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**IS THERE AN INCIPIENT CRISIS IN SECURITIES REGULATION?  
PRINCETON, 16 OCTOBER 2014****PAUL TUCKER****HARVARD KENNEDY SCHOOL AND HARVARD BUSINESS SCHOOL**

Better capitalized *banks*. More liquid *banks*. Less opaque *banks*. Less interconnected *banks*. *Banks* that can fail in an orderly way without a taxpayer bailout. Those are the rallying cries of the global programme to reform the financial system that has been underway in earnest since the G20 Leaders' Summit in 2009. They are, indeed, good guiding principles. But is it really only about banks?

No, of course not. There's reform underway of derivative markets, secured money markets (usually known as repo markets), securities-lending markets, securitization markets, central counterparty clearing houses, credit rating agencies<sup>1</sup>. These reforms are addressed to some of the economy's main capital markets: their structure and the terms under which participants meet and trade. In most countries, they fall under the jurisdiction not of central banks and bank supervisors, but of securities regulators. That's to say, the Securities and Exchange Commission and the Commodities and Futures Trading Commission here in the US; the Financial Conduct Authority in London; the European Securities and Markets Authority for the EU as a whole.

And then there's an area that falls in between: 'shadow banking'. These are firms, funds or structures that as a matter of law are not caught by banking legislation and regulation, but which have the economic substance of banks in that they borrow short term to fund loans to households and businesses. As such, they are, like banks, exposed to the risk of runs, possibly forcing them into bankruptcy and bringing about a contraction in the supply of credit to the economy, hurting more or less everyone. In other words, they can cause systemic distress. In this realm too, which

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<sup>1</sup> For a review of the overall reform programme, see Tucker "Regulatory Reform, Stability, and Central Banking" Brookings Hutchins Center, 2014

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by no means extends to the whole of market-based finance, it is often securities regulators that have jurisdiction.

The implications of the reform agenda for the banking authorities and for securities regulators are quite different. For central banks and bank supervisors, they are being forcibly taken back to their roots: preserving financial stability. But for securities regulators, what is entailed is closer to requiring a transformation of mandates, regulatory techniques and decision taking. In a nutshell, they are now in the business of preserving financial stability; they are very much policy makers as well as enforcement agencies; and those policies unavoidably have a big international component given that global capital markets are not respecters of national boundaries. While many securities regulators have been involved in the global reform programme, I am not convinced that the implications of these changes have been widely recognized and internalized.

This is not, therefore, a lecture about the detailed substance of securities regulation, but rather about its political economy. I see profound challenges on three fronts: three fronts which, as I shall explain, are related. First, how to validate and frame the independence of securities regulators. Why, and to what extent, are they insulated from politics? As their mandates evolve, should they remain independent? Second, can a reliance on detailed rule books, the stock-in-trade of policy for markets, deliver what society needs to preserve financial stability? And if not, can regulatory discretion be squared with independence? Third, to what extent can national securities regulators, and the national legislatures that created and oversee them, make policy independently of each other? And to the extent that some policymaking is unavoidably a collective international enterprise, how can securities regulatory policy enjoy democratic legitimacy? I believe that if these issues are not recognized and addressed, sooner or later securities regulators will find themselves torn in very different directions, creating a crisis of competence or authority, or both<sup>2</sup>.

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<sup>2</sup> In a striking coincidence, on the same day as I delivered this lecture, Daniel M Gallagher, a SEC Commissioner, delivered the 15<sup>th</sup> Annual A A Sommer Jr. Lecture on Corporate, Securities and Financial Law in New York. Dan

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### The independence of securities regulators: changing missions without changing mandates

For roughly a century in the US, and for a rather shorter period in Europe, democratically elected governments have been hiving off areas of public policy and delegating them to agencies that are ‘independent’ in the sense of being insulated, to a greater or lesser extent, from day-to-day politics. Monetary policy is an obvious example. But it goes well beyond that. So much so that commentators and scholars typically talk about the Administrative State or the Regulatory State.

Apart from political expediency --- such as shifting blame, or the legislature limiting the power of the executive government, or just following fashion --- it is sometimes less than clear why power is delegated to agencies led by unelected officials. In the case of monetary policy, the reason has been pinned down. Broadly, it neutralizes the incentive of politicians to generate inflationary booms in order to enjoy a boost to their popularity from faster economic growth before the inflationary costs become apparent. In other words, central bank independence helps to solve the problem of making a credible commitment to preserve low and stable inflation.

But it is not at all obvious that the same kind of argument carries across, *mutatis mutandis*, to securities regulation. Think about the traditional role of securities regulators.

Once upon a time, securities regulators policed the integrity of individual transactions and offerings on public exchanges served by specialized intermediaries. The intermediaries were typically small, and the key public policy interest in them was that they be sufficiently liquid to be wound down in an orderly way if they got into difficulty. That wasn’t the hardest thing in the world to ensure. More demanding was how to ensure that markets were fair, that the public

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spoke on similar themes but with a different point of view: “...the US capital markets, the manner in which they are regulated, and the SEC itself collectively face an existential threat: the encroaching imposition of so-called prudential regulation on markets wholly unsuited to that regulatory paradigm”. We seem to agree that this matters. Also on the same day, in remarks delivered to the US Managed Funds Association, Timothy G Massad, Chair of the CFTC, observed that “We must never forget the true cost of the crisis: eight million jobs lost, millions of foreclosed homes, countless retirements and college educations deferred and business shuttered.” The numbers would, of course, be considerably larger if the spillovers to the rest of the world were included. Alongside the effects of self-inflicted wounds elsewhere, those spillovers have boomeranged back to slow economic recovery, and so prolong the social costs, in the US.

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wasn't ripped off or defrauded. To meet that challenge, the central tenet of SEC policy was disclosure-enforcement<sup>3</sup>. Issuers of securities were expected to disclose all information materially relevant to investors. And pre-trade and post-trade transparency was required to make secondary markets fair.

This was a world where the key lever of the securities regulator was the power to enforce the law, whether administrative injunction, administrative fine or (acting through departments of justice) via prosecution brought in the courts. The securities regulator's central task was, accordingly, the adjudication of individual cases, whether or not action proceeded to the criminal justice system. The normative case for independence amounted, therefore, to a variant of the case for the courts and for the central prosecuting authorities being insulated from the influence of day-to-day politics. Justice was being administered. Apparent attempts by the Nixon Administration to intervene in SEC investigations in the early-1970s were seen as underlining the case for the agency's independence.

That mission and culture remained intact at most securities regulators, and notably at the SEC, even once their mandate had been extended beyond public exchanges to over-the-counter markets, to private placements, to fund management, and during the 1970s to clearing and settlement systems. The watchword was disclosure, and the key instrument was enforcement. On the whole, that proved popular with legislative overseers, especially in the US, as bringing wrong-doers to book was readily understood and supported by the public. For many years that salience underpinned the status of securities regulators. It harnessed their interest in their own reputation and standing --- in Congress, and amongst the securities lawyers whom they both draw upon and nurture --- to matters the public cared about<sup>4</sup>.

There was a wobble in this set up after the 1987 stock market crash, since that was a national and international *economic* event rather than a problem of opacity or of wickedness *per se*. But it did

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<sup>3</sup> Anne M Khademian, "The SEC and Capital Market Regulation: the Politics of Expertise" 1992.

<sup>4</sup> For a review of the role of reputation in agency behavior, see Daniel P Carpenter and George A Krause "Reputation and Public administration" 2012.

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not, in the end, give rise to a fundamental rethink of the purposes and modalities of securities regulation. The SEC's mission, as expressed in its annual strategy statement, has remained "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation"<sup>5</sup>. In the UK, the statutory objectives of the new Financial Conduct Authority are: "to secure an appropriate degree of protection for consumers; to protect and enhance the integrity of the UK financial system; to promote effective competition in the interests of consumers"<sup>6</sup>.

The latest crisis poses a more fundamental challenge to this conception, as I shall describe. But first I should acknowledge my oversimplification of traditional securities regulation. Separately from their enforcement activities, regulators approved, overrode or substituted for the rules of securities exchanges and market bodies, essentially self-regulating trade associations. Often that role would entail balancing the varying interests of different groups of participants in the capital markets, such as corporate issuers, small intermediaries, big intermediaries, fund managers, and so on. Although not a universal truth, rarely were the issues seen as being of first-order importance for the public, and even more rarely were they salient. The regulators' role in writing or approving rules was, therefore, widely seen as a technical arena, with the legitimacy of their independence resting largely on their central enforcement function.

The latest crisis alters that picture fundamentally. In the first place, not only was the initial crisis deep and at times chaotic, macroeconomic recovery has been slow and stuttering. That underlines the social importance both of avoiding systemic financial crises in future and, since success in that endeavour cannot be guaranteed, of having the tools to contain a crisis and stabilize the system. But, secondly, this is not a remotely a project that falls solely to macroeconomic policymakers and bank supervisors. Whether it is as regulator of securities issuance and distribution or of the terms on which derivatives are traded or of the structure of

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<sup>5</sup> SEC, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, And Facilitates Capital Formation" 2013.

<sup>6</sup> The "integrity" objective is elaborated in the statute in a way that gives a hook for financial stability. The old Financial Services Authority paraphrased its statutory objectives as: "Market confidence; public awareness; consumer protection; reduction of financial crime".

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financial markets or of clearing houses or of trade repositories or of ‘shadow banks’ --- and I could go on --- securities regulators, under which heading I obviously include derivatives regulators, are going to be in the front line<sup>7</sup>.

And so here’s the rub: this is about making public policy, setting the ‘rules of the game’ for finance, and it unavoidably involves more than playing umpire amongst different sectional interests. Precisely because the problem of financial stability is about spillovers (or negative externalities) from private sector behaviour, industry input, however diverse, is unlikely to capture the social costs of distress. And because the costs are broadly spread across society as a whole and because the issues are so technical, public input during peacetime, before it is too late, is either unlikely or relatively ill-informed or both. Regulatory policy in the pursuit of stability entails making (and openly debating) judgments about the public interest.

But should unelected agency leaders make those judgments? Not entirely. We need politicians to decide on, and be held accountable via the ballot box for, the degree of resilience required of the financial system. But we don’t really have that in the securities arena. There is a shift in mission without a legislative reform of mandates and objectives.

Indeed, securities regulators, in common with other independent regulatory agencies, often have statutory objectives that are, to put it mildly, vague. For example, the SEC is responsible, amongst other things, for “the protection of investors”. But how *much* protection is required? And is the ‘protection of investors’ sufficient to capture the public interest in systemic stability. A few years ago, the International Organization of Securities Commissions (IOSCO), a body to which I shall return when discussing my third challenge, agreed by consensus amongst its entire global membership to amend its high-level Principles to add a new provision that securities-

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<sup>7</sup>For my views while in office on the importance of securities regulation to stability, see Tucker, “Building resilient financial systems: macro-prudential regimes and securities market regulation”, Bank of England May 2011.

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regulator mandates should include stability as an objective<sup>8</sup>. Implementation is, shall we say, patchy<sup>9</sup>.

All this provides something of a challenge. If no standard is set for the system's desired resilience, then independent regulators are making high policy in their rule making.

The state of affairs is, I would suggest, somewhat better in the banking sphere. The standard of resilience is, effectively but implicitly, set in the minimum standard for the capitalization of banks. In many jurisdictions, that standard is subject to legislative scrutiny and endorsement.

In summary, the problem of vague objectives, familiar in the US since the New Deal, is more serious in the securities/markets field now that rule-making for stability, as well as disclosure-enforcement, is (or should be) so central to public policy. Perhaps that provides part of the explanation for the confusions surrounding reform of US money market mutual funds, which unleashed one of the most ferocious lobbying efforts in finance of recent times, notwithstanding that the industry had received fiscal --- that's to say, taxpayer --- support during the crisis on both sides of the Atlantic.

But there is a further twist to the argument. Just how independent are the securities regulators? And does it matter?

In the US there is a convention --- not much remarked upon but important --- that upon a change of Administration, the chair of a regulatory body offers their resignation to the incoming President. Although commissioners cannot be fired without cause and so *do* each enjoy some

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<sup>8</sup> IOSCO Principles 6 and 7 were added in 2010. They are, respectively, "The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate" and "The Regulator should have or contribute to a process to review the perimeter of regulation regularly". An exercise for the reader is to spot the loopholes.

<sup>9</sup> Interestingly, the preamble to the SEC's key governing legislation motivates the need for the agency very broadly, including the need for a more effective national banking system and Federal Reserve System, and the risk of sudden and unreasonable fluctuations in the prices of securities causing alternately unreasonable expansion and unreasonable contraction of the volume of credit supplied to the economy. That captures a good deal of modern thinking about why financial stability matters but it is not fleshed out in the body of the legislation. As Dan Gallagher has emphatically said, "...systemic risk reduction is not part of the SEC's mandate...", op cit.

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independence, this convention effectively means that the President can ensure that the overall direction of the agency is in sympathetic hands. That matters in a set up where, at agencies like the SEC and CFTC, the chair leads the staff and establishes the agenda. If, further, as would be expected, a 'retiring' chair chooses to step down from the commission altogether, the incoming President can seek to establish a majority of commissioners aligned with his or her political party. In other words, in marked contrast to monetary policy, securities regulatory policy can shift with a change in the party holding the executive branch<sup>10</sup>.

That's not to say that Congress is toothless; far from it. The capital markets regulators are subject to the standard budgetary process, so key Congressional committees can determine not only total resources but can prescribe or proscribe, with considerable granularity, how the budget is spent. That gives them powerful indirect, as well as direct, levers over policy. It would be surprising if regulatory agencies were not sensitive to that.

Looked at in this light, the capital markets regulators' independence, their insulation from day-to-day politics, is somewhat partial and fragile. And, given the conventions protecting the integrity of adjudicative decisions, this is liable to be most marked in policy making via the writing of rules. While that might have made sense when rule-writing was seen as largely striking bargains balancing the interests of competing private sector groups, it is less suitable when the policy purpose is stability.

Let me stress at this point that there is no contradiction between my seeking high-level and broad political endorsement for the standard of resilience demanded of the financial system and my questioning the modalities of political control/influence over US securities regulators. It is, as I see it, the wrong *kind* of political control for securities regulators to play their part in preserving stability: tactical rather than strategic control. What is needed in this area of their work is a standard set by elected legislators, after due public debate, with regulators free to apply that

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<sup>10</sup> That is not to say that it always done so. Both the current and previous SEC Chairs are, I believe, independents in US parlance, ie not affiliated to one of the two main political parties.

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policy across different segments of the industry and in changing financial conditions. That way, two goals can be achieved. Politicians do what only they can legitimately do in a democratic society, namely reflect and forge public preferences and objectives; and by delegating the implementation of the regime to an independent agency, the public can be insulated from the short-term incentives of elected politicians to depart from those agreed objectives in order to get re-elected by permitting some exuberance liable to burst and reap havoc only at a later, uncertain date.

In other words, by bringing securities regulators fair and square within the financial stability field, the crisis challenges the political economy of the current dispensation and the balance of political and technical forces operative in a regime established when society's goals could largely be met by a doctrine of disclosure-enforcement. Today's world is more complicated, and a more subtle regime is needed for securities regulators in recognition of the various roles society needs them to play.

Indeed, I have to report, with some regret, that the constraints imposed by the world are even more complicated than that. There is a question mark over whether a *static* rule book can suffice at all. That is the second of my challenges.

### Static rules versus *constrained discretion*: the problems of a shape-shifting industry and of exuberance

Legislators typically favour rules-based regulation, in order to guard against the exercise of arbitrary power by unelected regulators. But a static rulebook is the meat and drink of regulatory arbitrage. The more detailed the rules and the more thoroughly the public and the industry have been consulted on drafts, the more rules-arbitrage is implicitly legitimized, because the rule-makers must have said precisely what they meant and no more.

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This is particularly prevalent and problematic in finance. It is prevalent --- in fact, endemic --- because finance is a ‘shape-shifter’. The essentials of a banking business can be constructed in a non-bank. A derivatives business could be written as a portfolio of insurance policies. And so on.

It is problematic --- deeply so --- because it makes it hard to frame a regime that keeps risk-taking in the system as a whole within tolerable bounds, jeopardizing efforts to make the financial system more stable. Instead, excessive risk taking is likely to migrate to less regulated or unregulated parts of the system. Thus, with the re-regulation of *de jure* banks currently underway, some of the economic substance of banking will, again, inevitably re-emerge elsewhere, in what is known as shadow banking. It’s not a new problem. The role of Structured Investment Vehicles, asset-backed securitizations, commercial paper conduits and money market funds, each of them regulated to some extent, in cracking the financial ceiling in 2007 is well documented. That many of the most excessive structures of the past decade have since been in retreat doesn’t mean the general phenomenon has gone away. Anybody holding low-risk securities can, in principle, build themselves a shadow bank by lending-out (‘repo-ing’) their securities for cash and investing the proceeds in a riskier credit portfolio. And they can do so very quickly. Sometimes, their liquidity fragility and the systemic significance of their collapse will be identified only *ex post*.

Up to a point, this can be addressed through the regulation of institutions. If, to pluck an example from the air, an insurance company reinvents itself as a *de facto* banking and derivatives business, it could in principle be subjected to banking-like regulation of liquidity and leverage risk<sup>11</sup>. That is, of course, exactly part of the debate about ‘systemic designation’ domestically and internationally. But banking-like fragility can also be generated through Russian doll-like chains of transactions or structures, via which *aggregate* leverage and/or liquidity mismatches *gradually* accumulate, and which don’t involve a single financial firm which could be re-labelled and regulated as a bank. In the run up to the 2007 crisis conduits funded by short-term paper

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<sup>11</sup> A subsidiary of AIG is reported to have done just that in the run up to the 2007-08 part of the crisis.

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invested in tranches of securitizations themselves invested in securitized paper. Again, the possible examples are legion.

This shape-shifting dynamic can leave policymakers in a game of catch-up, responding only as each incarnation becomes systemically significant—next year, or perhaps even right now, who knows what: real-estate investment trusts, credit funds, leveraged exchange-traded funds? That is a game that sooner or later the authorities are doomed to lose, with potentially cataclysmic consequences. By the time the products of regulatory arbitrage are evidently systemically significant, those in the driving street will likely have the lobbying power to delay reform. The debates around the reform of the money market fund industry illustrate that in capital letters.

Nor is it only a problem of regulatory arbitrage. It is also hard to frame a regime that can cater for the tendency of markets to pass through a normal pattern of risk-taking to exuberance and then, after the euphoria blows itself out, to depressed risk-taking. As we have seen, those violent swings are not conducive to effective capital formation across the credit and business cycle. Static minimum regulatory requirements --- eg for counterparty credit risk --- could in theory be calibrated for the most exuberant risk environment, but that could adversely credit supply in normal conditions. This being so, static requirements are not going to prove enough once the system moves from 'normal' to 'exuberant'. In other words, a capacity for *dynamic* adjustment of regulatory requirements has to be introduced into such regimes, in order to maintain the desired degree of systemic resilience across different risk environments.

The challenge, therefore, and it is a serious one, is to frame a regulatory regime and policies that are flexible, capable of dynamic adjustment so as to help preserve stability, but also legitimate and consistent with statutory mandates.

This almost certainly entails granting greater discretion to regulatory agencies, and that means for regulation of capital markets as well as of banks. For example, they need to be able to vary minimum collateral (margin, haircut) requirements in derivatives and money markets when a

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cyclical upswing is morphing into exuberance; they need to be able to tighten the regime applying to a corner of finance that is shifting from systemic irrelevance to a systemic threat; they need to be able to tighten the substantive standards, not only the disclosure standards, applying to the issuance of securities when the pattern of aggregate issuance is driving or facilitating excessive borrowing by firms or households. They need, moreover, to be able to take each of those measures promptly, before it is too late. And so they need the information to make, explain and defend those judgments. Given the scope of their jurisdiction over capital markets, securities regulators will be in the middle of all that.

But the keys of the kingdom cannot be handed over to unelected bureaucrats! This points to a regime of *constrained discretion*. The objective would be clear; the instruments would be clear; there would be provision for dynamic adjustment where warranted to meet the objective. That, of course, sounds rather more like the monetary policy regimes developed over the past quarter century than traditional securities regulation (or indeed prudential supervision). Those degrees of constrained discretion are alien to securities regulation as it has evolved over nearly a century. The choices, crudely, are twofold.

One option would be that some other body be granted the power to override and set capital markets policy where that was demonstratively warranted in the interests of stability. In the UK, the Bank of England Financial Policy Committee, on which the chief executive of the securities regulator has a vote, has something approximating that role: reflecting the express wish of Parliament, the UK's new statutory regime is explicitly macro-prudential. The FPC's nearest analogue in the US is the Financial Services Oversight Council, established by the Dodd Frank Act but which, to date, has not been hugely popular with all SEC and CFTC commissioners. The second option is to introduce more degrees of freedom for securities regulators, under a new statutory objective of preserving stability and active Congressional oversight of that function. As I have admitted already, that too would entail a substantial change in remit, mindset and accountability.

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National versus international policy-making: are there still *national* capital markets?

My third challenge for the political economy of securities regulation is the internationalization of finance.

Just as once upon a time securities regulation was entirely separate from banking supervision and financial stability, so once upon a time ‘national’ capital markets were neatly segmented. That world lies in the distant past; after all, London’s multi-currency Euromarkets developed nearly half a century ago as developed economies progressively relaxed controls on capital flows. But the full implications of global capital markets for policy making (and for enforcement) have been obscured for a long time.

A decade ago, Anne-Marie Slaughter of Princeton argued in an important book that policy making, especially economic policy making, was increasingly centred on international organisations of various kinds, such as IOSCO which I have mentioned already, the Basel process, the IMF, the WTO<sup>12</sup>. But things aren’t always what they seem. Until recently at least, Basel and IOSCO have differed materially in how much they affect their member institutions and countries.

It is, indeed, true that significant policy initiatives have for decades been taken by central bankers and bank supervisors in Basel. With an internationalist outlook that arguably has its roots in the 19<sup>th</sup> century gold standard and the mid-20<sup>th</sup> century Bretton Woods regime, central bankers have long recognized that the spillovers from bank failures in one country can all too easily spill over into other countries. That much had been clear in the 1930s when Creditanstalt failed in Vienna, and the Governors were given a painful reminder when Bankhaus Herstatt failed in 1974 with outstanding foreign-exchange transactions that were only half-settled when the music stopped. As barriers to international banking were dismantled in the 1970s and ’80s, the Governors found it natural to try to agree common minimum standards to solve the collective

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<sup>12</sup> Anne-Marie Slaughter, “A New World Order” 2004.

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action problem they faced, reaching decisions by consensus and with a reasonably strong cultural barrier to holding out unreasonably. This was and is a world where even the most powerful countries can find it in their interests ---in the interests of their citizens --- to compromise in order to achieve a stronger common international standard for all than some would adopt on their own<sup>13</sup>.

Although it shares the form of a ‘transnational regulatory organisation’<sup>14</sup>, for much of its life IOSCO did not in fact operate in the same way. In the world of securities regulation, IOSCO was for many years much more a forum for exchanging views than for agreeing common minimum standards. Thus, the scene was set for the SEC to find it difficult when IOSCO, supported by the G20 Financial Stability Board, agreed a policy on the regulation of money market funds that some US commissioners opposed. In the wake of the crisis, IOSCO’s role and purpose in international economic life was changing, and that came as a bit of a shock. Suddenly, its endeavours --- its work programme and outputs --- were being scrutinized by G20 finance ministers and Leaders, with the FSB an intermediary between the politicians and the technical specialists. It is not surprising that some of the membership blinked as global securities regulators emerged into the sunlight. After all, IOSCO policy had in practice been dominated by the longest established and most seasoned securities regulators. As the issues they are responsible for gained public salience around the world and as emerging-market economies became more important in the global economy and balance of power, the *modus operandi* of IOSCO policy-making seemed to be changing, confronting national regulators with challenges on how to determine the lines they should take in their international work, and what to do if they could not get everything they wanted.

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<sup>13</sup> To be clear, the failure of the Basel Supervisors Committee prior to the crisis was that its capital standard was substantively flawed.

<sup>14</sup> A concept coined by Robert O Keohane and Joseph S Nye Jr, “Transgovernmental Relations and International Organizations” 1974, which as it happens was the year the decision to create the Basel Supervisors Committee was taken.

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To a greater or lesser extent, national securities regulators tend to hold onto two propositions. The first is that markets are still essentially national. That is largely untrue. The second is that they are empowered by and are accountable to their national legislatures, which expect them to protect their national citizenry. That, of course, is not only accurate, it is vitally important for generating and sustaining democratic legitimacy. But what national policy makers cannot maintain is that they are able to deliver on their national mandates without cooperating actively with their foreign counterparts. That is true these days for enforcement, as recently discussed by the SEC's Chair<sup>15</sup>. But on the financial stability front, it requires more than cooperation centred on exchanges of information. Without imposing capital controls, even the largest economies in the world cannot insulate themselves from problems in poorly regulated foreign financial systems.

This has given rise to an environment where some national regimes and regulators seek extraterritorial effect for their rules. For example, in the US the Dodd Frank Act laid down that CFTC regulations on derivatives should apply abroad when cross-border activities have a "direct and significant connection with activities in, or effect on, commerce in the United States". The CFTC has since published hundreds of pages of interpretation, and has been locked in negotiations with its counterparts. I find it hard to see this as a sustainable equilibrium if anything like the current global order is to be sustained. Oversimplifying, the reaction to the CFTC trying to apply some of their derivatives policy beyond the borders of the US has been for the EU to turn the tables on the US in a related sphere. Asia watches and waits.

The issues run deep. Hypothetically, should the US, the issuer of the world's main reserve currency, seek jurisdiction over a dollar-denominated transaction outside the US between two non-US domiciled entities, on the grounds that the transfer of dollars must ultimately be effected within the United States? For those inclined to answer 'yes', can I suggest that we also need to answer the reciprocal question of whether the sovereign issuer of some new reserve currency

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<sup>15</sup> Mary Jo White, "The Challenge of Coverage, Accountability and Deterrence in Global Enforcement", speech to IOSCO's 39<sup>th</sup> Annual Conference, Rio De Janeiro, October 2014.

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should have jurisdiction over trades in that currency transacted between entities in, say, California and Massachusetts. And what would the network of extraterritorial jurisdictional claims look like if and when, as in the latter part of the 19<sup>th</sup> century, we gradually move into a world monetary system with plural reserve currencies?

That, I would suggest, is a world where a combination of minimum international standards and some form of mutual recognition has attractions for all states. That is what the key US and European regulators have been attempting, but it was striking that CFTC, SEC and the EU initially set out with quite different conceptions of what mutual recognition or “substituted compliance” should comprise. Line-by-line equivalence, output equivalence, or what<sup>16</sup>?

This is also a world where international standard-setters need the wherewithal to check national delivery (compliance) with those standards, as Basel is now pursuing on bank capital regimes.

Further, it is a world where regulators, and indeed the executive branch of government, need to be open with legislators about the international component of their policy making. And it is a world where those legislators need to be open with the citizens they represent about how they factor international spillovers and policy making into their casting and oversight of domestic regimes.

None of that will be easy, and in some respects it is, again, alien to securities regulators and their overseers. But what is not remotely alien to them is protecting investors, and that is increasingly a shared, cross-border effort as, taken as a whole, investors hardly gain from systemic crisis.

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<sup>16</sup> In July 2013, IOSCO announced that it was establishing a Task Force on Cross-Border Regulation, chaired by Ashley Adler of the Hong Kong Securities and Futures Commission. This picks up issues identified within the SEC a few years earlier: Ethiopis Tafara and Robert J Peterson, “A Blueprint for Cross-Border Access to US Investors: A New International Framework”, Harvard International Law Journal, Winter2007.

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### Conclusion

Before summing up, let me offer a couple of preliminary, quite personal comments. In this lecture I do not mean to criticize securities regulators in general, or the US regulators in particular. The SEC's achievements over many decades in keeping markets clean stand proud in the world. I dearly wish that the UK had established a statutory regulator in the 1980s when the 'Big Bang' reforms of London's domestic markets rendered self-regulation by club-like bodies and associations inoperable. The SEC's doctrine of disclosure-enforcement remains as important as ever. That was very much in my mind when, following the 1987 stock market crash, I spent a period in Hong Kong helping to redesign its securities market infrastructure and, in particular, what became the Securities and Futures Commission<sup>17</sup>. I remain proud of that work and, more importantly, grateful for what I learnt from then Commissioners and staff of the SEC and the CFTC about securities regulation and how it differs from central banking.

Moreover, it is hardly as if bank supervisors covered themselves in glory. That the crisis was as deep as it was owes much to the banking system's almost invisibly thin equity cushion when the credit cycle turned. That economic recovery has been so slow owes much to the overhang of debt in many sectors and countries.

But it is *not* a competition between regulatory communities with different traditions and mindsets: either for turf or for self-mortification. The big point is that the public, and the economy, desperately need to be confident that financial stability can be restored and preserved. Given open capital markets and endemic regulatory arbitrage, that is unavoidably a shared and interdependent venture between, amongst others, central bankers and securities regulators.

As I have attempted to explain, I doubt whether the current configuration of securities regulators' mandates and powers is fully adequate to that new mission. There are challenges from the way objectives are framed, from the prospect that static rule-books are doomed to fail, and from

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<sup>17</sup> The Report of the Hong Kong Securities Review Committee, 1988.

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cross-border spillovers making essential not only co-operation but also a degree of shared policy-making. Those challenges need to be met in ways that preserve to elected politicians the role of setting objectives and the standard of resilience society demands, which they need then to oversee with sustained interest and vigour. And all that needs to be done without undermining disclosure-enforcement as the key to honest and fair markets. Quite an agenda, but an unavoidable one.