

AN EVALUATION OF THE THEORIES AND OBJECTIVES OF FINANCIAL REGULATION POST THE 2007-2009 FINANCIAL CRISIS: A EUROPEAN PERSPECTIVE

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1. Introduction

The financial crisis, which was unprecedented in its scope, brought to the brink of collapse the world financial system and contributed to a sharp decline in economic output and employment around the globe.¹ Like every historical event, the crisis came about as a consequence of the combination of different factors. An economic policy of low interest rates in the United States (hereinafter 'US') during most of the twenty first century, had been driven by economic conditions that were created by the bursting of the stock market bubble in the 1990s, encouraged the leveraging of portfolios, thereby increasing the level of liquidity in the economy and in financial markets.² This, coupled with a general perception that prices in the housing markets will always be on the increase, encouraged the taking of disproportionate loans for investment in the property market which generated a property price speculative bubble.³ In part, it was also caused by new trends in the financial sector such as the application of the 'originate to distribute model'⁴ in bank lending, which involves the origination of loans for the

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¹ K R French and others, *The Squam Lake Report – Fixing the financial system* (Princeton University Press 2010) 1.

² C A E Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar Publishing Limited 2009) 10.

³ R J Shiller, *The Subprime Solution: How today's global financial crisis happened and what to do about it* (Princeton University Press 2008) – Chapters 3 and 4 provide a detailed explanation of property bubble in the USA.

⁴ For a detailed examination of the originate to distribute model, refer to R H Weber & A Darbellay, 'The regulatory use of credit ratings in bank capital requirement regulation' (2008) *Journal of Banking Regulation*.

purpose of repackaging into a structured financial instrument through securitisation and consequently the redistribution of the credit risk exposure to the loans.⁵

A remuneration model in the financial sector which encouraged the taking of excessive risk to maximise short term profits and the knowledge that in the end this risk would have been transferred to a third party, were catalysts for mortgage providers to lower their credit underwriting standards and target higher risk market segments such as sub-prime mortgages to issue loans for securitisation and redistribution.⁶ Irresponsible remuneration incentives coupled with faulty risk management models and a general reliance on credit ratings to calculate credit risk⁷ encouraged: **[i]** the issuing of high credit ratings for these structured finance instruments based on sub-prime loans;⁸ **[ii]** the issuing by insurance companies of credit default insurance to cover the default of these financial instruments, and **[iii]** the wide investment in structured financial instruments by financial institutions around the globe without adequate internal risk management assessment of their real credit worth.⁹

In the end, the property price bubble burst and in 2007 the US experienced a substantial increase in delinquency and foreclosure for sub-prime loans that created uncertainty and turmoil in the market for structured finance instruments which were backed by these loans.¹⁰ This led to severe financial losses for US and European financial institutions which had exposure to these structured finance instruments. As a consequence of the interconnectedness and interdependence of financial institutions, severe systemic instability was generated by a general reduction of mutual trust between financial institutions and by the drying up of the inter-bank liquidity markets.¹¹ What had started as a liquidity crisis turned into a financial market emergency and finally into a general systemic crisis.¹² The world experienced a series of financial failures which culminated with the collapse of Lehman Brothers at the end of the third quarter of 2008, after which there was the worldwide fear of a possible breakdown of the entire financial system. The functioning of the financial system

⁵ D Chorafas, *Financial Boom and Gloom: The Credit and Banking Crisis of 2007 - 2009 and Beyond* (Palgrave Macmillan 2009) 133.

⁶ G I Clementi and others, 'Rethinking compensation in financial firms', Ch 8 in V V Acharya and M Richardson, *Restoring Financial Stability: How to repair a failed system* (John Wiley and Sons 2009).

⁷ In this article the term 'financial institution' has been used in its most general sense to refer to all types of financial services providers that are subject to financial regulation and supervision including credit institutions, investment firms and collective investment schemes.

⁸ L J White, 'The Credit Rating Agencies: Understanding Their Central Role in the Subprime Debacle of 2007-2008' (2009) *Critical Review* <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1434483> accessed February 2010.

⁹ Clementi and others (n 6).

¹⁰ Shiller (n 3).

¹¹ V V Acharya and others, 'A Bird's-Eye View: The Financial Crisis of 2007-2009: Causes and Remedies, Chapter 8 in V V Acharya and M Richardson, *Restoring Financial Stability: How to repair a failed system* (John Wiley and Sons 2009).

¹² Acharya and others (n 11).

became possible only after extensive public rescues of systemically relevant financial institutions,¹³ which allowed the stabilisation of the financial system so that financial institutions could once more support economic growth.

The financial crisis also brought into sharp focus the shortcomings of the model for financial regulation¹⁴ and mechanisms for financial supervision,¹⁵ which at the time were in force at international, regional, and national level. These had failed to predict the risks and consequently, did not identify and successfully mitigate the crisis. The financial crisis triggered a comprehensive rethinking of the scope of financial regulation and a broad policy response in favour of a wider and more intrusive financial regulation and supervision. Various regulatory initiatives have been proposed, some of which have been adopted or are in the process of being adopted in order to address the ambiguities of financial regulation and the inefficiencies of financial supervision. While the reforms are mainly aimed at mitigating systemic risk, other financial market failures are being addressed, such as the lack of investor protection and governance issues arising from conflicts of interest and market integrity, such as market abuse.

In the European Union (hereinafter 'EU'), the policy response to the financial crisis has been led by the seminal De Larosiere Report, which identified the weaknesses of financial regulation and supervision and made recommendations for the strengthening of the financial system. These recommendations have been endorsed and are being implemented by the European Institutions.¹⁶ In the US, the regulatory changes were adopted in the widely debated Dodd-Frank Wall Street Reform and Consumer Protection Act.¹⁷ The measures taken in Europe and the US have generated an extensive academic, political, and public debate on the objective and scope of financial regulation and the remit for financial supervisors. In the midst of this subject one finds the theories and objectives of financial regulation. To comprehend fully the forces that drive financial regulation, it is essential to understand the theoretical framework that accounts for the origins of and the rationale for regulation, and a proper knowledge of the objectives which the regulation of financial services aims to achieve.

¹³ In this article the term 'systemically relevant financial institutions' may be defined as those institutions that are large in scale and have complex interconnections with other financial institutions and that consequently the failure of which would pose a large threat to the stability or confidence in financial markets.

¹⁴ Financial regulation is construed as referring to the employment of legal instruments for the implementation of social-economic policy objectives in the field of financial services.

¹⁵ Supervision of financial services denotes the sustained and focused control exercised by an administrative regulatory agency over the activities of providers of financial services.

¹⁶ Jacques De Larosiere, 'The High-Level Group on Financial Supervision in the EU – Report' (25 February 2011) <http://ec.europa.eu/internal_market/finances/committees/index_en.htm> accessed August 2011.

¹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act: An act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.

The aim of this paper is to make some preliminary comments on the continued validity of the theories and objectives of financial regulation in the light of the financial crisis and the post-crisis policy response, mainly by reference to the European scenario. The main contention of this paper is two-fold. Firstly, the post-crisis policy response may be explained as a combination of factors that surface from the theories of regulation. Secondly, the causes of the financial crisis and the subsequent regulatory measures which have been proposed sustain the continued validity of the objectives of financial regulation. It is also argued that regulatory and supervisory action to realise a specific objective of financial regulation could, at times, generate tensions with and weaken the realisation of other regulatory and economic objectives. The paper also demonstrates the difficulties that could surface in finding the right balance between achieving the objectives of financial regulation, while avoiding instances of over-regulation by respecting the principles of proportionality, subsidiarity, and the fundamental rights of members of society.

The rest of this paper is divided into three other sections. The next section examines the public and private interest theories of regulation and concludes by highlighting their validity in understanding the rationale behind the policy response to the financial crisis. The third section evaluates the objectives of financial regulation in the light of the causes which brought about the financial crisis and the regulatory tools devised by policy makers in order to create order within the financial system. This section concludes that the financial crisis has strengthened the case for regulation to safeguard systemic stability; to protect the investor; and to ensure that financial markets are fair, efficient and transparent. The final section makes some additional concluding remarks.

2. Theories of Regulation

The development of market economies has been conditioned by the ideas of two main schools of thought, whose views are reflected in two systems of economic organisation,¹⁸ that is the market system and the collectivist system.

The market system, which is to a large extent based on the capitalist ideology, is characterised by market freedom, where individuals and in particular the industry, are subject to very simple controls and are otherwise uninhibited from pursuing their own welfare objectives.¹⁹ In a market system, the economy is supported by the legal order, particularly through instruments of private law²⁰ which have a facilitative function by offering a set of official arrangements through which the relationship between individuals is regulated and as a consequence of which they can conduct their activities and carry out their business. Consequences of a private law nature relate to, for example, the nullity of a contract and right to compensation or restitution. Private law is distinct from public law. The latter regulates the relationship between the general

¹⁸ An economic system is composed of all the institutional means through which national resources are used to satisfy human wants.

¹⁹ A Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing, 2004) 1.

²⁰ As Ogus explains, private law is predominantly facilitative in character. Its foundational concepts are property, enabling society's resources to be exploited and enjoyed by individuals, and contract, which gives security to the process required for those resources to be directed to their most valuable uses.

public and the State. Claims of a private law nature are usually brought before the civil courts, whereas public law, in the form of administrative regulatory requirements, is enforced by administrative regulatory agencies such as competent authorities responsible for financial supervision.

Private law is the means through which market failures can be addressed in a market system. State intervention through public law and the supervision of the market by an administrative regulatory agency, have only a minimal role to play, if any.

According to the collectivist system, private law is not enough to address all instances and forms of possible market failure. Therefore, public law and state intervention are deemed necessary to rectify the perceived imperfections of the market system in achieving the collective public interest. The State intervenes in order to promote behaviour that, in the absence of regulatory intervention, is believed to occur.²¹ State regulation is therefore generally identified with the collectivist system.

There are divergent views as to the reasons why regulation materialised, which actors contributed to its formation, and the patterns of interaction between such actors. Two broad categories of theories of regulation can be identified: the 'public interest' or 'helping hand' theories of regulation, and the 'private interest' or 'capture' theories of regulation.

The public interest theories explain regulation as a result of the public's demand for the rectification of the possible failure of some of the assumptions of the market system.²² These theories attribute to those who are responsible for the creation and application of regulation an aspiration to engage in communal goals, with the purpose of furthering the general welfare of the community.²³ An implied conclusion of the public interest theories is that regulation is mainly intended to defend the interests of the general public and thereby attain the common good, that is, the socio-economic well-being of society as a whole.²⁴ Public interest theorists perceive economic markets as extremely fragile and prone to operate very inefficiently (or inequitably) if left alone.²⁵ These theorists account for regulation as a means to achieve the best allocation of scarce resources for individual and collective benefit.²⁶ Regulation takes the form of an indispensable application of communal power through government, with the purpose of overcoming possible failures of the assumptions of the market system. Regulation is

²¹ Ogus (n 19) 2.

²² R Posner, 'Theories of Economic Regulation' (1974) *The Bell Journal of Economics and Management Science* 335.

²³ B Morgan & K Yeung, *An introduction to law and regulation* (Cambridge University Press, 2007) 17.

²⁴ C Uche, 'The theory of regulation: A review article' (2000) *Journal of Financial Regulation and Compliance* 68.

²⁵ Posner (n 22) 336.

²⁶ J Hertog, 'General Theories of Regulation' (1999) 225 <<http://www.scribd.com/doc/239491/General-Theories-of-Regulation>> accessed August 2011.

thus a means to achieve the common good in circumstances where for instance, the market falls short and fails to generate results.²⁷

Market failures can take various forms. Monopoly is considered as a fundamental market failure since monopolist practices impair competition, which is necessary for market efficiency and the proper allocation of scarce resources.²⁸ Failure to provide an optimum quantity of public goods, the benefit of which is shared by the public as a whole or by some group within it,²⁹ is also considered to be a market failure. Furthermore, the serious failure of the unregulated market to generate optimal information in relation to a particular area of decision making leads to uninformed and inefficient consumer choices.³⁰ In the field of financial regulation the mitigation of information asymmetries is one of the main investor protection objectives. Regulation is instrumental for the correction of market failures and a means to maximise general welfare and society's common economic interests. However, the common good is not defined exclusively in terms of efficient resource use and allocation. The public interest theories of regulation take a broader approach and propose that regulatory intervention by the State is directed towards the socially efficient use of scarce resources. Regulation is therefore necessary for the protection of the vulnerable members of society who, in the absence of regulation, would be subject to social injustice.³¹

The public interest theories of regulation have been formulated by academics with the aim of proposing what governments and administrative regulatory agencies should do and as a means of explaining what they actually do. They have become the cornerstone of the regulatory philosophy's attempt to justify regulation as applied in modern democratic states. Certain features of these theories have been the subject of much criticism.

One major criticism is that the theories are based on the assumption that government regulation is effective and that it can be implemented without cost. However, regulation could at times prove to be unsuccessful in reaching its objective because the administrative regulatory agencies responsible for supervising compliance with regulation are requested to fulfil impossible and sometimes conflicting functions. In attempting to succeed, they distort the efficient functioning of financial markets.³² Furthermore, effective regulation is very costly and is an area where an increase in output leads to a very sharp increase in the cost of production.³³

²⁷ R Baldwin and M Cave, *Understanding Regulation: Theory, Strategy and Practice* (Oxford University Press 1999) 19.

²⁸ Ogus (n 19) 30.

²⁹ Ogus (n 19) 33.

³⁰ Ogus,(n 19) 38.

³¹ A Ogus, 'W(h)ither the economic theory of regulation? What economic theory of regulation?' Chapter 2 in J Jordana and D Levi-Faur, *The Politics of Regulation* (Edward Elgar Publishing Limited 2004) 35.

³² Posner (n 22) 339.

Notwithstanding the criticism, it is reasonable to argue that the rationale behind regulation, as proposed by the public interest theories of regulation, could, even today, contribute a valid academic basis for the comprehension of certain objectives which the regulation of financial services aims to accomplish in practice. Moreover, one may contend that the public interest theories of regulation provoked an examination of whether it was viable to explain the ultimate rationale behind regulatory policy decisions and have unexpectedly led to the formation of certain private interest theories of regulation.

The private interest theories hold that regulation is a reaction to the demands of interest groups striving to increase the revenues of their members.³⁴ Private interest theorists are generally unconvinced of the so-called 'public interested-ness' of policy-makers and regulators. They contend that regulation could frequently be an instrument which benefits particular interest-groups, and not always those members of society it was allegedly expected to benefit. They argue that regulation which is designed to achieve the common good, in fact serves to protect the interests of the industry.³⁵ These theories are based on the assumption that as a consequence of the high-stakes and the interests in the outcome of policy or regulatory decisions, interest groups affected by regulation will focus their resources and energies to promote the policy outcomes they prefer. As a result of the influence of interest groups the positive aims of regulation are weakened and regulatory efficiency is compromised; the advantages of regulatory reform end up being distributed unequally and benefiting those engaged in lobbying the legislators at the cost of society at large.³⁶

The private interest theories hold that the financial industry controls the government institutions of our society including the administrative regulatory agencies that are responsible for supervising the economy.³⁷ Through such control, the industry can influence the regulatory and supervisory process in a manner that is exclusively to its own benefit.

The 'capture theory' argues that regulation is initially made to serve the general public but that by time, given the effort made, interest groups may capture the influence of policy-makers and regulators and gain the decisions which will serve their interests.³⁸ An administrative regulatory agency normally experiences a 'life cycle' in reaction to the political environment.³⁹ Initially such an agency draws the attention of the general

³³ I Ehrlich and R Posner, 'An Economic Analysis of Legal Rule-making' (1974) *Journal of Legal Studies* 260.

³⁴ Posner (n 22) 335.

³⁵ Baldwin and others (n 27) 21.

³⁶ A Estache, and D Martimort, 'Politics, Transaction Costs, and Design of Regulatory Institutions' (1999) *World Bank Policy Research Paper* 10.

³⁷ Posner (n 22) 341.

³⁸ Hertog (n 26) 235.

³⁹ Ogus (n 31) 57.

public and as a consequence acts with dynamism. Eventually, when the focus is shifted to other subjects, public support is reduced and the administrative regulatory agency becomes open to control by those licensed and supervised by the same agency. Therefore, regulatory capture, as explained by political scientists, occurs at the stage when the administrative regulatory agency is already an established entity and regulation is being implemented, supervised, and enforced.

Three main levels of regulatory capture may be identified. In the beginning, as a result of the pressure made by the regulated, the administrative regulatory agency allows the regulated to breach applicable regulatory requirements. At a second stage, the administrative regulatory agency assists the regulated to avert the regulatory enforcement after the breach of the law is committed. Finally, the capture becomes so deep that the administrative regulatory agency may even support and guide the regulated to overcome the regulatory regime before a breach of the regulation is committed. Experience suggests that the more a jurisdiction becomes dependent on the success and development of its financial system for its overall economic growth, the more the policy makers and administrative regulatory agencies of that jurisdiction become prone to regulatory capture by the financial industry.

The capture theory of financial regulation is not sufficiently distinguished from the public interest theory of regulation, given that both these theories base themselves on the assumption that the public interest is the basis for the initiation of regulation.⁴⁰ It is unclear why and how the regulated are successful in subjecting the administrative regulatory agency to their interests, but fail to prevent the establishment of such an entity by policy-makers. A more remarkable and refined adaptation of the private interest theory of regulation originates from economic theorists, and in particular from the Chicago School of Law and Economics. This adaptation of the private interest theory is generally referred to as the 'economic theory' of regulation and is based on the economic assumption that members of society press forward their self-interest and do so in a rational manner. Regulation is thus explained as the outcome of the forces of demand and supply, while the creation and the type of regulation may be expected as a reaction by politicians to the requests of interest groups which could profit from the measure.⁴¹

The democratic political system where politicians are subject to re-election and which depends on various variables, including the pursuing of very costly election campaigns, provides the industry with an opportunity to exercise political influence. Politicians who aim to be re-elected may be inclined to honour the demands from the industry for certain types of regulation in exchange for political support which can come in various forms including campaign contributions.⁴² The central proposition of the economic

⁴⁰ Hertog (n 26) 235.

⁴¹ Ogus (n 31) 71.

⁴² By way of example, refer to: Consumer Watchdog, 'Financial Sector Investments in Congress and the Senate Banking Committee' (U.S. 3 February 2010) <<http://www.consumerwatchdog.org/newsrelease/report-shows-financial-industry-gave-41-million-senate-banking-committee-spent-336-milli>> accessed March 2012. The report indicates that in the U.S., Members of the House and Senate receive significant campaign contributions from Wall Street. During the period when the U.S. was discussing financial reform, Wall Street contributions to House and Senate

theory of regulation is that, in the main, regulation operates so as to benefit interest groups not society, and the political system will function in such a manner to ensure that this will happen.⁴³ Financial regulation may therefore become a means to curtail competition through the introduction of excessive regulatory burdens which may only be complied with by big players within the market. The economic theory of regulation has however been criticised on various counts including the fact that this theory is based on the assumptions that interest groups control the result of elections and that policy-makers stick to the requests of such groups. These assumptions are challenged on the basis that they simplify the rather complex world of politics and in particular do not fully account for the outcome of the motivation, behaviour and interaction between other political actors such as individual voters, government workers and agencies.

The theories of regulation considered above, attempt to explain what can be referred to as the underlying philosophical rationale for regulation, including the regulation of financial services. Both the public and private interest theories have been heavily criticised and cannot individually be considered as being a conclusive explanation for the regulatory policy response that followed the financial crisis. The public interest theories of regulation, which explain regulation as a means to achieve the general wellbeing of society, may be considered as excessively naive. On the other hand, the private interest theories, which relate the regulatory process totally to individual interests, is exceptionally cynical. Positive elements exist in the contribution of industry lobbyists to the regulatory process. Practical experience teaches that their input may be beneficial to this process as legislators do not always have complete knowledge and appropriate expertise in the sector which is the subject of a proposal and may therefore not fully understand the implications of the same.

Industry lobby groups share their expertise in the field with legislators, which should, *ceteris paribus*, allow for a more informed decision to be made. It is considered best practice in Western democracies for legislators to formally consult the industry about draft regulatory measures, in order to give those who fall within the scope of the planned legislation the opportunity to express their views on the proposal. On the other hand, it has been objected that the financial industry lobbyists have extensive privileged

candidates were heavily concentrated on members of the relevant banking, commerce, and tax committees responsible for industry regulation. The report states that Sen. Christopher Dodd, Chairman of the Senate Banking committee, has been the top recipient of industry money, and took \$9,000,975 from the financial sector since 2005. Ranking Member Richard Shelby took \$2,461,009. Shelby has opposed an independent consumer protection regulator. Also refer to N Mathiason and others, 'Tory Party funding from City doubles under Cameron' (The Bureau of Investigative Journalism 8 February 2011) < <http://www.thebureauinvestigates.com/2011/02/08/city-financing-of-the-conservative-party-doubles-under-cameron/>> accessed March 2012. The article quotes research which suggests that the main source of U.K. Conservative Party financing comes from the City. It quotes Dr Stuart Wilks-Heeg (University of Liverpool) as stating the following 'The findings raise issues about how influenced and impartial the Conservatives are as they set about reforming and regulating the banking industry. It is admittedly difficult to prove that because parties access money from specific sources that there is a feed through into the policies they adopt. Yet, given we have just experienced a blowout in the financial system, and are witnessing an ongoing struggle over its regulation, the scale of Conservative Party funding from the City must be an issue – not least for a party committed to 'taking big money out of politics'.

⁴³ D Gowland, *The Regulation of Financial Markets in the 1990s* (Edward Elgar Publishing Limited 1990) 39.

access to policy makers and undue influence on the legislative process in Western democracies.⁴⁴ A case in point is the tremendous pressure exerted by the financial industry lobby groups on legislators in Brussels with regard to various aspects of the regulatory reform which has been proposed to address the causes of failures of the financial crisis.⁴⁵ As evidenced by the recent 'cash for laws' scandal, at times, the industry lobby may resort to unethical and immoral means to attain its goals.⁴⁶

In practice, basing oneself on the policy response post the financial crisis, it is reasonable to conclude that financial regulation is the result of a combination of factors propounded by the theories of regulation. A regulatory process in the financial field, such as that undertaken in the aftermath of the financial crisis, is generally aimed at achieving a policy initiative which addresses threats to the well-being of the financial system, thus benefitting the interests of society as a whole. However, as the pressure exerted on Brussels by the financial industry goes to prove, this process is more often than not influenced and possibly at times redirected by the financial industry lobby groups. By various means such lobbyists aim to satisfy the benefits of the interest groups they represent.

In the final analysis, the outcome of a process which gives rise to financial regulation is the result of a trade-off between implementing a policy designed to attain the common good through substantive law which is strictly aimed at meeting the high-level objectives of financial regulation, and making exceptions to address the points of interest raised by the industry. The latter are attended to, given the expertise of the industry in the field of the proposed regulatory measure, the susceptibility to capture of public institutions by private interests, and the individual utility-maximisation behaviour of policy-makers.

⁴⁴ SpinWatch, 'Doing God's Work: How Goldman Sachs Rigs the Game' March 2011 <<http://www.spinwatch.org/-articles-by-category-mainmenu-8/48-lobbying/5426-the-power-of-financial-lobbyists-must-be-curtailed>> accessed September 2011.

⁴⁵ By way of example, refer to: J Machintosh, 'Hedge funds move to limit rules burden' *Financial Times* (London 18 January 2009); B Wall and J Machintosh, 'France to call or Hedge Fund Crackdown' *Financial Times* (London 12 February 2009); J Plender, 'Re-regulation will fail to curb Bankers' worst excesses' *Financial Times* (London 27 May 2009); N Tait 'MEPs pledge to alter hedge fund proposal' *Financial Times* (London 2 September 2009); 'Fonds Alternatif: Un nouveau conflit bloque le vot du parlement' (Euroactive, 11 May 2010) <http://www.euractiv.fr/economie-finance/article/2010/05/12/hedge-funds-nouveau-conflit-bloque-vote-parlement_67624> accessed September 2012; 'EU moves to tighten control of Hedge Funds' *The Wall Street Journal* (19 May 2010); M J Rasmussen, Lobbying the European Parliament: A necessary evil (CEPS Policy Brief No 242, May 2011) <<http://www.ceps.be/book/lobbying-european-parliament-necessary-evil>> accessed August 2011, see also A Admati and M Hellwig, 'The battle has only just began to regulate the banks' *Financial Times* (London 3 June 2011).

⁴⁶ A Rowell, 'The Power of Financial Lobbyists Must be Curtailed' (SpinWatch, 20 March 2011) <<http://www.spinwatch.org/-articles-by-category-mainmenu-8/48-lobbying/5426-the-power-of-financial-lobbyists-must-be-curtailed>> accessed September 2011. In March 2011 a report by an undercover team from the UK's Sunday Times newspaper alleged that the MEPs had accepted offers of cash in exchange for influencing laws. As reported in the Sunday Times, four members of the European Parliament accepted a bribe from journalists, pretending to be lobbyists, in return for the watering down of a proposal for the reform of financial regulation.

3. Objectives of Financial Regulation

The debate on what should be the high-level objectives of financial regulation has ranged far and wide. It is generally accepted that financial regulation is an instrument of economic policy. As such, the objectives of financial regulation are a function of, and are determined by, economic policy objectives.⁴⁷ Economic policy is generally aimed at achieving economic stability and growth. Financial regulation has been found to have a significant influence on the output and productivity growth within an economy.⁴⁸ On the other hand, financial market failures, especially those of a systemic nature, could have grave consequences on a country's economic stability and its potential for growth. Financial market failures also have an impact on the confidence which the investing public has in a financial system.⁴⁹ Public confidence in a financial system is fundamental for the system to be able to function properly and continue to exist.⁵⁰ Therefore from an economic policy perspective, the main aim of financial regulation should be that of safeguarding economic integrity and building public confidence in the financial system. Apart from the economic policy aspect, it has been held that financial regulation also has a role to play in achieving consumer policy objectives and in curbing financial crime. It is widely acknowledged that financial regulation should also endeavour to protect the vulnerable users of the financial system from possible market misconduct or the fraudulent conduct of business by financial institutions.⁵¹

Policy makers have established three high-level objectives of financial regulation. The first objective is that of safeguarding the stability of the financial system, its safety, and soundness. This is primarily achieved by ensuring that financial institutions have adequate capital and that the financial system is properly monitored. The second objective is that of providing an optimum level of investor protection from exploitation and from the hazards caused by financial market failures. In this sense financial institutions are required to act in the best interest of their clients and the market at large, and are monitored to make sure they do so. The final objective of financial regulation is that of preserving the integrity of financial markets from market malpractice, such as market abuse and money laundering.⁵² These are the three core objectives of financial regulation upon which common regulatory and supervisory structures and procedures may be set-up on an international dimension.⁵³

⁴⁷ Gowland (n 43) 39.

⁴⁸ A De Serres and others, 'Regulation of Financial Systems and Economic Growth' (Organisation for Economic Co-operation and Development, 2007) 32.

⁴⁹ Gowland (n 43) 49.

⁵⁰ E Wymeersch, 'The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors' (2008) *European Business Law Review*.

⁵¹ Gowland (n 43) 49.

⁵² International Organisation of Securities Commissions, *Objectives and Principles of Securities Regulation* (IOSCO 2010).

⁵³ R H Weber, 'Multilayered Governance in International Financial Regulation and Supervision' (2010) *Journal of International Economic Law* 683.

From a European perspective, financial regulation strives to create an internal market for financial services. It is argued that the removal of barriers to cross-border financial services enhances economic growth and employment creation, as, *inter alia*, it widens business opportunities for individual financial institutions. It offers financial institutions a better possibility to diversify their business risks and it increases competition within the EU's financial services industry. However, the opening of national borders within the EU to cross-border business makes regulatory failure in one Member State more prone to generate negative repercussions in other Member States. Regulatory failure in one Member State may threaten investor confidence, systemic stability, and market integrity in the Member States which are on the receiving end. Indeed, the failures experienced during the financial crisis resulted in different segments of the European financial system to recede along national lines.⁵⁴ Within this context, the achievement of the three high level objectives of financial regulation within an environment of harmonised regulation and regulatory and supervisory convergence becomes a key tool to generate mutual trust between Member States and the proper operation of the internal market.

In this section of the paper, the argument is made that the financial crisis has demonstrated and sustained the continued validity of the objectives of financial regulation. The point is also made that the attainment of an objective of financial regulation could at times cause tensions with and weaken the realisation of other regulatory and economic objectives. It also demonstrates the difficulties that could surface in finding the right balance between achieving the objectives of financial regulation, while at the same time avoiding instances of over-regulation by respecting the principles of proportionality, subsidiarity and the fundamental rights of members of society.

3.1. Safeguarding Systemic Stability

A stable financial system supplies a favourable business environment for the efficient allocation of resources and by so doing, supports economic growth. An economy cannot function without financial intermediation, as companies would not be able to obtain the necessary liquidity to conduct their business. Therefore, the financial system services the interests of society by transferring extra savings to companies that require capital to invest. However, when left to themselves financial systems are prone to short periods of volatility and contagion.⁵⁵ Financial systems suffer from what is generally referred to as 'systemic risk'. Indeed, the history of the development of financial systems is characterised by various instances of systemic instability, triggered by an unexpected real or likely failure of a systemically relevant financial institution, which eventually results in a fully blown financial crisis. The paths of contagion within the financial system are multifaceted, with the inter-bank market, payment and settlement systems, and financial markets being the most noticeable.⁵⁶

⁵⁴ R D Kelemen, 'Eurolegalism: The Transformation of Law and Regulation in the European Union' (Harvard University Press, 2011) 103; European Commission, 'Staff Working Paper: European Financial Stability and Integration Report 2010', SEC (2011), 8 April, 2011.

⁵⁵ H Davies and D Green, 'Global Financial Regulation: The Essential Guide' (Polity press 2008) 15.

⁵⁶ Weber (n 53).

Systemic risk may be considered from various angles. From a wide perspective it refers to the breakdown of a national or regional or global financial system.⁵⁷ From a narrower point of view, systemic risk may arise due to broad lending mistakes which have an impact on the stability of many financial institutions.⁵⁸ The legal definition of systemic risk is:

a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.⁵⁹

The failure of a financial institution may not, *per se*, necessarily be the cause of a financial disaster. In reality, it is the possible dramatic and sudden structural changes in the equilibrium of the whole financial system that could result from such failure that can generate systemic instability. Systemic risk may be defined as the possibility that the failure of a financial institution may lead to correlated reactions, which ultimately contribute altogether to the breakdown of the entire financial system.

The vulnerability of the financial system as a result of systemic risk is a matter of concern to policy makers⁶⁰ and to those responsible for safeguarding the integrity of the economy.⁶¹ The financial crisis disrupted economic policy to the detriment of society at large. Austerity measures which had to be implemented in order to dedicate funds to the rescue of financial institutions had an impact on the available resources for social policy programmes such as those dedicated to health and education.⁶² In certain

⁵⁷ H S Scott, 'Reducing Systemic Risk through the reform of capital regulation' (2010) *Journal of International Economic Law* 763.

⁵⁸ Scott (n 57).

⁵⁹ Regulation EU No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing the European Systemic Risk Board, art 2.

⁶⁰ For example, in the United States, further to the sub-prime crisis, Congress held hearings on systemic risk and examined Financial supervisors' ability to respond to threats to the financial system – see for example United States House of Representatives, 'Systemic Risk: Examining Regulators' Ability to Respond to Threats to the Financial System: Hearing Before the H. Committee on Financial Services' (2 October, 2007) <http://www.house.gov/apps/list/hearing/financialsvcs_dem/ht1002072.shtml> accessed September 2012. At European level, financial stability has inter alia been extensively discussed by the ECOFIN Council, the European Parliament and the European Commission – see for example European Commission, 'Financial Turmoil: latest development on policy reponse' (Brussels 10 September, 2008) <<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/417&format=PDF&aged=0&language=EN&guiLanguage=en>> accessed September 2012.

⁶¹ The 2007-2008 financial crisis has also generated considerable debate at high-level Committees which bring together financial supervisors. For example in May 2008, IOSCO published its final report of its Technical Committee's Task Force on the sub-prime crisis which analyses the underlying causes of the subprime crisis, the implications for international capital markets and makes recommendations to better protect public markets from the spillover effects resulting from possible systemic problems caused by activity on private markets. This report is available at <www.iosco.org> accessed September 2012.

instances this has led to social unrest.⁶³ Therefore, financial regulation aimed at achieving systemic stability by minimising systemic risk is necessary to try and prevent the consequences of a financial crisis on the economy and on society itself. The cost of such consequences may be much higher than those which have to be incurred in order to avert it.⁶⁴

3.1.1. Regulatory Measures to Mitigate Systemic Risk

Various regulatory initiatives have been adopted at international, regional, and national level to safeguard systemic stability. As a consequence of the negative impact of the financial crisis on financial and economic stability, the focus of the majority of post-crisis regulatory initiatives aim at dealing with systemic risk. This part of the paper considers a selection of such regulatory initiatives, which have been categorised as follows: **[i]** the application of prudential requirements; **[ii]** the application of macro-prudential supervision; and **[iii]** measures for the ordinary winding down of financial institutions.

3.1.1.1. Prudential Requirements

At the micro-level, requiring financial institutions to comply with prudential capital requirements has been the traditional means to ensure that individual members of the financial system are resilient and are therefore in a position to confront financial shocks and imbalances.⁶⁵ These requirements are based on a methodology for the calculation of the risks which threaten the financial stability of the particular financial institution. In this regard, at international level, the Basel Committee on Banking Supervision has, since its inception in 1974, promoted prudential capital standards applicable to banks, known as the Basel Capital Accord. In 2010 a revision of the Basel Capital Accord was adopted to address the risks identified in the wake of the financial crisis.⁶⁶ On a European level, various proposals for reform were made in the De Larosiere Report.⁶⁷ In this regard, proposals for the revision of the Capital Requirements Directive (hereinafter '**CRD IV**'),⁶⁸ which sets the prudential capital requirements applicable to

⁶² European University Association, 'Impact of the economic crisis on European Universities', (January 2011) <www.eua.be> accessed September 2011.

⁶³ For example refer to S Coughlan, 'Student tuition fee protest ends with 153 arrests' (BBC, 1 December 2010) <<http://www.bbc.co.uk/news/education-11877034>> accessed September 2011.

⁶⁴ D Llewellyn, '*The Economic Rationale for Financial Regulation*' (Financial Services Authority Occasional Paper 1999) 13.

⁶⁵ Monitoring the financial stability of each individual regulated institution in order to achieve the overriding goal of protection of the customers of the institutions is generally referred to as micro-prudential supervision.

⁶⁶ Basel Committee on Banking Supervision <<http://www.bis.org/bcbs/index.htm>> accessed August 2011.

⁶⁷ De Larosiere (n 16) 15 – 19.

⁶⁸ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European

banks operating in the EU, have been put forward in light of the lessons learnt from the financial crisis.

In terms of the proposed CRD IV, banks will be required to hold better and more capital and to manage cash and liquidity in a more effective manner. In terms of the proposed CRD IV, banks will also be required to hold conservation buffers and countercyclical buffers to cover the impact of a possible sudden financial crash and to sustain economic downturns. Banks will be required to have more robust governance procedures and internal controls in place. They will also be required to reduce significantly their reliance on external credit ratings by adopting a wider application of internal risk measurement and management processes and functions.⁶⁹ Poor governance structures, lack of internal controls, weak risk management functions, and extensive reliance on credit ratings form part of the list of causes which brought about the financial crisis.

The stability of a financial system depends on the financial soundness and robust governance of the individual financial institutions. While prudential capital requirements seek to ensure the financial stability of a financial institution, the sustainable growth of such an institution largely depends on the way it is governed; the way it conducts its business; its awareness of the risks to which it is exposed; and the healthy management of those risks.⁷⁰ Experience suggests that a healthy financial institution is one which has in place sound administrative procedures and internal control mechanisms, including a well-documented organisational structure that clearly assigns responsibilities and ensures a good flow of information between all parties involved, in particular senior management and the board of directors. It may be argued that an effective governance structure for a financial institution would in practice ensure that senior management understand, control, and manage the activities of the institution, while the board of directors takes an active monitoring role by challenging policy decisions recommended by senior management and checking on their overall conduct of the business. Having proper control mechanisms in place is fundamental to maintaining the integrity and stability of the financial institution and to keep in check any possible excessive risk taking or illicit activity.

An effective risk management function is also of cardinal importance since risk management is a fundamental tool to ensure that the financial institution does not engage in excessive risk taking which could impact its long term sustainability. The application of risk management tools is so fundamental for the proper performance of financial activities, in that, competence in risk management is said to be one of the crucial determinants of competitive success for a financial institution.⁷¹ Experience suggests that the application of weak risk management procedures is likely to result in

Parliament and of the Council relating on the capital adequacy of investment firms and credit institutions.

⁶⁹ European Commission, 'Proposal for a European Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms' (27 August 2012). <http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm> accessed September 2012.

⁷⁰ European Commission, 'Green Paper: Corporate governance in financial institutions and remuneration policies' COM(2010) 284 final, 2 June 2010.

⁷¹ C Szylar, *Risk Management under UCITS III/IV* (Wiley 2010) xi.

business decisions which could impact on the financial soundness of a financial institution. The European Commission's recent initiative on corporate governance in financial services, which had the purpose of describing and analysing the weaknesses in this field as revealed by the financial crisis, describes risk management as one of the key aspects of corporate governance, especially in the case of financial institutions.⁷²

The prudential requirements set in the proposed CRD IV aim at creating mitigating factors that address systemic risk in the banking sector, thereby implementing the G20 policy commitment to require banks to have more robust capital, governance, and organisational structure.⁷³ The proposal however also applies to investment firms. Although banks and investment firms may be subject to similar risks, such as market risk and operational risk, certain requirements set in the proposal focus entirely at addressing issues emerging from the banking sector and do not seem to make an exception for the business model of investment firms, which at times differs significantly from that of banks. This is particularly true with regard to small and medium sized investment firms that are generally involved in very basic services such as the provision of investment advice and the execution of orders on behalf of clients, which invest primarily in non-complex financial instruments and do not actively trade on the market.

The European Commission's impact assessment on this proposal goes to great lengths in addressing concerns relating to the banking sector but makes minimal reference to the possible impact that the proposal could have on investment firms.⁷⁴ This suggests that in drafting this proposal the European Commission's focus was that of addressing weaknesses in the banking sector. It also suggests that not enough attention was therefore paid to the particularities of investment firms.⁷⁵ In the process however, certain requirements that are relevant to address bank related risks that could threaten the stability of a financial system have been applied to investment firms, even though these are not relevant for these types of firms. By way of example, while the proposed capital buffers were devised to ensure that banks can withstand losses during a period of systemic instability, these requirements are also being applied to investment firms across the board, even though these type of firms, particularly small-medium sized firms, are not considered as systemically relevant.

The proposal has been incorporated in a draft EU Regulation, which by nature is a legislative instrument that is directly enforceable and does not require transposition into national law. This makes it impossible for Member States to adapt the

⁷² European Commission (n 70).

⁷³ M Barnier, Speech on CRD IV, Speech/11/533, Brussels <www.europa.eu> accessed April 2012.

⁷⁴ European Commission, 'Commission Staff Working Paper, The Impact Assessment, Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms', Brussels, 20.7.2011, SEC(2011) 950 final <http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm> accessed April 2012.

⁷⁵ For a detailed examination of the concerns arising from the CRD IV in relation to investment firms, refer to C P Buttigieg, 'Implementing CRD for investment firms: Challenges for Malta' [2012] 20 4 Journal of Financial Regulation and Compliance.

requirements of CRD IV to the circumstances of their industry.⁷⁶ A one size fits all approach to regulation, coupled with a maximum harmonisation legal measure, raises potential issues of lack of proportionality.⁷⁷ The European Commission attempts to justify this approach on the basis that differences in the implementation of EU law and in the regulation of banks and investment firms could cause regulatory arbitrage. Moreover, it is also argued that local failures in Member States could have European wide repercussions.⁷⁸

It is reasonable to contend that the proposed CRD IV is important to address the weaknesses of the banking sector that could form a threat to systemic stability. Albeit, capturing investment firms, particularly small and medium sized firms, within the scope of such an EU Regulation does not respect the differences in the business model of banks and investment firms, is not proportionate and may result in over-regulation.⁷⁹ This may be indicative of an over-zealous approach to regulation that was triggered post the financial crisis, whereby a special concern with creating the right regulatory environment to prevent the next crisis, may lead to overregulation and generate laws that do not fully respect all the high-level principles of EU Law.

3.1.1.2. Macro-prudential Supervision

One of the fundamental lessons drawn from the financial crisis is that micro-prudential supervision on its own is not enough to safeguard the stability of the financial system. Having a dedicated systemic regulator responsible for macro-prudential supervision⁸⁰ is as fundamental as micro-prudential supervision for the well-being of the financial system.⁸¹ This was one of the key conclusions of the De Larosiere Report.⁸² Macro-prudential supervision supplements traditional micro-prudential supervision of individual financial institutions with specific focus on the possible threats to the financial system as a whole. Macro-prudential oversight demands the identification of emerging financial risks and structural weaknesses in the financial system. Various monitoring tools and interventionist powers have been granted to regional and national financial supervisors in order to ensure that they are in a position to monitor the

⁷⁶ Buttigieg (n 75).

⁷⁷ The principle of proportionality is a fundamental principle of EU Law which stipulates that the EU may only act to exactly the extent that is needed to achieve its objectives, and no further.

⁷⁸ European Commission, 'Frequently Asked Questions on CRD IV' (20 July 2011) <www.europa.eu> accessed April 2012.

⁷⁹ Buttigieg (n 75).

⁸⁰ There is no universal definition of macro-prudential supervision, B R Sabel and G L Rozansky, 'Translating Macro-Prudential Supervision Principles into Law' (2011) *New York Law Journal*, define it 'as the macro approach in terms of: [i] an overriding objective to maintain financial stability of the financial system as a whole, which is thought to be appropriate given the significant decline in economic wealth and activity that a system-wide failure could bring about; and [ii] a particular focus on those institutions, activities and behaviors that are seen to most threaten financial stability.'

⁸¹ French and others (n 1) 33-43.

⁸² De Larosiere (n 16) 39.

conventional and shadow⁸³ banking system so as to identify the possible build-up of systemic risk and to take the necessary measures to contain it.

At European level a new regulatory agency was established. The European Systemic Risk Board (hereinafter '**ESRB**') has the responsibility for macro-prudential supervision and is intended to contribute to the prevention and mitigation of systemic risk.⁸⁴ Given the apparent mismatch between integrated and interconnected European financial markets and predominately national supervision at the level of the Member States, the EU also established three regulatory authorities: the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority. These are responsible for micro-prudential supervision and also have the task of cooperating and assisting the ESRB to achieve its macro-prudential statutory objectives. Finally, through various new regulatory initiatives, the EU has provided national competent authorities which are responsible for financial supervision, with additional supervisory tasks and powers in order that they may achieve the systemic stability objective.

It is interesting to note that all the new regulatory initiatives in the field of securities regulation issued by the EU in the aftermath of the financial crisis refer to the mitigation of systemic risk as one of the primary objectives of regulation. By way of example, the 2011 European Alternative Investment Fund Managers Directive⁸⁵ (hereinafter '**AIFMD**'), which regulates the activity of portfolio managers of alternative investment funds, such as hedge funds⁸⁶ and private equity,⁸⁷ refers to the possible build-up of systemic risk which may be generated as a consequence of the employment of leverage by these managers in relation to the conduct of business of the funds they manage.⁸⁸ In order to ensure that Member State competent authorities responsible for financial supervision are in a position to monitor such activity, the AIFMD requires fund managers to report to their home Member State competent authority responsible for

⁸³ The shadow banking system has been broadly defined by the Financial Stability Board as 'credit intermediation involving entities and activities outside the regular banking system' <<http://www.financialstabilityboard.org/>> accessed August 2011.

⁸⁴ Regulation EU No 1092/2010, recitals 6 and 10 and art 3.

⁸⁵ Directive 2011/61/EC of the European Parliament and of the Council on Alternative Investment Fund Managers and amending directives 2003/41/EC and 2009/65/EC.

⁸⁶ EU law does not define what may constitute a 'hedge fund'. This is generally defined as 'an aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).'

⁸⁷ EU law does not define what may constitute 'private equity'. This may be defined as 'Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Capital for private equity is raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet.'

⁸⁸ Directive 2011/61/EC, recital 49.

financial supervision information on their leverage⁸⁹ positions, which information must be shared with other Member State and European competent authorities responsible for financial supervision and in particular the ESRB.⁹⁰ The Directive also gives national competent authorities responsible for financial supervision the power to set limits to leverage positions of a fund manager where these positions are considered as being potentially risky for the stability of the financial system.⁹¹

The Directive, which also aims at protecting investors in these funds, particularly from losses of financial instruments that are held by the depositary on behalf of the alternative investment fund, imposes strict liability on the depositary for any losses of such instruments, even where the assets are held by a sub-custodian.⁹² It may be argued that this requirement addresses investor protection issues arising from the losses sustained by a number of funds due to the Madoff fraud.⁹³ It however raises potential competition issues as a higher degree of liability may result in being too costly for small depositaries to sustain, thereby reducing the feasibility of depositary business for small and medium sized firms. As a consequence, the number of active depositaries could decrease, thereby increasing concentration risk in fewer, but larger depositaries, which in turn increases the probability of systemic risk in case of failure. This suggests that the importance of attaining a fundamental objective of financial regulation could at times result in regulatory measures that cause tensions with and weaken the realisation of other regulatory and economic objectives.

3.1.1.3. Measures for the Orderly Winding Down of Financial Institutions

While financial regulation and supervision should seek to reduce the instances of systemic instability, they cannot be expected to avert the collapse of financial institutions, but should at least seek to reduce the risk of failure.⁹⁴ Eradicating the likelihood of failure would interfere with the incentive to innovate and result in the penalisation of success.⁹⁵ In the event of the failure of a financial institution, financial regulation should strive to lessen the impact of that failure and in particular, should endeavour to minimise its effect on the entire financial system.⁹⁶ Therefore, while

⁸⁹ Directive 2011/61/EC, defines leverage as any method by which a fund manager increases the exposure of the fund it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means.

⁹⁰ Directive 2011/61/EC, recital 50 and art 25.

⁹¹ Directive 2011/61/EC, art 25.

⁹² Directive 2011/61/EC, art 21.

⁹³ A Sage, 'French investors to take legal action against banks over Madoff feeder funds' *The Times* (London 14 January 2009); P Skypala, 'UCITS victory soured by Madoff scandal' *Financial Times* (London 19 January 2009; EurActiv, 'Madoff scandal sparks EU row' (Brussels 21 January 2009) <www.euractive.com>.

⁹⁴ Gowland (n 43) 45.

⁹⁵ H Davis, 'Managing financial crises', Chapter in *The Regulation of Financial Markets* (The Institute of Economic Affairs 2003) 26-43.

⁹⁶ Llewellyn (n 64) 13.

prudential requirements in the form of capital adequacy standards and requirements on governance structures, internal controls, and risk management are incontrovertibly required to support a financial system against the threat of a domino type breakdown arising from a large financial institution's inability to meet its obligations;⁹⁷ financial regulation, and the supervisory framework should not be expected to guarantee a 'no failure' policy. It is indeed interesting to note that following the financial crisis, policy makers have been devising and enhancing regulatory frameworks to deal with the ordinary resolution of failing financial institutions. It is being proposed that the resolution of financial institutions should be carried out in a way that would force the shareholders of these institutions to bear the cost of failure. So far, as the government rescue measures taken to resolve the crisis suggest, these costs have been borne by society.

At international level the Basel Committee on Banking Supervision and the Financial Stability Board⁹⁸ have proposed various policy measures to be adopted at regional and national level to improve the capacity of financial supervisors to resolve systematically relevant financial institutions without systemic disruption and without exposing society to the risk of severe losses.⁹⁹ Within the European context, the European Commission is currently contemplating a possible regulatory framework for crisis management which would have the purpose of granting Member State competent authorities responsible for financial supervision the necessary powers and tools to manage the failure of a financial institution by either restructuring it or ensuring its orderly winding down.¹⁰⁰ The ultimate objective of this initiative is that of creating the regulatory mechanisms to ensure that systemically relevant financial institutions which are active within the internal market may be wound down in ways which would minimise the risks of contagion and the impact on the continuity of the financial system.¹⁰¹

The effect of the financial crisis on the liquidity and viability of several US and European financial institutions confirms the potential systemic instability which could be generated by conditions which are likely to result in the failure of systemically relevant financial institutions. It proves that due to the interconnectedness of financial

⁹⁷ Scott (n 57).

⁹⁸ The Financial Stability Board was established post the 2007-2008 financial crisis to coordinate at the international level the work of national financial authorities and international standard setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. In collaboration with the international financial institutions, the FSB will address vulnerabilities affecting financial systems in the interest of global financial stability.

⁹⁹ Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group' (BCBS March 2010) <<http://www.bis.org/bcbs/>>; Financial Stability Board, 'Consultative Document: Effective Resolution of Systematically Important Financial Institutions - Recommendations and Timelines' (FSB 19 July 2011) <<http://www.financialstabilityboard.org/>> Both accessed September 2011.

¹⁰⁰ European Commission, 'Consultation on Technical Details of a Possible Crisis Management Framework for financial institutions - Frequently Asked Questions', Memo/11/6, 6 January 2011.

¹⁰¹ European Commission, 'Technical Details of a Possible EU Framework for Bank Recovery and Resolution - Consultation Document', 2011. <http://ec.europa.eu/internal_market/consultations/2011/crisis_management_en.htm> accessed August 2011.

institutions, irresponsible practices within one systemically relevant financial institution are likely to cause severe systemic instability and can lead to a possible general collapse of the system as a whole.¹⁰² Although safeguarding systemic stability has long been a primary objective of financial regulation, the regulatory framework applicable before the financial crisis has been proven to be inadequate to deal with the failures of systemically relevant financial institutions. Financial supervisors were clearly not prepared and did not have adequate powers to deal with a crisis of such proportion. The financial crisis, its victims, and the negative impact it had on the financial system and the economy worldwide, brought the regulation of systemic risk high on the Western world's policy-makers' regulatory and supervisory agenda. In the final analysis, one may conclude that the wide spread of financial regulatory measures which have been or are in the process of being adopted to deal with systemic risk in response to the crisis, attest to the continuing relevance and importance of this primary objective of financial regulation. Undoubtedly, there is today an even stronger case for more robust macro and micro prudential financial regulation aimed at maintaining systemic stability.

3.2. Investor Protection

It is submitted that regulation aimed at safeguarding systemic stability is not enough to ensure a sound financial system. Appropriate regulation to protect the interests of investors is considered a fundamental element for the healthy development of financial markets which form an integral part of the financial system.¹⁰³ There is both empirical and theoretical literature that advocates that a country's level of investor protection has a significant effect on the value of companies, the development of the financial market, and economic growth.¹⁰⁴ It is indeed reasonable to argue that inadequate investor protection restricts the economy's access to capital, in particular to equity capital, as the existence of a financial market depends on the confidence which investors have in such market. In turn, public confidence depends on whether investors perceive that financial institutions are acting honestly, fairly, and in the best interest of their clients and the financial market. It also depends on the extent to which financial institutions are perceived to be financially solvent. Hence, the basic rationale for the investor protection objective of financial regulation is that of ensuring investor confidence in the financial market by protecting the investor from the possible consequences of the information asymmetries that exist between the investor and the financial services provider.¹⁰⁵

The provision of financial services is a field of business which is characterised by natural inbuilt information asymmetries between the financial institution and its

¹⁰² E Avgouleas, 'Financial Regulation, Behavioural Finance and the Global Credit Crisis: In search of a new regulatory model' (2008) 10 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1132665> ac 5 August 2011.

¹⁰³ UK Department of Trade and Industry, 'Financial Services in the United Kingdom – A new framework for investor protection' (DTI 1985) 3.

¹⁰⁴ R La Porta, and others, 'Investor Protection and Corporate Governance' (2000) *Journal of Financial Economics* 3-27.

¹⁰⁵ C Goodhart, *'The Central Bank and the financial system'* (MIT Press 1995) 434.

clients.¹⁰⁶ This is largely the case given that clients are purchasing from the financial institution a professional service that is based on expert knowledge. There are two principal forms of information asymmetries to which an investor is exposed, being the disparity in the ability of an investor to get access to and evaluate financial information; and the fact that information is generated on a small scale.¹⁰⁷ Empirical evidence indicates that investors generally fail to get access to adequate financial information and are usually financially illiterate.¹⁰⁸ The difference in knowledge between the financial institution and the investor could have a grave impact on the investor if the said financial institution becomes insolvent while holding and controlling the said investor's assets.¹⁰⁹

Investors are not always in a position to assess the safety and soundness of the financial institution to which they entrust their assets and therefore it is argued that financial regulation has a role to play in ensuring that investors' assets are properly safeguarded.¹¹⁰ There are consequences which could result from the failure of financial institutions that differ from the systemic consequences explained earlier on. These include the potential insecure economic situation that could hit investors as a consequence of the failure of a financial institution which is responsible for holding and controlling the said investors' financial assets. Safeguarding systemic stability is therefore not the only reason why financial regulation should aim at reducing the risk of failure of financial institutions through the application of prudential regulation.

Due to its very nature, the provision of financial services is inherently prone to principal-agent conflicts of interest and to the occurrence of fraud.¹¹¹ A conflict of interest arises when a person who has a duty to act in another party's interest has to decide how to act in the interest of that party while another interest interferes with his ability to decide according to his duty.¹¹² Nearly all financial market transactions undertaken by unsophisticated investors are made through, and with the assistance of financial institutions that act as intermediaries between the investor and the financial market. In their role as agents of investors, financial institutions have, in theory, a duty to act in the best interest of such investors. However, in practice, when acting as agents of an investor, financial institutions have to balance the interests of various parties, including their own interests, the interests of their employers and partners, and those of issuers and investors. Given the presumed high level of asymmetric information between the investor and the financial institution, the likelihood of opportunistic

¹⁰⁶ In this article, the terms investor and client are used interchangeably mainly to refer to retail investors being unsophisticated investors who do not transact regularly.

¹⁰⁷ S Collins, and J Black, *Cranston's Consumers and the Law* (3rd ed, Butterworths 2000) 30-4.

¹⁰⁸ A Georgosouli, 'Investor Protection Regulation: Economically Rational?' (2006) 9 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893451> accessed August 2011.

¹⁰⁹ Goodhart (n 105) 434.

¹¹⁰ C Goodhart and others, *Financial Regulation: Why, how and where now?* (Routledge, 1998) 5.

¹¹¹ Goodhart and others (n 110) 5.

¹¹² C Kumpan and P Leyens, 'Conflicts of interest of Financial Intermediaries – Towards a Global Common Core in Conflicts of Interest Regulation' (2008) *European Company and Financial Law Review* 72-100.

conduct by the financial institution would seem to be considerably high, not least because the value of the investment depends on the financial institution's performance after the point of purchase and not before.¹¹³

Various instances of financial product mis-selling came to light in the aftermath of the financial crisis. Financial institutions have been found responsible for either having sold financial products which turned out to be inadequate given the investors' profile or to have misled or misinformed clients regarding the nature of the product being sold by failing to communicate effectively the likely outcomes and risks involved.¹¹⁴ These attest to the possible negative consequences of the information asymmetries between the investor and the financial institution and sustain the validity of investor protection as one of the high-level objectives of financial regulation.

3.2.1. Regulatory Initiatives to Achieve Investor Protection

Regulation protecting investors attempts to address failures which may occur due to asymmetric information by requiring financial institutions to abide by detailed conduct of business rules. These rules have the purpose of regulating the activity of such institutions in a way which compels them to act in the best interest of the investor. Investor protection regulation is also based on transparency rules that require financial institutions to provide proper information to clients in order to allow them to make an informed investment decision. In the EU, a regulatory framework in this regard is set in the Markets in Financial Instruments Directive¹¹⁵ which, *inter alia*, stipulates detailed organisational, conduct of business, and transparency requirements applicable to financial institutions which act as an intermediary between investors and the financial markets with respect to the buying and selling of financial instruments.

Experience with investigations into instances of suspected product mis-selling however suggests that due to remuneration incentives which seek to [i] induce hard selling of financial products and [ii] encourage disregard to proper application of internal compliance procedures, financial institutions sometimes fail to act in the best interest of their clients. Investors do not always understand the nature and risks relating to their

¹¹³ Georgosouli(n 108).

¹¹⁴ By way of example, refer to: R Evans, 'Barclays ordered to pay almost £70 m over mis-sold investments' *The Telegraph* <<http://www.telegraph.co.uk/finance/personalfinance/investing/8266182/Barclays-ordered-to-pay-almost-70m-over-mis-sold-investments.html>> accessed September 2012; B Masters, 'Mis-selling cases to get fast track' *Financial Times* (London 2 August 2011); T Norman, 'J.P. Morgan and RBS sued for mis-selling mortgage bonds' *Mortgage Strategy (Online)* (London 21 June 2011) <<http://proquest.umi.com.ezproxy.sussex.ac.uk/pqdlink?index=18&did=2379962781&SrchMode=1&sid=4&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1314206460&clientId=5646>> accessed August 2011; J Bradshaw, 'Ucis clients receive a full refund after IFA pursues mis-selling case' *Financial Advisor* (London 21 July 2011) <<http://proquest.umi.com.ezproxy.sussex.ac.uk/pqdlink?index=10&did=2410201831&SrchMode=1&sid=4&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1314206460&clientId=5646>> accessed August 2011; and A Jones, 'Lloyds profits wiped out by mis-selling charge' *Financial Times* (London 2 August 2011).

¹¹⁵ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

investments, either because the investors do not have the necessary financial knowledge and experience and/or the financial institution has failed to provide the client with proper explanations on the particular financial product. In certain instances financial product documentation is not written in plain language and consequently it is not easily understandable by investors. One may therefore contend that providing an optimum level of investor protection from exploitation by financial institutions through robust conduct of business rules and transparency requirements remains an exceptionally valid objective of financial regulation. In this regard, post the financial crisis the European Commission initiated a review of the Markets in Financial Instruments Directive with a view to making structural reforms aimed at achieving a higher degree of investor protection.¹¹⁶

In the context of the debate on the quality of investment advice provided to clients, as examined in the light of the product mis-selling scandals, advisors would be required to inform the client on whether the investment advice is based on an independent and fair analysis of the client's knowledge and experience, his investment objectives, and his financial situation. Advisors would also be required to report to the client in writing the underlying reasons for the advice provided, including an explanation about how the advice meets the client's profile.¹¹⁷

Investment firms are also required to keep records of the business carried out on behalf of clients. In this regard, the European Commission is proposing that this requirement should be extended to telephone conversations and electronic communications between the advisors and the client.¹¹⁸ This information is to be provided to the client upon request.¹¹⁹ It is argued that keeping a record of telephone conversations between advisors and the client enhances investor protection and is useful for supervisory purposes as it: **[i]** ensures that there is evidence to resolve disputes between an investment firm and its clients over the terms of transactions; **[ii]** assists with supervisory work in relation to conduct of business rules; and **[iii]** helps to deter and detect market abuse and to facilitate enforcement in this area.¹²⁰

Data protection concerns and privacy issues exist with regard to supervisory access to the content of telephone records and electronic communications. In this regard, while the E-Privacy Directive¹²¹ and the Data Protection Directive¹²² do not prevent the

¹¹⁶ European Commission, 'Public consultation: Review of the Markets in Financial Instruments Directive ('MIFID')' (8 December 2010) <http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm> accessed August 2011.

¹¹⁷ *Ibid.*, 56 – 57.

¹¹⁸ European Commission, Proposal for a Directive of the European Parliament and of the Council on market in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council, COM(2011) 656 final, 20 October 2011 (MiFID II Proposal), art 16(7).

¹¹⁹ *Ibid.*

¹²⁰ CESR, 'Technical Advice to the European Commission in the context of the MiFID Review – Investor Protection and Intermediaries' CESR/10-859, 29 July 2010.

¹²¹ Directive 2002/58/EC of the European Parliament and of the Council of the 12 July 2002 concerning the processing of personal data and the protection of privacy in the electronic communications sector.

recording of telephone conversations and electronic communications, they however limit the circumstances in which recordings can be made and set certain safeguards on the handling of the recordings.¹²³ In order to address the data protection and privacy issues, the European Commission has proposed that the access by competent authorities responsible for financial supervision should be limited to data traffic records and not to the specific content of telephone recordings and the records on electronic communications to which they relate.¹²⁴

Experience suggests that restricting the ability of competent authorities to obtain information which could be relevant for supervisory, investigative, and enforcement purposes, could damage their capability of fulfilling their duties.¹²⁵ In this regard, the tensions that exist between the necessity of competent authorities to have access to information on telephone conversations and electronic communications and the necessity of respecting the right for privacy and the safeguarding of personal data, attest to the difficulties that could surface in finding the right balance between achieving the objectives of financial regulation, while at the same time respecting the fundamental rights of society.

The proposed record-keeping requirement also raises possible issues of proportionality, as it does not distinguish between small-medium sized firms and large firms. It has been determined that the costs of implementing a requirement to keep a record of telephone conversations and retain such a record for a number of years may result in a considerable expense for small firms.¹²⁶ However, in view of investor protection issues that might arise from telephone conversations between an advisor and his client, the importance of ensuring the same level of protection for all investors, and the EU's De Larosiere policy-decision of establishing a single rule book for financial services, it was determined that one record keeping requirement should apply across the board to all investment firms irrespective of the size of such firms.¹²⁷ This again demonstrates the possible tensions that could arise between achieving the objectives of financial regulation on the one hand and creating an equitable and proportionate regime on the other.

¹²² Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regards to the processing of personal data and on the free movement of such data.

¹²³ European Data Protection Supervisor, Opinion on the Commission Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (Recast), and for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation on OTC derivatives, central counterparties and trade repositories, 10 February 2012.

¹²⁴ MiFID II Proposal (n 117) art 71.

¹²⁵ CESR (n 120); In its advice to the European Commission, CESR indicates that sixteen Member States have in place requirements on the retention of records on telephone conversations and electronic communications.

¹²⁶ CESR (n 120) 14-16.

¹²⁷ MiFID II Proposal (n 17) recitals 42 & 45.

In addition to requiring financial institutions to act in the best interest of their clients by complying with detailed conduct of business and record keeping requirements, trust in a particular financial market is also a function of the extent and accuracy of the information provided to investors. Ensuring disclosure of information to investors which is sufficiently clear, comprehensible, and comparable and which therefore assists an investor in making an investment decision is fundamental to mitigate the information advantage of financial institutions.¹²⁸ Therefore, it is reasonable to argue that mandatory disclosure requirements which compel the financial institution to issue pertinent information that would allow an investor to understand the basis for the investment advice and the relevant financial instrument should mitigate information asymmetries. This should in turn reduce the risk of market failures which may come about as a consequence of product mis-selling, as more informed investors should, *ceteris paribus*, be able to identify financial products which match their investment risk profile.

3.3. Safeguarding the Integrity of Financial Markets

Transparency therefore has a cardinal function. It militates towards the preservation of the integrity of financial markets by contributing to the fairness and efficiency of such markets. Financial markets play a critical role in economic development and financial stability. The crucial purpose of such markets is to serve as a device for the transformation of savings generated by the various members of society into financing for the business community.¹²⁹ Financial markets also perform a wide range of economic and political functions.¹³⁰ In fact, stock exchanges play a fundamental role in the carrying out of privatisation programmes and are often an essential ingredient for a financial centre's success and the development of the economy.

In view of the important role which financial markets play, it is vital for such markets to operate properly and to transmit to all interested parties a sense of efficiency, integrity, and transparency. Financial markets should consequently be able to provide investors with the opportunity of transacting in a fair and informed environment where prices reflect full and correct information issued by listed companies and the market.¹³¹ However, given the potential for gains which may be generated through financial markets, and the existing risks of asymmetries of information, such markets are very often vulnerable to abuse and manipulation. Market malpractice has the capacity of damaging the integrity and reputation of financial markets and as a result undermines the confidence that investors have in such markets and the financial industry as a whole. This sort of conduct may preclude a financial market from performing its fundamental function of bringing together buyers and sellers who are interested in trading financial instruments, especially when investors feel that they are not in a

¹²⁸ J Tanega, 'Credit Crisis Solutions: Risk Symmetric Criteria for Reconstruction of Socially Fair Asset-backed Securities' in *The Future of Financial Regulation* (Hart Publishing 2010) 233.

¹²⁹ A Carvajal, and J Elliot, 'Strengths and weaknesses in Securities Market Regulation: A Global Analysis', (IMF Working Paper, 2007) 2.

¹³⁰ R Lee, *What is an Exchange? The Automation, Management and Regulation of Financial Markets* (Oxford University Press 2000) 4.

¹³¹ J Rydger, 'The Importance of Market Integrity', (SIRCA, 2004) 7.

position to engage in transactions with confidence that they are acting on a level playing field.¹³²

The EU's Transparency Directive,¹³³ the main purpose of which is the regulation of the disclosure of information by issuers of financial instruments, stipulates that:

[t]he disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance. This enhances both investor protection and market efficiency. [...] to that end, security issuers should ensure appropriate transparency with investors through regular flow of information.¹³⁴

The application of proper transparency standards which require prompt disclosure of relevant information by publicly listed companies and the market is indeed fundamental to reduce the extent of asymmetric information, thereby reducing the possibility of market malpractice and contributing towards the integrity of the market.¹³⁵ This is one of the foundations of EU law that promotes the integrity of financial markets through several Directives, such as the Markets in Financial Instruments Directive; the Market Abuse Directive;¹³⁶ the Prospectus Directive,¹³⁷ which regulates the prospectus to be published when securities are to be offered to the public or admitted to trading; and the Transparency Directive.¹³⁸

Ensuring that financial markets are transparent does not always correspond well with the objective of maintaining the stability of the financial system. The Northern Rock plc affair, whereby the announcement that this UK bank had requested for and had been provided with liquidity by the Bank of England, generated a run on the bank.¹³⁹ In order to prevent such situations from occurring, the Governor of the Bank of England had indicated a preference for a covert liquidity operation, whereby Northern Rock plc

¹³² J L Hansen, 'What constitutes insider dealing? – The Advocate General's opinion in Case C-45/08, Spector Photo Group' (2009) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1499093> accessed August 2011.

¹³³ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

¹³⁴ *Ibid.*, recitals 1 and 2.

¹³⁵ M S Siems, 'The EU Market Abuse Directive: A Case-Based Analysis' (2008) *Law and Financial Markets Review* 42.

¹³⁶ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse).

¹³⁷ Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading.

¹³⁸ (n 133).

¹³⁹ K Keasey & G Veronesi, 'Lessons from the Northern Rock Affair' (2008) *Journal of Financial Regulation and Compliance*, 15.

would have been provided with the liquidity it required without a public announcement being made to the market. Yet, this was not possible given that as a publicly listed entity, Northern Rock plc was subject to transparency requirements, which in such circumstances required a public announcement to be made.¹⁴⁰ The announcement therefore had to be made even though there was a probability that this would have had possible negative consequences for Northern Rock plc and the UK banking system in general. This is indicative of the tensions that regulators and supervisors face in striking the right balance between the different objectives of financial regulation. It again demonstrates that fulfilling a fundamental objective of financial regulation could at times result in regulatory measures that weaken the realisation of other regulatory objectives.

Transparency on its own, however, is not enough to address all forms of market malpractice. Market abuse, which comes in the form of either the prohibited use of inside information or in the form of market manipulation, is considered as the primary type of market malpractice which threatens the integrity and efficiency of financial markets. Company insiders, particularly company directors and senior management, are exposed to non-public information about their organisation, some of which could be of a price sensitive nature; being information which a reasonable investor would be likely to use as part of the basis for his investment decision.¹⁴¹ Company insiders can profit from such information by buying or selling their shares in the said company prior to the issue of the said information to the public. This can only be done at the expense of the uninformed investor. They can also pass on such information to other parties who would also have the opportunity to profit at the expense of genuine investors. While the prohibited use of inside information requires some form of intervention by a company insider, market manipulation does not necessitate such involvement and can be conducted through the creation of a false impression of trading activity or price movement or market information which leads to a distortion of the price formation process and in turn a reduction of market efficiency due to the fact that trading decisions are not made on financial fundamentals.¹⁴²

The primary rationale for the regulation of insider dealing and market manipulation is connected to market confidence and the perception of investors that the prices quoted on the market are fair and not distorted. It is worthwhile to point out that there are a number of theories which attempt to explain the rationale for the regulation of the prohibited use of inside information and market manipulation.¹⁴³ The Misappropriation

¹⁴⁰ House of Commons Treasury Committee 'The run on the Rock - Fifth Report of Session 2007-08' 54 - 63.

¹⁴¹ B Rider and others, *Market Abuse and Insider Dealing* (Butterworths 2002) 4.

¹⁴² F Kristen, 'Integrity on European Financial Markets: Backgrounds, Objectives, Reasons, Overall Contents and Implications of the Market Abuse Directive' (2005) *European Company Law* 19.

¹⁴³ It is noteworthy that not all authors agree that the prohibited use of inside information should be regulated. Indeed, certain authors have theorised that the prohibited use of inside information should not be regulated as it is a 'victimless crime' in that there is no direct connection between the activities of an insider and the position of an investor who, as a result of those activities, pays for dealing in financial instruments. Moreover, certain economists have also argued that insider dealing should be allowed, as it benefits a financial market given that active insiders ensure accuracy in the pricing of traded financial instruments by moving the price towards a level which correctly reflects the actual position of a

Theory is based on the notion of ownership, where information is considered as the property of the source of the information (the company to which it relates) and the prohibited use of inside information is deemed to be a serious breach of the fiduciary relationship between the receiver of the information (a director) and the source of the information.¹⁴⁴ On the other hand, the Unfair Advantage Theory is based on the idea that markets should operate on the basis of complete equality between investors and potential investors.¹⁴⁵ Trading should take place between parties who have equal rights and possibility of access to information. Lastly, the Market Stability Theory, which has certain similarities with the Unfair Advantage Theory, is based on the premise that flagrant prohibited use of inside information or market manipulation could seriously damage the confidence that investors have in financial markets which is largely based on the perception that financial markets are egalitarian, being the confidence that all investors have equal access to information on financial instruments traded on the market.¹⁴⁶

In a financial market where market abuse prevails, there is a significant potential for misallocation of resources, as savings will not always be channelled to the most efficient organisations.¹⁴⁷ Such abuse could significantly distort the price formation process of financial instruments traded on the said market, leading to inaccurate valuations of such instruments and the distribution of misleading post-trade information to the market. In a financial market where market abuse is rampant, liquidity providers such as market makers will protect themselves by increasing their selling price and decreasing their buy price which in turn affects the transaction costs on the market.¹⁴⁸ Once the investing public feels the impact of this and other consequences of market abuse, their willingness to actively participate in financial markets will decrease. In the short term, this lack of participation could undermine the liquidity and efficiency of such markets and increase the cost of capital for companies, while in the long run it could have serious repercussions on the stability, development, and prosperity of the entire economy of a country or region as a whole. Therefore, the rationale behind relevant legislation such as the Market Abuse Directive, which prohibits market abuse and requires the investigation of suspicious transactions and the enforcement of market abuse, is that of safeguarding the smooth functioning of the financial market and investor confidence in the same. Both are considered as prerequisites for economic growth and wealth creation.¹⁴⁹ Regulation on its own is not enough to deter market abuse. Experience suggests that enforcement is of fundamental importance if this sort of

company at a given point in time. See G Brazier, *Insider Dealing: Law and Regulation* (Cavendish Publishing 1996) 84-88.

¹⁴⁴ D Cohen, 'Old rule, New theory: Revising the personal benefit requirement for tipper/tippee liability under the misappropriation theory of insider dealing' (2006) *Boston College Law Review* 555.

¹⁴⁵ Brazier (n 146) 83.

¹⁴⁶ N Moloney, *EC Securities Regulation* (Oxford University Press 2008) 924.

¹⁴⁷ M Siems, 'The EU Market Abuse Directive: A Case-Based Analysis' (2008) *Law and Financial Markets Review* 3.

¹⁴⁸ G Ferrarini, 'The European Market Abuse Directive' (2004) *Common Market Law Review* 714.

¹⁴⁹ Directive 2003/6/EC, recital 2.

market malpractice is to be discouraged.

Prior to the financial crisis there was a general view that market abuse was widely practiced by financial market participants and that financial supervisors were not giving this area of financial regulation the attention and priority it deserves.¹⁵⁰ This reality was also acknowledged in the EU's De Larosiere Report, which expressed concern regarding inadequate supervisory resources coupled with insufficient skills and weak sanctioning and enforcement regimes.¹⁵¹ Experience in monitoring trading in shares on a financial market suggests that without credible deterrence, market abuse may become a common practice within a financial market. The lack of coherent monitoring and enforcement of market abuse led the European Commission to demand tougher action against this malpractice¹⁵² and the initiation of a legislative process for the development of a proposal for the reform of the EU regulatory framework.¹⁵³

In practice, however, experience in carrying out investigations of suspected market abuse suggests that suspicions of this nature are not only difficult to prove but also very hard and costly to investigate. However, the recent surge in enforcement action with regard to market abuse cases in Europe and the US indicates that following the financial crisis, addressing these cases has reached the top of the supervisory agenda.¹⁵⁴ This is a reasonable reaction directed towards enhancing investor confidence in financial markets after the latter had received a serious blow as a consequence of the crisis. In the final analysis, it is reasonable to conclude that the policy response in this field and the action taken by financial supervisors, sustains the view that, safeguarding and maintaining the fairness, honesty, and integrity of financial markets, in order to preserve investor confidence and the sustainability of such markets, continues to be one of the fundamental high level objectives of financial regulation.

¹⁵⁰ N Dorn, 'The metamorphosis of insider trading in the face of regulatory enforcement' (2011) *Journal of Financial Regulation and Compliance* 77-78; also refer to A Hayes, 'Market Abuse' (2010) *Compliance Officer Bulletin*.

¹⁵¹ De Larosiere (n 16) 23.

¹⁵² N Tait, 'EU urges tougher action against market abuse' *Financial Times* (London 25 October 2010).

¹⁵³ European Commission, 'Public consultation on a revision of the Market Abuse Directive (MAD) (26 June 2010) <http://ec.europa.eu/internal_market/consultations/2010/mad_en.htm> accessed August 2011.

¹⁵⁴ By way of example refer to: UK Financial Services Authority, *Annual Report 2010*, 11 <http://www.fsa.gov.uk/pages/Library/corporate/Annual/ar10_11.shtml> accessed August 2011; Malta Financial Services Authority, 'Annual Report 2010' 106 <<http://www.mfsa.com.mt/pages/viewcontent.aspx?id=45>> accessed August 2011; 'The smartest guys in the room; insider trading' *The Economist* (London 12 May 2011); A V Duyn, 'Lessons of Galleon case go much wider than stocks' *Financial Times* (London 14 May 2011) 15; B Masters, 'Trader fined pounds 1.1m for market abuse' *Financial Times* (London 25 May 2011) 16; T Selby 'FSA fines trader pounds 700,000 for market abuse' *Money marketing online* (London 14 June 2011).

4. Conclusion

The financial system was created to serve the needs of society. In effect, the provision of financial services constitutes a public good and serves the common good by transferring savings to efficient organisations that require capital to invest. A stable financial system provides a favourable business environment for the efficient allocation of resources and by so doing supports job creation and economic growth. In theory the financial system should be a means to an end and not an end in itself. The financial crisis points towards a different reality. As explained in the introductory section of this paper, its causes may primarily be attributed to greed and self-interest. Short term profit maximisation at all levels of the financial system, derived from transactions through which financial innovation allowed the transfer of risk, took over long-term sustainability. Largely led by a prevalent culture of instant fulfilment and a reluctance to postpone or defer gratification, while the going was good and the financial system was generating significant returns, policy makers and financial supervisors seem to have turned a blind eye and allowed the financial system to become an end in itself rather than a means to achieve the well-being of society and the economy. Irresponsible decisions based on short-term objectives turned financial institutions into a source of destruction rather than a means of sustaining job creation and economic growth. Through persuasive lobbying, financial institutions had managed to capture policy makers and thereby shift economic and political power to the financial community, weakening the rudiments of representative democracies.

A financial system that feeds on the economy instead of being a means to support the common good is not sustainable in the long run. Such a financial system in the end collapsed and could only be saved through rescue packages put together from taxpayers' money. In turn, this led to the taking of austerity measures to the detriment of social policies which aim to benefit society as a whole. The capture and dependence had become so deep that the paradigm on the role of the financial system had been shifted; society and the economy had become an instrument at the service of the financial system. The private interest theories of regulation explain this state of affairs as being the triumph of the industry over policies which strive to achieve the well-being of society as a whole. To resolve the causes of the financial crisis, the paradigm on the role of the financial system must once again be reversed to its natural condition. Attaining the high-level objectives of financial regulation is the means to ensure that the conduct of business of the financial system is controlled and does not threaten the welfare of society and the economy. Public interestedness is indeed the rationale for safeguarding systemic stability, protecting the investor, and ensuring that markets are fair, efficient, and transparent. In the aftermath of the financial crisis, the case for more effective financial regulation and supervision for the purpose of achieving these high level objectives is undeniable. In the final analysis, it is natural to conclude that the financial crisis, the identified causes thereof and the policy response, based on a wide array of regulatory measures, have proven and sustained the continued validity and relevance of the theories and objectives of financial regulation.