Reconceptualising Global Finance and Its Regulation

Ross P. Buckley, Emilios Avgouleas & Douglas W. Arner, eds.
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1. INTRODUCTION

From the dawn of civilization, the ever-growing sophistication of human society, division of labour, specialization, and comparative advantage rendered trade an indispensable part of any human enterprise. The need for trade begets the need for finance, and as trade becomes globally indispensable, so does finance. Indeed, trade and finance midwifed the birth of globalization, foster-mothered its infancy, and nurtured it into its prime age. Although globalization has seen ebbs and flows and has faced numerous disruptions by its enemies, in the wake of the global financial crisis (GFC), it was not the globalization's discontents but the masters of trade and finance who were about to push globalization off the precipice. To understand why globalization suffered a blow by its friends rather than its foes, the book successfully attempts to promote a better understanding of the workings of global finance, to unearth covert fault lines in its crust, to highlight serious flaws in its governance and regulation, and to propose remedies for the deficiencies in the governance and regulation of the global financial system. This is made possible by highlighting the gap between virtually seamlessly-globalized finance and its fragmented, unsystematic, inconsistent, and incomplete regulation and governance.

2. SUMMARY OF THE BOOK

Excluding introduction and conclusion, the book[1] is a collection of 20 essays and consists of five sections, each of which accommodates three to four different articles related to the overarching theme of the section. Having elaborated the changing nature of banking and the meaning of the term "global" in the term "global finance and regulation" in the introduction, the first section, entitled "Global Financial Architecture: Evolution, Shortcomings, and

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1 Ross P. Buckley, Emilios Avgouleas and Douglas W. Arner, eds., *Reconceptualising Global Finance and Its Regulation* (New York: Cambridge University Press, 2016) [Buckley, *et al*.].

Interdependence", focuses on the architecture of the global financial regulation. After studying the Financial Stability Board (FSB) and its role in the future of financial regulation, this section ventures into identifying certain overlooked regulatory networks in the global finance by highlighting the accomplishments of networks constituting the periphery rather than the core of the global financial regulation. This section closes by studying the application of the Basel III in China from a political economy perspective.

The second section, entitled "The Changing Face Of Central Banking", studies central banking and its increasing involvement in financial supervision, and the implications that the supervisory role of central banks would have for central-bank independence and the conduct of monetary policy. The book goes on to study "the quandary of macroprudential regulation" and argues for a systematic approach to financial regulation, which should be coherent, consistent, and capable of replacing ad-hoc regulation by systematic regulation. Furthermore, inspired by the legal theory of finance,[2] the role of law in creating "safe assets" is analyzed by focusing on four major examples of such assets: government debt, bank debt, repurchase agreements (repos),[3] and asset-backed securities.

In the third section, the focus shifts to "Reconceptualising Cross-Border Finance", in which competition of the financial centers for Renminbi-related businesses in the context of the Chinese government's intent to internationalize Renminbi is reviewed. Then, issues of market-design are analyzed by focusing on the concept of social efficiency versus "mercenary efficiency" in analyzing how market participants are likely to intervene in the process of design of the financial infrastructure to their own benefit. Thereafter, the evolution of bank secrecy and its erosion in a globalized financial world is examined. This section ends with an analysis of the liability for transnational securities fraud by focusing on the exclusionary effects of *Morrison v. National Australia Bank*[4] in the context of cross listings and in light of the "avoidance" versus "legal bonding" hypothesis.

The fourth section is entitled "Addressing Too-Big-To-Fail and Shadow Banking". The first article studies the arguments for and against the social utility

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2 Katharina Pistor, "A Legal Theory of Finance" (2013) 41 *Journal of Comparative Economics* 311 [Pistor].

3 A repo or repurchase agreement is the sale of securities coupled with a commitment to repurchase them at a specified price and at a future date or on demand. See Tobias Adrian, *et al.*, "Repo and Securities Lending" (2012) International Capital Market Association (ICMA) NBER Working Paper 18549, online: <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/frequently-asked-questions-on-repo/>. In the recent financial crisis, the run on repo markets, especially the repos collateralized by commercial paper, which led to forced deleveraging arguably played a role in the GFC. See Gary B. Gorton & Andrew Metrick, "Securitized Banking and the Run on Repo" (2012) 104 *Journal of Financial Economics* 425; Gary B. Gorton, *Slapped by the Invisible Hand: The Panic of 2007* (Oxford: Oxford University Press, 2010).

4 *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247, 130 S.Ct. 2869 (2010).

and disutility of too-big-to-fail (TBTF) banks. By reviewing the industrial organization literature and empirical findings, the article then examines the validity of the arguments based on economies of scale and scope in the banking sector, and the impact of the TBTF subsidy on competition and systemic stability in the banking industry. It also offers a concise but informative review of banking structural reforms, and concludes by critically opining on narrow banking proposals. The second article proposes a single enforcement handbook on top of the single supervisory mechanism and the single rulebook in the EU context. This section concludes by case studies of the shadow banking sector in China, highlighting the differences in the evolution and the role of shadow banking in Chinese economy, and spotting mismatches in Chinese regulatory architecture and the underlying markets it regulates.

The fifth section studies "The Role of Culture and Ethics in Global Finance" by first focusing on the emerging Asian model of promoting capital-market professionalism. The section then turns to the role of the equivalence requirement in the context of financial and tax law and its impact on the competitiveness of financial centers, emphasizing that the equivalence principle is likely to increase the competitiveness of financial centers. The next paper studies human-rights due diligence as a new policy in financial institutions. Then, the role of standards in supporting financial regulation is reviewed by taking stock of the role of standards in injecting ethics into finance and financial regulation. The book ends with concluding remarks by the editors, that sum up and highlight the main findings of each paper.

3. COMMENTARY

The most outstanding contribution of the book to the literature on the global financial regulation is particularly manifested in shedding light on the most recent regulations and institutional developments introduced after the GFC, that have significant implications for the governance and regulation of global finance. Its focus on many different aspects of regulation of global finance, underexplored institutions and organizations, and their contribution to the deepening of the globalization of the financial markets make its intuitions, insights and contributions to the literature on the international financial regulation unique and indisputable. These insights are particularly pronounced where the book highlights the role of law in giving shape to safe assets, the role of market participants in shaping financial infrastructure, and the role of often-overlooked, little-known, and underexplored global financial regulatory networks in regulating global finance, the evolution of central banking, its increasing role in prudential supervision and its impact on central-bank independence in monetary policy, and last but not least, the role of legal instruments such as the equivalence requirement in increasing the competitiveness among financial centers.

As the book discusses topical issues of global finance, it brings together contributions from renowned scholars from North America, Europe, South-East

Asia and Australia. Since the focus of the book is on the major global financial centers and trends, the absence of contributions from the rest of the world may be excused. However, one of the structural shortcomings of the book is in the absence of a coherent storyline that can put all contributions together and give them a general direction. Indeed, a bird's eye view of the table of contents reveals a general lack of cohesion, as do the disharmonized footnotes and citations styles.

From the range of substantive issues discussed in the book, this essay provides a critical evaluation of three central propositions, which cut across several articles and constitute a recurring theme of the book. First, it discusses whether global finance necessitates global regulation and governance. Second, it turns to the question of whether the regulatory regime changes in the aftermath of the GFC have gone far enough to address the potential problems in the global financial system. Third, it will provide a critical evaluation of the approach taken in the book to the role of culture, professionalism and ethics in global finance. Finally, this commentary highlights some overlooked aspects and pressing issues of global finance regulation, which could have been included in the book, and the book's ambivalence regarding some different and sometimes opposing viewpoints about certain unsettled issues raised by contributors to the volume.

(a) Does Global Finance Need Global Regulation and Governance?

One of the central ideas of the book is the pronounced emphasis on the need for a global governance or regulation. Highlighting the emergence of a new order, which is becoming "hierarchical, procedurally regular, and politically supervised",[5] emphasizing the misguided trend towards financial liberalization,[6] viewing regulatory arbitrage as a potentially harmful and sinister phenomenon,[7] along with raising concerns about issues of market fragmentation and deglobalization because of divergent policy choices throughout the world (e.g. the Volcker Rule and ring fencing),[8] and underlining the gap between global regulatory institutions and "truly global finance",[9] the book puts forward new policy recommendations in favour of harmonization, centralization and consolidation of regulatory regimes. These policy recommendations include, *inter alia*, completing a single European rulebook and a single supervisory handbook with a "single enforcement handbook",[10] centralizing equivalence

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5 David Zaring, "Financial Regulations' Overlooked Networks" in Buckley *et al., supra* note 1 at 70.

6 Emilios Avgouleas, "Large Systemic Banks and Fractional Reserve Banking: Intractable Dilemmas in Search of Effective Solutions" in Buckley *et al., supra* note 1 at 282.

7 Douglas W. Arner & Michael W. Taylor, "The Financial Stability Board and the Future of International Financial Regulation" in Buckley *et al., supra* note 1 at 64-65 [Arner & Taylor].

8 *Ibid.* at 64.

9 Lawrence G. Baxter, "Understanding the Global in Global Finance and Regulation" in Buckley *et al., supra* note 1 at 29.

assessment at the EU level,[11] and hardening of the soft laws in financial regulation.[12] In line with this agenda, the book seems to be unequivocal in suggesting that a global financial system lacking a global regulator, a global lender of last resort, or a global sovereign-bankruptcy regime will lead to another major financial crisis.[13]

The general underlying reason for these policy proposals seems to be the fact that since finance is global, financial regulation should be global too; in other words, "the domain of the regulator should be the same as the domain of the financial market."[14] However, despite the melody of this argument, the latter may not necessarily flow from the former, i.e., global finance might not necessitate global financial regulation.[15] One could even argue that global financial markets would be as prone to financial crises in the presence of such global institutions and regulation as they would be in their absence. One might even take a step forward and assert that global financial crises would occur not only despite the existence of such global regulatory institutions, but perhaps because of them.

Although the book goes as far as proposing far-fetched human-rights policy recommendations as lessons of the GFC,[16] perhaps mitigation of systemic risks and safeguarding the financial stability as a global public good[17] are the best

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10 Dalvinder Singh & James Hodges, "Turning the Tide? How European Banking and Financial Services Legislation are Making Waves on the Enforcement Front" in Buckley *et al., supra* note 1 at 322.

11 Dirk A. Zetzsche, "Competitiveness of Financial Centers in Light of Financial and Tax Law Equivalence Requirements" in Buckley *et al., supra* note 1 at 414.

12 Arner & Taylor, *supra* note 7.

13 Buckley *et al., supra* note 1 at 5.

14 Kern Alexander *et al.*, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford: Oxford University Press, 2006) at 15 [Alexander *et al.*]. For a similar argument, see Rosa M. Lastra, "Do We Need a World Financial Organization?" (2014) 17 *Journal of International Economic Law* 787. See also Dirk Schoenmaker, *Governance of International Banking: The Financial Trilemma* (Oxford: Oxford University Press, 2013) at 90 [Schoenmaker]. Schoenmaker particularly advocates a move away from soft-law approach to a hard-law approach, particularly for the purposes of making international cooperation effective in times of crisis, at 148. See also 151, where Shoenmaker asserts that "Global banks need global institutions."

15 Markus Brunnermeier *et al.*, "The Fundamental Principles of Financial Regulation: Geneva Report on the World Economy" (ICMB 2009) at xviii.

16 Alex A. Weber, "Human Rights Due Diligence as New Policy in Financial Institutions" in Buckley *et al., supra* note 1 at 441. Indeed, a hodgepodge of policy recommendations, which is advocated by reference to the financial crisis, has given birth to a new logical fallacy entitled "Argumentum a Crise". See Luca Enriques & Martin Bengtzen, "The 'Argumentum a Crise': So Powerful, So Prone to Misuse" (8 June 2016) University of Oxford, Faculty of Law, Business Law (blog), online: <https://www.law.ox.ac.uk/business-law-blog/blog/2016/06/argumentum-crise-so-powerful-so-prone-misuse>.

17 Charles Wyplosz, "Financial Stability as a Global Public Good" and Carles Wyplosz "International Financial Instability" in Inge Kaul, Isabelle Grunberg and Marc A.

arguments that could be put forward for regulatory globalization in finance.[18] In addition to the deficiencies and design flaws in financial market infrastructure, financial crises often correlate with the size and concentration of the financial institutions and markets,[19] extraordinarily high levels of leverage, liquidity mismatches,[20] interconnectedness among financial institutions,[21] and herd behaviour.[22] It seems that on nearly all these grounds, a move towards centralized regulation at the global level could amplify, rather than mitigate, the risks of financial crises. For the sake of brevity, this commentary only briefly discusses two unintended consequences of regulatory harmonization (i.e. their impact on homogeneity, and interconnectedness and herd behaviour).

A move towards regulatory harmonization (or regulatory monopoly or cartelization)[23] could be misguided,[24] because it could diminish diversity in the

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Stern, eds., *Global Public Goods: International Cooperation in the 21st Century* (New York: Oxford University Press, 1999).

18 Alexander *et al.*, *supra* note 14 at 23-26. Another interesting argument in favor of more harmonization and consolidation at the global level is the idea of financial trilemma which states that only two of the three objectives of having (1) a stable financial system, (2) international banking, and (3) national financial policies for supervision and resolution can be combined, but not all three. Arguing that the international supervisory cooperation should be analyzed in tandem with resolution regimes. See Schoenmaker, *supra* note 14 at 607.

19 Not surprisingly, market concentration has continued to rise in major financial centers since the financial crisis, not despite but perhaps because of post-crisis regulatory interventions. For a study providing evidence of increasing market concentration in the EU, see European Central Bank, "Report on Financial Structures" (October 2015), online: <https://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201510.en.pdf>.

20 Tobias Adrian & Hyun Song Shin, "Liquidity and Leverage" (2010) 19 *Journal of Financial Intermediation* 418.

21 For an illustration of such interconnectedness, see Darrell Duffie, "The Failure Mechanics of Dealer Banks" (2010) 24 *Journal of Economic Perspectives* 51.

22 Herding occurs when financial institutions mimic other financial institutions while their own private information or proprietary models suggest different strategies. See Christopher Avery & Peter Zemsky, "Multidimensional Uncertainty and Herd Behavior in Financial Markets" (1998) 88 *American Economic Review* 724.

> The less diverse a financial market, the more likely it is that the market participants act in unison and amplify positive feedback loops. Jean-Pierre Zigrand, *et al.*, "Financial Stability and Computer Based Trading" in *Foresight: The Future of Computer Trading in Financial Markets* (2012) Final Project Report, The Government Office for Science, London at 17.

23 Jonathan R. Macey, "Regulatory Globalization as a Response to Regulatory Competition" (2003) 52 *Emory LJ* 1353.

24 Roberta Romano, "Against Financial Regulation Harmonization: A Comment" (2010) Yale Law & Economics Working Paper No. 414 [Romano]. She sees the post-crisis regulatory response to hedge funds in light of the historical pattern of hostility to short-sellers. Romano offers her argument in the context of hedge fund regulation, her

financial sector, which can lead to lower levels of competition among different institutional forms, and business and earning models.[25] In other words, establishing a global financial regulatory authority or a global governance regime for financial markets through regulatory harmonization or consolidation may contribute to heightened systemic risk, because in a regime of global harmonization, regulators tend to adopt similar regulatory strategies and perhaps unintentionally encourage homogeneity and correlated financial strategies. Depriving financial markets of the benefits of diversity and heterogeneity, a harmonized regulatory regime, which also amplifies the potential impact of regulatory errors, could be more prone to systemic crises than its decentralized regulatory counterpart. For example, if harmonization results in homogeneity, it is more likely that, in times of distress, liquidity would dry up for the lack of contrarian position takers in the financial markets.[26]

On the other hand, regulatory arbitrage, which is perceived as a rather sinister phenomenon in the book, can mitigate the adverse impact of distortions and lead to positive welfare benefits in financial markets if regulation itself is inefficient and possibly designed to serve the interests of incumbents.[27] Therefore, it is impossible to know *ex ante* whether regulatory arbitrage is a boon or bane. However, turning a blind eye to the positive aspects of regulatory arbitrage and regulatory competition, as buffers against systemic regulatory and market failures,[28] and only highlighting their negative consequences in order to

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argument is based on the grounds that hedge funds were neither the cause of the financial crisis, nor is it likely that they will cause one in the future.

25 D.T. Llewellyn, "A Perspective from the UK" in R. Ayadi & R. Schmidt, eds., *Investigating Diversity in the Banking Sector in Europe: The Performance and Role of Savings Banks* (Centre for European Policy Studies, 2009).

26 As an example, studies suggest that the leverage of hedge funds is countercyclical to the leverage of mainstream financial institutions. This means that when other financial market participants deleverage, hedge funds lever up, and vice versa. This countercyclical leverage of hedge funds compared to that of mainstream financial institutions is healthy for the financial system as a whole, because it can smooth the effects of financial crises. See Andrew Ang, *et al.*, "Hedge Fund Leverage" (2011) 102 *Journal of Financial Economics* 102. If regulatory harmonization comes at the cost of lower levels of diversity among financial institutions, it is highly likely that it would eliminate contrarian position takers in distressed financial markets and thereby amplify the impact of financial distress in financial markets.

See also Hossein Nabilou, "Regulatory Arbitrage and Hedge Fund Regulation: A Need for a Transnational Response?" 22 *Fordham J. of Corp. and Fin. L.* [forthcoming in 2017]. (Explaining how regulatory arbitrage can increase market or downward accountability of regulators by increasing regulatory competition).

27 Luigi Zingales, "Does Finance Benefit Society?" (2015) NBER Working Paper Series at 21.

28 Romano, *supra* note 24. Empirical evidence tends to confirm the intuition that effective corporate and securities laws are the product of regulatory competition or competitive legal systems, embracing bottom-up legal innovations and experimentation, rather than

make an argument for further harmonization and consolidation is unlikely to lead to welfare-enhancing policy interventions.

Second, in addition to intensifying the asymmetric distributional effects of international financial regulation,[29] unifying financial laws at the global level and bringing several markets under a single regulatory umbrella may contribute to higher levels of interconnectedness and herd behaviour, this time not at a local but at a global level, by encouraging homogeneity in financial institutions and correlated financial positions and strategies.[30] Whereas a more localized and diversified financial regulatory design, which takes into account the different preferences of often dissimilar jurisdictions,[31] within which there is a healthy level of regulatory arbitrage and competition, would minimize the impact of regulatory errors. The risk-based capital adequacy requirements (CARs) of the Basel Committee on Banking Supervision (BCBS), as a *de facto* soft-law global

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the top-down approach by the regulators who are detached from the day-to-day operations of financial firms. See Roberta Romano, "*The Sarbanes-Oxley Act and the Making of Quack Corporate Governance"* (2005) 114 *Yale LJ* 1521 at 1529. A third view of the unitary vs. diversified regulatory systems — called "regulatory co-opetition" — sides with the approach that "optimal governance requires a flexible mix of competition and cooperation between governmental actors, as well as between governmental and non-governmental actors". See Damien Geradin & Joseph A. McCahery, "Regulatory Co-opetition: Transcending the Regulatory Competition Debate" in Jacint Jordana & David Levi-Faur, eds., *The Politics of Regulation: Institutions and Regulatory Reforms for the Age of Governance* (Cheltenham, UK: Edward Elgar, 2004) at 93.It is noteworthy to highlight that regulatory competition models have their own limits. See Lucian Bebchuk, *et al*., "Does the Evidence Favor State Competition in Corporate Law?" (2002) 90 California L. Rev. 1775. (Arguing that aside from the fact that regulatory competition may serve the managers of a company rather than its shareholders, it may create externalities too. In other words, regulatory competition might be beneficial for managers or shareholders of a firm, but it might not be so for the society at large.)

29 Chris Brummer, "Why Soft Law Dominates International Finance — and Not Trade" (2010) 13 *Journal of International Economic Law* 623.

30 See IMF, "Global Financial Stability Report: Potent Policies for a Successful Normalization" (April 2016). (Highlighting the positive relationship between financial market integration and increase in spillovers across countries which is more predominant between countries with similar micro-financial fundamentals.) Mario Giovanoli, "The Reform of the International Financial Architecture after the Global Crisis" (2009) 42 *New York University Journal of International Law and Politcs* 81 at 87-88. (Briefly summarizing the unintended side effects of international financial standards and their contribution to the global financial crisis.)

31 Lucia Quaglia, "The Sources of European Union Influence in International Financial Regulatory Fora" (2014) 21 *Journal of European Public Policy* 327. (Highlighting the different preferences of the U.S. and the EU in influencing the international regulatory fora and using the preference attainment as the indicator of the EU influence in shaping international regulatory standards. Furthermore, by highlighting the differences in banking systems within the EU (the UK, France and Germany) she finds that the lack of cohesiveness in the preferences in the EU contributed to the lack of cohesive position on Basel III and therefore, in formulating the Basel III standards, Europe had a relatively lower influence despite its big market size and its regulatory capacity.)

banking regulator, is a case in point. More localized approaches on CARs are advocated, because certain institutional and regional factors that might lead to variations in the optimal levels of capital and loss-absorbing capacity across jurisdictions should be taken into account in imposing capital requirements.[32] In the same vein, the appropriate levels of capital requirements might vary as between the Organization for Economic Co-operation and Development (OECD) countries and non-OECD countries.[33] In addition, the CARs were initially adopted to enhance the safety and soundness of individual banks. But in the meantime, they proved to be procyclical,[34] because of their implicit requirement that banks should increase their capital when the risks of their portfolio rise. Therefore, in distressed markets, the financial institutions facing leverage constraints are likely to deleverage with the possibility of causing fire-sales and downward spirals in asset prices,[35] thereby limiting the supply of credit and contributing to financial instability.[36]

In addition to CARs' impact on creating similar risk measurement and risk-mitigation techniques, which led to homogenization of income streams of different business divisions and encouraged procyclicality, capital regulation at the global level had one more hidden aspect. By providing opportunities for regulatory arbitrage, it also produced a symmetric gaming behaviour by big banks to minimize their levels of regulatory capital.[37] In other words, not only did the Basel standards homogenize financial strategies designed to comply with such standards, but also these standards homogenized the strategies designed to circumvent them.

The second example relates to the recent banking structural reforms adopted on both sides of the Atlantic in the wake of the GFC.[38] The literature on banking structures suggests that in addition to scope economies, there are diversification and stabilization benefits in combining commercial banking and investment banking businesses.[39] In addition, there is also evidence in favour of resilience of

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32 Jihad Dagher, *et al.*, "Benefits and Costs of Bank Capital", IMF Staff Discussion Notes (March 2016) at 4.

33 *Ibid.*

34 Henrik Andersen, "Procyclical Implications of Basel II: Can the Cyclicality of Capital Requirements be Contained?" (2011) 7 *Journal of Financial Stability* 138.

35 Andrei Shleifer & Robert W. Vishny, "Liquidation Values and Debt Capacity: A Market Equilibrium Approach" (1992) 47 *Journal of Finance* 1343.

36 The new countercyclical buffers are adopted to address such problems.

37 Emilios Avgouleas, "Large Systemic Banks and Fractional Reserve Banking: Intractable Dilemmas in Search of Effective Solutions" in Buckley *et al., supra* note 1 at 389.

38 Generally speaking, these reforms are to limit the universal banking model by setting some restrictions along the line with the commercial and investment banking business models often by prohibiting proprietary trading and investment in private funds by the banking entities.

39 Bernard Shull & Lawrence J. White, "The Right Corporate Structure for Expanded Bank Activities" (1998) 115 *Banking LJ* 446 at 464.

universal banks to systemic shocks vis-à-vis commercial banking and investment banking conducted separately.[40] Nevertheless, to the extent strategies follow structures, banking structural reforms would amplify homogeneity of structures and strategies in the banking industry by narrowing down the scope of activities of banking entities. Hence, it would be more likely that similar institutions may face difficulties at the same time. This would increase the likelihood of herd behaviour which in itself would give rise to the problem of too-many-to-fail,[41] making financial institutions systemic as a group. In their current forms, there are considerable differences among banking structural reforms in major financial centers around the world,[42] however, under a scenario in which the edicts to restructure banking entities and activities would come from a centralized global regulator, there would be considerable risks of amplified homogeneity and uniformity, contributing to higher levels of systemic risk. Indeed, it is likely that more and more centralization at the global level would throw the already dismal state of systemic risk regulation in financial markets and institutions out of the frying pan into the fire.

Empirical evidence suggests that over the past few decades, similarity or homogeneity between financial institutions has increased.[43] This trend is more prevalent among larger financial institutions. This similarity indeed manifested itself in the same market (globally), similar activities, similar risk management techniques and similar trading strategies which can amplify the effects of systemic risks. In addition, the sources of funding in the banking sector has converged. This has led to increasing reliance of the banking sector on the same sources of funding. Overall, increasing homogeneity and correlated strategies in financial markets, and potential for herd behaviour highlight the dark side of a move towards global governance and regulatory cartelization and their impact on the increased likelihood of financial crises at the global level.[44]

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40 Charles Calomiris, "The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870-1914" in Naomi R. Lamoreaux & Daniel M. G. Raff, eds., *Coordiation and Information: Historical Perspectives on the Organization of Enterprise* (Chicago: University of Chicago Press, 1995).

41 Viral V. Acharya & Tanju Yorulmazer, "Too Many to Fail—An Analysis of Time-Inconsistency in Bank Closure Policies" (2007) 16 *Journal of Financial Intermediation* 1.

42 Matthias Lehmann, "Volcker Rule, Ring-Fencing or Separation of Bank Activities-Comparison of Structural Reform Acts Around the World" LSE Law, Society and Economy Working Papers 25/2014.

43 Charles A.E. Goodhart & Wolf Wagner, "Regulators should encourage more diversity in the financial system" (12 April 2012) VOX EU, online: <http://voxeu.org/article/regulators-should-encourage-more-diversity-financial-system>.

44 See for example Mads Andenas & Iris HY Chiu, "Financial Stability and Legal Integration in Financial regulation" (2013) 38 *European L. Rev*. 335. (Putting forward similar arguments in the context of the European Union and discussing how the emphasis on legal integration can compromise financial stability objectives by over-looking local needs.)

Despite the general trend of the book towards global regulation and governance, the forces of localization come into picture later in the book. The articles discussing the Chinese markets highlight the idiosyncrasies of the problems of the Chinese shadow banking system.[45] The emphasis on China's uniqueness in defining shadow banking[46] and the acknowledgment of the fact that "global financial crisis affected different parts of the world in different ways",[47] along with the concerns about regional effects of global reforms,[48] soften the book's tone and makes it more ambivalent in its push toward globalized financial regulation and governance.

(b) Has Financial Regulation Gone Far Enough?

Another recurring theme in the book is that the financial reforms adopted in the aftermath of the GFC have not gone far enough.[49] Opining on the depth and breadth of the post-crisis financial reforms requires identifying the socially optimal level of financial regulation in each sector, which can be a daunting task if not an impossible one. However, the claim that the post-crisis financial regulatory reforms have not gone far enough does not seem plausible in the face of sweeping regulatory reforms, which resulted in major overhaul of the regulatory environment of the global financial markets.[50] Shortly after the

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45 Robin Hui Huang, "Shadow Banking and Its Regulation: The Case of China" in Buckley *et al., supra* note 1 at 348 [Huang]. It appears that China is not unique in its shadow banking being different from the rest of the Western economies. In neighboring India, it is also found that unlike Western economies where the growth of the shadow banking sector is driven by a desire to mitigate counterparty risks by providing "safe" collateral for financial transactions, or for the purposes of regulatory arbitrage, the shadow banking sector is a substitute for direct lending by banks in non-urban India. See Viral V. Acharya, *et al.*, "The growth of a shadow banking system in emerging markets: Evidence from India" (2013) 39 *Journal of International Money and Finance* 207; Viral V. Acharya, *et al.*, "Securitization Without Risk Transfer" (2013) 107 *Journal of Financial Economics* 515. (They find that securitization vehicles are mainly motivated by and used for regulatory arbitrage.)

46 Yingmao Tang, "Shadow Banking or 'Bank's Shadow': Reconceptualising Global Shadow Banking Regulation" in Buckley *et al., supra* note 1 at 329, 337-338 [Tang].

47 William Blair, "Reconceptualizing the Role of Standards in Supporting Financial Regulation" in Buckley *et al., supra* note 1 at 445 [Blair].

48 *Ibid.* at 446.

49 *Ibid.* at 5.

50 The Dodd-Frank Act amounts to 845 pages, 16 titles, 225 new rules involving 11 agencies. See Viral V. Acharya & Matthew Richardson, "Implications of the Dodd-Frank Act" (2012) 4 *Annual Review of Financial Economics* at 2. It is estimated that the Act will result in approximately 400 rules and 87 studies before its full implementation. Davis Polk, "Dodd-Frank Rulemaking Progress Report: Progress as of June 1, 2011" online: <https://www.davispolk.com/files/uploads/Dodd-Frank%20documents/Dodd-Frank.ProgressReport.jun11.pdf>. So far, a majority of regulations have been proposed and passed. See Davis Polk, "Dodd-Frank Progress Report: October 2013" online: <https://www.google.ca/webhp?sourceid=chrome-instant&ion=1&esp-

financial crisis, the U.S. Dodd-Frank Act[51] was passed. The range of financial activities it regulates is staggering.[52] In addition, European financial markets underwent similar transformations.[53] The European Commission proposed a dozen new rules for reforming the regulation, supervision, and governance of financial institutions at the EU level, which to date entirely transformed the landscape of EU financial regulation. Moreover, with the active role of international forums such as the Group of Twenty (G20), the rise of additional soft-law institutions such as the Financial Stability Board (FSB), increasingly active role played by the BCBS, and the transfiguration of transnational financial regulatory networks, we have witnessed similar movements at the global level.

Save a few papers, the book seems to underestimate these reforms and their potential promises. Although there still is ample room for concern about the financial instability in the post-crisis financial reform era,[54] such concerns should not underestimate the depth of the post-crisis-financial-reform agenda. More importantly, at a stage where sufficient data is not available to ascertain the

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v = 2&ie = UTF-8#q = See + Davis + Polk + Regulatory + Tracker, + Dodd-Frank + -Progress + Report: + October + 2013 + (2013).&* > .

51 The U.S. "Dodd-Frank Act" was signed into law on July 21, 2010. See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L. 111-203, H.R. 4173.

52 The most important changes involve, inter alia, identifying and regulating systemic risk by assigning the responsibility of designating firms as Systemically Important Nonbank Financial Companies (SINBFCs) to the Financial Stability Oversight Council (FSOC), establishing the Office of Financial Research (OFR) for measuring and providing tools for the measurement of systemic risk, and expanding the regulatory authority of the Federal Reserve (Fed) over systemic institutions, authorizing prompt corrective action through the Orderly Liquidation Authority (OLA) administered by the Federal Deposit Insurance Corporation (FDIC), introducing the Volcker Rule, regulating derivatives markets, and establishing the Consumer Financial Protection Bureau (CFPB), regulating mortgage lending practices, private funds (e.g. hedge funds and private equity funds), rating agencies, and securitization.

53 See Peter Praet & Grégory Nguyen, "Overview of Recent Policy Initiatives in Response to the Crisis" (2008) 4 *Journal of Financial Stability* 368; Charles A. E. Goodhart, "*The Regulatory Response to the Financial Crisis*" (2008) 4 *Journal of Financial Stability* 351.

54 Some of the unaddressed or partially addressed issues by the post-crisis financial reforms, which can potentially contribute to financial instability, are highlighted in Duffie's discussion of failure mechanism of large and systemically important dealer banks. See Darrell Duffie, "The Failure Mechanics of Dealer Banks" (2010) 24 *The Journal of Economic Perspectives* 51 at 68-70. Skeel also discusses further shortcomings in the insolvency regimes not only prior to the financial crisis, but also in the regime established after the financial reforms driven by the financial crisis. See David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* (Hoboken, NJ: John Wiley & Sons, 2011). However, some of the financial stability concerns may originate from the very post-crisis financial regulatory reforms such as the increased importance of financing through the shadow banking sector. See Hossein Nabilou & Alessio Pacces, "The Law and Economics of Shadow Banking" in Iris H. Chiu, ed., *Research Handbook in Shadow Banking* [forthcoming in 2017].

impact of these regulatory reforms — some of which are yet to be implemented[55] — such sweeping statements appear to be somewhat premature. Since ascertaining whether these reforms have gone far enough heavily depends on empirical research, and given the fact that such an assertion lends itself to empirical inquiries, the preponderance of theoretical papers and absence of empirical research do not help the book to drive these assertions home. Indeed, including empirical research would have given a more nuanced analysis of the state of affairs in the global finance and better informed the policy recommendations of the book.

Although the regulation and governance of global finance is far from perfect and the urge for betterment is a deeply engrained human desire, perfectionism may come with huge pitfalls and perils.[56] Therefore, the fear of losing the opportunity of the crisis to launch regulatory reforms should not encourage regulators to adopt hasty and rushed regulations by suppressing the virtues of incremental and evolutionary transformations. Instead, regulators should leave adequate room for local experimentation and "healthy ventilation of issues that occurs in the usual give-and-take negotiations over competing policy positions which works to improve the quality of decision-making".[57] In the absence of impact assessment studies and data, and facing uncertainty about the potential impacts of regulatory interventions, the "do-no-harm principle" should be given more weight, as it is a common practice in medicine.[58]

A second difficulty with the suggestion to deepen financial reforms is the legalistic view of the book to the world of finance and the inclination to fix each and every problem by legal tools and techniques. This legalistic view tends to overlook the impact of market forces, private initiatives, technological advancements and other exogenous factors in mitigating problems arising from market failures. For example, the book views regulatory arbitrage as a

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55 For example, some of the provisions of the Capital Requirements Directive and Regulation (CRD IV package), such as capital conservation buffer, the countercyclical buffer and the systemic risk buffer for global systemically important institutions (G-SIIs), which are largely the implementation of the Basel III capital requirements in the European Union, will not be fully implemented until 2019. Other provisions such as liquidity coverage ratio (LCR), net stable funding ratio (NSFR) and leverage ratio will be implemented in 2018.

56 Adam Smith, *The Theory of Moral Sentiments* (Knud Haakonssen, ed.) (Cambridge: Cambridge University Press, 2004) at 174.

57 Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114 Yale LJ 1521 at 1528. In addition, this cycle produces rushed regulatory reforms in financial markets, and leads to the so-called "quack corporate governance". See John Braithwaite, *Regulatory Capitalism: How it Works, Ideas for Making It Work Better* (Cheltenham, UK: Edward Elgar, 2008). For further discussion of this phenomenon in the context of the *Dodd-Frank Act*, see Stephen M. Bainbridge, "Dodd-Frank: Quack Federal Corporate Governance Round II" (2011) 95 Minnesota L. Rev. 1779.

58 Stijn Claessens & Laura Kodres, "The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions" (March 2014) IMF Working Paper WP/14/46.

potentially harmful phenomenon, however, it seems that in the absence of strong institutional infrastructure and legal environment such as strong protections for property and creditor's rights, lax regulation by itself is not sufficient to give rise to massive capital flows from heavily regulated to lightly regulated jurisdictions, because strong prudential regulations "may serve as a signal of quality and stability".[59] Indeed, empirical findings emphasize that "cross-country differences in regulations have a much more pronounced effect on bank flows if the recipient country has an advanced economy, strong creditor rights, strong property rights, and a high degree of information sharing among investors."[60] Therefore, legalistically-loaded views of the book about the global finance need to be accompanied by a caveat; equipped with legal knowledge, we might incline to deal with every problem with legal techniques. In other words, if everything looks like a nail and in need of pounding, it is perhaps because all we have is a hammer.

In this regard, the dearth of contributions from other disciplines to the book, such as economics, finance and information technology, which could lead to crosspollination of diverse views and could potentially result in different policy recommendation, is markedly pronounced. However, drawing attention to the impact of factors other than the law and regulation is neither intended to downplay the role of law in financial stability,[61] nor is it an advocacy of regulatory faineance, but it is a defense of regulatory sobriety, patience, data dependency, and a deference to the virtues of experimentation and evolutionary dynamics in the financial system.[62]

(c) Culture, Professionalism and Ethics in Global Finance

Another overarching theme in the book lies in the suggestion that the world of finance has witnessed a shift in the values and attitudes of bankers. This change is particularly highlighted in the shift in the fundamental purpose of banking from providing a "social good" to earning profit for its employees and itself.[63] Romanticizing the past, the book bemoans that no longer are banks incentivized to provide best professional advice to clients and instead they pursue profits above all.[64] The book further goes on recommending the promotion of peer learning from proud senior practitioners "(in following the professions of

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59 See Joel F. Houston, *et al*., "Regulatory arbitrage and international bank flows" (2012) 67 *Journal of Finance* 1845 at 1847.

60 *Ibid*.

61 For example, Gorton and Metrick concede that there is no pure private sector solution for ensuring the safety of the banking system and the laws and regulation will play an essential role in financial stability. See Gary B. Gorton & Andrew Metrick, "Regulating the Shadow Banking System" (2010) *Brooking Papers on Economic Activity* 261 at 289.

62 Simon A. Levin & Andrew W. Lo, "Opinion: A new approach to financial regulation" (2015) 112 *Proceedings of the National Acafdemy of Sciences*.

63 Ross P. Buckley, "The Changing Nature of Banking and Why It Matters" in Buckley *et al., supra* note 1 at 13.

64 *Ibid*. at 20.

old)" who are willing to share their experience.[65] It further recommends involving regulators in unfair treatment of counterparties and avoiding "socially excessive risk taking", and goes on to such lengths to make recommendations to regulators to encourage financial institutions to refrain from marketing products that are not understandable even by most discerning and sophisticated market participants.[66]

Regarding these propositions, several observations are in order. First, the underlying assumption that banks at certain points in the past were catering the needs of the society and providing social or public goods may not withstand a closer historical scrutiny. Second, regulatory interventions to curb socially excessive risk-taking and recommending the prohibition of marketing complex products even to sophisticated investors would not necessarily lead to greater social welfare. In addition, determining the optimal amount of risk-taking in financial markets *ex ante* would be an impossible task for regulators. Therefore, involving them in preventing socially excessive risk-taking would require further inquiries about what the *ex ante* socially optimal amount of risk-taking in financial markets is, the answer to which would be harder in practice than in theory. Third, pursuing self-interest does not necessarily mean compromising clients' interests. Indeed, putting self-interest versus clients' interests at the opposite sides of a spectrum may amount to a false dichotomy. Therefore, the presence of conflicts of interest between financial institutions and their clients should not automatically lead to government intervention. Indeed, as will be argued, there are clear conflicts of interest in financial institutions for which market solutions exist and the proverbial "invisible hand" could resolve certain conflicts of interest and create socially optimal outcomes.

First, it is not clear to which era in the banking history the book refers during which banks used to provide social goods. As far as the history of banking and finance suggests, profit motive has always been the driver of the banking business.[67] Indeed, digging into history in search of evidence of the provision of public or social goods by banks may turn out to be harder than looking for a needle in a haystack. Although lamented by almost any intellectual and ideologue, profit maximization has always been at the heart of any economic enterprise, and it should not surprise us to see reference to practices such as usury as "one of the oldest professions of man".[68] The pervasiveness of the profit motive was of such an extent that neither Aristotelian condemnation of interest as "an unnatural breeding of money by money"[69] and the most unnatural of all

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65 Brian W. Tang, "Promoting Capital Markets Professionalism: An Emerging Asian Model" in Buckley *et al., supra* note 1 at 383.

66 Blair, *supra* note 47 at 452.

67 See Jonathan Barron Baskin & Paul J. Miranti Jr,, *A History of Corporate Finance* (Cambridge: Cambridge University Press, 1999); Tim Parks, *Medici Money: Banking, Metaphysics and Art in Fifteenth-Century Florence* (London: Profile Books, 2013).

68 J. L. Berstein, "Background of a Gray Area in Law: The Checkered Career of Usury" (1965) 51 A.B.A. J. 846.

modes of business,[70] nor ecclesiastical and Islamic denunciation of interest, usury and/or Riba could stand in the way of the pursuit of profit in the banking industry.

In this regard, the dictum of history invariably confirms that civilizations are best served by the economic stimulus provided by free enterprise and varying wage and profit of its profit-maximizing economic agents.[71] Indeed, the small isles of ever-threatened communities based on ideological selflessness were always surrounded by the "raging individualistic sea".[72] The historical records illustrate that even the Church itself could not escape the imperatives of profiteering (religious) entrepreneurs. Innocent III famously — and probably haplessly — decried that if all usurers are to be excluded from the Church, all churches might be closed.[73] Therefore, the records of history show that far from being Benedictine monasteries, financial markets are more akin to a Darwinian jungle in which participants are driven by the instinct for self-preservation and the innate urge to keep up with the Joneses, even if that would amount to exploiting their peers,[74] or socializing risks and privatizing profits.

In an age of technological advancement and pervasiveness of momentum and high-frequency traders in the global trade and finance, the race to profit from the tiniest bits and pieces of inefficacies has become very much vigorous by a quest to extract the smallest pieces of profit opportunities and in the meantime (and unintentionally) contribute to the formation of more efficient and arbitrage-free markets.[75] Although the recent surge in the provision of socially responsible modes of financing — and particularly provision of microfinance to financially underserved communities — might contradict this assertion,[76] subsequent scandals and mission drifts in microfinance showed that the requisites of the marketplace and profit motives wielded their heavy weight on the supposedly benign intentions of the early micro-financiers.[77]

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69 William J. Bernstein, *A Splendid Exchange: How Trade Shaped the World* (New York: Atlantic Monthly Press, 2008).

70 Aristotle, *Politics* (Cambridge: Hackett Publishing Company, 1998), Book I. The proper limits of household management: The Unnaturalness of Money Lending.

71 Will Durant, *The Age of Faith: The Story of Civilization*, vol. 4, (New York: Simon and Schuster, 2011).

72 *Ibid.*

73 *Ibid.*

74 Charles W. Calomiris, "Is deposit insurance necessary? A historical perspective" (1990) 50 *Journal of Economic History* 283 at 286-287. (Showing how in the antebellum America adverse selection and moral hazard coupled with instances of fraud and unsound banking practices led to the failure of several deposit insurance schemes).

75 Michael Lewis, *Flash Boys: A Wall Street Revolt* (New York: W.W. Norton & Company, 2014).

76 Muhammad Yunus, *Creating a World without Poverty: Social Business and the Future of Capitalism* (New York: Public Affairs, 2007).

77 Gaamaa Hishigsuren, "Evaluating Mission Drift in Microfinance Lessons for Programs

Second, policy proposals to prevent marketing of financial products even to the most sophisticated financial market participants, can hardly be justifiable. This proposal indeed runs counter to the basic assumptions on which the financial markets are built. Although there might be a case for regulatory intervention to prevent companies and sophisticated individuals from selling pieces of the blue sky to unsuspecting investors,[78] extending such regulatory protections to sophisticated investors at best leads to a misallocation of regulatory resources and at worst to encouraging reckless behaviour by professional investors. Even turning a blind eye on the experimental studies suggesting that in certain market settings more information can hurt and better informed agents may suffer losses,[79] discouraging the sale and marketing of complex financial products — whose information is difficult to process — to professional investors would result in discouraging financial innovation, less efficient financial markets, or perhaps will be tantamount to closing down the markets for complex products.

In addition, the underlying assumption for putting forward such proposals seems to be the belief in and reliance on the supremacy of the knowledge of financial regulators over that of the financial market participants. It is not clear if the most sophisticated and discerning financial market participants, who have their skin in the game, are not able to assess the riskiness of a product, how government regulators, lacking strong incentives and not having very much at stake, would be trusted with the discretion to assess which product is not suitable for which sophisticated investor. Therefore, it is not obvious if a sophisticated and professional investor is not able to assess the riskiness of financial products, how regulators would be able to assess their riskiness and suitability for sophisticated market participants. The bottom line in such a proposal is to eliminate complex financial products and markets altogether, for if they cannot be marketed to sophisticated investors, who else would dare purchasing those products?

Viewed from a slightly different perspective, this proposal seems to be a stronger version of regulatory paternalism which goes as far as protecting sophisticated investors and counterparties — the kind of market participants that might ultimately turn out to be more sophisticated than regulators — from themselves. Not only hard paternalism, but also its softer forms such as the idea of nudging[80] — a soft form of libertarian paternalism based on the recognition that there are rampant cognitive biases in human behaviour[81] — are criticized on

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With Social Mission" (2007) 31 *Evaluation Review* 203; David Hulme & Mathilde Maitrot, "Has microfinance lost its moral compass?" (2014) online: SSRN <https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=2560331>.

78 *Hall* v. *Geiger-Jones Co*., 242 U.S. 539 (1917).

79 Colin Camerer, *et al*., "The Curse of Knowledge in Economic Settings: An Experimental Analysis" (1989) 97 *Journal of Political Economy* 1232. See also Vernon L. Smith, "Economics in the Laboratory" (1994) 8 *Journal of Economic Perspectives* 113 at 119.

80 For a detailed treatment of the concept of nudge, see Richard H. Thaler & Cass R.

the account that such paternalism would reduce an individual's incentives to learn from his/her mistakes and failures, and ultimately to de-bias him/herself. Indeed, government regulation of irrational human tendencies may exacerbate the problem by allowing the suboptimal behaviour to survive and prosper.[82]

In addition, a stream of literature, pioneered by Vernon Smith, underlines the "unconscious optimization in market interactions".[83] In this view, "markets may induce greater "rationality" in behaviour, because they force or promote a response to, or discovery of, opportunity cost conditions, that need not be readily forthcoming when agents merely think about the choices they make."[84] Therefore, in many experimental market settings, interactions of "poorly informed, error-prone, and uncomprehending human agents" according to the trading rules result in outcomes which are close approximations of the wealth maximizing models expected only from completely informed and cognitively rational market participants.[85] In other words, in this view of the market, paradoxically enough, individual irrationality may lead to or enhance collective rationality.[86] In sum, given that individuals make systematic mistakes, in the aggregate, those mistakes tend to cancel each other out in market interactions.

Third, highlighting the misaligned incentives, it seems that the book implies that there is a dilemma in providing the best professional advice and pursuing profits.[87] The question is whether there exists a tradeoff between providing the best advice to clients and pursuing profit, or whether this is simply a false dichotomy? If there is a tradeoff, are markets able to realign the misaligned incentives? And if not, what regulatory responses are in order?

Questioning the underlying dichotomy and policy proposals of the book does not mean that financial markets are free from conflicts of interests. Where there are agency problems and information asymmetry, conflicts of interests will inevitably be present. Given the credence goods nature of financial products and services[88] and intertemporal nature of financial transactions, which give rise to

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Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness* (New Haven: Yale University Press, 2008).

81 Daniel Kahneman & Amos Tversky have studied the systemic human cognitive biases. See Daniel Kahneman, *Thinking, Fast and Slow* (New York: Farrar, Straus and Giroux, 2011).

82 Jonathan Klick & Gregory Mitchell, "Government Regulation of Irrationality: Moral and Cognitive Hazards" (2006) 90 Minnesota L. Rev. 1620 at 1604.

83 Vernon L. Smith, "Economics in the Laboratory" (1994) 8 *Journal of Economic Perspectives* 113 at 118 [Smith] .

84 Vernon L. Smith, "Experimental Economics: Reply" (1985) 75 *American Economic Review* 264 at 267.

85 Smith, *supra* note 83 at 118.

86 Camerer, *et al.*, *supra* note 78 at 1233.

87 Ross P. Buckley, "The Changing Nature of Banking and Why It Matters" in Buckley *et al., supra* note 1 at 20.

88 For the concept of credence goods, see Philip Nelson, "Information and Consumer

higher levels of information asymmetry and uncertainty, these conflicts of interests play a more ominous role in financial markets. But it does not automatically follow that regulation is needed to address these conflicts of interests. For example, in the context of underwriting by universal banks vis-à-vis investment banks, there is evidence that market forces and private-law institutions governing the relationships between principals and agents can significantly reduce the scope of opportunistic behaviour.[89] For example, universal banking, which combines commercial and investment banking in one entity, is traditionally thought to be fraught with conflicts of interests and open to opportunistic behaviour. Indeed, one of the underlying reasons for the enactment of laws separating commercial banking from investment banking in the wake of the Great Depression (the *Glass-Steagall Act*) was the opportunistic behaviour created by the existence of conflicts of interests.[90] The recent surge of interest in adopting structural laws around the world is partly driven by the concerns regarding conflicts of interest embedded in mixing commercial banking and proprietary trading on the one hand, and conflicts of interests present in the relationship of banks, private funds and other bank clients on the other hand.[91]

As an example of a conflict of interest in universal banking, an underwriter may have an underlying lending relationship with the issuer prior to the underwriting relationship.[92] In this setting, conflicts of interest arise from the fact that a commercial bank may inflate the debt issuer's quality in underwriting its securities and use the proceeds of underwriting to retire its existing loans to the same borrower. In other words, by underwriting securities that the universal bank itself knows are of questionable value, and by requiring the firm to use the proceeds from the issue to pay off the loan to the underwriting universal bank, the bank may serve itself at the expense of outside investors in the newly issued securities.[93]

Behavior" (1970) 78 *Journal of Political Economy* 311. For why financial products are considered as credence goods, see Heremans Dirk, "Regulation of Banking and Financial Markets" in Roger J. Van den Bergh & Alessio M. Pacces, eds., *Encyclopedia of Law and Economics*, vol. 9 (Cheltenham, UK: Edward Elgar, 2011) at 9-10.

89 Amar Gande, "Commercial Banks in Investment Banking" in Anjan V. Thakor & Arnoud W.A. Boot, eds., *Handbook of Financial Intermediation and Banking* (Amstredam: North-Holland, 2008) [Gande].

90 Georg J. Benston, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered* (Oxford: Oxford University Press, 1990) at 4 [Benston] 3-47.

91 See Leonardo Gambacorta & Adrian Van Rixtel, "Structural bank regulation initiatives: approaches and implications" (2013) BIS Working Paper No. 412 at 2.

92 For more on conflicts of interests in the universal banking model, see Benston, *supra* note 90. (Discusses a variety of conflicts of interest in the universal banking model).

93 Anthony Saunders, "Conflicts of interest: An Economic View" in Ingo Walter, ed., *Deregulating Wall Street* (New York: Wiley, 1985). See also Benston, *supra* note 89.

The second issue regarding combining commercial and investment banking is the existence of lock-in effects. Universal banks may be tempted to extract monopoly profits or rents from the information accumulated over the life of the lending relationship. Since the existing relationship between the costumers and the universal bank (lending relationship) creates information about the borrowers to which only the lending institution has access, the universal bank can outcompete other underwriters because of its informational advantage.[94] In other words, outside underwriters trying to compete with the lending bank, who does the underwriting, may face a winner's curse problem.[95]

However, empirical evidence suggests that market forces can successfully address concerns about conflicts of interest in this setting.[96] These studies have found substantial evidence that universal banks, which combine investment banking with commercial banking, did not exploit such conflicts of interest.[97] In other words, the innate urges of market participants do not automatically lead to beggar-thy-neighbor strategies. Therefore, as the book concedes, at some point, "reputational sanctions may be real."[98] Here the insights from Vernon Smith implying that "to do good for others, does not require deliberate action to further the perceived interest of others"[99] comes into play again. Namely, it is not necessary to impose a legal obligation on banks to require them to make deliberate efforts to serve their clients' interests. Indeed, market interactions and processes help economic agents to achieve efficient outcomes which are not primarily intended by market participants.[100] The same logic applies to the banking sector, the pursuit of profit by bankers does not literally translate into trampling on clients' interests. On the contrary, profit motive may require banks to serve its clients' interests as best as they can.

Although government interventions may result in lesser degrees of conflicts of interest in certain situations, paradoxically, such interventions and their distortionary impact may lead to heightened conflicts of interest and market

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94 See Steven A. Sharpe, "Asymmetric Information, Bank Lending and Implicit Contracts: A Stylized Model of Customer Relationships" (1990) 45 *Journal of Finance* 1069; Christopher James, "Relationship-Specific Assets and the Pricing of Underwriter Services" (1992) 47 *Journal of Finance* 1865; Raghuram G. Rajan, "Insiders and Outsiders: The Choice between Informed and Arm's-Length Debt" (1992) 47 *Journal of Finance* 1367.

95 *Ibid.*

96 For an excellent literature review, see Gande, *supra* note 89.

97 Randall S. Kroszner & Raghuram G. Rajan, "Is the Glass—Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933" (1994) 84 *American Economic Review* 810. See also Manju Puri, "Commercial Banks in Investment Banking Conflict of Interest or Certification Role?" 40 (1996) *Journal of Financial Economics* 373.

98 Blair, *supra* note 47 at 451.

99 Vernon L. Smith, "Constructivist and Ecological Rationality in Economics" (2003) 93 *American Economic Review* 465 at 466. (Smith himself borrows this idea from the 18th-century Scottish philosophers).

100 Smith, *supra* note 83 at 118.

imperfections, and ultimately increase the distortions in the market.[101] In other words, along with market imperfections that may give rise to the profit motive to run amok, government intervention can be equally counterproductive. For example, it is illustrated that how control over access to data by financial institutions and especially government-sponsored enterprises, may lead to a capture of academics by institutions such as Fannie Mae.[102] Sometimes, however, the capture is not just motivated by money. Instead, regulators' mindset is captured by those whom they regulate, a phenomenon dubbed "cognitive capture".[103] In addition, despite benign intentions, sometimes bootleggers may join forces with Baptists to distort public policy to their advantage, enact laws which may seem benign at first blush, but in essence cater for the needs of special interest groups.[104] The *Glass-Steagall Act*, being the result of lobbying by investment banks to keep commercial banks at bay, is a case in point.[105] The collapse of underwriting spreads for both equity and debt underwritings following the repeal of the *Glass-Steagall Act*, which allowed commercial banks to enter into the securities-underwriting business and made underwriting markets more competitive, seems to confirm the public-choice account of the enactment of the *Glass-Steagall Act*.[106] To recapitulate, regulatory intervention is not the only tool to realign the misaligned interests in financial markets, there is also a role, and credit, to be given to markets and private law institutions.

(d) Unaddressed Opposing Views and Overlooked Areas of Global Finance

The book takes an agnostic position on certain unresolved and controversial issues on which different contributors have taken different positions. Encountering conflicting views on important matters of theory and policy, the reader would expect to see editorial resolve to opine on such issues. For example, there are conflicting views in the definitions of "shadow banking" in China in two consecutive chapters; one claiming that the definition of shadow banks in China is significantly different from that of the FSB,[107] while the other paper views the Chinese definition similar to the FSB's definition.[108] The second

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101 Zingales, *supra* note 27 at 19-21.

102 *Ibid.*

103 Joseph E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers our Future* (New York: W.W. Norton & Company, 2012).

104 Bruce Yandle, "Bootleggers and Baptists in Retrospect" (1999) 22 *Regulation American Enterprise Institute* 5.

105 Jonathan R. Macey, "Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall" (1984) 33 *Emory L.J.* 1.

106 Alan D. Morrison & William Wilhelm Jr., *Investment Banking: Institutions, Politics, and Law* (Oxford: Oxford University Press, 2007) at 24-25.

107 Tang, *supra* note 47 at 327.

108 Huang, *supra* note 45 at 341.

example of such opposing views seems to be on the role of law and legal institutions and whether they matter. In different contexts, the authors reach different conclusions. For example, Licht finds that evidence for legal bonding theory is limited,[109] while Zetzsche believes that "law and regulation do shape financial sector development",[110] and the study of safe assets is entirely based on highlighting the role and importance of law in giving shape to safe assets.[111] There is no scarcity of literature on the importance of law and legal institutions to economic performance, growth and development.[112] In law and finance literature,[113] the legal-origins thesis, which demarcates a distinctive line between common law countries and civil law countries,[114] and the nascent literature on the legal theory of finance,[115] all agree on the role of law in shaping financial markets, transactions and institutions. The above-mentioned conflicting views could have been clarified and opined on by the editors in order to save the reader from further intellectual meanderings.

The book could also have been enriched by opening up some extra room for new topical issues in global finance and its regulation. These overlooked areas would potentially include the role of financial technology in deepening the integration of the global finance, and the rise of digital currencies — particularly their underlying technologies — and the accompanying opportunities (e.g. the use of blockchain technology by central bankers),[116] and challenges (e.g. the potential threat they pose to central bankers' and regulators' role in monetary policy and detecting financial crimes). Further enriching topics would include the study of the role of law and global financial regulation in alleviating certain thorny problems of global finance, such as addressing potential challenges posed by climate change, the role of law in democratization of banking and finance, and financial inclusion.[117] And last but definitely not the least, among the issues

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109 Amir N. Licht, "Liability for Transnational Securities Fraud" in Buckley *et al., supra* note 1 at 263.

110 Dirk A. Zetzsche, "Competitiveness of Financial Centers in Light of Financial and Tax Law Equivalence Requirements" in Buckley *et al., supra* note 1 at 391.

111 Anna Gelpern & Erik F. Gerding, "Rethinking the Law in 'Safe Assets'" in Buckley *et al., supra* note 1.

112 See Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1960).

113 Rafael La Porta, *et al.*, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113.

114 *Ibid.*; Rafael La Porta, *et al.*, "The Economic Consequences of Legal Origins" (2008) 46 *Journal of Economic Literature* 285. The doctrine of legal origins is criticized for the shortcomings in its empirical methods, see e.g., Jonathan Klick, "The Perils of Empirical Work on Institutions: Comment" (2010) 166 *Journal of Institutional and Theoretical Economics/ Zeitschrift für die gesamte Staatswissenschaft* 166.

115 Pistor, *supra* note 2.

116 Max Raskin & David Yermack, "Digital Currencies, Decentralized Ledgers, and the Future of Central Banking" (2016) NBER Working Paper No. 22238.

117 Robert J. Shiller, *Finance and the Good Society* (Princeton: Princeton University Press, 2012).

to which less attention is paid are the emerging phenomena, which threaten to de-globalize finance and unravel the financial integration worldwide and to lead to global financial disintegration. Examples would include, the risks of heightened interconnectedness, and the downsides of unilateral financial sanctions and extraterritorial application of financial laws.[118] Covering such issues would have contributed to the fast-changing world of global finance and its regulation and would have addressed the ubiquitous criticism that the law lags behind the ever-increasing speed of global finance.

4. CONCLUSION

The book is a collection of essays from highly-renowned experts in the field of financial regulation, and despite its peaks and troughs, is a result of painstaking efforts by distinguished scholars to shed some light on critical aspects of global finance and to offer policy choices to improve the current dismal state of affairs in regulation and governance of global finance. This book will indeed benefit the academics working in the field of finance, financial regulation, and international financial law and regulation. It will also be appealing to practitioners as well as financial regulators and policymakers concerned with the current trends in global financial regulation.

Although not all readers may agree with certain major themes of the book, (e.g. the depth and reach of the post-crisis regulatory reforms and advocacy of more regulatory centralization and consolidation), its intuitions, insights and contributions to the literature on international financial regulation are indisputable. This is particularly outstanding where the book highlights the role of law in giving shape to safe assets, the role of market participants in shaping financial infrastructure, the role of often-overlooked global financial regulatory networks in regulating global finance, and the increasing role of central banks in prudential supervision and its interplay with central bank independence in monetary policy.

However, regarding the evaluation of current regulatory measures, given that a considerable number of proposed and adopted post-crisis financial regulatory reforms has yet to be implemented, a grain of patience would be necessary to assess the potential impacts of strong stream of regulations adopted in the post-crisis era. In addition, a need for more coordination among regulators does not necessarily imply that we need to move toward a unitary and centralized model of global governance and regulation. Instead, mitigating potential risks of gaps in the regulation of global finance may require a shift of focus from regulatory harmonization and consolidation to the quality of regulation within each and every individual regulatory regime encapsulated in the globally fragmented regulatory systems. With a tunnel vision towards centralization at the global level, one would be reasonably wary of the dreary prospects of a great credit and

[118] Kern Alexander, *Economic Sanctions: Law and Public Policy* (Basingstoke: Palgrave Macmillan, 2009).

liquidity famine as a result of a "Great Leap Forward" in the governance of the global finance toward centralization.