Press, 2009).

⁵⁷ Sharon Gilad, “Juggling Conflicting Demands: The Case of the UK Financial Ombudsman Service” (2009) 19:3 *Journal of Public Administration Research and Theory* 661; Julia Black, “The Rise, Fall and Fate of Principles Based Regulation” 2010 LSE Law Society and Economy Working Papers 17, online: London School of Economics <<http://eprints.lse.ac.uk>> at 18–19.

United States⁵⁸—were in the realm of “high politics” and garnering considerable public and political attention. With respect to prudential regulation during this period, however, powerful actors were operating relatively unhindered.

Linked to this discussion of power, this article takes the initial step of pointing out a few fairly clear examples of times when the exercise of power made the kind of technical regulatory design choices we have been talking about (as between outcome-oriented and management-based regulation, for example) simply irrelevant. As unremarkable as the point may seem, it bears elucidating as a first step in trying to connect the regulatory design literature to a broader set of forces. To focus on regulatory theory at the expense of looking at the context in which regulatory action is embedded is to look at a very thin slice of the picture. We should not assume that sophisticated regulatory design within that slice will necessarily be determinative of real life outcomes. Regulatory design will remain porous to those forces if attention is not paid to the process by which content will be filled in and systematic learning generated.

One way to think about power is in terms of the different, often incommensurable, sources from which it can derive. Thinking only of the run-up to the financial crisis and the power held by financial industry actors, a number of distinct forms of power may have played a role in creating the background conditions that provoked the regulatory changes that favoured those wielding the power. For example, scholars have investigated the role that political and economic power has played in shaping financial regulation through, for example, the industry’s ability to hire lobbyists and fund political campaigns.⁵⁹ Economic power can also be used more directly to force legislators’ hands by changing facts on the ground, as occurred with the *de facto*

⁵⁸ See especially *The Sarbanes–Oxley Act of 2002* Pub L 107-204, 116 Stat 745; Roberta Romano, “The Sarbanes-Oxley Act and the Making of Quack Corporate Governance” (2005) 114:7 Yale LJ 1521.

⁵⁹ See e.g. Christopher Arup, “The Global Financial Crisis: Learning from Regulatory and Governance Studies” (2010) 32:3 Law and Pol’y 363 at 365–67.

repeal of the *Glass Steagall Act* (*GSA*) in the 1990s.⁶⁰ Consider, also, the popular (and populist) tales of cronyist or oligarchic power presented in magazine articles by individuals as varied as former International Monetary Fund Chief Economist Simon Johnson⁶¹ and *Rolling Stone* journalist Matt Taibbi.⁶² Operating in the background is power deriving from the status quo. In other words, the mere fact that particular firms were in positions of influence made them more likely to maintain those positions of influence. Then there is structural power deriving from, for example, financial firms' ability to operate across regulatory jurisdictions and/or engage in regulatory arbitrage. Specifically—and this is in some tension with the notion of status quo power—consider that global financial institutions were able to credibly threaten to exit from either the New York or London financial markets, bringing their economically significant capital markets activity with them. This reality likely put downward pressure on regulatory standards in both jurisdictions.⁶³

One could equally talk about power in terms of its *exercise* and effect. For example, we could frame the repeal of the *Glass Steagall Act*, mentioned

⁶⁰ The Banking Act of 1933, Pub L 73-66, 48 Stat 162. By the 1990s, the GSA had already been considerably weakened by incremental bank incursions through the 1990s, but the merger between Citicorp, Inc. and Travelers Group, Inc. (which formed Citigroup) greatly influenced the government's repeal of the GSA with the Gramm-Leach-Bliley Act, Pub L 106-102, 113 Stat 1338 [GLBA]. Some have even suggested that "Citigroup [was] not the result of [the GLBA] but the cause of it": Kenneth H Thomas, "Don't Underestimate the Power of Sandy Weill", Letter to the Editor, *Business Week* (30 September 2002) 18.

⁶¹ Simon Johnson, "The Quiet Coup", *The Atlantic* 303:4 (May 2009) 46.

⁶² Matt Taibbi, "The Great American Bubble Machine", *Rolling Stone* 1082/1083 (7 September 2009) 52.

⁶³ For a discussion of regulatory arbitrage, see Joel Houston, Chen Lin & Yue Ma, "Regulatory Arbitrage and International Bank Flows" (18 December 2009), online: Social Science Research Network <<http://ssrn.com>>. See also John Braithwaite & Peter Drahos, *Global Business Regulation* (Cambridge: Cambridge University Press, 2000), describing global taxation as a problem of fit between uninodal banks and corporations operating multinationally, arrayed against multi-nodal national regulatory regimes subject to coordination problems.

above, as an overt exercise of power,⁶⁴ which may even have put in train the conditions for publicly-funded bailouts of too-big-to-fail banks engaged in excessive risk-taking on their proprietary accounts.⁶⁵ Scholars have also identified a positive relationship, in the United States in the 1999–2007 period, between the degree of risk taken by specific mortgage lending organizations and those organizations' targeted political activity and lobbying efforts to defeat laws against predatory lending.⁶⁶ Similarly, the US Securities and Exchange Commission established the disastrous Consolidated Supervised Entities Program, under which the same large financial institutions were permitted to ignore conventional capital requirements in favour of capital adequacy ratios determined based on their own internal risk analysis, as a direct result of an "urgent plea" by the large investment banks.⁶⁷ Some suggest that the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (a.k.a. the *Financial Reform Act*) signed by President Obama on 21 July 2010 has also been weakened as a result of industry lobbyist pressure.⁶⁸

These chronologies have received considerable attention, though there is still work to be done in testing these significant claims and tying them to the rich and varied scholarly literature concerning the nature of power and the

⁶⁴ Lukes, *supra* note 51 (describing the exercise of power along three dimensions: overt, covert, and normative).

⁶⁵ See Sandra L Suarez and Robin Kolodny, "Paving the Road to 'Too Big to Fail': Business Interests and the Politics of Financial Deregulation in the United States" (2011) 39:1 *Pol & Soc'y* 74.

⁶⁶ Deniz Igan, Prachi Mishra & Thierry Tresselt "A Fistful of Dollars: Lobbying and the Financial Crisis" (2009) IMF Working Paper 287, online: <<http://www.imf.org>>.

⁶⁷ Stephen Labaton, "The Reckoning: Agency's '04 Rule Let Banks Pile Up New Debt, and Risk" *The New York Times* (October 3, 2008) A1; US Securities and Exchange Commission, *Alternative Net-Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Entities* (2004), online: Securities and Exchange Commission <<http://www.sec.gov>>. See also SEC, *supra* note 46; Yalman Onaran, "Wall Street Gets Lift from SEC that may Boost Profit", *Bloomberg* (11 June 2007), online: <<http://www.bloomberg.com>>.

⁶⁸ Pub L 111-203, 124 Stat 1376. See e.g. John Cassidy, "The Volcker Rule", *The New Yorker* 86:21 (26 July 2010) 25.

limitations of this lens for understanding causality. More consequential to flexible regulation, however, is what Peter Bachrach and Morton Baratz have framed in terms of agenda-setting power.⁶⁹ In the recent history of financial regulation, agenda-setting power operated in subtle ways whose effects we are only now coming to appreciate.

2. AGENDA-SETTING POWER IN THREE MOVES

At the level of regulatory implementation, and particularly of implementation of flexible regulation in the financial sector, the “agenda-setting” dimension of power can play a significant role. Agenda-setting power is the power to decide what will be discussed. It is significant in any regime, but it takes on even greater significance within flexible regulatory regimes. Especially in flexible systems that evolve more or less organically, without conscious attention to who is setting the agenda and the implications for regulatory mandate and goals, agenda-setting power can exert significant and often underappreciated sway.

In the context of financial regulation, the regulatory agenda was substantially framed around three related claims: first, that modern financial markets were too fast-moving and complex to be regulated in a “command-and-control” way; second, that the innovative potential of the financial sector was of great social benefit and needed to be preserved and respected; and third, that the size of the regulatory burden on the financial sector was problematic. Enhanced emphasis on regulatory consultation with industry actors, and on finding industry-centred solutions, was part of emerging regulatory practice during this era.⁷⁰

⁶⁹ Peter Bachrach & Morton S Baratz, “Two Faces of Power” (1962) 56:4 Am Pol Sci Rev 947.

⁷⁰ The best example of this focus on consultation may be the FSA in the UK. See *Better Regulation Action Plan: What We Have Done and What We Are Doing* (2005), online: FSA <<http://www.fsa.gov.uk>> at 9–12. This major joint study (undertaken with the FSA’s Financial Services Practitioner Panel) describes the December 2005 Better Regulation Action Plan, which was aimed at “improving [the FSA’s] business capability and effectiveness.” The joint study focused, *inter alia*, on “looking closely at the costs we [the FSA] impose”; “reducing bureaucracy”; “emphasizing senior management responsibility” (as opposed to developing prescriptive rules around money laundering, in this case), “less

The problem is not that these assumptions are false. Taking the first point, global financial markets are obviously fast-moving and complex. The difficulty is rather that, by framing the agenda around the inevitability of speed and complexity in global financial markets, regulators lost the ability to articulate a regulatory agenda independent from the panicked need to “keep up” with industry developments. Malcolm Sparrow suggested some years ago that the trick to effective regulation was to “pick important problems and fix them”.⁷¹ Regulators came to understand the important problem they had to solve as the need to stay abreast of industry-driven developments. They sought to solve this problem in more and less effective ways (in terms of both theory and practice) using methods such as ongoing consultation, principles-based regulation, and “light touch” regulation. These methods can surely be effective when properly implemented, but in this case their application was limited by a blinkered view of the specific “important problem” they were designed to solve. The nature and implications of the speed and complexity of global financial markets, the reasons for it, the concerns it might raise, and the broader regulatory reorientation it might demand, were insulated from interrogation. The very difficult question of whether complexity can itself be an impediment to effective regulation in any form,⁷² and if so what to do about it, was scarcely raised.

The examination of innovation was similarly crabbed because the agenda was set around regulators’ obligation not to stifle innovation. The argument was primarily made regarding the vast expansion of credit and equity derivatives. In retrospect, the beneficial effects of this innovation were not as extensive or significant as industry had argued, and some of the expansion in available derivatives products was detrimental. As the FSA’s *Turner Review* pointed out in March 2009, the increasing importance of the financial sector as a percentage of GDP in the UK and elsewhere was in part due to innovation undertaken for the purpose of rent extraction by financial industry par-

detailed prescription for training and competence”, and “making life easier for smaller firms”.

⁷¹ Malcolm K Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (Washington DC: Brookings Institution Press, 2000) at 132.

⁷² See e.g. Schwarcz, *supra* note 32.

ticipants.⁷³ Innovation was also undertaken to avoid regulation. As Frank Partnoy has argued, the primary purpose of derivatives in contemporary capitalism was to allow financial institutions to get around regulatory responsibilities.⁷⁴ British journalist Martin Wolf's even broader claim has been that "an enormous part of what banks did in the early part of this [past] decade—the off-balance-sheet vehicles, the derivatives and the 'shadow banking system' itself—was to find a way round regulation."⁷⁵

In retrospect, it is not surprising that some of the innovations that firms were engaging in were expressly designed to circumvent compliance requirements.⁷⁶ Nevertheless, the prevailing assumption in the years leading up to the financial crisis was that all innovation was by definition beneficial, because unsound ideas would be winnowed out by market forces. As a result of this assumption, "regulators [had] not considered it their role to judge the value of different financial products, and . . . in general avoided direct product regulation".⁷⁷ Their agenda was rather to get out of the way of industry innovation. This made it effectively impossible for regulators to act on concerns—indeed, to legitimately *have* concerns—about the extraordinary growth of the over-the-counter derivatives market. It also prohibited a more nuanced examination of varieties of innovation, incentives for innovation, and effects of innovation.

The third assumption underpinning financial regulation over the last decade or more has been that, because of the factors above, regulators should seek to minimize the regulatory burden on industry. Usually, this priority

⁷³ UK Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), online: Financial Services Authority <<http://www.fsa.gov.uk>> at 47–49 [*Turner Review*].

⁷⁴ Frank Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Market* (New York: Times Books, 2003).

⁷⁵ Martin Wolf, "Reform of regulation has to start by altering incentives", *The Financial Times (UK)* (24 June 2009) 11.

⁷⁶ For a more optimistic version of the relationship between innovation in product development and innovation in compliance, see Ford, "New Governance", *supra* note 27 at 47–50.

⁷⁷ *Turner Review*, *supra* note 73 at 49.

was formally linked to the need to simultaneously maintain regulatory quality. For example, the FSA's then Chief Executive John Tiner claimed that principles-based regulation provided qualitatively "better" regulation overall, meaning "(1) a stronger probability that statutory outcomes are secured; (2) lower cost; *and* (3) more stimulus to competition and innovation."⁷⁸ Regulators at the time would certainly have agreed that the goal was to reduce the regulatory burden only to the extent possible without compromising the quality of regulatory oversight. When combined with the above views on the inevitability of complexity and the benefits of innovation, however, reducing the regulatory burden took on outsized importance on the agenda.

3. NORMATIVE POWER AND TRIPARTISM

Agenda-setting preceded but also interacted in complex ways with what one might call "normative" power. Financial institutions wielded normative power because they had the capacity to present compelling and well-crafted arguments, and had access to policy makers at multiple levels. Though difficult to quantify, this power likely also contributed to the deregulatory and market discipline-oriented mindset that characterized regulation in recent years in the US,⁷⁹ the UK,⁸⁰ and elsewhere. In a different historical, political, national, and industry environment, flexible regulation would certainly have played out differently than it did in the context of early 21st century Anglo-American financial regulation. In that context, though, agenda-setting and content-ascribing powers (discussed below)⁸¹ had a broader and mutually reinforcing knock-on effect on overarching theories of regulation and social ordering. Existing pillars in the normative framework, such as faith in efficient and perfectly orderly markets, were pointed to as justifications for in-

⁷⁸ John Tiner, "Better Regulation: Objective or Oxymoron" (Speech delivered at the Securities and Investment Institute Annual Conference, 9 May 2006), online: <<http://www.fsa.gov.uk>> [emphasis added].

⁷⁹ Johnson, *supra* note 61.

⁸⁰ Turner Review, *supra* note 73 at 39–46.

⁸¹ See especially *infra* notes 95–105 and accompanying text.

creasingly sweeping convictions about the wisdom of self-regulation.⁸² This in turn contributed to understaffing and under-resourcing of key regulators, and to regulatory timidity.⁸³

In this context, responsive regulation's notion of tripartism⁸⁴ did not eventuate. It may not even have been a realistic possibility. There were, simply, insufficient contrary voices within earshot of the regulators during the time in question. In part, this is a product of widespread bubble-era optimism that reigned throughout the 2003–2007 era, during which housing prices were rising, consumer prices were dropping, and former US Federal Reserve Chair Alan Greenspan was widely credited with having successfully navigated the aftermath of the dot com bust. This suggests a temporal limitation to the notion of tripartism. In bubble times, skeptics and independent thinkers may simply be harder to come upon.

Additionally, the experience of the financial crisis suggests that injecting a meaningfully independent perspective into regulation, by way of tripartism, may be more challenging in practice than is sometimes realized. Regulators operate within a relatively narrow, insulated, and expertise-based band of human experience, characterized by relationships with sophisticated repeat players. In spite of their public-regarding mandate they may be cognitively predisposed against “outsiders” who either lack facility with the dominant jargon, or who take issue with assumptions that no one in the industry takes

⁸² See e.g. Paul Krugman, “How Did Economists Get It So Wrong?,” *The New York Times Magazine* (6 September 2009) 36.

⁸³ See FSA Internal Audit Division, *The Supervision of Northern Rock: A Lessons Learned Review* (March 2008), online: Financial Services Authority <<http://www.fsa.gov.uk>> [FSA, Northern Rock]. The FSA acknowledged extraordinarily high turnover of FSA staff directly supervising the bank, inadequate numbers of staff, and very limited direct contact with bank executives among the reasons for its “unacceptable” regulatory performance. The SEC’s CSE program was also remarkably understaffed; its Division of Trading and Markets only had seven staffers and did not have an executive director. Nevertheless, it was charged with overseeing five otherwise unregulated major broker-dealer firms, which formed the backbone of the American-based shadow banking industry.

⁸⁴ Ayres & Braithwaite, *supra* note 9 at 54–100, describing a mechanism for deterring “harmful” regulatory capture and promoting “efficient capture” by empowering public interest groups as a form of countervailing power, within a reciprocal and dialogic regulatory structure.

issue with. They are also more likely to share social, educational, or experiential ties with industry actors than with others. Even well-informed activist shareholders may not receive the same measure of automatic regulatory respect. In short, it may be that a far greater push is required to force participation into regulatory conversations than is sometimes imagined by advocates and scholars of flexible regulation.⁸⁵

B. THE MICRO LEVEL: VAGUENESS, INCREMENTALISM, AND PRINCIPLES

Power also operates at the micro level, as the power to ascribe detailed content, in specific situations, to regulatory expectations that are only predefined in abstract and general terms. This is the power literally to interpret the meanings of regulatory terms—for example, what constitutes “compliance”, what is “reasonable”, or what “risks” are significant in relation to one’s business.

Even while ensuring flexibility, the *theoretical* version of principles-based securities regulation before late 2008 was intended to provide sufficient certainty and avoid granting excessive discretion to regulators—that is, to avoid through regulatory design the worst problems associated with principles at the level of pure theory. The essential correlate to what I have meant by the term “principles-based regulation”, for example, was a systematic method for ascribing, in consultation with industry, appropriate and detailed content to the high-level principles in question.⁸⁶ Three strategies were key to the theory. The first was the establishment of mechanisms for interrogating and validating the processes by which firms reached the conclusions they did. This could be through assessing their decision-making processes, through

⁸⁵ One mechanism for addressing the problem is to structure in participatory organs. The FSA and, following it, the Canadian Securities Transition Office, have established or proposed Investor Councils to ensure that investors have a greater say in the evolution of securities regulation. Why the Investor Councils in the UK apparently failed to make the difference (from a consumer protection perspective in, e.g., the events leading up to the failure of Northern Rock) is unclear.

⁸⁶ Ford, “New Governance”, *supra* note 27 at 27–33.

ongoing communication and regulatory guidance,⁸⁷ through a systematic effort to measure effectiveness in solving important problems,⁸⁸ and/or through promoting responsible deliberation within firms about matters such as compliance and obligations. Second, theoretical principles-based regulation established mechanisms for folding industry best practices and learning back to the regulator to enhance regulatory capacity. This was based on the pragmatic conviction that solving specific problems in context-appropriate ways is effective, but also that the pragmatic “muddling through” model is scalable.⁸⁹ The conviction was that a system founded on incremental situation-specific problem solving could amount in the aggregate (when accompanied by centralized information-gathering and analytic force) to a highly effective regulatory structure.⁹⁰ The third attribute was a strong *ex post* enforcement presence to make principles credible and regulation meaningful.⁹¹

In practice in some arenas, however, flexible regulation was characterized by unexpected pathologies at the level of implementation. For example, al-

⁸⁷ See also Julia Black, Martyn Hopper & Christa Band, “Making a Success of Principles-Based Regulation” (2007) 1:3 Law and Financial Markets Review 191.

⁸⁸ See Sparrow, *supra* note 71 at 99–122, 155–70. Sparrow found that certain common elements characterized the best innovations in regulation: (1) a clear focus on results and effectiveness, based on an expanded and more specific set of indicators including “big picture” high-level impacts, behavioural outcomes (compliance rates, agency activities), and resource efficiency; (2) adoption of a disciplined problem solving approach; and (3) an investment in collaborative partnerships where feasible.

⁸⁹ Charles Lindblom certainly envisioned the “muddling through” method to be scalable in this way: Charles E Lindblom, “The Science of ‘Muddling Through’” (1959) 19:2 Pub Ad Rev 79 at 80.

⁹⁰ This emphasis on a centralized learning and aggregating function appears most strongly in the experimentalist literature. See e.g. Charles F Sabel & William H Simon, “Minimalism and Experimentalism in the Administrative State” (2010) Columbia Law Research Paper 10-238, available at SSRN, online: <<http://papers.ssrn.com>>. The best real-life example may be the Arrow II risk assessment program at the FSA. See e.g. Financial Services Authority, Operating Framework, Arrow II, online: <<http://www.fsa.gov.uk>>: “ARROW II is designed to identify the main risks to our statutory objectives as they arise and to help us plan how to address these risks in line with our regulatory approach”.

⁹¹ See Ayres & Braithwaite, *supra* note 9: “the Benign Big Gun”, the “enforcement pyramid”, “tit-for-tat”; Ford, “New Governance”, *supra* note 27 at 25.

though principles-based *prudential* regulation was formally designed around a meaningful regulator-industry dialogic process, in practice the regulatory presence in the conversation was insufficient. The CSE program and the FSA were generally, at least according to their own post-mortem accounts, substantially under-resourced.⁹² (An alternative account may have more to do with managerial emphasis on other, more politically important priorities.) The FSA did not seem to approach its task with vigour, or with the transformed regulatory mindset required in a principles-based regulatory regime.⁹³ The lack of a robust regulatory presence meant principles-based regulation permitted flexibility, while failing to leverage the potential of those principles to guide the course of incremental change. In the result, the meaning of regulatory principles was poorly specified.

As noted above, principles-based and outcome-oriented regulation was not designed to perpetuate continual vagueness around the content of regulatory expectations. The idea was that the detailed content of relevant terms would be developed incrementally and situation-specifically, but also systematically. This is the reason that meta-regulation's insight about the importance of developing systems that are capable of learning, including learning about the appropriate detailed content one may legitimately ascribe to broadly worded principles in particular situations, is so crucial. As William Laufer pointed out more than a decade ago, in the absence of an established metric for measuring success around concepts such as "compliance", there will not be enforceability or accountability.⁹⁴

We now have some insight into the particular ways in which gaps were filled in flexible regulation, and they are telling. One significant and previously unappreciated factor was the automation of many risk and compliance processes. As it happens, in the run-up to the financial crisis, human beings actually had considerably less conscious, explicit knowledge about how they measured their own risk and compliance than anyone realized at the time, or than was anticipated by responsive regulation and its family of regulatory

⁹² See *supra*, note 83.

⁹³ See *Northern Rock*, *supra* note 83.

⁹⁴ William S Laufer, "Corporate Liability, Risk Shifting, and the Paradox of Compliance" (1999) 52 Vand L Rev 1341 at 1393–402.

approaches. By the turn of the millennium, risk assessment had necessarily become the responsibility of highly sophisticated and complex modeling and analytical software. That software was flawed.⁹⁵ Just as significantly from a regulatory design perspective, the increasing reliance on code to manage risk, or (as Erik Gerding has described it) the “outsourcing” of risk analysis to firm software, has also submerged and obscured contestable assumptions about the definition of compliance, and removed them from the ambit of human judgment.⁹⁶ Ken Bamberger has described in similar terms the more general phenomenon of managing compliance obligations through software.⁹⁷

Insights from behavioural psychology and organizational studies are also relevant. Specifically, industry actors operating in the absence of clear signals and hard questions from a regulator, aware of their peers’ conduct, and embedded within the self-regulatory zeitgeist, may genuinely take a different view of their levels of compliance than regulators or outside auditors would. They may be inclined, as part of an adaptive bias within the firm toward overconfidence and over-optimism, to overestimate the degree of their own compliance, competence, and knowledge.⁹⁸ Consider the UK’s Corporate Governance Code (then the Combined Code). Compliance with the Code is required by the Listing Rules for the London Stock Exchange. Studies indicate that 47% of companies self-report themselves to be in full compliance with the Code, while independent audits suggest that only thirty-four per cent are in full compliance.⁹⁹ Similar divergence can be seen around the FSA’s Treating Customers Fairly initiative. When the program was first introduced, and notwithstanding widespread and notorious mis-selling of certain finan-

⁹⁵ Gerding, *supra* note 6 at 168–79.

⁹⁶ Gerding, *supra* note 6 at 153–59.

⁹⁷ Bamberger, *supra* note 6.

⁹⁸ See e.g. Donald C. Langevoort, “Opening the Black Box of ‘Corporate Culture’ in Law and Economics” 162:1 *Journal of Institutional & Theoretical Economics* 80 (2006) (arguing that cultural over-optimism is an adaptive bias that allows firms to thrive in a competitive market place).

⁹⁹ Iain MacNeil & Xiao Li, “Comply or Explain: Market Discipline and Non-Compliance with the Combined Code” (2006) 14:5 *Corporate Governance: An International Review* 486.

cial products, many firms presumed that they were already “treating their customers fairly” within the meaning of the regulatory requirement. A primary factor in forcing firms to reorient themselves with respect to the program were FSA studies finding that an overwhelming majority of financial firms were not in fact in compliance, reinforced by enforcement action.¹⁰⁰

A recent article by Donald Langevoort helps illuminate the interpersonal and unconscious psychological conditions that contribute to gatekeepers’ favourable reception of new normative accounts.¹⁰¹ Langevoort’s insights, though especially on point with regard to gatekeepers because of their proximity to particular corporate cultures, may also be generalized to regulators and others, especially those operating within a dialogic and consultative model. Langevoort argues that where a gatekeeper’s corporate contacts do not exhibit the “visible markings of disloyalty: extreme selfishness, sloth, dishonesty, etc.” gatekeepers relax their guard and are more receptive to their clients’ accounts of reality.¹⁰² The positive disposition toward firm conduct is contagious, too, where authoritative figures publicly support it and where an attitudinal cascade develops. Because the change happens over time, it is poorly perceived.¹⁰³

¹⁰⁰ Sharon Gilad, “Overcoming Commitment to Internal Compliance via Reframing and Delegation” *Regulation & Governance* [forthcoming] [Gilad, “Overcoming”].

¹⁰¹ Donald C Langevoort, “Chasing the Greased Pig Down Wall Street: A Gatekeeper’s Guide to the Psychology, Culture and Ethics of Risk-Taking” (2011) 96:5 *Cornell L Rev* 1209 [Langevoort, “Greased Pig”]. Gatekeepers in financial regulation are those reputational intermediaries—accountants, lawyers, etc.—responsible for validating and vouching for the conduct of their clients. See generally John C Coffee Jr, *Gatekeepers: The Role of the Professions and Corporate Governance* (Oxford: Oxford University Press, 2006).

¹⁰² In his view, however, the markers of hard work, intensity, optimism and enthusiasm by people within an organization can actually be telltale indicators of an adaptive bias toward over-optimism within a firm. While adaptive for the firm in a competitive market place, the same highly culture serves to support a strong in-group versus out-group culture, to deflect doubt and uncertainty, and to be unrealistic about difficult realities that may threaten the firm’s identity or competitiveness. Langevoort, “Greased Pig” *supra* note 101 at 8–11.

¹⁰³ See e.g. Eugene Volokh, “The Mechanisms of the Slippery Slope” (2003) 116:4 *Harv L Rev* 1026 at 1105–14.

The problem of under-definition was exacerbated by the challenges posed by complexity and ever-faster innovation, which profoundly affected regulators' capacity.¹⁰⁴ Particularly in situations characterized by informational insecurity, decision makers may be more inclined to "satisfice" or to imitate others' responses.¹⁰⁵ This uncertainty would have affected both regulators' and industry actors' behaviour.

The disconnect between firms' evaluations of risk and actual manifestations of risk, *ex post*, was not inevitably the result of nefarious conduct. There were surely many incidences of gaming and conscious shirking of regulatory responsibilities. The debate about whether the financial crisis was the product of "greed or stupidity"¹⁰⁶ remains unresolved. (Presumably, different firms exhibited different degrees of each at different moments.) Beyond the egregious cases, though, the combination of vagueness around regulatory expectations and human psychological and organizational frailty adversely affected regulatory effectiveness. The impact is of real significance for process-based regulation generally.

IV. RESPONSIVE REGULATION ON THE EVE OF ITS THIRD DECADE

In the run-up to the financial crisis, many financial sector regulators embraced the notion that self-interest and market discipline would promote responsibility on their own, embraced industry innovation as an unmitigated good, embraced the notion (not wrong, but perhaps overstated by industry in its own interest) that the speed and complexity of financial markets meant that regulators had little choice but to follow industry's lead, and relied increasingly on information produced by industry, not produced independently. In the aggregate, this regulatory stance conveys the influence of "macro

¹⁰⁴ See e.g. Schwarcz, "Regulating Complexity", *supra* note 32 at 2–3 (describing complexity as the "greatest financial market challenge of the future").

¹⁰⁵ See e.g. Paul J DiMaggio & Walter W Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields" (1983) 48:2 *Am Soc Rev* 147.

¹⁰⁶ David Brooks, "Greed and Stupidity", *The New York Times* (3 April 2009) A29, online: <<http://www.nytimes.com>>.

level” agenda-setting power on regulatory design. As a consequence, regulators developed a chastened understanding of their own capacity and a heightened sense of the virtue and brilliance of industry. Regulatory capacity and status diminished, and regulators reacted predictably to their circumscribed mandate. At the “micro level” of implementational choices, as well, regulators did not have in place the kinds of robust learning systems that meta-regulation would have advocated. Consequently, in the face of gaps in their own knowledge, regulators ceded too much of the power to ascribe content to regulatory principles to industry alone. They did not engage in insistent, probing conversations with industry around their precise understandings of what constituted “compliance”, meaning that there really was no meeting of the minds around what “compliance” entailed. Problems deriving from overconfidence, which could have been anticipated, were not addressed. Problems associated with complexity and uncertainty, and their effects on both human decision making and regulatory capacity, were not grappled with. Nor does industry seem to have done better, or appreciated the consequence of embedding consequential risks analytical decisions into non-human computer code. Because regulators failed to manage change in conscious ways—by failing to record their own learning or to track movement over time in the meaning of terms, such as “adequate disclosure” or “material risk”—they failed to intervene in a downward behavioural cascade. Perhaps because the circle within which they operated was too narrow and homogeneous, regulators were not saved, through tripartism, from “harmful capture” in the way that Ayres’ and Braithwaite’s responsive regulation approach suggests they might have been.¹⁰⁷ This experience in financial regulation suggests that we must take seriously the very considerable regulatory capacity necessary to make flexible regulation work right.

Stepping back further, the worry with regard to some forms of flexible regulation is that they may not address the ways in which these layered stories of power under specification, and behavioural psychology can influence regulators’ ability to penetrate firm accounts and to evaluate compliance adequacy for themselves. The very attributes of responsive regulation that make it so compelling as a response to overly rigid, command-and-control

¹⁰⁷ Ayres & Braithwaite, *supra* note 9.

regulation—its flexibility, and its responsiveness to evolving context and to individual actors' conduct—have, in the economic and political circumstances of the past decade and the financial industry, had the effect of undermining regulatory and enforcement effectiveness in subtle but ultimately significant ways. Unless very carefully designed, dialogic mechanisms generally will be ill-suited to resisting either macro shifts in political culture, or micro shifts in under-the-radar implementation. Scholars such as Julia Black, who have developed compelling and insightful stories around the essential preconditions and critical success factors for regulatory conversations¹⁰⁸ or for principles-based regulation,¹⁰⁹ have not fully addressed the underlying risk of “creep” associated with iterative, discursive regulation. This is not to say that regulators always fail to take appropriate action to guide industry conduct.¹¹⁰ Given the events of the financial crisis, however, we should not assume that those efforts are the norm. It is more likely that in that historical context, most regulatory staffers and policy makers had at best a dim or partial awareness of how far from safety financial practice had actually strayed.

Returning to the subject of this volume, responsive regulation, these circumstances undermined the regulatory pyramid and negatively affected the regulator's credibility and perceived effectiveness in at least three ways. First, the phenomena above succeeded in considerably shifting the regulatory ground rules, in an under-the-radar manner, without triggering alarm bells. This suggests that responsive regulatory strategies based on improved prevention through improved detection, such as identifying hot spots where prior misconduct was concentrated,¹¹¹ could be of limited utility in detecting these subtler shifts in time to prevent problems. Second, and relatedly, there

¹⁰⁸ Julia Black, “Talking about Regulation” [1998] PL 77 (identifying the importance of (1) structuring conversations; (2) commitment; (3) access; (4) authority; and (5) trust and accountability to effective and legitimate regulatory conversations).

¹⁰⁹ Black, “Making a Success”, *supra* note 87 at 200–03 (identifying eight critical success factors for principles-based securities regulation, including the development of “criteria to identify the appropriate balance between principles and other types of rules”; “discipline and restraint in the provision of . . . guidance”; and “developing and maintaining a constructive dialogue between regulator and regulated firm”).

¹¹⁰ See e.g. MacNeil, *supra* note 99; Gilad, “Overcoming”, *supra* note 100.

¹¹¹ See e.g. Braithwaite, “Negative Licensing”, *supra* note 5 at 440.

was a clear cost in terms of transparency and effectiveness. Financial industry regulators such as the SEC and the FSA arguably embraced innovation to such a degree that industry innovation utterly outstripped regulators' ability to stay abreast of developments within their remit. In short order, complexity increased to the point that financial products exceeded the bounds of governability or even comprehensibility.¹¹² Third, the evolving zeitgeist, in which many accepted too sweepingly the beneficial nature of innovation, failing to recognize that some innovation was undertaken precisely to limit transparency or circumvent regulatory requirements,¹¹³ would have had an impact on internal firm worldviews and individual status. This would have compromised the possibility of the restorative justice moments that John Braithwaite envisions, during which the "wise old heads of banking" could seize on the opportunity presented by a restorative justice confrontation to address dangerous risk-shifting in their banks.¹¹⁴ In the midst of a pervasive narrative about the wisdom of modern financial engineering to manage risks, it is unlikely that those warnings would have been heard, even if they had been voiced.¹¹⁵

This is not a Hobbesian picture. As the narrative above tries to establish, dialogue, with an active, well-informed, critically thinking, and public-minded regulatory presence, has the affirmative power to change perspectives and even the rules of the game. As Ayres and Braithwaite note, there is "disorder in the multiple self". That is, "business actors are bundles of contradictory commitments to values of economic rationality, law abidingness, and business responsibility. Business executives have profit-maximizing selves and law-abiding selves; at different moments, in different contexts, the different selves prevail."¹¹⁶ The response to the frailties of flexible, dialogue based sys-

¹¹² See Schwarcz, "Regulating Complexity", *supra* note 72.

¹¹³ *Turner Review*, *supra* note 73.

¹¹⁴ Braithwaite, "Negative Licensing", *supra* note 5 at 447.

¹¹⁵ See e.g. Diane Vaughan, *The Challenger Launch Decision: Risky Technology, Culture, and Deviance at NASA* (Chicago: University of Chicago Press, 1996); Langevoort, "Greased Pig" *supra* note 101 at 9 (considering the literature on the ways in which organizational hierarchy silences dissent).

¹¹⁶ Ayres & Braithwaite, *supra* note 9 at 31.

tems to power, then, is not to terminate dialogue but rather to engage more strongly and insistently with it.

Among the lessons that the financial crisis has provided, we have learned that regulatory credibility matters. Relative to more “soft law” regulatory approaches, responsive regulation has fared well because of its emphasis on maintaining a robust regulatory and enforcement presence, in the form of a “benign big gun” and a tit-for-tat enforcement pyramid structure. Moreover, building a credible enforcement pyramid requires that regulators possess independent-mindedness and adequate resources (in absolute and relative terms).¹¹⁷ Flexible regulation, like any other regulatory approach, needs to be aware of and to consciously build in mechanisms to respond to its own relative frailties.¹¹⁸ Regulators should consider making more conscious use of tools like prophylactic rules, for example, to control the terms of an otherwise principles-level debate and help conserve regulatory resources. Generally speaking, the regulator should also bring a degree of skepticism to its dealings with industry. One may signal a desire to cooperate and view resistance as an opportunity to learn how to improve regulatory design,¹¹⁹ but it would be unwise to assume that industry actors necessarily come to the table in good faith.

We have also learned that, in the absence of conscious effort, no one may be immune from over-optimistic bubble thinking and other human psychological frailties. As Donald Langevoort suggests, noteworthy firm optimism, or broad consensus that “this time is different”, should be perceived as a po-

¹¹⁷ See Ford, “Expert Panel”, *supra* note 40 at 32–33 (discussing in more detail what constitutes adequate staff in the context of principles-based securities regulation). See also Ford, “Principles”, *supra* note 47 at 288–93.

¹¹⁸ See Samuel L Bray, “Power Rules” (2010) 110:4 Colum L Rev 1172 at 1173. The strategies put forward here, such as prophylactic rules and increasing regulatory capacity, can be understood as what Bray has called “power rules”. These are strategies designed not to directly regulate conduct that is perceived to be harmful, but rather to “regulate conduct or conditions that are not themselves perceived as harmful but which contribute to human power or vulnerability”. Efforts to break up banks that are deemed “too big to fail” are also power rules on this definition, though they are less specifically concerned with flexible and iterative systems.

¹¹⁹ Braithwaite, “Essence”, *supra* note 36.

tential warning sign, and not as a reason to fall in.¹²⁰ We also know a good deal more now than we did twenty years ago about the limitations of human and organizational decision-making capacity, including the capacity to deal with change.

Perhaps most salient to flexible regulation in the financial context, we have learned that regulators abdicate their responsibility where they implement flexible, iterative, collaborative systems without simultaneously developing mechanisms to “kick the tires” on industry-generated solutions. A regulator needs to consciously build in institutional learning and memory functions that allow it to learn from experience, to investigate causal relationships, to channel, understand, and respond to change and track “creep” in practice or attitudes, and to interrogate its own assumptions. Where change is fast and constant and regulation is designed to permit that change, the mechanisms and background conditions through which it happens should be taken especially seriously. Arguably, some of the root problems underlying regulatory failure prior to and during the financial crisis were an over-embrace of change, and a failure to grapple with pervasive uncertainty. In other words, they were problems that might have been addressed through a robust meta-regulatory approach that focused on building learning systems to respond to the “holes”—the gaps in knowledge and understanding—rather than the ostensibly known elements.

It may be that the main lesson we have learned is that nature abhors a vacuum, and if regulatory design does not provide for ways to manage uncertainty, then other forces, including self-interested action by powerful actors, or deflection (by industry through excessive reliance on risk modeling computer code, for example, or by regulators through excessive delegation to industry) will. As Professor Braithwaite’s contribution to this volume makes clear, responsive regulation circa 2011 is an approach based on in built mechanisms for learning through experience. In other words, it is evolving into a meta-regulatory approach. Consistent with meta-regulation, the experience of the financial crisis, and the effects of “macro level” power and “micro level” implementation decisions in its creation, are yet another set of

¹²⁰ Langevoort, “Greased Pig”, *supra* note 101 at 30–31.

data points to be incorporated into the ongoing learning method that responsive regulation represents.