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RECONFIGURED SELVES IN SELF- REGULATION

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Abstract: In the "New Regulatory State", regulation takes multiple, varied forms, and combines state control and private regulation. Some type of self-regulation is a frequent component of the new regulatory regimes. The term "self-regulation" is used to refer to many different things. For example, some financial exchanges developed as member organizations which discovered that they needed to adopt rules to regulate their own behavior, and the rules and enforcement practices of these organizations constitute one type of self-regulation. However, commentators and regulators also refer to codes of practice developed by trade associations as examples of self-regulation. Financial self-regulation tends to operate within a framework of governmental control.

Inherent in the idea of self-regulation is the concept of a self, or of a community, which is able to regulate itself. But the concept of self embedded in self-regulation is increasingly incoherent. Three separate recent developments in financial self-regulation illustrate this argument. First, the transition of financial exchanges from membership organizations to for-profit corporations raises the possibility of a separation between those who perform functions in the exchange marketplace and those who own the marketplace. Second, combinations of SROs create self-regulators which set standards for or monitor increasingly disparate entities. Where these combinations are transnational the picture is even more complex. Third, organizations outsource regulatory functions so that what occurs is in fact regulation by others rather than self-regulation.

The paper examines and critiques the changing conceptions of the self in modern self-regulation.

Language structures thought,[1] and influences behavior.[2] For lawyers, the relationships between politics, economics, and law are largely defined by language. This paper focuses on the meaning of the word "self"[3] in self-regulation.[4] In the

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[1] *See, e.g.*, Philip Pettit, *Rationality, Reasoning and Group Agency*, 61 DIALECTICA 495, 500 (2007) ("How can subjects like you and me form meta-propositional beliefs and engage in reasoning? The answer surely has to do with the fact that we have language and can use sentences as ways of making propositions into objects of attention.") The relationship between language and thought is complex and not uncontroversial.

[2] *See, e.g.*, Michael W. Morris, Oliver J Sheldon, Daniel R. Ames & Maia J. Young, *Metaphors and the Market: Consequences and Preconditions of Agent and Object Metaphors in Stock Market Commentary*, 102 ORGANIZATIONAL BEHAVIOR AND HUMAN DECISION PROCESSES 174, 189 (2007) ("Just describing price changes agentically (without explaining them) leads investors to biased judgments about tomorrow's trends.")

[3] *Cf.* Philip Pettit, *Collective Persons and Powers*, LEGAL THEORY, 443, 462 (2002) ("Whenever we speak of persons we think it is appropriate to speak of selves. We expect that persons will think of themselves in the first person and be able to self-ascribe beliefs and desires and actions by the use of an

literatures of self-regulation[5] the word "self" has multiple meanings and carries with it different implications. Commentators and policy-makers do not always use the term "self-regulation." Instead they may refer to decentred regulation,[6] or to a move from government to governance.[7] Nevertheless, decentred regulation and governance include components which are characterized as self-regulatory.

One set of arguments for self-regulation focuses on self-regulation as an alternative to governmental regulation.[8] These arguments tend to be based on claims that self-regulation is more efficient,[9] and/or more effective, than governmental

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indexical expression such as "I" or "my," "me" or "mine."..So far as integrated collectivities operate on the same lines as individual persons, they will also have this capacity to think in first-person terms. From the standpoint of those in an integrated collectivity, the words defended in the past, for example, will stand out from any words emanating from elsewhere as words that bind and commit them. Specifically, they will stand out for those of us in the collectivity as words that "we" as a plural subject maintain.")

[4] And, because practices described as self-regulation vary depending on the context, it is important to emphasize that this paper focuses on self-regulation in the context of financial activity.

[5] *See, e.g.*, John Braithwaite & Peter Drahos, GLOBAL BUSINESS REGULATION, 28, (2000) ("The last two decades of the twentieth century saw the rise of a 'new regulatory state', where states do not so much run things as regulate them or monitor self-regulation. Self-regulatory organizations frequently become more important than states in the epistemic communities where debates over regulatory design are framed.")

[6] *See, e.g.*, Julia Black, *Decentring Regulation: Understanding the Role of Regulation and Self Regulation in a "Post-regulatory" World*, 54 Current Legal Problems 103 (2001).

[7] *See, e.g.*, Bridget M. Hutter and Clive J. Jones, *From Government to Governance: External Influences on Business Risk Management*, 1 Regulation & Governance 27 (2007).

[8] Self-regulation may or may not constitute "law". *See, e.g.*, Joseph Raz, *Incorporation by Law*, 10 LEGAL THEORY, 1, 12 (2004) ("the distinction between what is part of the law and what are standards binding according to law but not themselves part of the law is particularly vague. That is not surprising given that we do not often need to rely on it. Though sometimes there are procedural differences regarding, say, judicial notice and rules of evidence and of presentation that do or do not apply to standards that are part of the law or merely enforceable according to law, much of the time the practical implications of a standard are the same either way. That is not to say that we can dispense with the distinction or that it is of no importance. So long as we maintain that what is required according to law is made so by law, we cannot dispense with it, and so long as the law maintains its place at the heart of the political organization of society and remains a focus of attitudes of identification and alienation, the distinction has an importance way beyond any legal technicalities.")

[9] Although *cf. e.g.*, Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 DUKE L. J. 389 (2003) (arguing that private regulation is not necessarily less costly for government than government regulation).

regulation because of its non-governmental characteristics.[10] A separate, but related, set of arguments focuses on ideas that regulation which is the product of epistemic communities, or which is produced through reflexive processes, is inherently preferable to that generated outside those communities and reflexivities through more general and more political processes.[11] These arguments appear in simpler and more sophisticated forms, from rather vague romantic and nostalgic notions,[12] to the idea that business people just like to set their own rules,[13] to complex claims about expertise.

In 1988, Michael Moran stated that "[t]he conventional justifications for self regulation are well known: it was supposed to produce quick decisions, flexible trading practices adapted to markets and compliance with the spirit, and not merely the letter, of rules." [14] But, as Moran also points out, self-regulation can be used to protect power.[15]

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[10] FINRA now describes itself as "the largest non-governmental regulator for all securities firms doing business in the United States". See About the Financial Industry Regulatory Authority at http://www.finra.org/AboutFINRA/CorporateInformation/index.htm.

[11] *See, e.g.*, Gunther Teubner, *'Global Bukowina': Legal Pluralism in the World Society*, in Gunther Teubner (Ed.) GLOBAL LAW WITHOUT A STATE 7 (1997)("The new living law of the world is nourished not from stores of tradition but from the ongoing self-reproduction of highly technical, highly specialized, often formally organized and rather narrowly defined, global networks of an economic, cultural, academic or technological nature.")

[12] Some romantic versions of the arguments for self-regulation are related to claims about lex mercatoria. *Cf.* Stephen E. Sachs, *From St. Ives to Cyberspace: the Modern Distortion of the Medieval 'Law Merchant'*, 21 AM. U. INT'L L. REV. 685, 690-694 (2006) (challenging the romantic view of the medieval law merchant and arguing that rather than the merchants of St. Ives regulating themselves they were subject to the authority of the King and of the Abbey of Ramsey) ; Anna Di Robilant, *Genealogies of Soft Law*, 54 AM. J. COMP. L. 499, 526 (2006) ("It is noteworthy that the romance of the lex mercatoria is a myth subject to cyclical revivals in different cultural and historical contexts.")

[13] *Cf.* Edward Manson, *The City of London Chamber of Arbitration*, 9 LQR 86, 87 (1893) ("Business men want, not only celerity and cheapness, but to make their own law for themselves, as they have done before.")

[14] Michael Moran, *Thatcherism and Financial Regulation*, 59 POLITICAL QUARTERLY 20, 22 (1988)

[15] *Id.* ("[S]elf regulation also had an important political function: by keeping the statute book at bay it helped make markets independent of courts, civil servants and politicians. In other words, it preserved the autonomy of powerful interests in the City from the normal workings of constitutional democracy in Britain."). *See also, e.g.*, Len Ross, *Investor Protection - Why Gower is Wrong*, 4 Economic Affairs 50 (1984) ("Gower issued a discussion document in 1982. In that he proposed setting up four regulatory agencies covering the whole investment industry. The comments he received from the 'producers'

Comparing and contrasting self-regulation and governmental regulation, and defining the relationships between them are complex tasks. Official terminology is not always reliable as an indicator of the nature of the regulatory system. Organizations which are described as "self-regulatory" often derive (or appear to derive) their (quasi) regulatory authority from the state.[16] Members of an SRO may find that they have to look beyond their SRO to assess the risks that they will be subject to enforcement action.[17] Self-regulatory rules may be introduced in order to fend off formal governmental regulation. At the same time governmental regulation may look very much like a negotiated order and may give effect to private agendas.

As a practical matter, governance generally involves a mix of state and non-state rules. The elements and organization of the mix vary in different jurisdictions and in different industries. Regulatory standards may be generated by legislators and governmental regulators, they may be generated by the regulated industry, or they may be generated through co-operation between governmental agencies and the regulated population. Enforcement of standards may be carried out through different

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themselves were largely on the lines that they did not require direct government regulation; all they wanted was government backing to regulate themselves.") *Cf.* Ferdinand Pecora, WALL STREET UNDER OATH, 287 (1968 reprint) ("The Securities Exchange Act of 1934...broke new ground. For the first time it sought to regulate operations on the New York Stock Exchange and the other securities exchanges , and to protect the public from the multitude of sharp practices that flourished there. It created a new body, known as the Securities and Exchange Commission, consisting of five members, to whom were granted very effective and far-reaching powers. This was indeed necessary in dealing with such an institution as the New York Stock Exchange. To have done otherwise, as a witness testified before the Committee, while the bill was pending, "would be like advising that one put a baby in a cage with a tiger to regulate the tiger.""")

[16] Stock Exchanges commonly exercise regulatory powers under the authority of statutes. *See*, *e.g.*, SRO Consultative Comm., Int'l Org. of Secs. Comm'ns, Model for Effective Regulation, 3 (May 2000) *available at* http://www.iosco.org/download/pdf/2000-effective_self-regulation.pdf ("In several jurisdictions around the world, effective self-regulation existed before statutory regulation. As markets developed, market participants recognized that regulation was necessary in order to protect the integrity of the market. Industry participants recognized that those who were most familiar with the customs and practices of a particular trade were best suited to create rules related to that trade, to enforce those rules and to resolve the disputes that arose from those rules. Moreover, the familiarity with the concepts involved ensured that such disputes were quickly resolved and that the rules for commerce in that particular market continually and quickly adapted to the evolutions in the manner in which trade was conducted."

[17] Jenny Anderson, *A New Inquiry Into Big Board Specialists*, New York Times, C1 (Feb. 7, 2005) (reporting that the Manhattan US Attorney's office was investigating whether NYSE members had cheated customers through illegal trading practices).

combinations of governmental and non-governmental processes.

Challenges to claims about the efficiency and effectiveness of self-regulation may be empirical. Scholars study the conditions under which self-regulation or governmental regulation may be more effective. Stories of successful self-regulation have often identified shared characteristics of self-regulating groups which enhance the effectiveness of the self-generated norms. For example, Barak Richman shows how Jewish community institutions function as an alternative to public regulation among diamond-merchants.[18] And there is some evidence that the source of rules matters for attitudes to compliance.[19]

This paper argues that the concept of self embedded in self-regulation in the financial markets is increasingly incoherent. Three separate recent developments illustrate this argument. First, the transition of financial exchanges from membership organizations to for-profit corporations means that the people who perform functions in the exchange marketplace and those who own the marketplace may be different. Second, combinations of self-regulatory organizations (SROs) create self-regulators which set standards for or monitor increasingly disparate entities. Where these combinations are transnational the picture is even more complex. Third, SROs are outsourcing regulatory functions so that what occurs is in fact regulation by others rather than self-regulation. In addition, and not really recognized in the literature, self-

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[18] Barak Richman, *How Communities Create Economic Advantage: Jewish Diamond Merchants in New York*, 31 LAW & SOCIAL INQUIRY 383 (2006). Richman distinguishes between two different groups of participants in the diamond markets: long-term players (dealers and buyers) and contracted parties (brokers and cutters). The long-term players are participants in intergenerational family businesses, whereas the contracted parties are mostly members of ultra-Orthodox Jewish communities. *Id.* at 399.

[19] *See, e.g.,* Carol A. Heimer, *Thinking about How to Avoid Thought: Deep Norms, Shallow Rules, and the Structure of Attention*, 2 Regulation & Governance 30, 44 (2008) ("In the HIV clinics I studied, people treated rules differently depending on whether they were about clinical care, research, or governance. Generally speaking, rules about clinical care have high moral authority and tend to be treated as deep norms rather than as shallow rules. They are more likely to be seen as created by ''us'' rather than ''them.'' They are seen as serving ''our'' purposes and they become naturalized. Rules about research are of intermediate authority. Some, like the rules about non-coercion of research subjects or the integrity of data, have high legitimacy; others, especially having to do with oversight, are more likely to be treated as empty rituals. Governance rules tend to be seen as the most ''imposed'' and arbitrary. That makes them strong candidates for ritualization. Because resources may be tied to compliance with governance rules, there is a good deal of struggle over them. Resistance to one cluster of rules is often legitimized by reference to an obligation to comply with another.")

regulatory rules and processes are increasingly developed and applied by lawyers working in SROs and in financial trade associations.

The questions in this paper about the nature of the self in self-regulation matter from the perspective of regulatory effectiveness if certain characteristics of the self are correlated with more effective regulation. The same questions matter for the legitimacy of regulatory processes if a rhetoric of self-regulation helps to disguise the nature of the regulatory compromises at stake. “Self-regulatory” rules developed subject to detailed statutory requirements and the close supervision of a governmental regulator are not really self-regulatory rules. “Self-regulatory” rules developed under the threat of governmental regulation are similarly problematic.

Financial regulation is inherently complex because financial activity is complex. The “deregulation “ of the late 20th century produced financial markets in which multi-function firms carry on business across national borders, and in which they seek to arbitrage between different national rules and, in some cases, to persuade governments to harmonize their rules with those of other jurisdictions.[20] Clearly, 19th century self-regulation is not appropriate to current conditions.

The statutory frameworks within which financial self-regulation operates aim to limit some of the disadvantages of traditional self-regulation. Exchanges are not allowed to limit membership to people who happen to fit in because of their race, background, or nationality.[21] Statutory constraints on a self-regulator may be part of a bargain which protects it from antitrust challenges.[22] But these statutory constraints result in a move away from pure forms of self-regulation (which could be more effective in some ways

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[20] *See, e.g.*, Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, forthcoming in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., Multilevel Regulation and the EU: The Interplay between Global, European and National Normative Processes (2008).

[21] For example, before the SEC registers a national securities exchange it must be satisfied that the rules of the exchange provide for fair access to the exchange. 15 U.S.C. §78f.

[22] *See*, *e.g.*, *Gordon* v. *New York Stock Exchange*, 422 U.S. 659, 688-91 (1975) (holding that the antitrust laws are deemed repealed to the extent necessary to permit the securities laws to function as intended by Congress). Securities Exchange Act of 1934, § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) requires the SEC "to assure . . . (f)air competition among . . . . exchange markets and markets other than exchange markets."

than the constrained versions), allow governments to distance themselves from regulatory failures,[23] and restructure the competitive landscape of markets.

MEANINGS OF SELF-REGULATION

Although recent writing on governance gives the impression that decentred regulation is entirely new, this impression is not really accurate. Self-regulation has been a feature of the financial markets for centuries.[24] Stock exchanges have always been able to exercise quasi-regulatory powers.[25] And the governance of stock exchanges has at times been more significant for market participants than the formal law.[26] In the 20th century policy-makers focusing on financial regulation combined features of self-regulation and governmental regulation.[27] By the early 21st century, policy-makers were re-examining the role of self-regulation in the financial markets.[28]

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[23] *Cf.* Alan C. Page, *Self-Regulation: The Constitutional Dimension*, 49 MOD. L. REV. 141, 143 (1986)

[24] *See*, *e.g.*, Paul Mahoney, *The Exchange as Regulator*, 83 VA. L REV. 1453, 1457 (1997) ("for most exchanges, comprehensive governmental regulation of rules and procedures is a twentieth-century phenomenon."); Moran, *supra* note 12 at 21-22 ("Regulation of the financial community in Britain was traditionally highly dispersed. Individual markets controlled their own affairs: historical peculiarity, social prestige and institutional power combined to produce a patchwork in which no organisation, either public or private, had responsibility for overall surveillance.")

[25] *See*, *e.g.*, Stuart Banner, *The Origin of the New York Stock Exchange*, 1791-1860 27 J. LEG. STUD. 113, 132 (1998) ("From its inception, the New York Stock and Exchange Board operated a miniature legal system, with its own rules governing securities trading and its own mechanism for resolving trade-related disputes.")

[26] *See, e.g.,* R. B. Ferguson, *Commercial Expectations and the Guarantee of the Law: Sales Transactions in Mid-Nineteenth Century England*, in G. R. Rubin & David Sugarman Eds., LAW, ECONOMY AND SOCIETY 1750-1914, 192, 197 (1984)("The Stock Exchange was a tight-knit, well-organised commercial club. As such it had it s own "code of honour" backed up by powerful sanctions. That code rendered the legal enforceability of bargains between members a superfluity. It is not clear, however, that the consequences of legal unenforceability between brokers and clients were equally negligible.")

[27] Moran points out that the 1986 reorganization of financial regulation in the UK, while using the language of self-regulation, in fact involved a significant move away from self regulation. Moran, *supra* note 12, at 22.

[28] *See, e.g.*, Sec. & Exch. Comm'n, Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71256 (Dec. 8, 2004) *available at* http://www.sec.gov/rules/concept/34-50700.pdf; Sec. & Exch. Comm'n, Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory

In social cognition theory the term "self-regulation" refers to an individual's regulation of her own behavior.[29] Individuals self-regulate in response to internal and external influences.[30] In regulation, commentators often use the term "self-regulation to refer to collective action:[31]

> Self-regulation...denotes the regulation by a voluntary association of the conduct of its members..in the exercise of statutory or, as is more common, non-statutory powers. It is collective rather than individual in character, and hence it is not to be confused with the integrity, honour and self-discipline of individual firms.[32]

This description of self-regulation, focusing on the idea of people or firms working together to regulate themselves is distinct from an idea of regulation imposed from outside, but is consistent with ideas of reflexive regulation. Purely voluntary self-regulation contrasts with legal regulation: in its most formal incarnations it binds its members through contract rather than through regulation. In less formal versions, self-

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Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, 69 Fed. Reg 71126 (Dec. 8, 2004) *available at* http://www.sec.gov/rules/proposed/34-51019.pdf . See also Sec. & Exch. Comm'n, *Proposed Rule Changes of Self-Regulatory Organizations*, 69 Fed. Reg. 60287 (Oct. 8 , 2004) *available at* http://www.sec.gov/rules/final/34-50486.pdf .

[29] *See, e.g.*, Albert Bandura, *Social Cognitive Theory of Self-Regulation*, 50 Organizational Behavior and Human Decision Processes 248, 249 (1991) ("If human behavior were regulated solely by external outcomes, people would behave like weathervanes, constantly shifting direction to conform to whatever momentary social influence happened to impinge upon them. In actuality, people possess self-reflective and self-reactive capabilities that enable them to exercise some control over their thoughts, feelings, motivation, and actions. In the exercise of self-directedness, people adopt certain standards of behavior that serve as guides and motivators and regulate their actions anticipatorily through self-reactive influence. Human functioning is, therefore, regulated by an interplay of self-generated and external sources of influence.")

[30] Psychologists recognize that the idea of self is inherently complex, even in individuals, and that individuals may emphasize different aspects of their selves in different circumstances. *See, e.g.*, Yifat Kivetz & Tom R. Tyler, *Tomorrow I'll be Me: The Effect of Time Perspective on the Activation of Idealistic Versus Pragmatic Selves*, 102 ORGANIZATIONAL BEHAVIOR AND HUMAN DECISION PROCESSES 193 (2007).

[31] Although see, e.g., negotiated compliance.

[32] A. C. Page & R. B. Ferguson, INVESTOR PROTECTION, 82 (1992).

regulation does not have even the force of contract.[33]

As a practical matter, what we describe as self-regulation is often defined by and subject to legislation.[34] Although stock exchanges may historically have been voluntary membership organizations where the members collectively regulated themselves, they now operate within the context of detailed statutory and regulatory regimes.[35] Moreover, in addition to managing self-regulation through legislation and rules, governmental authorities sometimes encourage the development of non-governmental structures for regulation. For example, regulation of the conduct of take-overs in the UK, including regulation of the defensive tactics a target managements might seek to use, began as a form of self-regulation, designed to fend off governmental regulation.[36] But it was non-governmental regulation developed in response to wishes expressed by the Bank of England,[37] a governmental body.

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[33] Consider, for example, informal money transmission systems such as hawala.

[34] The International Organisation of Securities Commissions, IOSCO, has declared that systems of securities regulation should use SROs and that these SROs should be subject to the control of a regulator. *See* IOSCO, Objectives and Principles of Securities Regulation, i (Feb. 2008) (stating principle 6: "The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets" and principle 7: "SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.")

[35] *See, e.g.*, BATS Exchange, Inc.; Notice of Filing of Application and Amendment No. 1 Thereto for Registration as a National Securities Exchange Under Section 6 of the Securities Exchange Act of 1934, 73 Fed. Reg. 9370 (Feb. 20, 2008).

[36] *See, e.g.*, Robert R. Pennington, *Takeover Bids in the United Kingdom*, 17 AM. J. COMP. L. 159, 160 (1969) ("the very effective sanction inducing the City institutions and the supervisory panel set up under the code to ensure that this is done, is the knowledge that if there are only a few serious contraventions, the self- regulation of the City will be supplanted by statutory control by the Government, with all the additional work, loss of time, (which is always material in takeover bids) and inflexibility which Government regulation entails.")

[37] *See, e.g.*, *id.* at 172 ("The City Code was first published in March 1968. It was the result of work by a committee organised by the Bank of England in the previous October; on this committee were represented the Accepting Houses Committee (the organ of the merchant banks), the Association of Investment Trusts, the British Insurance Association, the London Clearing Bankers' Committee (the organ of the joint stock banks), the Confederation of British Industry, the Federation of Stock Exchanges and the National Association of Pension Funds.") On early takeover regulation in the UK, see also e.g., D. Prentice, *Take-Over Bids - The City Code on Take-Over and Mergers*, 18 MCGILL L. J. 385 (1972); B.J. Davies, *An Affair of the City: A Case Study in the Regulation of Take-Overs and Mergers*, 36 MOD. L. REV.

In addition to these formally required and regulated and informally generated self-regulations, organizations which represent the interests of financial firms may try to pre-empt legal regulation by developing their own guidelines. For example, in response to concerns that firms that had acquired interests in syndicated loans were ignoring legal restrictions on insider trading, the trade associations representing participants in the syndicated loans market developed sets of guidelines.[38] The UK's Treasury and financial regulator, the Financial Services Authority (FSA), collaborated with private sector entities to implement the Markets on Financial Instruments Directive (MiFID)[39] in the UK in an initiative called MiFID Connect.[40] The FSA subsequently recognized some of the guidelines produced by MiFID Connect as confirmed industry guidance.[41] The FSA's November 2006 Discussion Paper on Industry Guidance distinguishes between guidance which establishes regulatory safe harbours and guidance which constitutes

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457 (1973).

[38] Loan Market Association, Dealing with Confidential and Price Sensitive Information (April 2006). See also Loan Market Association, Private and Inside Information in the Loan Market (August 2007); Loan Syndications and Trading Association, Statement of Principles for the Communication and Use of Confidential Information by Loan Market Participants (Oct. 16, 2006).

[39] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC OJ No. L 145/1 (Apr. 30, 2004).

[40] *See* http://www.mifidconnect.org/bba/jsp/polopoly.jsp?d=569&a=7552 ("MIFID Connect is a joint project designed to support member firms and simplify the UK implementation of the Markets in Financial Instruments Directive (MiFID). Statutory implementation in the UK will be carried through by the HM Treasury and by the FSA making rules in its handbook...The Association of British Insurers (ABI), The Association of Private Client Investment Managers and Stockbrokers (APCIMS), Association of Foreign Banks (AFB), The Bond Market Association, the British Bankers' Association (BBA), Building Societies Association (BSA), the Futures and Options Association (FOA), The International Capital Market Association (ICMA), Investment Management Association (IMA), The International Swaps and Derivatives Association (ISDA) and the London Investment Banking Association (LIBA) have established a joint programme for reducing the legal risk and simplifying the implementation of the Markets in Financial Instruments Directive (MiFID).")

[41] FSA, Confirmed Industry Guidance, at http://www.fsa.gov.uk/Pages/Library/Other_publications/industry_guidance/index.shtml. See also FSA, FSA Confirmation of Industry Guidance. Feedback on DP06/5, Policy Statement (Sept. 2007) *available at* http://www.fsa.gov.uk/pubs/policy/ps07_16.pdf. *See also, e.g.*, MiFID Connect, Guideline on the Application of the Suitability and Appropriateness Requirements under the FSA Rules Implementing MiFID in the UK, *available at* http://www.mifidconnect.org/content/1/c6/01/02/00/suitability_guideline_100807.pdf.

"sturdy breakwaters".[42] Sturdy breakwaters are established by confirmation by the FSA, and provide protection against action by the FSA but not by third parties. In the discussion paper, the FSA also recognized that other forms of guidance may benefit from implicit recognition.[43] In the subsequent policy statement the FSA sought to distance itself from guidance which is not confirmed,[44] and the FSA has taken pains to state that providers of confirmed guidance "are not quasi-regulators".[45]

During the discussions about the effect of industry guidance in the UK, some respondents to the consultation suggested that guidance should only have effects with respect to members of the organization which produced it:

> Some respondents raised concerns about our requirement to make Industry Guidance free and publicly available. They suggested Industry Guidance should be limited to trade association members only and that making it available to all is anti-competitive as it enables 'free riding' by non-members. Some smaller firms and trade associations suggested that in the worst case this could have serious implications for the future of their business.[46]

The FSA continued in its belief that guidance should be publicly available:

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[42] FSA, FSA Confirmation of Industry Guidance, 7 (Nov. 2006) *available at* http://www.fsa.gov.uk/pubs/discussion/dp06_05.pdf.

[43] *Id.* at 8 ("Implicit recognition: this has no legal effect on the FSA or anyone else. An example of this type of recognition is the provisions of the Banking Code that cover matters about which we have made no rules. Equally, we have made no rules, guidance or other statement recognising those provisions. The recognition is implicit in our inaction, because the industry has found a solution to address a market failure, rather than in actions giving explicit recognition. Implicit recognition is not subject to any statutory process")

[44] *See* Policy Statement, supra note 38, at 9 ("we propose to tighten our policy by limiting the endorsement of Industry Guidance to FSA confirmation only. This means we will not provide any public recognition we have approved, reviewed or commented on such guidance, nor would we be willing for guidance providers to refer to our involvement in terms that implied we were in agreement with it... However, where confirmation is not sought we will continue to engage with guidance providers (whether commenting on certain parts of their guidance or forming part of a working group) where appropriate.")

[45] *See id.* at 8. I have used the term "quasi-regulator" in this paper in a broader sense than the FSA's.

[46] *Id.* at 13.

> We still believe guidance should be free and publicly available. This is appropriate given its legal status; and is consistent with our formal regulatory approach. While we acknowledge the concerns of some trade bodies that this would diminish the benefits of membership, we believe there are benefits too for members, as collectively they will dictate when guidance should be produced, what guidance is required and the content of that guidance.[47]

This outline illustrates that the relationship between governmental and private regulation in the financial markets is recursive. However, it is not only the relations between governmental and private regulation which are complex. The following sections of the paper describe ways in which the private elements of regulation which we tend to think about as self-regulation, are changing.

THE LEGAL FORM OF THE SELF

Traditional discussions of self-regulation assume that the self-regulatory entity is a voluntary association of members. The idea of voluntariness is consistent with Bandura's theory of individual self-regulation, which, although it involves responsiveness to external factors, is ultimately a matter of individual will. In contrast, statutory mandates have limited the voluntariness of participation in self-regulatory organizations in two critical respects: financial firms may be required to join an SRO as a condition of doing business, and SROs may have limited discretion as to whom they must admit to membership. And whereas the romantic conception of self-regulation seems to assume that the voluntary association of members is of individual members, in fact SRO members tend to be firms.

Recent developments in the organization of exchanges have also affected the extent to which exchanges can be seen as associations of members. Financial exchanges have been transforming themselves from membership organizations to for-profit corporations, resulting in a separation between those who perform functions in the

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[47] *Id.* at 14.

exchange marketplace and those who own the marketplace.[48] In recent years there has been a trend in business organization law in the US to see firms as legal entities separate from their owners. Partnerships, which were traditionally conceptualized as aggregates of their owners now tend to be treated as separate legal entities. The UK legislation for limited liability partnerships describes their formation as involving incorporation. However, although such a separation may have advantages, it also means that there is a real difference between the legal entity and its owners. Whereas it makes sense to think of a mutual, not-for-profit, firm as an aggregate of its members, a for-profit incorporated entity is something other than an aggregate of its members.

The idea of collectivity in mutual organizations is reinforced by their decision-making processes. Members of a mutual organization may have the right to have binding decisions taken only by unanimity. In contrast, and cited among the reasons for demutualization of exchanges, incorporated firms operate through delegated and majority decision-making processes which make them better able to make decisions which involve change.[49]

While traditional self-regulation may benefit from voluntary association so that members feel bound by common standards of behavior, it may also suffer from conflicts of interest. The self-regulator may act to protect its members at the expense of outsiders in various ways. Statutory frameworks for self-regulation seek to minimize the costs of self-regulation for non-members. An SRO which is a for-profit firm may have different incentives to skew its regulation to benefit its owners. In particular, a for-profit SRO might act to increase profits by lowering regulatory standards to attract business

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[48] See, e.g., Technical Committee, Int'l Org. of Secs. Comm'ns, CONSULTATION REPORT - REGULATORY ISSUES ARISING FROM EXCHANGE EVOLUTION, (May 2006) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD212.pdf ("Traditionally, exchanges were owned by the market participants and were responsible for the regulation of both the markets they operated and of the members themselves. They were member-owned, self-regulatory organisations in the full sense of those terms. However, in recent years, the rationale and support for continuing mutual ownership has tended to weaken and most major exchanges have now converted into for-profit companies with broader shareholder bases.")

[49] *See, e.g.*, Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?* 21 N.W.J. INT'L L.&BUS. 657, 671 (2001).

or by reducing the amount of resources dedicated to regulation.[50] One illustration of the conflicts between the interests of different participants in the financial markets is the challenges by market participants to the actions of profit-making exchanges and their regulators in relation to the level of fees charged for market information.[51]

Different jurisdictions have responded in various ways to limit the potential negative impacts of new ownership structures for regulation. For example, in response to the London Stock Exchange's demutualization, the UK separated the listing function, which is regulated under European Community law, from the function of admission to trading.[52]

An alternative or supplement to governmental regulation to address issues of legitimacy of decision-making within a collective, but not mutual, organization, would be for the organization to adopt its own processes for ensuring legitimacy. Philip Pettit argues that purposive organizations will tend to face discursive dilemmas:

> The hard choice that a group in this dilemma faces is whether to let the views of the collectivity on any issue be fully responsive to the individual views of members, thereby running the risk of collective inconsistency; or whether to ensure that the views of the group are collectively rational, even where that means compromising responsiveness to the views of individual members on one or another issue.[53]

Pettit argues that collective purposive organizations may be regarded as integrated collectivities and as intentional agents under certain conditions. He describes such an entity as follows:

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[50] *See, e.g.*, *id.* at 8. The report notes that mutual SROs might also reduce standards to help their members. *Id.* Some have argued that a race-to-the-top model might work for exchange SROs.

[51] *See, e.g.*, SIFMA Letter to Sec Re: Order Granting Petition for Review of File No. SR - NYSEArca - 2006 - 21, a Rule Change Proposed by NYSEArca to Establish Fees for the Receipt and Use of Depth-of-Market Data, (Feb. 7, 2008) *available at* http://www.sifma.org/regulatory/comment_letters/62530990.pdf.

[52] *See, e.g.*, Financial Services Authority, The Transfer of the UK Listing Authority to the FSA, CP 37 (Dec. 1999), *available at* http://www.fsa.gov.uk/pubs/cp/cp37.pdf.

[53] Pettit, supra note 3, at 450.

> Within relevant domains it will generally act in a manner that is rationalized by independently discernible representations and goals; and within relevant domains it will generally form and unform those representations in a manner that is rationalized by the evidence that we take to be at its disposal. In particular, it will manifest this sort of functional organization not just at a time but over time; it will display the degree of constancy as well as the degree of coherence that we expect in any intentional subject.[54]

Thus, although the recent transitions of financial exchange SROs from mutual business forms to corporate forms risk increasing the conflicts of interest between the different stakeholders, and regulatory solutions may not entirely eliminate the conflicts, it is possible that a for-profit exchange SRO could coalesce around an operational model that would allow it to be seen as the sort of integrated collectivity which would constitute a new self.[55] This would require work.[56]

MULTI-FUNCTION (AND TRANSNATIONAL) SELVES

Securities exchanges are archetypes of traditional financial market self-regulation because of their history as voluntary membership organizations, but also because the activities of their members focused on their own exchange in one physical location. In the past traders on financial markets used to meet in coffee houses[57] and

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[54] *Id.* at 458. See also Pettit, supra note 1 at 504 ("In order to replicate the performance of a single agent, the members of a group will have to subscribe, directly or indirectly, to a common set of goals, plus a method for revising those goals, and to a common body of judgments, plus a method for updating those judgments. And in addition they will have to endorse a method of ensuring that one or more of them – or an appointed deputy – is selected to form and enact any intention, or perform any action, that those group attitudes may require. Or at least they will have to take steps that provide for these results, within feasible limits and under intuitively favourable conditions.")

[55] It is not obvious that most publicly traded incorporated entities satisfy Pettit's criteria.

[56] *See* Pettit, *supra* note 1 at 496 ("group agency among human beings does not emerge without effort; group agents are made, not born.")

[57] *See*, *e.g.*, David Kynaston, THE CITY OF LONDON. VOL 1, 16 (1994) (noting the London Stock Exchange's origins in the coffee houses of Change Alley.)

on the streets[58] to make their trades. Now traders' interactions are mediated by screens and they interact with each other at a distance rather than on the floor of a financial exchange.[59] Technological change facilitates new ways of doing business, but it also disallows or makes redundant old ways of doing business. Financial firms rely on computer programs to perform tasks once carried out by people.[60] Technology also facilitates outsourcing of functions beyond the firm.

Firms which deal in securities are not only trading at a distance from the markets in which they trade, but they are trading in multiple markets,[61] and they are often part of larger multi-function financial firms which engage in other varieties of financial business. Financial firms operate across traditional regulatory boundaries, and, in doing so, have encountered differences in the rules applied by different SROs. In 2007, the NASD and the NYSE combined their regulatory functions in a new SRO, called the Financial Industry Regulatory Authority (FINRA.).[62] Since the merger, FINRA has focused on

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[58] AMEX was originally known as the Curb Exchange because of its physical location. Robert Sobel, AMEX: A HISTORY OF THE AMERICAN STOCK EXCHANGE, 1921-1971.

[59] *See, e.g.*, Caitlin Zaloom, *Ambiguous Numbers: Trading Technologies and Interpretation in Financial Markets*, 30(2) AMERICAN ETHNOLOGIST 258-272, 265 (2003) ("In a sharp break from the complex information system in the pit, where fathers and sons, friends and allies pass information through tightly controlled networks, the screen displays the market in simple terms available to the eyes of any trader with access to it."); Karin Knorr Cetina & Alex Preda, *The Temporalization of Financial Markets: From Network to Flow*, 24 THEORY, CULTURE & SOCIETY 116 (2007).

[60] For a general assertion of this proposition (not referring solely to financial firms) *see, e.g.*, Hannah Knox, Damian O'Doherty, Theo Vurdubakis and Chris Westrup, *Transformative Capacity, Information Technology, and the Making of Business 'Experts'*, 55 SOCIOLOGICAL REVIEW 22, 25 (2007) ("In contemporary organisation, information technologies increasingly mediate the complex task of disentangling 'knowledge' from the situated practices of (lived) work settings and re-locating it in the screens and records of managers and consultants... In the performance of this task IT systems replace former ways of calculating and measuring, substituting the expert labour that was once central to these ways of knowing with technical systems that perform calculations increasingly unaided by human agents.")

[61] *See, e.g.*, Iain Hardie & Donald MacKenzie, *Assembling an Economic Actor: the Agencement of a Hedge Fund*, 55 SOCIOLOGICAL REVIEW 57 (2007) (describing a hedge fund's trading).

[62] *See* Sec. & Exch. Comm'n, Program for Allocation of Regulatory Responsibilities Pursuant to Rule 17d–2; Notice of Filing and Order Approving and Declaring Effective a Plan for the Allocation of Regulatory Responsibilities Between the National Association of Securities Dealers, Inc., New York Stock Exchange, LLC, and NYSE Regulation, Inc., 72 Fed. Reg. 42146, 42147 (Aug. 1, 2007) ("The consolidation is intended to streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and a single set of examiners with complementary areas

harmonizing its rules with those of other SROs. For example, FINRA recently proposed to amend its rules for communications with the public about options, stating "FINRA believes that the proposed rule change will better address the needs for regulating current options communications practices and promote consistency across SROs. After these proposed changes are filed with the SEC, FINRA and other SROs will begin work on updating the Guidelines for Options Communications."[63]

Such self-regulatory merger activity may increase rule harmonization, but it also increases the distance between the regulated entities and the SROs' regulatory processes and may render them less responsive to the needs of individual firm members. At some point the membership of an SRO must become too large and diverse to constitute any real sort of self for the purposes of meaningful self-regulation. Whereas the political system is understood as a system which develops rules for people with diverse interests,[64] self regulatory systems are typically understood to develop rules for people with convergent interests.

As SRO membership at the domestic level becomes less homogenous, financial firms and exchanges spread across territorial boundaries.[65] Unlike governmental

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of expertise within a single SRO.")

[63] Sec. & Exch. Comm'n, Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Amending NASD Rule 2220 (Options Communications with the Public) 73 Fed. Reg. 24332, 24337 (May 2, 2008). See also id at 24335 ("FINRA and other SROs have sought to modernize their rules concerning options communications with the public. One of the goals of this rule modernization is to make the rules on options communications consistent with the general rules on communications with the public.")

[64] *Cf.* Raz, *supra* note 7, at 5 ("Some people tend to think that in democratic countries people are bound only by laws that they themselves made. But those who live in democratic countries know that they are bound by laws made a hundred years before they were born and that their children are bound by laws that they had no say in, and they themselves are bound by laws whether or not they participated in the process leading to their enactment, let alone being bound by them whether or not they supported or opposed them.")

[65] *Cf.* Knorr Cetina & Preda, supra note 56, at 118 ("Most stock exchanges were originally national financial centers, insulated from other countries by national regulatory codes, linguistic and geographical communication barriers, and traders' monopolizing strategies. The creation of transcontinental exchanges is something that is taking place in the stock market only as this article is written.")

regulation, self-regulation can apply across national borders.[66] However, as financial markets operate across territory this increases pressures for harmonization of rules, adding to the distance between SROs and their members.

Exchange SROs merge and develop convergent rules and standards, but at the same time multi-function financial firms belong to trade associations which focus on different aspects of financial activity in which they engage.[67] Large, multi-national, multi-function financial firms[68] are subject to a wide range of regulatory and self-regulatory regimes[69] and they participate in non-regulatory standard-setting processes. As a

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[66] Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization and Consolidation*, 22 U. PA. J. INT'L ECON 497, 538 (2001) ("These are not rules promulgated by a government agency, but by contractual arrangements among the participants. This suggests that self-regulation has the ability to finesse the problems of national sovereignty and differing legal systems that stand in the way of developing and enforcing common governmental regulatory standards.")

[67] For example, Merrill Lynch entities are members of ISDA, SIFMA, the ICMA and LIBA. *See* http://www.isda.org/membership/list_of_primary.html; http://www.sifma.org/about/members/ ; http://www.icma-group.org/membership/isma/list/alphabetical/m.html ; http://www.liba.org.uk/members/default.htm#m . Merrill Lynch entities are regulated by SROs including FINRA and the National Futures Association.

[68] *See, e.g.*, Knorr Cetina & Preda, supra note 56, at 125 ("Imagine the trading floor of a large investment bank in one of the world's global financial cities. You may see between 200 (Zurich) and 800 (New York) traders engaged in stock, bond and currency trading involving various trading techniques and instruments.")

[69] *See, e.g.*, Merrill Lynch, 2007 Annual Report, Where We Stand, 159 *available at* http://www.ml.com/annualmeetingmaterials/2007/ar/pdfs/annual_report_2007_complete.pdf ("Certain aspects of our business, and the business of our competitors and the financial services industry in general, are subject to stringent regulation by U.S. federal and state regulatory agencies and securities exchanges and by various non-U.S. government agencies or regulatory bodies, securities exchanges, self-regulatory organizations, and central banks, each of which has been charged with the protection of the financial markets and the interests of those participating in those markets.
• These regulatory agencies in the United States include, among others, the SEC, the CFTC, the Federal Energy Regulatory Commission ("FERC"), the FDIC, the Municipal Securities Rulemaking Board ("MSRB"), the UTDFI and the OTS.
• Outside the United States, these regulators include the FSA in the United Kingdom; the Irish Financial Regulator; the Federal Financial Supervisory Authority in Germany; the Commission Bancaire, the Comite des Establissements de Credit et des Enterprises d'Investissement and the Autorite des marches financiers in France; the Swiss Federal Banking Commission; the Johannesburg Securities Exchange; the Japanese Securities and Exchange Surveillance Commission; the Monetary Authority of Singapore; the Office of the Superintendent of Financial Institutions in Canada; the National Securities Commission in Argentina; the Securities and Exchange Commission in Brazil; the National Securities and Banking Commission in Mexico; the Securities and Exchange Board of India; and the Securities and Futures

practical matter, such firms are embedded in networks of regulation, self-regulation and quasi-regulation.

OUTSOURCED SELF-REGULATION (OTHER-REGULATION)

Outsourcing of financial regulation is another mechanism which undermines claims of regulatory systems to the "self-regulatory" title. Self-regulators may outsource supervision functions and/or standard-setting. In Canada, one firm, Market Regulation Services (RS), acts as a regulation services provider to the Toronto Stock Exchange, TSX Venture Exchange, Canadian Trading and Quotation System (including Pure Trading), Bloomberg Tradebook, Liquidnet Canada, Blockbook, MATCH Now, Omega ATS and Chi-X Canada.[70] RS states that its "mandate is to foster investor confidence and market integrity through the administration, interpretation and enforcement of the Universal Market Integrity Rules (UMIR). UMIR is a common set of market integrity principles designed to foster trading in a fair and transparent manner and is applied to all regulated persons, including broker/dealers and access persons, in all marketplaces the Company regulates."[71] Some of the markets which RS regulates have additional market rules which RS also enforces.[72] The UMIR are rules developed by RS, so that the markets which outsource regulation services to RS are outsourcing standard-setting and supervision functions.

Commission in Hong Kong, among many others.
Additional legislation and regulations, and changes in rules promulgated by the SEC or other U.S. federal and state government regulatory authorities and self-regulatory organizations and by non-U.S. government regulatory agencies may directly affect the manner of our operation and profitability. Certain of our operations are subject to compliance with privacy regulations enacted by the U.S. federal and state governments, the EU, other jurisdictions and/or enacted by the various self-regulatory organizations or exchanges. New laws or regulations or changes to existing laws either in the U.S. or in other jurisdictions where we conduct business could adversely affect us. As we expand into new regions we are subject to different regulatory regimes which impose additional complexities, compliance requirements and costs.")

[70] http://www.rs.ca/en/about/markets.asp?printVersion=no&loc1=about&loc2=markets.

[71] RS Market Regulation Services Inc. Annual Report 2007, 14, *available at* http://docs.rs.ca/ArticleFile.asp?Instance=100&ID=1DF37EF3B89141DAABA4B98EF32CF05C

[72] http://www.rs.ca/en/mktPol/marketSpecRules.asp?printVersion=no&loc1=mktPol&loc2=marketSpecRules

LAWYERS AND FINANCIAL SELF-REGULATION

The romantic, nostalgic notion of market self-regulation assumes that it is market participants who develop the rules which regulate their activities. But this idea of self-regulatory rules as rules generated by voluntary membership associations seems to imply an informality which is not present in the self-regulatory processes of SROs embedded in statutory regimes, Formalization of self-regulation means that it is lawyers, and not traders, who write the rules which regulate the traders. Lawyers are evident at all levels of SROs. For example, Mary Schapiro, the CEO of FINRA, is a lawyer.[73]

CONCLUSIONS

The paper begins by referring to some of the traditional ideas underpinning discussions of self-regulation: essentially that the advantages of self-regulation are that standards generated within self-regulatory contexts have an authenticity based in expertise and a connection to market practices that would not be as possible in the context of non-self-regulatory processes. One could describe the advantages differently as advantages of localization or of connection to a relevant community.

The examples in the paper challenge this idea by illustrating that what is commonly described as self-regulation in the context of the financial markets involves selves which are increasingly disparate and dislocated if not, in fact, others.

[73] *See* http://www.finra.org/AboutFINRA/CorporateInformation/FINRALeadership/p009733.