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NEW GOVERNANCE IN THE TEETH OF HUMAN FRAILTY: LESSONS FROM FINANCIAL REGULATION

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New governance scholarship has made important theoretical and practical contributions to a broad range of regulatory arenas, including securities and financial markets regulation. In the wake of the global financial crisis, questions about the scope of possibilities for this scholarship are more pressing than ever. Is new governance a full-blown alternative to existing legal structures, or is it a useful complement? Are there essential preconditions to making it work, or can a new governance strategy improve any decision making structure? If there are essential preconditions, what are they? Is new governance "modular"—that is, does it still confer benefits when applied partially or imperfectly—or does it fail to achieve good regulatory results unless all the elements are in place? This Article starts from the conviction that new governance is a promising response to the fluidity and complexity of contemporary regulatory environments. It then draws on three essentially unhappy narratives from recent financial markets regulation (around securities law enforcement, capital adequacy, and the impact of securitization) in an attempt to identify lessons for new governance scholarship at the level of practical implementation. These are not narratives about the failure of new governance structures. However, central to each narrative are components, or incomplete versions of components, that are also central to new governance structures. The Article considers the significance of incrementalism, regulatory capacity, and destabilization and complexity for regulatory design. It closes with some preliminary recommendations for making new governance structures effective, even as implemented by flawed human actors.

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INTRODUCTION

New governance scholarship has made important contributions in a broad range of regulatory arenas, ranging from environmental regulation to workplace discrimination, international employment standards, and beyond.

As the field has developed, some scholars have also turned their minds to the scope of possibilities for new governance. Is it a full-blown alternative to existing legal structures, or is it a useful complement? Are there essential preconditions to making it work, or can a new governance strategy improve any decision making structure? If there are essential preconditions, what are they? When it works, why does it work? Is new governance "modular"[1]—that is, does it still confer benefits when applied partially or imperfectly—or does it fail to achieve good regulatory results unless all the elements are in place?

For students of financial market regulation, the global financial crisis of 2007–09 (GFC)[2] has been a sobering illustration of human greed and short-sightedness, and regulatory failure. This Article is a preliminary attempt to identify lessons from recent financial markets regulation and their bearing on new governance scholarship. Part I sets out the continuing importance of new governance scholarship for regulation. Part II presents three narratives, from different aspects of financial regulation. In this Part, the Article proceeds from the most discrete example to the most far-reaching and challenging, but each one bears on the nature of the relationship between new governance

1. With apologies to Jody Freeman and Daniel Farber, this variety of modularity is not the same as their positive account of modular environmental regulation in which regulatory components can be assembled and reassembled in different arrangements depending on circumstance. *See generally* Jody Freeman & Daniel A. Farber, *Modular Environmental Regulation*, 54 DUKE L.J. 795 (2005).

2. The GFC is broadly global in scope. Focusing only on the United States, it can be dated from the first effects of the subprime mortgage crisis in the United States in 2006–07, through the collapse of global credit markets in fall 2008, which saw the failure of major investment banks in the United States and brought about an industry bailout and economic stimulus package of unprecedented size, and into the present day. For a timeline of the core of the crisis, from September 2008 to September 2009, see *A Year of Financial Turmoil*, N.Y. TIMES, Sept. 11, 2009, http://www.nytimes.com/interactive/2009/09/11/business/economy/20090911_FINANCIALCRISIS_TIMELINE.html?ref=businessspecial4.

regulatory design and the much less satisfactory regulation-as-implemented. These are not narratives about the failure of new governance structures. Financial regulation was not new governance regulation. Moreover, the main regulatory failures implicated in the GFC were the products of gaps in regulation, extraordinarily inadequate execution, and a regulatory mindset excessively well-disposed toward self-regulation. That said, central to each narrative are components (or incomplete versions of components) that are also central to new governance structures.

More precisely, these are stories about how regulatory oversight mechanisms that were designed to be both robust and flexible proved in practice to lose their robustness and to have their flexibility invoked primarily in the interests of powerful industry actors. For example, the first narrative describes how certain corporate compliance monitorships have been only anemically implemented, highlighting the importance of cognitive distance, capacity, and impartiality on the part of the real-life human decision-makers central to those structures. The second narrative argues that principles-based regulation around capital adequacy (such as provided for under the Consolidated Supervised Entities program at the SEC, and the Basel II regime on which it was based), when built on inadequately scrutinized internal firm risk assessment models, enabled a behavioral cascade and permitted flawed methodologies to increase systemic risk. The third narrative focuses on complexity in structured products. It tries to illuminate some of the ways in which the use of derivatives and securitization technology have amplified power, allowed power to be exercised covertly within corporate structures, and permitted financial institutions to circumvent or neutralize regulatory oversight.

Part III of this Article sets out to identify the lessons that emerge for new governance scholarship at the level of practical implementation. This Article explains these implementation failures substantially as a product of power imbalances, bounded rationality, and the human tendency to "satisfice."[3] Different scholars may reach different conclusions as to how often problems like these will actually sabotage new governance regulatory design. But if they are unavoidable background conditions, and influential enough to affect practical outcomes in a significant number of cases, then—in keeping with a method that reflects learning back into regulatory design—new governance scholars should be turning their attention to designing compensatory structures to address these foreseeable problems.

3. HERBERT A. SIMON, MODELS OF MAN: SOCIAL AND RATIONAL 204–05 (1957) (explaining that "satisficing" means settling for an adequate, but not optimal solution).

The Article closes with a call for more serious attention to the "architecture" of new governance, and in particular to the need to build in practically effective counterweights to the predictable pitfalls that can undermine the potential of new governance theory. It argues that one should not underestimate the considerable determination and focus required to make new governance structures reliably robust across different regulatory concerns. In particular, it argues for a renewed appreciation of the amount of energy required to move people off their short-term incentives—an amount substantially greater than was put into the monitorship or principles-based regulatory initiatives described below, and that may even be greater than is politically palatable in some number of contexts. Second, the Article points out that reason-giving and problem-solving techniques collapse when key players' interests are aligned, as they tend to be during a market bubble, or in contexts already characterized by a readiness to accept merely "cosmetic compliance."[4] This points to the need to build in diversity and internal contestation in a much more serious way than generally has been done. Third, the Article suggests that Knightian uncertainty[5] is not necessarily, or not only, a new governance-enhancing background condition. It can present profound problems to which new governance may not be a necessary and sufficient response—or even, at least over the short term, the wisest response.

I. CRUCIAL COMPONENTS OF NEW GOVERNANCE IN THE POST-GFC ENVIRONMENT

The term "new governance" is something of a big tent that captures several discrete but related approaches.[6] Within new governance, we might identify as a tighter subset the "experimentalist" approach principally generated by Charles Sabel and his colleagues, including Michael Dorf and Bill Simon.[7] Susan Sturm's important work on

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4. Kimberly Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003).

5. *See generally* FRANK KNIGHT, RISK, UNCERTAINTY AND PROFIT (1921).

6. *See, e.g.*, LAW AND NEW GOVERNANCE IN THE EU AND US (Gráinne de Búrca & Joanne Scott eds., 2006); Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004).

7. *See generally* Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267 (1998); James S. Liebman & Charles F. Sabel, *A Public Laboratory Dewey Barely Imagined: The Emerging Model of School Governance and Legal Reform*, 28 N.Y.U. REV. L. & SOC. CHANGE 183 (2004); Charles F. Sabel & William H. Simon, *Destabilization Rights: How Public Law Litigation Succeeds*, 117 HARV. L. REV. 1015 (2004).

institutional change and public-law remedies is another new governance approach.[8] New governance also likely incorporates, or at least bears a strong relationship to, versions of reflexive law,[9] responsive regulation or enforced self-regulation,[10] co-regulation,[11] and management-based regulation.[12]

For purposes of this Article, the essential components of a new governance approach are regulation that is informed and underpinned by a bottom-up, decentered, horizontal experimental process by private actors—which, on our facts, depending on context, could include registrants like investment banks and broker-dealers, professional "gatekeepers"[13] such as accountants and lawyers, and public companies. My own focus is on new governance in the context of regulation, that is, on designs that assume a systemic ordering role for a public bureaucratic structure, rather than relying primarily on private interparty arrangements or courts. New governance regulation, unlike command-and-control regulation, is regulation based on an iterative process between private-party experience and a regulator that serves variously as clearinghouse, catalyst, monitor, prod, and coordinator.

The new governance regulator prioritizes mechanisms that share information from localized experiments and that push localities to improve by comparison to the experience of others, rather than trying to regulate via detailed, process-based, top-down regulatory requirements. The process is pragmatic, information- and experience-based, directed toward ongoing problem-solving, and built around highly participatory and carefully structured dialogue. As a matter of institutional design, it relies on information-based and information-forcing techniques:

8. Sturm's work informs and is informed by the experimentalist approach, but see Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 555 n.353 (2001).

9. *See* Eric Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227 (1995); Gunther Teubner, *Substantive and Reflexive Elements in Modern Law*, 17 LAW & SOC'Y REV. 239 (1983). *But see* Bradley C. Karkkainen, *"New Governance" in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471 (2004).

10. *See* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION (1992); John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 MICH. L. REV. 1466 (1981).

11. *See* Linda Senden, *Soft Law, Self-Regulation and Co-Regulation in European Law: Where Do They Meet?*, 9.1 ELECTRONIC J. COMP. L. 1 (2005), *available at* http://www.ejcl.org/91/abs91-3.html.

12. *See* Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 LAW & SOC'Y REV. 691 (2003).

13. JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006).

specifically, reason-giving, transparent processes, benchmarking and outcome analysis, and shared information. It is incrementalist in that it uses discrete, situational learning to cause regulation to evolve in empirically justified ways. It is ambitious in that it folds those discrete experiences, operating in parallel, into a flexible, "best practices"-driven process[14] that has the potential to fundamentally reshape both means and ends.

Above all, for purposes of this Article, three related convictions that underlie new governance regulatory strategies are indispensable to modern regulation, because they are designed to handle the complexity, speed, and interconnection that characterize both contemporary society and contemporary capital markets. The first is the emphasis on "learning by doing." Empirical experience, the "doing," is the foundation of new governance regulation. In itself that is a step that is likely to lead to greater pragmatic effectiveness than an ideologically driven methodology.[15] The doing is then the driver for a structured learning process that pulls that experience into a self-reflexive process, rather than letting it dissipate across time and multiple actors.

The second component is revisability, or the explicit recognition of contingency. Flexibility is a key characteristic of new governance methods. Learning by doing is the method, but it needs to be accompanied by actual mechanisms that make it possible for regulation to move. Examples might include principles-based regulation, supported by a regulator-based notice-and-comment rulemaking method that can permit speedy decisions by informed actors; or broad-based destabilization rights available under particular conditions.[16]

The third, linked component is a degree of humility about knowability. At an initial level, new governance recognizes that *regulators* cannot know as much about the practical operations of the industries they oversee as those within those industries themselves. This is what drives the bottom-up process in the first place. At a deeper level, along with civic republicans, new governance scholars like Michael Dorf and Charles Sabel recognize the socially constructed, profoundly contingent, and path dependent nature of legal artifacts generally, such as

14. Whether regulators ought to rely on "best practices" or "good practices" is a matter of debate among securities regulators. *See* Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 43 n.144 (2008) [hereinafter Ford, *New Governance, Compliance*].

15. On Deweyan pragmatism and experimentalism, see, e.g., Brandon L. Garrett & James S. Liebman, *Experimentalist Equal Protection*, 22 YALE L. & POL'Y REV. 261 (2004).

16. *See, e.g.*, Sabel & Simon, *supra* note 7.

rights.[17] Still more profoundly, a relationship exists between new governance and epistemological uncertainty. It is a relationship marked by paradox,[18] but it is not without promise. New governance authors have argued that conditions of extreme uncertainty, in which participants cannot identify either the means they want to use or the ends they are trying to achieve, are environments where new governance is more likely to emerge, and to be useful in breaking through impasses. Radical uncertainty resulting from extreme complexity has been a central feature of capital markets regulation, and was closely implicated in the GFC. The problem is a wicked one, without easy solutions. Nevertheless, new governance revisability based on closely monitored practical experience and broad stakeholder participation may be one of the few potentially promising ways that we might try to deal with it.

With these tools in hand we can proceed to the narratives, which ultimately both reinforce and complicate the insights that new governance offers. Recent events in financial markets regulation have profoundly shaken our collective confidence in existing regulatory approaches. They have also undermined our collective faith in our own capacity to understand events as they transpire, to anticipate future developments, and to design systems that can be robust in complex environments. All of this should recommend more incremental, pragmatic, learning-by-doing regulatory design strategies. At the same time, these same narratives describe incremental, apparently pragmatic regulatory moves that, though believed by many to be sensible at the time, collectively operated to the great detriment of many. They suggest that incrementalism as it operated here—within built regulatory environments that share important features with new governance regulatory environments—cannot on its own be relied upon to advance collective welfare—in the sense of increasing transparency, reducing systemic risk, protecting investors and members of the public, supporting real economy productivity, and maintaining an adequate level of social stability and interpersonal accountability. The challenge, then, is to imagine an alternative within which regulatory design is not always a drag on human capacity and imagination, in the way that old style non-reflexive command-and-control regulation can be, and yet that puts sufficient brakes on risk-blind hubris, socially detrimental self-aggrandizement, and predictable human flaws in decision-making and information processing.

17. *See* Dorf & Sabel, *supra* note 7, at 446–52 (arguing that experimentalist rights are "the only kind of rights that we actually have").

18. *See* discussion *infra* Part II.C ("Clever People: Destabilization, Complexity, and Power in Securitization Practice").

II. THREE NARRATIVES FROM FINANCIAL AND SECURITIES REGULATION

Each of the narratives below comes from securities and financial markets regulation, although from distinct contexts within that field. The first narrative concerns monitorships being employed in securities law enforcement. It identifies the ways in which new governance-style enforcement mechanisms can be undermined by failure to build in meaningful accountability. The second narrative considers principles-based regulatory structures, particularly the U.S. Securities and Exchange Commission's Consolidated Supervised Entities (CSE) program, which allowed parent entities of "shadow banks" to use internal risk modeling to assess the risks associated with their business, and thereby to set their own capital reserve levels. Devolving this responsibility, which took place within a highly complex, highly competitive, fast-moving and yet non-transparent and poorly overseen environment, turned out to be disastrous. Again, the story is primarily about regulatory failure to build accountability and enforceability into a self-regulatory model. The third narrative looks at the influence of securitization itself, in particular with regard to how it affects regulators' capacity to regulate the financial services industry. Derivatives and structured finance products have been core tools for speculation and hedging for many years now. Their recent massive proliferation does, however, have implications for corporate law and securities regulation in terms of transparency and accountability.

The leitmotif that runs through all three accounts concerns the ways in which background conditions that are either subtle or taken for granted—including lack of diversity, power imbalances, unequal access to information, and failures of transparency and accountability—have the potential to make reasonably designed regulatory initiatives ineffective, or worse. These are stories in which well-resourced actors were able to control loosely structured, fluid environments in their own interest, with minimal pushback from public-interested voices. In other words, they are situations in which our flawed humanity (tribal, short-sighted, self-interested but often irrational, and prone to satisficing) infiltrated regulatory models, reintroduced power relationships in indistinct but convincing ways, and arguably determined outcomes to a greater degree than did regulatory design. The section titles below offer shorthand labels for the relevant characteristics of the individuals involved, with the intention of keeping the human element in the foreground of each narrative.

A. Reliable People: Corporate Monitorships in Theory and Practice

Securities law enforcement has recently been making use of a particular set of innovations: the non-prosecution or deferred prosecution agreement in the criminal realm, and its civil regulatory equivalent, the reform undertaking. These are settlement agreements under which, in exchange for leniency or a deferral or prosecution for alleged violations of the securities laws, a corporation or firm agrees to end its wrongful practices, develop and implement an improved compliance program, and—most importantly for purposes of this Article—hire an independent monitor to oversee those undertakings and make reform recommendations.[19] Monitorships have been imposed on some very well-known firms and corporations, including America Online, KPMG, Boeing, Monsanto, and AIG (this last for reasons unrelated to credit default swaps or executive bonuses).[20] They are not unlike consent decrees in civil-rights-based structural reform litigation.[21] Being systemic remedies, they seem well suited to responding to systemic problems. They could be used to push corporations to implement effective compliance and ethics programs and improve the ethics aspects of their organizational cultures—meaning, the informal control system within the organization. What is less clear is whether, as implemented, they stand a decent chance of doing so.

At a theoretical level, monitorships can be understood as a nascent new governance form developing within the securities law enforcement milieu.[22] Seen in these terms, the ideal monitorship structure requires a

19. *See generally* Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 855–56 (2007); Benjamin M. Greenblum, Note, *What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements*, 105 COLUM. L. REV. 1863 (2005); Jennifer O'Hare, *The Use of the Corporate Monitor in SEC Enforcement Actions*, 1 BROOK. J. CORP. FIN. & COM. L. 89 (2006); Leonard Orland, *The Transformation of Corporate Criminal Law*, 1 BROOK. J. CORP. FIN. & COM. L. 45 (2006).

20. Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance?*, 34 J. CORP. L. 679, 680 (2009). On AIG, see Peter Lattman, *The US's Fly on the Wall at AIG*, WALL ST. J., Mar. 27, 2009, at C1 (noting that a monitor was in place at AIG before and during the financial crisis, but was not charged with investigating matters directly related to the financial crisis, such as the use of credit default swaps).

21. *See, e.g.*, Garrett, *supra* note 19, at 869–74.

22. *See generally* Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757 (2005) [hereinafter Ford, *Toward a New Model*] (discussing the civil "reform undertaking" process at the United States Securities and Exchange Commission). Miriam Baer has since challenged this view at a descriptive level, arguing that whatever else they may be, reform undertakings and deferred prosecution agreements are not and can never be an example of new governance. *See generally* Miriam Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009).

broadly participatory, dialogic, and transparent problem-solving process capable of learning from its own mistakes. The idea here is that monitorships can create a space for meaningful dialogue because, although they are embedded within the enforcement context, they are sufficiently set apart by virtue of being post-settlement and managed by an independent third party monitor. Relative to one-off sanctions such as fines, such a forward-looking and participatory method could be more effective in catalyzing cultural reform.[23] It uses the organization's own language and norms to foster endogenous learning. This increases the likelihood of buy-in, which is especially essential when dealing with ethical cultural problems.[24] Moreover, such a monitorship can potentially identify more useful recommendations, because it relies on more sources of information, consulted in a less high-pressure environment.[25] This can make scapegoating and cosmetic compliance[26] harder to get away with.

Clearly, catalyzing a new governance deliberative process by way of a monitorship requires careful design choices. For one thing, the monitor would have to possess an impressive range of attributes. It (or he or she) would have to have credibility with both regulator and corporation, while still maintaining structural and psychological independence from the corporation in particular—even while working closely with its management and employees. It would need to possess considerable strategic planning, problem solving, facilitating, and information management capabilities. It should be able to generate useful and, ideally, generalizable data. The monitor would also require substantive experience including knowledge about best practices in compliance and corporate governance, as well as a grasp of legal concepts such as fairness and due process sufficient to allow it to identify and respond to scapegoating and other, often subtle, justice-related challenges.[27] The framing enforcement environment around the monitorship, and in particular the background threat of renewed enforcement action in the event of shirking or failure, would also be crucial to forcing change within recalcitrant organizations. Additionally, regulators would need the ability to centrally aggregate and work with data coming from discrete monitorships—in new governance terms, they would require a "clearinghouse" function—in order to make risk assessment, comparative analysis, and outcome evaluation possible.[28]

23. Ford, *Toward a New Model*, *supra* note 22, at 802–10.
24. *Id.* at 808.
25. *Id.* at 802.
26. Krawiec, *supra* note 4.
27. Ford, *Toward a New Model*, *supra* note 22, at 810–14.
28. *Id.* at 814–17.

In 2008, Professor David Hess and I conducted an empirical study to investigate how corporate monitorships were functioning in practice.[29] We found, perhaps not surprisingly, that actually existing monitorships tend to fall short of the idealized new governance monitorship in one or more ways. In our project, we separated the monitorship process into five stages: the decision to settle and establish a monitorship, setting the scope of the monitorship, selecting the monitor, conducting the monitorship, and post-monitorship learning.[30] What we found was that the potential for a breakdown in effective implementation exists at each stage of the monitorship. Moreover, problems at early stages put the monitorship on a downward trajectory, in terms of ambition, that make its prospects for achieving meaningful reform increasingly remote with every subsequent stage.[31] Without saying that successful monitorships have never occurred, our analysis suggests that positive results have more to do with self-motivated individual efforts of monitors and corporations, than with a model that reliably produces good process and meaningful reform.[32]

For example, one of the first decisions a regulator faces is how to proceed against the corporation and individuals in it: whether to indict or charge the corporation, whether to agree to a settlement (with or without a monitor), or alternatively whether to prosecute individuals only.[33] Where corporations have the sense that this choice is primarily motivated by external considerations, such as perceived need to be *seen* to be taking action against a corporation, the legitimacy of the process is undermined from the start.[34] Developing the scope of the monitorship can also be problematic. In many cases, monitorship agreements seem to develop mimetically[35] rather than in response to careful attention to a unique context. The starting point often seems to be some other, generic monitorship agreement, whose terms are then modified based in large part on the negotiating position of the corporation.[36] Sometimes, we had

29. Our study and its findings are described in Ford & Hess, *supra* note 20. The discussion of monitorships contained here draws on that work.

30. *Id.* at 695–96.

31. *Id.* at 730.

32. *Id.* at 728.

33. *Id.* at 697.

34. *See id.* at 728–29.

35. *See* Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. 147, 151–52 (1983) (describing mimetic isomorphism as a process through which organizations copy each other to draw on the legitimacy established by the prior example, and not due to its fitness to the new environment).

36. Jayne W. Barnard, *Corporate Therapeutics at the Securities and Exchange Commission*, 2008 COLUM. BUS. L. REV. 793, 816–20 (2008) (describing the settlement negotiating process). Barnard shares many of our concerns regarding the effectiveness of

the impression that only cursory attention had been paid, at this stage, to ensuring that the resulting monitorship was appropriately tailored to the particular mix of potential systemic, process-based, and cultural problems at a particular corporation.

Early stage flaws in scope definition would not be terribly worrisome if monitorship agreements could be renegotiated on a rolling basis, but the high costs of monitorships, the fear of "scope creep," and monitorships' entrenchment in formal legal settlement documents makes this very unlikely. More often, the response is to build some vagueness into the exact terms of the monitorship—which is something different from building in carefully designed flexibility provisions. When vagueness is introduced, the course of the monitorship depends less on the agreement itself, and more on the monitor's interpretation of it based on the monitor's own background and predilections. And it is at the point of selecting the monitor that the reformative potential of the monitorship seems most fundamentally to be undermined.

Monitors may be appointed by the government, or selected based on varying degrees of input from the corporation. Regardless of the process used, with striking frequency the end result is the selection of a former prosecutor or other government employee, with legal training but little to no experience as a monitor, and no formal training in compliance or management. The reason for the significant use of former prosecutors seems to be perceived credibility.[37] The government wants someone it can identify with and believes it can trust, and the corporation wants to ensure that its monitor has credibility with the government.[38] The significant potential problem, at least according to compliance consultants we interviewed, is that these monitors are unlikely to have the experience and knowledge necessary to analyze a corporation's culture or provide advice on how to manage that culture as it relates to the corporation's compliance program.[39] For example, such monitors are more likely to believe that the root causes of wrongdoing within the

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monitorships, the monitor selection process, and the capacity of lawyers in general and SEC (or, for us, criminal and civil) Enforcement staffers in particular to craft monitorships with the potential to achieve meaningful structural change. *Id.* at 837–38. Barnard also agrees that the SEC should be managing the data coming from monitorships more effectively, and making better use of monitors' final reports. *Id.* at 837–39. Her views differ from ours in other respects, including her confidence in mainstream corporate law mechanisms (e.g., the presence of independent directors) to discipline firms. *Id.* at 837–38. She concludes that monitorships and other "therapeutics" should be used sparingly because their usefulness has not been demonstrated. *Id.* at 838.

37. Ford & Hess, *supra* note 20, at 713.

38. *Id.*

39. *Id.* at 714.

organization are employee ignorance of laws and corporate policies, as opposed to management pressure to meet performance expectations.[40]

We also found wide variation in how monitors conduct their work.[41] Some monitors felt that they had no choice but to consider issues of corporate culture based on what the settlement agreement tasked them with accomplishing.[42] Others, appointed under virtually identical settlement agreement language, told us that they focused on the technical aspects of compliance and controls, and that issues of culture could not be measured, had no real meaning, or were beyond their assigned duties.[43] Even those monitors that claimed to be considering corporate culture took significantly different approaches to assessing it.[44] Some interviewed employees at all levels of the corporation and sat in on meetings where important decisions were being made, while others interviewed only those at the top of the organization.[45] The monitors we interviewed did not generally engage in the broad-based interviews and focus groups that compliance consultants and business ethics professionals would recommend, let alone the kind of reflexive process imagined by new governance scholarship.

Finally, we identified a clear lack of architecture designed to permit systematic post-monitorship learning and analysis.[46] Especially with regard to criminal monitorships, notwithstanding that they are rich sources of information and insight, we found little evidence that monitorships were treated with anything near the attention that pre-settlement cases received.[47] Little effort seemed to be made, on conclusion of a monitorship, to evaluate its successes and failures or to fold its insights into subsequent monitorships.[48] Monitors also lack systematic opportunities to learn from each other. Their reports are kept confidential, and monitors do not share information with each other.[49]

40. GARY E. EDWARDS & ROBERT REID, CHALLENGES FACING CORPORATE ETHICS AND COMPLIANCE PROGRAMS: A RESEARCH REPORT FROM ETHOS INTERNATIONAL 10–11 (2007), *available at* http://www.ethosinternational.net/files/689_file_PDF_EthosResearchReport2007.pdf (reporting the results of a survey of legally trained chief compliance officers versus those from a management background).

41. *See* Ford & Hess, *supra* note 20, at 715–19.

42. *Id.* at 716.

43. *Id.* at 716–17.

44. *Id.* at 717–18.

45. *Id.* at 718.

46. *See id.* at 724–26, 736–37.

47. *Id.* at 726. Civil-side regulators more commonly pass monitors' reports onto their compliance or examinations departments, which may use the reports as blueprints for subsequent compliance examinations and audits; prosecutors' offices lack the institutional structure to do this. *Id.*

48. *Id.* at 725.

49. *Id.* at 736.

Although settlement agreement terms are replicated, the lessons of actual practice are not being captured.[50] What happens after a monitorship ends was poignantly summarized by one of our interviewees:

> Maybe it turned out okay, maybe it didn't, maybe nobody knows, because there's nobody out there evaluating these things. And unless a company gets caught doing something improper again nobody may find out whether the deferred prosecution agreement worked or didn't work.[51]

Some recommendations for improved monitorships spring easily to mind. We would prefer the scope of monitorships to be determined in a more outcome-oriented, flexible, yet context-specific fashion. Monitors should be selected for a broader range of applicable skills. Former prosecutors with no monitorship experience do not stand out as the only good option here, despite their perceived credibility with other prosecutors. A more participatory and dialogue-based approach is likely to be more effective. The absence of mechanisms to systematize learning at the prosecutor or regulator level is another major failing, and affects those actors' abilities to provide effective oversight.

But the thornier problem is that in the final analysis, contemporary monitorships seem disposed toward being "closed shops." The participants share a fundamental unity of interest around keeping the monitorship project and the corporation's rehabilitation moving ahead smoothly. None of the parties involved—the corporation, the government agency, or the monitor—have an incentive to drive the monitorship beyond technical fixes and good optics to something more profound, more uncertain, and more unpredictable (in the way that real, open-ended dialogue and deep analysis can be).

Although there are exceptions, the following seems to be a common story: the corporation naturally wants to retain as much freedom as possible. It will push the government and the monitor to devise and implement as limited a monitorship as possible. It is helped in its case by the argument that unaccountable monitors should not be permitted to run amok and interfere with a public company's internal operations at infinitum and at shareholders' expense. For their part, monitors may not provide significant push-back against the corporation's limited interpretation of their mandate, because the monitor may naturally come to view the corporation as their "client," due to the close working relationship that develops over time, the corporation's role in selecting that monitor in certain cases, or the monitor's background as a corporate

50. *Id.*

51. *Id.* at 725.

defense attorney in private practice (which is a common career move for former prosecutors). Finally, especially on the criminal side, government enforcers may be more focused on closing their file and moving on to the next the case, rather than pushing the monitor to dig deeper into the workings of the corporation. This is particularly so because it is exceedingly difficult to assess, from outside, whether a firm has an effective compliance program in place and whether a monitor has done an adequate job of rooting out problems. Prosecutors hire monitors to do this work precisely because they do not have the skills or bandwidth to do it themselves, and therefore may not even know the right questions to ask. The end result is the strong likelihood of low ambition monitorships focused on technical compliance with policy and procedure requirements.

B. Self-Interested People: Principles-Based Regulation and Basel II

Principles-based regulation has been a feature of regulatory innovation in securities law in recent years, most notably the United Kingdom, but also in Canada. Principles-based and analogous approaches are also used at transnational and intersystemic levels, as a way of moving toward policy-level or outcome-level coordination or convergence, even though the necessary step of reconciling separate legal regimes has not taken place.[52] The June 2004 Basel II Capital

52. The familiar example here is the European Union's Open Method of Coordination, a functional and ongoing process that has attracted positive attention from new governance scholars. *See, e.g.*, GRÁINNE DE BÚRCA & JONATHAN ZEITLIN, CENTRE FOR EUROPEAN POL'Y STUDS., CEPS POLICY BRIEF NO. 31, CONSTITUTIONALISING THE OPEN METHOD OF COORDINATION: WHAT SHOULD THE CONVENTION PROPOSE? (2003), *available at* http://www.ceps.eu/system/files/book/1010.pdf. The seeds of the FSA's principles-based approach were also sewn in response to the need to amalgamate regimes across preexisting regulatory entities. FIN. SERVS. AUTH., CONSULTATION PAPER NO. 8, DESIGNING THE FSA HANDBOOK OF RULES AND GUIDANCE 4–6 (1998), *available at* http://www.fsa.gov.uk/pubs/cp/CP08.pdf. In the interest of maintaining continuity and a "good standard of regulation during the transitional period," the FSA was launched in 1997, but did not have its own statutory source of regulatory power until December 2001. *See* Financial Services and Markets Act [FSMA], 2000, cl. 8, §§ 2(2)–(3) (Eng.); Howard Davies, Chairman, Fin. Servs. Auth., Speech at the FSA Launch Conference (Oct. 28, 1997), *available at* http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/1997/SP02.shtml. The FSMA replaced much of the previous legislation, including the Financial Services Act of 1986, the Banking Act of 1987, and the Insurance Companies Act of 1982 under which banks, insurance companies and other financial services firms had been authorized and supervised. In its early days the FSA did not see itself as a principles-based regulator, so much as a risk-based, outcome-oriented, cost-effective, consultative, and management-based one. *See, e.g.*, FIN. SERVS. AUTH., ANNUAL REPORTS 11 (2002–03), *available at* http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02?03.pdf; FIN. SERVS. AUTH., FINANCIAL SERVICES AUTHORITY: AN OUTLINE 31–33 (1997), *available at* http://www.fsa.gov.uk/pubs/

Accords[53] are an essentially principles-based transnational agreement, this time governing supervision of banks. I have argued elsewhere that principles-based regulation in securities law should be seen as a new governance approach to regulation,[54] and propose to use that lens here in describing the troubles that devolution, when not accompanied by adequate regulatory oversight, can pose for new governance scholarship.

In the context of statutory drafting, more principles-based (as opposed to rules-based) regulation means legislation that contains more directives that are cast at a higher level of generality. But statutory drafting is only a small, formal, and ultimately inessential component of principles-based regulation.[55] The essential components of a principles-

policy/launch.pdf. The principles-based turn came later. The frequency of use of the term "more principles-based" had increased by orders of magnitude by late 2006 or early 2007. *See, e.g.*, Press Release, Fin. Servs. Auth., FSA Business Plan Focuses on More Principles-Based Regulation (Feb. 6, 2007), http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/019.shtml.

53. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004), *available at* http://www.bis.org/publ/B.C.bs107.pdf [hereinafter 2004 BASEL II ACCORDS].

54. Ford, *New Governance, Compliance*, *supra* note 14, at 5–6. The term "principles-based regulation" is the dominant one in securities regulation, likely for path-dependent reasons stemming from post-Enron worries about whether U.S. GAAP rules were too rules-based. However, some scholars would argue that new governance methods transcend the rules-versus-principles debate. *See* Kathleen G. Noonan et al., *Legal Accountability in the Service-Based Welfare State: Lessons from Child Welfare Reform*, 34 LAW & SOC. INQUIRY 523, 536–37, 554–56 (2009) (arguing that new governance, or "experimentalist," practice resolves "the rules/standard antimony" debate through a "simultaneous emphasis on articulation and flexibility"). These scholars argue, by contrast, that an experimentalist regime actually transcends the rules-versus-principles debate. Despite differences in terminology and emphasis, the fully articulated version of what I call principles-based regulation is not actually in tension with what Noonan et al. would describe. They find it most useful to frame the phenomenon as a pragmatic, practical method that bypasses an unproductive theoretical conversation. I find it most useful to describe essentially the same phenomenon by focusing on principles-based regulation as a first-order decision that reflects an appreciation of the relative capacities of legislative drafters, regulators, and industry actors. Nevertheless, my version of principles-based regulation calls for careful attention to implementation mechanisms that pull detailed industry knowledge into the articulation of those principles, in a way that is strongly similar to what Noonan et al. describe.

55. I am not alone in describing principles-based regulation as requiring more than principles-based drafting. *See also* Julia Black, *Forms and Paradoxes of Principles-Based Regulation* 12 (Law, Soc'y & Econ. Working Papers, 13/2008, 2008), *available at* http://www.scribd.com/doc/14726527/Forms-and-Paradoxes-of-Principles-Based-Regulation-by-Julia-Black [hereinafter Black, *Forms and Paradoxes*] (distinguishing "formal PBR," meaning principles in the rule books; "substantive PBR," which has some of the operational elements of PBR but not principles on the rule books; "full PBR," exhibiting both principles in the rule books and a principles-based operational approach;

based approach are to be found at the level of implementation, in terms of the techniques that are developed to translate those principles into specific business conduct expectations in context-sensitive, flexible, dialogue-based ways.

Structurally, the most profound differences between more principles-based and more rules-based approaches to securities regulation are in two areas: the proportion of decision making and interpretive power that is explicitly left to be filled in through the rulemaking function, rather than statutory drafting; and the proportion of outcome-oriented versus process-oriented statutory requirements. Principles-based regulation moves substantial authority over detailed requirements from legislator to regulator, to be addressed through its rule-making power. It also tends to be structured in a more outcome-oriented, as opposed to process-oriented, manner, meaning that the regulator in turn devolves decision making over detailed process to the industry actors it regulates.[56] Outcome-oriented regulation measures performance against regulatory goals, whereas process-based regulation measures compliance with detailed procedural requirements.[57]

As a regulatory strategy, outcome orientation has a clear new governance cast to it. It also has important implications for the approach to regulation. By definition, outcome-oriented regulation recognizes that there may be more than one means (i.e., more than one process) through which to achieve a regulatory goal. It transfers decision making about detailed process from regulators to industry. For its proponents, outcome-oriented regulation establishes a more direct relationship between regulatory goals and regulatory requirements, thereby making more efficient use of regulatory and industry resources. By contrast, process-oriented requirements that are developed by regulators in advance, in disregard of the fact that regulators possess less contextual information than industry actors, may not be perfectly tailored to regulatory goals. Process-oriented regulation can also permit market participants to abide by the letter of the law while ignoring its spirit. This

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and "polycentric PBR," which is full PBR with the additional element of incorporating third parties into the regulatory process).

56. *See, e.g.*, FIN. SERVS. AUTH., PRINCIPLES-BASED REGULATION: FOCUSING ON THE OUTCOMES THAT MATTER 4, 6–7, 9, 12 (2007), *available at* http://www.fsa.gov.uk/pubs/other/principles.pdf.

57. In actual practice, there is no necessary disconnect between outcome-oriented regulation and a third approach that some scholars call management-based regulation. *See* Coglianese & Lazer, *supra* note 12, at 692, 694. There are differences between the two concepts in terms of at what stage of firm conduct the regulator intervenes, but both place responsibility for detailed decision-making with industry actors, and give those actors the flexibility to design mechanisms that work for them based on their greater knowledge about their own businesses.

is especially the case when it comes to highly complex instruments, or areas where events are fast-moving and regulators on their own (let alone legislatures!) could not hope to keep up with the pace of innovation.

Fundamental to a principles-based system is the existence or development of an "interpretive community"[58] that collectively develops, on a rolling basis, the detailed content of statutory principles. In order to function transparently and predictably, a principles-based system must build in mechanisms that allow regulators to communicate with industry about their expectations, and that both allow and require industry to speak openly and regularly with regulators about their processes. Communication can take place through a number of channels including official administrative guidance, speeches, "no action" letters, compliance audits, the incorporation and dissemination of good or best practices, comments on industry standards, or specific enforcement actions.[59] Over time, such communication can help develop an interpretive community that understands regulatory expectations, and can usefully interpret regulatory pronouncements about "reasonableness" or "effectiveness" in different situations.[60]

What principles-based securities regulation means, then, is a particular way of structuring regulation, not a decision to do away with rules. Principles-based regulation is based on the conviction that while legislators and statutory drafters have the public legitimacy to establish broad regulatory goals, they are not in the best position to develop detailed guidelines for industry conduct, especially in fast-moving arenas like securities regulation. Those powers are allocated to frontline regulators at the relevant securities commission, whose expertise derives from their proximity to industry and whose accountability derives from the notice-and-comment aspect of their rulemaking powers. Moreover, and crucially, even those frontline regulators are limited in their access to information by comparison to the industries they regulate. These are the parties thought to be in the best position to both assess and bear their

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58. JULIA BLACK, RULES AND REGULATORS 30–37 (1997); STANLEY FISH, IS THERE A TEXT IN THIS CLASS: THE AUTHORITY OF INTERPRETIVE COMMUNITIES 354–57 (1980); Julia Black, *Talking About Regulation*, PUB. L. 77, 77 (1998); Sol Picciotto, *Constructing Compliance: Game Playing, Tax Law, and the Regulatory State*, 29 LAW & POL'Y 11 (2007).

59. On best practices and critical success factors in principles-based regulation see, e.g., Julia Black et al., *Making a Success of Principles-Based Regulation*, 1 LAW & FIN. MKTS. REV. 191 (2007).

60. Don Langevoort makes the thought-provoking argument that this kind of collaborative regulation is more likely to be successful in small and socially interconnected sectors. Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025 (2009). Retail-heavy markets like the American one may have to rely more heavily on ex-post enforcement, despite its disadvantages. *Id.*

own risks. In order to stay relevant and informed about fast-moving industry practice, to keep regulation sufficiently flexible, and to avoid inhibiting productive innovation, regulators need to establish open and perpetual communication lines with industry. They need to use industry's own good and best practices to add the "meat" of detail to the "bones" of their principles-based regulatory expectations.

International banking regulation, in the form of the Basel II Capital Accord,[61] shares similar assumptions. It establishes high-level, outcome-oriented requirements around the amount of capital that financial institutions need to maintain in reserve, and then devolves the process-based risk assessment details to the institutions themselves.[62] The greater risk a financial institution was carrying, the greater its reserves had to be.[63] Basel II capital adequacy formulae, in turn, were incorporated in 2004 into the United States Securities and Exchange Commission's alternative net capital requirements for leading broker-dealers, under the Consolidated Supervised Entities (CSE) Program.[64] The CSE Program, which was voluntary,[65] gave the leading "shadow banks" operating in the United States the same leeway that international banks had to assess their own capital reserve levels.

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61. *See* 2004 BASEL II ACCORDS, *supra* note 53.

62. *Id.*

63. *Id.*

64. Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities, Exchange Act Release No. 34-49830, 69 Fed. Reg. 34,428 (June 21, 2004), *available at* http://www.sec.gov/rules/final/34-49830.pdf. The text of the rule acknowledges that a "broker-dealer's deductions for market and credit risk probably will be lower under the alternative method of computing net capital than under the standard net capital rule." *Id.* To be eligible to use the alternative method of computing net capital, the broker-dealer had to maintain tentative net capital (meaning net capital before deducting securities haircuts and charges on inventory) of at least $1 billion and net capital of at least $500 million. *Id.* It also had to have in place comprehensive internal risk management procedures that addressed market, credit, liquidity, legal, and operational risk at the firm, and to observe certain disclosure requirements vis-à-vis the SEC. *Id.* The ultimate holding company of those broker-dealers—which were global financial institutions operating in the shadow banking sector—also had to consent to certain disclosure and risk assessment protocols, to permit the SEC to examine it and its affiliates, and monthly to compute capital requirements and risk in accordance with Basel standards. *Id.* The Program was terminated in September 2008. Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), http://www.sec.gov/news/ press/2008/2008-230.htm.

65. SEC, OFFICE OF INSPECTOR GEN., OFFICE OF AUDITS, REPORT NO. 446–A, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM 81 (2008), *available at* http://www.sec.gov/ about/oig/audit/2008/446-a.pdf [hereinafter, CSE REPORT]. That the CSE Program was voluntary was reportedly a function of the fact that no U.S. agency had regulatory authority over certain investment bank holding companies. *Id.*

The alternative net capital requirements established under Basel II and the CSE Program are technical rules whose details do not need to be recited here. The point for current purposes is that the overall strategy of establishing capital adequacy requirements based on internal firm risk modeling failed dramatically. The nature of the modern structured financial products is relevant. Assessing risks associated with standard equity products is fairly straightforward. Regulators could likely assess establish decent estimates of those risks on their own. Many modern structured finance products, by contrast, are almost indescribably complex, and assessing the risks associated with them calls for high math and powerful modeling tools. Following (in the United States) the passage of the Commodity Futures Modernization Act of 2000, the over-the-counter market for derivatives, notably including subprime mortgage-based consolidated debt obligations and their squares and cubes, and credit default swaps, expanded massively.[66] These structured financial products tend to be relatively illiquid (because they are traded over the counter, and not on exchanges which could enable more efficient price discovery); proprietary and non-standardized (and so difficult to compare); extraordinarily complex; and rapidly evolving.[67] As Basel II and the CSE Program implicitly acknowledged, regulators—

66. *See* Stephen Labaton & Timothy L. O'Brien, *Financiers Plan to Put Controls on Derivatives*, N.Y. TIMES, Jan. 7, 1999, at C1 (discussing the move towards self-regulation in derivative markets, prior to the GFC); *Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions Before S. Comm. on Banking, Housing, & Urban Affairs* (2008) (statement of SEC Chairman Christopher Cox), *available at* http://www.sec.gov/news/testimony/2008/ts092308cc.htm (recognizing a lack of regulatory oversight in the market for CDSs and other derivative products).

67. They differ in their attributes, but most over-the counter (OTC) derivative contracts are at least documented under standard forms, known as Masters, created by the International Swaps and Derivatives Association, Inc. *See* International Swap and Derivatives Association, Inc., http://www.isda.org (last visited Mar. 19, 2010). The United States Department of the Treasury recently presented a bill to Congress that would significantly augment private standardization initiatives. *See* Press Release, U.S. Dep't of the Treasury, Administration's Regulatory Reform Agenda Reaches New Milestone: Final Piece of Legislation Language Delivered to Capitol Hill (Aug. 11, 2009), http://www.ustreas.gov/press/releases/tg261.htm. The Treasury's bill would allow bank regulators to establish margin and capital requirements for banks entering into derivatives contracts; would require standardized OTC derivatives contracts to be cleared by a derivatives clearing organization regulated by the Commodity Futures Trading Commission or the SEC; and would require banks to have their standardized contracts centrally cleared and traded over regulated exchanges. *Id.* Dealers, also, would no longer be able to directly trade standardized derivatives contracts among themselves, but would be required to use an exchange or equivalent trading platform. *Id.*

let alone a disclosure-oriented regulator like the SEC[68]—could not hope to adequately assess the risks associated with these products themselves.

Moreover—and here is a clear lesson for new governance—the inadequacy of Basel II style capital adequacy conditions were virtually a laboratory experiment of the failure of the kind of decentralized, firm-based contextual information gathering and process development that underpins new governance and principles-based systems. Firms' self-interest, competence, and understanding of their own businesses were expected to keep the Basel II capital reserve system viable. As it turned out, in the absence of external discipline, the bank-developed models produced extraordinarily insufficient capital reserves, unprecedentedly high leverage, and enormous systemic risk.[69]

Regulatory faith in industry actors' competence, if not literally their bona fides, proved to have been misplaced to catastrophic effect. George Soros has charged that the GFC reflects a "shocking abdication of responsibility" on the part of regulators.[70] Investment banks and others engaged in originating, structuring and selling financial products engaged in breathtakingly bad behavior. There was real dishonesty.[71] The firms also made grave errors in safeguarding even their own interests. In the hands of in-house financial economists, academic caveats about the limitations of EMT models[72] as well as limits of valuation models were ploughed under.[73] Predictable psychological irrationalities, including groupthink, overconfidence, self-serving biases, and excessive faith in "hard" numbers, also seem to have been at work within firms. They were not accounted for in the regulatory decision to devolve the details to industry. There is also a strong public choice narrative. Banks had little incentive to behave prudently in building tranches of consumer debt-based securities because they sold them onto third parties, in a market

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68. *See, e.g.*, John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 777–78 (2009).

69. Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. TIMES, Oct. 2, 2008, at A1.

70. George Soros, *The Worst Market Crisis in 60 Years*, FIN. TIMES, Jan. 23, 2008, at 9.

71. *See, e.g*., Les Christie, *Mortgage Fraud Still Soaring*, CNN.COM, Aug. 26, 2008, http://money.cnn.com/2008/08/25/real_estate/soaring_mortgage_fraud/index.htm; Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAG., Apr. 27, 2008, at MM36.

72. For a discussion of the future of the "efficient-markets hypothesis" see *Efficiency and Beyond*, ECONOMIST, July 18, 2009.

73. *See, e.g.*, Joe Nocera, *Risk Mismanagement*, N.Y. TIMES MAG., Jan. 4, 2009, at MM24 (describing oversimplification of the VAR model in banking practice); Felix Salmon, *A Formula for Disaster*, WIRED MAG., Mar. 2009, at 74 (describing oversimplification of Li's gaussian cupola in banking practice).

eager to buy them.[74] At a structural level, financial institutions may have focused on short-term gain at the expense of long-term value because they had become public corporations, not partnerships, and because bank CEOs were compensated based on short term earnings.[75]

Regulators also seem to have underestimated the degree to which industry actors would use the available flexibility to try to avoid or circumvent regulatory oversight. Whether out of short-term self-interest, economic pressure, or simple lack of understanding,[76] firms within the CSE Program that applied the alternative net capital requirements valued illiquid assets too generously, underestimated long tail risks, and maintained inadequate capital buffers, all the while taking the position that their behavior was reducing rather than exacerbating risk. They innovated in structured products, not only reflecting increasing sophistication or in order to make their product more attractive to purchasers, but also sometimes to avoid regulation.[77] They avoided comparability in order to reduce transparency and arguably to make it harder for regulators to understand what they were selling.[78]

Each of these factors, even in isolation, represents a considerable challenge to what Julia Black has termed the "regulatory Utopia," within which the self-examining, responsible firm, which possesses the greatest

74. Ben S. Bernanke, Remarks at the Sandridge Lecture, Virginia Association of Economics (Mar. 10, 2005), *available at* http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/ (referring to a global "saving glut").

75. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. (forthcoming 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410072; *see also* Michael Lewis, *The End*, CONDE NAST PORTFOLIO, Dec.-Jan. 2008–09, at 114 (blaming Wall Street excesses on the decision to take investment banks public).

76. David Brooks, Op.-Ed., *Greed and Stupidity*, N.Y. TIMES, Apr. 3, 2009, at A29 (contrasting two theories explaining decision-making failures at financial institutions). Precisely why financial institutions managed risk so poorly is an important question, the answer to which is also multi-factorial and variable from one firm to another.

77. This may be the least of it. As Martin Wolf has pointed out, "an enormous part of what banks did in the early part of this decade—the off-balance-sheet vehicles, the derivatives and the 'shadow banking system' itself—was to find a way round regulation." Martin Wolf, Comment, *Reform of Regulation has to Start by Altering Incentives*, FIN. TIMES, June 23, 2009, at 11.

78. *See* JONATHAN GOLIN, COVERED BONDS: BEYOND PFANDBRIEFE – INNOVATIONS, INVESTMENT AND STRUCTURED ALTERNATIVES 323 (2006) (indicating the lack of legislation in the American market for covered bonds, which produces products which lack the standardization and comparability of their European counterparts). Recent legislative initiatives have seen an interest in standardizing certain OTC derivative products, in an effort to mitigate systemic risk, see, e.g., *"Over-the-Counter Derivatives" Before the S. Subcomm. on Secs., Ins., and Inv.* (June 22, 2009), *available at* http://www.federalreserve.gov/newsevents/testimony/white20090622a.htm (statement of Patricia White, Associate Director, Division of Research Statistics).

contextual information, helps to elaborate the content of principles-based regulation through ongoing dialogue with a flexible and outcome-oriented regulator, in the service of the mutual goal of optimized regulation.[79]

Meanwhile, regulators at the SEC and elsewhere were dealing with an inadequate regulatory mandate and insufficient resources. For example, the SEC's Division of Trading and Markets had only seven staffers and no Executive Director.[80] Yet since March 2007 it was charged the CSE Program—that is, with overseeing five otherwise-unregulated major broker-dealer firms, which formed the backbone of the U.S.-based shadow-banking industry, based on a novel alternative capital adequacy method.[81] One of the effects of understaffing was that Trading and Markets staff had not completed *any* inspections of its subject firms in the eighteen months prior to the collapse of Bear Stearns in September 2008.[82] CSE staff failed to adequately track material issues in regulated firms, approved changes to capital requirements before completing full inspections, and failed to exchange information with other SEC divisions.[83] This would have been problematic in any event, of course, but it was even more catastrophic in an outcome-oriented system where so much of the detailed procedural design for achieving regulatory goals was delegated to industry.

The Northern Rock debacle in the United Kingdom highlighted very similar problems within its financial regulator, the Financial Services Authority (FSA). The FSA was also far from adequately staffed. Its Major Retail Groups Division was reduced by some twenty staff between 2004 and 2008, notwithstanding that Division's responsibility for substantial and complex FSA priorities such as Basel II and the Treating

79. Black, *Forms and Paradoxes*, *supra* note 55, at 7–12.

80. CSE REPORT, *supra* note 65, at 49.

81. *Id.*

82. *Id.* at 49–50.

83. *Id.* at 37–41. The SEC's failures in oversight do not appear to be limited to the CSE program. That agency's review of its failure to detect and prevent Bernard Madoff's fraud also records that Mr. Madoff's funds were overseen by inexperienced or unsuitably skilled staff who conducted inadequate examinations, failed to verify information, and failed to respond to "red flags." SEC, OFFICE OF INVESTIGATIONS, REPORT NO. OIG-509, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME – PUBLIC VERSION 23, 29, 31, 144 (Aug. 31, 2009), *available at* http://www.sec.gov/spotlight/secpostmadoffreforms.htm. Investigations were also delayed, questions were left unresolved, and SEC offices failed to communicate with each other. *Id.* The SEC's post-Madoff reforms include many of the initiatives recommended here, such as conducting surprise exams, recruiting staff with specialized experience, improving staff training, and seeking more resources. SEC, The Securities and Exchange Commission Post-Madoff Reforms (Dec. 7, 2009), http://www.sec.gov/spotlight/secpostmadoffreforms.htm.

Customers Fairly initiative, in addition to its core firm risk assessment work.[84] The postmortem account of regulatory failure in the Northern Rock case identified a number of instances in which the FSA failed to collect, or did not have access to, the information necessary to accurately access the systemic risk that bank posed.[85] Supervisors were found not to have been "proactive in ensuring there was a robust process that meant they built up a complete picture of issues."[86] 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.[87]

In retrospect, programs like the CSE Program and the FSA's understaffed application of principles-based regulation are internally incoherent, at least if one believes in a role for public regulation. On one hand, regulators justified the delegation of risk assessment to firms on the basis that regulators did not and could not possess the knowledge those firms had about their own operational risks. Yet, the compensatory steps that might have reduced the knowledge gap and ensured sufficient oversight—compliance audits, close supervision by adequate numbers of well-trained staff—were not taken. Whether because the regimes' regulator-level architects accepted too unthinkingly the laissez-faire ethos of recent years,[88] or because they had no choice given their lack of regulatory mandate from legislators[89] (and these two are connected), regulatory programs like the SEC's CSE Program lacked a commitment to a robust public role in either design or implementation.

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84. FIN. SERVS. AUTH., INTERNAL AUDIT DIVISION, THE SUPERVISION OF NORTHERN ROCK: A LESSONS LEARNED REVIEW 7, 108–21 (2008), *available at* http://www.fsa.gov.uk.pubs/other/nr_report.pdf.

85. *Id.* at 13–59.

86. *Id.* at 5. *But see* Norma Cohen & Chris Giles, *Northern Rock Risk Revealed in 2004*, FIN. TIMES, May 30, 2009, at 1, *available at* http://www.ft.com/cms/s/0/4cc9637a-4c8a-11de-a6c5-00144feabdc0.html?nclick_check=1 (reporting that the FSA had conducted "war games" in 2004 that identified the systemic risk that Northern Rock posed).

87. Hector Sants, Chief Executive, Financial Services Authority, Speech at the FSA Annual Public Meeting (July 24, 2008), http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0724_hs.shtml.

88. *See* FIN. SERVS. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 45–49 (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf [hereinafter TURNER REVIEW] (criticizing the FSA for adopting "laissez faire" mentality); Labaton, *supra* note 69 (noting that "[t]he commission's decision effectively to outsource its oversight to the firms themselves fit squarely in the broader Washington culture of the last eight years under President Bush").

89. CSE REPORT, *supra* note 65, at 81–82 (Chairman Cox's comments justifying CSE program on the basis that it was voluntary and the SEC did not have a mandate to regulate CSEs otherwise).

C. Clever People: Destabilization, Complexity, and Power in Securitization Practice

As alluded to above, the over-the-counter market for derivatives expanded enormously in the years leading up to the GFC, and has been highly under-regulated.[90] Devolution accompanied by an ideology of self-regulation was especially problematic because of the conditions of extraordinary complexity that characterized these products and the market for them. The second narrative focused on the troubles caused by devolving risk assessment to private parties under the Basel II and CSE Program initiatives, without ensuring meaningful regulatory oversight. This next narrative tries to confront a phenomenon that is equally relevant to the financial crisis and to new governance thinking, but also thornier.

At the core of new governance is an embrace of the challenge and the promise of destabilization and social plasticity.[91] New governance values incrementalism and learning-by-doing, as it should, because new governance starts from the premise that in an increasingly complex and decentered (or at least polycentric and networked) world, the path to human flourishing is through permitting innovation and parallel experimentation, and creating flexible and revisable structures that open the door to new possibilities.[92] The difficulty is that bold, decentralized innovation and the deconstruction of traditional legal structures were centrally implicated in the GFC, in the form of structured finance products. The point here is certainly not that the innovations that took place in structured finance represent a new governance regime in some fashion. They do not. All the same, their story is a cautionary tale about some potential effects of innovation and complexity on transparency, accountability, and power.

Briefly, a derivative is a financial product whose value is derived from the value of one or more underlying assets. The underlying asset can be virtually anything—a currency index, a loan agreement, or a company's shares—but the most familiar kinds of derivatives are options and swaps based on the value of underlying corporate shares. Options, swaps, and analogous tools have been used for years to fine-tune particular investment strategies; to hedge against risks associated with currency fluctuations, company performance, credit, and other relevant

90. *See* Labaton & O'Brien, *supra* note 66.

91. *See generally* Simon & Sabel, *supra* note 7. The concept of destabilization rights is borrowed from Unger. *See, e.g.*, ROBERTO UNGER, FALSE NECESSITY 1–8, 530–32 (1987). I am not suggesting that new governance envisions a world as plastic as Unger does. *See infra* notes 134-136 and accompanying text.

92. *See generally* Dorf & Sabel, *supra* note 7.

variables; and to speculate on the same things. Securitization is a second order process that, in one version, uses derivatives to transform an illiquid asset pool (for example, a collection of subprime mortgages), structured through a conduit entity or special purpose vehicle, into multiple, credit-ratable tranches of sellable new securities.[93] A securitized product based on underlying debt obligations, such as mortgages or consumer credit card debt, is a consolidated debt obligation (CDO). CDOs require considerable financial expertise to structure, but while notorious, they—and the credit default swaps, or CDSs, that were designed to serve as a form of insurance for them—are not the most complex structured products that have been developed by financial institutions. Global financial firms produced an ever greater volume of ever-more-complex synthetic securities in recent years, and it all sold.[94]

Securitization can bring real benefits in terms of hedging and risk management. After a certain point, however, those benefits are extracted and additional innovation exists primarily to serve speculators, to move risk downstream, and to generate book-level financial value that exists at a metaphysical remove from the "real" economy. This poses great risk to systemic stability. Even taken on their own terms—in terms of the benefits that structured products confer for fine-tuning risk profiles and improving investor choice—by design or in effect, at some point the costs of innovative new products outweigh their benefits to overall social welfare. As the March 2009 Turner Review from the United Kingdom suggested, the GFC has challenged the "underlying assumption of financial regulation in the US, the UK and across the world . . . that financial innovation is by definition beneficial, since market discipline will winnow out any unnecessary or value destructive innovations."[95] On the contrary, in retrospect, some recent forms of financial innovation delivered few benefits, but permitted rent-seeking and contributed to significantly increased levels of systemic risk.[96] As the Turner Review noted,

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93. *See, e.g.*, Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP. & INT'L L. 541 (2002); Michael Durrer, *Asset-Backed Commercial Paper Conduits*, 1 N.C. BANKING INST. 119 (1997). Not incidentally, conduits also allowed banks to move debt off their balance sheets and to maintain less capital on hand for purposes of Basel II and the CSE Program. Other significant difficulties with the incentive structures around structured finance, including the fact that through CDSs one could effectively buy more protection than one had risk exposure, are beyond this Article's scope.

94. *See* Bernanke, *supra* note 74 (discussing the global "saving glut" and its effect on the U.S. current account deficit); Lewis, *supra* note 75 (discussing the subprime mortgage crisis).

95. TURNER REVIEW, *supra* note 88, at 49.

96. *Id*. at 109.

> it seems likely that some and perhaps much of the structuring and trading activity involved in the complex version of securitised credit [over the last ten to fifteen years], was not required to deliver credit intermediation efficiently. Instead, it achieved an economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships between investors and companies and between companies and individual employees.[97]

Derivatives and the development of increasingly sophisticated structured financial products have also increased uncertainty and destabilized preexisting accommodations in at least two significant ways. First, at the corporate-law level, derivatives have "shattered the atom" of property well beyond anything contemplated by Berle and Means.[98] This has reduced transparency, undermined corporate governance principles, and put even greater power into the hands of the most powerful and sophisticated market actors. Second, the origination and sale of securitized products have introduced enormous complexity into global financial markets. This has affected those markets' functioning, and presents a profound challenge to their regulation.

The effect of the derivatives revolution[99] on corporate law and governance have been described in a series of articles by Henry T.C. Hu and Bernard Black.[100] As they point out, corporate governance has long been premised on a proportional relationship between economic interest and shareholder votes: one share, one vote.[101] This relationship gives

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97. *Id*. at 49.

98. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 8–9 (1932).

99. The term is not a new one. For a prescient analysis of the systemic risk associated with widespread use of over-the-counter derivatives, see Mary L. Schapiro, Comm'r, SEC, Remarks at the Eighth Annual Symposium for the Foundation for Research in International Banking and Finance: The Derivatives Revolution and the World Financial System (Oct. 14, 1993), *available at* http://www.sec.gov/news/speech/1993/101493schapiro.pdf [hereinafter Schapiro Remarks].

100. *See generally* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008) [hereinafter Hu & Black, *Equity and Debt Decoupling*]; Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811–908 (2006) [hereinafter Hu & Black, *The New Vote Buying*]. In September 2009, Professor Hu was appointed the first Director of the SEC's newly established Division of Risk, Strategy, and Financial Innovation. Press Release, SEC, SEC Announces New Division of Risk, Strategy, & Financial Innovation (Sept. 16, 2009), http://www.sec.gov/news/press/2009/2009-199.htm.

101. Hu & Black, *The New Vote Buying*, *supra* note 100, at 851–52.

shareholders the incentive to exercise their voting power responsibly, makes possible the market for corporate control, and legitimizes the power of management. Derivatives have the power to sever that relationship. They allow investors (often, hedge funds) as well as corporations to engage in what Hu and Black call "the new vote buying," by decoupling voting rights from economic ownership.[102]

For example, a shareholder can use equity swaps or options to hold more votes, as of the record date for a shareholder vote, than it actually owns.[103] Holding a disproportionate number of votes has clear implications in a proxy fight. In an extreme situation, it can even mean that a vote holder has a negative economic interest in the wellbeing of the company and, thus, an incentive to vote in ways that reduce share value.[104] The opposite phenomenon is "hidden," or "morphable," ownership, through which a shareholder uses derivatives, such as equity swaps, to maintain a greater economic interest in a company than it has votes. Hu and Black describe this as "morphable" voting rights, because the shareholder often maintains the de facto ability to acquire the votes if needed, for example by unwinding its swaps.[105] Ownership is "hidden" in that the shareholder's economic stake and de facto voting ownership are often not disclosed. The ability to make one's voting rights disappear when one wants to hide a stake, only to reappear when needed, has obvious implications in the takeover context, and the decoupling of voting right from economic interest has significant effects for corporate law and governance generally.[106]

Moreover, Hu and Black assert that this decoupling is really just one instance of a broader, global trend, generally not addressed by regulation, toward decoupling the bundles of rights and obligations we traditionally know as equity and debt.[107] It bears noting that sophisticated parties are the ones most able to take advantage of the power of this flexibility, which is beyond the capacity of small or retail investors. The collapse of structure and the increased irrelevance of formal voting rights for all shareholders benefits the powerful.[108]

In addition to undermining conventional corporate governance mechanisms and notions of property, derivatives beget complexity. One of the striking lessons from the GFC has been the impact of complexity

102. *Id*. at 823.

103. *Id*. at 825.

104. *Id.* at 832–35.

105. *Id.* at 825–26.

106. *Id.* at 836–42, 850–63.

107. *See generally* Hu & Black, *Equity and Debt Decoupling, supra* note 100.

108. *Cf., e.g.,* PATRICIA J. WILLIAMS, THE ALCHEMY OF RACE AND RIGHTS 146–49 (1991).

on the financial markets, and the degree to which existing regulatory structures failed to manage its effects. Steven Schwarcz has suggested, plausibly, that complexity is the "greatest financial market challenge of the future."[109] He describes complexity in the assets that underlie modern structured financial products—for example, variability in property values, interest rates, mortgage terms, and the creditworthiness of individual mortgagees[110]—over layered with complexity in the design of the structured products themselves—for example, in the design of synthetic products so complex that adequate disclosure to investors was virtually impossible[111]—and exacerbated by complexity in modern financial markets (including indirect holding systems and the widespread use of complex mathematical risk modeling).[112] Schwarcz examines how these multiple complexities can lead to inappropriate lending standards, failures of disclosure, and a lack of transparency and even comprehensibility.[113] Perhaps most difficult to manage, they also create a complex system characterized by intricate causal relationships and a "tight coupling" within credit markets, in which events tend to amplify each other and move rapidly into crisis mode.[114] Prior to the GFC, there was a general failure by all concerned to appreciate the myriad interrelated ways in which complexity can impair markets and financial regulation.

III. LESSONS LEARNED

The three narratives above are pitched in different registers, though all are stories through which one can try to understand how financial regulation functions. Each one also offers lessons for new governance scholarship, especially around three key concepts: incrementalism, capacity, and plasticity.

A. Does Incrementalism Mean More of the Same?

As a design strategy, there are reasons to prefer experience-based incrementalism to solo-designed regulatory reform undertaken by even the most talented and experienced observers. Knowledge is dispersed

109. Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. L. REV. (forthcoming 2010) (manuscript at 2–3, on file with author), *available at* http://ssrn.com/abstract =1240863.

110. *Id.* at 7–11.

111. *Id.* at 11–25.

112. *Id.* at 25–32.

113. *Id.* at 7–11.

114. *Id.* at 25–31.

within society, redundancy and parallel experiments are useful learning methods, and the extent of what we do not know is great enough that the potential for activating unintended consequences must be seen as a real risk.

At the same time, incrementalism inevitably reflects surrounding conditions. It may be a powerful tool for change over time, but the direction of that change will be a product of myriad distinct decisions made along the way, and those decisions will be a function of the interests of those making them and the extent of their influence. New governance scholarship is preoccupied with the fascinating possibilities inhering in incrementalism—and indeed, many large and beneficial changes have been produced through incremental, pragmatic action. It is one of the key insights of new governance that one should design deliberative and regulatory regimes that can capture and fine-tune that progress by reflecting learning back to those doing the doing, evaluate it based on sound and revisable methods, and roll that learning back into the regime itself.

As important as this is, it would be unwise to underestimate the amount of energy and focus required to push incremental change (or even to identify its direction, given the background noise) in the direction of prior commitments and empirically demonstrable improvement. Moreover, under stable background conditions and without that enormous input of energy, incremental movement is very likely to reflect status quo priorities and power relations. Consider the example of monitorships. In many (though not all) of the monitorships we studied, incremental decisions taken at each stage meant that at no stage was there a true destabilization along the lines imagined by new governance scholarship. There was no opening up of the process to a more diverse set of interests.

In practical terms, the "local level" in new governance regulation cannot be a black box. Moreover, we cannot presume that public-regarding or long term thinking will automatically be produced at this level. Without a considerable oversight mechanism that tests those groups' assumptions, those groups will develop suboptimal resolutions. For example, a local level comprised of self-interested bankers cannot be counted on to self-regulate effectively where no one is acting as an active, public-regarding counterweight in their interpretive community. What this means is that we should perhaps be wary of industry efforts toward "pre-emptive self-regulation." We should not assume that regulators will necessarily be able to adapt measures that were initially taken to pre-empt regulation into a more consequential project. At a minimum, the monitorship story here points to features that have to be incorporated in order to translate self-regulation, especially of the pre-emptive variety, to truly enforced self-regulation or co-regulation. Above all, it would be essential to reinject meaningful contestation and diversity. Without structural avenues for intervention by those with allegiances truly "outside the circle,"[115] we should anticipate seeing closed, non-diverse, and ultimately unaccountable systems.

B. Who Cares About Regulatory Capacity? The Tendency to Slide Downhill

The absence of meaningful accountability meant that Basel II and the CSE Program effectively ran downhill toward self-regulation. This need not have been the case. Devolution does not automatically imply weak public oversight or irresponsible private action. The Turner Review, produced by the FSA's now-Chairman, Lord Adair Turner is insightful in describing the regulatory worldview that made possible regulatory failure on the scale we have seen.[116] According the Turner Review, the FSA did not fail because it embraced principles-based regulation.[117] Rather, Lord Turner ascribes blame to flaws in FSA philosophy—that is, to a hands-off, market-based regulatory approach that assumed that markets were generally self-correcting and that market discipline could be counted on to contain risk; that primary responsibility for managing risk lay with senior management, not regulators, because they possessed better information; and that consumers were best protected through unfettered and transparent markets, not product regulation or direct intervention.[118]

New governance scholarship cuts across the proverbial public/private divide in many ways, one of which is that it takes seriously, as governance strategies, initiatives occurring within regulatory bodies,[119] on the part of private actors,[120] and at junctions in

115. This would include, for example, meaningful protections for corporate whistleblowers. *See generally* Orly Lobel, *Citizenship, Organizational Citizenship, and the Laws of Overlapping Obligations*, 2009 CAL. L. REV. 433.

116. TURNER REVIEW, *supra* note 88.

117. This notwithstanding premature and ultimately inaccurate reports by credible UK media sources that principles-based regulation would be abandoned. *See* Peter Thal Larsen & Jennifer Hughes, *Sants Takes a Fresh View of Regulator's Principles*, FIN. TIMES, Mar. 13, 2009, at 17.

118. Just as fundamental, but best put in the category of regulatory gaps rather than regulatory approaches, was failure in the oversight of systemic risk. *See* TURNER REVIEW, *supra* note 88, at 52–53.

119. *E.g.*, Dorf & Sabel, *supra* note 7; Noonan et al., *supra* note 54.

120. *See, e.g.*, Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431 (2008); Katharina Pistor, *Global Network Finance: Organizational Hedging in Times of Uncertainty* (Columbia Law & Economics, Working Paper No. 339, Oct. 14, 2008), *available at* http://ssrn.com/abstract=1284606.

between.[121] One lesson that emerges from the failure of internal risk assessment under Basel II and the CSE Program is that, while traditionally "public" and traditionally "private" actors should not be drawn reductively, and while each can perform a range of different functions, they nevertheless operate from distinct starting positions. Neither group, of course, would want to see the financial system collapse, but in the shorter term private parties can be expected to be driven principally by profits, market share, and interfirm competition. We may hope for them to generate reputation-driven accountability measures in at least certain contexts,[122] but in the meantime they are susceptible to taking shortcuts and satisficing in ways that may be individually beneficial even if they are collectively catastrophic. One cannot expect industry actors to act in the public interest, except insofar as that public interest conforms to their understanding of their own (sometimes short term) self-interest, and there will be a non-negligible number of circumstances in which they will not conform. For example, each firm operating under the SEC's CSE Program had the incentive to minimize capital reserves and to maximize leverage, in the interest of maximizing profits. The result was a classic collective action problem.[123]

Excessively deep faith in the public potential of self-interested private actors can impose other blinkers as well. One risk may be an unreflective over-embrace of localism and local knowledge. As new governance scholars know, the principle of subsidiarity asserts that responsibility for addressing a particular problem should be located at the most local level capable of handling it. In retrospect, if any party was in a position to assess the systemic risk that arose from the tightly interconnected conduct of the global banks in recent years, it could only plausibly have been a regulator. The assumption that local actors possess the best information seems to have been accepted too uncritically, and applied too sweepingly.[124]

121. *See, e.g.*, Sabel & Simon, *supra* note 7 (describing situations in which private action can be catalyzed by a publicly mandated process); Joanne Scott & Susan Sturm, *Courts as Catalysts: Re-Thinking the Judicial Role in New Governance*, 13 COLUM. J. EUR. L. 565 (2007); Sturm, *supra* note 8.

122. *See, e.g.*, Gilson et al., *supra* note 120.

123. *See* Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-Outs*, FIN. TIMES, July 9, 2007, at 1, *available at* http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html (statement of Charles Prince, Citigroup CEO) ("As long as the music is playing you need to get up and dance.").

124. *Cf.* Robert K. Vischer, *Subsidiarity as a Principle of Governance: Beyond Devolution*, 35 IND. L. REV. 103 (2001) (arguing that the conservative political spin the principle sometimes assumes misconstrues the public-minded Catholic social theory from which the principle arises).

Similarly, the Basel II Accord and CSE Program did not account for the possibility that self-interested private actors could collectively cascade into risky and irrational behavior. Information-based analysis and reason-giving (essential elements of new governance thinking)[125] also seem to collapse in times of economic exuberance, when those involved are more willing to suspend disbelief. Market bubbles may also be times when regulators' budgets are under pressure, because problems are not at the forefront of peoples' minds. The duty to give reasons and explain is further hampered by extreme complexity of the sort that characterizes modern financial markets. Being more flexible, new governance methods may reflect the zeitgeist more forcefully as well.

Working effectively with principles-based regulation and similar decentered models therefore requires considerable changes to traditional regulatory culture, and considerable resources.[126] Indeed, as Julia Black has pointed out—and this seems crucial for new governance generally—principles-based regulation may be more "hands-off" in its approach to the procedural details, but this does not mean that it requires fewer regulatory resources.[127] Principles-based regulation may actually require intensive interaction with firms, at least around certain issues or situations.[128] It means having an adequate number of staff, and giving regulators the ability to obtain transparent and reliable information from and about industry. It requires that regulators have and use robust investigatory powers where necessary, conduct regular and adequate compliance audits, and possess the quantitative expertise and relevant experience to independently scrutinize information. As one commentator observed, contemporary regulators need to be pursuing "the same PhD rocket scientists the banks are chasing."[129] Regulatory staffers also need sufficient confidence in their own judgment and a healthy degree of skepticism about industry. Yet, both the FSA and the SEC's CSE

125. *See, e.g.*, William H. Simon, *Solving Problems vs. Claiming Rights: The Pragmatist Challenge to Legal Liberalism*, 46 WM. & MARY L. REV. 127, 181–82 (2004).

126. *See, e.g.*, Black et al., *Making a Success*, *supra* note 59, at 201; Cristie L. Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, 55 MCGILL L.J. (forthcoming 2010), *available at* http://www.ssrn.com/abstract=1516734.

127. Black et al., *Making a Success*, *supra* note 59, at 202.

128. *See generally id.* (discussing U.K. Treat Customers Fairly rules, which require registrants to demonstrate that they are in fact treating customers fairly at every stage).

129. Jennifer Hughes, *FSA Admits Catalogue of Failures*, FIN. TIMES, Mar. 27, 2008, at 3. The fact that quantitative analysis has been abused, misapplied, and overgeneralized in the past does not mean that banks will not use it in the future. Despite its theoretical limitations and the recent example of real-life catastrophe, quantitative analysis continues to have substantial predictive value, and it will continue to be a central tool for financial industry actors.

Program were under-resourced on virtually every measure.[130] In a system where information is power, such as in the principles-based regulation of complex derivative instruments, a regulator without the ability to obtain and manage information cedes the field to those it regulates.

Herein lies the problem. Who, precisely, can be relied on to ensure that such decentralized systems are accountable, and that learning truly is reflected upward and used effectively? Who has the incentive to do this rather than to "satisfice"? Consider again the example of corporate monitorships. Certainly, each of the prosecutor, the corporation, and the monitor had an interest in achieving some measurable positive effect through the process. But they also each had some degree of common interest in resolving the monitorship in the least destabilizing and most efficient manner possible. We should not then be surprised that, where there was room to satisfice, and given the absence of a forceful, external, destabilizing accountability mechanism, incremental decisions at each stage downgraded their potential effectiveness. Considering the lack of appetite for long-term, close monitoring of public companies—by securities regulators, let alone by criminal prosecutors—we may reasonably ask ourselves exactly how this regime could ever be robust.[131]

The lesson seems to be that moving people and organizations out of complacent stasis (or, worse, regulatory collapse) and toward meaningful, accountable new governance functionality calls for a substantially larger push than the new governance literature always

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130. *See supra* notes 64–69 and accompanying text. The FSA implemented a "supervisory enhancement program" in response to the failure of Northern Rock. *See* Hector Sants, Fin. Servs. Auth., The FSA's Supervisory Enhancement Programme, in Response to the Internal Audit Report on Supervision of Northern Rock, High Level Summary (Mar. 26, 2008), *available at* http://www.fsa.gov.uk/pubs/other/enhancement.pdf. It has announced plans to enhance its supervisory teams (meaning more staff, better training, a mandatory minimum number of staff per high-impact institution, and closer contact between senior staff and the biggest firms). *Id.* at 2. It also plans to improve the quality of its staff, hiring risk specialists to support frontline supervision teams by focusing on the complex models used by banks to gauge financial risk. *Id.* at 3. *See also* TURNER REVIEW, *supra* note 88, at 88 (describing the FSA's new approach as "intensive supervision"). Lord Turner describes intensive supervision as entailing much greater resources devoted to the supervision of high impact firms, more intense focus on business strategies and system-wide risks, more focus on technical competence of FSA supervisors, more focus on the details of bank accounting, and greater willingness to reach judgments about the overall risks that firms are running. *Id.*

131. *See* Ford & Hess, *supra* note 20, at 726 (discussing civil side regulators passing monitors' reports onto compliance for use as blueprints). That said, even within the civil regulatory context, there is a clear distinction between regulated entities and public companies in terms of follow-up and oversight. Broker-dealer firms and other regulated entities operate in a highly regulated environment and are required to be in contact with their regulators through a number of prescribed mechanisms. Nothing similar is required of public companies as a condition of listing, and most people would probably agree that nothing similar should be required.

acknowledges. Moreover, the push would have to be continuous and unrelenting, since the same tendencies toward satisficing, pie-dividing, and short term thinking will reemerge at many crucial decision points along the way. A new governance approach to regulation will be susceptible to downgrading throughout its life cycle. Designing a system that can maintain its integrity despite such human foibles will require a greater degree of ambition than has characterized many implementation efforts.

C. Destabilization Rights and Prophylactic Rules

New governance scholarship seeks to develop governance mechanisms that in terms of flexibility, effectiveness, and inclusiveness are superior to command-and-control mechanisms. This makes sense. In part, the roots of new governance thought (for example, in new public management or Japanese management models) represent a reaction to bureaucracies and hierarchies that had become ineffective because of over-reliance on rigid rule-making processes and centralized decision making structures, or because of co-optation by interest group politics. Today, the problems caused by derivatives and securitization reflect practically the *opposite risk*—innovation bounded only by the imagination, in a financial sector increasingly distanced from the "real economy" and free from the constraining influences of rigid institutions and legal structures.[132] Moreover, in real life that flexibility was not used in the service of greater emancipation or human potential.[133] Until it proved to be to the detriment of everyone, financial product innovation primarily benefited financial firms themselves, at great cost to transparency and the possibility of oversight. We should therefore get clear about the boundaries of the destabilization right that *is* fundamental to new governance.

Destabilization in new governance does not mean free-for-all plasticity. Radical uncertainty on its own it is neither necessary nor

132. *See, e.g.*, Bell & Dawson, *supra* note 93, at 561 (suggesting that synthetic securitization "is the second great leap forward in the road to a totally disintermediated financial world").

133. *Contra* UNGER, FALSE NECESSITY, *supra* note 91, at 530 ("Destabilization rights protect the citizen's interest in breaking open the large-scale organizations or the extended areas of social practice that remain closed to the destabilizing effects of ordinary conflict and thereby sustain insulated hierarchies of power and advantage."); ROBERTO MANGABEIRA UNGER, SOCIAL THEORY: ITS SITUATION AND ITS TASK 210 (1987) ("The paramount condition of material progress [once poverty is overcome] becomes the plasticity of social life: the relative ease with which people can subject their forms of production and exchange, of machine design and work organization, to the logic of problem-solving.").

sufficient to generate the conditions for human flourishing. New governance understands this, of course. It is not anarchism, or radical democracy theory, and it situates its destabilization mechanism within a matrix of abiding institutions.[134] At the same time, conditions of deep instability are sometimes proposed as the moment when New Governance approaches stand the best chance of being realized—times when no one knows what the solution to a problem might be, or how to get there, but everyone knows that the status quo cannot persist.[135] Ronald Gilson, Charles Sabel, and Robert Scott similarly describe a promising "contracting for innovation" phenomenon arising around interfirm collaboration, as a response to what they understand as a problem of Knightian uncertainty.[136]

Good and important things do happen in malleable environments. There is real power in the new governance conviction that moving people off their pre-existing positions can open new and unexpected possibilities. At the same time, we might be forgiven in this historical moment for fixating on the bad things that can also happen in malleable environments. The financial crisis is partly a story about the fallibility of industry actors in safeguarding their own enlightened self-interest, behaving rationally, and responding to (or perhaps even grasping) the systemic risk their conduct was generating. Considerable human experience in fact suggests that in the face of uncertainty, bounded human rationality has considerable presence. People may satisfice where possible to avoid the discomfort of uncertainty; will be more inclined to accept the status quo for the same reason; will have difficulty absorbing information that is inconsistent with their prior convictions and interests; and sometimes, may freeze up completely or revert to tribalism.

As regulatory failure in principles-based regimes and Schwarcz's dissection of financial complexity show, unknowability is a real threat to systems based on information-forcing and analysis. In addition, power relationships assert themselves in fluid space, like the space created between ownership and voting rights through mechanisms such as empty voting and morphable ownership. Nontransparency can be beneficial to powerful actors. Those that profit from it will resist efforts to force

134. *See, e.g.*, Noonan et al., *supra* note 54; Sabel & Simon, *supra* note 7; Scott & Sturm, *supra* note 121.

135. Edward Rubin, *The Myth of Accountability and the Anti-Administrative Impulse*, 103 MICH. L. REV. 2073, 2131–34 (2005) (arguing for open-ended formulations where the regulator "knows the result it is trying to achieve but does not know the means for achieving it, when circumstances are likely to change in ways that the [regulator] cannot predict, or when the [regulator] does not even know the precise result that she desires").

136. Gilson et al., *supra* note 120.

transparency and accountability—and resist those efforts both overtly, and in hard-to-measure ways.[137]

So, what to do? Unger's response to the derivatives problem would probably be that we have not gone far enough. The use of structured financial products has atomized equity, and debt, but a broadly available destabilization right (for example, a power to profoundly disrupt the status quo, available not only to shareholders but all stakeholders including creditors, employees, local communities, citizens writ large, and representatives of the global environment) did not follow.[138] Consolidated property holding, also, remains with us.[139] The result is the persistence of a hollowed-out legacy mechanism for ensuring voice through shareholder voting, which is no longer connected to the central interests to be protected, and that is available to be used strategically by sophisticated parties.

Be that as it may, both the GFC and the regulatory response to it suggest that the establishment of broadly available destabilization rights is unlikely to follow the disintegration of formal property rights. While it is theoretically possible that "ungoverned" mechanisms can create rich accountability in the absence of formal mechanisms,[140] this is not an inevitable outcome. All three narratives above demonstrate that in a world of imperfect information, complexity, and status quo bias, less happy results, which reflect existing power relationships, may result.

137. *See* Sturm, *supra* note 8 (identifying such problems of subtle resistance, and a solution based on building in responsive architecture rather than perpetuating plasticity).

138. Unger actually proposes four fundamentally restructured categories of rights: immunity rights, which protect the individual from the state, organizations, and other individuals; destabilization rights, which make it possible to dismantle institutions and practices that create social hierarchy and division; market rights, which constitute claims to social capital and replace conventional property rights; and solidarity rights, which are "the legal entitlements of communal life." UNGER, *supra* note 133, at 508–38.

139. For Unger, the traditional property right was an unhelpful formative context that impeded societal plasticity. Unger would disaggregate private property rights and transfer control over major productive assets to a "rotating capital fund," which would disaggregate property rights down through tiers: (1) an ultimate social fund controlled by government, leasing capital to (2) autonomous investment funds operating in different sectors, which then (3) auction or ration resources to competitive teams of producers for stipulated periods of time. UNGER, FALSE NECESSITY, *supra* note 91, at 491–501. Welfare rights guarantees to citizens would protect them from the vagaries of markets, which would also allow innovators (capital-takers) to be even more innovative and to take larger risks. *See also* ROBERTO MANGABEIRA UNGER, DEMOCRACY REALIZED: THE PROGRESSIVE ALTERNATIVE 273–75 (1987).

140. *See, e.g.*, Matthew C. Jennejohn, *Collaboration, Innovation, and Contract Design*, 14 STAN. J.L. BUS. & FIN. 83, 86–87 & nn.12–14 (2008); Charles Sabel, *Ungoverned Production*, *in* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 310 (Jeffrey N. Gordon & Mark J. Roe eds., 2004).

Even where acute problems associated with securitization are resolved, it is not clear from where the impetus will come to generate a fundamental revision of existing structures on Ungerian lines.

Another response to the problems posed by securitization might be to try to reintroduce certainty in a convincing manner, for example by shoring up non-negotiable substantive rights.[141] Leaving aside the considerable torque this would put on new governance methods, this does not seem realistic in this situation. There is virtually no hope of returning the twin genies of innovation and complexity in structured products to the bottle.[142] The reassertion of facially straightforward rights cannot make a complex situation simple, or avoid the need for ongoing and explicit principles-based problem-solving that is designed to handle complexity. New governance needs to be understood as a response to those very real problems.

Perhaps, though, in light of finite regulatory capacity and the clear necessity of decent prudential regulation for worldwide economic stability, *prophylactic rules* have a role to play. They are far from perfect, virtually by definition, but their overall costs may prove justifiable relative to the costs of complete new governance systems that are more iterative and complex "all the way down," if those complex systems exceed the capacity of regulators to regulate.[143]

Without regulatory oversight, self-interested actors can be expected to act in their own interest. Where there is underlying uncertainty anyway—for example, around a new or extraordinarily complex product or line of business—or where there is no metric for evaluating something (a compliance program, a product, a risk) across institutions, the problem of self-interested action can be exacerbated.[144] Collectively, the infamous "risky shift"[145] can occur, especially when markets are experiencing a

141. *See, e.g.*, Lisa T. Alexander, *Stakeholder Participation in New Governance: Lessons From Chicago's Public Housing Reform Experiment*, 16 GEO. J. ON POVERTY L. & POL'Y 117, 127–28, 180–84 (2009); Douglas NeJaime, *When New Governance Fails*, 70 OHIO ST. L.J. 323 (2009) (making essentially this recommendation albeit in different contexts).

142. For example, one post-GFC innovation in securitization is based on "life settlements." Jenny Anderson, *New Exotic Investments Emerging on Wall Street*, N.Y. TIMES, Sept. 5, 2009, at A1.

143. On the other hand, prophylactic rules can impose considerable costs due to international regulatory arbitrage. The obvious response, which is international harmonization, remains elusive. I am grateful to Eric Pan for this observation.

144. *See generally* William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343 (1999).

145. *See, e.g.*, Sushil Bikhchandani et al., *A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades*, 100 J. POL. ECON. 992 (1992); J.H. Davis, *Group Decision and Social Interaction: A Theory of Social Decision Schemes*, 80 PSYCHOL. REV. 97 (1973). "Risky shift" is part of a broader phenomenon of group

bubble or competitive pressures push actors toward greater risk-taking.[146] Without countervailing, independent-minded regulatory power to push back against self-interested industry conduct, the "creep" may run downwards—to more risk, less transparency, less systemic stability, and less consumer protection.

Meaningful regulatory oversight is therefore an important consideration, and complexity makes that oversight harder to achieve. We know now that our financial regulatory approaches were not built to handle the effects of complexity and constant innovation that characterize modern financial markets. The new governance approach regulation is, of course, a response to those very phenomena. But as John Coffee and Hillary Sale have argued, even an optimal regulatory model will not work if it is too complex for regulators to implement.[147] If the alternative is a governance system without the capacity to provide meaningful oversight, then the (ultimately superficial) certainty provided by (inevitably imperfect) prophylactic rules may still be more functional than the flexibility and contextuality offered by the more sophisticated new governance approach. In other words, we need to take into account both theory *and* realistic prospects for effective implementation when deciding how to structure particular regulatory provisions.

We may also want to consider the role that particular regulatory requirements play in overall system stability and efficiency. Rules around capital requirements, like much of prudential regulation, are so fundamental to effective functioning of the system that they should not necessarily be subject to contestation, innovation, and potential "creep" through collaborative regulatory practice. The analogy in democratic theory would be to participation rights, seen by some to be so fundamental to deliberation that they should not themselves be subject to the risk of erosion in the process of that deliberative exercise.[148]

polarization, referred to as "choice shift" in more recent academic work, though in this case the narrower term "risky shift" applies.

146. *See* Nakamoto & Wighton, *supra* note 123 (statement of Charles Prince) ("As long as the music is playing, you've got to get up and dance.").

147. Coffee & Sale, *supra* note 68, at 742, 782 (claiming that Basel II criteria generated a "very sophisticated tool that was beyond the capacity of the SEC's largely legal staff to administer effectively" and that simple, suboptimal might be capable of implementation while "a more optimal rule (in terms of its theoretical design) may not be").

148. *See, e.g.*, Scott & Sturm, *supra* note 121, at 567. Strong safeguards for participation rights, being fundamental to the new governance deliberative process, need to be distinguished from providing guarantees to particular substantive outcomes, like the "right of return" proposed in Alexander, *supra* note 141. There is an analogous debate in new governance scholarship about the degree of "hard law" background measures needed (or assumed to exist) to safeguard participatory rights or address power disparities. *See, e.g.*, Amy Cohen, *Negotiation, Meet New Governance: Interests, Skills, and Selves*, 33

Returning to Basel II and the CSE Program, capital requirements are a concrete example in which firms that were forced to observe more rigid, rule-based requirements weathered the acute phase of the fall 2008 credit crisis better.[149] In Canada, for example, capital requirements for financial institutions were comparatively high, and tended even to be exceeded by the actual practice of Canadian banks.[150] Asset-to-capital ratios were capped at a comparatively low level.[151] Canadian financial institutions' overall success in weathering the GFC has been often attributed to these regulatory restrictions.[152] Another example of prophylactic provisions might be provisional contract term standardization. Especially with respect to derivative contracts, standardization can help cabin complexity, make innovation subject to a degree of price discovery and oversight, and make derivatives easier to regulate.[153]

We should be careful not to overstate the lesson here. The fact that systems with rigid, mandatory capital requirements performed better during the financial crisis does not mean that such capital requirements will necessarily be better than any more flexible alternative, or that we can generalize from capital requirements to other areas of financial regulation. We did not learn that rigid capital requirements are better than any mechanism we could possibly imagine. They may not even be better than the CSE Program might have been, had it been buttressed by

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LAW & SOC. INQUIRY 503, 543 n.47 (2008). Even assuming that capital requirements and other prudential measures are fundamental to financial markets' operation, a range of reasonable opinion could exist as to the optimal degree of flexibility for what I still maintain need to be *prophylactic* standards around them.

149. Andrea Beltratti & Rene Stulz, *Why Did Some Banks Perform Better During the Credit Crisis?: A Cross Country Study of the Impact of Governance and Regulation* (Fisher College of Business, Working Paper No. 2009-03-012, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1433502 (finding that banks in countries with stricter capital requirement regulations and with more independent supervisors performed better in the July 2007 to December 2008 period).

150. *See, e.g.*, Kevin G. Lynch, Clerk of the Privy Council, Secretary to the Cabinet and Head of the Public Service to the Hertie School of Governance, Remarks in Berlin, Germany: Public Policy Making in a Crisis: A Canadian Perspective (May 7, 2009).

151. *Id.*

152. *But see* Lev Ratnovski & Rocco Huang, *Why Are Canadian Banks More Resilient?* (IMF Working Paper, WP/09/152, 2009), *available at* https://www.imf.org/external/pubs/ft/wp/2009/wp09152.pdf (identifying the "key determinant" of Canadian banks' success as having a larger base of insured retail depositors). Other factors include steadier housing prices, a more unified regulatory structure, and the fact that mortgage lenders in Canada tend to hold the mortgages they extend. *See* Lynch, *supra* note 150; Ratnovski & Huang, *supra*, at 16–18; Fareed Zakaria, Worthwhile Canadian Initiative, NEWSWEEK, Feb. 16, 2009, at 31.

153. *See supra* note 67 and accompanying text.

adequate regulatory capacity. Rigid requirements impose significant costs, as well. What we learned is that rigid capital requirements worked better than the flawed and basically unaccountable capital adequacy system that was in place under, for example, the SEC's CSE Program.

It is helpful to see our current struggles with complexity as epistemological ones.[154] Complexity is worrisome right now in part because, like the frozen credit markets in fall 2008, we do not know what we do not know. In time, based on greater understanding, we may be able to develop a more sophisticated approach to complexity, with more and different safeguards in place, which does not seem to force us to choose so starkly between flexibility and systemic stability. In other words, tools like bright line capital requirements should be cast as prophylactic, not permanent, rules. Prophylactic rules are clear and generally overdrawn requirements, like the *Miranda* rights-reading requirement on police in the United States, which serve as placeholders to protect an important interest until and unless a better, more tailored method for achieving the same end can be implemented.[155] A "better" approach to capital requirements would have to improve flexibility and congruence, but not at the expense of the transparency, accountability, and ease of application that rigid requirements provide in this crucial aspect of financial markets regulation.[156]

Prophylactic rules are helpful in keeping essential systems functioning and in conserving regulatory resources. However, under

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154. Jeffrey M. Lipshaw, *The Epistemology of the Financial Crisis: Complexity, Causation, Law, and Judgment* (Suffolk Univ. Law Sch., Legal Studies Research Paper No. 09–30, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1421837.

155. The term derives from American constitutional law theory, and is controversial in that context. *Miranda v. Arizona*, 384 U.S. 436 (1966) (holding that certain warnings must be given before a suspect's statement made during custodial interrogation could be admitted in evidence). The case invited legislative action to protect the constitutional right against coerced self-incrimination, but stated that any legislative alternative must be "at least as effective in appraising accused persons of their right of silence and in assuring a continuous opportunity to exercise it." *Id.* at 467. The Miranda warning requirement was upheld in *Dickerson v. United States*, but its prophylactic nature was severely narrowed and the warning requirement was constitutionalized. 530 U.S. 428 (2000). For a new governance perspective on prophylactic rules, see Dorf & Sabel, *supra* note 7, at 452–59.

156. In *Dickerson*, arguments about costs and workability for law enforcement personnel were made successfully in support of upholding the *Miranda* warning requirements, notwithstanding the "undeniabl[e] instances in which the exclusionary rule of Miranda imposes costs on the truth-seeking function of a trial, by depriving the trier of fact of 'what concededly is relevant evidence.'" Brief for the United States, at I, *Dickerson v. United States*, 530 U.S. 428 (2000) (No. 99-5525), *available at* http://www.justice.gov/osg/briefs/1999/0responses/99-5525.resp.html; *Dickerson*, 530 U.S. at 442.

conditions of underlying factual uncertainty, rigid rules cannot resolve that uncertainty. They will paper over uncertainty, forcing difficult interpretations underground—or alternatively forcing rule revisions through legislative processes that are far too cumbersome to be serviceable in "live," fast-moving systems. New governance style regulation is a more promising long term response to extreme complexity and consequent uncertainty, because it is about designing problem-solving architecture that can respond directly to situations where neither the precise goal nor the means for achieving it can be determined in advance. This is the kind of environment in which it makes sense to enlist the context-specific knowledge of a broad band of stakeholders in a collective, comparative, learning-by-doing regulatory project, while not being naïve about the impact of self-interest and power.

IV. PUTTING PEOPLE AT THE CENTER OF REGULATORY DESIGN

In a recent work, "Optimization and its Discontents," Bill Simon discussed the connection between new governance thought and recent failures in banking regulation.[157] As this Article also tries to point out, both are, inter alia, systems that draw on local level knowledge and implementation, aggregate it through a regulator, and operate from best practices in industry rather than through command-and-control regulation. In his paper, Simon draws a useful distinction between what he calls the "vulgar optimization" underpinning the failure of Basel II initiatives, and "designing for reliability" as new governance is meant to do.[158] Ultimately, Simon argues that Basel II, if it can indeed be seen as having failed—something he does not automatically concede[159]—failed as a result of unenlightened implementation.

Simon describes vulgar optimization on the part of industry actors as being marked by reductionist analytical methods around risk that missed weak signals, normalized the unexpected, and were not structured to systematically learn from experience.[160] In the run-up to the GFC, vulgar optimization caused financial regulators to miss the dynamic, self-reinforcing nature of "systemic risk" in a deregulatory environment, especially "liquidity risk," "network externalities", and the effect of

157. William H. Simon, *Optimization and its Discontents in Regulatory Design: Bank Regulation as an Example* 3 (Columbia Pub. Law, Research Paper No. 10-224, 2010), *available at* http://ssrn.com/abstract=1533446 (noting that "some of the most prominent pre-crisis regulatory initiatives, especially those associated with 'Basel II' . . . have a strong 'new governance' and reliability flavor").

158. *See generally id.*

159. *Id.* at 3, 22–23.

160. *Id.* at 4–6, 20–23.

procyclical regulatory requirements.[161] It also caused them to mischaracterize Knightian uncertainty (the "unknown unknowns") for Knightian risk (the quantifiable "known unknowns").[162]

Simon contrasts this approach with one based on "designing for reliability," as new governance does.[163] Designing for reliability folds in prior experience with near misses, and employs root cause analysis and deliberative processes to solve problems. Simon argues that what we are seeing, in post-GFC reform proposals, is a turn to a more "dynamic perspective" that is more consistent with a real new governance approach.[164] For example, regulators are proposing mechanisms designed to ensure continuous self-assessment, as with iterative, multi-round stress tests; continuously shifting countercyclical capital reserve requirements; and continuous validation of risk assessment models. Embedded into the validation process is an appreciation of the importance of "complex judgment," meaning professional human due diligence and not just risk modeling; a more nuanced understanding of risk; more collaborative or deliberative decision-making around a broader set of regulatory norms; and more emphasis on and careful implementation of diagnostic and comparative analysis (such as outlier analysis and benchmarking).[165]

All of this seems correct. Simon's analysis illustrates the sweeping cognitive and methodological failures that underlay the failed implementation of decentralized initiatives like Basel II and the CSE Program. We should note, however, the reassertion of the need to design methods for better *rational analysis* and deliberation, as a response to reductionism and vulgar optimization. While I share these convictions and cannot propose a better system than a new governance one based on learning-by-doing, transparency, and the examination of root causes, what recent experience in the financial markets teaches us is that we should not underestimate the agency and energy required to make new governance happen. Recognizing the large risks inherent in trying to paint with a brush as broad as this one, I nevertheless draw three lessons from recent experience in financial regulation.

First, new governance methods may simply not be feasible in some contexts. In retrospect, the amount of energy required to move people off their short term incentives turns out to be substantially more than was put into the monitorship or CSE Program initiatives. In fact, it may even be more than is politically palatable in some situations. It may not be possible in all environments, given existing incentives and available

161. *Id.* at 15–20.
162. *Id.* at 20–21.
163. *Id.* at 6–12, 22–28.
164. *Id.* at 24–26.
165. *Id.* at 26–28.

resources, to create and maintain meaningful and not just cosmetic new governance initiatives. In other words, we need to consider that new governance will not work everywhere. Where no one who is in a position to influence the situation is prepared to build in accountability and capacity, there will not be any, and that may happen unpleasantly often.

Second, the development of active contestation and deliberation within new governance structures cannot be presumed. It must be fostered, ensured, and protected. Reason-giving, problem identification, and careful problem-solving techniques tend to collapse when everyone's interests are aligned—during bubble times, for example, but also where players' pre-existing incentives (combined with insufficient attention to real destabilization) mean that cosmetic compliance is probably what those players are ultimately prepared to settle for. One response to this is to build in real diversity and internal contestation, and to take silence not as consent but as an alarm bell. It may require much more serious attention to ensuring that a full range of perspectives, including perspectives unpopular with traditional "insiders," are at the table.

Greater diversity in perspectives should perhaps have been introduced in the monitorship situation, but the point is broader than that. Understanding how to structure in active contestation and deliberation may ultimately call for a richer description of the relationships between capital markets actors and the other crucial social, institutional, and historical milieus in which they are embedded—to understand which actors might "keep their heads" and how to ensure their participation to that end. In multiple and intricately connected ways, firm and industry and broader culture can affect the degree to which parties are capable of acting independently in the face of competitive pressures and behavioral cascades. Goldman Sachs famously managed to avoid some of the worst excesses in mortgage-backed securities, arguably as a result of its culture of "contrary thinking" relative to the rest of its industry.[166] Internal diversity may also influence a firm's stance toward risk-taking, as Michael Lewis's analysis of Icelandic banks and culture,[167] and studies of the influence of gender in the financial services industry,[168] suggest. Enforced self-regulation also stands the best chance of success when industry actors genuinely care about their broader reputations, something

166. *See, e.g.*, Jenny Anderson & Landon Thomas Jr., *Goldman Sachs Rakes In Profit in Credit Crisis*, N.Y. TIMES, Nov. 19, 2007, at A1.

167. Michael Lewis, *Wall Street on the Tundra*, VANITY FAIR, Apr. 2009, at 140, *available at* http://www.vanityfair.com/politics/features/2009/04/iceland200904.

168. LINDA MCDOWELL, CAPITAL CULTURE: GENDER AT WORK IN THE CITY (1997); Paola Sapienza et al., *Gender Differences in Financial Risk Aversion and Career Choices are Affected by Testosterone*, 106 PROC. NAT'L ACAD. SCI. 15268 (2009), *available at* http://www.pnas.org/content/106/36/15268.full.pdf+html?sid= a5f6e12c-e595-4b48-b407-c1cbb78db59b.

that requires commitments and allegiances beyond one's own firm and industry.[169]

All of this should lead us to wonder whether institutions that draw on a broader range of perspectives may be better able to maintain some cognitive distance from group pathologies, to their own advantage and to the advantage of a new governance regulatory approach. This suggests that conscious thought needs to be given to how the various pieces of a new governance regulatory approach will function together—where each actor's strengths and vulnerabilities lie, who is and is not participating in the interpretive community, and what is required to build checks and balances into the system's functioning.[170] The ultimate question has to be who in that environment seems to have sufficient confidence and independence of mind (however obtained) to operate independently, how to maintain that independence, and how to actively keep the process destabilizing and challenging.

Third, uncertainty may not be the great friend of new governance. Knightian uncertainty is a serious problem for which new governance does not necessarily offer a silver bullet, even though it is a promising response over the long haul. Knightian uncertainty is a breeding ground for pathologies in decision making and human conduct. It can be, but is not necessarily, a hoped-for opportunity for out-of-the-box thinking, surprising collaborations, and unanticipated progress we might hope for. There may be situations in which the disadvantages of fluid processes (in terms of increased complexity, decreased transparency and knowability, and reduced regulatory capacity to provide meaningful oversight) are very significant. We may want to consider the need for clear, prophylactic rules around areas where fundamental systemic requirements are involved and/or regulatory mechanisms can otherwise become unwieldy—not because rigid, command-and-control style rules are anything like an ideal solution, but because they may help to at least temporarily bracket some areas of uncertainty, and allow bounded human regulators to be more strategic about where new governance methods can be most effectively implemented. Real life regulatory systems do this all

169. Edward J. Balleisen & Marc Eisner, *The Promise and Pitfalls of Co-Regulation: How Governments Can Draw on Private Governance for Public Purpose*, *in* NEW PERSPECTIVES ON REGULATION 127 (David Moss & John Cisternino eds., 2009) (describing the other prerequisites to effective co-regulation to be the relevance of flexibility in regulatory detail; the existence of sufficient bureaucratic capacity and autonomy on the part of nongovernmental regulators; the degree of transparency in the regulatory process; and the seriousness of accountability).

170. For an example that assesses American institutions along these lines, see Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549 (2002).

the time, of course, but the time may be ripe for new governance scholars as well to incorporate attention to real life constraints into their thinking.

None of this is out of line with familiar new governance thought, but there is a tendency to focus on the success stories as conclusive evidence that new governance can be very effective. Where experiments fail, the simple answer is that those implementing it did not do it correctly. The fact that similar failures occur in a variety of environments, and that one could even perhaps attribute those failures to predictable shortcomings, should provoke us to build in safeguards for those failures—even if we cannot identify safeguards that work ideally and integrally with new governance at the theoretical level. In this, we should not allow the perfect (in the form of perfectly free, broadly participatory, dialogic and reflective problem-solving) to be the enemy of the good (in the sense of creating systems with as much of these elements as possible, while remaining clear-eyed about human capacity).

We need to consider the risk that the phenomena described above will replicate themselves in the interstices of many new governance processes, including those outside financial regulation. A clear view of human nature needs to be at the core of the new governance model because within fluid space, it will drive process and outcomes. Understanding how people and their institutions operate, individually and in groups, requires us to build in compensatory responses in regulatory design in the same way that we would design for other predictable flaws.