5 The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance

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As noted in the introductory chapter, the global financial crisis that began in 2007 has produced an important shift in the balance of public-private responsibilities in international financial regulation. This paper examines two areas where this trend has been particularly dramatic: hedge funds and derivatives. Although these two sectors were put on the agenda of international regulatory bodies several times over the past two decades, policymakers decided not to take on the task of regulating them directly. They chose instead to rely on market discipline and self-regulatory mechanisms designed by the financial industry. At the outset of the current crisis, the initial international regulatory response followed the same pattern. But in the fall of 2008 and spring of 2009, this situation suddenly changed as policymakers set out new international objectives to place the responsibility to regulate these two sectors squarely on the shoulders of public officials. Although hedge funds and derivatives played a very different role in generating the crisis, with the latter clearly at its core and the former being more a channel of transmission, they were both suddenly brought under the public international regulatory umbrella.

What explains this transformation? We argue that it was primarily the result of a change in domestic politics within the United States, Britain and to some extent the rest of the European Union. In the past, the endorsement of market discipline and self-regulation in international rules was largely a product of the preferences of the US and Britain, as the two dominant powers in these sectors. During this crisis, their preferences changed as a result of three interconnected domestic developments: an unprecedented politicization of regulatory politics among the public and legislators, an ideational shift among elite policymakers, and new private sector support for regulation. Reinforcing these trends were pressures from other countries in the European Union, reflecting similar domestic shifts, as well as some longstanding reform objectives in the case of hedge funds. As these leading states' policies moved in the same direction, their policymakers saw international coordination as useful for addressing the general public unease and the competitive consequences of unilateral regulation, as well as for locking in their preferred regulatory solution internationally. In our view, these explanations have some broader theoretical implications for literature on the politics of international financial regulation, most importantly that of demonstrating how the financial crisis reinforced the role of domestic politics in leading states as a key driver of international regulatory change.

HEDGE FUNDS AND DERIVATIVES BEFORE THE CRISIS

Hedge funds and derivatives were brought to the attention of policymakers well before the recent crisis by their rapid growth over the past two decades and by several episodes of financial instability throughout the 1990s involving these segments of global financial markets. After the collapse of the American fund Long-Term Capital Management (LTCM) in 1998 in particular, the Basel Committee, IOSCO and especially the Financial Stability Forum (FSF) actively debated the regulation of hedge funds. Derivatives have also been the subject of considerable discussion within IOSCO, the Basel Committee, and the Joint Forum since the 1990s. Before the current crisis, however, none of these bodies recommended that national authorities directly regulate the activities of hedge funds or derivatives markets. In the case of hedge funds, regulators focused their attention on the role of banks in providing these investment vehicles with credit (so called "indirect regulation"), while encouraging the funds and their bank counterparties to self-regulate and disclose greater information to the markets (FSF 2000, see also Eichengreen 2003, Robotti 2006). In the case of derivatives, international regulatory bodies refrained from recommending direct regulation of these markets and focused instead on tasks of strengthening supervisory cooperation, while encouraging private actors to regulate themselves (Tsingou 2006).

The encouragement of market discipline and self-regulation by private industry groups in lieu of direct regulation was largely a product of the preferences of the two dominant financial powers in these markets: the United States and Britain. Although policymakers in some other countries were keen to see more formal regulation, these two states were able to veto international initiatives to move in that direction because hedge fund managers and derivatives dealers are heavily concentrated within their territories. US regulators opposed proposals to introduce mandatory disclosure requirements upon hedge funds advanced from the countries where the funds had been most active during the East Asian crisis, as well as other regulatory initiatives put forward by France and Germany after the collapse of LTCM (Eichengreen 2003, Robotti 2006). US authorities also opposed the regulation of derivatives markets, going so far as to support the passage of a bill in 2000 that locked in their domestic deregulatory environment by precluding the regulation of over-the-counter (OTC) derivatives markets (that is, those negotiated privately on a bilateral basis between the buyer and the seller). British authorities were also skeptical of heavy-handed international regulatory initiatives and, within the European context, they also defended their financial industry from the various proposals to regulate coming from Brussels and continental European countries (Zimmermann in this volume).

US and British opposition to formal regulation was motivated in part by competitive pressures, as officials in both countries worried that tighter domestic regulations could result in business fleeing to the other's markets or offshore. Also important was the ideological orientation of US and British officials in this period, an orientation which left them skeptical of what direct regulatory intervention in the financial markets could achieve, and wary of the costs of regulation in terms of lost financial sector's efficiency and profitability. In the case of hedge funds, US officials opposed disclosure requirements that would place the task of overseeing hedge funds upon the shoulder of supervisors, arguing that public authorities would not have the same capacity to process this information as financial market participants. Instead, they urged hedge funds to disclose more information to their counterparties and investors in order to delegate to market actors the task of supervising the funds' activities (PWG 1999). In the case of derivatives, opposition to direct regulation reflected prevailing ideas among their financial policymakers about the virtues of the market-led securitization trend in which risks became increasingly commodified, bundled, sliced and diced. The growth of derivatives was a key part of this trend and its proponents – of whom Federal Reserve Chair Alan Greenspan was among the most enthusiastic – argued that the result was a more efficient and resilient financial system.

The British and US positions also partly reflected the influence of industry groups. Like other parts of the financial industry, derivatives and hedge fund groups have benefited from close access to policymakers. The complex nature of these sectors has only strengthened the industry's ability to shape the terms of the regulatory debate and to fend off regulation. Alongside their lobbying power, the private sector has also shown a capacity to promote and coordinate international self-regulatory initiatives in these two sectors. Notable examples are the initiatives of groups such as the G30, the global derivatives industry association (International Swaps and Derivatives Association), hedge funds' bank counterparties groups (Counterparty Risk Management Policy Group) and hedge funds managers' groups (Managed Funds Association, Hedge Fund Working Group, Asset Managers' Committee, Alternative Investment Management Association) (see Coleman 2003, Tsingou 2006, Eichengreen 2003). When episodes of instability brought the regulation of hedge funds and derivatives onto the political agenda, these industry groups were constantly able to deflect official regulatory pressures through self-regulatory efforts.

THE CASE OF HEDGE FUNDS

Given this past history, what changed in the recent crisis to bring hedge funds and derivatives under the umbrella of public international regulation? Let us first examine the case of hedge funds. The international emphasis on self-regulation, and indirect regulation of hedge funds that emerged after the collapse of LTCM also informed the initial reaction to the subprime mortgage crisis. When the regulation of hedge funds returned on the international regulatory agenda at the first leaders' summit in November 2008, the G20 leaders did not depart from the traditional support for self-regulation, inviting hedge funds bodies to "bring forward proposals for a set of unified best practices" (G20 2008: 4).

The next G20 Summit at the leaders' level in London on April 2 2009, however, represented a turning point. For the first time, direct regulation and oversight of hedge funds were endorsed at the international level when the G20 leaders agreed that:

> Hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management.
>
> (G20 2009: 3)

This agreement placed the task of overseeing the operation of hedge funds firmly on the shoulders of supervisors/regulators rather than on their bank counterparties. To achieve this goal, the G20 also called upon the FSF "to develop mechanisms for cooperation and information sharing between relevant authorities in order to ensure that effective oversight is maintained where a fund is located in a different jurisdiction from the manager" (G20 2009: 3). References to self-regulatory measures from the industry were noticeably absent.

The Role of the United States

A central cause of this shift was a change in American domestic politics triggered by the increasing politicization of hedge funds regulation starting in the fall of 2008. The hedge fund industry had weathered the first year of the financial storm far better than other financial sectors and largely escaped public scrutiny, which focused instead on actors such as mortgage originators, banks, and credit rating agencies. Although the collapse in June 2007 of two hedge funds established by the US investment bank Bear Stearns had signaled the beginning of the crisis, US policymakers initially saw this development as merely a symptom of a larger problem whose origins lay elsewhere. This attitude came to an end in September 2008, however, when the convulsions in financial markets that followed the bankruptcy of Lehman Brothers created a "perfect storm" that hedge funds could not weather. The prime brokers and investment banks that represented hedge funds' traditional sources of leverage scaled back their lending, while the panic in the markets prompted many investors to withdraw their investments. Caught in the middle between the Scylla of the credit crunch and the Charybdis of large scale withdrawals by investors, most hedge funds were forced to quickly unwind positions, further fuelling declining asset prices in a pro-cyclical way.

As it became clear that the activities of hedge funds were amplifying the crisis, the perception of hedge funds in the political debate progressively shifted from victims to villains. In particular, critics accused hedge funds of driving falls in stock markets and exacerbating the volatility in the markets and pointed the finger at their traditional high levels of leverage and their short-selling of stocks. Four days after the bankruptcy of Lehman Brothers, the Securities and Exchange Commission (SEC) placed temporary restrictions on short-selling, followed by securities regulators from all around the world.

The unprecedented politicization of financial regulatory politics within the US at this time and the increasing critiques directed towards hedge funds led the US Congress to pay attention to this sector. Five of the most highly compensated hedge fund managers were called to testify before the House Oversight Committee in November 2008, in a series of hearings that saw various top financiers questioned by US lawmakers over their roles in generating the crisis. In front of the mounting public scrutiny and Congressional activism, hedge fund associations sought to differentiate the image of the industry from what they described as the real culprit for the financial meltdown: the "regulated" banks. Hedge funds stressed how the size of the entire global hedge fund industry was smaller than the balance sheet of some banks, how they were less leveraged than banks, and, above all, how they had not required any bailouts despite the liquidation of 1471 funds in 2008.

These efforts were not sufficient to prevent Congress from proposing legislative measures. In January 2009, two bipartisan bills were introduced in Congress with the goal of requiring hedge funds to register with the SEC and to grant federal regulators a greater role in monitoring the activities of hedge funds. Since the collapse of LTCM in 1998, there had been similar legislative attempts to regulate hedge funds but past initiatives were never brought up for consideration by the full House or Senate. The politicization of financial regulatory politics in late 2008/early 2009, however, opened a window of opportunity for some key Congressmen to bring back on the Congressional agenda their proposals to regulate hedge funds. Moreover, this time they found a more sympathetic hearing not only within Congress, but also within the new Obama administration.

Since their confirmation hearings in January 2009 both Obama's nominee to head of the SEC, Mary Schapiro, and the Treasury Secretary-nominee, Timothy Geithner, pledged to pursue mandatory registration of hedge funds with the SEC in order to subject funds to new disclosure requirements and inspections by the SEC's staff. The new course of action charted by the US federal financial authorities represented not only a tactical recognition of the degree of Congressional and public concern, but also an broader shift in the approach to regulation that matured with the transition from the Bush administration to the Obama administration. In developing guidelines for the regulation of hedge funds and other private pool of capitals at the outset of the crisis, Bush's Treasury Secretary Henry Paulson and other federal regulators had emphasized that "market discipline of risk-taking is the rule and government regulation is the exception" (PWG 2007: 1). The blueprint for "*Rebuilding Financial Regulation and Supervision*" published by the new Treasury Secretary Geithner in June 2009 instead placed on the shoulders of regulators the task of overseeing and regulating not only hedge funds, but also every systemically important financial institution (US Government 2009b). The new proposal assigned to the SEC the power to gather information about hedge fund trades on a confidential basis and to share them with a systemic-risk regulator with the authority to place limits on their activities and leverage if they were deemed to pose systemic risks to the economy.

The shift in US policy also reflected a change in the position of the hedge fund industry, which reversed its traditional opposition to greater regulatory oversight. To be sure, as in the past, hedge fund groups initially reacted to the regulatory threats generated by the financial crisis by renewing their self-regulatory efforts. Individual hedge fund associations released new voluntary codes of best practices (see for example, MFA 2009a), and three of the four most important hedge fund groups announced in March 2009 their intention to work together towards a global set of standards for the industry. But at the beginning of 2009, the same hedge fund groups that had fought past attempts by the SEC to impose upon them a mandatory registration did not oppose this kind of regulatory intervention (MFA 2009b).

The endorsement of regulation from the hedge funds industry was in part a defensive move. The aggressive Congressional activism and the election of the Obama administration sent the hedge fund industry the signal that escaping closer scrutiny from regulators was no longer tenable. While at the beginning of 2008, only eight per cent of US hedge fund managers expected increased regulation of the industry, this percentage raised to 98 per cent in February 2009 (Rothstein Kass 2009). As the writing on the wall became clearer, hedge funds attempted to "lock in" the form of regulatory intervention they considered the most acceptable. Since most of the major US hedge fund managers already registered voluntarily with the SEC, mandatory registration was not too onerous. At the same time, they focused their lobbying efforts on preventing any limitations on their trading activities, such as a cap on leverage or capital requirements. Similarly, hedge fund associations came to accept the disclosure of information to the regulators on a confidential basis, while fighting against public disclosure of information that could shed light upon their investment strategies.

The endorsement of regulation coming from the industry can also be seen in part as reflecting a shift of power brought by the crisis within the sector, with the hedge funds' managers losing bargaining power vis-à-vis their investors. Since the fall of 2008, the poor performance of hedge funds triggered an unprecedented outflow of investors. The difficulties in raising capital were further intensified after the arrest in December 2008 of Bernard Madoff for his $65 billion Ponzi scheme. Madoff was not a hedge fund manager; rather, he executed trades for other "feeder funds" through his brokerage firms. However, the scandal inflicted a further blow to the reputation of the hedge fund industry and intensified the concerns about their lack of oversight. Pension funds and other institutional investors took advantage of the weakness of hedge fund managers to turn the tables and demand more favourable fees, as well as greater transparency about hedge funds' investments and valuation methods (see for example Karmin and Strasbourg 2009). After the Madoff scandal, some hedge fund managers came to see a minimum level of regulation as a way to restore confidence in the industry and to stem the unprecedented hemorrhage of capital. As a hedge fund manager acknowledged, "This is an Enron moment for hedge funds … Regulation would be welcome, primarily from a trust standpoint" (quoted in Ivry, Kishan, Katz 2008).

The Role of Europe

Hedge funds in Europe were also able to weather the first year of the financial crisis relatively unscathed. During this time, European Commissioner Charles McCreevy repeatedly rejected calls to regulate them, and his strenuous defense of self-regulation was initially supported by the leaders of major European countries who endorsed a set of voluntary codes of best practices drafted by a group of 14 London-based hedge funds (UK Government 2008). However, beginning in the fall of 2008 McCreevy progressively reversed his position and gave way to a European directive regulating hedge funds. At the end of February 2009, McCreevy explained this shift acknowledging that the financial crisis had "profoundly altered the economic and political context in which decisions on the regulation of hedge funds and private equity will be made. The ground has shifted in this debate. Closer direct regulatory and supervisory oversight of hedge funds and private equity is inevitable” (McCreevy 2009: 5).

How did the financial crisis cause such a dramatic shift in the approach of the European Commission? As in the US, the politicization of financial regulatory politics triggered by the financial crisis had given strength to pro-regulation forces within the European Parliament. In September 2008, the European Parliament adopted by a vote of 562 to 86 a report drafted by the Poul Nyrup Rasmussen, President of the Party of European Socialists, demanding that the European Commission present a legislative proposal to regulate hedge funds and private equity funds. This forced Commissioner McCreevy to soften his opposition to regulating hedge funds and to launch a public consultation on this issue in December 2008.

Even more significantly, McCreevy’s defense of the self-regulatory approach came under attack from those continental European countries that had favoured direct regulation of hedge funds before the crisis (Zimmermann in this volume). The politicization of financial regulation in the fall of 2008 opened a window of opportunity for French President Nicholas Sarkozy to push the regulation of hedge funds back on to the international agenda. This initiative was supported by German Chancellor Angela Merkel, who criticized British and US policymakers for having placed too much confidence in the self-regulation of financial markets and having thwarted the recommendations to regulate hedge funds directly advanced by Berlin during the German presidency of the G8 in 2007 (Erdem 2008). From the perspective of London and Washington, the behavior of France and Germany was similar to a pugilist in a bar brawl: “You wait until a fight breaks out and then take a swing at the guy you have always wanted to hit, … whether or not he had anything to do with starting the fight is not the point" (quoted in Beattie 2009).

However, the development that most significantly marked the end of self-regulation for hedge funds in Europe was the change in the position of Britain. Although London had traditionally been the most important advocate of the self-regulatory approach endorsed by McCreevy, in February 2009 the British Government agreed to lift its veto to a European regulation of hedge funds (Agence France Press 2009). This shift was not simply the result of French and German pressures but rather the product of a domestic shift provoked by the financial crisis, which made the traditional opposition of British officials to any change in the regulation of hedge funds politically untenable.

As in the US, the British hedge fund industry was not able to escape the backlash against the City of London that followed the bailouts of some British banks, especially after it was revealed that some hedge funds had made profits for hundreds of millions of pounds by short-selling the stocks of those same financial institutions. When the British Financial Services Authority (FSA) placed a temporary ban on short-selling of financial stocks, Prime Minister Gordon Brown justified this decision arguing that "the interests of savers and homeowners and mortgage holders came before the interests of a few hedge funds" (quoted in Mackintosh 2008b). Moreover, while the FSA had at the beginning of the crisis defended the codes of best practices drafted by the London-based Hedge Fund Working Group, these self-regulatory measures came under attack in late January 2008 from the parliamentary Treasury Select Committee, which denounced the fact that they had only attracted 34 signatories out of more than 400 British funds (UK Treasury

Committee 2009). The March 2009 report of the chair of the FSA, Lord Turner, signaled a further intellectual shift in the approach of British authorities towards the regulation of the City of London. The Turner report recommended that the FSA request that London-based hedge fund managers disclose more information on their holdings and risk exposure. It also suggested that capital and liquidity requirements should be imposed if hedge funds started to pose systemic risks or became "bank-like" in their activities (FSA 2009, p. 75).

Like its American counterpart, the British hedge fund industry did not oppose the greater level of oversight advocated by the Turner Report (HFSB 2009, AIMA 2009b). This position was driven in part by the recognition of the political momentum behind regulation and in part by the deep suspicion of the regulation being drafted by the European Commission. British hedge funds opposed a purely European response that could drive business away from London or undermine its competitiveness and called instead for a "global solution" (AIMA 2009a). When a European regulation of the industry became unavoidable, the British hedge funds formed a common front with the FSA to defend the British regulatory approach as the model to be emulated. This move was partially successful since the proposal advanced by the European Commission in April 2009 to require all hedge fund managers operating in Europe to be authorised and regulated by a national regulator was closer to the manager-authorisation and supervision template already in place in Britain than to other proposals advanced by members of the European Parliament or policymakers from Continental European countries targeting the underlying funds. At the same time, hedge funds with the support of British authorities have fought to limit the regulatory, governance, and disclosure requirements – including capital requirements and leverage restrictions – attached to this European "passport", although the outcome of this battle is still largely to be defined at the time of our writing.

With both Washington and London removing their veto to an internationally coordinated regulation of hedge funds, continental European countries were able to "lock in" the new British and US commitment at the G20 Summit in London. The summit also allowed Sarkozy and Merkel to claim a victory in front of their domestic audiences, proclaiming that the world had turned the page on a dominant model of Anglo-Saxon capitalism. However, the content of the agreement reached in London on hedge funds was certainly closer to the proposal endorsed at the domestic level by British and American regulators in the lead-up to the summit than to the French and German proposals. British and American authorities supported international coordination because this allowed them to create a playing level field and to address the concerns raised by their respective financial industries that regulation could push financial jobs away from London and New York. Similar to the first time that hedge funds were brought into the international agenda after the collapse of LTCM, international regulatory coordination allowed British and American authorities to secure their domestic approach as the model to be followed internationally and to deflect the calls for more stringent regulatory solutions. Unlike in the aftermath of the collapse of LTCM, this time the much wider impact of the crisis on their domestic politics determined the shift in the content of international regulation from self-regulation to direct regulation.

THE CASE OF DERIVATIVES

Turning to the case of derivatives markets, during the first phase of the current financial crisis, the international regulatory response also initially stuck to the past practices of simply encouraging private actors to regulate themselves. The FSF's important report of April 2008 continued to delegate responsibility to the private sector, noting that "market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound" (FSF 2008a: 20). It outlined a number of specific initiatives that officials hoped market actors would tackle such as making trading infrastructure more reliable, robust and automated as well as incorporating into documentation a "cash settlement protocol" that the ISDA had previously developed to replace cumbersome physical settlement procedures at the time of defaults. In its October update, the FSF put particular emphasis on the need for clearing by a central counterparty (CCP) in the CDS market (FSF 2008b: 3). CCPs reduce counterparty risks by acting as an intermediary between the seller and buyer of a contract, forcing all participants to put up collateral against their trades which can be drawn upon collectively to cover losses if a counterparty collapses.

The first G20 leaders meeting in mid-November 2008 marked the key turning point when official regulation of derivatives was endorsed at the international level for the first time. The final communiqué said the following:

> Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that

> market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes. (G20 2008: 4).

This statement squarely placed the responsibility for addressing systemic risks, transparency and infrastructural issues relating to derivatives with regulators. Moreover, in the one place where market participants were mentioned, the language was no longer voluntary: authorities were told to "insist" on market compliance with the use of exchanges or electronic trading platforms for CDS (which are an insurance-like derivatives product that promise a payout if there is a default on the bond on which the contract was written).

At the subsequent G20 leaders summit in London in early April 2009, the leaders made clear their commitment to see CCPs established that were subject to official regulation (G20 2009). The G20's Working Group 1's report at the time noted that CCPs would have to "meet high standards" not just for "risk management" but also for issues that the FSF had raised earlier such as "operational arrangements, default procedures" as well as "fair access and transparency" (G20 Working Group 1, 2009: xvi). A subsequent report from IOSCO in May recommended that CCPs for CDS could also help reduce the opacity of the markets through a requirement that they "make available transaction and market information that would inform the market and regulators" (IOSCO 2009: 32).

It remained a little unclear the extent to which market participants would be *forced* to use CCPs. The G20's Working Group 1 noted simply that "national authorities should enhance incentives as needed for the use of central counterparties to clear OTC credit derivatives" (G20 Working Group 1: xvi). Similarly, when endorsing the use of CCPs for non-CDS OTC derivatives as well, the Group noted that "if needed, some incentives may be provided by national authorities, for example, by taking a higher capital charge for transactions not cleared through central counterparties." (G20 Working Group 1: 30). The G20 also reverted to the language of delegation to the private sector in promoting the idea that contracts should be standardized in order to increase transparency and boost CCP use: "We call on the industry to develop an action plan on standardization by autumn 2009" (G20 2009: 3). In addition, an IOSCO report in May simply stated its objective to "encourage" market actors to standardize CDS contracts (IOSCO 2009: 31).

The Role of the United States

While these various developments did not go as far as some wanted, the official international endorsement of public regulation was an important step. How do we explain it? As in the hedge funds case, a key part of the answer was a change in domestic politics within the United States, where the question of derivatives regulation was politicized to an unprecedented degree. The crises involving Bear Stearns in March 2008 and then Lehman Brothers and AIG in September highlighted how the OTC CDS market had concentrated risk in large counterparties, some of which had very questionable risk management practices. Because of the extensive interconnections between these larger counterparties and other institutions via CDS contracts, their collapse risked triggering chain reactions. The uncertainties and panic in the markets at this time were only compounded by the opacity of the CDS market; no one knew who held specific

CDS contracts and what their exposure was. Prominent analysts – such as George Soros (2009) – also argued that the sudden collapse of Lehman and AIG had been accelerated by bear raids made possible by the fact that CDS contracts offered speculators convenient ways to short bonds with limited risk.

These circumstances made derivatives and CDS household names across the US and provoked a widespread backlash against the lack of regulation of derivatives markets. In addition to being a key channel of contagion in the crisis, derivatives more generally were criticized for having helped generate the economic bubble that lead up to the crisis in the first place by enabling excessive leverage and the hiding of risks (Morris 2008: 135; Soros 2008). The sudden spike in energy and food prices in the summer of 2008 also highlighted the growing size of speculative activity – relative to regular hedging – in commodities futures markets and its potential contribution to price volatility and distortion. In addition, some now suggested that CDS contracts – especially "unattached" contracts where the holder did not own the underlying asset – distorted incentives by encouraging creditors to push for defaults in order to activate their CDS contracts (Tett 2009, Sender 2009). Finally, many began to highlight how the opacity and complexity of many OTC derivatives markets facilitated the circumvention of taxes and regulations, as well as leaving investors reliant for price and trading information on the large dealers who were able to derive excessive profits from their asymmetric access to information (Whalen 2009, Das 2009).

These various critiques attracted the attention of many in Congress. Beginning in the fall of 2008, bills began to be debated in Congress to regulate derivatives markets, including provisions to force all OTC derivatives onto exchanges (in order to boost standardization and transparency) and to empower regulators to ban the use of unattached derivatives. Bush administration officials were supportive of some of the initiatives being promoted in Congress not just because of their tactical recognition of the degree of Congressional and public concern. A genuine ideational shift took place among key US officials in the context of the crisis. Already, in the immediate wake of the March 2008 Bear Stearns crisis, they had begun to push industry very hard to create CCPs, particularly for the OTC CDS market. US officials also urged more use of automation and electronic trading, greater standardization of contracts, the cancellation (or "compression") of outstanding CDS contracts that offset each other, and the hard wiring of the ISDA cash settlement protocol into documentation. Then, on the day before the November G20 summit, they announced detailed regulatory objectives for the OTC derivatives markets, some of which went beyond the subsequent G20 statement in their specificity and/or goals such as: 1) required public reporting of prices, trading volumes and aggregate open interest for CDS, 2) access for regulators to trade and position information regarding CDS at CCPs and central trade repositories (with one objective being that of "preventing market manipulation"), 3) standards (particularly regarding risk management) for regulated entities that transact in OTC derivatives, and 4) review by regulatory agencies to determine if they have adequate enforcement authority to police against "fraud and market manipulation" (PWG 2008).

The new Obama administration then targeted derivatives as its first major financial regulatory initiative, announcing an agenda in May 2009 which again went well beyond the G20 summit commitments made in London or Washington. In addition to reiterating many of the provisions above, the agenda promised: 1) mandatory use of CCPs for all standardized OTC derivatives and registration for all other trades, 2) requirements for capital, reporting, initial margins and business conduct for all OTC dealers "and all other firms who create large exposures to counterparties", 3) mandatory trade on exchanges and electronic trade execution systems for standardized contracts, and encouragement of all regulated institutions to make more use of exchange-trade derivatives, and 4) rules allowing for position limits to be imposed on OTC derivatives that influence price discovery with respect to futures markets (US Government 2009a). A number of the prominent officials in the Obama administration had been involved in the effort to *prevent* derivatives regulation in the late 1990s and they now acknowledged their change of heart on the issue (Chung 2009, Hirsh and Thomas 2009). Even those out of office admitted their mistakes from that era, including Alan Greenspan who acknowledged in October 2008 that he had been "partially" wrong to oppose regulation of CDS (quoted in Das 2009; for others, see Hirsh and Thomas 2009).

The shift in US policy also reflected a change in the position of the private sector. After steadfastly insisting for over twenty years that self-regulation was adequate, leading US derivatives dealers swung around to back mandatory regulation in November 2008 and began to develop proposals for Congress. The endorsement of regulation partly reflected recognition of the strength of political momentum in favour of regulation within the US as well as the broader weakness in the political position of financial interests at this time (including the fact that many top dealer banks were now recipients of extensive state support). If regulation was to happen, they needed to try to shape its direction (Labaton and Calmes 2009). Many in the industry were especially concerned to head off any ban on unattached CDS contracts, which made up as much as 80% of CDS trades according to some estimates (Grant and Tait 2009b). The large banks involved in OTC markets (on both the buy and sell side) also had good reason to oppose forced moves to exchanges for all OTC contracts since this would erode the high profit margins they earned on the transactions. If regulation was to come, the dealers preferred to focus on the use of CCPs which enabled dealers to retain their central place in the market (Bullock and Mackenzie 2008, Tett, van Duyn, and Grant 2009).

Industry's endorsement of regulation was not entirely defensive. Leading figures in the private sector argued that many of the changes being promoted by policymakers were in the long-term material interest of the derivatives industry given the economic costs experienced during the crisis (e.g. CRMPG III 2008: 15). In the short-term, the introduction of CCPs also promised to reduce operating costs for banks (Bullock and Mackenzie 2008, Alexander and Schoenholtz 2008). Investors had also long favoured the kinds of infrastructural reforms that regulators were now pushing since they promised to bring greater efficiency and transparency to the dealer-dominated markets. Recognizing this, US regulators in fact pressured dealers successfully to improve the representation of investors in the governance of trading and settlement issues through the ISDA (Mackenzie, Bullock and Tett 2009. See also van Duyn 2009). Other "pro-change" private interests were the exchanges which had long hoped to lure the OTC business away from the New York banker/dealers to their facilities. While the regulators' push for exchange trading obviously met their applause, the exchanges also supported even the more limited move of forcing the use of CCPs because many saw the clearing business as one of their more promising growth areas of the future. Indeed, very soon after regulators began to push CCPs for CDS, four of the world's largest exchanges were actively developing proposals of this kind, three of which involved US interests (van Duyn and Gangahar 2009, Tett, van Duyn and Grant 2009).[1]

Although the derivatives industry had come around to support the principle of official OTC derivatives regulation, its preference was for a form of regulation that was flexible and which delegated the details and implementation to the private sector. Its considerable success in resisting more heavy-handed and detailed forms of regulation was a function of the fact that it showed an ability – as it had in the past – to respond to policymakers' concerns. Since the start of the crisis, ISDA and other industry groups pushed the sector to develop CCPs, improve infrastructural deficiencies, and accelerate compression of CDS contracts. ISDA also showcased its capacity for private international rule-making by developing a Big Bang protocol that was implemented by more than 1400 banks and asset managers in April 2009, and which incorporated the cash settlement protocol into CDS contracts, eliminated time lags in protection coverage from the moment of purchase, and streamlined contracts for single-named CDS (Mackenzie, Bullock and Tett 2009).

The Role of Europe

The unilateral tightening of regulation in the US created a competitive opportunity for European financial institutions to capture market share in the highly mobile global derivatives business and for London, in particular, to strengthen its position as the most important financial center for the trading of OTC derivatives. Instead of rejecting international regulatory coordination to reap the competitive advantages, however, European policymakers backed the international regulatory agenda at the Washington G20 summit and after. The reason was quite simple: they too had already begun moving towards tighter regulation unilaterally at this time, albeit at a slower and more uneven pace than their US counterparts. European officials were discussing the need for CCPs as early as July 2008 and by October, the European Commission and European Central Bank (ECB) were actively encouraging industry to build a CCP in Europe for CDS. The European Parliament and European Commission had also been discussing legislative initiatives to address other issues raised by OTC derivatives, such as the need for more transparency (Tait 2009). In July 2009, the European Commission (2009) launched a process of public consultation around goals which were quite similar to many of the US initiatives, such as promoting standardization, CCPs for OTC derivatives, central data repositories, information disclosure, and greater use of exchanges. This consultation will be followed by concrete initiatives, including legislative ones where necessary.

Europe's initiatives were driven by similar domestic pressures as those in the US. European financial institutions had been afflicted by many of the same problems as their US counterparts, and they had also been highly exposed to the Lehman and AIG crises. In this context, the issue of derivatives regulation had become increasingly politicized within many European countries and European policymakers had become increasingly sceptical of the lack of regulation of derivatives markets. This scepticism was apparent in the February 2009 de Larosière report commissioned by the European Commission which called for the creation of at least one CCP for OTC CDS in the EU that would be regulated, and for the simplification and standardization of most OTC derivatives, as well as "appropriate risk-mitigation techniques plus transparency measures" (High Level Group 2009: 25).

The shift in attitudes also took place among British officials who historically had been particularly keen to defend the competitive position of London's financial sector. The content of March 2009 Turner report was particularly striking for the thoroughness of its critiques of derivatives. In addition to calls for compression and CCPs for standardized CDS contracts, the report also went into considerable detail critiquing the pro-cyclicality of OTC derivatives markets and asked whether it might be necessary to address this by regulating collateral margins in OTC derivatives contracts (FSA 2009: 22, 24, 82). The Turner report also insisted strongly that the option of directly constraining CDS products must remain on the table (FSA 2009: 110). A subsequent report from the UK Treasury (2009) in July 2009 was less pointed in its critiques but it also echoed many of the official goals set out by the US and the European Commission.

Although London financial interests accepted some regulation (such as those involving CCPs), they resisted other initiatives vigorously. As in the United States, proposals to move OTC business to exchanges fueled tensions between dealers and exchanges, with the London interdealer brokers strongly opposing any such move which would threaten their core business (see for example WMBA 2009). As in the case of hedge funds, London-based financial interests also expressed concerns about the regulatory initiatives unfolding in the continent, with the ECB and European Commission discussing the possibility to require at least one CCP to be located, regulated and supervised in the EU for CDS on European reference entities (and indices based on these entities). This latter initiative was driven by European authorities' desire to avoid European dependence on US regulators that would result if all OTC derivatives clearing took place in the US (Grant and Tait 2009a). But London interests – backed by the ISDA – preferred to see global clearers rather than required regional ones. Their concerns only grew when it was revealed that the Banque de France was pushing for a more exclusive euro-zone CCP as a way of helping Paris financial markets prevent "an increase in the weight of the London financial market" (quoted in Grant 2009. For London and British concerns, see for example Jones 2009; FSA 2009: 83). In the end, however, nine ISDA members (including Barclays Capital), along with the European Banking Federation, backed down and committed to use a EU-based CCP for eligible CDS by July 31, 2009 when confronted by the threat of legislative action from the European Parliament, backed by the Commission, to impose higher capital requirements against uncleared contracts.

Having set out down the road of endorsing direct regulation, European authorities shared the same interest as US policymakers in international regulatory coordination. International coordination would help to ensure that European and American goals were not undermined by externalities stemming from unregulated markets elsewhere (see for example High Level Group 2009: 25, 60). International coordination also addressed competitive concerns. In the past, policymakers and participants in the derivatives markets on both sides of the Atlantic were able to thwart regulatory initiatives by highlighting that such initiatives would undermine the competitive position of London and New York. Competitiveness concerns were certainly raised by industry and by officials during discussions this time around (see for example Grant and Tait 2009b). But given the overwhelming domestic political momentum behind regulation, these arguments now pushed regulators towards coordinating regulation internationally in order to maintain a level playing field between the American and European industry. For policymakers from countries such as France and Germany (as well as many developing countries), the G20 commitments also helped to "lock in" the new British and US commitment to regulation. More generally, given the very public nature of the G20 summits, international coordination provided the added benefit of signaling to the public that something was being done about this very politicized issue.

CONCLUSION

Because they have fallen outside of the ambit of international public regulation, hedge funds and derivatives markets have often been invoked as evidence that global financial markets have outgrown the capacity of states to adequately regulate and supervise them. Moreover, since private industry groups, rather than public authorities, had emerged as key rule-makers for these markets, these two sectors seemingly strengthened arguments about the rise of private transnational authorities. The current global financial crisis has challenged these lines of thought as states have now asserted their regulatory authority in an internationally coordinated manner over these two sectors. As Louis Pauly (2002) anticipated back in 2002, the crisis has revealed that it is public – not private – authorities that provide the ultimate political foundation for global financial markets.

We have argued that the absence of international public regulation in these two sectors before the crisis simply reflected the preferences of the two dominant financial powers of the day: the United States and Britain. Those preferences, in turn, stemmed primarily from the interests of private financial groups, competitiveness concerns, and the ideas of key elite policymakers about the superiority of market discipline and self-regulatory mechanisms. When the shockwaves generated by current financial crisis triggered a shift in domestic politics in the leading financial powers, the content of international rules changed accordingly. The unprecedented politicization of financial regulatory politics triggered by large-scale use of taxpayers' money to rescue financial institutions unleashed popular and legislative pressures in the US and Europe for policymakers to regulate. Elite policymakers also shifted their ideas about the merits of market discipline and self-regulation in light of lessons learned during the crisis. Many in the private financial sector also came to favour regulation both for defensive reasons at a moment of weakened political legitimacy and for more positive reasons of improving the functioning of their industry, restoring confidence, and/or gaining market shares. As the leading states moved for domestic reasons towards stronger official regulation, they had important reasons – as noted above – to make sure that the content of international rules changed in the same direction.

At a theoretical level, this analysis points towards the centrality of domestic politics in leading states as a key driver of international regulatory change in finance. The degree of domestic politicization of financial regulatory issues triggered by the crisis also suggests that domestic-level explanations of international regulatory politics need to analyze the international regulatory preferences of a wider range of societal actors than just the financial sector. The cases also reveal how industry preferences are more complicated, context-specific, and heterogeneous than many theoretical models suggest. In addition, these two episodes suggest the need to move beyond purely rationalist interest-based analyses to incorporate the role of ideational shifts both at the level of elite financial officials and at a broader societal level.

The centrality of domestic politics highlighted by these two episodes has some important implications for other analytical perspectives on the politics of international financial regulation. While transnationalist perspectives may help to explain the initial response to the crisis up until the fall of 2008, we believe that the politicization of regulatory issues within the domestic arena after that point undermined the strength of this analytical perspective. The autonomy of transgovernmental networks of regulators became increasingly constrained by their domestic political systems, and the priorities of international financial industry associations became challenged by domestic political pressures.

Analyses focusing on inter-state power relations might be tempted to interpret the end of self-regulation as a product of the decline of US and British power and the success of states with more interventionist preferences such as France and Germany in overcoming their opposition. In our view, however, this interpretation would neglect the significance of the domestic changes in the US and Britain in explaining the shift to direct regulation. At the same time, we do believe that analysts focusing on inter-state power relations would be right to identify the growing capacity of the European Union to act collectively both unilaterally and at the international level as significant development in this story (see Posner, Chapter 7 in this volume). As we have shown, this change increasingly constrained Britain's autonomy in international regulatory politics, while strengthening the ability of countries such as France and Germany, as well as bodies such as the ECB, the European Commission and the European Parliament, to influence international outcomes.

As a final comment, let us return to the title of this paper: is this the end of self-regulation? The answer is certainly yes in the sense that public authorities have accepted formal responsibility over the regulation of derivatives markets and hedge funds. But it is noteworthy that they have so far refrained from endorsing heavy handed and detailed kinds of international regulation such as limits on the use of any derivatives products or constraints on the investment strategies of hedge funds. Public authorities are also continuing to rely on several elements of self-regulation, particularly in the case of derivatives. Whether these patterns will endure remains an open question. If the domestic pressures generated by the crisis fade away and competitive concerns raised by the industry regain strength, regulators in major financial centers will come under pressure to scale back the perimeter of public regulation and to revert to more market-driven regulatory mechanisms. If, however, the lessons of the crisis trigger a deeper ideational shift or the coalitions of private sector interests who stand to gain from greater regulation become institutionalized, then the movement away from self-regulation may endure and could even intensify in the coming years.

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[1]The fourth exchange was Eurex Clearing which is jointly operated by Deutsche Börse and SIX Swiss Exchange.